1ST CONSTITUTION BANCORP
Form 10-K
April 02, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

(Mark One)
x ANNUAL REPORT UNDER SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

o TRANSITION REPORT UNDER 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 (State or Other Jurisdiction of Incorporation or Organization)	22-3665653 IRS Employer Identification Number)

2650 Route 130, P.O. Box 634, Cranbury, NJ 08512
(Address of Principal Executive Offices, including Zip Code)

(609) 655-4500
(Registrant’s telephone number, including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Common Stock, No Par Value

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

Stock Purchase Rights Relating to Common Stock, No Par Value
(Title of Class)

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

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

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

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

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant, computed by reference to the price at which the common stock was last sold, or the average bid and asked price of such common stock, as of the last business day of the registrant's most recently completed second quarter, is $57,045,025.

As of March 13, 2007, 3,742,662 shares of the registrant's common stock were outstanding.

Portions of the registrant's definitive Proxy Statement for its 2007 Annual Meeting of Shareholders are incorporated by reference into Part III of this report.

FORM 10-K

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PART I

Item 1. Business.

1st Constitution Bancorp

1st Constitution Bancorp (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 1st Constitution Bank (the "Bank") and thereby enabling the Bank to operate within a bank holding company structure. The Company became an active bank holding company on July 1, 1999. The Bank is a wholly-owned subsidiary of the Company. Other than its investment in the Bank, the Company currently conducts no other significant business activities.

As of December 31, 2006, the Company, on a consolidated basis, had total assets of approximately $392.7 million, total deposits of approximately $312.7 million, total gross loans of approximately $265.1 million and total shareholders' equity of approximately $35.2 million.

The main office of the Company and the Bank is located at 2650 Route 130 North, Cranbury, New Jersey 08512, and the telephone number is (609) 655-4500.

1st Constitution Bank

The Bank, a commercial bank formed under the laws of the State of New Jersey, engages in the business of commercial and retail banking. As a community bank, the Bank offers a wide range of services (including demand, savings and time deposits and commercial and consumer/installment loans) to individuals, small businesses and not-for-profit organizations principally in Middlesex, Mercer and Somerset Counties, New Jersey. The Bank conducts its operations through its main office located in Cranbury, New Jersey, and operates nine additional branch offices in downtown Cranbury, Hamilton Square, Jamesburg, Montgomery, Perth Amboy, Plainsboro, West Windsor, Fort Lee and Princeton, New Jersey. The Bank's deposits are insured up to applicable legal limits by the Federal Deposit Insurance Corporation ("FDIC").

Management efforts focus on positioning the Bank to meet the financial needs of the communities in Middlesex, Mercer and Somerset Counties and the Fort Lee area of Bergen County and to provide financial services to individuals, families, institutions and small businesses. To achieve this goal, the Bank is focusing its efforts on:

- personal service;

- expansion of its branch network;

- innovative product offerings; and

- technological advances and e-commerce.

Personal Service

The Bank provides a wide range of commercial and consumer banking services to individuals, families, institutions and small businesses in central New Jersey and the Fort Lee area of Bergen County. The Bank's focus is to understand the needs of the community and the customers and tailor products, services and advice to meet those needs. The Bank seeks to provide a high level of personalized banking services, emphasizing quick and flexible responses to customer demands.

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Expansion of Branch Banking

The Bank continually evaluates opportunities for branch bank expansion, either mini branches or full service banks, to continue to grow and meet the needs of the community. During the third quarter of 2006, the Bank relocated its Plainsboro branch office from 10 Schalks Crossing Road to 11 Schalks Crossing Road and opened a new branch office at 180 Main Street, Fort Lee, Bergen County, New Jersey. During the fourth quarter of 2006, the Bank announced that it had entered into a Purchase and Assumption Agreement to acquire all of the deposit liabilities and related assets of the Hightstown, New Jersey branch banking office of Sun National Bank. Pending the receipt of regulatory agency approvals, the transaction is scheduled to close during the first quarter of 2007.

Innovative Product Offerings

In the fourth quarter of 2006, the Bank launched its new EZ Deposit service. This new product allows customers of the Bank to scan checks, using a scanning device furnished by the Bank, at the customer's place of business and transmit them directly to the Bank for deposit into the customer's account. The Check 21 Act allows for the creation of Image Replacement Documents ("IRD") that are the legal equivalent of the original check. Therefore, the check images captured at customer locations are sent electronically to the Bank and customers can reduce the number of trips to the Bank, as deposits are made directly from their place of business to the Bank. The service also has a later deposit time cutoff than branch locations and this allows customers to process deposits and have them posted the same day rather than the following business day.

By the end of 2006, there were 13 EZ Deposit customers using the service and a number of customers requesting the service in 2007. Management believes that there is great customer acceptance of this service and that the demand for this service will be strong in 2007.

Technological Advances and e-Commerce

The Bank recognizes that customers want to receive service via their most convenient delivery channel, be it the traditional branch office, by telephone, ATM, or the internet. For this reason, the Bank continues to enhance its e-commerce capabilities. At www.1stconstitution.com, customers have easy access to online banking, including account access, and to the Bank's bill payment system. Consumers can apply online for loans and interact with senior management through the e-mail system. Business customers have access to cash management information and transaction capability through the Bank's online Business Express product offering. This overall expansion in electronic banking offers the Bank's customers another means to access the Bank's services easily and at their own convenience.

Competition

The Bank experiences substantial competition in attracting and retaining deposits and in making loans. In attracting deposits and borrowers, the Bank competes with commercial banks, savings banks, and savings and loan associations, as well as regional and national insurance companies and non-bank financial institutions, regulated small loan companies and local credit unions, regional and national issuers of money market funds and corporate and government borrowers. Within the direct market area of the Bank, there are a significant number of offices of competing financial institutions. In New Jersey generally, and in the Bank's local market specifically, large commercial banks, as well as savings banks and savings and loan associations, including Provident Savings Bank and Hudson City Savings Bank, hold a dominant market share and there has been significant merger activity in the last few years, creating even larger competitors.

Locally, the Bank's most direct competitors include Bank of America, PNC Bank, Wachovia Bank, and Sovereign Bank. The Bank is at a competitive disadvantage compared with these larger national and regional commercial and savings banks. By virtue of their larger capital, asset size or reserves, many of such institutions have substantially

greater lending limits (ceilings on the amount of credit a bank may provide to a single customer that are linked to the institution's capital) and other resources than the Bank. Many such institutions are empowered to offer a wider range of services, including trust services, than the Bank and, in some cases, have lower funding costs (the price a bank must pay for deposits and other borrowed monies used to make loans to customers) than the Bank. In addition to having established deposit bases and loan portfolios, these institutions, particularly large national and regional commercial and savings banks, have the financial ability to finance extensive advertising campaigns and to allocate considerable resources to locations and products perceived as profitable.

In addition, non-bank financial institutions offer services that compete for deposits with the Bank. For example, brokerage firms and insurance companies offer such instruments as short-term money market funds, corporate and government securities funds, mutual funds and annuities. It is expected that competition in these areas will continue to increase. Some of these competitors are not subject to the same degree of regulation and supervision as the Company and the Bank and therefore may be able to offer customers more attractive products than the Bank.

However, management of the Bank believes that loans to small and mid-sized businesses and professionals, which represent the main commercial loan business of the Bank, are not always of primary importance to the larger banking institutions. The Bank competes for this segment of the market by providing responsive personalized services, local decision-making, and knowledge of its customers and their businesses.

Lending Activities

The Bank’s lending activities include both commercial and consumer loans. Loan originations are derived from a number of sources including real estate broker referrals, mortgage loan companies, direct solicitation by the Bank’s loan officers, existing depositors and borrowers, builders, attorneys, walk-in customers and, in some instances, other lenders. The Bank has established disciplined and systematic procedures for approving and monitoring loans that vary depending on the size and nature of the loan.

Commercial Lending

The Bank 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. The Bank also makes construction loans to real estate developers for the acquisition, development and construction of residential subdivisions.

Commercial 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 loans is substantially dependent on the success of the business itself and on the quality of its management. As a general practice, the Bank takes as collateral a security interest in any available real estate, equipment, inventory, receivables or other personal property of its borrowers, although occasionally the Bank makes commercial loans on an unsecured basis. Generally, the Bank requires personal guaranties of its commercial loans to offset the risks associated with such loans.

Residential Consumer Lending

A portion of the Bank’s lending activities consists of the origination of fixed and adjustable rate residential first mortgage loans secured by owner-occupied property located in the Bank’s primary market areas. Home mortgage lending is unique in that a broad geographic territory may be serviced by originators working from strategically placed offices either within the Bank’s traditional banking facilities or from affordable storefront locations in commercial buildings. The Bank also offers construction loans, second mortgage home improvement loans and home equity lines of credit.

The Bank finances the construction of individual, owner-occupied houses on the basis of written underwriting and construction loan management guidelines. First mortgage construction loans are made to contractors secured by real estate that is both a pre-sold and a “speculation” basis. Such loans are also made to qualified individual borrowers and are generally supported by a take-out commitment from a permanent lender. The Bank makes residential construction loans to individuals who intend to erect owner occupied housing on a purchased parcel of real estate. The construction phase of these loans has certain risks, including the viability of the contractor, the contractor’s ability to complete the project and changes in interest rates.

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In most cases, the Bank will sell its mortgage loans with terms of 15 years or more in the secondary market. The sale to the secondary market allows the Bank to hedge against the interest rate risks related to such lending operations. This brokerage arrangement allows the Bank to accommodate its clients' demands while eliminating the interest rate risk for the 15- to 30- year period generally associated with such loans.

The Bank in most cases requires borrowers to obtain and maintain title, fire, and extended casualty insurance, and, where required by applicable regulations, flood insurance. The Bank maintains its own errors and omissions insurance policy to protect against loss in the event of failure of a mortgagor to pay premiums on fire and other hazard insurance policies. Mortgage loans originated by the Bank customarily include a "due on sale" clause, which gives the Bank the right to declare a loan immediately due and payable in certain circumstances, including, without limitation, upon the sale or other disposition by the borrower of the real property subject to a mortgage. In general, the Bank enforces due on sale clauses. Borrowers are typically permitted to refinance or repay loans at their option without penalty.

Non-Residential Consumer Lending

Non-residential consumer loans made by the Bank include loans for automobiles, recreation vehicles, and boats, as well as personal loans (secured and unsecured) and deposit account secured loans. The Bank also conducts various indirect lending activities through established retail companies in its market areas. Non-residential consumer loans are attractive to the Bank because they typically have a shorter term and carry higher interest rates than are charged on other types of loans. Non-residential consumer loans, however, do pose additional risk of collectibility when compared to traditional types of loans, such as residential mortgage loans granted by commercial banks.

Consumer loans are granted based on employment and financial information solicited from prospective borrowers as well as credit records collected from various reporting agencies. Stability of the borrower, willingness to pay and credit history are the primary factors to be considered. The availability of collateral is also a factor considered in making such a loan. The Bank seeks collateral that can be assigned and has good marketability with a clearly adequate margin of value. The geographic area of the borrower is another consideration, with preference given to borrowers in the Bank's primary market areas.

Supervision and Regulation

Banking is a complex, highly regulated industry. The primary goals of the bank regulatory scheme are to maintain a safe and sound banking system and to facilitate the conduct of monetary policy. In furtherance of those goals, Congress has created several largely autonomous regulatory agencies and enacted a myriad of legislation that governs banks, bank holding companies and the banking industry. This regulatory framework is intended primarily for the protection of depositors and not for the protection of the Company's shareholders. Descriptions of, and references to, the statutes and regulations below are brief summaries thereof, and do not purport to be complete. The descriptions are qualified in their entirety by reference to the specific statutes and regulations discussed.

State and Federal Regulations

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended (the "BHCA"). As a bank holding company, the Company is subject to inspection, examination and supervision by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") and is required to file with the Federal Reserve Board an annual report and such additional information as the Federal Reserve Board may require pursuant to the BHCA. The Federal Reserve Board may also make examinations of the Company and its subsidiaries. The Company is subject to capital standards similar to, but separate from, those applicable to the Bank.

Under the BHCA, bank holding companies that are not financial holding companies generally may not acquire the ownership or control of more than 5% of the voting shares, or substantially all the assets, of any company, including a bank or another bank holding company, without the Federal Reserve Board's prior approval. The Company has not applied to become a financial holding company but did obtain such approval to acquire the shares of the Bank. A bank holding company that does not qualify as a financial holding company is generally limited in the types of activities in which it may engage to those that the Federal Reserve Board had recognized as permissible for bank holding companies prior to the date of enactment of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999. For example, a holding company and its banking subsidiary are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit or lease or sale of any property or the furnishing of services. At present, the Company does not engage in any significant activity other than owning the Bank.

In addition to federal bank holding company regulation, the Company is registered as a bank holding company with the New Jersey Department of Banking and Insurance (the "Department"). The Company is required to file with the Department copies of the reports it files with the federal banking and securities regulators.

Capital Adequacy

The Company is required to comply with minimum capital adequacy standards established by the Federal Reserve Board. There are two basic measures of capital adequacy for bank holding companies and the depository institutions that they own: a risk based measure and a leverage measure. All applicable capital standards must be satisfied for a bank holding company to be considered in compliance.

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") required each federal banking agency to revise its risk-based capital standards to ensure that those standards take adequate account of interest rate risk, concentration of credit risk and the risks of non-traditional activities. In addition, pursuant to FDICIA, each federal banking agency has promulgated regulations, specifying the levels at which a bank would be considered "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized," ar to take certain mandatory and discretionary supervisory actions based on the capital level of the institution.

The regulations implementing these provisions of FDICIA provide that a bank will be classified as "well capitalized" if it (i) has a total risk-based capital ratio of at least 10.0 percent, (ii) has a Tier 1 risk-based capital ratio of at least 6.0 percent, (iii) has a Tier 1 leverage ratio of at least 5.0 percent, and (iv) meets certain other requirements. A bank will be classified as "adequately capitalized" if it (i) has a total risk-based capital ratio of at least 8.0 percent, (ii) has a Tier 1 risk-based capital ratio of at least 4.0 percent, (iii) has a Tier 1 leverage ratio of (a) at least 4.0 percent, or (b) at least 3.0 percent if the institution was rated 1 in its most recent examination and is not experiencing or anticipating significant growth, and (iv) does not meet the definition of "well capitalized." A bank will be classified as "undercapitalized" if it (i) has a total risk-based capital ratio of less than 8.0 percent, (ii) has a Tier 1 risk-based capital ratio of less than 4.0 percent, or (iii) has a Tier 1 leverage ratio of (a) less than 4.0 percent, or (b) less than 3.0 percent if the institution was rated 1 in its most recent examination and is not experiencing or anticipating significant growth. A bank will be classified as "significantly undercapitalized" if it (i) has a total risk-based capital ratio of less than 6.0 percent, (ii) has a Tier 1 risk-based capital ratio of less than 3.0 percent, or (iii) has a Tier 1 leverage ratio of less than 3.0 percent. An institution will be classified as "critically undercapitalized" if it has a tangible equity to total assets ratio that is equal to or less than 2.0 percent. An insured depository institution may be deemed to be in a lower capitalization category if it receives an unsatisfactory examination.

As of December 31, 2006, the Bank's capital ratios exceed the requirements to be considered a well capitalized institution under these regulations.

The risk-based capital guidelines for bank holding companies such as the Company currently require a minimum ratio of total capital to risk-weighted assets (including off-balance sheet activities, such as standby letters of credit) of 8%.

At least half of the total capital is required to be Tier 1 capital, consisting principally of common shareholders' equity, non-cumulative perpetual preferred stock, a limited amount of cumulative perpetual preferred stock and minority interest in the equity accounts of consolidated subsidiaries, less goodwill. The remainder of the total capital (Tier 2 capital) may consist of a limited amount of subordinated debt and intermediate-term preferred stock, certain hybrid capital instruments and other debt securities, perpetual preferred stock and a limited amount of the general loan loss allowance. At December 31, 2006, the Company maintained a Tier 1 capital ratio of 15.42% and total qualifying capital ratio of 20.23%.

In addition to the risk-based capital guidelines, the federal banking regulators established minimum leverage ratio (Tier 1 capital to total assets) guidelines for bank holding companies. These guidelines provide for a minimum leverage ratio of 3% for those bank holding companies which have the highest regulatory examination ratings and are not contemplating or experiencing significant growth or expansion. All other bank holding companies are required to maintain a leverage ratio of at least 1% to 2% above the 3% stated minimum. The Company's leverage ratio at December 31, 2006 was 12.18%.

On April 10, 2002, 1ST Constitution Capital Trust I ("Trust I"), a statutory business trust and a wholly owned subsidiary of the Company, issued $5.0 million of variable rate Trust Preferred Securities in a pooled institutional placement transaction maturing April 22, 2032. These Subordinated Debentures constitute the sole assets of Trust I. These Subordinated Debentures are redeemable in whole or part prior to maturity after April 22, 2007. Trust I is obligated to distribute all proceeds of a redemption of these Subordinated Debentures, whether voluntary or upon maturity, to holders of the Trust Preferred Securities. The Company's obligation with respect to the Trust Preferred Securities and the Subordinated Debentures, when taken together, provides a full and unconditional guarantee on a subordinated basis by the Company of the obligations of Trust I to pay amounts when due on the Trust Preferred Securities. On February 23, 2007, the Company notified Wilmington Trust Company, as Indenture Trustee, of the Company's intention to redeem on April 22, 2007 the debt securities issued by the Company to Trust I.

On May 30, 2006, 1ST Constitution Bancorp established 1ST Constitution Capital Trust II, a Delaware business trust subsidiary ("Trust II"), for the sole purpose of issuing $18 million of trust preferred securities (the "Capital Securities"). The Capital Securities were issued in connection with a pooled offering involving approximately 50 other financial institution holding companies. All of the Capital Securities were sold to a single pooling vehicle. The proceeds from the sale of the Capital Securities were loaned to the Company under 30-year floating rate junior subordinated debentures issued to Trust II by the Company. The debentures are the only asset of Trust II. Interest payments on the debentures flow through Trust II to the pooling vehicle. Payments of distributions by Trust II to the pooling vehicle are guaranteed by the Company.

Management has determined that Trust I and Trust II (together the "Trusts") qualify as variable interest entities under FASB Interpretation 46 ("FIN 46"). The Trusts issued mandatorily redeemable preferred stock to investors and loaned the proceeds to the Company. Each of the Trusts holds, as its sole asset, subordinated debentures issued by the Company. Subsequent to the issuance of FIN 46 and the establishment of Trust I, the FASB issued a revised interpretation, FIN 46(R), the provisions of which were required to be applied to certain variable interest entities, including Trust I, by March 31, 2004, at which time Trust I was deconsolidated.

In March 2005, the Federal Reserve Board adopted a final rule that would continue to allow the inclusion of trust preferred securities of the kind issued by the Trusts in Tier 1 capital, but with stricter quantitative limits. Under the final rule, after a five-year transition period, the aggregate amount of trust preferred securities and certain other capital elements would be limited to 25% of Tier 1 capital elements, net of goodwill. The amount of trust preferred securities and certain other elements in excess of the limit could be included in Tier 2 capital, subject to restrictions. Based on the final rule, the Company included all of its $23.7 million in trust preferred securities in Tier 1 capital at December 31, 2006. Management has evaluated the effects of the final rule and does not anticipate a material impact on its capital ratios by the end of the transition period.

Restrictions on Dividends

The primary source of cash to pay dividends, if any, to the Company's shareholders and to meet the Company's obligations is dividends paid to the Company by the Bank. Dividend payments by the Bank to the Company are subject to the New Jersey Banking Act of 1948 (the "Banking Act") and the Federal Deposit Insurance Act (the "FDIA"). Under the Banking Act and the FDIA, the Bank may not pay any dividends if after paying the dividend, it would be undercapitalized under applicable capital requirements. In addition to these explicit limitations, the federal regulatory agencies are authorized to prohibit a banking subsidiary or bank holding company from engaging in an unsafe or

unsound banking practice. Depending upon the circumstances, the agencies could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

It is the policy of the Federal Reserve Board that bank holding companies should pay cash dividends on common stock only out of income available over the immediately preceding year and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. The policy provides that bank holding companies should not maintain a level of cash dividend that undermines the bank holding company's ability to serve as a source of strength to its banking subsidiary. A bank holding company may not pay dividends when it is insolvent.

The Company has never paid a cash dividend and the Company's Board of Directors has no plans to pay a cash dividend in the foreseeable future. The Bank paid a stock dividend every year from 1993 to 1999, when it was acquired by the Company. The Company has paid a stock dividend every year since its formation in 1999. From 1999 through 2006, the Company paid a 5% stock dividend each year. On December 21, 2006, the Company declared a 6% stock dividend, which was paid on January 31, 2007 to shareholders of record as of the close of business on January 23, 2007. The Company also declared a two-for-one stock split on January 20, 2005, which was paid on February 28, 2005 to shareholders of record on February 10, 2005. All share and per share data has been retroactively adjusted for stock dividends.

Priority on Liquidation

The Company is a legal entity separate and distinct from the Bank. The rights of the Company as the sole shareholder of the Bank, and therefore the rights of the Company's creditors and shareholders, to participate in the distributions and earnings of the Bank when the Bank is not in bankruptcy, are subject to various state and federal law restrictions as discussed above under the heading "Restrictions of Dividends." In the event of a liquidation or other resolution of an insured depository institution such as the Bank, the claims of depositors and other general or subordinated creditors are entitled to a priority of payment over the claims of holders of an obligation of the institution to its shareholders (the Company) or any shareholder or creditor of the Company. The claims on the Bank by creditors include obligations in respect of federal funds purchased and certain other borrowings, as well as deposit liabilities.

Financial Institution Legislation

The Gramm-Leach-Bliley Financial Modernization Act of 1999 (the "Modernization Act") became effective in early 2000. The Modernization Act:

· allows bank holding companies meeting management, capital and Community Reinvestment Act standards to engage in a substantially broader range of non-banking activities than is permissible for a bank holding company, including insurance underwriting and making merchant banking investments in commercial and financial companies; if a bank holding company elects to become a financial holding company, it files a certification, effective in 30 days, and thereafter may engage in certain financial activities without further approvals;

· allows banks to establish subsidiaries to engage in certain activities which a financial holding company could engage in, if the bank meets certain management, capital and Community Reinvestment Act standards;

· allows insurers and other financial services companies to acquire banks and removes various restrictions that currently apply to bank holding company ownership of securities firms and mutual fund advisory companies; and establishes the overall regulatory structure applicable to financial holding companies that also engage in insurance and securities operations.

The Modernization Act modified other financial laws, including laws related to financial privacy and community reinvestment.

The Modernization Act also amends the BHCA and the Bank Merger Act to require the federal banking agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing an application under these acts.

Additional proposals to change the laws and regulations governing the banking and financial services industry are frequently introduced in Congress, in the state legislatures and before the various bank regulatory agencies. The likelihood and timing of any such changes and the impact such changes might have on the Company cannot be determined at this time.

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"), which became law on July 30, 2002, added new legal requirements affecting corporate governance, accounting and corporate reporting for companies with publicly traded securities.

The Sarbanes-Oxley Act provides for, among other things:

- a prohibition on personal loans made or arranged by the issuer to its directors and executive officers (except for loans made by a bank subject to Regulation O);
- independence requirements for audit committee members;
- disclosure of whether at least one member of the audit committee is a "financial expert" (as such term is defined by the SEC) and if not, why not;
- independence requirements for outside auditors;
- a prohibition by a company's registered public accounting firm from performing statutorily mandated audit services for the company if the company's chief executive officer, chief financial officer, comptroller, chief accounting officer or any person serving in equivalent positions had been employed by such firm and participated in the audit of such company during the one-year period preceding the audit initiation date;
- certification of financial statements and reports on Forms 10-K, 10-KSB, 10-Q, and 10-QSB by the chief executive officer and the chief financial officer;
- the forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer's securities by directors and senior officers in the twelve month period following initial publication of any financial statements that later require restatement due to corporate misconduct;
- disclosure of off-balance sheet transactions;
- two-business day filing requirements for insiders filing Forms 4;
- disclosure of a code of ethics for financial officers and filing a Form 8-K for a change or waiver of such code;
- "real time" filing of periodic reports;
- posting of certain SEC filings and other information on the company website;
- the reporting of securities violations "up the ladder" by both in-house and outside attorneys;
- restrictions on the use of non-GAAP financial measures;

- the formation of a public accounting oversight board; and
- various increased criminal penalties for violations of securities laws.

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Additionally, Section 404 of the Sarbanes-Oxley Act requires that a public company subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), include in its annual report (i) a management’s report on internal control over financial reporting assessing the company’s internal controls, and (ii) an auditor’s attestation report, completed by the registered public accounting firm that prepares or issues an accountant’s report which is included in the company’s annual report, attesting to the effectiveness of management’s internal control assessment. Because we are neither a “large accelerated filer” nor an “accelerated filer”, under current rules, we are not required to provide management’s report on internal control over financial reporting until we file our annual report for 2007 and compliance with the auditor’s attestation report requirement is not required until we file our annual report for 2008.

Each of the national stock exchanges, including the Nasdaq Global Market where the Company’s common stock is listed, have implemented new corporate governance rules, including rules strengthening director independence requirements for boards, and the adoption of charters for the nominating, corporate governance, and audit committees. The rule changes are intended to, among other things, make the board of directors independent of management and allow shareholders to more easily and efficiently monitor the performance of companies and directors. These increased burdens have increased the Company’s legal and accounting fees and the amount of time that the Board of Directors and management must devote to corporate governance issues.

Effective August 29, 2002, as directed by Section 302(a) of Sarbanes-Oxley, the Company’s chief executive officer and chief financial officer are each required to certify that the Company’s Quarterly and Annual Reports do not contain any untrue statement of a material fact. The rules have several requirements, including having these officers certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of the Company’s internal controls; they have made certain disclosures to the Company’s auditors and the audit committee of the Board of Directors about the Company’s internal controls; and they have included information in the Company’s Quarterly and Annual Reports about their evaluation and whether there have been significant changes in the Company’s internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation.

As part of the USA Patriot Act, signed into law on October 26, 2001, Congress adopted the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (the “Act”). The Act authorizes the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to financial institutions such as banks, bank holding companies, broker-dealers and insurance companies. Among its other provisions, the Act requires each financial institution: (i) to establish an anti-money laundering program; (ii) to establish due diligence policies, procedures and controls that are reasonably designed to detect and report instances of money laundering in United States private banking accounts and correspondent accounts maintained for non-United States persons or their representatives; and (iii) to avoid establishing, maintaining, administering, or managing correspondent accounts in the United States for, or on behalf of, a foreign shell bank that does not have a physical presence in any country. In addition, the Act expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours.

The Department of Treasury has issued regulations implementing the due diligence requirements. These regulations require minimum standards to verify customer identity and maintain accurate records, encourages cooperation among financial institutions, federal banking agencies, and law enforcement authorities regarding possible money laundering or terrorist activities, prohibits the anonymous use of “concentration accounts,” and requires all covered financial institutions to have in place an anti-money laundering compliance program.

The Bank, a New Jersey-chartered commercial bank, is subject to supervision and examination by the New Jersey Department of Banking and Insurance. The Bank is also subject to regulation by the FDIC, which is its principal federal bank regulator.

The Bank must comply with various requirements and restrictions under federal and state law, including the maintenance of reserves against deposits, restrictions on the types and amounts of loans that may be granted and the interest that may be charged thereon, limitations on the types of investments that may be made and the services that may be offered, and restrictions on dividends as described in the preceding section. Consumer laws and regulations also affect the operations of the Bank. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the Federal Reserve Board which influence the money supply and credit availability in the national economy.

Community Reinvestment Act

Under the Community Reinvestment Act (“CRA”), as implemented by FDIC regulations, a bank has a continuing and affirmative obligation, consistent with its safe and sound operation, to help meet the credit needs of its entire community, including low- and moderate-income neighborhoods. CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution’s discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with CRA. CRA requires the FDIC to assess an institution’s record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications by the applicable institution. The CRA requires public disclosure of an institution’s CRA rating and requires that the FDIC provide a written evaluation of an institution’s CRA performance utilizing a four-tiered descriptive rating system. An institution’s CRA rating is considered in determining whether to grant charters, branches and other deposit facilities, relocations, mergers, consolidations and acquisitions. Performance less than satisfactory may be the basis for denying an application. At its last CRA examination, the Bank was rated “satisfactory” under CRA.

Insurance of Deposits

The Bank’s deposits are insured up to a maximum of $100,000 per depositor under the Deposit Insurance Fund. The FDICIA is applicable to depository institutions and deposit insurance. The FDICIA requires the FDIC to establish a risk-based assessment system for all insured depository institutions. Under this legislation, the FDIC is required to establish an insurance premium assessment system based upon: (i) the probability that the insurance fund will incur a loss with respect to the institution, (ii) the likely amount of the loss, and (iii) the revenue needs of the insurance fund. In compliance with this mandate, the FDIC has developed a matrix that sets the assessment premium for a particular institution in accordance with its capital level and overall rating by the primary regulator. Under the matrix as currently in effect, the assessment rate ranges from 0 to 27 basis points of assessed deposits. The Bank is also subject to a quarterly FICO assessment.

Employees

The Company has two paid employees. Banking operations are conducted by the Bank, and as of December 31, 2006, the Bank had 88 full-time employees and 12 part-time employees. Neither the Bank’s nor the Company’s employees are represented by any collective bargaining group. The Bank and the Company each considers its relations with such employees to be good.

Forward Looking Statements

When used in this and in future filings by the Company with the Securities and Exchange Commission, 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,” “pla
continue,” “is anticipated,” “estimated,” “project” or “outlook” or similar expressions (including confirmations by an authorize
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 wishes to caution readers not to place undue reliance on any such forward-looking statements, each of which speak 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 below under “Risk Factors”; 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; and technological changes. 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 have an adverse effect on profitability. Such risks and other aspects of the Company’s business and operations are described in “Business”, “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operation.” The Company has no obligation to publicly release the result of any revisions which may be made to any forward-looking statements to reflect anticipated or unanticipated events or circumstances occurring after the date of such statements.

Item 1A. Risk Factors.

The common stock of the Company is speculative in nature and involves a significant degree of risk. The risk factors below are not listed in order of importance.

The Company Faces Significant Competition.

The Company faces significant competition from many other banks, savings institutions and other financial institutions which have branch offices or otherwise operate in the Company’s market area. Non-bank financial institutions, such as securities brokerage firms, insurance companies and money market funds, engage in activities which compete directly with traditional bank business which has also led to greater competition. Many of these competitors have substantially greater financial resources than the Company, including larger capital bases that allow them to attract customers seeking larger loans than the Company is able to accommodate and the ability to aggressively advertise their products. There can be no assurance that the Company and the Bank will be able to successfully compete with these entities in the future. See “BUSINESS -- Competition.”

The Company’s Business is Affected by Economic Conditions and Related Uncertainties.

Commercial banking is affected, directly and indirectly, by local, domestic, and international economic and political conditions, and by government monetary and fiscal policies. Conditions such as inflation, recession, unemployment, volatile interest rates, tight money supply, scarce natural resources, real estate values, international conflicts and other factors beyond the control of the Company may adversely affect the potential profitability of the Company. A downtrend in several areas, such as real estate, construction and consumer spending, could have a material adverse impact on the Company’s ability to maintain or increase profitability.

The Company is Subject to Interest Rate Risk.

The Company’s earnings are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond the Company’s control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, could influence not only the interest the Company receives on loans and securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (i) the Company’s ability to originate loans and obtain deposits, (ii) the fair value of the Company’s financial assets and liabilities, and (iii) the average duration of the Company’s mortgage-backed securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, the Company’s net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on the Company's results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the Company's financial condition and results of operations.

The Company is Subject to Risks Associated With Speculative 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 of the project within projected absorption periods, the economic risks associated with real estate collateral, and the potential of a rising interest rate environment. Such loans may include financing the development and/or construction of residential subdivisions. This activity may involve financing land purchase, infrastructure development (i.e. roads, utilities, etc.), as well as construction of residences or multi-family dwellings for subsequent sale by developer/builder. Because the sale 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. Management has established underwriting and monitoring criteria to minimize the inherent risks of speculative commercial real estate construction lending. Further, management concentrates lending efforts with developers demonstrating successful performance on marketable projects within the Bank’s lending areas.

Federal and State Government Regulation Impact the Company’s Operations.

The operations of the Company and the Bank are heavily regulated and will be affected by present and future legislation and by the policies established from time to time by various federal and state regulatory authorities. In particular, the monetary policies of the Federal Reserve Board have had a significant effect on the operating results of banks in the past and are expected to continue to do so in the future. Among the instruments of monetary policy used by the Federal Reserve Board to implement its objectives is changes in the discount rate charged on bank borrowings. It is not possible to predict what changes, if any, will be made to the monetary policies of the Federal Reserve Board or to existing federal and state legislation or the effect that such changes may have on the future business and earnings prospects of the Company.

The Company and the Bank are subject to examination, supervision and comprehensive regulation by various federal and state agencies. Compliance with the rules and regulations of these agencies may be costly and may limit growth and restrict certain activities, including payment of dividends, investments, loans and interest rate charges, interest rates paid on deposits, and locations of offices. The Bank is also subject to capitalization guidelines set forth in federal legislation. See “BUSINESS -- Supervision and Regulation.”

The laws and regulations applicable to the banking industry could change at any time, and we cannot predict the impact of these changes on our business and profitability. Because government regulation greatly effects the business and financial results of all commercial banks and bank holding companies, the cost of compliance could adversely affect the Company’s ability to operate profitably.

If Economic Conditions Deteriorate, Particularly in the Bank’s Market Area, Our Results of Operations and Financial Condition Could Be Adversely Affected as Borrowers' Ability to Repay Loans Declines and the Value of the Collateral Securing Our Loans Decreases.

Our financial results may be adversely affected by changes in prevailing economic conditions, particularly in the Bank’s market area, including decreases in real estate values, changes in interest rates which may cause a decrease in interest rate spreads, adverse employment conditions, the monetary and fiscal policies of the federal government and other significant external events.

Decreases in local real estate values would adversely affect the value of property used as collateral for our 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, which would have an adverse impact on our earnings.

If Our Allowance For Loan Losses is Not Sufficient to Cover Actual Loan Losses, Our Earnings Could Decrease.

We make various assumptions and judgments about the collectibility of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and our loss and delinquency experience, and we evaluate economic conditions. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in additions to our allowance. Material additions to our allowance would materially decrease our net income.

In addition, bank regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory authorities might have a material adverse effect on our financial condition and results of operations.

Item 1B. Unresolved Staff Comments

Not Applicable.

Item 2. Properties.

General

The Company's and the Bank's principal office in Cranbury, New Jersey (the "Principal Office"), which it occupies under a lease that expires in December 2010, provides for an aggregate monthly rental of $16,619, subject to annual rental increases plus real estate taxes and certain common space charges allocated by the landlord. This lease grants the Bank two additional five-year renewal periods. The Bank also has the right of first refusal to purchase the premises of which the Principal Office is a part on the same terms and conditions as contained in any bona fide offer for the premises. In 2003, the Bank entered into a five-year lease for an additional 1,900 square feet of office space in this building for an aggregate monthly rental of $2,216 per month, subject to annual rental increases. This lease grants the Bank two additional five-year renewal periods.

The Bank leases approximately 2,400 square feet for its branch office in Montgomery Township, New Jersey for an aggregate monthly rental of $5,845. This lease expires on September 30, 2007.

In September 2005, the Bank exercised its right of first refusal option granted under the existing lease agreement and purchased the land and building comprising its branch office in downtown Cranbury, New Jersey. The Bank had previously leased this 3,780 square feet branch office.

In December 2005, the Bank elected to exercise its option for the early termination of the lease for its branch located in Plainsboro, New Jersey. The Bank applied for and received regulatory agency approval to relocate this branch into the Plainsboro Village Center which was accomplished in June 2006. The Bank entered into a 15 year lease for approximately 2,500 square feet with two drive-through lanes in the multi-tenant retail/office building. The Bank has two five year renewal options for this space. The aggregate monthly payment for this lease is $7,381 with annual escalations.

The Bank entered into a lease for the branch located in Hamilton Square, New Jersey in April 1999. This lease expires in July 2014 and provides for a rental of approximately 4,170 square feet. The Bank has two five-year renewal options for this space. The aggregate monthly rental payment for this lease is $9,683, with annual escalations.

In January 2004, the Bank entered into a two-year lease for a new Loan Production Office in Fort Lee, New Jersey. The lease provided for the rental of 1,567 square feet with an aggregate monthly rental of $2,873 in the first year and

$2,938 in the second year. In December 2005, the Bank entered into a lease to house a de novo branch plus the loan production office in Fort Lee, New Jersey. The Bank applied for and received regulatory agency approval to relocate the loan production office and establish a de novo branch which was opened in November 2006. This lease expires in February 2014 and provides for the rental of 3,100 square feet on the ground floor plus 800 square feet in the basement. The aggregate monthly rental payment for this lease is $6,458, with annual escalations.

In June 2004, the Bank commenced the lease for the West Windsor, New Jersey branch. The lease expires in July 2019 and provides for a rental of approximately 3,000 square feet. The lease provides for three five-year renewal options for this space. The aggregate monthly rental payment for this lease is $2,083, with annual escalations.

In August 2004, the Bank commenced the lease for the Perth Amboy, New Jersey branch. This lease expires in August 2019 and provides for a rental of approximately 3,000 square feet The lease provides for two seven and one-half year renewal options for this space. The aggregate monthly rental payment for this lease is $6,250, with annual escalations.

In June 2004, the Bank completed the construction and renovation project associated with opening a branch office in Jamesburg, New Jersey. The Bank purchased the site at 1 Harrison Street in 2002.

Management believes the foregoing facilities are suitable for the Company's and the Bank's present and projected operations.

Item 3. 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. The Company may also have various commitments and contingent liabilities which are not reflected in the accompanying consolidated statement of condition. Management is not aware of any present legal proceedings or contingent liabilities and commitments that would have a material impact on the Company's financial position or results of operations.

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

No matters were submitted to a vote of the Company's shareholders during the fourth quarter of the fiscal year ended December 31, 2006.

PART II

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

The common stock of the Company trades on the Nasdaq Global Market under the trading symbol "FCCY". The following are the high and low sales prices per share for 2006 and 2005, as reported on the Nasdaq Global Market.

	2006			2005		
	High	Low		High	Low	
First Quarter	$19.76	$16.18	(1)	$18.40	$14.28	(1)
Second Quarter	$18.64	$16.48	(1)	18.18	14.99	(1)
Third Quarter	$17.92	$16.22	(1)	18.75	15.75	(1)
Fourth Quarter	$18.84	$16.51	(1)	18.82	14.98	(1)

(1) Prices have been retroactively adjusted for the 6% stock dividend declared December 21, 2006 and paid January 31, 2007 to shareholders of record on January 23, 2007.

As of March 6, 2007, there were approximately 334 holders of the Company's common stock.

The Company paid a 6% stock dividend on January 31, 2007 and a 5% stock dividend on January 31, 2006. The Company has never paid a cash dividend and there are no plans to pay a cash dividend at this time. All per share data has been retroactively adjusted for stock dividends. The Company will retain its earnings in order to provide capital for growth of the Bank.

Issuer Purchases of Equity Securities

In 2005, the Board of Directors authorized a stock repurchase program under which the Company may repurchase in open market or privately negotiated transactions up to 5% of its common shares outstanding at that date. The Company undertook this repurchase program in order to increase shareholder value. The following table provides common stock repurchases made by or on behalf of the Company during the three months ended December 31, 2006.

Issuer Purchases of Equity Securities [1]

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	Ending				
October 1, 2006	October 31, 2006	3,016	$17.52	3,016	169,135
November 1, 2006	November 30, 2006	3,694	$18.12	3,694	165,441
December 1, 2006	December 31, 2006	-	-	-	165,441
	Total	6,710	$17.85	6,710	165,441

(1) The Company's common stock repurchase program covers a maximum of 175,271 shares of common stock of the Company, representing 5% of the outstanding common stock of the Company on July 21, 2005 as adjusted for the 6% stock dividend declared December 21, 2006 and paid January 31, 2007.

Item 6. Selected Financial Data.

The following selected financial data should be read in conjunction with the Company's Consolidated Financial Statements and the accompanying notes presented elsewhere herein.

For years ended December 31	2006	2005	2004	2003	2002	Five Year Compounded Growth Rate
Highlights						
Net income	$5,332,844	$4,560,127	$3,837,714	$3,228,500	$2,687,322	19.9%
Return on average assets	1.40%	1.31%	1.22%	1.18%	1.06%	
Return on average equity	16.62%	16.49%	15.54%	14.85%	14.09%	
Net interest margin	5.03%	4.78%	4.25%	3.94%	3.87%	
Income Statement Data						
Net interest income	$17,787,685	$15,299,893	$12,470,773	$10,012,780	$9,209,044	17.2%
Provision for loan losses	893,500	405,000	240,000	240,000	240,000	
Non-interest income	2,591,009	2,646,861	2,557,242	2,401,349	1,525,526	
Non-interest expenses	12,037,856	10,887,225	8,989,961	7,168,722	6,287,881	
Balance Sheet Data at December 31						
Total assets	$392,677,546	$372,495,466	$335,830,440	$293,483,174	$273,862,343	11.0%
Total deposits	312,724,422	305,809,467	276,887,033	245,353,724	224,149,464	10.0%
Total gross loans	265,142,313	240,014,349	210,653,051	163,950,306	151,049,736	16.2%
Shareholders' equity	35,196,570	29,796,867	26,790,384	25,585,256	20,994,842	15.4%
Allowance for loan losses	3,228,360	2,361,375	2,005,169	1,786,632	1,669,882	15.0%
Share Information [1]						
Earnings per share - basic	$1.45	$1.25	$1.05	$0.89	$0.75	18.2%
Earnings per share - diluted	$1.41	$1.20	$1.02	$0.84	$0.71	18.3%
Book value per share	$9.40	$8.18	$7.28	$6.45	$5.81	13.3%
Average diluted shares Outstanding	3,772,182	3,803,871	3,799,270	3,825,688	3,808,305	
Capital Ratios[2]						
Total capital to risk-weighted assets	20.23%	13.30%	13.99%	14.94%	14.75%	
Tier 1 capital to risk-weighted assets	15.42%	12.47%	13.17%	14.06%	13.84%	
Tier 1 capital to average assets	12.18%	9.76%	10.16%	9.74%	9.64%	

[1] All share information has been restated for the effect of a 6% stock dividend declared on December 21, 2006 and paid on January 31, 2007 to shareholders of record on January 23, 2007.

[2] Capital ratios are for the Company. See footnote 15 to the financial statements for capital ratios of the Company and the Bank.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation.

This discussion should be read in conjunction with the consolidated financial statements, notes and tables included elsewhere in this report. Throughout the following sections, the "Company" refers to 1ST Constitution Bancorp and its wholly owned subsidiaries, 1ST Constitution Bank, 1ST Constitution Capital Trust I, and 1ST Constitution Capital Trust II, the "Bank" refers to 1ST Constitution Bank, and the "Trusts" refers to 1ST Constitution Capital Trust I and 1ST Constitution Capital Trust II, collectively. The purpose of this discussion and analysis is to assist in the understanding and evaluation of the Company's financial condition, changes in financial condition and results of operations.

Executive Summary

The Company reported net income for the 12 months ended December 31, 2006 of $5,332,844, an increase of 16.9% from the $4,560,127 reported for the 12 months ended December 31, 2005. Diluted net income per share was $1.41 for the year ended December 31, 2006 compared to $1.20 reported for the year ended December 31, 2005. Basic net income per share for the year ended December 31, 2006 was $1.45 as compared to the $1.25 reported for the year ended December 31, 2005. The Company has achieved a five-year compounded growth rate for net income of 19.9% over the 2001-2006 period. All share information has been restated for the effect of a 6% stock dividend declared on December 21, 2006 and paid on January 31, 2007 to shareholders of record on January 23, 2007.

Key performance ratios continued to improve in the 2006 fiscal year as compared to the prior year. Return on average assets ("ROA") and return on average equity ("ROE") were 1.40% and 16.62%, respectively, for the year ended December 31, 2006, compared to 1.31% and 16.49%, respectively, for the year ended December 31, 2005.

The Company's record earnings for the 2006 fiscal year reflect continuing momentum across a broad range of product and service offerings. Increased lending activity, coupled with increases in deposits through branch network expansion and secondary market loan sales volume, fueled both the record earnings and balance sheet growth.

The Company's net interest income for the year ended December 31, 2006 was $17,787,685, an increase of 16.3% from the $15,299,893 reported for the year ended December 31, 2005. For the year ended December 31, 2006, the Company's net interest margin increased to 5.03% compared to 4.78% reported for the year ended December 31, 2005. During 2004, a rising interest rate environment evolved during the latter half of the year and continued through the first half of 2006. The Federal Reserve Bank's Open Market Committee ("FOMC") held eight meetings in 2004, 2005 and 2006. Beginning with the June 30, 2004 meeting, the FOMC increased short-term interest rates by 25 basis points and continued with a series of 16 consecutive 25 basis point increases in each of the subsequent meetings through June 2006. The FOMC then made no changes to short-term rates at any of the remaining four meetings in 2006. The immediate benefit of the interest rate increases to the Company's investment security purchases and floating rate assets resulted in an 106 basis point increase in the yield on total interest-earning assets for 2006. In addition, management's ability to lag the interest rate increases on deposits coupled with a tight discipline in deposit pricing resulted in an increase of 25 basis points in the Company's net interest margin for the year ended December 31, 2006 when compared to the year ended December 31, 2005. Management expects the FOMC to continue to hold interest rates at their current level in early 2007 and has structured the Company's balance sheet in a moderately asset sensitive position in response to this present market rate environment.

Driven by construction loan growth, the Bank's loan portfolio increased 8.6% at December 31, 2006 as compared to December 31, 2005. At December 31, 2006, total loans outstanding (including loans held for sale) reached $278,751,255 compared to $256,772,083 at December 31, 2005. The Bank's deposit base increased by $6,914,955 to $312,724,422 at December 31, 2006 from $305,809,467 at December 31, 2005. Management strategically priced deposit products to be competitive with other financial institutions with branch locations in its market yet still maintain a strong net interest margin to support earnings growth.

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Management believes that the Company has positioned itself for continued success with the combination of a strong capital base, a commitment to provide exceptional customer service, and a commitment to maintain the technology necessary to provide its customers with easy access to the financial products and services offered by the Bank.

Critical Accounting Policies and Estimates

"Management's Discussion and Analysis of Financial Condition and Results of Operation" is based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Note 1 to the Company's Consolidated Financial Statements for the year ended December 31, 2006 contains a summary of the Company's significant accounting policies. Management believes the Company's policy with respect to the methodology for the determination of the allowance for loan losses involves a higher degree of complexity and requires management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could materially impact results of operations. This critical policy and its application is periodically reviewed with the Audit Committee and the Board of Directors. The provision for loan losses is based upon management's evaluation of the adequacy of the allowance, including an assessment of known and inherent risks in the portfolio, giving consideration to the size and composition of the loan portfolio, actual loan loss experience, level of delinquencies, detailed analysis of individual loans for which full collectibility may not be assured, the existence and estimated net realizable value of any underlying collateral and guarantees securing the loans, and current economic and market conditions. Although management uses the best information available to it, the level of the allowance for loan losses remains an estimate which is subject to significant judgment and short-term change. Various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to make additional provisions for loan losses based upon information available to them at the time of their examination. Furthermore, the majority of the Company's loans are secured by real estate in the State of New Jersey. Accordingly, the collectibility of a substantial portion of the carrying value of the Company's loan portfolio is susceptible to changes in local market conditions and may be adversely affected should real estate values decline or the Central New Jersey area experience an adverse economic shock. Future adjustments to the allowance for loan losses may be necessary due to economic, operating, regulatory and other conditions beyond the Company's control.

Results of Operations

The Company reported record earnings of $5,332,844, or $1.41 per share (diluted), for the year ended December 31, 2006 compared to $4,560,127, or $1.20 per share (diluted), in 2005. Net income and diluted earnings per share grew 16.9% and 17.5%, respectively, for the year ended December 31, 2006. The Company posted net income of $3,837,714, or $1.02 per share (diluted), for the year ended December 31, 2004. All share information has been restated for the effect of a 6% stock dividend declared on December 21, 2006 and paid on January 31, 2007 to shareholders of record on January 23, 2007.

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 87.3% of the Company's net revenues for the year ended December 31, 2006. Net interest income also depends upon the relative amount of interest earning assets, interest-bearing liabilities, and the interest rate earned or paid on them.

The following tables set forth the Company's consolidated average balances of assets and liabilities and shareholders' equity as well as interest income and expense on related items, and the Company's average yield or rate for the years ended December 31, 2006, 2005 and 2004. The average rates are derived by dividing interest income and expense by

the average balance of assets and liabilities, respectively.

Average Balance Sheets with Resultant Interest and Rates

(yields on a tax-equivalent basis)	2006			2005			2004		
	Average Balance	**Interest**	**Average Rate**	**Average Balance**	**Interest**	**Average Rate**	**Average Balance**	**Interest**	**Avera Rat**
Assets:									
Federal Funds Sold/Short-Term Investments	$ 1,457,568	$ 85,012	5.83%	$ 850,741	$ 27,181	3.19%	$ 976,584	$ 10,977	1.1
Investment Securities:									
Collateralized Mortgage Obligations / Mortgage Backed Securities	70,048,748	3,448,780	4.92%	75,758,305	3,017,885	3.98%	87,636,728	3,196,936	3.6
Obligations of States and Political Subdivisions (4)	16,198,497	895,172	5.53%	18,975,766	978,099	5.15%	10,132,976	571,410	5.6
Total	86,247,245	4,343,952	5.04%	94,734,071	3,995,984	4.22%	97,769,704	3,768,346	3.8
Loan Portfolio:									
Construction	125,022,769	11,129,600	8.90%	94,253,131	7,010,571	7.44%	76,191,687	4,108,903	5.3
Residential Real Estate	8,072,109	517,146	6.41%	9,127,634	572,844	6.28%	9,448,423	645,026	6.8
Commercial and Commercial Real Estate	99,521,245	7,706,864	7.74%	93,871,685	6,831,503	7.28%	82,412,002	5,985,833	7.2
Installment	2,013,438	167,126	8.30%	2,394,026	200,020	8.35%	3,255,459	264,074	8.1
All Other Loans	37,111,086	3,645,808	9.82%	31,772,196	3,007,190	9.46%	27,144,851	2,418,231	8.9
Total (1)	271,740,647	23,166,544	8.53%	231,418,672	17,622,128	7.61%	198,452,422	13,422,067	6.7
Total Interest-Earning Assets	**359,445,460**	**27,595,508**	**7.68%**	**327,003,484**	**21,645,293**	**6.62%**	**297,198,710**	**17,201,390**	**5.7**
Allowance for Loan Losses	(2,662,370)			(2,177,263)			(1,909,294)		
Cash and Due From Banks	9,391,415			9,130,543			7,853,303		
Other Assets	15,422,593			12,893,312			10,815,249		
Total Assets	**$ 381,597,098**			**$ 346,850,076**			**$ 313,957,968**		
Liabilities and Shareholders' Equity:									
Interest-Bearing Liabilities:									

Money Market and NOWAccounts	$ 87,135,125	$ 1,455,755	1.67%	$ 101,189,352	$ 1,211,901	1.20%	$ 96,113,368	$ 986,531	1.0
Savings Accounts	44,867,384	939,324	2.09%	33,671,684	409,397	1.22%	26,890,218	136,530	0.5
Certificates of Deposit	58,183,657	2,907,883	5.00%	77,183,169	2,383,392	3.09%	74,136,634	1,917,353	2.5
Certificates of Deposit of $100,000 and Over	43,870,647	1,385,118	3.16%	9,771,290	309,159	3.16%	10,156,576	260,109	2.5
Other Borrowed Funds	32,539,699	1,687,749	5.19%	31,143,663	1,363,507	4.38%	24,812,983	981,689	3.9
Trust Preferred Securities	14,863,014	1,141,668	7.68%	5,000,000	350,823	7.02%	5,000,000	263,083	5.2
Total Interest-Bearing Liabilities	**281,459,526**	**9,517,497**	**3.38%**	**257,959,158**	**6,028,179**	**2.34%**	**237,109,779**	**4,545,295**	**1.9**
Net Interest Spread (2)			**4.30%**			**4.28%**			**3.8**
Non-interest Bearing Demand Deposits	63,040,519			57,792,902			49,622,127		
Other Liabilities	5,013,813			3,447,534			2,536,002		
Total Liabilities	349,513,857			319,199,594			289,267,908		
Shareholders' Equity	32,083,240			27,650,482			24,690,060		
Total Liabilities and Shareholders' Equity	**$ 381,597,097**			**$ 346,850,076**			**$ 313,957,968**		
Net Interest Margin (3)		**$ 18,078,011**	**5.03%**		**$ 15,617,114**	**4.78%**		**$ 12,656,095**	**4.2**

(1) Loan origination fees are considered an adjustment to interest income. For the purpose of calculating loan yields, average loan balances include nonaccrual loans with no related interest income.
(2) The interest rate spread is the difference between the average yield on interest earning assets and the average rate paid on interest bearing liabilities.
(3) The net interest margin is equal to net interest income divided by average interest earning assets.
(4) Tax equivalent basis.

Changes in net interest income and margin result from the interaction between the volume and composition of interest earning assets, interest bearing liabilities, related yields, and associated funding costs. The Rate/Volume Table demonstrates the impact on net interest income of changes in the volume of interest earning assets and interest bearing liabilities and changes in interest rates earned and paid.

The Company's net interest income increased on a tax equivalent basis by $2,460,897, or 15.8%, to $18,078,011 for the year ended December 31, 2006, from the $15,617,114 reported for the year ended December 31, 2005. As indicated in the Rate/Volume Table, the principal factor contributing to the 2006 increase in net interest income was an increase in the interest income of $3,368,409, resulting from increased balances in the loan portfolio components. This was partially offset by an increase in interest expense resulting from increases in the rates paid on deposit components.

The Company's net interest income on a tax-equivalent basis increased by $2,961,019, or 23.4%, to $15,617,114 for the year ended December 31, 2005, from the $12,656,095 reported for the year ended December 31, 2004. As indicated in the Rate/Volume Table, the principal factor contributing to the 2005 increase in net interest income was an increase in the interest income of $2,319,709, resulting from increased balances in the loan portfolio components. This was partially offset by an increase in interest expense resulting from increases in the rates paid on deposit components.

Rate/Volume Table	**Amount of Increase (Decrease)**					
	Year Ended December 31, 2006 versus 2005 Due to Change in:			Year Ended December 31, 2005 versus 2004 Due to Change in:		
(Tax-equivalent basis)	Volume	Rate	Total	Volume	Rate	Total
Interest Income:						
Loans:						
Construction	$ 2,516,095	$ 1,602,934	$ 4,119,029	$ 1,156,625	$ 1,745,044	$ 2,901,668
Residential Real Estate	(67,564)	11,866	(55,698)	(20,216)	(51,966)	(72,182)
Commercial and Commercial Real Estate	427,419	447,942	875,361	829,188	16,482	845,670
Installment	(31,770)	(1,115)	(32,894)	(71,867)	7,813	(64,054)
All Other Loans	524,238	114,380	638,618	425,979	162,981	588,960
Total Loans	3,368,409	2,176,006	5,544,415	2,319,709	1,880,353	4,200,063
Investment Securities :						
Collat. Mortg. Obligations / Mortg. Backed Securities	(281,233)	712,128	430,895	(450,907)	271,857	(179,050)
States and political subdivisions	(155,035)	72,108	(82,927)	477,537	(70,849)	406,688
Total Investment Securities	(436,268)	784,236	347,968	26,630	201,008	227,638
Federal Funds Sold / Short-Term Investments	30,300	27,531	57,831	(4,011)	20,215	16,204
Total Interest Income	2,962,440	2,987,774	5,950,214	2,342,328	2,101,576	4,443,904
Interest Expense :						
Money Market and NOW Accounts	(168,651)	412,505	243,854	51,775	173,595	225,370
Savings Accounts	186,786	343,141	529,927	58,265	214,602	272,867

Certificates of Deposit	(1,340,184)	1,864,675	524,491	83,271	382,768	466,039
Certificates of Deposit of $100,000 And Over	1,268,520	(192,561)	1,075,959	(9,825)	58,874	49,049
Other Borrowed Funds	61,146	263,096	324,242	262,592	119,226	381,818
Trust Preferred Securities	757,845	33,000	790,845	-	87,740	87,740
Total interest expense	765,462	2,723,856	3,489,318	446,078	1,036,805	1,482,883
Net Interest Income	$ 765,461	$ 2,723,857	$ 3,489,318	$ 446,078	$ 1,036,805	$ 1,482,884

Average interest earning assets increased by $32,441,976, or 9.9%, to $359,445,460 for the year ended December 31, 2006 from $327,003,484 for the year ended December 31, 2005, consisting primarily of an increase for 2006 of $40,321,975 in loans partially offset by a decrease of $8,486,826 in investment securities compared to 2005. Led by the construction loans component, the Bank's average total loan portfolio grew by 17.4% and loan yields averaged 8.53% for the year ended December 31, 2006, 92 basis points higher than for the year ended December 31, 2005. This increase was primarily the result of 2006 loan growth at floating yields amid the increasing interest rate environment that continued during the first half of the year. The Bank's average investment securities portfolio decreased 9.0%, and the yield on that portfolio increased 82 basis points for the year ended December 31, 2006 compared to the year ended December 31, 2005. Net premium amortization for the year ended December 31, 2006 was $41,405 compared to $139,507 for the year ended December 31, 2005. Overall, the yield on interest earning assets increased 106 basis points to 7.68% in the 2006 fiscal year from 6.62% in the 2005 fiscal year.

Average interest earning assets increased by $29,805,774, or 10.0%, to $327,003,484 for the year ended December 31, 2005 from $297,198,710 for the year ended December 31, 2004, consisting primarily of an increase in 2005 of $32,966,250 in loans partially offset by a decrease of $3,035,633 in investment securities compared to 2004. Led by the construction component, the Bank’s average total loan portfolio grew by 16.6%, and loan yields averaged 7.61%, in 2005, 85 basis points higher than 2004. This increase was primarily the result of 2005 loan growth at floating yields amid the increasing interest rate environment that continued during the year. The Bank’s average investment securities portfolio decreased 3.1%, and the yield on that portfolio increased 37 basis points in 2005 compared to 2004, primarily as a result of the reduced level of premium amortization on mortgage-backed securities due to the rising rate environment that continued throughout the year during 2005. Net premium amortization for 2005 was $139,507 compared to $350,168 for 2004. Overall, the yield on interest earnings assets increased 83 basis points to 6.62% in 2005 from 5.79% in 2004.

Interest expense increased by $3,489,318, or 57.9%, to $9,517,497 for the year ended December 31, 2006, from $6,028,179 for the year ended December 31, 2005. This increase in interest expense is principally attributable to higher levels of interest-bearing liabilities priced at a higher market interest rate level. Savings accounts increased on average by $11,195,700 in 2006, or 33.2%, as compared to 2005, contributing to the funding of loan portfolio growth. The cost on these deposits increased 87 basis points in 2006 from 2005. Average interest bearing liabilities rose 9.1% in 2006 from 2005. The cost of total interest-bearing liabilities increased 104 basis points to 3.38% in 2006 from 2.34% in 2005.

Interest expense increased by $1,482,884, or 32.6%, to $6,028,179 for the year ended December 31, 2005, from $4,545,295 for the year ended December 31, 2004. This increase in interest expense is principally attributable to higher levels of interest-bearing liabilities priced at a higher market interest rate level. Savings accounts increased on average by $6,781,466 in 2005 as compared to 2004, contributing to the funding of loan portfolio growth. The cost on these deposits increased 71 basis points in 2005 from 2004. Average interest bearing liabilities rose 8.8% in 2005 from 2004. The cost of total interest-bearing liabilities decreased 43 basis points to 2.34% in 2005 from 1.91% in 2004.

Average non-interest bearing demand deposits increased by $5,247,617, or 9.1%, to $63,040,519 for the year ended December 31, 2006 from $57,792,902 for the year ended December 31, 2005. Expansion of the branch network and the resulting new business relationships have generated most of this increase. Throughout the comparative periods, increases in average non-interest bearing deposits contributed to the increases in net interest income.

Non-Interest Income

Non-interest income decreased by $55,852, or 2.1%, to $2,591,009 for the year ended December 31, 2006 from $2,646,861 for the year ended December 31, 2005. Non-interest income in 2005 increased by $89,618, or 3.5%, from a total of $2,557,242 for 2004.

Service charges on deposit accounts represent a significant source of non-interest income. Service charge revenues decreased by $22,033, or 3.2%, to $668,071 for the year ended December 31, 2006 from $690,104 for the year ended December 31, 2005. Service charge revenue totaled $514,494 in 2004. This component of non-interest income represented 25.8%, 26.1%, and 20.1% of the total non-interest income for the years ended December 31, 2006, 2005, and 2004, respectively. Service charge income decreased in 2006 principally due to management’s actions to restructure service charges and fees based on the results of a comparative study of market fees performed in early 2005. During 2005, new fees were assessed on accounts overdrawn for drawing on uncollected funds and for processing incoming wire transfers. Service charge income decreased in 2004 as a result of the Bank waiving service charges on new accounts during the period of branch expansion, and a decreasing number of accounts subject to service charges. Management continues to utilize a strategy of requiring compensating balances from its commercial customers. Those who meet balance requirements are not assessed service charges.

Gains on sales of loans held for sale decreased by $371,790, or 25.7%, to $1,072,731 for the year ended December 31, 2006, from $1,444,521 for the year ended December 31, 2005. Gains on sales of loans held for sale totaled $1,373,660 in 2004. Market interest rates on 30-year fixed rate mortgages fell consistently during 2004, and into the first half of 2005. Consumer refinance of home loans, which, along with a strong housing market, led to the Bank achieving high levels in mortgage origination volumes and mortgage loan sale gains, as newly-originated loans were sold at higher than normal spreads due to the consistently lower level of market interest rates. The rising rate environment that evolved during late 2004 and continued throughout the first half of 2006 has significantly impacted the mortgage market and resultant secondary loan sales for 2006 as long term rates have increased.

Non-interest income also includes income from bank-owned life insurance (“BOLI”) which amounted to $350,476 for the year ended December 31, 2006 compared to $235,430 for the year ended December 31, 2005. The Bank purchased $6.0 million in tax-free BOLI assets in 2002 and $2.0 million in 2005, which partially offset the cost of employee benefit plans and reduced the overall effective tax rate. The Bank also generates non-interest income from a variety of fee-based services. These include safe deposit rentals, wire transfer service fees and Automated Teller Machine fees for non-customers. Deposit and service fee charges are reviewed and adjusted as needed from time to time by management to reflect current costs incurred by the Bank to offer the products or services and prices charged by competitor financial institutions amid the Bank’s competitive market.

The Company recorded net losses on sales of securities available for sale of $99,714 for the year ended December 31, 2006 and $271,871 for the year ended December 31, 2005. The Company recorded net gains on sales of securities available for sale of $27,545 in 2004. These portfolio transactions in 2006, 2005 and 2004 were primarily the result of modest portfolio restructurings. Their purpose was to improve the Company’s longer-term interest rate risk position.

Non-Interest Expenses

Non-interest expenses increased by $1,150,631, or 10.6%, to $12,037,856 for the year ended December 31, 2006, from $10,887,225 for the year ended December 31, 2005. Non-interest expenses in 2005 increased 21.1% to $10,887,225 from $8,989,961 in 2004. The largest increase in non-interest expenses for 2006 compared to 2005 was in salaries and employees benefits. To a lesser extent, occupancy, and other non-interest expenses also reflect increases for the comparable periods. The largest increase in non-interest expenses in 2005 compared to 2004 was in salaries and employee benefits and, to a lesser extent, other non-interest expenses, as indicated in the table below. The following table presents the major components of non-interest expenses for the years 2004 through 2006.

Non-interest Expenses

	2006	2005	2004
Salaries and employee benefits	$ 6,799,619	$ 5,894,200	$ 4,955,587
Occupancy expense	1,434,728	1,365,930	1,071,463
Equipment expense	507,402	491,735	464,928
Marketing	258,012	292,352	274,095
Date processing services	733,954	623,001	636,076
Regulatory, professional and other fees	802,309	1,102,691	542,001
Office expense	470,211	401,490	462,586
All other expenses	1,031,621	715,826	583,225
Total	$ 12,037,856	$ 10,887,225	$ 8,989,961

Salaries and employee benefits, which represent the largest portion of non-interest expenses, increased by $905,419, or 15.4%, to $6,799,619 for the year ended December 31, 2006 compared to $5,894,200 for the year ended December

31, 2005. The 2006 increase is primarily due to (a) increased staffing levels for all of 2006 as a result of the opening of two new branch locations (b) normal employee salary increases. These expenses increased in 2005 by $938,613, or 18.9%, over the $4,955,587 reported for 2004. The increase in the level of salaries and employee benefits for 2005 versus 2004 reflects the increase in staffing levels due to the branch expansion program plus normal salary increases. Salaries and employee benefits as a percentage of average assets were 1.78% for 2006, 1.70% for 2005 and 1.58% for 2004. As the result of the adoption by the Company as of January 1, 2006 of Financial Accounting Standards Board Statement No. 123(R), *Share Based Payment*, the Company is required to recognize for the first time the expense of stock options. For the year ended December 31, 2006, the expense amounted to $95,230, which represented all the unvested and issued stock options outstanding on December 31, 2006 plus all stock options issued in 2006.

For the year ended December 31, 2006, occupancy expense increased by $68,798, or 5.0%, to $1,434,728 from $1,365,930 for the year ended December 31, 2005. During June 2006, the Bank opened the new Plainsboro branch which is now relocated in the newly constructed Plainsboro Village Center. This expanded location allows the Bank to offer drive-through banking plus ATM services that were not available at the previous location. The current period increase in occupancy costs is primarily attributable to this branch relocation project. In addition, the relocation and expansion of our Fort Lee loan production office to a full service branch of the Bank was completed in early November 2006. Certain costs related to this relocation have been incurred prior to the actual opening of this branch.

The occupancy expense component of total non-interest expense as a percentage of average assets was 0.38% for the year ended December 31, 2006, 0.39% for the year ended December 31, 2005 and 0.34% for the year ended December 31, 2004, respectively.

Data processing service expense increased by $110,953, or 17.8%, to $733,954 for the year ended December 31, 2006 compared to $623,001 for the year ended December 31, 2005 as the Company incurred operating costs to bring the two new branch locations online during 2006 as well upgrading existing systems throughout the year.

The Bank's ratio of non-interest expense to average assets has remained consistently favorable at 3.16% for the year ended December 31, 2006 compared to 3.14% for the year ended December 31, 2005 and 2.86% for the year ended December 31, 2004.

An important industry productivity measure is the efficiency ratio. The efficiency ratio is calculated by dividing total operating expenses by net interest income and other income. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same or greater volume of income, while a decrease would indicate a more efficient allocation of resources. The Bank's efficiency ratio decreased for the year ended December 31, 2006 to 59.1% compared to 60.7% for the year ended December 31, 2005 and 59.8% for the year ended December 31, 2004.

Financial Condition

Cash and Cash Equivalents

At December 31, 2006, cash and cash equivalents totaled $10,361,812 compared to $12,137,750 at December 31, 2005. Cash and cash equivalents at December 31, 2006 consisted of cash and due from banks of $10,336,334 and federal funds sold/short-term investments of $25,478. The corresponding balances at December 31, 2005 were $9,394,929 and $2,742,821, respectively.

Investment Securities

The Bank's investment securities portfolio amounted to $89,675,804, or 22.8% of total assets at December 31, 2006, compared to $90,995,028, or 24.4% of total assets at December 31, 2005. On an average balance basis, the investment securities portfolio represented 24.0% and 29.0% of average interest-earning assets for the years ended December 31, 2006 and 2005, respectively. The average yield earned on the portfolio was 5.04% for the year ended December 31, 2006, an increase of 82 basis points from 4.22% earned for the year ended December 31, 2005.

Securities available for sale are investments that may be sold in response to changing market and interest rate conditions or for other business purposes. Securities available for sale consist primarily of U.S. Government and Federal agency securities as well as mortgage-backed securities. Activity in this portfolio is undertaken primarily to manage liquidity and interest rate risk and to take advantage of market conditions that create economically more attractive returns. At December 31, 2006, available-for-sale securities amounted to $70,421,328, an increase of $1,184,670 from December 31, 2005. The Company recorded net losses on sales of securities available for sale of $99,714 for 2006 and $271,871 for 2005.

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2006		Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair Value
Available for sale-								
U. S. Treasury securities and								
obligations of U.S. Government								
sponsored corporations and agencies	$	35,625,182	$	124,144	$	(694,261)	$	35,055,065
Mortgage backed securities		28,305,557		113,353		(216,111)		28,202,799
Obligations of State and								
Political subdivisions		3,655,197		15,902		(31,749)		3,639,350
FHLB stock and other securities		3,554,759		304		(30,949)		3,524,115
	$	71,140,695	$	253,703	$	(973,070)	$	70,421,328
Held to maturity-								
Mortgage backed securities	$	5,540,670	$	2,015	$	175,826)	$	5,366,859
Obligations of State and								
Political subdivisions		13,713,806		131,955		(47,941)		13,797,820
	$	19,254,476	$	133,970	$	(223,767)	$	19,164,679

2005		Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair Value
Available for sale-								
U. S. Treasury securities and								
obligations of U.S. Government								
sponsored corporations and agencies	$	34,032,814	$	7,198	$	(977,560)	$	33,062,452
Mortgage backed securities		29,250,341		90,286		(302,193)		29,038,434
Obligations of State and								
Political subdivisions		3,855,987		1,333		(65,063)		3,792,257
FHLB stock and other securities		3,371,673		-		(28,158)		3,343,515

	$	70,510,815	$	98,817	$	(1,372,974)	$	69,236,658
Held to maturity-								
Mortgage backed securities	$	5,807,730	$	7,233	$	(206,275)	$	5,608,688
Obligations of State and								
Political subdivisions		15,950,640		108,525		(146,827)		15,912,338
	$	21,758,370	$	115,758	$	(353,102)	$	21,521,026

2004	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale-				
U. S. Treasury securities and obligations of U.S. Government sponsored corporations and agencies	$ 57,848,615	$ 85,649	$ 538,057	$ 57,396,206
Mortgage backed securities	20,877,821	412,179	53,848	21,236,152
Obligations of State and Political subdivisions	3,883,354	3,070	47,662	3,838,762
FHLB stock and other securities	3,149,734	0	32,205	3,117,529
	$ 85,759,524	$ 500,897	$ 671,772	$ 85,588,649
Held to maturity-				
Mortgage backed securities	$ 604,705	$ 24,174	$ 0	$ 628,879
Obligations of State and Political subdivisions	11,562,432	164,247	63,308	11,553,371
	$ 12,167,137	$ 188,421	$ 63,308	$ 12,292,250

Proceeds from maturities and prepayments of securities available for sale amounted to $13,736,214 for the year ended December 31, 2006 and $17,074,576 for the year ended December 31, 2005. At December 31, 2006, the portfolio had net unrealized losses of $719,367, compared to net unrealized losses of $1,274,157 at December 31, 2005. These unrealized losses are reflected net of tax in shareholders' equity as other comprehensive income (loss).

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. The held-to-maturity portfolio consists primarily of obligations of states and political subdivisions. At December 31, 2006, securities held to maturity were $19,254,476, a decrease of $2,503,894 from $21,758,370 at December 31, 2005. The fair value of the held-to-maturity portfolio at December 31, 2006 was $19,164,679, resulting in a net unrealized loss of $89,796.

The amortized cost, estimated fair value and weighted average yield of investment securities at December 31, 2006, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Federal Home Loan Bank stock is included in "Held to maturity - Due in one year or less."

	Amortized Cost	Estimated Fair Value	Weighted Average Yield*
Available for sale-			
Due in one year or less	$ 1,301,989	$ 1,301,354	5.27%

Due after one year through five years		17,420,177		17,352,325	4.67%
Due after five years through ten years		15,836,536		15,698,842	4.22%
Due after ten years		36,581,993		36,068,807	4.73%
Total	$	71,140,695	$	70,421,328	5.01%
Held to maturity-					
Due in one year or less	$	2,363,612	$	2,351,783	3.47%
Due after one year through five years		2,839,631		2,838,985	5.38%
Due after five years through ten years		3,615,640		3,625,656	5.52%
Due after ten years		10,435,593		10,348,255	5.59%
Total	$	19,254,476	$	19,164,679	5.41%

* computed on a tax equivalent basis.

Loans

The loan portfolio, which represents the Bank's largest asset, is a significant source of both interest and fee income. Elements of the loan portfolio are subject to differing levels of credit and interest rate risk. The Bank's primary lending focus continues to be construction loans (wholesale and retail), commercial loans, owner-occupied commercial mortgage loans and tenanted commercial real estate loans. Total loans averaged $271,740,647 for the year ended December 31, 2006, an increase of $40,321,975, or 17.4%, compared to an average of $231,418,672 for the year ended December 31, 2005. Growth in the average loan portfolio balance was generated primarily by an increase of $30,769,638, or 32.6%, in construction loans. At December 31, 2006, total loans amounted to $265,142,313 compared to $240,014,349 at December 31, 2005, an increase of $25,127,964, or 10.5%. The average yield earned on the loan portfolio was 8.53% for the year ended December 31, 2006 compared to 7.61% for the year ended December 31, 2005, an increase of 92 basis points. This increase is primarily due to the rising interest rate environment that evolved during the last half of 2004 and continued throughout the first half of 2006.

The following table represents the components of the loan portfolio for the dates indicated.

	December 31,									
	2006		2005		2004		2003		2002	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Construction loans	$ 125,268,871	47%	$ 109,862,614	46%	$ 88,027,024	42%	$ 56,971,265	35%	$ 32,342,880	21%
Residential real estate loans	7,670,370	3%	8,602,975	4%	9,815,366	5%	8,059,032	5%	9,023,228	6%
Commercial and commercial real estate loans	114,897,040	44%	104,448,196	43%	96,021,077	46%	83,840,831	51%	89,415,759	59%
Loans to individuals	16,728,025	6%	16,441,994							