

1ST CONSTITUTION BANCORP  
Form 10-Q  
November 07, 2018

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 September 30, 2018

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 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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company) Emerging growth company

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

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 November 6, 2018, there were 8,404,292 shares of the registrant's common stock, no par value, outstanding.

1ST CONSTITUTION BANCORP  
FORM 10-Q  
INDEX

|  | Page      |
|--|-----------|
| <b>PART I. FINANCIAL INFORMATION</b>   |           |
| Item 1. Financial Statements   | <u>1</u>  |
| Consolidated Balance Sheets at September 30, 2018 and December 31, 2017 (unaudited)  | <u>1</u>  |
| Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2018 and September 30, 2017 (unaudited)                | <u>2</u>  |
| Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2018 and September 30, 2017 (unaudited)  | <u>3</u>  |
| Consolidated Statements of Changes in Shareholders' Equity for the Nine Months Ended September 30, 2018 and September 30, 2017 (unaudited) | <u>4</u>  |
| Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2018 and September 30, 2017 (unaudited)                      | <u>5</u>  |
| Notes to Consolidated Financial Statements (unaudited)   | <u>6</u>  |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations  | <u>37</u> |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk   | <u>61</u> |
| Item 4. Controls and Procedures  | <u>62</u> |
| <b>PART II. OTHER INFORMATION</b>  |           |
| Item 1. Legal Proceedings  | <u>62</u> |
| Item 1A. Risk Factors  | <u>62</u> |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds  | <u>63</u> |
| Item 3. Defaults Upon Senior Securities  | <u>63</u> |

Item 4. Mine Safety Disclosures 63

Item 5. Other Information 63

Item 6. Exhibits 64

SIGNATURES 65

---

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

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

|   | September 30,<br>2018 | December<br>31, 2017 |
|---|-----------------------|----------------------|
| Assets  |                       |                      |
| Cash and due from banks   | \$ 5,133              | \$5,037              |
| Interest-earning deposits   | 14,131                | 13,717               |
| Total cash and cash equivalents   | 19,264                | 18,754               |
| Investment securities:  |                       |                      |
| Available for sale, at fair value   | 131,192               | 105,458              |
| Held to maturity (fair value of \$91,220 and \$111,865 at September 30, 2018 and December 31, 2017, respectively)   | 91,379                | 110,267              |
| Total investment securities   | 222,571               | 215,725              |
| Loans held for sale   | 4,362                 | 4,254                |
| Loans   | 881,538               | 789,906              |
| Less: allowance for loan losses   | (8,265                | ) (8,013 )           |
| Net loans   | 873,273               | 781,893              |
| Premises and equipment, net   | 11,768                | 10,705               |
| Accrued interest receivable   | 3,652                 | 3,478                |
| Bank-owned life insurance   | 28,555                | 25,051               |
| Other real estate owned   | 2,515                 | —                    |
| Goodwill and intangible assets  | 12,294                | 12,496               |
| Other assets  | 14,228                | 6,918                |
| Total assets  | \$ 1,192,482          | \$ 1,079,274         |
| Liabilities and Shareholders' Equity  |                       |                      |
| Liabilities:  |                       |                      |
| Deposits  |                       |                      |
| Non-interest bearing  | \$ 211,492            | \$ 196,509           |
| Interest bearing  | 730,185               | 725,497              |
| Total deposits  | 941,677               | 922,006              |
| Short-term borrowings   | 99,475                | 20,500               |
| Redeemable subordinated debentures  | 18,557                | 18,557               |
| Accrued interest payable  | 927                   | 804                  |
| Accrued expenses and other liabilities  | 8,072                 | 5,754                |
| Total liabilities   | 1,068,708             | 967,621              |
| Shareholders' Equity:   |                       |                      |
| Preferred stock, no par value; 5,000,000 shares authorized; none issued   | —                     | —                    |
| Common stock, no par value; 30,000,000 shares authorized; 8,437,590 and 8,116,201 shares issued and 8,404,292 and 8,082,903 shares outstanding as of September 30, 2018 and December 31, 2017, respectively | 79,256                | 72,935               |
| Retained earnings   | 47,067                | 39,822               |
| Treasury stock, 33,298 shares at September 30, 2018 and December 31, 2017   | (368                  | ) (368 )             |
| Accumulated other comprehensive loss  | (2,181                | ) (736 )             |

Edgar Filing: 1ST CONSTITUTION BANCORP - Form 10-Q

|  |              |              |
|--|--------------|--------------|
| Total shareholders' equity                 | 123,774      | 111,653      |
| Total liabilities and shareholders' equity | \$ 1,192,482 | \$ 1,079,274 |

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

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

|   | Three Months<br>Ended September<br>30,<br>2018 |           | Nine Months<br>Ended September<br>30,<br>2017 |           |
|---|--|-----------|---|-----------|
| Interest income                                     |  |           |   |           |
| Loans, including fees                               | \$12,193                                       | \$ 9,416  | \$33,078                                      | \$ 26,161 |
| Securities:   |  |           |   |           |
| Taxable   | 1,060  | 846       | 2,915   | 2,500     |
| Tax-exempt  | 494  | 527       | 1,518   | 1,628     |
| Federal funds sold and short-term investments       | 36   | 25        | 208   | 183       |
| Total interest income                               | 13,783   | 10,814    | 37,719  | 30,472    |
| Interest expense                                    |  |           |   |           |
| Deposits  | 1,854  | 1,204     | 4,542   | 3,351     |
| Borrowings  | 349  | 113       | 576   | 349       |
| Redeemable subordinated debentures                  | 184  | 134       | 508   | 380       |
| Total interest expense                              | 2,387  | 1,451     | 5,626   | 4,080     |
| Net interest income                                 | 11,396   | 9,363     | 32,093  | 26,392    |
| Provision for loan losses                           | 225  | 150       | 675   | 450       |
| Net interest income after provision for loan losses | 11,171   | 9,213     | 31,418  | 25,942    |
| Non-interest income                                 |  |           |   |           |
| Service charges on deposit accounts                 | 173  | 142       | 476   | 445       |
| Gain on sales of loans                              | 1,292  | 1,329     | 3,425   | 3,936     |
| Income on Bank-owned life insurance                 | 152  | 131       | 425   | 391       |
| Gain from bargain purchase                          | —  | —         | 184   | —         |
| Gain on sales of securities                         | —  | 24        | 12  | 128       |
| Other income  | 537  | 490       | 1,560   | 1,385     |
| Total non-interest income                           | 2,154  | 2,116     | 6,082   | 6,285     |
| Non-interest expenses                               |  |           |   |           |
| Salaries and employee benefits                      | 4,900  | 4,617     | 14,714  | 13,882    |
| Occupancy expense                                   | 907  | 865       | 2,604   | 2,604     |
| Data processing expenses                            | 331  | 338       | 1,009   | 983       |
| FDIC insurance expense                              | 105  | 95        | 381   | 255       |
| Other real estate owned expenses                    | 73   | 11        | 75  | 26        |
| Merger-related expenses                             | —  | —         | 2,141   | —         |
| Other operating expenses                            | 1,578  | 1,691     | 4,866   | 5,204     |
| Total non-interest expenses                         | 7,894  | 7,617     | 25,790  | 22,954    |
| Income before income taxes                          | 5,431  | 3,712     | 11,710  | 9,273     |
| Income taxes  | 1,420  | 1,227     | 2,975   | 2,920     |
| Net income  | \$4,011  | \$ 2,485  | \$8,735                                       | \$ 6,353  |
| Net income per common share                         |  |           |   |           |
| Basic   | \$0.48   | \$ 0.31   | \$1.05  | \$ 0.79   |
| Diluted   | \$0.46   | \$ 0.30   | \$1.02  | \$ 0.76   |
| Weighted average shares outstanding                 |  |           |   |           |
| Basic   | 8,392,631                                      | 8,063,119 | 8,282,888                                     | 8,040,955 |

Diluted

8,678,678,328,252 8,565,408,309,363

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

2

---

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

|   | Three Months<br>Ended<br>September 30,<br>2018 |         | 2017     |         | Nine Months<br>Ended<br>September 30,<br>2018 |  | 2017 |  |
|---|--|---------|----------|---------|---|--|------|--|
| Net income  | \$4,011  | \$2,485 | \$8,735  | \$6,353 |   |  |      |  |
| Other comprehensive income (loss):  |  |         |          |         |   |  |      |  |
| Unrealized holding (losses) gains on securities available for sale                    | (513   | ) 18    | (2,015   | ) 745   |   |  |      |  |
| Tax effect  | 126  | (7      | ) 484    | (275    | )   |  |      |  |
| Net of tax amount   | (387   | ) 11    | (1,531   | ) 470   |   |  |      |  |
| Reclassification adjustment for gains on securities available for sale <sup>(1)</sup> | —  | (12     | ) (12    | ) (92   | )   |  |      |  |
| Tax effect <sup>(2)</sup>   | —  | 5       | 3        | 37      |   |  |      |  |
| Net of tax amount   | —  | (7      | ) (9     | ) (55   | )   |  |      |  |
| Pension liability   | 89   | —       | 178      | —       |   |  |      |  |
| Tax effect  | (25  | ) —     | (50      | ) —     |   |  |      |  |
| Net of tax amount   | 64   | —       | 128      | —       |   |  |      |  |
| Reclassification adjustment for actuarial gains for unfunded pension liability        |  |         |          |         |   |  |      |  |
| Income <sup>(3)</sup>   | (15  | ) (32   | ) (45    | ) (75   | )   |  |      |  |
| Tax effect <sup>(2)</sup>   | 4  | 13      | 12       | 30      |   |  |      |  |
| Net of tax amount   | (11  | ) (19   | ) (33    | ) (45   | )   |  |      |  |
| Total other comprehensive (loss) income   | (334   | ) (15   | ) (1,445 | ) 370   |   |  |      |  |
| Comprehensive income  | \$3,677  | \$2,470 | \$7,290  | \$6,723 |   |  |      |  |

<sup>(1)</sup> Included in gain on sales of securities on the consolidated statements of income

<sup>(2)</sup> Included in income taxes on the consolidated statements of income

<sup>(3)</sup> Included in salaries and employee benefits expense on the consolidated statements of income

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

1<sup>ST</sup> Constitution Bancorp  
Consolidated Statements of Changes in Shareholders' Equity  
For the Nine Months Ended September 30, 2018 and 2017  
(Dollars in thousands)  
(Unaudited)

|  | Common<br>Stock | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Shareholders'<br>Equity |
|--|-----------------|----------------------|-------------------|---|----------------------------------|
| Balance, January 1, 2017                   | \$ 71,695       | \$ 34,074            | \$ (368 )         | \$ (600 )                                     | \$ 104,801                       |
| Net income                                 | —               | 6,353                | —                 | —   | 6,353                            |
| Exercise of stock options (18,790 shares)  | 150             | —                    | —                 | —   | 150                              |
| Share-based compensation                   | 739             | —                    | —                 | —   | 739                              |
| Cash dividends declared (\$0.10 per share) | —               | (803 )               | —                 | —   | (803 )                           |
| Other comprehensive income                 | —               | —                    | —                 | 370   | 370                              |
| Balance, September 30, 2017                | \$ 72,584       | \$ 39,624            | \$ (368 )         | \$ (230 )                                     | \$ 111,610                       |
| Balance, January 1, 2018                   | \$ 72,935       | \$ 39,822            | \$ (368 )         | \$ (736 )                                     | \$ 111,653                       |
| Net income                                 | —               | 8,735                | —                 | —   | 8,735                            |
| Exercise of stock options (9,307 shares)   | 67              | —                    | —                 | —   | 67                               |
| Share-based compensation                   | 759             | —                    | —                 | —   | 759                              |
| Issuance of common stock (249,785 shares)  | 5,495           | —                    | —                 | —   | 5,495                            |
| Cash dividends declared (\$0.18 per share) | —               | (1,490 )             | —                 | —   | (1,490 )                         |
| Other comprehensive loss                   | —               | —                    | —                 | (1,445 )                                      | (1,445 )                         |
| Balance, September 30, 2018                | \$ 79,256       | \$ 47,067            | \$ (368 )         | \$ (2,181 )                                   | \$ 123,774                       |

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

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

|   | Nine Months<br>Ended September<br>30, |           |
|---|---------------------------------------|-----------|
|   | 2018                                  | 2017      |
| <b>Operating Activities:</b>  |                                       |           |
| Net income  | \$8,735                               | \$6,353   |
| Adjustments to reconcile net income to net cash provided by operating activities- |                                       |           |
| Provision for loan losses   | 675                                   | 450       |
| Depreciation and amortization   | 1,056                                 | 1,037     |
| Net amortization of premiums and discounts on securities                          | 435                                   | 678       |
| SBA discount accretion  | (235 )                                | —         |
| Gain from bargain purchase of NJCB  | (184 )                                | —         |
| Gains on sales and calls of securities available for sale                         | (12 )                                 | (128 )    |
| Gains on sales of other real estate owned   | —                                     | (14 )     |
| Gains on sales of loans held for sale   | (3,425 )                              | (3,936 )  |
| Originations of loans held for sale   | (85,285 )                             | (83,754 ) |
| Proceeds from sales of loans held for sale  | 88,602                                | 96,500    |
| Income on Bank-owned life insurance   | (439 )                                | (391 )    |
| Loss on cash surrender value on Bank-owned life insurance                         | 14                                    | —         |
| Share-based compensation expense  | 759                                   | 739       |
| (Increase) decrease in accrued interest receivable                                | 85                                    | (46 )     |
| Increase in other assets  | (499 )                                | (114 )    |
| Increase (decrease) in accrued interest payable                                   | 123                                   | (151 )    |
| Increase (decrease) in accrued expenses and other liabilities                     | 1,816                                 | (824 )    |
| Net cash provided by operating activities   | 12,221                                | 16,399    |
| <b>Investing Activities:</b>  |                                       |           |
| <b>Purchases of securities:</b>   |                                       |           |
| Available for sale  | (30,122 )                             | (29,729 ) |
| Held to maturity  | (2,868 )                              | (16,460 ) |
| <b>Proceeds from maturities and payments of securities:</b>                       |                                       |           |
| Available for sale  | 13,282                                | 15,892    |
| Held to maturity  | 21,584                                | 30,538    |
| <b>Proceeds from sales of securities:</b>   |                                       |           |
| Available for sale  | —                                     | 7,602     |
| Held to maturity  | —                                     | 1,033     |
| Proceeds from Bank-owned life insurance benefits paid                             | 893                                   | —         |
| Net (purchase)/redemption of restricted stock                                     | (3,756 )                              | 494       |
| Net increase in loans   | (19,368 )                             | (47,771 ) |
| Capital expenditures  | (535 )                                | (575 )    |
| Forfeitable deposit on other real estate owned                                    | 175                                   | —         |
| Cost of improvements to other real estate owned                                   | —                                     | (5 )      |
| Net cash paid for acquisition of NJCB   | (996 )                                | —         |
| Proceeds from sales of other real estate owned                                    | —                                     | 284       |
| Purchase of Bank-owned life insurance   | —                                     | (1,550 )  |
| Net cash used in investing activities   | (21,711 )                             | (40,247 ) |

## Financing Activities:

|  |           |           |
|--|-----------|-----------|
| Exercise of stock options                        | 67        | 150       |
| Cash dividends paid to shareholders              | (1,490 )  | (803 )    |
| Net (decrease) increase in deposits              | (67,552 ) | 35,297    |
| Increase (decrease) in short-term borrowings     | 78,975    | (25 )     |
| Repayment of long-term borrowing                 | —         | (10,000 ) |
| Net cash provided by financing activities        | 10,000    | 24,619    |
| Increase (decrease) in cash and cash equivalents | 510       | 771       |
| Cash and Cash Equivalents at Beginning of Period | 18,754    | 14,886    |
| Cash and Cash Equivalents at End of Period       | \$19,264  | \$15,657  |

## Supplemental Disclosures of Cash Flow Information

## Cash paid during the period for -

|  |         |         |
|--|---------|---------|
| Interest                                     | \$5,503 | \$4,231 |
| Income taxes                                 | 3,226   | 2,572   |
| Transfer of loans to other real estate owned | 1,460   | 455     |

## Non-cash activities.

## Acquisition of New Jersey Community Bank

## Noncash assets acquired:

|  |        |
|--|--------|
| Investment securities available for sale | 11,173 |
| Loans                                    | 75,144 |
| Premises and equipment, net              | 1,120  |
| Bank-owned life insurance                | 3,972  |
| Accrued interest receivable              | 259    |
| Core deposit intangible asset            | 80     |
| Other assets                             | 2,786  |
|  | 94,534 |

## Liabilities assumed:

|                   |        |
|-------------------|--------|
| Deposits          | 87,223 |
| Other liabilities | 636    |
|                   | 87,859 |

|                                      |       |
|--------------------------------------|-------|
| Common stock issued as consideration | 5,495 |
|--------------------------------------|-------|

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

1<sup>ST</sup> Constitution Bancorp  
Notes to Consolidated Financial Statements  
September 30, 2018  
(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. 1<sup>ST</sup> 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 10 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, 2017, filed with the SEC on March 19, 2018.

In the opinion of the Company, all adjustments (consisting only of normal recurring accruals) that 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 September 30, 2018 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.

Adoption of New Accounting Standards

ASU 2014-09 - Revenue from Contracts with Customers (Topic 606)

On January 1, 2018, the Company adopted Accounting Standards Update (“ASU”) 2014-09, “Revenue from Contracts with Customers” and all subsequent amendments to the ASU (collectively, “Topic 606”), which (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revises when it is appropriate to recognize a gain or loss from the transfer of nonfinancial assets, such as other real estate owned (“OREO”). The majority of the Company’s revenues come from interest income, other services to customers and other sources, including loans, leases and securities that are outside the scope of Topic 606. The Company’s services that fall within the scope of Topic 606 are presented within non-interest income and are recognized as revenue as the Company satisfies its obligations to customers. Services within the scope of Topic 606 include service charges on deposits, interchange income, other services and the sale of OREO. Refer to Note 6 - Revenue from Contracts with Customers - for further discussion on the Company’s accounting policies for revenue sources within the scope of Topic 606.

The Company adopted Topic 606 using the modified retrospective method for reporting periods beginning after January 1, 2018. The Company did not have any contracts that were not completed as of January 1, 2018. The adoption of Topic 606 did not result in a change to the accounting for any of the in-scope revenue streams; therefore, no cumulative effect adjustment was recorded.

ASU 2017-07 - Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost

In March 2017, the FASB issued ASU 2017-07, “Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost,” which requires that an employer disaggregate the service cost component from the other components of net benefit costs as follows: (1) service cost must be presented in the same line item(s) as other employee compensation costs. These costs are generally included within income from continuing operations but in some cases, may be eligible for capitalization if certain criteria are met; and (2) all other components of net benefit cost must be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. These generally include interest cost, actual return on plan assets, amortization of prior service cost included in accumulated other comprehensive income and gains or losses from changes in the value of the projected benefit obligation or plan assets.

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those years. The adoption of this guidance in 2018 did not have a material impact on the Company's consolidated financial statements.

#### ASU 2017-01 - Business Combinations (Topic 805): Clarifying the Definition of a Business

In January 2017, the FASB issued ASU 2017-01 "Business Combinations (Topic 805): Clarifying the Definition of a Business," which clarifies the definition of a business with the objective of adding guidance to assist companies and other reporting organizations with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The amendments in this ASU provide a more robust framework to use in determining when a set of assets and activities is a business. The current definition of a business is interpreted broadly and can be difficult to apply. Stakeholders indicated that analyzing transactions is inefficient and costly and the definition does not permit the use of reasonable judgment.

Under current implementation guidance, there are three elements of a business: inputs, processes and outputs. While an integrated set of assets and activities (collectively referred to as a "set") that is a business usually has outputs, outputs are not required to be present. Additionally, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs, for example, by integrating the acquired set with their own inputs and processes.

The ASU introduces a "screen" to assist entities in determining when a set should not be considered a business. If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business. If the screen is not met, the ASU requires that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output. Further, the ASU removes the evaluation of whether a market participant could replace missing elements (as required under current U.S. GAAP).

For the Company, the ASU is effective for annual periods beginning after December 15, 2017, including interim periods within those periods. The amendments in this ASU should be applied prospectively on or after the effective date. No disclosures are required at transition. The adoption of this guidance in 2018 did not have a material impact on the Company's consolidated financial statements.

#### ASU 2016-15 - Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments.

In August 2016, the FASB issued ASU 2016-15 "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments," which clarifies whether the following items should be categorized as operating, investing or financing in the statement of cash flows: (1) debt prepayment and extinguishment costs, (2) settlement of zero-coupon debt, (3) settlement of contingent consideration, (4) insurance proceeds, (5) settlement of corporate-owned life insurance ("COLI") and bank-owned life insurance ("BOLI") policies, (6) distributions from equity method investees, (7) beneficial interests in securitization transactions and (8) receipts and payments with aspects of more than one class of cash flows.

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company classifies cash flows related to BOLI in accordance with the guidance, and the adoption of this guidance in 2018 did not have a material impact on its consolidated financial statements.

#### ASU 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.

For the Company, the guidance in this ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The adoption of this guidance in 2018 did not have a material impact on the Company's consolidated financial statements.

(2) Acquisition of New Jersey Community Bank

On April 11, 2018, the Company completed its acquisition of 100 percent of the shares of common stock of New Jersey Community Bank ("NJCB"), which merged with and into the Bank. The shareholders of NJCB received total consideration of \$8.6 million, which was comprised of 249,785 shares of common stock of the Company with a market value of \$5.5 million and cash of \$3.1 million, of which \$401,000 was placed in escrow to cover costs and expenses, including settlement costs, if any, that the Company may incur after closing the merger as a result of a certain litigation matter.

The merger was accounted for under the acquisition method of accounting, and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at preliminary estimated fair values as of the acquisition date. NJCB's results of operations have been included in the Company's Consolidated Statements of Income since April 11, 2018.

The assets acquired and liabilities assumed in the merger were recorded at their estimated fair values based on management's best estimates, using information available at the date of the merger, including the use of third party valuation specialists. The fair values are preliminary estimates and subject to adjustment for up to one year after the closing date of the merger.

The following table summarizes the estimated fair value of the acquired assets and liabilities assumed:

| (Dollars in thousands)   | Amount  |
|--------------------------|---------|
| Consideration paid:      |         |
| Company stock issued     | \$5,495 |
| Cash payment             | 2,668   |
| Cash held in escrow      | 401     |
| Total consideration paid | \$8,564 |

Recognized amounts of identifiable assets acquired and liabilities assumed at fair value:

|  |          |
|--|----------|
| Cash and cash equivalents                      | \$2,073  |
| Investment securities available for sale       | 11,173   |
| Loans  | 75,144   |
| Premises and equipment, net                    | 1,120    |
| Core deposit intangible asset                  | 80       |
| Bank-owned life insurance                      | 3,972    |
| Accrued interest receivable                    | 259      |
| Other assets                                   | 2,786    |
| Deposits                                       | (87,223) |
| Other liabilities                              | (636 )   |
| Total identifiable assets and liabilities, net | \$8,748  |

Gain from bargain purchase \$ 184

Accounting Standards Codification ("ASC") Topic 805-10 provides that if the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report, in its financial statements, provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognized at the acquisition date and may recognize additional assets or liabilities to reflect new information obtained from facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the

amounts recognized as of that date. The measurement period may not exceed one year from the acquisition date.

8

---

Investments were recorded 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.

Loans acquired in the NJCB merger were recorded at fair value and subsequently accounted for in accordance with ASC Topic 310. The fair values of loans acquired were estimated, utilizing cash flow projections based on the remaining maturity and repricing terms. Cash flows were adjusted for estimated future credit losses of approximately \$1.6 million and estimated prepayments. Projected cash flows were then discounted to present value, utilizing a risk-adjusted market rate for similar loans that management determined market participants would likely use.

At the acquisition date, the Company recorded \$74.3 million of loans without evidence of credit quality deterioration and \$881,000 of loans with evidence of credit quality deterioration.

The following table summarizes the composition of the loans acquired and recorded at fair value:

| (Dollars in thousands)  | At April 11,<br>2018  |  | Total    |
|-------------------------|---|--|----------|
|                         | Loans<br>acquired<br>with no<br>credit quality<br>deterioration | Loans<br>acquired<br>with credit<br>quality<br>deterioration |          |
| Commercial              |   |  |          |
| Construction            | \$ 798  | \$ —   | \$798    |
| Commercial real estate  | 58,191  | 873  | 59,064   |
| Commercial business     | 1,293   | 8  | 1,302    |
| Residential real estate | 7,572   |  | 7,572    |
| Consumer                | 6,409   |  | 6,409    |
| Total loans             | \$ 74,263   | \$ 881   | \$75,144 |

The following is a summary of the loans acquired with evidence of deteriorated credit quality in the NJCB acquisition as of the date of the closing of the merger:

| (Dollars in thousands)   | Acquired<br>Credit<br>Impaired<br>Loans |
|--|---|
| Contractually required principal and interest at acquisition                       | \$ 1,658                                |
| Contractual cash flows not expected to be collected<br>(non-accretable difference) | 609                                     |
| Expected cash flows at acquisition   | 1,049                                   |
| Interest component of expected cash flows (accretable difference)                  | 168                                     |
| Fair value of acquired loans   | \$ 881                                  |



Bank-owned life insurance was recorded at the cash surrender value of the insurance policies, which approximates the redemption value of the policies.

The core deposit intangible asset totaled \$80,000 and is being amortized over its estimated useful life of approximately 10 years, using an accelerated method. No goodwill was recognized in the transaction.

The following table presents the projected amortization of the core deposit intangible asset for each period:

(Dollars in thousands) Amount

|            |       |
|------------|-------|
| Year       |       |
| 2018       | \$ 15 |
| 2019       | 13    |
| 2020       | 12    |
| 2021       | 10    |
| 2022       | 8     |
| Thereafter | 22    |
|            | \$ 80 |

The fair values of deposit liabilities with no stated maturities, such as checking, money market and savings accounts, were assumed to equal the carrying value amounts since these deposits are payable on demand. The fair values of certificates of deposit represent the present value of contractual cash flows discounted at market rates for similar certificates of deposit.

Direct costs related to the acquisition were expensed as incurred. No merger-related expenses were incurred for the three months ended September 30, 2018. During the nine months ended September 30, 2018, the Company incurred \$2.1 million of expenses for termination of contracts, legal and financial advisory fees, severance and other integration related expenses, which have been separately stated as merger-related expenses in the Company's Consolidated Statements of Income.

#### Supplemental Pro Forma Financial Information

The following table presents financial information regarding the former NJCB operations included in the Company's Consolidated Statements of Income from the date of the acquisition (April 11, 2018) through September 30, 2018 under the column "Actual from Acquisition Date to September 30, 2018." In addition, the table presents unaudited condensed pro forma financial information assuming that the NJCB acquisition had been completed as of January 1, 2018 and January 1, 2017, respectively. In the table, merger-related expenses of \$2.1 million were excluded from the pro forma non-interest expenses for the nine months ended September 30, 2018. Income taxes were also adjusted to exclude income tax benefits of \$568,000 related to the merger expenses for the nine months ended September 30, 2018.

The table has been prepared for comparative purposes only and is not necessarily indicative of the actual results that would have been attained had the acquisition occurred as of the beginning of the periods presented, nor is it indicative of future results. Furthermore, the unaudited pro forma financial information does not reflect management's estimate of any revenue-enhancing opportunities nor anticipated cost savings that may have occurred as a result of the integration and consolidation of NJCB's operations. The pro forma financial information reflects adjustments related to certain merger expenses and the related income tax effects.

|                        |             | Pro Forma | Pro Forma |
|------------------------|-------------|-----------|-----------|
| (Dollars in thousands) | Actual from | for the   | for the   |
|                        | Acquisition | Nine      | Nine      |
|                        | Date to     | Months    | Months    |
|                        | 9/30/2018   | Ended     | Ended     |
|                        |             | 9/30/2018 | 9/30/2017 |
| Net interest income    | \$ 1,577    | \$ 32,941 | \$ 28,582 |
| Non-interest income    | 70          | 6,074     | 6,502     |
| Non-interest expenses  | 823         | 24,737    | 26,248    |
| Income taxes           | 248         | 3,543     | 2,920     |

|            |     |        |       |
|------------|-----|--------|-------|
| Net income | 576 | 10,060 | 5,466 |
|------------|-----|--------|-------|

10

---

## (3) 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.

Awards of restricted shares are included in outstanding shares when granted. Unvested restricted shares are entitled to non-forfeitable dividends and participate in undistributed earnings with common shares. Awards of this nature are considered participating securities and basic and diluted earnings per share are computed under the two-class method.

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. For the three and nine months ended September 30, 2018 and 2017, no options and 9,500 options, respectively, were anti-dilutive and were not included in the computation of diluted earnings per common share.

The following table illustrates the calculation of both basic and diluted earnings per share for the three and nine months ended September 30, 2018 and 2017:

|   | Three Months<br>Ended September<br>30, |           | Nine Months<br>Ended September<br>30, |           |
|---|--|-----------|---------------------------------------|-----------|
| (Dollars in thousands, except per share data) | 2018                                   | 2017      | 2018                                  | 2017      |
| Net income                                    | \$4,011                                | \$ 2,485  | \$8,735                               | \$ 6,353  |
| Basic weighted average shares outstanding     | 8,392,631                              | 8,063,119 | 8,282,889                             | 8,040,955 |
| Plus: common stock equivalents                | 286,048                                | 265,133   | 282,512                               | 268,408   |
| Diluted weighted average shares outstanding   | 8,678,679                              | 8,328,252 | 8,565,401                             | 8,309,363 |
| Earnings per share:                           |  |           |                                       |           |
| Basic   | \$0.48                                 | \$ 0.31   | \$1.05                                | \$ 0.79   |
| Diluted                                       | \$0.46                                 | \$ 0.30   | \$1.02                                | \$ 0.76   |

## (4) Investment Securities

A summary of amortized cost and approximate fair value of investment securities available for sale follows:

| (Dollars in thousands)  | September 30, 2018 |                              |                               |               |
|---|--------------------|------------------------------|-------------------------------|---------------|
|   | Amortized<br>Cost  | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| U.S. Treasury securities and obligations of U.S. Government sponsored entities ("GSE") and agencies | \$3,989            | \$ —                         | \$(74)                        | \$3,915       |
| Residential collateralized mortgage obligations - GSE   | 45,362             | 4                            | (1,097)                       | 44,269        |
| Residential mortgage backed securities - GSE  | 14,802             | 14                           | (254)                         | 14,562        |
| Obligations of state and political subdivisions   | 23,869             | 56                           | (593)                         | 23,332        |
| Trust preferred debt securities - single issuer   | 1,489              | —                            | (83)                          | 1,406         |
| Corporate debt securities   | 28,349             | —                            | (532)                         | 27,817        |
| Other debt securities   | 15,930             | 50                           | (89)                          | 15,891        |

Total \$133,790 \$ 124 \$(2,722 ) \$131,192

11

---

| (Dollars in thousands)  | December 31, 2017 |                        |                         | Fair Value |
|---|-------------------|------------------------|-------------------------|------------|
|   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses |            |
| U.S. Treasury securities and obligations of U.S. Government sponsored entities ("GSE") and agencies | \$1,997           | \$ —                   | \$ (30 )                | \$1,967    |
| Residential collateralized mortgage obligations - GSE   | 27,688            | 18                     | (381 )                  | 27,325     |
| Residential mortgage backed securities - GSE  | 14,231            | 129                    | (72 )                   | 14,288     |
| Obligations of state and political subdivisions   | 19,575            | 227                    | (82 )                   | 19,720     |
| Trust preferred debt securities - single issuer   | 2,481             | —                      | (132 )                  | 2,349      |
| Corporate debt securities   | 27,917            | 14                     | (248 )                  | 27,683     |
| Other debt securities   | 12,140            | 12                     | (26 )                   | 12,126     |
| Total   | \$106,029         | \$ 400                 | \$ (971 )               | \$105,458  |

A summary of amortized cost, carrying value and approximate fair value of investment securities held to maturity follows:

| (Dollars in thousands)  | September 30, 2018 |  |                |                        |                         |            |
|---|--------------------|--|----------------|------------------------|-------------------------|------------|
|   | Amortized Cost     | Recognized In Accumulated Other Comprehensive Loss | Carrying Value | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| U.S. treasury securities and obligations of U.S. government-sponsored entities ("GSE") and agencies | \$—                | \$ —   | \$—            | \$ —                   | \$—                     | \$—        |
| Residential collateralized mortgage obligations - GSE   | 7,118              | —  | 7,118          | 7                      | (231 )                  | 6,894      |
| Residential mortgage backed securities - GSE  | 31,625             | —  | 31,625         | 51                     | (789 )                  | 30,887     |
| Obligations of state and political subdivisions   | 49,259             | —  | 49,259         | 591                    | (225 )                  | 49,625     |
| Trust preferred debt securities - pooled  | 657                | (501 )   | 156            | 600                    | —                       | 756        |
| Other debt securities   | 3,221              | —  | 3,221          | —                      | (163 )                  | 3,058      |
| Total   | \$91,880           | \$ (501 )  | \$91,379       | \$ 1,249               | \$ (1,408 )             | \$91,220   |

| (Dollars in thousands)  | December 31, 2017 |  |                |                        |                         |            |
|---|-------------------|--|----------------|------------------------|-------------------------|------------|
|   | Amortized Cost    | Recognized In Accumulated Other Comprehensive Loss | Carrying Value | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| U.S. treasury securities and obligations of U.S. government-sponsored entities ("GSE") and agencies | \$3,234           | \$ —   | \$3,234        | \$ —                   | \$ (84 )                | \$3,150    |
| Residential collateralized mortgage obligations - GSE   | 8,701             | —  | 8,701          | 94                     | (123 )                  | 8,672      |
| Residential mortgage backed securities - GSE  | 34,072            | —  | 34,072         | 231                    | (127 )                  | 34,176     |
| Obligations of state and political subdivisions   | 63,797            | —  | 63,797         | 1,224                  | (35 )                   | 64,986     |
| Trust preferred debt securities - pooled  | 657               | (501 )   | 156            | 418                    | —                       | 574        |
| Other debt securities   | 307               | —  | 307            | —                      | —                       | 307        |
| Total   | \$110,768         | \$ (501 )  | \$110,267      | \$ 1,967               | \$ (369 )               | \$111,865  |

At September 30, 2018 and December 31, 2017, \$83.0 million and \$98.4 million of investment securities, respectively, were pledged to secure public funds and collateralized borrowings from the FHLB and for other purposes required or permitted by law.

Restricted stock was included in other assets at September 30, 2018 and December 31, 2017 and totaled \$5.3 million and \$1.6 million, respectively. Restricted stock consisted of \$5.2 million of Federal Home Loan Bank of New York stock and \$135,000 of Atlantic Community Bankers Bank stock at September 30, 2018 and \$1.5 million of Federal Home Loan Bank of New York stock and \$65,000 of Atlantic Community Bankers Bank stock at December 31, 2017.



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 September 30, 2018. 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.

|  | September 30, 2018 |               |        |
|--|--------------------|---------------|--------|
| (Dollars in thousands)                 | Amortized<br>Cost  | Fair<br>Value | Yield  |
| Available for sale                     |                    |               |        |
| Due in one year or less                | \$9,464            | \$9,422       | 2.07 % |
| Due after one year through five years  | 29,731             | 29,189        | 2.91 % |
| Due after five years through ten years | 23,074             | 22,681        | 2.92 % |
| Due after ten years                    | 71,521             | 69,900        | 2.86 % |
| Total                                  | \$133,790          | \$131,192     | 2.83 % |

|  | Carrying<br>Value | Fair<br>Value | Yield  |
|--|-------------------|---------------|--------|
| Held to maturity                       |                   |               |        |
| Due in one year or less                | \$19,224          | \$19,252      | 2.28 % |
| Due after one year through five years  | 19,185            | 19,405        | 3.64 % |
| Due after five years through ten years | 23,649            | 23,392        | 3.04 % |
| Due after ten years                    | 29,321            | 29,171        | 3.23 % |
| Total                                  | \$91,379          | \$91,220      | 3.07 % |

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 September 30, 2018 and December 31, 2017 were as follows:

|   | September 30, 2018         |                     |                      |                     |                      |               |                      |
|---|----------------------------|---------------------|----------------------|---------------------|----------------------|---------------|----------------------|
|   |                            | Less than 12 months |                      | 12 months or longer |                      | Total         |                      |
| (Dollars in thousands)  | Number<br>of<br>Securities | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| U.S. Treasury securities and obligations of U.S. Government sponsored entities (GSE) and agencies | 4                          | \$1,989             | \$(2)                | \$1,926             | \$(72)               | \$3,915       | \$(74)               |
| Residential collateralized mortgage obligations - GSE   | 36                         | 33,858              | (504)                | 15,486              | (824)                | \$49,344      | \$(1,328)            |
| Residential mortgage backed securities - GSE  | 49                         | 30,396              | (708)                | 8,160               | (335)                | \$38,556      | \$(1,043)            |
| Obligations of state and political subdivisions   | 91                         | 25,712              | (626)                | 5,310               | (192)                | \$31,022      | \$(818)              |
| Trust preferred debt securities - single issuer   | 2                          | —                   | —                    | 1,406               | (83)                 | \$1,406       | \$(83)               |
| Corporate debt securities   | 10                         | 20,321              | (264)                | 7,496               | (268)                | \$27,817      | \$(532)              |
| Other debt securities   | 6                          | 7,932               | (89)                 | 2,868               | (163)                | \$10,800      | \$(252)              |
| Total temporarily impaired  | 198                        | \$120,208           | \$(2,193)            | \$42,652            | \$(1,937)            | \$162,860     | \$(4,130)            |

securities

14

---

| (Dollars in thousands)  | December 31, 2017          |                        |                      |                     |                      |               |                      |
|---|----------------------------|------------------------|----------------------|---------------------|----------------------|---------------|----------------------|
|   | Number<br>of<br>Securities | Less than 12<br>months |                      | 12 months or longer |                      | Total         |                      |
|   |                            | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| U.S. Treasury securities and obligations of U.S. Government sponsored entities (GSE) and agencies | 2                          | \$1,967                | \$ (30 )             | \$3,150             | \$ (84 )             | \$5,117       | \$ (114 )            |
| Residential collateralized mortgage obligations - GSE   | 11                         | 19,237                 | (205 )               | 8,788               | (299 )               | \$28,025      | \$(504 )             |
| Residential mortgage backed securities - GSE  | 35                         | 21,770                 | (141 )               | 3,074               | (58 )                | \$24,844      | \$(199 )             |
| Obligations of state and political subdivisions   | 42                         | 11,594                 | (82 )                | 2,717               | (35 )                | \$14,311      | \$(117 )             |
| Trust preferred debt securities - single issuer   | 4                          | —                      | —                    | 2,349               | (132 )               | \$2,349       | \$(132 )             |
| Corporate debt securities   | 7                          | 11,967                 | (98 )                | 7,662               | (150 )               | \$19,629      | \$(248 )             |
| Other debt securities   | 4                          | 8,840                  | (25 )                | 21                  | (1 )                 | \$8,861       | \$(26 )              |
| Total temporarily impaired securities   | 105                        | \$75,375               | \$ (581 )            | \$27,761            | \$ (759 )            | \$103,136     | \$(1,340 )           |

U.S. Treasury securities and obligations of U.S. Government sponsored entities and agencies: The unrealized losses on investments in these securities were caused by increases in market interest rates. 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 two corporate trust preferred securities issued by one large financial institution 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. The issuer maintains an investment grade credit rating and has not defaulted on interest payments. The decline in fair value is attributable to the widening of interest rate and credit spreads and the lack of an active trading market for these securities. 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 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 a 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 September 30, 2018, the security was in an unrealized gain position.

#### (5) Allowance for Loan Losses and Credit Quality

The Company’s primary lending emphasis is the origination of commercial business 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 September 30, 2018:

| (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<br>Days<br>Accruing | Non-accrual<br>Loans |
|--|---------------|---------------|----------------------------|----------------------|-----------|------------------------------|--|----------------------|
| Commercial   |               |               |                            |                      |           |                              |  |                      |
| Construction                                       | \$—           | \$—           | \$—                        | \$—                  | \$144,601 | \$144,601                    | \$   | —\$ —                |
| Commercial Business                                | 185           | 10            | 623                        | 818                  | 105,178   | 105,996                      | —  | 3,583                |
| Commercial Real Estate                             | 1,045         | 506           | 1,251                      | 2,802                | 373,201   | 376,003                      | —  | 1,608                |
| Mortgage Warehouse Lines                           | —             | —             | —                          | —                    | 182,791   | 182,791                      | —  | —                    |
| Residential Real Estate                            | 1,343         | —             | 707                        | 2,050                | 45,515    | 47,565                       | —  | 1,162                |
| Consumer   |               |               |                            |                      |           |                              |  |                      |
| Loans to Individuals                               | 255           | 8             | 207                        | 470                  | 23,603    | 24,073                       | —  | 408                  |
| Other  | —             | —             | —                          | —                    | 174       | 174                          | —  | —                    |
| Total loans  | \$2,828       | \$524         | \$2,788                    | \$6,140              | \$875,063 | 881,203                      | \$   | —\$ 6,761            |
| Deferred loan costs, net                           |               |               |                            |                      |           | 335                          |  |                      |
| Total loans, including deferred loan costs,<br>net |               |               |                            |                      |           | \$881,538                    |  |                      |

The following table provides an aging of the loan portfolio by loan class at December 31, 2017:

| (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<br>Days<br>Accruing | Non-accrual<br>Loans |
|---|---------------|---------------|-------------------------------|----------------------|-----------|------------------------------|--|----------------------|
| Commercial                                      |               |               |                               |                      |           |                              |  |                      |
| Construction                                    | \$—           | \$—           | \$—                           | \$—                  | \$136,412 | \$136,412                    | \$—  | \$—                  |
| Commercial Business                             | 180           | 545           | 619                           | 1,344                | 91,562    | 92,906                       | —  | 4,212                |
| Commercial Real Estate                          | 540           | —             | 2,465                         | 3,005                | 305,919   | 308,924                      | —  | 2,465                |
| Mortgage Warehouse Lines                        | —             | —             | —                             | —                    | 189,412   | 189,412                      | —  | —                    |
| Residential Real Estate                         | 911           | 256           | 69                            | 1,236                | 39,258    | 40,494                       | —  | 69                   |
| Consumer  |               |               |                               |                      |           |                              |  |                      |
| Loans to Individuals                            | 119           | —             | 116                           | 235                  | 20,790    | 21,025                       | —  | 368                  |
| Other   | —             | —             | —                             | —                    | 183       | 183                          | —  | —                    |
| Total loans                                     | \$1,750       | \$801         | \$3,269                       | \$5,820              | \$783,536 | 789,356                      | \$—  | \$7,114              |
| Deferred loan costs, net                        |               |               |                               |                      |           | 550                          |  |                      |
| Total loans, including deferred loan costs, net |               |               |                               |                      |           | \$789,906                    |  |                      |

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. At September 30, 2018, there was one purchased credit impaired (“PCI”) loan for \$506,000 that was not classified as a non-performing loan. At December 31, 2017, there were no PCI loans that 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 their 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 Company and adequately margined. Loans that are based upon “blue chip” stocks listed on the major stock 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 and, for service companies, the sources of revenue are abundant. Future needs have been planned for. Character and management ability of individuals or company principals are excellent. Loans to individuals are supported by their high net worth 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 their high net worth but whose supporting assets are illiquid.
- 3w. Watch - Included in this category are loans evidencing problems identified by Company management that require closer supervision. Such problems have not developed to the point that requires a “special mention” rating. This category also covers situations where the Company does not have adequate current information upon which credit

quality can be determined. The 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 Company’s credit position at some future date. Special mention loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

5. Substandard - A “substandard” loan is inadequately protected by the current 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 Company will sustain some loss if the deficiencies are not corrected.

6. Doubtful - A loan classified as “doubtful” has all the weaknesses inherent in a loan classified as 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 as “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 loan even though partial recovery may occur in the future.

The following table provides a breakdown of the loan portfolio by credit quality indicator at September 30, 2018: (Dollars in thousands)

| Commercial Credit Exposure - By Internally Assigned Grade | Construction         | Commercial Business | Commercial Real Estate | Mortgage Warehouse Lines | Residential Real Estate |
|---|----------------------|---------------------|------------------------|--------------------------|-------------------------|
| Grade:  |                      |                     |                        |                          |                         |
| Pass  | \$ 141,333           | \$ 91,454           | \$ 355,755             | \$ 182,359               | \$ 46,119               |
| Special Mention   | 3,268                | 10,754              | 11,313                 | 432                      | 110                     |
| Substandard   | —                    | 3,528               | 8,935                  | —                        | 1,336                   |
| Doubtful  | —                    | 260                 | —                      | —                        | —                       |
| Total   | \$ 144,601           | \$ 105,996          | \$ 376,003             | \$ 182,791               | \$ 47,565               |
| Consumer Credit Exposure - By Payment Activity            | Loans To Individuals | Other               |                        |                          |                         |
| Performing  | \$ 23,665            | \$ 174              |                        |                          |                         |
| Non-performing  | 408                  | —                   |                        |                          |                         |
| Total   | \$ 24,073            | \$ 174              |                        |                          |                         |

The following table provides a breakdown of the loan portfolio by credit quality indicator at December 31, 2017: (Dollars in thousands)

| Commercial Credit Exposure - By Internally Assigned Grade | Construction         | Commercial Business | Commercial Real Estate | Mortgage Warehouse Lines | Residential Real Estate |
|---|----------------------|---------------------|------------------------|--------------------------|-------------------------|
| Grade:  |                      |                     |                        |                          |                         |
| Pass  | \$ 136,180           | \$ 84,746           | \$ 289,203             | \$ 189,412               | \$ 39,539               |
| Special Mention   | 232                  | 3,454               | 13,267                 | —                        | 666                     |
| Substandard   | —                    | 1,252               | 6,454                  | —                        | 289                     |
| Doubtful  | —                    | 3,454               | —                      | —                        | —                       |
| Total   | \$ 136,412           | \$ 92,906           | \$ 308,924             | \$ 189,412               | \$ 40,494               |
| Consumer Credit Exposure - By Payment Activity            | Loans To Individuals | Other               |                        |                          |                         |
| Performing  | \$ 20,657            | \$ 183              |                        |                          |                         |
| Non-performing  | 368                  | —                   |                        |                          |                         |
| Total   | \$ 21,025            | \$ 183              |                        |                          |                         |

## Impaired Loans

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 agreement, including scheduled interest payments. When a loan is placed on non-accrual status, it is also considered to be impaired. Loans are placed on non-accrual 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 September 30, 2018 and December 31, 2017:

September 30, 2018

| (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      |
|---|--------------|------------------------|------------------------------|--------------------------------|-------------------------------|-------------------------|--------|-------------|------------|
| Allowance for loan losses:                      |              |                        |                              |                                |                               |                         |        |             |            |
| Individually evaluated for impairment           | \$—          | \$ 431                 | \$ 70                        | \$—                            | \$—                           | \$—                     | \$—    | \$—         | \$ 501     |
| Loans acquired with deteriorated credit quality | —            | —                      | 1                            | —                              | —                             | —                       | —      | —           | 1          |
| Collectively evaluated for impairment           | 1,721        | 1,256                  | 3,286                        | 832                            | 367                           | 156                     | —      | 145         | 7,763      |
| Ending Balance                                  | \$ 1,721     | \$ 1,687               | \$ 3,357                     | \$ 832                         | \$ 367                        | \$ 156                  | \$—    | \$ 145      | \$ 8,265   |
| Loans receivable:                               |              |                        |                              |                                |                               |                         |        |             |            |
| Individually evaluated for impairment           | \$ 104       | \$ 3,831               | \$ 5,274                     | \$—                            | \$ 1,162                      | \$ 408                  | \$—    | \$—         | \$ 10,779  |
| Loans acquired with deteriorated credit quality | —            | 308                    | 1,437                        | —                              | —                             | —                       | —      | —           | 1,745      |
| Collectively evaluated for impairment           | 144,497      | 101,857                | 369,292                      | 182,791                        | 46,403                        | 23,665                  | 174    | —           | 868,679    |
| Ending Balance                                  | \$ 144,601   | \$ 105,996             | \$ 376,003                   | \$ 182,791                     | \$ 47,565                     | \$ 24,073               | \$ 174 | \$—         | 881,203    |
| Deferred loan costs, net                        |              |                        |                              |                                |                               |                         |        |             | 335        |
|   |              |                        |                              |                                |                               |                         |        |             | \$ 881,538 |

December 31, 2017

| (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  |
|---|--------------|------------------------|------------------------------|--------------------------------|-------------------------------|-------------------------|-------|-------------|--------|
| Allowance for loan losses:                      |              |                        |                              |                                |                               |                         |       |             |        |
| Individually evaluated for impairment           | \$—          | \$ 592                 | \$ 92                        | \$—                            | \$—                           | \$—                     | \$—   | \$—         | \$ 684 |
| Loans acquired with deteriorated credit quality | —            | —                      | —                            | —                              | —                             | —                       | —     | —           | —      |
| Collectively evaluated for impairment           | 1,703        | 1,128                  | 2,857                        | 852                            | 392                           | 114                     | —     | 283         | 7,329  |

Edgar Filing: 1ST CONSTITUTION BANCORP - Form 10-Q

|   |           |           |            |            |           |           |        |        |           |
|---|-----------|-----------|------------|------------|-----------|-----------|--------|--------|-----------|
| Ending Balance                                  | \$1,703   | \$ 1,720  | \$ 2,949   | \$ 852     | \$ 392    | \$ 114    | \$—    | \$ 283 | \$8,013   |
| Loans receivable:                               |           |           |            |            |           |           |        |        |           |
| Individually evaluated for impairment           | \$232     | \$ 4,459  | \$ 5,713   | \$—        | \$ 69     | \$ 368    | \$—    | \$ —   | \$10,841  |
| Loans acquired with deteriorated credit quality | —         | 274       | 590        | —          | —         | —         | —      | —      | 864       |
| Collectively evaluated for impairment           | 136,180   | 88,173    | 302,621    | 189,412    | 40,425    | 20,657    | 183    | —      | 777,651   |
| Ending Balance                                  | \$136,412 | \$ 92,906 | \$ 308,924 | \$ 189,412 | \$ 40,494 | \$ 21,025 | \$ 183 | \$ —   | 789,356   |
| Deferred loan costs, net                        |           |           |            |            |           |           |        |        | 550       |
|   |           |           |            |            |           |           |        |        | \$789,906 |

Edgar Filing: 1ST CONSTITUTION BANCORP - Form 10-Q

The activity in the allowance for loan loss by loan class for the three and nine months ended September 30, 2018 and 2017 was as follows:

| (Dollars in thousands)                     | Construction | Commercial Business | Commercial Real Estate | Mortgage Warehouse Lines | Residential Real Estate | Loans to Individuals | Other | Unallocated | Total    |
|--|--------------|---------------------|------------------------|--------------------------|-------------------------|----------------------|-------|-------------|----------|
| Balance - July 1, 2018                     | \$ 1,661     | \$ 1,665            | \$ 3,314               | \$ 920                   | \$ 462                  | \$ 169               | \$ —  | \$ 307      | \$ 8,498 |
| Provision charged/(credited) to operations | 60           | 21                  | 484                    | (88 )                    | (95 )                   | (13 )                | 18    | (162 )      | 225      |
| Loans charged off                          | —            | —                   | (441 )                 | —                        | —                       | —                    | (18 ) | —           | (459 )   |
| Recoveries of loans charged off            | —            | 1                   | —                      | —                        | —                       | —                    | —     | —           | 1        |
| Balance - September 30, 2018               | \$ 1,721     | \$ 1,687            | \$ 3,357               | \$ 832                   | \$ 367                  | \$ 156               | \$ —  | \$ 145      | \$ 8,265 |
| Balance - July 1, 2017                     | \$ 1,455     | \$ 1,437            | \$ 2,991               | \$ 902                   | \$ 385                  | \$ 120               | \$ —  | \$ 417      | \$ 7,707 |
| Provision charged/(credited) to operations | 139          | 39                  | (252 )                 | (31 )                    | 3                       | (4 )                 | —     | 256         | 150      |
| Loans charged off                          | —            | (61 )               | —                      | —                        | —                       | —                    | —     | —           | (61 )    |
| Recoveries of loans charged off            | —            | —                   | 4                      | —                        | —                       | 2                    | —     | —           | 6        |
| Balance - September 30, 2017               | \$ 1,594     | \$ 1,415            | \$ 2,743               | \$ 871                   | \$ 388                  | \$ 118               | \$ —  | \$ 673      | \$ 7,802 |

| (Dollars in thousands)                     | Construction | Commercial Business | Commercial Real Estate | Mortgage Warehouse Lines | Residential Real Estate | Loans to Individuals | Other | Unallocated | Total    |
|--|--------------|---------------------|------------------------|--------------------------|-------------------------|----------------------|-------|-------------|----------|
| Balance - January 1, 2018                  | \$ 1,703     | \$ 1,720            | \$ 2,949               | \$ 852                   | \$ 392                  | \$ 114               | \$ —  | \$ 283      | \$ 8,013 |
| Provision charged/(credited) to operations | 18           | (15 )               | 788                    | (20 )                    | (25 )                   | 48                   | 19    | (138 )      | 675      |
| Loans charged off                          | —            | (32 )               | (441 )                 | —                        | —                       | (7 )                 | (19 ) | —           | (499 )   |
| Recoveries of loans charged off            | —            | 14                  | 61                     | —                        | —                       | 1                    | —     | —           | 76       |
| Balance - September 30, 2018               | \$ 1,721     | \$ 1,687            | \$ 3,357               | \$ 832                   | \$ 367                  | \$ 156               | \$ —  | \$ 145      | \$ 8,265 |
| Balance - January 1, 2017                  | \$ 1,204     | \$ 1,732            | \$ 2,574               | \$ 973                   | \$ 367                  | \$ 112               | \$ —  | \$ 532      | \$ 7,494 |
| Provision charged/(credited) to operations | 390          | (259 )              | 156                    | (102 )                   | 122                     | 2                    | —     | 141         | 450      |
| Loans charged off                          | —            | (61 )               | —                      | —                        | (101 )                  | —                    | —     | —           | (162 )   |
| Recoveries of loans charged off            | —            | 3                   | 13                     | —                        | —                       | 4                    | —     | —           | 20       |
| Balance - September 30, 2017               | \$ 1,594     | \$ 1,415            | \$ 2,743               | \$ 871                   | \$ 388                  | \$ 118               | \$ —  | \$ 673      | \$ 7,802 |

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)

| (Dollars in thousands)   | Recorded Investment | Unpaid Principal Balance | Related Allowance | Three Months Ended September 30, 2018 |                             | Nine Months Ended September 30, 2018 |                             |
|--------------------------|---------------------|--------------------------|-------------------|---------------------------------------|-----------------------------|--------------------------------------|-----------------------------|
|                          |                     |                          |                   | Average Interest Recorded Investment  | Average Interest Recognized | Average Interest Recorded Investment | Average Interest Recognized |
| With no allowance:       |                     |                          |                   |                                       |                             |                                      |                             |
| Commercial:              |                     |                          |                   |                                       |                             |                                      |                             |
| Construction             | \$ 104              | \$ 104                   | \$ —              | \$104                                 | \$ 2                        | \$118                                | \$ 6                        |
| Commercial Business      | 882                 | 1,079                    | —                 | 1,022                                 | 28                          | 1,201                                | 83                          |
| Commercial Real Estate   | 2,806               | 3,039                    | —                 | 2,557                                 | 27                          | 2,870                                | 74                          |
| Mortgage Warehouse Lines | —                   | —                        | —                 | —                                     | —                           | —                                    | —                           |
| Subtotal                 | 3,792               | 4,222                    | —                 | 3,683                                 | 57                          | 4,189                                | 163                         |
| Residential Real Estate  | 1,162               | 1,242                    | —                 | 1,149                                 | —                           | 742                                  | —                           |
| Consumer:                |                     |                          |                   |                                       |                             |                                      |                             |
| Loans to Individuals     | 408                 | 483                      | —                 | 409                                   | —                           | 413                                  | —                           |
| Other                    | —                   | —                        | —                 | —                                     | —                           | —                                    | —                           |
| Subtotal                 | 408                 | 483                      | —                 | 409                                   | —                           | 413                                  | —                           |
| With no allowance:       | \$ 5,362            | \$ 5,947                 | \$ —              | \$5,241                               | \$ 57                       | \$5,344                              | \$ 163                      |
| With an allowance:       |                     |                          |                   |                                       |                             |                                      |                             |
| Commercial:              |                     |                          |                   |                                       |                             |                                      |                             |
| Construction             | \$ —                | \$ —                     | \$ —              | \$ —                                  | \$ —                        | \$ —                                 | \$ —                        |
| Commercial Business      | 3,257               | 3,359                    | 431               | 3,422                                 | 2                           | 3,376                                | 50                          |
| Commercial Real Estate   | 3,905               | 3,905                    | 71                | 4,796                                 | 55                          | 4,376                                | 169                         |
| Mortgage Warehouse Lines | —                   | —                        | —                 | —                                     | —                           | —                                    | —                           |
| Subtotal                 | 7,162               | 7,264                    | 502               | 8,218                                 | 57                          | 7,752                                | 219                         |
| Residential Real Estate  | —                   | —                        | —                 | —                                     | —                           | —                                    | —                           |
| Consumer:                |                     |                          |                   |                                       |                             |                                      |                             |
| Loans to Individuals     | —                   | —                        | —                 | —                                     | —                           | —                                    | —                           |
| Other                    | —                   | —                        | —                 | —                                     | —                           | —                                    | —                           |
| Subtotal                 | —                   | —                        | —                 | —                                     | —                           | —                                    | —                           |
| With an allowance:       | \$ 7,162            | \$ 7,264                 | \$ 502            | \$8,218                               | \$ 57                       | \$7,752                              | \$ 219                      |
| Total:                   |                     |                          |                   |                                       |                             |                                      |                             |
| Construction             | 104                 | 104                      | —                 | 104                                   | 2                           | 118                                  | 6                           |
| Commercial Business      | 4,139               | 4,438                    | 431               | 4,444                                 | 30                          | 4,577                                | 133                         |
| Commercial Real Estate   | 6,711               | 6,944                    | 71                | 7,353                                 | 82                          | 7,246                                | 243                         |
| Mortgage Warehouse Lines | —                   | —                        | —                 | —                                     | —                           | —                                    | —                           |
| Residential Real Estate  | 1,162               | 1,242                    | —                 | 1,149                                 | —                           | 742                                  | —                           |
| Consumer                 | 408                 | 483                      | —                 | 409                                   | —                           | 413                                  | —                           |
| Total                    | \$ 12,524           | \$ 13,211                | \$ 502            | \$13,459                              | \$ 114                      | \$13,096                             | \$ 382                      |

## Impaired Loans Receivables (By Class)

|                          | December 31, 2017      |                                |                      |
|--------------------------|------------------------|--------------------------------|----------------------|
| (Dollars in thousands)   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
| With no allowance:       |                        |                                |                      |
| Commercial:              |                        |                                |                      |
| Construction             | \$232                  | \$232                          | \$ —                 |
| Commercial Business      | 1,271                  | 1,419                          | —                    |
| Commercial Real Estate   | 1,348                  | 1,372                          | —                    |
| Mortgage Warehouse Lines | —                      | —                              | —                    |
| Subtotal                 | 2,851                  | 3,023                          | —                    |
| Residential Real Estate  | 69                     | 123                            | —                    |
| Consumer:                |                        |                                |                      |
| Loans to Individuals     | 368                    | 438                            | —                    |
| Other                    | —                      | —                              | —                    |
| Subtotal                 | 368                    | 438                            | —                    |
| With no allowance        | \$3,288                | \$3,584                        | \$ —                 |
| With an allowance:       |                        |                                |                      |
| Commercial:              |                        |                                |                      |
| Construction             | \$—                    | \$—                            | \$ —                 |
| Commercial Business      | 3,462                  | 3,464                          | 592                  |
| Commercial Real Estate   | 4,955                  | 5,748                          | 92                   |
| Mortgage Warehouse Lines | —                      | —                              | —                    |
| Subtotal                 | 8,417                  | 9,212                          | 684                  |
| Residential Real Estate  | —                      | —                              | —                    |
| Consumer:                |                        |                                |                      |
| Loans to Individuals     | —                      | —                              | —                    |
| Other                    | —                      | —                              | —                    |
| Subtotal                 | —                      | —                              | —                    |
| With an allowance        | \$8,417                | \$9,212                        | \$ 684               |
| Total:                   |                        |                                |                      |
| Construction             | 232                    | 232                            | —                    |
| Commercial Business      | 4,733                  | 4,883                          | 592                  |
| Commercial Real Estate   | 6,303                  | 7,120                          | 92                   |
| Mortgage Warehouse Lines | —                      | —                              | —                    |
| Residential Real Estate  | 69                     | 123                            | —                    |
| Consumer                 | 368                    | 438                            | —                    |
| Total                    | \$11,705               | \$12,796                       | \$ 684               |

## Impaired Loans Receivables (By Class)

| (Dollars in thousands)   | Three Months Ended<br>September 30, 2017 |                        | Nine Months Ended<br>September 30, 2017 |                        |
|--------------------------|--|------------------------|---|------------------------|
|                          | Average<br>Investment                    | Interest<br>Recognized | Average<br>Investment                   | Interest<br>Recognized |
| With no allowance:       |  |                        |   |                        |
| Commercial:              |  |                        |   |                        |
| Construction             | \$231                                    | \$ 3                   | \$201                                   | \$ 9                   |
| Commercial Business      | 693                                      | 25                     | 725                                     | 123                    |
| Commercial Real Estate   | 2,880                                    | 18                     | 2,808                                   | 128                    |
| Mortgage Warehouse Lines | —  | —                      | —                                       | —                      |
| Subtotal                 | 3,804                                    | 46                     | 3,734                                   | 260                    |
| Residential Real Estate  | 76                                       | —                      | 166                                     | —                      |
| Consumer:                |  |                        |   |                        |
| Loans to Individuals     | 366                                      | —                      | 332                                     | —                      |
| Other                    | —  | —                      | —                                       | —                      |
| Subtotal                 | 366                                      | —                      | 332                                     | —                      |
| With no allowance:       | \$4,246                                  | \$ 46                  | \$4,232                                 | \$ 260                 |
| With an allowance:       |  |                        |   |                        |
| Commercial:              |  |                        |   |                        |
| Construction             | \$—                                      | \$ —                   | \$114                                   | \$ —                   |
| Commercial Business      | 3,045                                    | 44                     | 2,745                                   | 171                    |
| Commercial Real Estate   | 3,092                                    | 44                     | 2,764                                   | 129                    |
| Mortgage Warehouse Lines | —  | —                      | —                                       | —                      |
| Subtotal                 | 6,137                                    | 88                     | 5,623                                   | 300                    |
| Residential Real Estate  | —  | —                      | 100                                     | —                      |
| Consumer:                |  |                        |   |                        |
| Loans to Individuals     | —  | —                      | —                                       | —                      |
| Other                    | —  | —                      | —                                       | —                      |
| Subtotal                 | —  | —                      | —                                       | —                      |
| With an allowance:       | \$6,137                                  | \$ 88                  | \$5,723                                 | \$ 300                 |
| Total:                   |  |                        |   |                        |
| Construction             | 231                                      | 3                      | 315                                     | 9                      |
| Commercial Business      | 3,738                                    | 69                     | 3,470                                   | 294                    |
| Commercial Real Estate   | 5,972                                    | 62                     | 5,572                                   | 257                    |
| Mortgage Warehouse Lines | —  | —                      | —                                       | —                      |
| Residential Real Estate  | 76                                       | —                      | 266                                     | —                      |
| Consumer                 | 366                                      | —                      | 332                                     | —                      |
| Total                    | \$10,383                                 | \$ 134                 | \$9,955                                 | \$ 560                 |

### Purchased Credit-Impaired Loans

Purchased credit-impaired loans (“PCI”) are loans acquired at a discount that are due in part to credit quality. On April 11, 2018, as part of the NJCB acquisition, the Company acquired purchased credit-impaired loans with loan balances totaling \$1.1 million and fair values totaling \$881,000. The following table presents additional information regarding purchased credit-impaired loans at September 30, 2018 and December 31, 2017:

| (Dollars in thousands) | September 30, December 31, |        |
|------------------------|----------------------------|--------|
|                        | 2018                       | 2017   |
| Outstanding balance    | \$ 2,050                   | \$ 998 |
| Carrying amount        | \$ 1,745                   | \$ 864 |

Changes in accretible discount for purchased credit-impaired loans for the three and nine months ended September 30, 2018 and September 30, 2017 were as follows:

| (Dollars in thousands)                | Three months ended |       | Nine months ended |       |
|---------------------------------------|--------------------|-------|-------------------|-------|
|                                       | September 30,      |       | September 30,     |       |
|                                       | 2018               | 2017  | 2018              | 2017  |
| Balance at beginning of period        | \$233              | \$171 | \$126             | \$30  |
| Acquisition of impaired loans         | —                  | —     | 168               | —     |
| Transfer from non-accretible discount | —                  | —     | —                 | 161   |
| Accretion of discount                 | (34 )              | (23 ) | (95 )             | (43 ) |
| Balance at end of period              | \$199              | \$148 | \$199             | \$148 |

### 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):

| September 30, 2018  | December 31, 2017   |
|---------------------|---------------------|
| Number of loans     | Number of loans     |
| Recorded Investment | Recorded Investment |
| 4 \$ 821            | 1 \$ 77             |

At September 30, 2018, there was one residential property with a fair value of \$1.1 million held in other real estate owned. At December 31, 2017, there were no residential properties held in other real estate owned.

### Troubled Debt Restructurings

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 to re-amortize or extend 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 two commercial real estate loans with an aggregate pre- and post-modified recorded investment of \$1.0 million and one commercial business loan with a pre- and post-modified recorded investment of \$135,000 that were each modified as a TDR during the three and nine months ended September 30, 2018. There was one commercial real estate loan with a pre- and post-modification recorded investment of \$2.3 million that was modified as a TDR during the nine months ended September 30, 2017. There were no troubled debt restructurings that subsequently defaulted within twelve months of restructuring during the nine months ended September 30, 2018. There were no troubled debt restructuring that defaulted within twelve months of restructuring during the nine months ended September 30, 2017.

#### (6) Revenue from Contracts with Customers

All of the Company's revenue from contracts with customers in the scope of ASC 606 is recognized within non-interest income. The following table presents the Company's sources of non-interest income for the three and nine months ended September 30, 2018 and 2017. Items outside the scope of ASC 606 are noted as such.

| (Dollars in thousands)   | Three months ended |                    | Nine months ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2018 | September 30, 2017 | September 30, 2018 | September 30, 2017 |
| Service charges on deposits:                                       |                    |                    |                    |                    |
| Overdraft fees   | \$96               | \$ 71              | \$257              | \$ 222             |
| Other  | 77                 | 71                 | 219                | 223                |
| Interchange income   | 119                | 118                | 294                | 257                |
| Other income - in scope  | 89                 | 84                 | 418                | 213                |
| Income on BOLI <sup>(1)</sup>                                      | 152                | 131                | 425                | 391                |
| Net gains on sales of loans <sup>(1)</sup>                         | 1,292              | 1,329              | 3,425              | 3,936              |
| Loan servicing fees <sup>(1)</sup>                                 | 174                | 143                | 482                | 426                |
| Net gains (losses) on sales and calls of securities <sup>(1)</sup> | —                  | 24                 | 12                 | 128                |
| Gain from bargain purchase <sup>(1)</sup>                          | —                  | —                  | 184                | —                  |
| Other income <sup>(1)</sup>  | 155                | 145                | 366                | 489                |
|  | \$2,154            | \$ 2,116           | \$6,082            | \$ 6,285           |

<sup>(1)</sup> Not within the scope of ASC 606

A description of the Company's revenue streams accounted for under ASC 606 follows:

**Service Charges on Deposit Accounts:** The Company earns fees from its deposit account customers for transaction-based, account maintenance and overdraft services. Transaction-based fees, which include services such as ATM use fees, stop payment charges, statement rendering and ACH fees, are recognized at the time the transaction is executed as that is the point in time the Company fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer's account balance.

**Interchange Income:** The Company earns interchange fees from debit cardholder transactions conducted through the Visa payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder.

**Other Income:** The Company earns other fees from the execution of and receipt of wire transfers for customers, the rental of safe deposit boxes and fees for other services provided to customers. These fees are recognized at the time the transaction is executed or the service is provided as that is the point in time the Company fulfills the customer's request.

**Gain or Loss on Sales of OREO:** The Company records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. The Company generally does not finance the sale of OREO to the buyer; however, in determining the gain or loss on the sale, the Company adjusts the transaction price and related gain or loss on sale if a significant financing component is present. There were no sales of OREO during the three and nine months ended September 30, 2018 or 2017.

## (7) Share-Based Compensation

The Company's share-based incentive plans ("Stock Plans") authorize the issuance of an aggregate of 485,873 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").

As of September 30, 2018, there were 55,136 shares of common stock available for future grants under the Stock Plans.

The following table summarizes stock option activity during the nine months ended September 30, 2018:

| (Dollars in thousands, except share amounts) | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value |
|--|------------------|---------------------------------|---|---------------------------|
| Outstanding at January 1, 2018               | 142,005          | \$ 7.86                         |   |                           |
| Granted                                      | 10,450           | 18.30                           |   |                           |
| Exercised                                    | (9,307 )         | 7.01                            |   |                           |
| Outstanding at September 30, 2018            | 143,148          | \$ 8.68                         | 4.2   | \$ 1,721                  |
| Exercisable at September 30, 2018            | 124,132          | \$ 7.48                         | 3.5   | \$ 1,641                  |

The fair value of each option and the significant weighted average assumptions used to calculate the fair value of the options granted for the nine months ended September 30, 2018 were as follows:

Fair value of options granted \$5.93

Risk-free rate of return 2.46 %

Expected option life in years 7

Expected volatility 31.35 %

Expected dividends 1.18 %

Share-based compensation expense related to options was \$45,000 and \$44,000 for the nine months ended September 30, 2018 and 2017, respectively. As of September 30, 2018, there was approximately \$82,000 of unrecognized compensation cost related to non-vested stock options.

The following table summarizes the activity in non-vested restricted shares for the nine months ended September 30, 2018:

| (Dollars in thousands, except share amounts) | Number of Shares | Average Grant-Date Fair Value |
|--|------------------|-------------------------------|
| Outstanding at January 1, 2018               | 150,745          | \$ 11.87                      |
| Granted                                      | 62,150           | 20.19                         |
| Vested                                       | (65,345 )        | 16.76                         |
| Non-vested at September 30, 2018             | 147,550          | \$ 13.21                      |

Share-based compensation expense related to stock grants was \$714,000 and \$695,000 for the nine months ended September 30, 2018 and 2017, respectively. As of September 30, 2018, there was approximately \$1.8 million of unrecognized compensation cost related to non-vested stock grants.

## (8) Benefit Plans

The Bank has a 401(k) plan that 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. At September 30, 2018 and December 31, 2017, the Company's President and Chief Executive Officer was the only eligible participant in the supplemental executive retirement plans.

In connection with the benefit plans, the Bank has life insurance policies on the lives of its executives, directors and employees. The Bank is the owner and beneficiary of these policies. The cash surrender values of these policies totaled approximately \$28.6 million and \$25.1 million at September 30, 2018 and December 31, 2017, respectively.

The components of net periodic expense for the Company's supplemental executive retirement plans for the three and nine months ended September 30, 2018 and 2017 were as follows:

|                           | Three<br>Months<br>Ended<br>September<br>30, |       | Nine Months<br>Ended<br>September<br>30, |       |
|---------------------------|--|-------|--|-------|
| (Dollars in thousands)    | 2018   | 2017  | 2018                                     | 2017  |
| Service cost              | \$53   | \$67  | \$140                                    | \$178 |
| Interest cost             | 43   | 39    | 114                                      | 117   |
| Actuarial gain recognized | (15 )  | (32 ) | (45 )                                    | (75 ) |
| Total                     | \$81   | \$74  | \$209                                    | \$220 |

## (9) Other Comprehensive Income (Loss) and Accumulated Other Comprehensive 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 loss, and the related tax effects, are as follows:

|   | September 30, 2018   |                         |                      |
|---|----------------------|-------------------------|----------------------|
| (Dollars in thousands)  | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
| Net unrealized holding losses on investment securities available for sale | \$(2,598)            | \$ 624                  | \$(1,974 )           |
| Unrealized impairment loss on held to maturity security                   | (501 )               | 119                     | (382 )               |
| Gains on unfunded pension liability                                       | 244                  | (69 )                   | 175                  |
| Accumulated other comprehensive loss                                      | \$(2,855)            | \$ 674                  | \$(2,181 )           |
|   | December 31, 2017    |                         |                      |
| (Dollars in thousands)  | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
| Net unrealized holding losses on investment securities available for sale | \$(571)              | \$ 137                  | \$(434 )             |
| Unrealized impairment loss on held to maturity security                   | (501 )               | 119                     | (382 )               |

Edgar Filing: 1ST CONSTITUTION BANCORP - Form 10-Q

|                                      |         |        |   |           |
|--------------------------------------|---------|--------|---|-----------|
| Gains on unfunded pension liability  | 111     | (31    | ) | 80        |
| Accumulated other comprehensive loss | \$(961) | \$ 225 |   | \$ (736 ) |

27

---

Changes in the components of accumulated other comprehensive loss are as follows and are presented net of tax for the three and nine months ended September 30, 2018 and 2017:

| (Dollars in thousands)   | Unrealized  |   |                            |                                      |
|--|---|---|----------------------------|--------------------------------------|
|  | Unrealized Holding Gains/ (Losses) on Available for Sale Securities | Unrealized Impairment Loss on Held to Maturity Securities | Unfunded Pension Liability | Accumulated Other Comprehensive Loss |
| Balance - July 1, 2018   | \$ (1,587 )   | \$ (382 )   | \$ 122                     | \$ (1,847 )                          |
| Other comprehensive income (loss) before reclassifications       | (387 )  | —   | 64                         | (323 )                               |
| Amounts reclassified from accumulated other comprehensive income | —   | —   | (11 )                      | (11 )                                |
| Reclassification adjustment for gains realized in income         | —   | —   | —                          | —                                    |
| Other comprehensive loss   | (387 )  | —   | 53                         | (334 )                               |
| Balance - September 30, 2018                                     | \$ (1,974 )   | \$ (382 )   | \$ 175                     | \$ (2,181 )                          |
| Balance - July 1, 2017   | \$ 77   | \$ (331 )   | \$ 39                      | \$ (215 )                            |
| Other comprehensive income before reclassifications              | 11  | —   | —                          | 11                                   |
| Amounts reclassified from accumulated other comprehensive income | —   | —   | (19 )                      | (19 )                                |
| Reclassification adjustment for gains realized in income         | (7 )  | —   | —                          | (7 )                                 |
| Other comprehensive income (loss)                                | 4   | —   | (19 )                      | (15 )                                |
| Balance - September 30, 2017                                     | \$ 81   | \$ (331 )   | \$ 20                      | \$ (230 )                            |
|  |   |   |                            |                                      |
| (Dollars in thousands)   | Unrealized  |   |                            |                                      |
|  | Unrealized Holding Gains/ (Losses) on Available for Sale Securities | Unrealized Impairment Loss on Held to Maturity Securities | Unfunded Pension Liability | Accumulated Other Comprehensive Loss |
| Balance January 1, 2018  | \$ (434 )   | \$ (382 )   | \$ 80                      | \$ (736 )                            |
| Other comprehensive income (loss) before reclassifications       | (1,531 )  | —   | 128                        | (1,403 )                             |
| Amounts reclassified from accumulated other comprehensive income | —   | —   | (33 )                      | (33 )                                |
| Reclassification adjustment for gains realized in income         | (9 )  | —   | —                          | (9 )                                 |
| Other comprehensive income (loss)                                | (1,540 )  | —   | 95                         | (1,445 )                             |
| Balance September 30, 2018                                       | \$ (1,974 )   | \$ (382 )   | \$ 175                     | \$ (2,181 )                          |
| Balance January 1, 2017  | \$ (334 )   | \$ (331 )   | \$ 65                      | \$ (600 )                            |
| Other comprehensive income before reclassifications              | 470   | —   | —                          | 470                                  |
| Amounts reclassified from accumulated other comprehensive income | —   | —   | (45 )                      | (45 )                                |

Edgar Filing: 1ST CONSTITUTION BANCORP - Form 10-Q

|  |       |   |         |   |       |         |   |
|--|-------|---|---------|---|-------|---------|---|
| Reclassification adjustment for gains realized in income | (55   | ) | —       | — | (55   | )       |   |
| Other comprehensive income (loss)                        | 415   | — | (45     | ) | 370   |         |   |
| Balance September 30, 2017                               | \$ 81 |   | \$ (331 | ) | \$ 20 | \$ (230 | ) |

28

---

(10) Recent Accounting Pronouncements

ASU 2018-15 - Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40)

In August 2018, the FASB issued ASU 2018-15, “Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement,” to help entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement (hosting arrangement) by providing guidance for determining when the arrangement includes a software license.

The amendments in this Update align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal use software license). The accounting for the service element of a hosting arrangement that is a service contract is not affected by the amendments in this Update.

The amendments in this ASU also require the entity (customer) to expense the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement. The term of the hosting arrangement includes the non-cancellable period of the arrangement plus periods covered by (1) an option to extend the arrangement if the customer is reasonably certain to exercise that option, (2) an option to terminate the arrangement if the customer is reasonably certain not to exercise the termination option, and (3) an option to extend (or not to terminate) the arrangement in which exercise of the option is in the control of the vendor. The entity also is required to apply the existing impairment guidance in Subtopic 350-40 to the capitalized implementation costs as if the costs were long-lived assets.

The amendments in this ASU also require the entity to present the expense related to the capitalized implementation costs in the same line item in the statement of income as the fees associated with the hosting element (service) of the arrangement and classify payments for capitalized implementation costs in the statement of cash flows in the same manner as payments made for fees associated with the hosting element. The entity is also required to present the capitalized implementation costs in the statement of financial position in the same line item that a prepayment for the fees of the associated hosting arrangement would be presented.

The Company is currently evaluating the potential impact, if any, of adopting this ASU on its financial statements. The provisions of this ASU are effective for fiscal years beginning after December 15, 2019.

ASU 2018-14 - Compensation - Retirement Benefits - Defined Benefit Plans - General (Subtopic 715-20)

In August 2018, the FASB issued ASU 2018-14 - “Compensation - Retirement Benefits - Defined Benefit Plans - General (Subtopic 715-20),” which consist of amendments to the disclosure framework project to improve the effectiveness of disclosures in the notes to the financial statements. The amendments in this Update modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans.

The following disclosure requirements are removed from Subtopic 715-20:

1. The amounts in accumulated other comprehensive income expected to be recognized as components of net periodic benefit cost over the next fiscal year;
2. The amount and timing of plan assets expected to be returned to the employer;
3. The disclosures related to the June 2001 amendments to the Japanese Welfare Pension Insurance Law.
4. Related party disclosures about the amount of future annual benefits covered by insurance and annuity contracts and significant transactions between the employer or related parties and the plan;
5. For nonpublic entities, the reconciliation of the opening balances to the closing balances of plan assets measured on a recurring basis in Level 3 of the fair value hierarchy. However, nonpublic entities will be required to disclose separately the amounts of transfers into and out of Level 3 of the fair value hierarchy and purchases of Level 3 plan

assets; and

29

---

For public entities, the effects of a one-percentage point change in assumed health care cost trend rates on the (a) 6. aggregate of the service and interest cost components of net periodic benefit costs and (b) benefit obligation for postretirement health care benefits.

The following disclosure requirements are added to Subtopic 715-20:

1. The weighted-average interest crediting rates for cash balance plans and other plans with promised interest crediting rates; and
2. An explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period.

The amendments in this ASU also clarify the disclosure requirements in paragraph 715-20-50-3, which state that the following information for defined benefit pension plans should be disclosed:

1. The projected benefit obligation (“PBO”) and fair value of plan assets for plans with PBOs in excess of plan assets; and
2. The accumulated benefit obligation (“ABO”) and fair value of plan assets for plans with ABOs in excess of plan assets.

The amendments in this ASU remove disclosures that no longer are considered cost beneficial, clarify the specific requirements of disclosures and add disclosure requirements identified as relevant. Although narrow in scope, the amendments are considered an important part of the FASB’s efforts to improve the effectiveness of disclosures in the notes to financial statements by applying concepts in the Concepts Statement.

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2020. The Company does not expect the adoption of this guidance to have a material impact on the Company’s consolidated financial statements.

#### ASU 2018-13 - Fair Value Measurement (Topic 820)

In August 2018 the FASB issued ASU 2018-13, “Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement,” which modifies the disclosure requirements on fair value measurements. The following disclosure requirements that are applicable to public entities were removed from Topic 820:

1. The amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy;
2. The policy for timing of transfers between levels; and
3. The valuation process for Level 3 fair value measurements.

The following disclosure requirements were modified in Topic 820:

1. In lieu of a roll-forward for Level 3 fair value measurements, a nonpublic entity is required to disclose transfers into and out of Level 3 of the fair value hierarchy and purchases and issues of Level 3 assets and liabilities;  
For investments in certain entities that calculate net asset value, an entity is required to disclose the timing of
2. liquidation of an investee’s assets and the date when restrictions from redemption might lapse only if the investee has communicated the timing to the entity or announced the timing publicly; and
3. The amendments clarify that the measurement uncertainty disclosure is to communicate information about the uncertainty in measurement as of the reporting date.

The following disclosure requirements were added to Topic 820; however, the disclosures are not required for nonpublic entities:

The changes in unrealized gains and losses for the period included in other comprehensive income for recurring  
1. Level 3 fair value measurements held at the end of the reporting period; and

30

---

The range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements. For certain unobservable inputs, an entity may disclose other quantitative information (such as the 2. median or arithmetic average) in lieu of the weighted average if the entity determines that other quantitative information would be a more reasonable and rational method to reflect the distribution of unobservable inputs used to develop Level 3 fair value measurements.

In addition, the amendments eliminate “at a minimum” from the phrase “an entity shall disclose at a minimum” to promote the appropriate exercise of discretion by entities when considering fair value measurement disclosures and to clarify that materiality is an appropriate consideration of entities and their auditors when evaluating disclosure requirements.

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those years. The Company does not expect the adoption of this guidance to have a material impact on the Company’s consolidated financial statements.

#### ASU 2018-11 - Leases - Targeted Improvements (Topic 842)

In July, 2018 the FASB issued ASU 2018-11, “Leases-Targeted Improvements,” which provides an additional (and optional) transition method for a cumulative effect adjustment. The additional transition method allows entities to initially apply the new lease standard at the adoption date (January 1, 2019 for calendar-year-end public business entities) and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. This additional transition method changes only when an entity is required to initially apply the transition requirements of the new leases standard; it does not change how those requirements apply. An entity’s reporting for the comparative periods presented in the financial statements in which it adopts the new lease standard will continue to be in accordance with current U.S. GAAP (Topic 840, Leases).

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those years. The Company is evaluating the impact of this ASU in connection with the evaluation of the impact of the adoption of ASU 2016-02-, “Leases.”

#### ASU 2018-07 - Compensation - Stock Compensation (Topic 718)

In June 2018, the FASB issued ASU 2018-07, “Compensation-Stock Compensation,” which expands the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from non-employees.

The amendments specify that Topic 718 applies to all share-based payment transactions in which a grantor acquires goods or services to be used or consumed in a grantor’s own operations by issuing share-based payment awards. The amendment also clarifies that Topic 718 does not apply to share-based payments used to effectively provide (1) financing to the issuer or (2) awards granted in conjunction with selling goods or services to customers as part of a contract accounted for under Topic 606, “Revenue from Contracts with Customers.”

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those years. Early adoption is permitted, including adoption in an interim period. 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 the interim period.

The Company does not expect the adoption of this guidance to have a material impact on the Company’s consolidated financial statements.

#### ASU 2017-08 - Premium Amortization on Purchased Callable Debt Securities

In March 2017, the FASB issued ASU 2017-08, "Premium Amortization on Purchased Callable Debt Securities," which shortens the amortization period for premiums on purchased callable debt securities to the earliest call date (i.e., yield-to-earliest call amortization) rather than amortizing over the full contractual term. The ASU does not change the accounting for securities held at a discount.

The amendments apply to callable debt securities with explicit, non-contingent call features that are callable at fixed prices and on preset dates. If a security may be prepaid based upon prepayments of the underlying loans and not because the issuer exercised a date specific call option, it is excluded from the scope of the new standard. However, for instruments with contingent call features, once the contingency is resolved and the security is callable at a fixed price and preset date, the security is within the scope of the amendments. Further, the amendments apply to all premiums on callable debt securities, regardless of how they were generated.

The amendments require companies to reset the effective yield using the payment terms of the debt security if the call option is not exercised on the earliest call date. If the security has additional future call dates, any excess of the amortized cost basis over the amount repayable by the issuer at the next call date should be amortized to the next call date.

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those years. Early adoption is permitted, including adoption in an interim period. 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 the interim period.

The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

#### ASU 2017-04 - Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment

In January 2017, the FASB issued ASU 2017-04, "Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment," which simplifies how all entities assess goodwill for impairment by eliminating Step 2 from the goodwill impairment test. As amended, the goodwill impairment test will consist of one step comparing the fair value of a reporting unit with its carrying amount. An entity should recognize a goodwill impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. The primary goal of this ASU is to simplify the goodwill impairment test and provide cost savings for all entities by removing the requirement to determine the fair value of individual assets and liabilities in order to calculate a reporting unit's "implied" goodwill under current U.S. GAAP.

For the Company, the provisions of this ASU are effective for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. The amendments should be adopted prospectively. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017.

The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

#### ASU 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 to be 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 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 the Company, the provisions of this ASU 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 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 adoption of this guidance on its consolidated financial statements and has determined that the provisions of ASU 2016-02 will result in an increase in assets to recognize the present value of the lease obligations (right-of-use assets) with a corresponding increase in liabilities. The initial measurement of the right-of-use asset and the corresponding liability will be affected by certain key assumptions, such as expectations of renewals or extensions of leases and the interest rate to be used to discount the future lease obligations. The Company has completed a review and inventory of its lease portfolio and expects to implement lease accounting software to account for the leases by the end of the fourth quarter of 2018. The total impact of the new standard will be affected by any new leases that are executed, leases that are terminated prior to the effective date and any leases with changes to key assumptions or expectations, such as renewals and extensions and discount rates. The Company is evaluating the effective date transition method as described in ASU 2018-11.

#### (11) 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.

**Interest Rate Lock Derivatives.** Interest rate lock commitments do not trade in active markets with readily observable prices. The fair value of an interest rate lock commitment is estimated based upon the forward sales price that is obtained in the best efforts commitment at the time the borrower locks in the interest rate on the loan and the probability that the locked rate commitment will close.

**Impaired loans.** Impaired loans 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"), thereby 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 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:

|   | September 30, 2018 |                   |                   |                        |
|---|--------------------|-------------------|-------------------|------------------------|
| (Dollars in thousands)  | Level 1<br>Inputs  | Level 2<br>Inputs | Level 3<br>Inputs | Total<br>Fair<br>Value |
| Securities available for sale:  |                    |                   |                   |                        |
| U.S. Treasury securities and obligations of U.S. Government sponsored entities ("GSE") and agencies | \$998              | \$2,917           | \$                | -\$3,915               |
| Residential collateralized mortgage obligations - GSE   | —                  | 44,269            | —                 | 44,269                 |
| Residential mortgage backed securities - GSE  | —                  | 14,562            | —                 | 14,562                 |
| Obligations of state and political subdivisions   | —                  | 23,332            | —                 | 23,332                 |
| Trust preferred debt securities - single issuer   | —                  | 1,406             | —                 | 1,406                  |
| Corporate debt securities   | 16,380             | 11,437            | —                 | 27,817                 |
| Other debt securities   | —                  | 15,891            | —                 | 15,891                 |
| Interest rate lock derivative   | —                  | 120               | —                 | 120                    |
| Total   | \$17,378           | \$113,934         | \$                | -\$131,312             |

| (Dollars in thousands)  | December 31, 2017 |                   |                   |                        |
|---|-------------------|-------------------|-------------------|------------------------|
|   | Level 1<br>Inputs | Level 2<br>Inputs | Level 3<br>Inputs | Total<br>Fair<br>Value |
| Securities available for sale:  |                   |                   |                   |                        |
| U.S. Treasury securities and obligations of U.S. Government sponsored entities ("GSE") and agencies | \$—               | \$1,967           | \$—               | —\$1,967               |
| Residential collateralized mortgage obligations - GSE   | —                 | 27,325            | —                 | 27,325                 |
| Residential mortgage backed securities - GSE  | —                 | 14,288            | —                 | 14,288                 |
| Obligations of state and political subdivisions   | —                 | 19,720            | —                 | 19,720                 |
| Trust preferred debt securities - single issuer   | —                 | 2,349             | —                 | 2,349                  |
| Corporate debt securities   | 16,080            | 11,603            | —                 | 27,683                 |
| Other debt securities   | —                 | 12,126            | —                 | 12,126                 |
| Interest rate lock derivative   | —                 | 135               | —                 | 135                    |
| Total   | \$16,080          | \$89,513          | \$—               | —\$105,593             |

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 liabilities subject to fair value adjustments (impairment) on a nonrecurring basis for the nine months ended September 30, 2018 and the twelve months ended December 31, 2017 were as follows:

| (Dollars in thousands)  | Level 1<br>Inputs | Level 2<br>Inputs | Level 3<br>Inputs | Total<br>Fair<br>Value |
|-------------------------|-------------------|-------------------|-------------------|------------------------|
| September 30, 2018      |                   |                   |                   |                        |
| Impaired loans          | \$—               | —\$               | —\$9,992          | \$9,992                |
| Other real estate owned | —                 | —                 | 1,460             | 1,460                  |
| December 31, 2017       |                   |                   |                   |                        |
| Impaired loans          | \$—               | —\$               | —\$8,313          | \$8,313                |

Impaired loans measured at fair value and included in the above table at September 30, 2018 consisted of 21 loans having an aggregate recorded investment of \$10.5 million and specific loan loss allowance of \$502,000. Impaired loans measured at fair value and included in the above table at December 31, 2017 consisted of 14 loans having an aggregate balance of \$9.0 million with specific loan loss allowance of \$684,000.

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:

| (Dollars in thousands)  | Fair<br>Value<br>Estimate | Valuation<br>Techniques                | Unobservable Input                   | Range<br>(Weighted Average) |
|-------------------------|---------------------------|--|--------------------------------------|-----------------------------|
| September 30, 2018      |                           |  |                                      |                             |
| Impaired loans          | \$ 9,992                  | Appraisal of collateral <sup>(1)</sup> | Appraisal adjustments <sup>(2)</sup> | 2.9% - 69% (14.15%)         |
| Other real estate owned | \$ 1,460                  | Appraisal of collateral (1)            | Appraisal adjustments <sup>(2)</sup> | 47% - 80% (63.5%)           |
| December 31, 2017       |                           |  |                                      |                             |
| Impaired loans          | \$ 8,313                  | Appraisal of collateral <sup>(1)</sup> | Appraisal adjustments <sup>(2)</sup> | 0.5%-100% (28.2%)           |

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

<sup>(2)</sup> 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 assets and liabilities are considered financial instruments. Many of

35

---

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.

The estimated fair values and carrying amounts of financial assets and liabilities as of September 30, 2018 and December 31, 2017 were as follows:

|                                    | September 30, 2018 |                |                |                |            |
|------------------------------------|--------------------|----------------|----------------|----------------|------------|
| (Dollars in thousands)             | Carrying Value     | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Fair Value |
| Cash and cash equivalents          | \$19,264           | \$19,264       | \$ —           | \$ —           | —\$19,264  |
| Securities available for sale      | 131,192            | 17,378         | 113,814        | —              | 131,192    |
| Securities held to maturity        | 91,379             | —              | 91,220         | —              | 91,220     |
| Loans held for sale                | 4,362              | —              | 4,681          | —              | 4,681      |
| Loans, net                         | 873,273            | —              | —              | 876,773        | 876,773    |
| SBA servicing asset                | 895                | —              | 1,016          | —              | 1,016      |
| Interest rate lock derivative      | 120                | —              | 120            | —              | 120        |
| Accrued interest receivable        | 3,652              | —              | 3,652          | —              | 3,652      |
| FHLB stock                         | 5,175              | —              | 5,175          | —              | 5,175      |
| Deposits                           | (941,677)          | —              | (939,054)      | —              | (939,054)  |
| Borrowings                         | (99,475 )          | —              | (99,475 )      | —              | (99,475 )  |
| Redeemable subordinated debentures | (18,577 )          | —              | (12,797 )      | —              | (12,797 )  |
| Accrued interest payable           | (927 )             | —              | (927 )         | —              | (927 )     |
|                                    | December 31, 2017  |                |                |                |            |
| (Dollars in thousands)             | Carrying Value     | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Fair Value |
| Cash and cash equivalents          | \$18,754           | \$18,754       | \$ —           | \$ —           | —\$18,754  |
| Securities available for sale      | 105,458            | 16,080         | 89,378         | —              | 105,458    |
| Securities held to maturity        | 110,267            | —              | 111,865        | —              | 111,865    |
| Loans held for sale                | 4,254              | —              | 4,539          | —              | 4,539      |
| Loans, net                         | 781,893            | —              | —              | 784,064        | 784,064    |
| SBA servicing asset                | 726                | —              | 1,016          | —              | 1,016      |
| Interest rate lock derivative      | 135                | —              | 135            | —              | 135        |
| Accrued interest receivable        | 3,478              | —              | 3,478          | —              | 3,478      |
| FHLB stock                         | 1,490              | —              | 1,490          | —              | 1,490      |
| Deposits                           | (922,006)          | —              | (920,732)      | —              | (920,732)  |
| Borrowings                         | (20,500 )          | —              | (20,500 )      | —              | (20,500 )  |
| Redeemable subordinated debentures | (18,557 )          | —              | (12,326 )      | —              | (12,326 )  |
| Accrued interest payable           | (804 )             | —              | (804 )         | —              | (804 )     |

Loan commitments and standby letters of credit as of September 30, 2018 and December 31, 2017 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 nine months ended September 30, 2018 and financial condition at September 30, 2018 is intended to help readers analyze the accompanying financial statements, notes and other supplemental information contained in this quarterly report. Results of operations for the three and nine month periods ended September 30, 2018 are not necessarily indicative of results to be attained for any other periods.

This discussion and analysis should be read in conjunction with the consolidated financial statements, notes and tables included elsewhere in this Quarterly Report on Form 10-Q for the three and nine month periods ended September 30, 2018 (this "Form 10-Q") 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, 2017, as filed with the SEC on March 19, 2018.

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>T1</sup> Constitution Investment Company of New Jersey, Inc., FCB Assets Holdings, Inc., 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 that 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 20 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.

On April 11, 2018, the Company and the Bank completed the merger of NJCB with and into the Bank. See Note 2 - Acquisition of New Jersey Community Bank - for further information.

When used in 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, 2017, which was filed with the SEC on March 19, 2018, 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. Other risks and uncertainties that could cause actual results to differ from those described above include, but are not limited to, the inability to retain NJCB’s customers and employees.

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.

## RESULTS OF OPERATIONS

Three and Nine Months Ended September 30, 2018 Compared to Three and Nine Months Ended September 30, 2017

### Summary

The Company reported net income of \$4.0 million and diluted earnings per share of \$0.46 for the three months ended September 30, 2018 compared to \$2.5 million, or \$0.30 per diluted share, for the three months ended September 30, 2017.

For the nine months ended September 30, 2018, the Company reported net income of \$8.7 million, or \$1.02 per diluted share, compared to net income of \$6.4 million, or \$0.76 per diluted share, for the nine months ended September 30, 2017.

Return on average assets and return on average equity were 1.34% and 12.89%, respectively, for the three months ended September 30, 2018 compared to return on average assets and return on average equity of 0.94% and 8.94%, respectively, for the three months ended September 30, 2017. Return on average assets and return on average equity were 1.03% and 9.94%, respectively, for the nine months ended September 30, 2018 compared to return on average assets and return on average equity of 0.83% and 7.87%, respectively, for the nine months ended September 30, 2017. Book value and tangible book value per share were \$14.73 and \$13.26, respectively, at September 30, 2018 compared

to \$13.81 and \$12.27, respectively, at December 31, 2017.

On April 11, 2018, the Company completed the merger of NJCB with and into the Bank (the “NJCB merger”). As a result of the NJCB merger, merger related expenses of \$2.1 million were incurred primarily in the second quarter of 2018 and the after-tax effect of the merger expenses reduced net income for the nine months ended September 30, 2018 by \$1.6 million. The acquisition method of accounting for the business combination resulted in the recognition of a gain from the bargain purchase of \$184,000 and no goodwill.

For the nine months ended September 30, 2018, net income was \$8.7 million and Adjusted Net Income, which is net income excluding the after-tax effect of the merger expenses and the gain from the bargain purchase, was \$10.1 million compared to net income of \$6.4 million for the nine months ended September 30, 2017. There were no merger related expenses incurred for the three and nine months ended September 30, 2017. For the nine months ended September 30, 2018, diluted earnings per share were \$1.02 and Adjusted Net Income per diluted share was \$1.18 compared to diluted earnings per share of \$0.76 for the nine months ended September 30, 2017.

Adjusted Net Income, Adjusted Net Income per diluted share, adjusted return on average assets and adjusted return on average equity are non-U.S. GAAP financial measures. These non-U.S. GAAP financial measures should be considered in addition to, but not as a substitute for, the Company's U.S. GAAP financial results. A reconciliation of these non-U.S. GAAP financial measures to the U.S. GAAP financial results is set forth below. Management believes that the presentation of these non-U.S. GAAP financial measures of the Company may be helpful to readers in understanding the Company's financial performance without including the financial impact of the NJCB merger when comparing the Company's income statement for the three and nine-month periods ended September 30, 2018 and 2017.

The following table reflects the reconciliation of non-U.S. GAAP measures for the three and nine months ended September 30, 2018 and 2017:

| (Dollars in thousands, except per share data)   | Three months ended |                    | Nine months ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2018 | September 30, 2017 | September 30, 2018 | September 30, 2017 |
| Adjusted Net Income                             |                    |                    |                    |                    |
| Net income                                      | \$4,011            | \$2,485            | \$8,735            | \$6,353            |
| Adjustments:                                    |                    |                    |                    |                    |
| Merger-related expenses                         | —                  | —                  | 2,141              | —                  |
| Gain from bargain purchase                      | —                  | —                  | (184)              | —                  |
| Income tax effect of adjustments <sup>(1)</sup> | —                  | —                  | (568)              | —                  |
| Adjusted Net Income <sup>(2)</sup>              | \$4,011            | \$2,485            | \$10,124           | \$6,353            |
| Adjusted Net Income per diluted share           |                    |                    |                    |                    |
| Adjusted net income                             |                    |                    | \$10,124           | \$6,353            |
| Diluted shares outstanding                      |                    |                    | 8,565,401          | 8,309,363          |
| Adjusted Net Income per diluted share           |                    |                    | \$1.18             | \$0.76             |
| Adjusted return on average assets               |                    |                    |                    |                    |
| Adjusted Net Income                             |                    |                    | \$10,124           | \$6,353            |
| Average assets                                  |                    |                    | 1,132,045          | 1,021,645          |
| Adjusted return on average assets               |                    |                    | 1.20               | % 0.83 %           |
| Adjusted return on average equity               |                    |                    |                    |                    |
| Adjusted net income                             |                    |                    | \$10,124           | \$6,353            |
| Average equity                                  |                    |                    | 117,484            | 107,871            |
| Return on average equity                        |                    |                    | 11.52              | % 7.87 %           |
| Book value and tangible book value per share    |                    |                    |                    |                    |
| Shareholders' equity                            |                    |                    | \$123,774          | 111,610            |
| Less: goodwill and intangible assets            |                    |                    | 12,294             | 12,591             |
| Tangible shareholders' equity                   |                    |                    | 111,480            | 99,019             |
| Shares outstanding                              |                    |                    | 8,404,292          | 8,069,560          |
| Book value per share                            |                    |                    | \$14.73            | \$13.83            |
| Tangible book value per share                   |                    |                    | \$13.26            | \$12.27            |

(1) Tax effected at an income tax rate of 30.09%, less the impact of non-deductible merger expenses and the non-taxable gain from the bargain purchase.

(2) There were no non-U.S. GAAP adjustments for the three months ended September 30, 2018 and the three and nine-month periods ended September 30, 2017.

### THIRD QUARTER 2018 HIGHLIGHTS

Return on average assets and return on average equity were 1.34% and 12.89%, respectively.

Book value per share and tangible book value per share were \$14.73 and \$13.26, respectively, at September 30, 2018.

Net interest income was \$11.4 million and the net interest margin was 4.09% on a tax equivalent basis.

A provision for loan losses of \$225,000 and net charge-offs of \$458,000 were recorded.

Total loans were \$881.5 million at September 30, 2018 and included \$68.9 million of loans acquired in the NJCB merger. Commercial business, commercial real estate and construction loans totaled \$626.6 million and included \$56.0 million of loans acquired in the NJCB merger. Excluding the loans acquired in the NJCB merger, commercial business, commercial real estate and construction loans totaled \$565.8 million and increased \$27.6 million, or 5.1%, compared to \$538.2 million at December 31, 2017 and increased \$52.8 million, or 10.3%, compared to \$513.0 million at September 30, 2017.

There were no merger related expenses incurred in the third quarter of 2018.

Non-performing assets were \$9.3 million, or 0.78% of assets, and included \$2.5 million of OREO at September 30, 2018.

### Earnings Analysis

The Company'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 Company'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 84.1% of the Company's net revenues (defined as net interest income plus non-interest income) for the three months ended September 30, 2018 compared to 81.6% of net revenues for the three months ended September 30, 2017. 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.

The following table sets forth the Company's consolidated average balances of assets and liabilities and shareholders' equity, as well as interest income and interest expense on related items, and the Company's average yield or rate for the three and nine months ended September 30, 2018 and 2017. The average rates are derived by dividing interest income and interest expense by the average balance of assets and liabilities, respectively.

| (Dollars in thousands)                                     | Three months ended September 30, 2018 |           |               | Three months ended September 30, 2017 |           |               |
|--|---------------------------------------|-----------|---------------|---------------------------------------|-----------|---------------|
|  | Average Balance                       | Interest  | Average Yield | Average Balance                       | Interest  | Average Yield |
| <b>Assets:</b>   |                                       |           |               |                                       |           |               |
| <b>Interest-earning assets:</b>                            |                                       |           |               |                                       |           |               |
| Federal funds sold/short-term investments                  | \$ 11,953                             | \$ 36     | 1.19 %        | \$ 12,383                             | \$ 25     | 0.80 %        |
| <b>Investment securities:</b>                              |                                       |           |               |                                       |           |               |
| Taxable  | 151,115                               | 1,060     | 2.81          | 142,353                               | 846       | 2.38          |
| Tax-exempt <sup>(1)</sup>                                  | 73,621                                | 625       | 3.40          | 89,034                                | 781       | 3.51          |
| Total investment securities                                | 224,736                               | 1,685     | 3.00          | 231,387                               | 1,627     | 2.81          |
| <b>Loans: <sup>(2)</sup></b>                               |                                       |           |               |                                       |           |               |
| Commercial real estate                                     | 377,719                               | 4,901     | 5.08          | 272,548                               | 3,573     | 5.13          |
| Mortgage warehouse lines                                   | 180,430                               | 2,504     | 5.43          | 174,610                               | 1,901     | 4.26          |
| Construction   | 142,365                               | 2,406     | 6.61          | 123,822                               | 1,895     | 5.99          |
| Commercial business  | 106,717                               | 1,496     | 5.51          | 107,158                               | 1,326     | 4.86          |
| Residential real estate                                    | 46,777                                | 530       | 4.53          | 42,436                                | 445       | 4.19          |
| Loans to individuals                                       | 24,655                                | 306       | 4.92          | 22,379                                | 228       | 4.04          |
| Loans held for sale  | 3,203                                 | 38        | 4.75          | 3,715                                 | 37        | 3.98          |
| All other loans  | 1,061                                 | 12        | 4.43          | 1,526                                 | 11        | 2.82          |
| Total loans  | 882,927                               | 12,193    | 5.41          | 748,194                               | 9,416     | 4.93          |
| Total interest-earning assets                              | 1,119,616                             | \$ 13,914 | 4.88 %        | 991,964                               | \$ 11,068 | 4.39 %        |
| <b>Non-interest earning assets:</b>                        |                                       |           |               |                                       |           |               |
| Allowance for loan losses                                  | (8,388 )                              |           |               | (7,770 )                              |           |               |
| Cash and due from bank                                     | 5,767                                 |           |               | 5,371                                 |           |               |
| Other assets   | 70,527                                |           |               | 59,328                                |           |               |
| Total non-interest earning assets                          | 67,906                                |           |               | 56,929                                |           |               |
| Total assets   | \$ 1,187,522                          |           |               | \$ 1,048,893                          |           |               |
| <b>Liabilities and shareholders' equity:</b>               |                                       |           |               |                                       |           |               |
| <b>Interest-bearing liabilities:</b>                       |                                       |           |               |                                       |           |               |
| Money market and NOW accounts                              | \$ 338,783                            | \$ 499    | 0.58 %        | \$ 324,940                            | \$ 358    | 0.44 %        |
| Savings accounts   | 194,223                               | 371       | 0.76          | 208,548                               | 338       | 0.64          |
| Certificates of deposit                                    | 230,490                               | 984       | 1.69          | 158,737                               | 508       | 1.27          |
| Other borrowed funds                                       | 63,429                                | 349       | 2.18          | 27,533                                | 113       | 1.63          |
| Redeemable subordinated debentures                         | 18,557                                | 184       | 3.97          | 18,557                                | 134       | 2.89          |
| Total interest-bearing liabilities                         | 845,482                               | \$ 2,387  | 1.12 %        | 738,315                               | \$ 1,451  | 0.78 %        |
| <b>Non-interest bearing liabilities:</b>                   |                                       |           |               |                                       |           |               |
| Demand deposits  | 211,291                               |           |               | 193,937                               |           |               |
| Other liabilities  | 7,329                                 |           |               | 6,395                                 |           |               |
| Total non-interest bearing liabilities                     | 218,620                               |           |               | 200,332                               |           |               |
| Shareholders' equity                                       | 123,420                               |           |               | 110,246                               |           |               |
| Total liabilities and shareholders' equity                 | \$ 1,187,522                          |           |               | \$ 1,048,893                          |           |               |
| Net interest spread <sup>(3)</sup>                         |                                       |           | 3.76 %        |                                       |           | 3.61 %        |
| Net interest income and net interest margin <sup>(4)</sup> |                                       | \$ 11,527 | 4.09 %        |                                       | \$ 9,617  | 3.85 %        |

(1) Tax equivalent basis, using federal tax rate of 21% in 2018 and 34% in 2017.

- (2) 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 held for sale.
- (3) The net interest spread is the difference between the average yield on interest-earning assets and the average rate paid on interest-bearing liabilities.
- (4) The net interest margin is equal to net interest income divided by average interest-earning assets.

Edgar Filing: 1ST CONSTITUTION BANCORP - Form 10-Q

| (Dollars in thousands)                                     | Nine Months Ended September 30, 2018 |          |               | Nine Months Ended September 30, 2017 |          |               |
|--|--------------------------------------|----------|---------------|--------------------------------------|----------|---------------|
|  | Average Balance                      | Interest | Average Yield | Average Balance                      | Interest | Average Yield |
| <b>Assets:</b>   |                                      |          |               |                                      |          |               |
| <b>Interest-earning assets:</b>                            |                                      |          |               |                                      |          |               |
| Federal funds sold/short-term investments                  | \$21,287                             | \$208    | 1.31 %        | \$30,199                             | \$183    | 0.81 %        |
| <b>Investment securities:</b>                              |                                      |          |               |                                      |          |               |
| Taxable  | 146,003                              | 2,915    | 2.66          | 141,662                              | 2,500    | 2.35          |
| Tax-exempt <sup>(1)</sup>                                  | 76,872                               | 1,922    | 3.33          | 92,341                               | 2,409    | 3.48          |
| Total investment securities                                | 222,875                              | 4,837    | 2.89          | 234,003                              | 4,909    | 2.79          |
| <b>Loans: <sup>(2)</sup></b>                               |                                      |          |               |                                      |          |               |
| Commercial real estate                                     | 349,423                              | 13,391   | 5.05          | 253,793                              | 10,088   | 5.24          |
| Mortgage warehouse lines                                   | 157,422                              | 6,318    | 5.35          | 155,755                              | 5,014    | 4.29          |
| Construction   | 135,049                              | 6,548    | 6.48          | 111,436                              | 4,817    | 5.78          |
| Commercial business  | 110,101                              | 4,391    | 5.33          | 109,335                              | 4,006    | 4.90          |
| Residential real estate                                    | 45,955                               | 1,517    | 4.35          | 42,136                               | 1,335    | 4.18          |
| Loans to individuals                                       | 23,386                               | 780      | 4.40          | 22,428                               | 701      | 4.12          |
| Loans held for sale  | 3,067                                | 101      | 4.39          | 4,408                                | 165      | 4.99          |
| All other loans  | 1,132                                | 32       | 3.73          | 1,828                                | 35       | 2.52          |
| Total loans  | 825,535                              | 33,078   | 5.31          | 701,119                              | 26,161   | 4.94          |
| Total interest-earning assets                              | 1,069,697                            | \$38,123 | 4.73 %        | 965,321                              | \$31,253 | 4.29 %        |
| <b>Non-interest earning assets:</b>                        |                                      |          |               |                                      |          |               |
| Allowance for loan losses                                  | (8,295 )                             |          |               | (7,646 )                             |          |               |
| Cash and due from bank                                     | 5,782                                |          |               | 5,234                                |          |               |
| Other assets   | 64,861                               |          |               | 58,736                               |          |               |
| Total non-interest earning assets                          | 62,348                               |          |               | 56,324                               |          |               |
| Total assets   | \$1,132,045                          |          |               | \$1,021,645                          |          |               |
| <b>Liabilities and shareholders' equity:</b>               |                                      |          |               |                                      |          |               |
| <b>Interest-bearing liabilities:</b>                       |                                      |          |               |                                      |          |               |
| Money market and NOW accounts                              | \$362,048                            | \$1,437  | 0.53 %        | \$329,089                            | \$1,032  | 0.42 %        |
| Savings accounts   | 208,780                              | 1,079    | 0.69          | 210,056                              | 992      | 0.63          |
| Certificates of deposit                                    | 180,250                              | 2,026    | 1.50          | 147,109                              | 1,327    | 1.21          |
| Other borrowed funds                                       | 36,407                               | 576      | 2.12          | 20,494                               | 349      | 2.28          |
| Redeemable subordinated debentures                         | 18,557                               | 508      | 3.65          | 18,557                               | 380      | 2.73          |
| Total interest-bearing liabilities                         | 806,042                              | \$5,626  | 0.93 %        | 725,305                              | \$4,080  | 0.75 %        |
| <b>Non-interest bearing liabilities:</b>                   |                                      |          |               |                                      |          |               |
| Demand deposits  | 199,953                              |          |               | 181,892                              |          |               |
| Other liabilities  | 8,566                                |          |               | 6,577                                |          |               |
| Total non-interest bearing liabilities                     | 208,519                              |          |               | 188,469                              |          |               |
| Shareholders' equity                                       | 117,484                              |          |               | 107,871                              |          |               |
| Total liabilities and shareholders' equity                 | \$1,132,045                          |          |               | \$1,021,645                          |          |               |
| Net interest spread <sup>(3)</sup>                         |                                      |          | 3.80 %        |                                      |          | 3.54 %        |
| Net interest income and net interest margin <sup>(4)</sup> |                                      | \$32,497 | 4.06 %        |                                      | \$27,173 | 3.76 %        |

(1) Tax equivalent basis, using federal tax rate of 21% in 2018 and 34% in 2017.

(2) 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 held for sale.

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

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

Three months ended September 30, 2018 compared to three months ended September 30, 2017

Net interest income was \$11.4 million for the quarter ended September 30, 2018 and increased \$2.0 million, or 21.7%, compared to net interest income of \$9.4 million for the third quarter of 2017. The tax equivalent net interest margin was 4.09% for the third quarter of 2018 compared to 3.85% for the third quarter of 2017.

Total interest income was \$13.8 million for the three months ended September 30, 2018 compared to \$10.8 million for the three months ended September 30, 2017. This increase was due primarily to the \$134.7 million increase in average loans, reflecting growth primarily of commercial real estate, mortgage warehouse lines and construction loans. The growth of average loans also included average loans of approximately \$70.7 million from the NJCB merger.

Average interest-earning assets were \$1.12 billion and \$992.0 million for the third quarters of 2018 and 2017, respectively.

For the third quarters of 2018 and 2017, the tax-equivalent yield on interest-earning assets was 4.88% and 4.39%, respectively. The higher yield on average interest-earning assets for the third quarter of 2018 reflected primarily the higher yield earned on the loan portfolio. The 100 basis point increase in the Federal Reserve's targeted federal funds rate and the corresponding increase in the Prime Rate since September 2017 have had a positive effect on the yields of construction, commercial business, home equity and warehouse loans with variable interest rate terms for the third quarter of 2018.

Interest expense on average interest-bearing liabilities was \$2.4 million, with an interest cost of 1.12%, for the third quarter of 2018 compared to \$1.5 million, with an interest cost of 0.78%, for the third quarter of 2017. The \$936,000 increase in interest expense on interest-bearing liabilities for the third quarter of 2018 reflected primarily higher deposit interest costs due to higher short-term market interest rates in the third quarter of 2018 compared to the third quarter of 2017 and an increase of \$107.2 million in average interest-bearing liabilities. The increase in interest expense also reflects the increase in certificates of deposit and short-term borrowings, which generally have higher interest cost than other types of interest-bearing deposits.

Average interest-bearing liabilities increased \$107.2 million, or 14.5%, to \$845.5 million for the three months ended September 30, 2018 from \$738.3 million for the same three months of 2017 due primarily to increases in money market and NOW accounts, certificates of deposit and other borrowed funds. Money market and NOW accounts averaged \$338.8 million for the third quarter of 2018 compared to \$324.9 million for the third quarter of 2017, which represented an increase of \$13.8 million, or 4.3%. Average certificates of deposit increased \$71.8 million, or 45.2%, for the third quarter of 2018 compared to the third quarter of 2017. Average other borrowed funds increased \$35.9 million, or 130.4%, for the third quarter of 2018 compared to the same period of 2017. The majority of the growth in average interest-bearing deposits resulted from the NJCB merger. The increase in average other borrowed funds was primarily due to additional short-term borrowings to fund the organic growth in average loans.

The increase in average non-interest bearing demand deposits of \$17.4 million provided the Company with additional funding to support the organic growth in average loans.

The net interest margin, on a tax-equivalent basis, increased to 4.09% for the three months ended September 30, 2018 compared to 3.85% for the comparable period in 2017 due primarily to the higher yield on average interest-earning assets, which more than offset the increase in the average cost of interest-bearing liabilities. The higher tax-equivalent yield earned on average interest-earning assets reflected the growth of loans, the increase in loans as a percentage of earning assets and the higher interest rate environment in the third quarter of 2018 compared to the third quarter of 2017.

Nine Months Ended September 30, 2018 compared to Nine Months Ended September 30, 2017

For the nine months ended September 30, 2018, net interest income increased \$5.7 million, or 21.6%, to \$32.1 million compared to \$26.4 million for the comparable period in 2017. The tax equivalent net interest margin was 4.06% for the nine months ended September 30, 2018 compared to 3.76% for the nine months ended September 30, 2017.

Total interest income was \$37.7 million for the nine months ended September 30, 2018 compared to \$30.5 million for the nine months ended September 30, 2017. This increase was due primarily to the \$124.4 million increase in average loans, reflecting growth primarily of commercial real estate and construction loans. The growth of average loans also included average loans of approximately \$44.2 million from the NJCB merger.

Average interest-earning assets increased \$104.4 million to \$1.07 billion for the nine months ended September 30, 2018 compared to \$965.3 million for the same period in 2017. This increase was due primarily to the \$124.4 million increase in average loans, which was partially offset by a decline of \$8.9 million in average federal funds sold and a decline of \$11.1 million in average investment securities.

For the nine months ended September 30, 2018 and 2017, the tax-equivalent yield on interest-earning assets was 4.73% and 4.29%, respectively. The higher yield on average interest-earning assets for the nine months ended September 30, 2018 reflected primarily the higher yield earned on the loan portfolio. The 100 basis point increase in the Federal Reserve's targeted federal funds rate and the corresponding increase in the Prime Rate since September 2017 have had a positive effect on the yields of construction, commercial business, home equity and warehouse loans with variable interest rate terms for the first nine months of 2018.

Interest expense on average interest-bearing liabilities was \$5.6 million, with an interest cost of 0.93%, for the nine months ended September 30, 2018 compared to \$4.1 million, with an interest cost of 0.75%, for the same period in the prior year. The \$1.5 million increase in interest expense on interest-bearing liabilities reflected primarily higher deposit interest costs due to higher short-term market interest rates in the first nine months of 2018 compared to the same period in the prior year and an increase of \$80.7 million in average interest-bearing liabilities.

Average interest-bearing liabilities increased \$80.7 million, or 11.1%, to \$806.0 million for the nine months ended September 30, 2018 from \$725.3 million for the same nine months of 2017 due primarily to increases in money market and NOW accounts, certificates of deposit and other borrowed funds. The majority of the growth of average deposits resulted from the NJCB merger. The increase in average interest-bearing liabilities was used to partially fund the growth of average loans.

The increase in average non-interest bearing demand deposits of \$18.1 million provided the Company with additional funding to support the growth of average loans.

The net interest margin, on a tax-equivalent basis, increased to 4.06% for the nine months ended September 30, 2018 compared to 3.76% for the comparable period in 2017 due primarily to the higher yield on average interest-earning assets. The higher tax-equivalent yield earned on average interest-earning assets reflected the growth of loans, the increase in loans as a percentage of earning assets and the higher interest rate environment in the first nine months of 2018 compared to the same period in 2017.

#### Provision for Loan Losses

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, size and risk elements 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 five years, the Company 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 level of non-performing loans at September 30, 2018. Net charge-offs of commercial business and commercial real estate loans in 2018 and 2017 have declined significantly from prior periods, which has resulted in a reduction of the historical loss factors for these segments of the loan portfolio that were applied by management to estimate the allowance for loan losses at September 30, 2018.

Three months ended September 30, 2018 compared to three months ended September 30, 2017

During the third quarter of 2018, the Company recorded a provision for loan losses of \$225,000, charge-offs of \$459,000 and recoveries of loans previously charged-off of \$1,000 compared to a provision for loan losses of

\$150,000, charge-offs of \$61,000 and recoveries of loans previously charged-off of \$6,000 recorded for the third quarter of 2017. The allowance for loan losses was \$8.3 million, or 0.94% of loans, at September 30, 2018 compared to \$7.8 million, or 1.01% of loans, at September 30, 2017. The increase in the allowance for loan losses was due primarily to the increase in loans and the change in the mix of loans from September 30, 2017 to September 30, 2018.

Management believes that the current economic conditions in New Jersey and surrounding areas and the current operating conditions for the Company are generally positive, which were considered in management's evaluation of the adequacy of the allowance for loan losses.

Nine Months Ended September 30, 2018 compared to Nine Months Ended September 30, 2017

For the nine months ended September 30, 2018, the Company recorded a provision for loan losses of \$675,000 compared to \$450,000 recorded for the first nine months of 2017. The provision for loan losses for the first nine months of 2018 reflected charge-offs of \$499,000 and recoveries of previously charged-off loans of \$76,000 compared to charge-offs of \$162,000 and recoveries of previously charged-off loans of \$20,000 for the nine months ended September 30, 2017. The higher provision for

loan losses recorded for the first nine months of 2018 was due primarily to the growth of commercial real estate, construction and commercial business loans and the change in the mix of loans in the loan portfolio.

#### Non-Interest Income

Three months ended September 30, 2018 compared to three months ended September 30, 2017

Total non-interest income was \$2.2 million for the third quarter of 2018, an increase of \$38,000, or 1.8%, compared to \$2.1 million for the third quarter of 2017. Other income increased \$47,000 due primarily to higher debit card interchange income and customer service fees, which more than offset a decline of \$37,000 in gain on sales of loans.

Gains on sales of loans was \$1.3 million for each of the third quarters of 2018 and 2017. The Company originates and sells commercial loans guaranteed by the Small Business Administration (“SBA”) and residential mortgage loans in the secondary market. SBA guaranteed commercial lending activity and loan sales vary from period to period. For the third quarter of 2018, \$7.6 million of SBA loans were sold and gains of \$590,000 were recorded compared to \$5.8 million of SBA loans sold and gains of \$520,000 recorded for the third quarter of 2017. Residential mortgage loans totaling \$25.0 million were sold and \$702,000 of gains were recorded for the third quarter of 2018 compared to \$28.9 million of residential mortgage loans sold and \$809,000 of gains recorded for the third quarter of 2017. Management believes that the lower amounts of residential mortgage loans sold and gains recorded for the third quarter of 2018 were due primarily to lower residential mortgage lending activity as a result of higher mortgage interest rates in 2018 compared to 2017.

Service charges on deposit accounts increased \$31,000 during the third quarter of 2018 compared to the third quarter of 2017 due primarily to deposit accounts acquired in the NJCB merger.

Non-interest income also includes income from BOLI, which was \$152,000 for the three months ended September 30, 2018 compared to \$131,000 for the three months ended September 30, 2017. The majority of the increase in income from BOLI was directly related to the increase of \$4.0 million in BOLI as a result of the NJCB merger.

Nine Months Ended September 30, 2018 compared to Nine Months Ended September 30, 2017

Total non-interest income was \$6.1 million for the nine months ended September 30, 2018, a decrease of \$203,000, or 3.2%, compared to \$6.3 million for the comparable period of 2017. The decrease was due primarily to the \$511,000 decline in gain on the sales of loans, which was partially offset by the \$184,000 gain from the bargain purchase related to the NJCB merger.

Gain on the sales of loans decreased \$511,000 to \$3.4 million for the nine months ended September 30, 2018 compared to \$3.9 million for the nine months ended September 30, 2017. The Bank sells commercial business loans guaranteed by the SBA and residential mortgage loans in the secondary market. For the nine months ended September 30, 2018, sales of SBA loans were \$15.8 million, which generated gain on sales of loans of \$1.4 million, compared to sales of SBA loans of \$11.8 million, which generated gain on sales of loans of \$1.1 million, for the nine months ended September 30, 2017.

For the nine months ended September 30, 2018, the Bank's residential mortgage banking operation sold \$69.7 million of residential mortgage loans, which generated gain on sales of loans of \$2.0 million. For the nine months ended September 30, 2017, the Bank's residential mortgage banking operation sold \$92.3 million of residential mortgage loans, which generated gain on sales of loans of \$2.8 million. Management believes the decrease in residential lending activity and gain on sales of loans was due to the lower volume of residential lending and loans sold in 2018 as a result of higher mortgage interest rates in 2018 compared to 2017.

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 increased to \$1.6 million for the nine months ended September 30, 2018 compared to \$1.4 million for the nine months ended September 30, 2017. The increase in other income for the first nine months of 2018 was due primarily to higher debit card interchange fee income, customer service charges and SBA loan servicing income.

### Non-Interest Expenses

For the three months ended September 30, 2018, non-interest expenses were \$7.9 million compared to \$7.6 million for the three months ended September 30, 2017, an increase of \$277,000, or 3.6%. For the nine months ended September 30, 2018, non-interest expenses were \$25.8 million compared to \$23.0 million for the same period in 2017. The increase in non-interest expenses during the third quarter of 2018 reflected primarily an increase in expenses related to the operations of the former NJCB, which was partially offset by a decline in regulatory, professional and consulting fees. The increase in non-interest expenses for the nine months ended September 30, 2018 were due primarily to merger related expenses of \$2.1 million and expenses related to the operations of the former NJCB.

The following table presents the major components of non-interest expenses for the three and nine months ended September 30, 2018 and 2017:

|  | Three months<br>ended<br>September 30, |         | Nine months<br>ended September<br>30, |          |
|--|--|---------|---------------------------------------|----------|
| (Dollars in thousands)                       | 2018                                   | 2017    | 2018                                  | 2017     |
| Salaries and employee benefits               | \$4,900                                | \$4,617 | \$14,714                              | \$13,882 |
| Occupancy expense                            | 907                                    | 865     | 2,604                                 | 2,604    |
| Data processing expenses                     | 331                                    | 338     | 1,009                                 | 983      |
| Equipment expense                            | 295                                    | 258     | 841                                   | 768      |
| Marketing                                    | 52                                     | 42      | 231                                   | 182      |
| Telephone                                    | 97                                     | 96      | 299                                   | 292      |
| Regulatory, professional and consulting fees | 413                                    | 625     | 1,369                                 | 1,762    |
| Insurance                                    | 91                                     | 96      | 293                                   | 269      |
| Supplies                                     | 65                                     | 68      | 231                                   | 193      |
| FDIC insurance expense                       | 105                                    | 95      | 381                                   | 255      |
| Other real estate owned expenses             | 73                                     | 11      | 75                                    | 26       |
| Merger-related expenses                      | —                                      | —       | 2,141                                 | —        |
| Amortization of intangible assets            | 94                                     | 96      | 281                                   | 289      |
| Other expenses                               | 471                                    | 410     | 1,321                                 | 1,449    |
| Total  | \$7,894                                | \$7,617 | \$25,790                              | \$22,954 |

Three months ended September 30, 2018 compared to three months ended September 30, 2017

Non-interest expenses were \$7.9 million for the third quarter of 2018, an increase of \$277,000, compared to \$7.6 million for the third quarter of 2017.

Salaries and employee benefits, which represent the largest portion of non-interest expenses, increased by \$283,000, or 6.1%, to \$4.9 million for the three months ended September 30, 2018 compared to \$4.6 million for the three months ended September 30, 2017. The increase in salaries and employee benefits was due primarily to salaries for former NJCB employees who joined the Company, merit increases and increases in employee benefits expenses.

Occupancy expense increased by \$42,000 to \$907,000 for the third quarter of 2018 compared to \$865,000 for the same quarter in 2017 due primarily to the addition of the two former NJCB branch offices in the second quarter of 2018.

Regulatory, professional and consulting fees decreased \$212,000, or 33.9%, to \$413,000 for the three months ended September 30, 2018 from \$625,000 for the same period of 2017 due primarily to lower legal and consulting fees related to loan collections and litigation expenses.

FDIC insurance expense increased modestly for the three months ended September 30, 2018 compared to the same period of 2017 due to the internal growth of assets and the increase in assets as a result of the NJCB merger.

Other operating expenses increased \$61,000 for the three months ended September 30, 2018 compared to the same period of 2017 due primarily to increases in postage and business development expenses.

Nine Months Ended September 30, 2018 compared to Nine Months Ended September 30, 2017

Non-interest expenses were \$25.8 million for the nine months ended September 30, 2018 and increased \$2.8 million, or 12.4%, compared to \$23.0 million for the nine months ended September 30, 2017.

Salaries and employee benefits, which represent the largest portion of non-interest expenses, increased by \$832,000, or 6.0%, to \$14.7 million for the nine months ended September 30, 2018 compared to \$13.9 million for the nine months ended September 30, 2017. The increase in salaries and employee benefits was due primarily to salaries for former NJCB employees who joined the Company, merit increases and increases in employee benefits expenses.

Data processing expenses increased \$26,000 to \$1.0 million for the nine months ended September 30, 2018 compared to \$983,000 for the same period in 2017 as a result of separate NJCB data processing costs incurred from the date of the merger through the date of the core operating system conversion on June 15, 2018.

Marketing expenses were \$231,000 for the nine months ended September 30, 2018, an increase of \$49,000 compared with \$182,000 for the same period of 2017. The majority of the increase was directly related to marketing of the Bank's products and services to the former customers of NJCB.

Regulatory, professional and consulting fees decreased \$393,000, or 22.3%, to \$1.4 million for the nine months ended September 30, 2018 from \$1.8 million for the same period of 2017 due primarily to lower legal and consulting fees related to loan collections and litigation expenses.

Supplies increased \$38,000 to \$231,000 for the nine months ended September 30, 2018 compared to \$193,000 for the same period in 2017. The majority of the increase was related to the NJCB merger.

FDIC insurance expense increased \$126,000, or 49.4%, for the nine months ended September 30, 2018 compared to the same period of 2017 due primarily to the internal growth of assets and the increase in assets as a result of the NJCB merger.

Merger expenses of \$2.1 million related to the NJCB merger were incurred in the first nine months of 2018.

The Company recorded other expenses of \$1.3 million for the nine months ended September 30, 2018, a decrease of \$128,000 compared to \$1.4 million for the nine months ended September 30, 2017. The decrease in other expenses was due primarily to the absence in the 2018 period of any write-off of deferred loan origination costs, which were approximately \$500,000 for the first nine months of 2017.

#### Income Taxes

Three months ended September 30, 2018 compared to three months ended September 30, 2017

Income tax expense was \$1.4 million for the third quarter of 2018, resulting in an effective tax rate of 26.2%, compared to income tax expense of \$1.2 million for the third quarter of 2017, which resulted in an effective tax rate of 33.1%. The decline in income tax expense and the effective tax rate for the third quarter of 2018 was due principally to the enactment of the Tax Cuts and Jobs Act ("Tax Act") in December 2017, which reduced the maximum federal corporate income tax rate from 35% to 21% effective January 1, 2018. Partially offsetting the lower federal corporate income tax rate was the enactment of legislation by the State of New Jersey in July 2018, which increased the corporate income tax rate to 11.5% from 9% for taxable income of \$1.0 million or more effective January 1, 2018 and resulted in a 2% higher effective tax rate for the third quarter of 2018.

Nine Months Ended September 30, 2018 compared to Nine Months Ended September 30, 2017

Income tax expense was \$3.0 million for the nine months ended September 30, 2018, resulting in an effective tax rate of 25.4%, compared to income tax expense of \$2.9 million for the comparable period in 2017, which resulted in an effective tax rate of 31.5%. The decline in the effective tax rate for the first nine months of 2018 was due principally to the enactment of the Tax Act in December 2017, which reduced the maximum federal corporate income tax rate from 35% to 21% effective January 1, 2018. Partially offsetting the lower federal corporate income tax rate was the enactment of legislation by the State of New Jersey in July 2018, which increased the corporate income tax rate to 11.5% from 9% for taxable income of \$1.0 million or more effective January 1, 2018 and resulted in a 2% higher effective tax rate for the first nine months of 2018.

## Financial Condition

### September 30, 2018 Compared with December 31, 2017

Total consolidated assets were \$1.2 billion at September 30, 2018 and increased \$113.2 million from total consolidated assets of \$1.08 billion at December 31, 2017 due primarily to a \$91.6 million increase in total loans and an increase of \$6.8 million in investment securities. In general, the increase in assets was funded primarily by a \$19.7 million increase in deposits and a \$79.0 million increase in overnight borrowings. The NJCB merger contributed approximately \$83.8 million to the increase in assets at September 30, 2018.

### Cash and Cash Equivalents

Cash and cash equivalents totaled \$19.3 million at September 30, 2018 compared to \$18.8 million at December 31, 2017, an increase of \$510,000. To the extent that the Bank does not utilize funds for loan originations or securities purchases, the cash is invested in overnight deposits at the Federal Reserve Bank of New York.

### Loans Held for Sale

Loans held for sale were \$4.4 million at September 30, 2018 compared to \$4.3 million at December 31, 2017. The amount of loans held for sale varies from period to period due to changes in the amount and timing of sales of residential mortgage loans and SBA guaranteed commercial loans.

### Investment Securities

Investment securities represented approximately 18.7% of total assets at September 30, 2018 and approximately 20.0% of total assets at December 31, 2017. Total investment securities increased \$6.8 million to \$222.6 million at September 30, 2018 from \$215.7 million at December 31, 2017. Purchases of investment securities totaled \$33.0 million during the nine months ended September 30, 2018, and proceeds from sales, calls, maturities and payments totaled \$34.9 million during this same 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 September 30, 2018, securities available for sale were \$131.2 million, an increase of \$25.7 million, or 24.4%, compared to securities available for sale of \$105.5 million at December 31, 2017.

At September 30, 2018, the securities available for sale portfolio had net unrealized losses of \$2.6 million compared to net unrealized losses of \$571,000 at December 31, 2017. These net unrealized losses were reflected, net of tax, in shareholders' equity as a component of accumulated other comprehensive loss. The increase in the net unrealized loss in the first nine months of 2018 was due principally to the increase in market interest rates during the period.

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 September 30, 2018, securities held to maturity were \$91.4 million, a decrease of \$18.9 million from \$110.3 million at December 31, 2017. The fair value of the held to maturity portfolio was \$91.2 million at September 30, 2018.

### Loans

The loan portfolio, which represents the Company'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 Company's primary lending focus continues to be the financing of 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 September 30, 2018 and December 31, 2017:

| (Dollars in thousands)                          | September 30,<br>2018 |      | December 31,<br>2017 |      |
|---|-----------------------|------|----------------------|------|
|   | Amount                | %    | Amount               | %    |
| Commercial real estate                          | \$376,003             | 43 % | \$308,924            | 39 % |
| Mortgage warehouse lines                        | 182,791               | 21   | 189,412              | 24   |
| Construction loans                              | 144,601               | 16   | 136,412              | 17   |
| Commercial business                             | 105,996               | 12   | 92,906               | 12   |
| Residential real estate                         | 47,565                | 5    | 40,494               | 5    |
| Loans to individuals                            | 24,073                | 3    | 21,025               | 3    |
| All other                                       | 174                   | —    | 183                  | —    |
| Total loans                                     | 881,203               | 100% | 789,356              | 100% |
| Deferred loan costs, net                        | 335                   |      | 550                  |      |
| Total loans, including deferred loan costs, net | \$881,538             |      | \$789,906            |      |

Total loans increased by \$91.6 million, or 11.6%, to \$881.5 million at September 30, 2018 compared to \$789.9 million at December 31, 2017 due, in part, to an increase of \$67.1 million in commercial real estate loans, an \$8.2 million increase in construction loans and a \$13.1 million increase in commercial business loans, which more than offset a decline of \$6.6 million in mortgage warehouse lines. The NJCB merger contributed \$68.9 million to the increase in loans at September 30, 2018.

Mortgage warehouse lines' outstanding balances decreased \$6.6 million to \$182.8 million at September 30, 2018 compared to \$189.4 million at December 31, 2017, reflecting a decreased level of residential mortgage originations by the Bank's mortgage banking customers that was due primarily to the increase in residential mortgage interest rates, which reduced the level of mortgage refinancing activity.

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. The Bank collects interest and a transaction fee at the time of repayment. The Bank funded \$2.6 billion of residential mortgages through customers' warehouse lines of credit during the first nine months of 2018 compared to \$2.6 billion during the first nine months of 2017.

Commercial business loans increased \$13.1 million, or 14.1%, to \$106.0 million at September 30, 2018 from \$92.9 million at December 31, 2017. 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. Business assets of the commercial borrower are generally pledged as collateral for these loans.

Commercial real estate loans increased \$67.1 million, or 21.7%, to \$376.0 million at September 30, 2018 from \$308.9 million at December 31, 2017. Commercial real estate loans consist primarily of loans to businesses collateralized by real estate employed in the business and loans to finance investor owned income-producing properties.

Construction loans totaled \$144.6 million at September 30, 2018 compared to \$136.4 million at December 31, 2017. 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 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 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.

At September 30, 2018, non-performing loans decreased by \$353,000 to \$6.8 million from \$7.1 million at December 31, 2017 and the ratio of non-performing loans to total loans decreased to 0.77% at September 30, 2018 compared to 0.90% at December 31, 2017. During the first nine months of 2018, \$2.2 million of non-performing loans were resolved and \$2.5 million of loans were placed on non-accrual. In the first quarter of 2017, the Bank was notified that a shared national credit syndicated loan in which it was a participant in a \$4.3 million facility had further deteriorated. As of the date of notification, the Bank downgraded the loan, which had a balance of \$4.0 million at that time, and placed it on non-accrual. In the first quarter of 2018, the Bank was notified by federal bank regulators that this loan had been upgraded from doubtful to substandard. The balance of this loan was \$2.9 million at September 30, 2018.

The major segments of non-accrual loans consist of commercial business, commercial real estate 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.

| (Dollars in thousands)  | September 30,<br>2018 | December 31,<br>2017 |      |   |
|---|-----------------------|----------------------|------|---|
| Non-performing loans:   |                       |                      |      |   |
| Loans 90 days or more past due and still accruing                                       | \$ —                  | \$ —                 |      |   |
| Non-accrual loans   | 6,761                 | 7,114                |      |   |
| Total non-performing loans  | 6,761                 | 7,114                |      |   |
| Other real estate owned   | 2,515                 | —                    |      |   |
| Total non-performing assets   | 9,276                 | 7,114                |      |   |
| Performing troubled debt restructurings   | 4,018                 | 3,728                |      |   |
| Performing troubled debt restructurings and total non-performing assets                 | \$ 13,294             | \$ 10,842            |      |   |
| Non-performing loans to total loans   | 0.77                  | %                    | 0.90 | % |
| Non-performing loans to total loans excluding mortgage warehouse lines                  | 0.97                  | %                    | 1.18 | % |
| Non-performing assets to total assets   | 0.78                  | %                    | 0.66 | % |
| Non-performing assets to total assets excluding mortgage warehouse lines                | 0.92                  | %                    | 0.80 | % |
| Total non-performing assets and performing troubled debt restructurings to total assets | 1.11                  | %                    | 1.00 | % |

Non-performing loans to total loans decreased to 0.77% at September 30, 2018 from 0.90% at December 31, 2017 due primarily to the increase in loans. Non-performing assets represented 0.78% of total assets at September 30, 2018 compared to 0.66% of total assets at December 31, 2017.

Non-performing assets increased by \$2.2 million to \$9.3 million at September 30, 2018 from \$7.1 million at December 31, 2017. In addition to the increase in non-performing loans, OREO increased \$2.5 million from December 31, 2017 to September 30, 2018. OREO at September 30, 2018 was comprised of one residential property with a carrying value of \$1.1 million acquired in the NJCB merger, land with a carrying value of \$93,000 and a commercial real estate property that was foreclosed in the third quarter of 2018 with a fair value of \$1.3 million. There was no OREO at December 31, 2017.

At September 30, 2018, the Bank had twelve loans totaling \$7.3 million that were troubled debt restructurings. Four of these loans totaling \$3.3 million are included in the above table as non-accrual loans and the remaining eight loans totaling \$4.0 million were performing. At December 31, 2017, the Bank had ten loans totaling \$5.5 million that were troubled debt restructurings. Two of

these loans totaling \$1.8 million are included in the above table as non-accrual loans and the remaining eight loans totaling \$3.7 million were performing.

In accordance with U.S. GAAP, the excess of cash flows expected at acquisition over the initial investment in the purchase of a credit impaired loan is recognized as interest income over the life of the loan. At September 30, 2018, there was one purchased credit impaired loan for \$506,000 that was not classified as a non-performing loan. At December 31, 2017, there were no loans acquired with evidence of deteriorated credit quality that were not classified as non-performing loans.

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 ten days or more. An action plan is discussed for delinquent 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 fifteen 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 that 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 United States Bankruptcy Reform Act of 1978, as amended.

#### 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 business, construction 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 business 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 ASC Topic 310. The second major component is an estimation of losses under ASC Topic 450, 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, the Company 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; and
- 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 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 that 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 business loans, 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 that 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 that 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 portfolios.

#### Commercial Business

The Company offers a variety of commercial loan services, including term loans, lines of credit and loans secured by equipment and receivables. A broad range of short-to-medium term commercial loans, both secured and unsecured, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition and development of real estate and improvements) and the purchase of equipment and machinery. Commercial business loans are granted based on the borrower's ability to generate cash flow to support its debt obligations and other cash related expenses. A borrower's ability to repay commercial business loans is substantially dependent on the success of the business itself and on the quality of its management. As a general practice, the Company takes, as collateral, a security interest in any available real estate, equipment, inventory, receivables or other personal property of its borrowers, although the Company occasionally makes commercial business loans on an unsecured basis. Generally, the Company requires personal guarantees of its commercial business loans to offset the risks associated with such loans.

Much of the Company's lending is in northern and central New Jersey. As a result of this geographic concentration, a significant broad-based deterioration in economic conditions in the New Jersey and the New York City metropolitan area could have a material adverse impact on the Company's loan portfolio. A prolonged decline in economic conditions in our market area could restrict borrowers' ability to pay outstanding principal and interest on loans when due. The value of assets pledged as collateral may decline and the proceeds from the sale or liquidation of these assets may not be sufficient to repay the loan.

#### Commercial Real Estate

Commercial real estate loans are made to businesses to expand their facilities and operations and to real estate operators to finance the acquisition of income producing properties. The Company's loan policy requires that borrowers have sufficient cash flow to meet the debt service requirements and the value of the property meets the loan-to-value criteria set in the loan policy. The Company monitors loan concentrations by borrower, by type of property and by location and other criteria.

The Company's commercial real estate portfolio is largely secured by real estate collateral located in the State of New Jersey. Conditions in the real estate markets in which the collateral for the Company's loans are located strongly influence the level of the Company's non-performing loans. A decline in the New Jersey real estate market could adversely affect the Company's loan portfolio. Decreases in local real estate values would adversely affect the value of property used as collateral for the Company's loans. Adverse changes in the economy also may have a negative effect on the ability of our borrowers to make timely repayments of their loans.

#### Construction Financing

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 and commercial properties. First mortgage construction loans are made to developers and builders primarily for single family homes and multi-family buildings that are presold or are to be sold or leased on a speculative basis.

The Company lends to builders and developers with established relationships, successful operating histories and sound financial resources. Management has established underwriting and monitoring criteria to minimize the inherent risks of real estate construction lending. The risks associated with speculative construction lending include the borrower's

inability to complete the construction process on time and within budget, the sale or rental of the project within projected absorption periods and the economic risks associated with real estate collateral. Such loans may include financing the development and/or construction of residential subdivisions. This activity may involve financing land purchases and infrastructure development (i.e., roads, utilities, etc.) as well as construction of residences or multi-family dwellings for subsequent sale by the developer/builder. Because the sale or rental of developed properties is integral to the success of developer business, loan repayment may be especially subject to the volatility of real estate market values.

#### Mortgage Warehouse Lines of Credit

The Company'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 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 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 Company at the time of repayment.

As a separate class of the total loan portfolio, the warehouse loan portfolio is individually analyzed as a whole for allowance for loan losses 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 us, (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.

#### Consumer

The Company's consumer loan portfolio 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. The principal risk is that the borrower becomes unemployed or has a significant reduction in income.

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; and
- Collection experience.

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

| (Dollars in thousands)  | Nine months<br>ended<br>September 30,<br>2018 | Year ended<br>December 31,<br>2017 | Nine months<br>ended<br>September 30,<br>2017 |
|---|---|------------------------------------|---|
| Balance, beginning of period  | \$ 8,013                                      | \$ 7,494                           | \$ 7,494                                      |
| Provision charged to operating expenses   | 675   | 600                                | 450   |
| Loans charged off:  |   |                                    |   |
| Residential real estate loans   | —   | (101 )                             | (101 )  |
| Commercial business and commercial real estate  | (473 )  | (61 )                              | (61 )   |
| Loans to individuals  | (7 )  | —                                  | —   |
| All other loans   | (19 )   | —                                  | —   |
| Total loans charged off   | (499 )  | (162 )                             | (162 )  |
| Recoveries:   |   |                                    |   |
| Commercial business and commercial real estate  | 75  | 64                                 | 16  |
| Loans to individuals  | 1   | 4                                  | 4   |
| All other loans   | —   | 13                                 | —   |
| Total recoveries  | 76  | 81                                 | 20  |
| Net charge offs   | (423 )  | (81 )                              | (142 )  |
| Balance, end of period  | \$ 8,265                                      | \$ 8,013                           | \$ 7,802                                      |
| Loans:  |   |                                    |   |
| At period end   | \$ 881,538                                    | \$ 789,906                         | \$ 771,982                                    |
| Average during the period   | 825,535                                       | 717,010                            | 701,119                                       |
| Net (charge offs) recoveries to average loans outstanding                                     | (0.05 )%                                      | (0.01 )%                           | (0.02 )%                                      |
| Net (charge offs) recoveries to average loans outstanding, excluding mortgage warehouse loans | (0.06 )%                                      | (0.01 )%                           | (0.03 )%                                      |
| Allowance for loan losses to:   |   |                                    |   |
| Total loans at period end   | 0.94 %  | 1.01 %                             | 1.01 %  |
| Total loans at period end excluding mortgage warehouse loans                                  | 1.06 %  | 1.19 %                             | 1.20 %  |
| Non-performing loans  | 122.25 %                                      | 112.64 %                           | 119.83 %                                      |

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 September 30, 2018 and December 31, 2017, respectively. The total allowance is available to absorb losses from any portfolio of loans.

| (Dollars in thousands)        | September 30, 2018 |                                  |                        |       | December 31, 2017 |                                  |                        |   |
|-------------------------------|--------------------|----------------------------------|------------------------|-------|-------------------|----------------------------------|------------------------|---|
|                               | Amount             | As a<br>%<br>of<br>Loan<br>Class | Loans<br>% of<br>Loans | %     | Amount            | As a<br>%<br>of<br>Loan<br>Class | Loans<br>% of<br>Loans | % |
| Commercial real estate loans  | \$3,357            | 0.89%                            | 43 %                   | %     | \$2,949           | 0.95%                            | 39 %                   | % |
| Commercial Business           | 1,687              | 1.59                             | 12                     | 1,720 | 1.85              | 12                               |                        |   |
| Construction loans            | 1,721              | 1.19                             | 16                     | 1,703 | 1.25              | 17                               |                        |   |
| Residential real estate loans | 367                | 0.77                             | 5                      | 392   | 0.97              | 5                                |                        |   |
| Loans to individuals          | 156                | 0.65                             | 3                      | 114   | 0.54              | 3                                |                        |   |
| Subtotal                      | 7,288              | 1.04                             | 79                     | 6,878 | 1.15              | 76                               |                        |   |

Edgar Filing: 1ST CONSTITUTION BANCORP - Form 10-Q

|                          |         |       |      |         |       |      |
|--------------------------|---------|-------|------|---------|-------|------|
| Mortgage warehouse lines | 832     | 0.46  | 21   | 852     | 0.45  | 24   |
| Unallocated reserves     | 145     | —     | —    | 283     | —     | —    |
| Total                    | \$8,265 | 0.94% | 100% | \$8,013 | 1.01% | 100% |

55

---

During the first nine months of 2018, the Company recorded a provision for loan losses of \$675,000, charge-offs of \$499,000 and recoveries of loans previously charged-off of \$76,000 compared to a provision for loan losses of \$450,000, charge-offs of \$162,000 and recoveries of loans previously charged-off of \$20,000 recorded for the first nine months of 2017. For the three and nine months ended September 30, 2018, \$441,000 of the charge-offs was related to the foreclosure of one commercial real estate loan in the third quarter of 2018. The higher provision for loan losses recorded for the first nine months of 2018 was due primarily to the growth of commercial real estate loans and the change in the mix of loans in the loan portfolio.

At September 30, 2018, the allowance for loan losses was \$8.3 million, or 0.94% of loans, compared to \$8.0 million, or 1.01% of loans, at December 31, 2017 and \$7.8 million, or 1.01% of loans, at September 30, 2017. The allowance for loan losses was 122% of non-performing loans at September 30, 2018 compared to 113% of non-performing loans at December 31, 2017 and 120% of non-performing loans at September 30, 2017. The decrease in the allowance as a percentage of loans was due primarily to acquisition accounting for the NJCB merger, which resulted in the NJCB loans being recorded at their fair value and included a credit risk adjustment discount of approximately \$1.6 million.

Management believes that the quality of the loan portfolio remains sound, considering the economic climate in the State of New Jersey and the New York City metropolitan area 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 Company offers a variety of products designed to attract and retain customers, with the Company's primary focus on the building and expanding of long-term relationships.

The following table summarizes deposits at September 30, 2018 and December 31, 2017:

| (Dollars in thousands)  | September 30,<br>2018 | December 31,<br>2017 |
|-------------------------|-----------------------|----------------------|
| Demand                  |                       |                      |
| Non-interest bearing    | \$ 211,492            | \$ 196,509           |
| Interest bearing        | 334,552               | 372,133              |
| Savings                 | 189,747               | 215,197              |
| Certificates of deposit | 205,886               | 138,167              |
| Total                   | \$ 941,677            | \$ 922,006           |

At September 30, 2018, total deposits were \$941.7 million, an increase of \$19.7 million, or 2.1%, from \$922.0 million at December 31, 2017. The NJCB merger contributed \$82.7 million of deposits at September 30, 2018. Total deposits, excluding the NJCB deposits, declined \$63.0 million during the first nine months of 2018. Municipal deposits, primarily interest bearing demand deposits and savings deposits, declined approximately \$43.2 million from the end of 2017. As a result of the Tax Act, a number of the Bank's municipal customers experienced significant advance payments in December 2017 for real estate taxes that were due in 2018. This was due to income tax planning considerations by individuals. As the Bank's municipal customers expended these additional funds in the first nine months of 2018, their deposit balances declined from the levels at December 31, 2017. Management believes that the Bank's liquidity resources are adequate to meet any future outflow of deposits. The balance of the outflow of interest bearing demand deposits and savings deposits was due to the routine movement of customers' funds.

## 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. At September 30, 2018, the Company had \$99.5 million of short-term borrowings from the FHLB compared to \$20.5 million of short-term borrowings from the FHLB at December 31, 2017.

## Liquidity

At September 30, 2018, 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 interest-earning assets.

The Bank has established a borrowing relationship with the FHLB that further supports and enhances liquidity. The FHLB provides member banks with a fully secured line of credit 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 of its total assets, or \$596.2 million, at September 30, 2018. 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 September 30, 2018, the Bank pledged collateral to the FHLB to support additional borrowing capacity of \$68.0 million. The Bank also maintains unsecured federal funds lines of \$46.0 million with two correspondent banks, all of which were unused and available at September 30, 2018.

The Consolidated Statements of Cash Flows present the changes in cash from operating, investing and financing activities. At September 30, 2018, the balance of cash and cash equivalents was \$19.3 million.

Net cash provided by operating activities totaled \$12.2 million for the nine months ended September 30, 2018 compared to net cash provided by operating activities of \$16.4 million for the nine months ended September 30, 2017. 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 nine months ended September 30, 2018 was lower than net cash provided by operating activities for the nine months ended September 30, 2017 due primarily to higher net proceeds from the origination and sale of loans of approximately \$9.4 million in the first nine months of 2017. Partially offsetting this lower cash flow from operations in the 2018 period was the net increase in accrued expenses and other liabilities compared to the net decrease in accrued expenses and other liabilities in the 2017 period.

Net cash used in investing activities totaled \$21.7 million for the nine months ended September 30, 2018 compared to \$40.2 million for the nine months ended September 30, 2017. The loans and securities portfolios are a source of liquidity, providing cash flows from maturities and periodic payments of principal. The primary use of cash from investing activities for the first nine months of 2018 was a net increase in loans of \$19.4 million compared to a net increase in loans of \$47.8 million for the first nine months of 2017. Net cash of \$996,000 was used in the NJCB merger. For the nine months ended September 30, 2018 and 2017, payments and maturities of investment securities totaled \$34.9 million and \$46.4 million, respectively. Cash was used to purchase investment securities of \$33.0 million for the nine months ended September 30, 2018 compared to purchases of \$46.2 million of investment securities for the nine months ended September 30, 2017. There were no sales of investment securities in the nine months ended September 30, 2018 and proceeds from the sale of investment securities totaled \$8.6 million for the nine months ended September 30, 2017.

Net cash provided by financing activities was \$10.0 million for the nine months ended September 30, 2018 compared to \$24.6 million for the nine months ended September 30, 2017. The primary source of funds for the 2018 period was the increase in short-term borrowings of \$79.0 million, which was partially offset by the decrease in deposits of \$67.6 million. Cash dividends of \$1.5 million were paid in the first nine months of 2018. The primary source of funds for the nine months ended September 30, 2017 was the increase in deposits of \$35.3 million. Management believes that the Company's and the Bank's liquidity resources are adequate to provide for the Company's and the Bank's planned operations.

## Shareholders' Equity and Dividends

Shareholders' equity increased by \$12.1 million, or 10.9%, to \$123.8 million at September 30, 2018 from \$111.7 million at December 31, 2017. Shareholders' equity increased \$12.1 million due primarily to the issuance of 249,785 shares of common stock with a fair value of \$5.5 million in connection with the NJCB merger and an increase of \$7.2 million in retained earnings, which was partially offset by a \$1.4 million increase in accumulated other comprehensive loss.

The Company began declaring and paying cash dividends on its common stock in September 2016 and has declared and paid a cash dividend for each quarter since then. The timing and the amount of the payment of future cash dividends, if any, on the Company's common stock will be at the discretion of the Company's Board of Directors and will be determined after consideration of various factors, including the level of earnings, cash requirements, regulatory capital and financial condition.

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 common stock repurchase program. Under the common stock repurchase program, the Company may repurchase in open market or privately negotiated transactions up to five percent (5%) of its common stock outstanding on the date of approval of the stock repurchase program, which limitation is adjusted for any subsequent stock dividends. This repurchase program replaced the repurchase program authorized on August 3, 2005.

Disclosure of repurchases of shares of common stock of the Company that were made during the quarter ended September 30, 2018 is set forth under Part II, Item 2 of this report, "Unregistered Sales of Equity Securities and Use of Proceeds."

## Capital Resources

The Company and the Bank are subject to various regulatory capital requirements administered by the Federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of Common Equity Tier 1, Total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined) and Tier I capital to average assets (Leverage ratio, as defined). As of September 30, 2018 and December 31, 2017, the Company and the Bank met all capital adequacy requirements to which they are subject.

To be categorized as adequately capitalized, the Company and the Bank must maintain minimum Common Equity Tier 1, Total capital to risk-weighted assets, Tier 1 capital to risk-weighted assets and Tier I leverage capital ratios as set forth in the below table. As of September 30, 2018 and December 31, 2017, the Bank's capital ratios exceeded the regulatory standards for well-capitalized institutions. Certain bank regulatory limitations exist on the availability of the Bank's assets for the payment of dividends by the Bank without prior approval of bank regulatory authorities.

In July 2013, the Federal Reserve Board and the Federal Deposit Insurance Corporation (“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 Wall Street Reform and Consumer Protection 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 (which was subsequently increased to \$1 billion or more in May 2015) and top-tier savings and loan holding companies (“banking organizations”). Among other things, the rules established a Common Equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets) and increased 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 limited 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 rules became effective for the Company and the Bank on January 1, 2015. The capital conservation buffer requirement began phasing in on

January 1, 2016 at 0.625% of Common Equity Tier 1 capital to risk-weighted assets and increases by that amount each year until fully implemented in January 2019 at 2.5% of Common Equity Tier 1 capital to risk-weighted assets. As of January 1, 2018, the Company and the Bank were required to maintain a capital conservation buffer of 1.875%.

Management believes that the Company's and the Bank's capital resources are adequate to support the Company's and the Bank's current strategic and operating plans.

The Company's actual capital amounts and ratios are presented in the following table:

|  | Actual    |         | For Capital Adequacy Purposes |        | To Be Well Capitalized Under Prompt Corrective Action Provision |       |
|--|-----------|---------|-------------------------------|--------|---|-------|
|  | Amount    | Ratio   | Amount                        | Ratio  | Amount  | Ratio |
| (Dollars in thousands)                 |           |         |                               |        |   |       |
| As of September 30, 2018               |           |         |                               |        |   |       |
| Common equity Tier 1 (CET1)            | \$113,463 | 10.43 % | \$48,961                      | 4.50 % | N/A   | N/A   |
| Total capital to risk-weighted assets  | 139,728   | 12.84 % | 87,041                        | 8.00 % | N/A   | N/A   |
| Tier 1 capital to risk-weighted assets | 131,463   | 12.08 % | 65,281                        | 6.00 % | N/A   | N/A   |
| Tier 1 leverage capital                | 131,463   | 11.19 % | 47,001                        | 4.00 % | N/A   | N/A   |
| As of December 31, 2017                |           |         |                               |        |   |       |
| Common equity Tier 1 (CET1)            | \$99,839  | 10.19 % | \$44,106                      | 4.50 % | N/A   | N/A   |
| Total capital to risk-weighted assets  | 125,852   | 12.84 % | 78,411                        | 8.00 % | N/A   | N/A   |
| Tier 1 capital to risk-weighted assets | 117,839   | 12.02 % | 58,808                        | 6.00 % | N/A   | N/A   |
| Tier 1 leverage capital                | 117,839   | 11.23 % | 41,987                        | 4.00 % | N/A   | N/A   |

The Bank's actual capital amounts and ratios are presented in the following table:

|  | Actual    |         | For Capital Adequacy Purposes |        | To Be Well Capitalized Under Prompt Corrective Action Provision |         |
|--|-----------|---------|-------------------------------|--------|---|---------|
|  | Amount    | Ratio   | Amount                        | Ratio  | Amount  | Ratio   |
| (Dollars in thousands)                 |           |         |                               |        |   |         |
| As of September 30, 2018               |           |         |                               |        |   |         |
| Common equity Tier 1 (CET1)            | \$131,535 | 12.10 % | \$48,936                      | 4.50 % | \$70,685  | 6.50 %  |
| Total capital to risk-weighted assets  | 139,800   | 12.86 % | 86,996                        | 8.00 % | 108,746   | 10.00 % |
| Tier 1 capital to risk-weighted assets | 131,535   | 12.10 % | 65,247                        | 6.00 % | 86,996  | 8.00 %  |
| Tier 1 leverage capital                | 131,535   | 11.19 % | 47,001                        | 4.00 % | 58,752  | 5.00 %  |
| As of December 31, 2017                |           |         |                               |        |   |         |
| Common equity Tier 1 (CET1)            | \$115,031 | 11.74 % | \$44,106                      | 4.50 % | \$63,709  | 6.50 %  |
| Total capital to risk-weighted assets  | 123,044   | 12.55 % | 78,411                        | 8.00 % | 98,014  | 10.00 % |
| Tier 1 capital to risk-weighted assets | 115,031   | 11.74 % | 58,808                        | 6.00 % | 78,411  | 8.00 %  |
| Tier 1 leverage capital                | 115,031   | 10.96 % | 41,987                        | 4.00 % | 52,484  | 5.00 %  |



## 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 the economic value of equity. Based on, 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 the economic value of equity.

Based upon the current interest rate environment, as of September 30, 2018, 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         | \$      | %      | Dollar    | \$                       | %       |
|   | Amount         | Change  | Change | Amount    | Change                   | Change  |
| +300  | \$49,988       | \$3,592 | 7.74 % | \$170,564 | \$(3,613)                | (2.07)% |
| +200  | 48,797         | 2,401   | 5.18 % | 172,381   | (1,796 )                 | (1.03)% |
| —   | 46,396         | —       | — %    | 174,177   | —                        | — %     |

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

<sup>(2)</sup> Economic value of equity 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 that is validated by third-party reviewers periodically.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's Asset Liability Committee ("ALCO") is responsible for developing, implementing and monitoring asset liability management strategies and advising the Company's Board of Directors on such strategies, as well as the related level of interest rate risk. Interest rate risk simulation models are prepared on a quarterly basis. These models demonstrate balance sheet gaps and predict changes to net interest income and the economic market value of equity under various interest rate scenarios.

ALCO is generally authorized to manage interest rate risk through the management of capital, cash flows and duration of assets and liabilities, including sales and purchases of assets, as well as additions of borrowings and other sources of medium or longer-term funding.

The following strategies are among those used to manage interest rate risk:

- Actively market commercial business loan originations, which tend to have adjustable rate features and which generate customer relationships that can result in higher core deposit accounts;
- Actively market commercial mortgage loan originations, which tend to have shorter maturity terms and higher interest rates than residential mortgage loans and which generate customer relationships that can result in higher core deposit accounts;
- Actively market core deposit relationships, which are generally longer duration liabilities;
- Utilize short term and long-term certificates of deposit and/or borrowings to manage liability duration;
- Closely monitor and actively manage the investment portfolio, including management of duration, prepayment and interest rate risk;
- Maintain adequate levels of capital; and
- Utilize loan sales and/or loan participations.

ALCO uses simulation modeling to analyze the Company's net interest income sensitivity as well as the Company's economic value of portfolio equity under various interest rate scenarios. The model is based on the actual maturity and estimated repricing characteristics of rate sensitive assets and liabilities. The model incorporates certain prepayment and interest rate assumptions, which management believes to be reasonable as of September 30, 2018. The model assumes changes in interest rates without any proactive change in the balance sheet by management. In the model, the forecasted shape of the yield curve remained static as of September 30, 2018.

In an immediate and sustained 200 basis point increase in market interest rates at September 30, 2018, net interest income for year 1 would increase approximately 5.2%, when compared to a flat interest rate scenario.

Certain shortcomings are inherent in the methodologies used in determining interest rate risk. Simulation modeling requires making certain assumptions that may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. In this regard, the modeling assumes that the composition of our interest-sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and assumes that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration or repricing of specific assets and liabilities. Accordingly, although the information provides an indication of our interest rate risk exposure at a particular point in time, such measurements are not intended to, and do not, provide a precise forecast of the effect of changes in market interest rates on our net interest income and will differ from actual results.

Model simulation results indicate the Company is asset sensitive, which indicates the Company's net interest income should increase in a rising rate environment. Management believes the Company's interest rate risk position is balanced and reasonable.



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 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.

Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports it files under the Exchange Act is accumulated and communicated to management, including the principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

The Company's principal executive officer and principal financial officer have 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 September 30, 2018 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company may, in the ordinary course of business, become a party to litigation involving collection matters, contract claims and other legal proceedings relating to the conduct of its business. Management is not aware of any material pending legal proceedings against the Company which, if determined adversely, would have a material adverse effect on the Company's financial condition or results of operations.

Item 1A. Risk Factors

There has been no material change in the risk factors previously disclosed under the heading "Risk Factors" within the Company's Form 10-K for the year ended December 31, 2017.

## 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 common stock repurchase program. Under this common stock repurchase program, the Company may repurchase in open market or privately negotiated transactions up to five percent (5%) of its common stock outstanding on the date of approval of the stock repurchase program, which limitation is adjusted for any subsequent stock dividends. The Company's common stock repurchase program covers a maximum of 396,141 shares of common stock of the Company, representing 5% of the outstanding common stock of the Company on January 21, 2016, as adjusted for subsequent common stock dividends. There were no repurchases under the plan during the third quarter of 2018.

The following table provides common stock repurchases made by or on behalf of the Company during the three months ended September 30, 2018.

| Period                      | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased As Part of Publicly Announced Plan or Program | Maximum Number of Shares That May Yet be Purchased Under the Plan or Program |
|-----------------------------|----------------------------------|------------------------------|--|--|
| Beginning July 1, 2018      | —                                | \$                           | —  | 394,141  |
| Ending July 31, 2018        | —                                | \$                           | —  | 394,141  |
| Beginning August 1, 2018    | —                                | \$                           | —  | 394,141  |
| Ending August 31, 2018      | —                                | \$                           | —  | 394,141  |
| Beginning September 1, 2018 | —                                | \$                           | —  | 394,141  |
| Ending September 30, 2018   | —                                | \$                           | —  | 394,141  |
| Total                       | —                                | \$                           | —  | 394,141  |

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

## Item 5. Other Information

None.

Item 6. Exhibits.

- 3(i)(A) Certificate of Incorporation of the Company (conformed copy) (incorporated by reference to Exhibit 3(i)(A) to the Company's Form 10-K (SEC File No. 000-32891) filed with the SEC on March 27, 2009)
- 3(ii)(A) By-laws of the Company, 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)
- 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

---

\* 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: November 7, 2018 By: /s/ ROBERT F. MANGANO  
Robert F. Mangano  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: November 7, 2018 By: /s/ STEPHEN J. GILHOOLY  
Stephen J. Gilhooly  
Senior Vice President, Treasurer and Chief Financial Officer  
(Principal Financial Officer)