

1ST CONSTITUTION BANCORP  
Form 10-Q  
May 15, 2012

---

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2012  
or

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

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

Commission file Number: 000-32891

1ST CONSTITUTION BANCORP  
(Exact Name of Registrant as Specified in Its Charter)

New Jersey  
(State of Other Jurisdiction  
of Incorporation or Organization)

22-3665653  
(I.R.S. Employer Identification  
No.)

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

08512  
(Zip Code)

(609) 655-4500  
(Issuer's Telephone Number, Including  
Area Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required

to submit and post such files). Yes  No

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

- |                         |                          |                           |                                     |
|-------------------------|--------------------------|---------------------------|-------------------------------------|
| Large accelerated filer | <input type="checkbox"/> | Accelerated filer         | <input type="checkbox"/>            |
| Non-accelerated filer   | <input type="checkbox"/> | Smaller reporting company | <input checked="" type="checkbox"/> |
- (Do not check if a smaller reporting company)

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

As of May 13, 2012, there were 5,096,230 shares of the registrant’s common stock, no par value, outstanding.

---

---

---

## 1ST CONSTITUTION BANCORP

## FORM 10-Q

## INDEX

	Page
PART I.	FINANCIAL INFORMATION
<u>Item 1.</u>	<u>Financial Statements</u> 1
	<u>Consolidated Balance Sheets</u> <u>(unaudited) at March 31, 2012</u> <u>and December 31, 2011</u> 1
	<u>Consolidated Statements of Income</u> <u>(unaudited) for the Three Months Ended</u> <u>March 31, 2012 and March 31, 2011</u> 2
	<u>Consolidated Statements of Comprehensive Income</u> <u>(unaudited) for the Three Months Ended</u> <u>March 31, 2012 and March 31, 2011</u> 3
	<u>Consolidated Statements of Changes in Shareholders' Equity</u> <u>(unaudited) for the Three Months Ended</u> <u>March 31, 2012 and March 31, 2011</u> 4
	<u>Consolidated Statements of Cash Flows</u> <u>(unaudited) for the Three Months Ended</u> <u>March 31, 2012 and March 31, 2011</u> 5
	<u>Notes to Consolidated Financial Statements (unaudited)</u> 6
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition</u> <u>and Results of Operations</u> 33
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u> 48
<u>Item 4.</u>	<u>Controls and Procedures</u> 48
PART II.	OTHER INFORMATION
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u> 49
<u>Item 6.</u>	<u>Exhibits</u> 50

SIGNATURES

Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

1st Constitution Bancorp and Subsidiaries  
Consolidated Balance Sheets  
(Unaudited)

	March 31, 2012	December 31, 2011
<b>ASSETS</b>		
CASH AND DUE FROM BANKS	\$ 27,149,715	\$ 15,183,853
FEDERAL FUNDS SOLD / SHORT-TERM INVESTMENTS	11,410	11,406
Total cash and cash equivalents	27,161,125	15,195,259
<b>INVESTMENT SECURITIES:</b>		
Available for sale, at fair value	91,154,435	93,683,774
Held to maturity (fair value of \$136,015,150 and \$147,621,280 at March 31, 2012 and December 31, 2011, respectively)	130,659,186	142,474,423
Total securities	221,813,621	236,158,197
LOANS HELD FOR SALE	17,497,128	19,234,111
LOANS	438,522,190	475,431,771
Less- Allowance for loan losses	(5,881,942 )	(5,534,450 )
Net loans	432,640,248	469,897,321
PREMISES AND EQUIPMENT, net	10,788,002	10,439,304
ACCRUED INTEREST RECEIVABLE	2,523,723	2,996,848
BANK-OWNED LIFE INSURANCE	13,690,903	13,578,981
OTHER REAL ESTATE OWNED	11,839,585	12,409,201
OTHER ASSETS	11,645,449	11,817,693
Total assets	\$ 749,599,784	\$ 791,726,915
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>LIABILITIES:</b>		
Deposits		
Non-interest bearing	\$ 117,360,122	\$ 105,470,543
Interest bearing	541,203,836	518,391,942
Total deposits	658,563,958	623,862,485
BORROWINGS	10,000,000	88,300,000
REDEEMABLE SUBORDINATED DEBENTURES	18,557,000	18,557,000
ACCRUED INTEREST PAYABLE	1,074,733	1,186,511
ACCRUED EXPENSES AND OTHER LIABILITIES	5,061,527	4,821,144
Total liabilities	693,257,218	736,727,140
<b>COMMITMENTS AND CONTINGENCIES</b>		
-		
<b>SHAREHOLDERS' EQUITY:</b>		
Preferred stock, no par value; 5,000,000 shares authorized, none issued	-	-
Common Stock, no par value; 30,000,000 shares authorized; 5,097,781 and 5,096,054 shares issued and 5,096,230 and 5,094,503 shares outstanding as of March 31, 2012 and December 31, 2011, respectively	41,012,267	40,847,929
Retained earnings	14,237,338	13,070,606

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

Treasury Stock, at cost, 1,551 shares at March 31, 2012 and December 31, 2011	(10,222 )	(10,222 )
Acc Accumulated other comprehensive income	1,103,183	1,091,462
Total shareholders' equity	56,342,566	54,999,775
Total liabilities and shareholders' equity	\$ 749,599,784	\$ 791,726,915

See accompanying notes to consolidated financial statements.

Table of Contents

1st Constitution Bancorp and Subsidiaries  
Consolidated Statements of Income  
(Unaudited)

	Three Months Ended March 31,	
	2012	2011
<b>INTEREST INCOME:</b>		
Loans, including fees	\$ 6,414,459	\$ 5,354,207
Securities:		
Taxable	1,184,205	1,284,944
Tax-exempt	420,569	285,072
Federal funds sold and short-term investments	15,034	9,106
<b>Total interest income</b>	<b>8,034,267</b>	<b>6,933,329</b>
<b>INTEREST EXPENSE:</b>		
Deposits	1,186,474	1,398,130
Borrowings	117,922	106,920
Redeemable subordinated debentures	99,312	264,154
<b>Total interest expense</b>	<b>1,403,708</b>	<b>1,769,204</b>
<b>Net interest income</b>	<b>6,630,559</b>	<b>5,164,125</b>
<b>PROVISION FOR LOAN LOSSES</b>	<b>599,998</b>	<b>399,998</b>
<b>Net interest income after provision for loan losses</b>	<b>6,030,561</b>	<b>4,764,127</b>
<b>NON-INTEREST INCOME:</b>		
Service charges on deposit accounts	227,972	175,842
Gain on sales of loans	468,217	436,739
Income on Bank-owned life insurance	111,922	95,137
Other income	357,054	317,032
<b>Total non-interest income</b>	<b>1,165,165</b>	<b>1,024,750</b>
<b>NON-INTEREST EXPENSES:</b>		
Salaries and employee benefits	2,940,350	2,576,664
Occupancy expense	723,786	566,738
FDIC insurance expense	147,393	227,547
Data processing expenses	263,575	303,473
Other operating expenses	1,537,413	988,410
<b>Total non-interest expenses</b>	<b>5,612,517</b>	<b>4,662,832</b>
<b>Income before income taxes</b>	<b>1,583,209</b>	<b>1,126,045</b>
<b>INCOME TAXES</b>	<b>416,477</b>	<b>336,177</b>
<b>Net income</b>	<b>\$ 1,166,732</b>	<b>\$ 789,868</b>
<b>NET INCOME PER COMMON SHARE:</b>		
Basic	\$ 0.23	\$ 0.16
Diluted	\$ 0.23	\$ 0.15

See accompanying notes to consolidated financial statements.



Table of Contents

1st Constitution Bancorp and Subsidiaries  
 Consolidated Statements of Comprehensive Income  
 (Unaudited)

	Three months ended March 31,	
	2012	2011
Net Income	\$ 1,166,732	\$ 789,868
Other comprehensive income (loss), net of tax		
Unrealized gains on securities available for sale	9,795	(117,197 )
Pension liability	1,926	1,927
Unrealized gain on interest rate swap contract	0	104,371
Other comprehensive income (loss)	11,721	(10,899 )
Comprehensive income	\$ 1,178,453	\$ 778,969

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

Table of Contents

1st Constitution Bancorp and Subsidiaries  
 Consolidated Statements of Changes in Shareholders' Equity  
 For the Three Months Ended March 31, 2012 and 2011  
 (Unaudited)

	Common Stock	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive (Loss) Income	Total Shareholders' Equity
Balance, January 1, 2011	\$38,899,855	\$10,741,779	\$(58,652 )	\$ 98,174	\$49,681,156
Issuance of vested shares under employee benefit program	46,294		11,597		57,891
Share-based compensation	17,503				17,503
Treasury stock purchased			(15,354 )		(15,354 )
Net Income for the three months ended March 31, 2011		789,868			789,868
Other comprehensive loss				(10,899 )	(10,899 )
Balance, March 31, 2011	\$38,963,652	\$11,531,647	\$(62,409 )	\$ (87,275 )	\$50,520,165
Balance, January 1, 2012	\$40,847,929	\$13,070,606	\$(10,222 )	\$ 1,091,462	\$54,999,775
Exercise of stock options, net, and issuance of vested shares under employee benefit programs	140,798				140,798
Share-based compensation	23,540				23,540
Net income for the three months ended March 31, 2012		1,166,732			1,166,732
Other comprehensive income				11,721	11,721
Balance, March 31, 2012	\$41,012,267	\$14,237,338	\$(10,222 )	\$ 1,103,183	\$56,342,566

Table of Contents

1st Constitution Bancorp and Subsidiaries  
Consolidated Statements of Cash Flows  
(Unaudited)

	Three Months Ended March 31,	
	2012	2011
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 1,166,732	\$ 789,868
Adjustments to reconcile net income to net cash provided by operating activities-		
Provision for loan losses	599,998	399,998
Provision for loss on other real estate owned	211,644	147,178
Depreciation and amortization	267,576	218,243
Net amortization of premiums and discounts on securities	366,528	447,515
Gains on sales of loans held for sale	(468,217)	(436,739)
Originations of loans held for sale	(41,388,684)	(25,228,512)
Proceeds from sales of loans held for sale	43,593,884	41,940,375
Income on Bank – owned life insurance	(111,922)	(95,137)
Share-based compensation expense	111,362	90,518
Decrease (increase) in accrued interest receivable	473,125	(44,647)
Decrease in other assets	98,912	(745,772)
Decrease in accrued interest payable	(111,778)	(215,411)
(Decrease) increase in accrued expenses and other liabilities	155,781	(375,625)
Net cash provided by operating activities	4,964,941	16,891,852
<b>INVESTING ACTIVITIES:</b>		
Purchases of securities -		
Available for sale	(18,134,939)	(62,763,601)
Held to maturity	0	(65,546,545)
Proceeds from maturities and prepayments of securities -		
Available for sale	20,607,265	35,216,978
Held to maturity	11,520,563	5,899,501
Net decrease in loans	36,657,075	86,597,345
Capital expenditures	(549,282)	(255,029)
Additional investment in other real estate owned	(81,812)	(139,668)
Proceeds from sales of other real estate owned	439,784	595,363
Cash consideration received in connection with acquisition of branches	0	101,539,588
Net cash provided by investing activities	50,458,654	101,143,932
<b>FINANCING ACTIVITIES:</b>		
Exercise of stock options and issuance of vested shares	140,798	57,891
Purchase of Treasury Stock	0	(15,354)
Net increase (decrease) in demand, savings and time deposits	34,701,473	(5,829,713)
Net (decrease) in borrowings	(78,300,000)	(15,900,000)
Net cash used in financing activities	(43,457,729)	(21,687,176)
Increase in cash and cash equivalents	11,965,866	96,348,608
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>15,195,259</b>	<b>17,710,501</b>
<b>CASH AND CASH EQUIVALENTS</b>		

AT END OF PERIOD	\$ 27,161,125	\$ 114,059,109
<b>SUPPLEMENTAL DISCLOSURES OF CASHFLOW INFORMATION</b>		
Cash paid during the period for -		
Interest	\$ 1,515,486	\$ 1,984,615
Income taxes	-	-
Non-cash investing activities		
Real estate acquired in full satisfaction of loans in foreclosure	\$ -	\$ 2,110,287

See accompanying notes to consolidated financial statements.

Table of Contents

1st Constitution Bancorp and Subsidiaries  
Notes To Consolidated Financial Statements  
March 31, 2012 (Unaudited)

(1) Summary of Significant Accounting Policies

The accompanying unaudited Consolidated Financial Statements include 1ST Constitution Bancorp (the “Company”), its wholly-owned subsidiary, 1ST Constitution Bank (the “Bank”), and the Bank’s wholly-owned subsidiaries, 1ST Constitution Investment Company of New Jersey, Inc., FCB Assets Holdings, Inc., 1ST Constitution Title Agency, LLC, 204 South Newman Street Corp. and 249 New York Avenue, LLC. 1ST Constitution Capital Trust II, a subsidiary of the Company, is not included in the Company’s consolidated financial statements, as it is a variable interest entity and the Company is not the primary beneficiary. All significant intercompany accounts and transactions have been eliminated in consolidation and certain prior period amounts have been reclassified to conform to current year presentation. The accounting and reporting policies of the Company and its subsidiaries conform to accounting principles generally accepted in the United States of America and pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) including the instructions to Form 10-Q and Article 8 of Regulation S-X. Certain information and footnote disclosures normally included in financial statements have been condensed or omitted pursuant to such rules and regulations. These Consolidated Financial Statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company’s Form 10-K for the year ended December 31, 2011, filed with the SEC on March 23, 2012.

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

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of March 31, 2012 for items that should potentially be recognized or disclosed in these financial statements. The evaluation was conducted through the date these financial statements were issued.

(2) Acquisition of Unaffiliated Branches

On March 25, 2011, the Bank acquired certain deposit and other liabilities, real estate and related assets of the Rocky Hill, Hillsborough and Hopewell, New Jersey branch banking offices from another financial institution for a purchase price of \$9.85 million (the “March 2011 Acquisition”). The Acquisition was completed pursuant to the terms and conditions of the Branch Purchase and Assumption Agreement and Agreement for Purchase dated as of December 30, 2010, which was previously disclosed on a Current Report on Form 8-K filed by the Company with the SEC on January 3, 2011.

The Company accounted for this transaction using applicable accounting guidance regarding business combinations. The fair value of savings and transaction deposit accounts acquired was assumed to approximate the carrying value as these accounts have no stated maturity and are payable on demand. A core deposit intangible was ascribed to the value of non-maturity deposits based upon an independent third party evaluation which was prepared using the actual characteristics of the deposits and assumptions we believe to be reasonable. Certificates of deposit accounts were valued utilizing a discounted cash flows analysis based upon the underlying accounts’ contractual maturities and interest rates. The present value of the projected cash flow was then determined using discount rates based upon certificate of deposit interest rates available in the marketplace for accounts with similar terms. The fair value of the three branch buildings was determined via appraisals performed by qualified independent third party appraisers. The fair value of loans acquired, all of which were performing, was assumed to approximate amortized cost based upon the small size and nature of those loans.

As a result of the March 2011 Acquisition, the three branches became branches of the Bank. Included in the March 2011 Acquisition were the assumption of deposit liabilities of \$111.9 million, primarily consisting of demand deposits, and the acquisition of cash of approximately \$101.5 million, fixed assets of approximately \$4.6 million, which includes, without limitation, ownership of the real estate and improvements upon which the branches are situated, and loans of \$862,000. The Bank recorded goodwill of approximately \$3.2 million and a core deposit intangible asset of approximately \$1.7 million as a result of the March 2011 Acquisition.

Table of Contents

## (3) Net Income Per Common Share

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

Diluted net income per common share is calculated by dividing net income stock by the weighted average number of common shares outstanding, as adjusted for the assumed exercise of potential common stock, warrants, common stock options and unvested restricted stock awards (as defined below), using the treasury stock method. All share information has been adjusted for the effect of a 5% common stock dividend declared December 15, 2011 and paid on February 2, 2012 to shareholders of record on January 17, 2012.

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

	Three Months Ended March 31, 2012		
	Income	Weighted- average shares	Per share Amount
Basic earnings per common share:			
Net income	\$1,166,732	5,096,186	\$0.23
Effect of dilutive securities:			
Stock options and unvested stock awards		54,454	
Diluted EPS:			
Net income plus assumed conversion	\$1,166,732	5,150,640	\$0.23
	Three Months Ended March 31, 2011		
	Income	Weighted- average shares	Per share Amount
Basic earnings per common share:			
Net income	\$789,868	5,043,023	\$0.16
Effect of Dilutive Securities:			
Stock options and unvested stock awards		93,926	
Diluted EPS:			
Net income plus assumed conversions	\$789,868	5,136,949	\$0.15

Table of Contents

## (4) Investment Securities

Amortized cost, gross unrealized gains and losses, and the estimated fair value by security type are as follows:

March 31, 2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for Sale Portfolio				
U. S. Treasury securities and obligations of U.S. Government sponsored corporations (“GSE”) and agencies	\$16,991,703	\$41,204	\$(5,997 )	\$17,026,910
Residential collateralized mortgage obligations- GSE	12,297,320	463,048	(39 )	12,760,329
Residential collateralized mortgage obligations- non GSE	3,873,351	124,123	(10,713 )	3,986,761
Residential mortgage backed securities – GSE	37,806,261	2,053,630	(7 )	39,859,884
Obligations of State and Political subdivisions	5,358,455	335,765	(2,685 )	5,691,535
Trust preferred debt securities – single issuer	2,464,080	0	(626,770 )	1,837,310
Corporate debt securities	9,116,025	10,477	(48,896 )	9,077,606
Restricted stock	889,100	0	0	889,100
Mutual fund	25,000	0	0	25,000
	\$88,821,295	\$3,028,247	\$(695,107 )	\$91,154,435



Table of Contents

March 31, 2012	Amortized Cost	Other-Than- Temporary Impairment Recognized In Accumulated Other Comprehensive Income	Carrying Value	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Held to maturity-						
U. S. Treasury securities and obligations of U.S. Government sponsored corporations ("GSE") and agencies	\$ 4,108,136	\$ 0	\$ 4,108,136	\$ 44,229	\$ 0	\$ 4,152,365
Residential collateralized mortgage obligations – GSE	23,729,543	0	23,729,543	1,093,060	0	24,822,603
Residential collateralized mortgage obligations – non – GSE	13,950,860	0	13,950,860	724,073	0	14,674,933
Residential mortgage backed securities – GSE	19,152,385	0	19,152,385	854,163	0	20,006,548
Obligations of State and Political subdivisions	46,461,177	0	46,461,177	2,593,317	(1,002)	49,053,492
Trust preferred debt securities-pooled	649,257	(500,944)	148,313	0	(45,795)	102,518
Corporate debt securities	23,108,772	0	23,108,772	110,892	(16,973)	23,202,691
	\$ 131,160,130	\$ (500,944)	\$ 130,659,186	\$ 5,419,734	\$ (63,770)	\$ 136,015,150

December 31, 2011	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 ("GSE") and agencies	\$ 19,400,856	\$ 71,833	\$ 0	\$ 19,472,689
Residential collateralized mortgage obligations – GSE	13,421,544	476,589	0	13,898,133
Residential collateralized mortgage obligations – non-GSE	4,177,115	143,480	(20,151)	4,300,444

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

Residential mortgage backed securities – GSE	40,655,157	2,032,059	(7)	42,687,209
Obligations of State and Political subdivisions	5,366,145	339,747	(5,378)	5,700,514
Trust preferred debt securities – single issuer	2,463,296	0	(712,055)	1,751,241
Corporate Debt Securities	1,443,762	0	(7,818)	1,435,944
Restricted stock	4,412,600	0	0	4,412,600
Mutual fund	25,000	0	0	25,000
	\$ 91,365,475	\$ 3,063,708	\$ (745,409)	\$ 93,683,774

Table of Contents

December 31, 2011	Amortized Cost	Other-Than- Temporary Impairment Recognized In Accumulated Other Comprehensive Income	Carrying Value	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Held to maturity-						
U. S. Treasury securities and obligations of U.S. Government sponsored corporations ("GSE") and agencies	\$ 11,118,649	\$ 0	\$ 11,118,649	\$ 59,571	\$ 0	\$ 11,178,220
Residential collateralized Mortgage obligations – GSE	24,705,415	0	24,705,415	1,007,737	0	25,713,152
Residential mortgage backed Securities – GSE	14,386,327	0	14,386,327	704,792	0	15,091,119
Residential mortgage backed Securities – non-GSE	20,260,354	0	20,260,354	801,882	0	21,062,236
Obligations of State and Political subdivisions	46,820,985	0	46,820,985	2,848,587	(2,507)	49,667,065
Trust preferred debt securities – pooled	646,574	(500,944)	145,630	0	(142,122)	3,508
Corporate debt securities	25,037,063	0	25,037,063	85,701	(216,784)	24,905,980
	\$ 142,975,367	\$ (500,944)	\$ 142,474,423	\$ 5,508,270	\$ (361,413)	\$ 147,621,280

Restricted stock at March 31, 2012 and December 31, 2011 consists of \$874,100 and \$4,397,600, respectively, of Federal Home Loan Bank of New York stock and \$15,000 of Atlantic Central Bankers Bank stock.

The amortized cost and estimated fair value of investment securities at March 31, 2012, 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. Restricted stock is included in "Available for sale - Due in one year or less."

	Amortized Cost	Fair Value
Available for sale-		
Due in one year or less		
Corporate Debt Securities	\$ 1,344,602	\$ 1,344,371

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

Restricted Stock	889,100	889,100
Mutual Fund	25,000	25,000
	\$ 2,258,702	\$ 2,258,471
Due after one year through five years		
U.S. Treasury securities and obligations of		
US Government sponsored corporations (“GSE”)and agencies	\$ 16,991,703	\$ 17,026,910
Residential mortgage backed securities-GSE	429,659	455,533
Obligations of State and Political subdivisions	593,895	599,201
Corporate Debt Securities	6,520,809	6,497,473
	\$ 24,536,066	\$ 24,579,117
Due after five years through ten years		
Residential collateralized mortgage obligations -GSE	\$ 228,481	\$ 232,909
Residential mortgage backed Securities - GSE	3,680,070	4,017,483
Obligations of State and Political Subdivisions	2,718,289	2,951,483
Corporate Debt Securities	1,250,614	1,235,762
	\$ 7,877,454	\$ 8,437,324
Due after ten years		
Residential collateralized mortgage obligations -GSE	\$ 12,068,839	\$ 12,527,420

Table of Contents

Residential collateralized mortgage obligations –non GSE	3,873,351	3,986,761
Residential mortgage backed securities - GSE	33,696,532	35,386,868
Obligations of State and Political subdivisions	2,046,271	2,141,164
Trust Preferred Debt Securities	2,464,080	1,837,310
	\$ 54,149,073	\$ 55,879,523
<b>Total</b>	<b>\$ 88,821,295</b>	<b>\$ 91,154,435</b>
<b>Held to maturity-</b>		
Due in one year or less		
Obligations of State and Political subdivisions	\$ 4,115,682	\$ 4,119,232
Corporate Debt Securities	11,703,554	11,752,159
	\$ 15,819,236	\$ 15,871,391
Due after one year through five years		
U.S. Treasury securities and obligations of US Government sponsored corporations (“GSE”) and agencies	\$ 3,110,510	\$ 3,150,165
Obligations of State and Political subdivisions	5,272,554	5,461,630
Corporate Debt Securities	11,405,218	11,450,532
	\$ 19,788,282	\$ 20,062,327
Due after five years through ten years		
Residential collateralized mortgage obligations – GSE and non GSE	\$ 801,696	\$ 824,304
Residential mortgage backed securities – GSE	4,322,174	4,420,461
Obligations of State and Political subdivisions	22,330,941	23,626,696
	\$ 27,454,811	\$ 28,871,461
Due after ten years		
U.S. Treasury securities and obligations of US Government sponsored corporations (“GSE”) and agencies	\$ 997,626	\$ 1,002,200
Residential collateralized mortgage obligations - GSE	22,927,847	23,998,299
Residential collateralized mortgage obligations – non GSE	13,950,860	14,674,933
Residential mortgage backed securities - GSE	14,830,211	15,586,087
Obligations of State and Political subdivisions	14,742,000	15,845,934
Trust Preferred Debt Securities - Pooled	148,313	102,518
	\$ 67,596,857	\$ 71,209,971
<b>Total</b>	<b>\$ 130,659,186</b>	<b>\$ 136,015,150</b>

Table of Contents

Gross unrealized losses on securities and the estimated fair value of the related securities aggregated by security category and length of time that individual securities have been in a continuous unrealized loss position at March 31, 2012 and December 31, 2011 are as follows:

March 31, 2012	Number of Securities	Less than 12 months		12 months or longer		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. Government sponsored corporations and agencies	2	\$ 9,939,850	\$ (5,997)	\$ 0	\$ 0	\$ 9,939,850	\$
Residential collateralized mortgage obligations - GSE	1	183,960	(39)	0	0	183,960	
Residential collateralized mortgage obligations – non-GSE	1	0	0	238,140	(10,713)	238,140	
Residential mortgage backed Securities - GSE	1	5,196	(7)	0	0	5,196	
Obligations of State and Political Subdivisions	3	1,050,660	(3,687)	0	0	1,050,660	
Trust preferred debt securities – single issuer	4	0	0	1,837,310	(626,770)	1,837,310	(
Trust preferred debt securities – single issuer - pooled	1	0	0	102,518	(546,739)	102,518	(
Corporate Debt Securities	18	10,983,223	(59,598)	667,809	(6,271)	11,651,032	
<b>Total temporarily impaired securities</b>	<b>31</b>	<b>\$ 22,162,689</b>	<b>\$ (69,328)</b>	<b>\$ 2,845,777</b>	<b>\$ (1,190,493)</b>	<b>\$ 25,008,666</b>	<b>\$ (1,</b>

December 31, 2011	Number of Securities	Less than 12 months		12 months or longer		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Residential collateralized mortgage Obligations – non-GSE	1	\$ 0	\$ 0	\$ 251,723	\$ (20,151)	\$ 251,723	\$ (20,151)
Residential mortgage backed securities GSE	1	5,280	(7)	0	0	5,280	(7)
Obligations of State and Political	3	1,049,362	(7,885)	0	0	1,049,362	(7,885)

Subdivisions							
Trust preferred debt securities – Single issuer	4	0	0	1,751,241	(712,055)	1,751,241	(712,055)
Trust preferred debt securities – Pooled	1	0	0	3,508	(643,066)	3,508	(643,066)
Corporate debt securities	25	13,668,246	(211,075)	666,956	(13,527)	14,335,202	(224,602)
Total temporarily impaired securities	35	\$ 14,722,888	\$ (218,967)	\$ 2,673,428	\$ (1,388,799)	\$ 17,396,316	\$ (1,607,766)

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

Table of Contents

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

Obligations of State and Political Subdivisions: The unrealized losses or investments in these securities were caused by interest rate increases. It is expected that the securities would not be settled at a price less than the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell these investments and it is not more likely than not that the Company will be required to sell these investments before a market price recovery or maturity, these investments are not considered other-than-temporarily impaired.

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

Trust preferred debt securities – single issuer: The investments in these securities with unrealized losses are comprised of four corporate trust preferred securities that mature in 2027, all of which were single-issuer securities. The contractual terms of the trust preferred securities do not allow the issuer to settle the securities at a price less than the face value of the trust preferred securities, which is greater than the amortized cost of the trust preferred securities. None of the corporate issuers have defaulted on interest payments. Because the decline in fair value is attributable to widening of interest rate spreads and the lack of an active trading market for these securities and to a lesser degree market concerns on the issuers' credit quality, and because the Company does not intend to sell these investments and it is not more likely than not that the Company will be required to sell these investments before a market price recovery or maturity, these investments are not considered other-than-temporarily impaired.

Trust preferred debt securities – pooled: On a quarterly basis, management evaluates each security in the portfolio with an individual unrealized loss to determine if that loss represents other-than-temporary impairment. During the fourth quarter of 2009, management determined that it was necessary, following other-than-temporary impairment requirements, to write down the cost basis of the Company's only pooled trust preferred security. This trust preferred debt security was issued by a two issuer pool (Preferred Term Securities XXV, Ltd. Co-issued by Keefe, Bruyette and Woods, Inc. and First Tennessee ('PreTSL XXV')), consisting primarily of financial institution holding companies. During 2009, the Company recognized an other-than-temporary impairment of \$864,727, of which \$363,783 was determined to be a credit loss and charged to operations and \$500,944 was recognized in other comprehensive income (loss) component of shareholders' equity.

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





Table of Contents

On a quarterly basis, management evaluates this security to determine if any additional other-than-temporary impairment is required. As of March 31, 2012, our evaluation was as follows:

- a. We obtained the PRETSL XXV Depository Institutions Issuer List as of March 31, 2012 from the FTN Financial Corp. (“FTN”) website and reviewed the financial ratios and capital levels of each individual financial institution issuer.
- b. We sorted the financial institutions on the issuer list to develop three “buckets” (or categories) for further deferred/default analysis based upon the indicated “Texas Ratio.” The Texas Ratio is calculated by dividing the institution’s Non-Performing Assets plus loans 90 days past due by the combined total of Tangible Equity plus the Allowance for Loan Losses. The three buckets consisted of those institutions with a Texas Ratio of:

- |     |                |
|-----|----------------|
| (1) | Above 100;     |
| (2) | 75 to 100; and |
| (3) | Below 75.      |

c. We then applied the following asset specific deferral/default assumptions to each of these buckets:

- |     |   |
|-----|---|
| (1) | Above 100 - 100% default; 0% recovery;  |
| (2) | 75 to 100 – 100% deferred; 15% recovery at 2 years from initial date of deferral; and |
| (3) | Below 75 – no deferral/default.   |

d. We then ran a cash flow projection to analyze the impact of future deferral/default activity by applying the following assumption on those institutions in bucket (3) of our analysis:

- Defaults at 75 basis points applied annually; 15% recovery with a 2-year lag from the initial date of deferral.

Our rationale for these metrics is as follows: (1) The FDIC lists the number of bank failures each year from 1934 – 2008. Comparing bank failures to the number of FDIC institutions produces an annual average default rate of 36 basis points. Given the continuing uncertain economic environment, we believe the doubling of this amount, or 75 basis points, to be an appropriate measurement for defaults; and (2) Standard & Poor’s published “Global Methodology for Rating Trust Preferred/Hybrid Securities Revised” on November 21, 2008. This analysis uses a recovery assumption of 15%, which we also deem an appropriate measurement.

Our position is that it is appropriate to apply this future default factor in our analysis as it is not realistic to assume no adverse conditions will occur over the remaining 26-year stated maturity of this pooled security even though the individual institutions are currently performing according to terms.

e. This March 31, 2012 projection of future cash flows produced a present value factor that exceeded the carrying value of the pooled trust preferred security; therefore, management concluded that no other-than-temporary impairment issues were present at March 31, 2012.

Table of Contents

Any one or more factors, or combinations thereof, could cause management to conclude in future reporting periods that an unrealized loss that exists with respect to PRETSL XXV constitutes an additional credit impairment. These factors include, but are not limited to, failure to make interest payments, an increase in the severity of the unrealized loss, an increase in the continuous duration of the unrealized loss without an impairment in value or changes in market conditions and/or industry or issuer specific factors that would render management unable to forecast a full recovery in value. In addition, the fair value of trust preferred securities could decline if the overall economy and the financial condition of the issuers continue to deteriorate and there remains limited liquidity for this security.

The following table sets forth information with respect to this security at March 31, 2012:

Security Class	Amortized Cost	Fair Value	Unrealized (Loss)	Percent of Underlying Collateral Performing	Percent of Collateral In Deferral (1)	Percent of Underlying Collateral In Default (1)	Expected Deferrals and Defaults	Percent of as a % of Moody's S&P / Ratings	Excess Subordination Amount	(2)	% of Current Performing Collateral
PreTSL XXV	\$649,257	\$102,518	(\$546,739)	61.7%	20.8%	17.5%	16.0%	C/ NR	\$80,000,000		16.0%

Notes to table above:

- (1) This percentage represents the amount of specific deferrals / defaults that have occurred, plus those that are known for the following quarters to the total amount of original collateral. Fewer deferrals / defaults produce a lower percentage.
- (2) "Excess subordination" amount is the additional defaults / deferrals necessary in the next reporting period to deplete the entire credit enhancement (excess interest and over-collateralization) beneath our tranche within each pool to the point that would cause a "break in yield". This amount assumes that all currently performing collateral continues to perform. A break in yield means that our security would not be expected to receive all the contractual cash flows (principal and interest) by maturity. The "percent of underlying collateral performing" is the ratio of the "excess subordination amount" to current performing collateral - a higher percentage means there is more excess subordination to absorb additional defaults / deferrals, and the better our security is protected from loss.

The Company regularly reviews the composition of the investment securities portfolio, taking into account market risks, the current and expected interest rate environment, liquidity needs, and its overall interest rate risk profile and strategic goals.

The following table presents a cumulative roll forward of the amount of other-than-temporary impairment related to credit losses, all of which relate to PreTSL XXV, which have been recognized in earnings for debt securities held to maturity and not intended to be sold.

(in thousands)	Three months ended March 31, 2012	Three months ended March 31, 2011
Balance at beginning of period	\$ 364	\$ 364

Change during the period		-	-
Balance at end of period	\$	364	\$ 364

Table of Contents

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

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

The following table provides an aging of the loan portfolio by loan class at March 31, 2012:

	30-59 Days	60-89 Days	Greater than 90 Days	Total Past Due	Current	Total Loans Receivable	Recorded Investment > 90 Days Accruing	Nonaccrual Loans
<b>Commercial</b>								
Construction	\$0	\$0	\$107,405	\$ 107,405	55,991,199	\$56,098,604	\$ 0	\$ 107,405
Commercial Business	581,506	216,224	200,217	997,947	50,448,903	51,446,850	0	458,872
Commercial Real Estate	1,030,181	0	747,519	1,777,700	102,473,360	104,251,060	245,235	1,436,889
Mortgage Warehouse Lines	0	0	0	0	201,321,038	201,321,038	0	0
Residential Real Estate	360,504	0	659,760	1,020,264	11,112,827	12,133,091	0	659,760
<b>Consumer</b>								
Loans to Individuals	0	0	54,904	54,904	12,082,681	12,137,585	0	54,904
Other	0	0	0	0	246,438	246,438	0	0
Deferred Loan Costs	0	0	0	0	887,524	887,524	0	0
<b>Total</b>	<b>\$1,972,191</b>	<b>\$216,224</b>	<b>\$1,769,805</b>	<b>\$3,958,220</b>	<b>\$434,563,970</b>	<b>\$438,522,190</b>	<b>\$245,235</b>	<b>\$2,717,830</b>

Table of Contents

The following table provides an aging of the loan portfolio by loan class at December 31, 2011:

	30-59 Days	60-89 Days	Greater than 90 Days	Total Past Due	Current	Total Loans Receivable	Recorded Investment > 90 Days Accruing	Nonaccrual Loans
<b>Commercial</b>								
Construction	\$ 0	\$ 0	140,055	\$ 140,055	\$ 49,145,728	\$ 49,285,783	0	\$ 140,055
Commercial						50,784,674		669,166
Business	364,743	564,152	122,535	1,051,430	49,733,244		0	
Commercial						99,636,976		1,443,220
Real Estate	0	245,874	503,877	749,751	98,887,225		0	
Mortgage								
Warehouse								
Lines	0	0	0	0	249,345,831	249,345,831	0	0
Residential						12,885,352		661,171
Real Estate	905,310	0	661,171	1,566,481	11,318,871		0	
<b>Consumer</b>								
Loans to						12,219,640		77,858
Individuals	0	144,904	77,858	222,762	11,996,878		0	
Other	0	0	0	0	255,556	255,556	0	0
Deferred Loan						1,017,959		
Costs	0	0	0	0	1,017,959		0	0
<b>Total</b>	<b>\$ 1,270,053</b>	<b>\$ 954,930</b>	<b>\$ 1,505,496</b>	<b>\$ 3,730,479</b>	<b>\$ 471,701,292</b>	<b>\$ 475,431,771</b>	<b>0</b>	<b>\$ 2,991,470</b>

Management reviews the adequacy of the allowance on at least a quarterly basis to ensure that the provision for loan losses has been charged against earnings in an amount necessary to maintain the allowance at a level that is adequate based on management's assessment of probable estimated losses. The Company's methodology for assessing the adequacy of the allowance for loan losses consists of several key elements. These elements include a specific reserve for impaired loans, an allocated reserve, and an unallocated portion.

The Company consistently applies the following comprehensive methodology. During the quarterly review of the allowance for loan losses, the Company considers a variety of factors that include:

- General economic conditions.
- Trends in charge-offs.
- Trends and levels of delinquent loans.
- Trends and levels of non-performing loans, including loans over 90 days delinquent.
- Trends in volume and terms of loans.
- Levels of allowance for specific classified loans.
- Credit concentrations.

The methodology includes the segregation of the loan portfolio into loan types with a further segregation into risk rating categories, such as special mention, substandard, doubtful, and loss. This allows for an allocation of the

allowance for loan losses by loan type; however, the allowance is available to absorb any loan loss without restriction. Larger balance, non-homogeneous loans representing significant individual credit exposures are evaluated individually through the internal loan review process. It is this process that produces the watch list. The borrower's overall financial condition, repayment sources, guarantors and value of collateral, if appropriate, are evaluated. Based on these reviews, an estimate of probable losses for the individual larger-balance loans are determined, whenever possible, and used to establish specific loan loss reserves. In general, for non-homogeneous loans not individually assessed, and for homogeneous groups, such as residential mortgages and consumer credits, the loans are collectively evaluated based on delinquency status, loan type, and historical losses. These loan groups are then internally risk rated.

## Table of Contents

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

The specific reserve for impaired loans is established for specific loans which have been identified by management as being impaired. The specific portion of the allowance is the total amount of potential unconfirmed losses for these individual loans. To assist in determining the fair value of loan collateral, the Company often utilizes independent third party qualified appraisal firms which in turn employ their own criteria and assumptions that may include occupancy rates, rental rates, and property expenses, among others.

The second category of reserves consists of the allocated portion of the allowance. The allocated portion of the allowance is determined by taking pools of loans outstanding that have similar characteristics and applying historical loss experience for each pool. This estimate represents the potential unconfirmed losses within the portfolio. Individual loan pools are created for commercial and commercial real estate loans, construction loans, and various types of loans to individuals. The historical estimation for each loan pool is then adjusted to account for current conditions, current loan portfolio performance, loan policy or management changes, or any other factor which may cause future losses to deviate from historical levels.

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

The following discusses the risk characteristics of each of our loan portfolio segments, commercial and consumer.

### Commercial

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

### Consumer

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

In general, for homogeneous groups, such as residential mortgages and consumer credits, the loans are collectively evaluated based on delinquency status, loan type, and industry historical losses. These loan groups are then internally risk rated.





Table of Contents

The Company considers the following credit quality indicators in assessing the risk in the loan portfolio:

- Consumer credit scores
- Internal credit risk grades
- Loan-to-value ratios
- Collateral
- Collection experience

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

1. Excellent - Loans that are based upon cash collateral held at the Bank and adequately margined. Loans that are based upon "blue chip" stocks listed on the major exchanges and adequately margined.
2. Above Average - Loans to companies whose balance sheets show excellent liquidity and long-term debt is on well-spread schedules of repayment easily covered by cash flow. Such companies have been consistently profitable and have diversification in their product lines or sources of revenue. The continuation of profitable operations for the foreseeable future is likely. Management is comprised of a mix of ages, experience, and backgrounds and management succession is in place. Sources of raw materials and service companies, the source of revenue is abundant. Future needs have been planned for. Character and ability of individuals or company principals are excellent. Loans to individuals supported by high net worths and liquid assets.
3. Good - Loans to companies whose balance sheets show good liquidity and cash flow adequate to meet maturities of long-term debt with a comfortable margin. Such company has established a profitable record over a number of years, and there has been growth in net worth. Operating ratios are in line with those of the industry, and expenses are in proper relationship to the volume of business done and the profits achieved. Management is well-balanced and competent in their responsibilities. Economic environment is favorable; however, competition is strong. The prospects for growth are good. Loans in this category do not meet the collateral requirements of loans in categories 1 and 2 above. Loans to individuals supported by good net worths but whose supporting assets are illiquid.
- 3w. Watch List - Included in this category are loans evidencing problems identified by Bank management requiring closer supervision. Such problem has not developed to the point which requires a Special Mention rating. This category also covers situations where the Bank does not have adequate current information upon which credit quality can be determined. The account officer has the obligation to correct these deficiencies within 30 days after the time of notification.
4. Special Mention - Loans or borrowing relationships that require more than the usual amount of attention by Bank management. Industry conditions may be adverse or weak. The borrower's ability to meet current payment schedules may be questionable, even though interest and principal are being paid as agreed. Heavy reliance has been placed on the collateral. Profits, if any, are interspersed with losses. Management is "one man" or weak or incompetent or there is no plan for management succession. Expectations of a loan loss are not immediate; however, if present trends continue, a loan loss could be expected.
5. Substandard - Loans in this category possess weaknesses that jeopardize the ultimate collection of total outstanding. These weaknesses require close supervision by Bank management. Current financial statements are unavailable and the loan is inadequately protected by the collateral pledged. This category will normally include loans that have been classified as substandard by the regulators.

6. Doubtful - Loans with weaknesses inherent in the substandard classification and where collection or liquidation in full is highly questionable. It is likely that the loan will not be collected in full and the Bank will suffer some loss which is not quantifiable at the time of review.

Table of Contents

7. Loss - Loans considered uncollectable and of such little value that their continuance as an active asset is not warranted. Loans in this category should immediately be eliminated from the Bank's loan loss reserve. Any accrued interest should immediately be backed out of income.

The following table provides a breakdown of the loan portfolio by credit quality indicator at March 31, 2012.

Commercial Credit Exposure - By Internally Assigned Grade	Mortgage				
	Construction	Commercial Business	Commercial Real Estate	Warehouse Lines	Residential Real Estate
Grade:					
Pass	\$ 50,936,454	\$ 48,719,860	\$ 84,807,945	\$201,321,038	\$ 11,473,331
Special Mention	4,514,673	1,734,022	14,683,312	0	0
Substandard	647,477	849,819	4,759,803	0	659,760
Doubtful	0	143,149	0	0	0
Total	\$ 56,098,604	\$ 51,446,850	\$104,251,060	\$201,321,038	\$ 12,133,091

## Consumer Credit Exposure

- By Payment Activity	Loans To	
	Individuals	Other
Performing	\$ 12,082,681	\$ 246,438
Nonperforming	54,904	0
Total	\$ 12,137,585	\$ 246,438

The following table provides a breakdown of the loan portfolio by credit quality indicator at December 31, 2011.

Commercial Credit Exposure - By Internally Assigned Grade	Mortgage				
	Construction	Commercial Business	Commercial Real Estate	Warehouse Lines	Residential Real Estate
Grade:					
Pass	\$ 44,106,827	\$ 47,973,545	84,642,510	\$249,345,831	\$ 12,224,181
Special Mention	5,038,901	1,657,993	10,574,489	0	142,477
Substandard	107,405	865,160	3,823,225	0	518,694
Doubtful	32,650	287,976	596,752	0	0
Total	\$ 49,285,783	\$ 50,784,674	99,636,976	\$249,345,831	\$ 12,885,352

## Consumer Credit Exposure

- By Payment Activity	Loans To	
	Individuals	Other
Performing	\$ 12,141,782	\$ 255,556
Nonperforming	77,858	0
Total	\$ 12,219,640	\$ 255,556

## Impaired Loans Disclosures

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

The following tables summarize the distribution of the allowance for loan losses and loans receivable by loan class and impairment method at March 31, 2012 and December 31, 2011:

Table of Contents

## Period-End Allowance for Credit Losses by Impairment Method March 31, 2012

	Construction	Commercial	Commercial Real Estate	Mortgage Warehouse	Residential Real Estate	Consumer	Other	Unallocated
Allowance for credit losses:								
Ending Balance	\$ 1,242,949	\$ 810,999	\$ 1,838,882	\$ 1,006,605	\$ 239,573	\$ 131,570	\$ 3,179	\$ 60,000
Ending Balance								
Individually evaluated for impairment	0	138,597	292,366	0	159,260	0	0	0
Collectively evaluated for impairment	\$ 1,242,949	\$ 672,402	\$ 1,546,516	\$ 1,006,605	\$ 80,313	\$ 131,570	\$ 3,179	\$ 60,000
Loans receivables:								
Ending Balance	\$ 56,098,604	\$ 51,446,850	\$ 104,251,060	\$ 201,321,038	\$ 12,133,091	\$ 12,137,585	\$ 246,438	\$ 60,000
Individually evaluated for impairment	107,405	850,159	1,923,643	0	659,760	54,904	0	0
Collectively evaluated for impairment	\$ 55,991,199	\$ 50,596,691	\$ 102,327,417	\$ 201,321,038	\$ 11,473,331	\$ 12,082,681	\$ 246,438	\$ 60,000

## Period-End Allowance for Credit Losses by Impairment Method December 31, 2011

	Construction	Commercial	Commercial Real Estate	Mortgage Warehouse	Residential Real Estate	Consumer	Other	Unallocated
Allowance for credit losses:								
Ending Balance	\$ 1,054,695	\$ 934,642	\$ 1,597,702	\$ 1,122,056	\$ 91,076	\$ 187,352	\$ 2,377	\$ 544,550
Ending Balance								
Individually evaluated for impairment	0	283,424	186,055	0	11,619	77,858	0	0
Collectively evaluated for impairment	\$ 1,054,695	\$ 651,218	\$ 1,411,647	\$ 1,122,056	\$ 79,457	\$ 109,494	\$ 2,377	\$ 544,550
Loans receivables:								
Ending Balance	\$ 49,285,783	\$ 50,784,674	\$ 99,636,976	\$ 249,345,831	\$ 12,885,352	\$ 12,219,640	\$ 255,556	\$ 60,000
Individually evaluated for impairment	140,055	952,156	1,934,120	0	661,171	77,858	0	0
Collectively evaluated for impairment	\$ 49,145,728	\$ 49,832,518	\$ 97,702,856	\$ 249,345,831	\$ 12,224,181	\$ 12,141,782	\$ 255,556	\$ 60,000

The activity in the allowance for loan loss by loan class for the three months ended March 31, 2012, and 2011, is as follows:

	Construction	Commercial Business	Commercial Real Estate	Mortgage Warehouse	Residential Real Estate	Consumer	Other	Unallocated	Total
Balance - December 31, 2011	\$ 1,054,695	\$ 934,642	\$ 1,597,702	\$ 1,122,056	\$ 91,076	\$ 187,352	\$ 2,377	\$ 544,550	\$ 5,534,000
Provision charged to operations	217,501	15,757	241,180	(115,451)	148,497	22,076	6,803	63,635	599,000
Loans charged off	(32,650)	(144,827)	0	0	0	(77,858)	(6,001)	0	(261,336)
Reverses of loans charged off	3,403	5,427	0	0	0	0	0	0	8,830

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

Balance - March 31, 2012	\$ 1,242,949	\$ 810,999	\$ 1,838,882	\$ 1,006,605	\$ 239,573	\$ 131,570	\$ 3,179	\$ 608,185	\$ 5,881,111
Balance - December 31, 2010	\$ 1,744,068	\$ 971,994	\$ 1,723,865	\$ 763,092	\$ 67,828	\$ 192,457	\$ 1,910	\$ 297,498	
Provision charged to operations	1,183,736	(55,760)	(318,432)	(344,826)	9,777	(1,990)	571	(73,078)	
Loans charged off	(366,587)	(46,319)	0	0	0	0	0	0	
Recoveries of loans charged off	0	239	0	0	0	0	0	0	
Balance - March 31, 2011	\$ 2,561,217	\$ 870,154	\$ 1,405,433	\$ 418,266	\$ 77,605	\$ 190,467	\$ 2,481	\$ 224,420	

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

Table of ContentsImpaired Loans Receivables (By Class) –  
March 31, 2012

				Three months ended March 31, 2012	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial					
Construction	\$107,405	\$107,405	\$0	\$107,405	\$0
Commercial Business	426,745	449,228	0	407,577	0
Commercial Real Estate	0	0	0	335,406	0
Mortgage Warehouse Lines	0	0	0	0	0
Subtotal	534,150	556,633	0	850,388	0
Residential Real Estate	0	0	0	94,398	0
Consumer					
Loans to Individuals	54,904	54,904	0	54,904	0
Other	0	0	0	0	0
Subtotal	54,904	54,904	0	54,904	0
With no related allowance:	\$589,054	\$611,537	\$0	\$999,690	\$0
With a related allowance:					
Commercial					
Construction	\$0	\$0	\$0	\$0	\$0
Commercial Business	423,414	568,241	138,597	424,367	3,649
Commercial Real Estate	1,923,643	1,923,643	292,366	1,591,691	7,417
Mortgage Warehouse Lines	0	0	0	0	0
Subtotal	2,347,057	2,491,884	430,963	2,016,058	11,066
Residential Real Estate	659,760	659,760	159,260	565,716	0
Consumer					
Loans to Individuals	0	0	0	0	0
Other	0	0	0	0	0
Subtotal	0	0	0	0	0
With a related allowance:	3,006,817	3,151,644	590,223	2,866,446	11,066
Total:					
Commercial	2,881,207	3,048,517	430,963	2,866,446	11,066
Residential Real Estate	659,760	659,760	159,260	660,114	0
Consumer	54,904	54,904	0	54,904	0
Total	\$3,595,871	\$3,763,181	\$590,223	\$3,581,464	\$11,066



Table of Contents

## Impaired Loans Receivables (By Class)

December 31 ,2011

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Year to Date Average Recorded Investment	Year to Date Interest Income Recognized	
With no related allowance:						
Commercial						
Construction	\$140,055	\$277,405		\$0	\$610,358	\$0
Commercial Business	381,190	426,803		0	257,942	0
Commercial Real Estate	503,877	611,389		0	457,464	0
Mortgage Warehouse Lines	0	0		0	0	0
Subtotal	1,025,122	1,315,597		0	1,325,764	0
Residential Real Estate	142,477	142,477		0	11,873	
Consumer						
Loans to Individuals	0	0		0	0	0
Other	0	0		0	0	0
Subtotal	0	0		0	0	0
Subtotal with no Related Allowance	1,167,599	1,315,597		0	1,337,637	0
With an allowance:						
Commercial						
Construction	0	0		0	2,389,162	0
Commercial Business	570,966	570,966	283,424		791,808	10,001
Commercial Real Estate	1,430,243	1,430,243	186,055		1,036,007	2,294
Mortgage Warehouse Lines	0	0		0	0	0
Subtotal	2,001,209	2,001,209	469,479		4,216,977	12,295
Residential Real Estate	518,694	518,694	11,619		490,081	0
Consumer						
Loans to Individuals	77,858	77,858	77,858		77,858	0
Other	0	0		0	0	0
Subtotal	77,858	77,858	77,858		77,858	0

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

Subtotal with an Allowance	2,597,761	2,597,761	558,956	4,784,916	12,295
Total:					
Commercial	3,026,331	3,316,806	469,479	5,542,741	12,295
Residential Real Estate	661,171	518,694	11,619	501,954	0
Consumer	77,858	77,858	77,858	77,858	0
Total	\$3,765,360	\$3,913,358	\$558,956	\$6,122,553	\$12,295

Table of Contents

## Impaired Loans Receivables (By Class) – March 31, 2011

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Three months ended March 31, 2011	
				Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial					
Construction	\$170,921	\$189,921	\$0	\$2,779,171	\$0
Commercial Business	478,609	490,299	0	443,643	0
Commercial Real Estate	359,192	359,192	0	424,298	0
Mortgage Warehouse Lines	0	0	0	0	0
Subtotal	1,008,722	1,039,412	0	3,647,112	0
Residential Real Estate	0	0	0	0	1,516
Consumer					
Loans to Individuals	0	0	0	0	0
Other	0	0	0	0	0
Subtotal	0	0	0	0	0
With no related allowance:	\$1,008,722	\$1,039,412	\$0	\$3,647,112	\$1,516
With a related allowance:					
Commercial					
Construction	\$3,921,500	\$3,997,000	\$904,432	\$2,931,167	\$0
Commercial Business	659,436	659,436	216,995	463,058	0
Commercial Real Estate	1,048,353	1,048,353	306,173	984,370	0
Mortgage Warehouse Lines	0	0	0	0	0
Subtotal	5,629,289	5,704,789	1,427,600	4,378,595	0
Residential Real Estate	519,610	519,610	11,619	346,709	0
Consumer					
Loans to Individuals	77,858	77,858	77,858	77,858	0
Other	0	0	0	0	0
Subtotal	77,858	77,858	77,858	77,858	0
With a related allowance:	6,226,757	6,302,257	1,517,077	4,803,162	0
Total:					
Commercial	6,638,011	6,744,201	1,427,600	8,025,707	0
Residential Real Estate	519,610	519,610	11,619	346,709	1,516
Consumer	77,858	77,858	77,858	77,858	0
Total	\$7,235,479	\$7,341,669	\$1,517,077	\$8,450,274	\$11,066

The Bank adopted Accounting Standards Update (“ASU”) No. 2011-02 on July 1, 2011. ASU No. 2011-02 provides additional guidance to creditors for evaluating whether a modification or restructuring of a receivable is a troubled debt restructuring. In evaluating whether a restructuring constitutes a troubled debt restructuring, ASU No. 2011-02 requires that a creditor must separately conclude that the restructuring constitutes a concession and the borrower is experiencing financial difficulties. As a result of our adoption of ASU No. 2011-02, we reassessed the terms and

restructurings. The following table is a breakdown of troubled debt restructurings, all of which are classified as impaired at March 31, 2012.

Table of Contents

## Modifications

During the three months ended March 31, 2012

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
<b>Troubled Debt Restructurings:</b>			
Commercial	1	\$ 137,028	\$ 137,028

	Number of Contracts	Recorded Investment
<b>Troubled Debt Restructurings During the Prior Twelve Months That Subsequently Defaulted:</b>		
Commercial	1	\$ 22,471
Residential Real Estate	1	518,694

If the Bank determines that a borrower has suffered deterioration in their financial condition, a restructuring of the loan terms may occur. Such loan restructurings may include, but are not limited to, reductions in principal or interest, reductions in interest rates, and extensions of the maturity date. When modifications are implemented, such loans meet the definition of a troubled debt restructuring. Most of the modifications employed by the Bank during the three month period ended March 31, 2012 have resulted in lower amortization payments for a limited time period without any reduction in the interest rate. The lower payments are determined by an analysis of the borrower's cash flow ability to meet the modified terms while anticipating an improved financial condition to enable a resumption of the original payment terms.

## (6) Share-Based Compensation

The Company establishes fair value for its equity awards to determine its cost and recognizes the related expense for stock options over the vesting period using the straight-line method. The grant date fair value for stock options is calculated using the Black-Scholes option valuation model.

The Company's stock based incentive plans ("Stock Plans") authorize the issuance of an aggregate of 1,298,193 shares of common stock (as adjusted for subsequent stock dividends) pursuant to awards that may be granted in the form of stock options to purchase common stock ("Options") and awards of shares of common stock ("Stock Awards"). The purpose of the Stock Plans is to attract and retain personnel for positions of substantial responsibility and to provide additional incentive to certain officers, directors, employees and other persons to promote the success of the Company. Under the Stock Plans, options expire ten years after the date of grant. Options are granted at the then fair market value of the Company's stock. The grant date fair value is calculated using the Black – Scholes option valuation model. As of March 31, 2012, there were 123,974 shares of common stock (as adjusted for the 5% stock dividend declared December 15, 2011 and paid February 2, 2012 to shareholders of record on January 17, 2012) available for future grants under the Stock Plans.

Stock-based compensation expense related to Options was \$23,540 and \$17,503 for the three months ended March 31, 2012 and 2011, respectively.

Transactions under the Stock Plans during the three months ended March 31, 2012 are summarized as follows:

25

---

Table of Contents

Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at January 1, 2012	196,906	\$ 9.66		
Granted	26,670	6.42		
Exercised	-	-		
Forfeited	-	-		
Expired	-	-		
Outstanding at March 31, 2012	223,576	\$ 9.27	6.4	\$ 125,874
Exercisable at March 31, 2012	162,094	\$ 10.24	5.3	\$ 37,089

The fair value of each option and the significant weighted average assumptions used to calculate the fair value of the options granted for the three months ended March 31, 2012 are as follows:

Fair value of options granted	\$ 2.20
Risk-free rate of return	0.84%
Expected option life in years	7
Expected volatility	31.48%
Expected dividends (1)	-

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

As of March 31, 2012, there was approximately \$172,143 of unrecognized compensation cost related to nonvested stock option based compensation arrangements granted under the Company's Stock Plans. That cost is expected to be recognized over the next three years.

The following table summarizes nonvested restricted shares for the three months ended March 31, 2012 (as adjusted to reflect the 5% stock dividend declared in December 2011).

Non-vested shares	Number of Shares	Average Grant Date Fair Value
Non-vested at January 1, 2012	151,753	\$ 6.87
Granted	1,995	6.42
Vested	(20,875 )	(8.12 )
Forfeited	-	-
Non-vested at March 31, 2011	132,873	\$ 6.67

The value of restricted shares is based upon the closing price of the common stock on the date of grant. The shares generally vest over a four year service period with compensation expense recognized on a straight-line basis.

Stock based compensation expense related to stock grants was \$87,822 and \$73,015 for the three months ended March 31, 2012 and 2011.

As of March 31, 2012, there was approximately \$749,147 of unrecognized compensation cost related to nonvested stock grants that will be recognized over the next three years.



Table of Contents

## (7) Benefit Plans

The Company has a 401(k) plan which covers substantially all employees with six months or more of service. The Company's contributions to the 401(k) plan are expensed as incurred.

The Company also provides retirement benefits to certain employees under supplemental executive retirement plans (the "SERPs"). The SERPs are unfunded and the Company accrues actuarial determined benefit costs over the estimated service period of the employees in the SERPs. The Company recognizes the over funded or under funded status of a defined benefit post-retirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur, through comprehensive income.

The components of net periodic expense for the Company's SERPs for the three months ended March 31, 2012 and 2011 are as follows:

	Three months ended March 31,	
	2012	2011
Service cost	\$ 61,823	\$ 68,425
Interest cost	50,073	57,057
Actuarial (gain) loss recognized	5,300	(2,062 )
Prior service cost recognized	24,858	19,859
	\$ 142,054	\$ 143,279

## (8) Other Comprehensive Income and Accumulated Other Comprehensive Income

The components of accumulated other comprehensive income, other comprehensive income, and their related income tax effects were as follows:

	March 31, 2012	December 31, 2011	Three months ended March 31,	
			2012	2011
Unrealized holding gains on Securities available for sale	\$2,333,140	\$ 2,318,299	\$14,841	\$(177,572 )
Related income tax effect	(793,267 )	(788,221 )	(5,046 )	60,375
	1,539,873	1,530,078	9,795	(117,197 )
Unrealized impairment loss On held to maturity security	(500,944 )	(500,944 )	-	-
Related income tax effect	170,321	170,321	-	-
	(330,623 )	(330,623 )	-	-
Unrealized loss on interest Rate swap contract	-	-	-	173,749
Related income tax effect	-	-	-	(69,378 )
	-	-	-	104,371
Pension liability	(175,441 )	(178,661 )	3220	3219
Related income tax effect	69,374	70,668	(1294 )	(1292 )

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

	(106,067 )	(107,993 )	1926	1927
Accumulated other comprehensive income	\$1,103,183	\$ 1,091,462	\$11,721	\$(10,899 )

27

---

Table of Contents

(9) Recent Accounting Pronouncements

ASU 2011-11 (Disclosures about offsetting Assets and Liabilities)

On December 19, 2011, The FASB issued Accounting Standards Update (ASU) 2011-11, “Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities.” This new guidance affects all entities with financial instruments or derivatives that are either presented on a net basis in the balance sheet or subject to an enforceable master netting arrangement or a similar arrangement. The ASU does not change existing offsetting criteria in U.S. generally accepted accounting principles (U.S. GAAP) or the permitted balance sheet presentation for items meeting the criteria. To help financial statement users better assess the effect or potential effect of offsetting arrangements on an entity’s financial position, the new guidance requires disclosures in the financial statement notes that provide both net and gross information about assets and liabilities that have been offset and the related arrangements.

The new disclosure requirements in the ASU are intended to enhance comparability between financial statements prepared using U.S. GAAP and those prepared in accordance with international Financial Reporting Standards (IFRS). The eligibility criteria for offsetting are different in U.S. GAAP and IFRS. In January 2011, the FASB and the International Accounting Standards Board issued an exposure draft proposing new common criteria for offsetting, but the boards could not agree. The FASB voted to retain existing U.S. GAAP guidance on offsetting and to require expanded disclosures for financial instruments and derivative instruments that are either offset in the balance sheet or eligible for offset subject to a master netting arrangement or similar arrangement.

The ASU is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. Disclosures required by the amendments should be provided retrospectively for all comparative periods. The FASB has published a short recap highlighting the significant issues the ASU addresses. The Company does not expect the adoption of this ASU to have a material impact on the Company’s consolidated financial position or results of operations.

ASU 2011-08 (Testing for Goodwill for Impairment)

In September, 2011, the FASB issued Accounting Standards Update (ASU) 2011-08, Testing Goodwill for Impairment. The purpose of this ASU is to simplify how entities test goodwill for impairment by adding a new first step to the preexisting goodwill impairment test under ASC Topic 350, Intangibles-Goodwill and other. This amendment gives the entity the option to first assess a variety of qualitative factors such as economic conditions, cash flows, and competition to determine whether it was more likely than not that the fair value of goodwill has fallen below its carrying value. If the entity determines that it is not likely that the fair value has fallen below its carrying value, then the entity will not have to complete the original two-step test under Topic 350. The amendments in this ASU are effective for impairment tests performed for fiscal years beginning after December 15, 2011. The Company is evaluating the impact of this ASU on its consolidated financial statements.

ASU 2011-05 (Presentation of Comprehensive Income)

The provisions of this ASU amend FASB ASC Topic 220, Comprehensive Income, to facilitate the continued alignment of U.S. GAAP with International Accounting Standards. The ASU prohibits the presentation of the components of comprehensive income in the statement of shareholders’ equity. Reporting entities are allowed to present either: a statement of comprehensive income, which reports both net income and other comprehensive income; or separate, but consecutive, statements of net income and other comprehensive income. Under previous GAAP, all three presentations were acceptable. Regardless of the presentation selected, the reporting entity is required to present all reclassifications between other comprehensive and net income on the face of the new statement or statements. The provisions of this ASU are effective for fiscal years and interim periods beginning after December 31, 2011 for public

entities.

ASU 2011-12, “Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income (“AOCI”) in Accounting Standards Update No. 2011-05,” was issued by the FASB on December 23, 2011. This ASU defers the implementation of only those provisions in ASU 2011-05, dealing with the presentation of items reclassified out of AOCI.

28

---

## Table of Contents

The amendments in ASU 2011-12 and ASU 2011-05 are effective at the same time: For public entities, the guidance is effective for fiscal years and interim periods within those years, beginning after December 15, 2011. The requirements are effective for nonpublic entities for fiscal years ending after December 15, 2012. The FASB has published a short recap of the reasons for the ASU 2011-12 deferrals. The adoption of this guidance did not to have any impact on the Company's consolidated financial position or results of operations.

ASU 2011-04 (Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs)

This ASU amends FASB ASC Topic 820, Fair Value Measurements, to bring U.S. GAAP for fair value measurements in line with International Accounting Standards. The ASU clarifies existing guidance for items such as: the application of the highest and best use concept to non-financial assets and liabilities; the application of fair value measurement to financial instruments classified in a reporting entity's shareholders' equity; and disclosure requirements regarding quantitative information about unobservable inputs used in the fair value measurements of level 3 assets. The ASU also creates an exception to Topic 820 for entities which carry financial instruments within a portfolio or group, under which the entity is now permitted to base the price used for fair valuation upon a price that would be received to sell the net asset position or transfer a net liability position in an orderly transaction. The ASU also allows for the application of premiums and discounts in a fair value measurement if the financial instrument is categorized in level 2 or 3 of the fair value hierarchy. Lastly, the ASU contains new disclosure requirements regarding fair value amounts categorized as level 3 in the fair value hierarchy such as: disclosure of the valuation process used; effects of and relationships between unobservable inputs; usage of nonfinancial assets for purposes other than their highest and best use when that is the basis of the disclosed fair value; and categorization by level of items disclosed at fair value, but not measured at fair value for financial statement purposes. For public entities, this ASU is effective for interim and annual periods beginning after December 15, 2011. The adoption of this ASU did not affect the Company's consolidated financial position or results of operations.

### (10) Fair Value Disclosures

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

- Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.
- Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.
- Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

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

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Company's financial assets and financial liabilities carried at fair value.

Table of Contents

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

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

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

**Other Real Estate Owned.** Foreclosed properties are adjusted to fair value less estimated selling costs at the time of foreclosure in preparation for transfer from portfolio loans to other real estate owned ("OREO"), establishing a new accounting basis. The Company subsequently adjusts the fair value on the OREO utilizing Level 3 inputs on a non-recurring basis to reflect partial write-downs based on the observable market price, current appraised value of the asset or other estimates of fair value.

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

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
March 31, 2012:				
Securities available for sale:				
U. S. Treasury securities and obligations of U.S. Government sponsored corporations ("GSE") and agencies	\$ 17,026,910	-	-	\$ 17,026,910
Residential collateralized mortgage obligations- GSE	-	12,760,329	-	12,760,329
Residential collateralized mortgage obligations - non GSE	-	3,986,761	-	3,986,761
Residential mortgage backed securities – GSE	-	39,859,884	-	39,859,884
Obligations of State and Political subdivisions	-	5,691,535	-	5,691,535
Trust preferred debt securities – single issuer	-	1,837,310	-	1,837,310
Corporate debt securities	-	9,077,606	-	9,077,606
Restricted stock	-	889,100	-	889,100
Mutual fund	-	25,000	-	25,000





Table of Contents

December 31, 2011:

Securities available for sale:

U. S. Treasury securities and obligations of U.S. Government sponsored corporations (“GSE”) and agencies	\$ 7,108,870	\$ 12,363,819	-	\$ 19,472,689
Residential collateralized mortgage obligations- GSE	-	13,898,133	-	13,898,133
Residential collateralized mortgage obligations - non GSE	-	4,300,444	-	4,300,444
Residential mortgage backed securities – GSE	-	42,687,209	-	42,687,209
Obligations of State and Political subdivisions	-	5,700,514	-	5,700,514
Trust preferred debt securities – single issuer	-	1,751,241	-	1,751,241
Corporate debt securities	-	1,435,944	-	1,435,944
Restricted stock	-	4,412,600	-	4,412,600
Mutual fund	-	25,000	-	25,000

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets and financial liabilities measured at fair value on a non-recurring basis at March 31, 2012 and December 31, 2011 are as follows:

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
March 31, 2012:				
Impaired loans	-	-	\$ 2,416,594	\$ 2,416,594
Other real estate owned	-	-	2,991,838	2,991,838

December 31, 2011:

Impaired loans	-	-	\$ 2,038,805	\$ 2,038,805
Other real estate owned	-	-	491,536	491,536

Impaired loans measured at fair value and included in the above table consisted of 11 loans having an aggregate recorded investment of \$3,006,817 and specific loan loss allowances of \$590,223 at March 31, 2012 and nine loans at December 31, 2011, having an aggregate recorded investment of \$2,597,761 and specific loan loss allowances of \$558,956.

The following table presents additional qualitative information about assets measured at fair value on a nonrecurring and for which the Company has utilized Level 3 inputs to determine fair value:

	Quantitative Information about Level 3 Fair Value Measurements			Range (Weighted Average)
	Fair Value Estimate	Valuation Techniques	Unobservable Input	
March 31, 2012				
Impaired loans	\$2,416,594	Appraisal of collateral (1)	Appraisal adjustments (1)	50%(-50%)
Other Real Estate Owned	\$2,991,838	Appraisal of	Appraisal	

collateral (1), (2)

adjustments (1) 3% to -75% (-6%)

- (1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.
- (2) Includes qualitative adjustments by management and estimated liquidation expenses.

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

Table of Contents

The following is a summary of fair value versus the carrying value of all the Company's financial instruments. For the Company and the Bank, as for most financial institutions, the bulk of its assets and liabilities are considered financial instruments. Many of the financial instruments lack an available trading market as characterized by a willing buyer and willing seller engaging in an exchange transaction. Therefore, significant estimations and present value calculations were used for the purpose of this note. Changes in assumptions could significantly affect these estimates.

Estimated fair values have been determined by using the best available data and an estimation methodology suitable for each category of financial instruments as follows:

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

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

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

Gross Loans Receivable (Carried at Cost). The fair values of loans, excluding impaired loans subject to specific loss reserves, are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values.

Deposit Liabilities (Carried at Cost). The fair values disclosed for demand deposits (e.g., interest and non-interest demand and savings accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Borrowings and Subordinated Debentures (Carried at Cost). The carrying amounts of short-term borrowings approximate their fair values. The fair values of long-term FHLB advances and subordinated debentures are estimated using discounted cash flow analysis, based on quoted or estimated interest rates for new borrowings with similar credit risk characteristics, terms and remaining maturity.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company's financial instruments carried at cost or amortized cost as of March 31, 2012 and December 31, 2011. This table excludes financial instruments for which the carrying amount approximates fair value. For short-term financial assets such as cash and cash equivalents and accrued interest receivable, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For financial liabilities such as interest-bearing demand deposits and accrued interest payable, the carrying amount is a reasonable estimate of fair value due to these liabilities having no stated maturity.

Table of Contents

(dollars in thousands)	Carrying Amount	Fair Value	Fair Value Measurement Placement		
			(Level 1)	(Level 2)	(Level 3)
March 31, 2012					
Financial Instruments - Assets					
Investment Securities					
Held-to-Maturity	\$ 130,659,186	\$ 136,015,150	\$ -	\$ 135,912,632	\$ 102,518
Loans Held for Sale	17,497,128	17,497,128	-	17,497,128	-
Gross Loans	438,522,190	441,180,000	-	-	441,180,000
Financial Instruments - Liabilities					
Deposits	658,563,958	660,409,000	509,644,077	150,764,923	-
Borrowings	10,000,000	11,742,000	-	11,742,000	-
Redeemable Subordinates					
Debentures	18,557,000	18,557,000	-	18,557,000	-

The estimated fair values and carrying amounts of financial assets and liabilities were as follows:

	March 31, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Cash and cash equivalents	\$ 27,161,125	\$ 27,161,125	\$ 15,195,259	\$ 15,195,259
Securities available for sale	91,154,435	91,154,435	93,683,774	93,683,774
Securities held to maturity	130,659,186	136,015,150	142,474,423	147,621,280
Loans held for sale	17,497,128	17,497,128	19,234,111	19,234,111
Gross loans	438,522,190	441,180,000	475,431,771	477,168,000
Accrued interest receivable	2,523,723	2,523,723	2,996,848	2,996,848
Deposits	(658,563,958)	(660,409,000)	(623,862,485)	(625,764,000)
Borrowings	(10,000,000)	(11,742,000)	(88,300,000)	(90,163,000)
Redeemable subordinated debentures	(18,557,000)	(18,557,000)	(18,557,000)	(18,557,000)
Accrued interest payable	(1,074,733)	(1,074,733)	(1,186,511)	(1,186,511)

Loan commitments and standby letters of credit as of March 31, 2012 and December 31, 2011 are based on fees charged for similar agreements; accordingly, the estimated fair value of loan commitments and standby letters of credit is nominal.

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

The purpose of this discussion and analysis of the operating results and financial condition at March 31, 2012 is intended to help readers analyze the accompanying financial statements, notes and other supplemental information contained in this document. Results of operations for the three month period ended March 31, 2012 are not necessarily indicative of results to be attained for any other period.

This discussion and analysis should be read in conjunction with the Consolidated Financial Statements, notes and tables included elsewhere in this report and Part II, Item 7 of the Company's Form 10-K (Management's Discussion and Analysis of Financial Condition and Results of Operations) for the year ended December 31, 2011, as filed with the Securities and Exchange Commission (the "SEC") on March 23, 2012.

General

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

## Table of Contents

The Company is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. The Company was organized under the laws of the State of New Jersey in February 1999 for the purpose of acquiring all of the issued and outstanding stock of the Bank, a full service commercial bank which began operations in August 1989, 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 ownership interest in the Bank, the Company currently conducts no other significant business activities.

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

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

## Forward-Looking Statements

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

Factors that may cause actual results to differ from those results expressed or implied, include, but are not limited to, those listed under "Business", "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's Annual Report on Form 10-K filed with the SEC on March 23, 2012, such as the overall economy and the interest rate environment; the ability of customers to repay their obligations; the adequacy of the allowance for loan losses; competition; significant changes in accounting, tax or regulatory practices and requirements; certain interest rate risks; risks associated with investments in mortgage-backed securities; and risks associated with speculative construction lending. Although management has taken certain steps to mitigate any negative effect of the aforementioned items, significant unfavorable changes could severely impact the assumptions used and could have an adverse effect on profitability. The Company undertakes no obligation to publicly revise any forward-looking statements to reflect anticipated or unanticipated events or circumstances occurring after the date of such statements, except as required by law.

## Acquisition of Three Branches in 2011

On March 25, 2011, the Bank acquired certain deposit and other liabilities, real estate and related assets of the Rocky Hill, Hillsborough and Hopewell, New Jersey branch banking offices from another financial institution for a purchase price of \$9.85 million (the "March 2011 Acquisition"). The March 2011 Acquisition was completed pursuant to the terms and conditions of the Branch Purchase and Assumption Agreement and Agreement for Purchase dated as of December 30, 2010, which was previously disclosed on a Current Report on Form 8-K filed by the Company with the Securities and Exchange Commission on January 3, 2011.

As a result of the March 2011 Acquisition, the three branches became branches of the Bank. Included in the March 2011 Acquisition were the assumption of deposit liabilities of \$111.9 million, primarily consisting of demand deposits, and the acquisition of cash of approximately \$101.5 million, fixed assets of approximately \$4.6 million, which includes, without limitation, ownership of the real estate and improvements upon which the branches are situated, and loans of \$862,000. The Bank recorded goodwill of approximately \$3.2 million and a core deposit intangible asset of approximately \$1.7 million as a result of the March 2011 Acquisition.

Table of Contents

RESULTS OF OPERATIONS

Three Months Ended March 31, 2012 Compared to the Three Months Ended March 31, 2011

Summary

The Company reported net income of \$1,166,732 for the three months ended March 31, 2012, an increase of \$376,864, or 47.7%, from the \$789,868 reported for the three months ended March 31, 2011. The increase is due primarily to increases in net interest income and non-interest income. Net income per diluted common share was \$0.23 for the three months ended March 31, 2012 compared to net income per diluted common share of \$0.15 for the three months ended March 31, 2011. All prior year share information has been adjusted for the effect of a 5% stock dividend declared on December 15, 2011 and paid on February 2, 2012 to shareholders of record on January 17, 2012.

Key performance ratios improved for the three months ended March 31, 2012 due to higher net income for that period compared to the three months ended March 31, 2011. Return on average assets and return on average equity were 0.62% and 8.46% for the three months ended March 31, 2012 compared to 0.49% and 6.49%, respectively, for the three months ended March 31, 2011.

The Bank's results of operations depend primarily on net interest income, which is primarily affected by the market interest rate environment, the shape of the U.S. Treasury yield curve, and the difference between the yield on interest-earning assets and the rate paid on interest-bearing liabilities. Other factors that may affect the Bank's operating results are general and local economic and competitive conditions, government policies and actions of regulatory authorities. The net interest margin for the three months ended March 31, 2012 was 3.98% as compared to the 3.54% net interest margin recorded for the three months ended March 31, 2011, an increase of 44 basis points. The Company will continue to closely monitor the mix of earning assets and funding sources to maximize net interest income during this challenging interest rate environment.

Earnings Analysis

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 85.1% of the Company's net revenues for the three month period ended March 31, 2012 and 83.4% of net revenues for the three-month period ended March 31, 2011. Net interest income also depends upon the relative amount of average interest-earning assets, average interest-bearing liabilities, and the interest rate earned or paid on them, respectively.

The following table sets forth the Company's consolidated average balances of assets and liabilities and shareholders' equity as well as interest income and expense on related items, and the Company's average yield or rate for the three month periods ended March 31, 2012 and 2011. The average rates are derived by dividing interest income and expense by the average balance of assets and liabilities, respectively.



Table of Contents

## Average Balance Sheets with Resultant Interest and Rates

(yields on a

tax-equivalent basis)

	Three months ended March 31, 2012			Three months ended March 31, 2011		
	Average Balance	Interest	Average Yield	Average Balance	Interest	Average Yield
<b>Assets:</b>						
Federal Funds						
Sold/Short-Term						
Investments	\$ 25,778,075	\$ 15,034	0.23%	\$ 14,984,566	\$ 9,106	0.25%
<b>Investment Securities:</b>						
Taxable	169,451,907	1,184,205	2.81%	204,398,959	1,284,944	2.55%
Tax-exempt	52,496,087	622,441	4.77%	32,125,900	421,907	5.33%
<b>Total</b>	<b>221,947,994</b>	<b>1,806,646</b>	<b>3.27%</b>	<b>236,524,859</b>	<b>1,706,851</b>	<b>2.93%</b>
<b>Loan Portfolio:</b>						
Construction	51,229,408	886,115	6.96%	66,996,941	1,015,700	6.15%
Residential real estate	12,553,551	160,487	5.14%	10,487,786	170,146	6.58%
Home Equity	11,017,237	155,074	5.66%	12,380,893	175,411	5.75%
Commercial and commercial real estate	142,809,968	2,618,799	7.38%	135,025,788	2,498,671	7.5%
Mortgage warehouse lines	192,404,738	2,289,469	4.79%	101,779,484	1,227,643	4.89%
Installment	414,501	6,927	6.72%	421,663	7,450	7.17%
All Other Loans	32,488,520	297,588	3.68%	28,432,869	259,186	3.70%
<b>Total</b>	<b>442,917,923</b>	<b>6,414,459</b>	<b>5.82%</b>	<b>355,525,424</b>	<b>5,354,207</b>	<b>6.11%</b>
<b>Total Interest-Earning Assets</b>	<b>690,643,992</b>	<b>8,236,139</b>	<b>4.80%</b>	<b>607,034,849</b>	<b>7,070,164</b>	<b>4.72%</b>
Allowance for Loan Losses	(5,759,191)			(6,050,453)		
Cash and Due From Bank	17,525,148			17,307,166		
Other Assets	53,200,991			34,107,247		
<b>Total Assets</b>	<b>\$ 755,610,940</b>			<b>\$ 652,398,809</b>		
<b>Liabilities and Shareholders' Equity:</b>						
<b>Money Market and NOW</b>						
Accounts	\$ 204,819,526	\$ 306,804	0.60%	\$ 136,295,377	\$ 373,313	1.11%
Savings Accounts	188,803,014	318,354	0.68%	172,918,852	375,488	0.88%
Certificates of Deposit	144,509,899	561,316	1.56%	153,113,579	649,329	1.72%
Other Borrowed Funds	22,069,231	117,922	2.15%	13,895,000	106,920	3.12%
Trust Preferred Securities	18,557,000	99,312	2.15%	18,557,000	264,154	5.77%
<b>Total Interest-Bearing Liabilities</b>	<b>578,758,670</b>	<b>1,403,708</b>	<b>0.98%</b>	<b>494,779,808</b>	<b>1,769,204</b>	<b>1.45%</b>

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

Net Interest Spread		3.82%		3.27%	
Demand Deposits	112,977,065		96,658,478		
Other Liabilities	8,426,611		11,578,464		
Total Liabilities	700,162,346		603,016,750		
Shareholders' Equity	55,448,594		49,382,059		
Total Liabilities and Shareholders' Equity	\$755,610,940		\$652,398,809		
Net Interest Margin		\$ 6,832,431	3.98%	\$ 5,300,960	3.54%

The Company's net interest income increased on a tax-equivalent basis by \$1,531,471, or 28.9%, to \$6,832,431 for the three months ended March 31, 2012 from the \$5,300,960 reported for the three months ended March 31, 2011. The principal factors contributing to the increase in net interest income was an increase in average rate earned on interest earnings assets and a decrease in the average rate paid on interest bearing liabilities.

## Table of Contents

Average interest earning assets increased by \$83,609,143, or 13.8%, to \$690,643,992 for the three month period ended March 31, 2012 from \$607,034,849 for the three month period ended March 31, 2011. The overall yield on interest earning assets, on a tax-equivalent basis, increased 8 basis points to 4.80% for the three month period ended March 31, 2012 when compared to 4.72% for the three month period ended March 31, 2011.

Average interest bearing liabilities increased by \$83,978,862, or 17.0%, to \$578,758,670 for the three month period ended March 31, 2012 from \$494,779,808 for the three month period ended March 31, 2011. Overall, the cost of total interest bearing liabilities decreased 47 basis points to 0.98% for the three months ended March 31, 2012 compared to 1.45% for the three months ended March 31, 2011.

The net interest margin (on a tax-equivalent basis), which is net interest income divided by average interest earning assets, was 3.98% for the three months ended March 31, 2012 compared to 3.54% the three months ended March 31, 2011.

### Provision for Loan Losses

Management considers a complete review of the following specific factors in determining the provisions for loan losses: historical losses by loan category, non-accrual loans, and problem loans as identified through internal classifications, collateral values, and the growth and size of the loan portfolio. In addition to these factors, management takes into consideration current economic conditions and local real estate market conditions. Using this evaluation process, the Company's provision for loan losses was \$599,998 for the three months ended March 31, 2012 and \$399,998 for the three months ended March 31, 2011. The increased provision for 2012 was primarily the result of increased general allowances on commercial real estate loans.

### Non-Interest Income

Total non-interest income for the three months ended March 31, 2012 was \$1,165,165, an increase of \$140,415, or 13.7%, over non-interest income of \$1,024,750 for the three months ended March 31, 2011.

A significant portion of the increase in total non-interest income and its major components when compared with non-interest income for the prior year period was attributable to the March 2011 Acquisition.

Service charges on deposit accounts represent a consistent source of non-interest income. Service charge revenues increased to \$227,972 for the three months ended March 31, 2012 from the \$175,842 for the three months ended March 31, 2011. This increase was the result of a higher volume of uncollected funds and overdraft fees collected on deposit accounts during the first three months of 2012 compared to the first three months of 2011.

Gain on sales of loans held for sale increased by \$31,478, or 7.2%, to \$468,217 for the three months ended March 31, 2012 when compared to \$436,739 for the three months ended March 31, 2011. The Bank sells both residential mortgage loans and Small Business Administration loans in the secondary market. The volume of mortgage loan sales increased for the first three months of 2012 compared to the first three months of 2011.

Non-interest income also includes income from bank-owned life insurance ("BOLI"), which amounted to \$111,922 for the three months ended March 31, 2012 compared to \$95,137 for the three months ended March 31, 2011, an increase of \$16,785 for the first quarter of 2012 as compared to the first quarter of 2011. The Bank purchased additional tax-free BOLI assets during the fourth quarter of 2011 to partially offset the cost of employee benefit plans and reduced the Company's overall effective tax rate.

The Bank also generates non-interest income from a variety of fee-based services. These include safe deposit box rental, wire transfer service fees and Automated Teller Machine fees for non-Bank customers. Increased customer

demand for these services contributed to the other income component of non-interest income amounting to \$357,054 for the three months ended March 31, 2012, compared to \$317,032 for the three months ended March 31, 2011, an increase of \$40,022 for the first quarter of 2012 as compared to the first quarter of 2011.

Table of Contents

## Non-Interest Expense

Non-interest expenses increased by \$949,685, or 20.4%, to \$5,612,517 for the three months ended March 31, 2012 from \$4,662,832 for the three months ended March 31, 2011. A significant portion of the increase in total non-interest expense and its major components when compared with non-interest expense for the prior year period was attributable to the March 2011 Acquisition. The following table presents the major components of non-interest expenses for the three months ended March 31, 2012 and 2011.

Non-interest Expenses	Three months ended March 31,	
	2012	2011
Salaries and employee benefits	\$ 2,940,350	\$ 2,576,664
Occupancy expenses	723,786	566,738
Data processing services	263,575	303,473
Equipment expense	271,963	176,561
Telephone	96,868	69,740
Marketing	45,035	27,966
Regulatory, professional and other fees	182,708	198,152
Office expense	77,667	68,086
FDIC insurance expense	147,393	227,547
Directors' fees	24,000	27,000
Other real estate owned expenses	377,627	236,381
Amortization of intangible assets	66,992	9,178
Other expenses	394,553	175,346
Total	\$ 5,612,517	\$ 4,662,832

Salaries and employee benefits, which represent the largest portion of non-interest expenses, increased by \$363,686, or 14.1%, to \$2,940,350 for the three months ended March 31, 2012 compared to \$2,576,664 for the three months ended March 31, 2011. The increase in salaries and employee benefits for the three months ended March 31, 2012 was a result of an increase in the number of employees, regular merit increases and increased health care costs. Staffing levels overall increased to 147 full-time equivalent employees at March 31, 2012 as compared to 144 full-time equivalent employees at March 31, 2011. Salaries and benefit expense at March 31, 2012 includes three months of expenses for those employees added as a result of the March 2011 Acquisition.

Occupancy expenses increased by \$157,048, or 27.7%, to \$723,786 for the three months ended March 31, 2012 compared to \$566,738 for the three months ended March 31, 2011. The increase in expense was primarily attributable to increased depreciation, property taxes and maintenance costs in maintaining the Bank's branch properties. In addition, the expenses of the three branch offices added as a result of the March 2011 Acquisition are included for the full 2012 first quarter.

The cost of data processing services has decreased to \$263,575 for the three months ended March 31, 2012 from \$303,473 for the three months ended March 31, 2011, as additional expenses were incurred in the prior year quarter to convert the three new branch offices acquired in the March 2011 Acquisition to the Bank's data systems.

Equipment expense increased by \$95,402, or 54.0%, to \$271,963 for the three months ended March 31, 2012 compared to \$176,561 for the three months ended March 31, 2011 primarily due to increased costs associated with the number of maintenance contracts and supplies on equipment in the three acquired branch offices as compared with the prior period.

Marketing expense increased by \$17,069, or 61.0%, to \$45,035 for the three months ended March 31, 2012 compared to \$27,966 for the three months ended March 31, 2011 as the Bank resumed the use of radio broadcast media in promoting products and services during the first three months of 2012.

## Table of Contents

Regulatory, professional and other fees decreased by \$15,444, or 7.8%, to \$182,708 for the three months ended March 31, 2012 compared to \$198,152 for the three months ended March 31, 2011. During the first three months of 2011, the Company incurred professional fees in connection with the March 2011 Acquisition.

FDIC insurance expense decreased to \$147,393 for the three months ended March 31, 2012 compared to \$227,547 for the three months ended March 31 2011 as a result of the changes required by the Dodd-Frank Act with respect to FDIC assessment rules.

Other real estate owned expenses increased by \$141,246, to \$377,627 for the three months ended March 31, 2012 compared to \$236,381 for the three months ended March 31, 2011 as the Company incurred increased loss provisions, property taxes, maintenance and other expenses on more properties during the three months ended March 31, 2012 than were incurred during the same period in 2011.

Amortization of intangible assets expense increased to \$66,992 for the three months ended March 31, 2012 compared to \$9,178 for the three months ended March 31, 2011, as the expense for 2012 included amortization of the \$1.7 million core deposit intangible asset resulting from the March 2011 Acquisition.

All other expenses increased by \$252,916, to \$593,088 for the three months ended March 31, 2012 compared to \$340,172 for the three months ended March 31, 2011 as current year increases occurred in telephone expense, correspondent bank fees, maintenance agreements and ATM operating expenses. All other expenses are comprised of a variety of operating expenses and fees as well as expenses associated with lending activities. The March 2011 Acquisition was a significant factor in the increased expenses.

An important financial services industry productivity measure is the efficiency ratio. The efficiency ratio is calculated by dividing total operating expenses by net interest income plus non-interest 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 Company's efficiency ratio decreased to 72.0% for the three months ended March 31, 2012, compared to 75.3% for the three months ended March 31, 2011.

## Income Taxes

Income tax expense increased by \$80,300 to \$416,477 for the three months ended March 31, 2012 from \$336,177 for the three months ended March 31, 2011. The increase was primarily due to a higher level of pretax income for the first quarter of 2012 as compared to the first quarter of 2011.

## Financial Condition

### March 31, 2012 Compared with December 31, 2011

Total consolidated assets at March 31, 2012 were \$749,599,784, representing a decrease of \$42,127,131, or 5.3%, from total consolidated assets of \$791,726,915 at December 31, 2011.

## Cash and Cash Equivalents

Cash and cash equivalents at March 31, 2012 totaled \$27,161,125 compared to \$15,195,259 at December 31, 2011. Cash and cash equivalents at March 31, 2012 consisted of cash and due from banks of \$27,149,715 and Federal funds sold/short term investments of \$11,410. The corresponding balances at December 31, 2011 were \$15,183,853 and \$11,406, respectively. To the extent that the Bank did not utilize the funds for loan originations or securities purchases, the cash inflows accumulated in cash and cash equivalents.





Table of Contents

## Loans Held for Sale

Loans held for sale at March 31, 2012 amounted to \$17,497,128 compared to \$19,234,111 at December 31, 2011. As indicated in the Consolidated Statements of Cash Flows, the amount of loans originated for sale was \$41,388,684 for the three months ended March 31, 2012.

## Investment Securities

Investment securities represented 29.6% of total assets at March 31, 2012 and 29.8% at December 31, 2011. Total investment securities decreased \$14,344,576, or 6.1%, to \$221,813,621 at March 31, 2012 from \$236,158,197 at December 31, 2011. Purchases of investments totaled \$18,134,939 during the three months ended March 31, 2012, and proceeds from calls and repayments totaled \$32,127,828 during the period.

Securities available for sale are investments that may be sold in response to changing market and interest rate conditions or for other business purposes. Activity in this portfolio is undertaken primarily to manage liquidity and interest rate risk and to take advantage of market conditions that create more economically attractive returns. At March 31, 2012, securities available for sale totaled \$91,154,435, which is a decrease of \$2,529,339, or 2.7%, from securities available for sale totaling \$93,683,774 at December 31, 2011.

At March 31, 2012, the securities available for sale portfolio had net unrealized gains of \$2,333,140, compared to net unrealized gains of \$2,318,299 at December 31, 2011. These unrealized gains are reflected, net of tax, in shareholders' equity as a component of accumulated other comprehensive income.

Securities held to maturity, which are carried at amortized historical cost, are investments for which there is the positive intent and ability to hold to maturity. At March 31, 2012, securities held to maturity were \$130,659,186, a decrease of \$11,815,237, or 8.3%, from \$142,474,423 at December 31, 2011. The fair value of the held to maturity portfolio at March 31, 2011 was \$136,015,150.

Proceeds from maturities and prepayments of securities during the first three months of 2012 were used to reduce the Company's borrowings.

## Loans

The loan portfolio, which represents our 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 mortgage warehouse lines, construction loans, commercial loans, owner-occupied commercial mortgage loans and tenanted commercial real estate loans.

The following table sets forth the classification of loans by major category at March 31, 2012 and December 31, 2011.

Loan Portfolio Composition Component	March 31, 2012		December 31, 2011	
	Amount	% of total	Amount	% of total
Construction loans	\$ 56,098,604	13%	\$ 49,285,783	10%
Residential real estate loans	12,133,091	3%	12,885,352	3%
Commercial business	51,446,091	12%	50,784,674	11%
Commercial real estate	104,251,060	24%	99,636,976	21%
Mortgage warehouse lines	201,321,038	46%	249,345,831	52%

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

Loans to individuals	12,137,585	3%	12,219,640	3%
Deferred loan fees and costs	887,524	0%	1,017,959	0%
All other loans	246,438	0%	255,556	0%
	\$ 438,522,190	100%	\$ 475,431,771	100%

40

---

## Table of Contents

The loan portfolio decreased by \$36,909,581, or 7.8%, to \$438,522,190 at March 31, 2012, compared to \$475,431,771 at December 31, 2011. The mortgage warehouse lines portfolio decreased by \$48,024,793, or 19.3%, to \$201,321,038 at March 31, 2012 compared to \$249,345,831 at December 31, 2011. This component's decrease at March 31, 2012 compared to December 31, 2011 was principally the result of a current period increase in market rates for mortgage loans.

The Bank's Mortgage Warehouse Funding Group offers a revolving line of credit that is available to licensed mortgage banking companies (the "Warehouse Line of Credit") and that we believe has been successful from inception in 2008. The Warehouse Line of Credit is used by mortgage bankers to originate one-to-four family residential mortgage loans that are pre-sold to the secondary mortgage market, which includes state and national banks, national mortgage banking firms, insurance companies and government-sponsored enterprises, including the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and others. On average, an advance under the Warehouse Line of Credit remains outstanding for a period of less than 30 days, with repayment coming directly from the sale of the loan into the secondary mortgage market. Interest (the spread between our borrowing cost and the rate charged to the client) and a transaction fee are collected by the Bank at the time of repayment. Additionally, customers of the Warehouse Line of Credit are required to maintain deposit relationships with the Bank that, on average, represent 10% to 15% of the loan balances.

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

### Non-Performing Assets

Non-performing assets consist of non-performing loans and other real estate owned. Non-performing loans are composed of (1) loans on a non-accrual basis, (2) loans which are contractually past due 90 days or more as to interest and principal payments but have not been classified as non-accrual, and (3) loans whose terms have been restructured to provide a reduction or deferral of interest and/or principal because of a deterioration in the financial position of the borrower.

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

Non-performing loans decreased by \$28,405 to \$2,963,065 at March 31, 2012 from \$2,991,470 at December 31, 2011. The major segments of non-accrual loans consist of commercial loans, commercial real estate loans and SBA loans, which are in the process of collection and residential real estate which is either in foreclosure or under contract to close after March 31, 2012. The table below sets forth non-performing assets and risk elements in the Bank's portfolio for the periods indicated.

As the table demonstrates, non-performing loans to total loans increased modestly to 0.68% at March 31, 2012 from 0.63% at December 31, 2011. Loan quality is still considered to be sound. This was accomplished through quality loan underwriting, a proactive approach to loan monitoring and aggressive workout strategies.



Table of Contents

Non-Performing Assets and Loans	March 31, 2012	December 31, 2011
Non-Performing loans:		
Loans 90 days or more past due and still accruing	\$ 245,235	\$ 0
Non-accrual loans	2,717,830	2,991,470
Total non-performing loans	2,963,065	2,991,470
Other real estate owned	11,839,585	12,409,201
Total non-performing assets	\$ 14,802,650	\$ 15,400,671
Non-performing loans to total loans	0.68%	0.63%
Non-performing loans to total loans excluding mortgage warehouse lines	1.25%	1.32%
Non-performing assets to total assets	1.97%	1.95%
Non-performing assets to total assets excluding mortgage warehouse lines	2.70%	2.84%

Non-performing assets decreased by \$598,021 to \$14,802,650 at March 31, 2012 from \$15,400,671 at December 31, 2011. Other real estate owned decreased by \$569,616 to \$11,839,585 at March 31, 2012 from \$12,409,201 at December 31, 2011. Since December 31, 2011, the Bank sold and transferred out of other real estate owned properties totaling approximately \$439,784. In addition, during the three months ended March 31, 2012, the Bank recorded a provision for loss on other real estate owned of \$211,644.

At March 31, 2012, the Bank had nine loans totaling \$1,795,406 which were troubled debt restructurings. Four of these loans totaling \$917,365 are included in the above table as non-accrual loans; the remaining five loans totaling \$878,041 are considered performing.

Non-performing assets represented 1.97% of total assets at March 31, 2012 and 1.95% at December 31, 2011.

Management takes a proactive approach in addressing delinquent loans. The Company's President meets weekly with all loan officers to review the status of credits past-due 10 days or more. An action plan is discussed for delinquent loans to determine the steps necessary to induce the borrower to cure the delinquency and restore the loan to a current status. Also, delinquency notices are system generated when loans are five days past-due and again at 15 days past-due.

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

#### Allowance for Loan Losses and Related Provision

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

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

Table of Contents

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

Management reviews the adequacy of the allowance on at least a quarterly basis to ensure that the provision for loan losses has been charged against earnings in an amount necessary to maintain the allowance at a level that is adequate based on management's assessment of probable estimated losses. The Company's methodology for assessing the adequacy of the allowance for loan losses consists of several key elements. These elements may include a specific reserve for doubtful or high risk loans, an allocated reserve, and an unallocated portion.

The Company consistently applies the following comprehensive methodology. During the quarterly review of the allowance for loan losses, the Company considers a variety of factors that include:

- General economic conditions.
- Trends in charge-offs.
- Trends and levels of delinquent loans.
- Trends and levels of non-performing loans, including loans over 90 days delinquent.
- Trends in volume and terms of loans.
- Levels of allowance for specific classified loans.
- Credit concentrations.

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

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

The specific reserve for impaired loans is established for specific loans which have been identified by management as being high risk loan assets. These impaired loans are assigned a doubtful risk rating grade because the loan has not performed according to payment terms and there is reason to believe that repayment of the loan principal in whole, or part, is unlikely. The specific portion of the allowance is the total amount of potential unconfirmed losses for these

individual doubtful loans. To assist in determining the fair value of loan collateral, the Company often utilizes independent third party qualified appraisal firms which in turn employ their own criteria and assumptions that may include occupancy rates, rental rates, and property expenses, among others.



Table of Contents

The second category of reserves consists of the allocated portion of the allowance. The allocated portion of the allowance is determined by taking pools of loans outstanding that have similar characteristics and applying historical loss experience for each pool. This estimate represents the potential unconfirmed losses within the portfolio. Individual loan pools are created for commercial and commercial real estate loans, construction loans, and various types of loans to individuals. The historical estimation for each loan pool is then adjusted to account for current conditions, current loan portfolio performance, loan policy or management changes, or any other factor which may cause future losses to deviate from historical levels.

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

Loans are placed in a nonaccrual status when the ultimate collectability of principal or interest in whole, or part, is in doubt. Past-due loans contractually past-due 90 days or more for either principal or interest are also placed in nonaccrual status unless they are both well secured and in the process of collection. Impaired loans are evaluated individually.

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

## Allowance for Loan Losses

	Three Months Ended March 31, 2012	Year Ended December 31, 2011	Three Months Ended March 31, 2011
Balance, beginning of period	\$ 5,534,450	\$ 5,762,712	\$ 5,762,712
Provision charged to operating expenses	599,998	2,558,328	399,998
Loans charged off :			
Construction loans	(32,650)	(2,361,783)	(366,587)
Residential real estate loans	(77,858)	-	-
Commercial and commercial real estate	(144,827)	(437,699)	(46,319)
Loans to individuals	-	-	-
Lease financing	-	-	-
All other loans	(6,001)	-	-
	(261,336)		