

Federal Deposit Insurance Corporation
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2020

or

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

For the transition period from _____ to _____

FDIC Certificate Number: 58481

FIRST BANK

(Exact Name of Registrant as Specified in its Charter)

New Jersey

(State or Other Jurisdiction of
Incorporation or Organization)

20-8164471

(I.R.S. Employer Identification No.)

2465 Kuser Road, Hamilton, New Jersey

(Address of Principal Executive Offices)

08690

(Zip Code)

(877) 821-2265

(Registrant's Telephone Number, Including Area Code)

Not Applicable

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

| Title of each class | Trading Symbol | Name of each exchange on which registered |
|------------------------------------------|----------------|-------------------------------------------|
| Common Stock, par value \$5.00 per share | FRBA | NASDAQ Global Market |

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

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

As of August 6, 2020, there were 19,654,892 shares of the registrant's Common Stock, par value \$5.00 per share, outstanding.

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PART I – FINANCIAL INFORMATION**Item 1. Financial Statements.**

FIRST BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(in thousands, except for share data)

| | June 30, 2020 | December 31, 2019 |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|--------------------------|
| | (unaudited) | |
| Assets | | |
| Cash and due from banks | \$ 24,434 | \$ 16,751 |
| Federal funds sold | - | 40,000 |
| Interest bearing deposits with banks | 99,723 | 25,041 |
| Cash and cash equivalents | 124,157 | 81,792 |
| Interest bearing time deposits with banks | 7,160 | 6,087 |
| Investment securities available for sale | 66,757 | 47,462 |
| Investment securities held to maturity (fair value of \$43,790 at June 30, 2020 and \$47,100 at December 31, 2019) | 43,013 | 46,612 |
| Restricted investment in bank stocks | 6,585 | 6,652 |
| Other investments | 6,469 | 6,388 |
| Loans, net of deferred fees and costs | 1,955,007 | 1,723,574 |
| Less: Allowance for loan losses | 21,441 | 17,245 |
| Net loans | 1,933,566 | 1,706,329 |
| Premises and equipment, net | 11,320 | 11,881 |
| Other real estate owned, net | 1,142 | 1,363 |
| Accrued interest receivable | 8,656 | 4,810 |
| Bank-owned life insurance | 49,677 | 49,580 |
| Goodwill | 16,253 | 16,253 |
| Other intangible assets, net | 1,939 | 2,083 |
| Deferred income taxes | 10,088 | 10,400 |
| Other assets | 13,812 | 13,895 |
| Total assets | \$ 2,300,594 | \$ 2,011,587 |
| Liabilities and Stockholders' Equity | | |
| Liabilities: | | |
| Non-interest bearing deposits | \$ 459,123 | \$ 275,778 |
| Interest bearing deposits | 1,464,143 | 1,365,089 |
| Total deposits | 1,923,266 | 1,640,867 |
| Borrowings | 104,897 | 105,476 |
| Subordinated debentures | 29,475 | 21,964 |
| Accrued interest payable | 790 | 1,076 |
| Other liabilities | 15,716 | 15,811 |
| Total liabilities | 2,074,144 | 1,785,194 |
| Stockholders' Equity: | | |
| Preferred stock, par value \$2 per share; 10,000,000 shares authorized; no shares issued and outstanding | - | - |
| Common stock, par value \$5 per share; 40,000,000 shares authorized; 20,629,892 shares issued and 19,629,892 shares outstanding at June 30, 2020 and 20,458,665 shares issued and outstanding at December 31, 2019 | 102,573 | 101,887 |
| Additional paid-in capital | 78,384 | 78,112 |
| Retained earnings | 52,514 | 46,367 |
| Accumulated other comprehensive income | 863 | 27 |
| Treasury stock, 1,000,000 shares at June 30, 2020 | (7,884) | - |
| Total stockholders' equity | 226,450 | 226,393 |
| Total liabilities and stockholders' equity | \$ 2,300,594 | \$ 2,011,587 |

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

FIRST BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except for share data, unaudited)

| | Three Months Ended | | Six Months Ended | |
|-----------------------------------------------------------------------|--------------------|-----------------|------------------|-----------------|
| | June 30, | | June 30, | |
| | 2020 | 2019 | 2020 | 2019 |
| Interest and Dividend Income | | | | |
| Investment securities—taxable | \$ 612 | \$ 527 | \$ 1,162 | \$ 1,078 |
| Investment securities—tax-exempt | 76 | 91 | 154 | 189 |
| Interest bearing deposits with banks, Federal funds sold and other | 203 | 450 | 626 | 976 |
| Loans, including fees | 21,088 | 19,412 | 42,251 | 38,080 |
| Total interest and dividend income | <u>21,979</u> | <u>20,480</u> | <u>44,193</u> | <u>40,323</u> |
| Interest Expense | | | | |
| Deposits | 4,565 | 5,282 | 9,951 | 10,228 |
| Borrowings | 550 | 636 | 1,109 | 1,100 |
| Subordinated debentures | 536 | 398 | 934 | 796 |
| Total interest expense | <u>5,651</u> | <u>6,316</u> | <u>11,994</u> | <u>12,124</u> |
| Net interest income | 16,328 | 14,164 | 32,199 | 28,199 |
| Provision for loan losses | 2,977 | 1,721 | 5,909 | 2,086 |
| Net interest income after provision for loan losses | <u>13,351</u> | <u>12,443</u> | <u>26,290</u> | <u>26,113</u> |
| Non-Interest Income | | | | |
| Service fees on deposit accounts | 116 | 116 | 287 | 208 |
| Loan fees | 649 | 149 | 934 | 179 |
| Income from bank-owned life insurance | 592 | 274 | 936 | 541 |
| Gains on sale of loans | 38 | 55 | 117 | 55 |
| Gains on recovery of acquired loans | 293 | 187 | 474 | 322 |
| Other non-interest income | 192 | 143 | 346 | 292 |
| Total non-interest income | <u>1,880</u> | <u>924</u> | <u>3,094</u> | <u>1,597</u> |
| Non-Interest Expense | | | | |
| Salaries and employee benefits | 5,308 | 5,137 | 10,692 | 10,217 |
| Occupancy and equipment | 1,548 | 1,283 | 2,964 | 2,644 |
| Legal fees | 235 | 127 | 455 | 239 |
| Other professional fees | 569 | 360 | 1,025 | 787 |
| Regulatory fees | 277 | 177 | 510 | 294 |
| Directors' fees | 215 | 194 | 430 | 394 |
| Data processing | 430 | 451 | 994 | 882 |
| Marketing and advertising | 81 | 225 | 225 | 450 |
| Travel and entertainment | 13 | 135 | 114 | 246 |
| Insurance | 122 | 97 | 318 | 184 |
| Other real estate owned expense, net | 94 | 44 | 211 | 113 |
| Merger-related expenses | - | 110 | - | 228 |
| Other expense | 875 | 787 | 1,744 | 1,449 |
| Total non-interest expense | <u>9,767</u> | <u>9,127</u> | <u>19,682</u> | <u>18,127</u> |
| Income Before Income Taxes | 5,464 | 4,240 | 9,702 | 9,583 |
| Income tax expense | 1,347 | 1,400 | 2,352 | 2,473 |
| Net Income | <u>\$ 4,117</u> | <u>\$ 2,840</u> | <u>\$ 7,350</u> | <u>\$ 7,110</u> |
| Basic earnings per common share | \$ 0.21 | \$ 0.15 | \$ 0.37 | \$ 0.38 |
| Diluted earnings per common share | \$ 0.21 | \$ 0.15 | \$ 0.36 | \$ 0.38 |
| Cash dividends per common share | \$ 0.03 | \$ 0.03 | \$ 0.06 | \$ 0.06 |
| Basic weighted average common shares outstanding | 19,651,679 | 18,670,010 | 19,984,353 | 18,653,533 |
| Diluted weighted average common shares outstanding | 19,744,575 | 18,954,171 | 20,165,726 | 18,950,589 |

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

FIRST BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands, unaudited)

| | Three Months Ended | | Six Months Ended | |
|--------------------------------------------------------------------------------------------|---------------------------|-----------------|-------------------------|-----------------|
| | June 30, | | June 30, | |
| | 2020 | 2019 | 2020 | 2019 |
| Net income | \$ 4,117 | \$ 2,840 | \$ 7,350 | \$ 7,110 |
| Other comprehensive income: | | | | |
| Unrealized holding gains on investments arising during the period | 445 | 501 | 1,147 | 1,124 |
| Amortization of unrealized losses on investment securities transferred to held to maturity | - | 19 | - | 50 |
| | 445 | 520 | 1,147 | 1,174 |
| Income tax effect | (120) | (141) | (311) | (320) |
| Total other comprehensive income, net of tax | 325 | 379 | 836 | 854 |
| Total comprehensive income | <u>\$ 4,442</u> | <u>\$ 3,219</u> | <u>\$ 8,186</u> | <u>\$ 7,964</u> |

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

FIRST BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(in thousands, except for share data, unaudited)

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total Stockholders' Equity |
|----------------------------------------------|-------------------|----------------------------------|----------------------|--------------------------------------------------------|-------------------|----------------------------------|
| Balance—March 31, 2020 | \$ 102,387 | \$ 78,225 | \$ 48,987 | \$ 538 | \$ (3,878) | \$ 226,259 |
| Net income | - | - | 4,117 | - | - | 4,117 |
| Other comprehensive income, net of tax | - | - | - | 325 | - | 325 |
| Vesting of restricted stock, 26,255 shares | 131 | (131) | - | - | - | - |
| Exercise of stock options, 11,000 shares | 55 | - | - | - | - | 55 |
| Stock-based compensation expense | - | 290 | - | - | - | 290 |
| Cash dividends - common, \$0.03 per share | - | - | (590) | - | - | (590) |
| Purchase of 557,864 shares of common stock | - | - | - | - | (4,006) | (4,006) |
| Balance—June 30, 2020 | <u>\$ 102,573</u> | <u>\$ 78,384</u> | <u>\$ 52,514</u> | <u>\$ 863</u> | <u>\$ (7,884)</u> | <u>\$ 226,450</u> |
| Balance—December 31, 2019 | \$ 101,887 | \$ 78,112 | \$ 46,367 | \$ 27 | \$ - | \$ 226,393 |
| Net income | - | - | 7,350 | - | - | 7,350 |
| Other comprehensive loss, net of tax | - | - | - | 836 | - | 836 |
| Vesting of restricted stock, 52,636 shares | 263 | (263) | - | - | - | - |
| Exercise of stock options, 84,500 shares | 423 | 5 | - | - | - | 428 |
| Stock-based compensation expense | - | 530 | - | - | - | 530 |
| Cash dividends - common, \$0.06 per share | - | - | (1,203) | - | - | (1,203) |
| Purchase of 1,000,000 shares of common stock | - | - | - | - | (7,884) | (7,884) |
| Balance—June 30, 2020 | <u>\$ 102,573</u> | <u>\$ 78,384</u> | <u>\$ 52,514</u> | <u>\$ 863</u> | <u>\$ (7,884)</u> | <u>\$ 226,450</u> |
| Balance—March 31, 2019 | \$ 93,301 | \$ 67,565 | \$ 38,931 | \$ (460) | \$ - | \$ 199,337 |
| Net income | - | - | 2,840 | - | - | 2,840 |
| Other comprehensive income, net of tax | - | - | - | 379 | - | 379 |
| Vesting of restricted stock, 13,053 shares | 65 | (65) | - | - | - | - |
| Exercise of stock options, 2,000 shares | 10 | 1 | - | - | - | 11 |
| Stock-based compensation expense | - | 237 | - | - | - | 237 |
| Cash dividends - common, \$0.03 per share | - | - | (562) | - | - | (562) |
| Balance—June 30, 2019 | <u>\$ 93,376</u> | <u>\$ 67,738</u> | <u>\$ 41,209</u> | <u>\$ (81)</u> | <u>\$ -</u> | <u>\$ 202,242</u> |
| Balance—December 31, 2018 | \$ 93,132 | \$ 67,417 | \$ 35,222 | \$ (935) | \$ - | \$ 194,836 |
| Net income | - | - | 7,110 | - | - | 7,110 |
| Other comprehensive income, net of tax | - | - | - | 854 | - | 854 |
| Vesting of restricted stock, 31,296 shares | 156 | (156) | - | - | - | - |
| Exercise of stock options, 17,500 shares | 88 | 9 | - | - | - | 97 |
| Stock-based compensation expense | - | 468 | - | - | - | 468 |
| Cash dividends - common, \$0.06 per share | - | - | (1,123) | - | - | (1,123) |
| Balance—June 30, 2019 | <u>\$ 93,376</u> | <u>\$ 67,738</u> | <u>\$ 41,209</u> | <u>\$ (81)</u> | <u>\$ -</u> | <u>\$ 202,242</u> |

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

FIRST BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands, except for share data)

| | Six Months Ended June 30, | |
|------------------------------------------------------------------------------------------|----------------------------------|------------------|
| | 2020 | 2019 |
| Cash flows from operating activities: | | |
| Net income | \$ 7,350 | \$ 7,110 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 5,909 | 2,086 |
| Depreciation and amortization of premises and equipment | 776 | 277 |
| Amortization and accretion of premiums/discounts on investment securities, net | 211 | 212 |
| Amortization and accretion of fair value adjustments, net | (815) | (603) |
| Amortization and accretion of deferred loan fees and costs, net | (523) | (605) |
| Amortization of intangible assets | 144 | 143 |
| Amortization of subordinated debentures issuance cost | 45 | 54 |
| Stock-based compensation | 530 | 468 |
| Proceeds from sale of loans | 1,604 | 1,082 |
| Gains on sale of loans | (117) | (55) |
| Gains on sale of other real estate owned, net | (8) | (81) |
| Writedowns of other real estate owned | 79 | 71 |
| Income from bank-owned life insurance | (936) | (541) |
| Decrease in deferred income taxes | 1 | - |
| Changes in assets and liabilities: | | |
| Increase in accrued interest receivable | (3,846) | (776) |
| Decrease in other assets | 83 | 62 |
| (Decrease) increase in accrued interest payable | (286) | 136 |
| Decrease in other liabilities | (95) | (484) |
| Net cash provided by operating activities | <u>10,106</u> | <u>8,556</u> |
| Cash flows from investing activities: | | |
| Net increase in interest bearing time deposits with banks | (1,073) | (946) |
| Net loan originations | (233,358) | (86,381) |
| Purchases of investment securities available for sale | (23,584) | - |
| Purchases of investment securities held to maturity | (1,000) | (750) |
| Proceeds from maturities, calls and paydowns of investment securities available for sale | 5,354 | 3,423 |
| Proceeds from maturities, calls and paydowns of investment securities held to maturity | 4,470 | 7,319 |
| Net redemptions (purchases) of restricted stocks | 67 | (2,482) |
| Purchases of other investments | (81) | (89) |
| Proceeds from sales of other real estate owned | 150 | 764 |
| Redemption of bank-owned life insurance policies | 839 | - |
| Purchases of premises and equipment | (182) | (345) |
| Net cash used in investing activities | <u>(248,398)</u> | <u>(79,487)</u> |
| Cash flows from financing activities: | | |
| Net increase in deposits | 282,429 | 50,278 |
| Proceeds from borrowings | 6,641 | 84,827 |
| Repayments of borrowings | (7,220) | (31,925) |
| Proceeds from issuance of subordinated debentures | 29,466 | - |
| Redemption of subordinated debentures | (22,000) | - |
| Proceeds from stock option exercises | 428 | 97 |
| Cash dividends paid on common stock | (1,203) | (1,123) |
| Purchase of treasury stock | (7,884) | - |
| Net cash provided by financing activities | <u>280,657</u> | <u>102,154</u> |
| Net increase in cash and cash equivalents | 42,365 | 31,223 |
| Cash and cash equivalents at beginning of year | 81,792 | 55,430 |
| Cash and cash equivalents at end of year | <u>\$ 124,157</u> | <u>\$ 86,653</u> |
| Supplemental disclosures of cash flow information: | | |
| Cash paid for interest on deposits and borrowings | \$ 12,280 | \$ 11,988 |
| Cash paid for income taxes | 470 | 1,660 |
| Supplemental schedule of non-cash activities: | | |
| Initial recognition of operating lease right-of-use assets | \$ - | \$ (9,229) |
| Initial recognition of operating lease liabilities | - | 9,655 |
| Transfer of loans to other real estate owned | - | 75 |
| Vesting of restricted stock | 263 | 156 |

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 1 – Summary of Significant Accounting Policies

Basis of Financial Statement Presentation

The accompanying consolidated financial statements of First Bank and Subsidiaries (collectively, the “Company”), include the accounts of First Bank, a New Jersey commercial bank, and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated. The accounting and reporting policies of the Company conform to U.S. generally accepted accounting principles (“U.S. GAAP”) and general practices within the financial services industry. As used in this Quarterly Report on Form 10-Q, “the Bank” and “the Company” refer to First Bank and its consolidated subsidiaries unless otherwise noted.

The consolidated statement of financial condition as of June 30, 2020, the consolidated statements of income, the consolidated statements of comprehensive income and the consolidated statements of changes in stockholders’ equity for the three and six months ended June 30, 2020 and 2019, and the consolidated statements of cash flows for the six months ended June 30, 2020 and 2019 are unaudited. The consolidated statement of financial condition as of December 31, 2019 was derived from the audited consolidated statement of financial condition as of that date.

In the opinion of management, all adjustments and disclosures which are generally routine and recurring in nature and necessary for a fair presentation of interim results have been made. In preparing the unaudited consolidated financial statements, management has made estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated statements of financial condition and results of operations for the periods indicated. Material estimates that are particularly susceptible to change are: the allowance for loan losses; the evaluation of investment securities for other than temporary impairment; fair value measurements of assets and liabilities; and income taxes. Estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the consolidated financial statements in the period they are deemed necessary. While management uses its best judgment, actual results could differ from those estimates.

The interim unaudited consolidated financial statements included herein have been prepared in accordance with instructions for the Quarterly Report on Form 10-Q and the rules and regulations of the Securities and Exchange Commission (“SEC”) incorporated by reference into the regulations of the Federal Deposit Insurance Corporation (“FDIC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP and industry practice have been condensed or omitted from interim reporting pursuant to SEC rules. Certain prior period amounts have been reclassified to conform to the current year presentation, with no impact on stockholders’ equity or net income. The results of operations for the three and six months ended June 30, 2020 are not necessarily indicative of the results which may be expected for the entire year. The Company has evaluated subsequent events for potential recognition and/or disclosure through the date the consolidated financial statements in this Quarterly Report on Form 10-Q were issued. Interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2019 as filed with the FDIC.

Operating, Accounting and Reporting Considerations related to COVID-19

The COVID-19 pandemic has negatively impacted the global economy, including our markets. In response to this crisis, the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”) was passed by Congress and signed into law on March 27, 2020. The CARES Act provides over \$2 trillion to fight the COVID-19 pandemic and stimulate the economy by supporting individuals and businesses through loans, grants, tax changes, and other types of relief. Some of the provisions applicable to the Company include, but are not limited to:

- Accounting for Loan Modifications - The CARES Act provides that a financial institution may elect to temporarily suspend (1) the requirements under U.S. GAAP for certain loan modifications that would otherwise be categorized as a troubled debt restructuring (“TDR”) and (2) any determination that such loan modifications would be considered a TDR, including the related impairment for accounting purposes.
- Paycheck Protection Program - The CARES Act established the Paycheck Protection Program (“PPP”), an expansion of the Small Business Administration’s (“SBA”) 7(a) loan program, and the Economic Injury Disaster Loan Program, administered directly by the SBA. The PPP provides for a full guarantee of these loans by the SBA and allows for borrowers to have their loans forgiven if the funds were utilized in a manner consistent with the stipulations as outlined in the PPP. Through June 30, 2020 the Company submitted and received approval from the SBA for 1,128 PPP loans with a balance of \$190.5 million at June 30, 2020. The Company also realized gross fees of approximately \$6.9 million from the SBA from the origination of these loans through June 30, 2020. These fees, net of the associated direct origination costs of approximately \$519,000, are being amortized through interest income over the life of the PPP loans.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 1 – Summary of Significant Accounting Policies (continued)

- Mortgage Forbearance - Under the CARES Act, through the earlier of December 31, 2020, or the termination date of the COVID-19 national emergency, a borrower with a federally backed mortgage loan that is experiencing financial hardship due to COVID-19 may request a forbearance. A multifamily borrower with a federally backed multifamily mortgage loan that was current as of February 1, 2020, and is experiencing financial hardship due to COVID-19 may request forbearance on the loan for up to 30 days, with up to two additional 30-day periods at the borrower's request.

Also in response to the COVID-19 pandemic, the Board of Governors of the Federal Reserve System, the FDIC, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Consumer Financial Protection Bureau, in consultation with the state financial regulators (collectively, the “agencies”) issued a joint interagency statement (issued March 22, 2020; revised statement issued April 7, 2020). Some of the provisions applicable to the Company include, but are not limited to:

- Accounting for Loan Modifications - Loan modifications that do not meet the conditions of the CARES Act may still qualify as a modification that does not need to be accounted for as a troubled debt restructuring. The agencies confirmed with Financial Accounting Standards Board (“FASB”) staff that short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief are not TDRs. This includes short-term (e.g., six months) modifications such as payment deferrals, fee waivers, extensions of repayment terms, or insignificant delays in payment.
- Past Due Reporting - With regard to loans not otherwise reportable as past due, financial institutions are not expected to designate loans with deferrals granted due to COVID-19 as past due because of the deferral. A loan's payment date is governed by the due date stipulated in the legal agreement. If a financial institution agrees to a payment deferral, these loans would not be considered past due during the period of the deferral.
- Nonaccrual Status and Loan Classifications - During short-term COVID-19 modifications, these loans generally should not be reported as nonaccrual or as classified.

Recent Authoritative Accounting Guidance

Accounting Standards Update (“ASU”) 2016-13, “Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” This guidance requires the earlier recognition of credit losses on loans and other financial instruments based on an expected loss model, replacing the incurred loss model that is currently in use. Under this guidance, an entity will measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions and reasonable and supportable forecasts. The expected loss model will apply to loans and leases, unfunded lending commitments, held-to-maturity debt securities and other debt instruments measured at amortized cost. The impairment model for available-for-sale debt securities will require the recognition of credit losses through a valuation allowance when fair value is less than amortized cost, regardless of whether the impairment is considered to be other-than-temporary. In November 2019, the FASB issued ASU 2019-10 to defer the effective date of ASU 2016-13 from January 1, 2020 to January 1, 2023 for calendar year smaller reporting companies like the Company. The Company is currently evaluating the impact of this guidance on its consolidated financial statements and has retained a specialized consultant to assist in its implementation and adoption.

ASU 2017-04, “Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment.” This guidance simplifies the measurement of goodwill impairment. An entity will no longer perform a hypothetical purchase price allocation to measure goodwill impairment. Instead, impairment will be measured using the difference between the carrying amount and the fair value of the reporting unit. This guidance is effective for impairment tests in fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. The Company adopted this guidance in the first quarter of 2020 and it did not have an impact on its consolidated financial statements and did not have a material impact on its disclosures.

ASU 2018-13, “Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement.” The amendments in this update change the disclosure requirements on fair value measurements in Topic 820, Fair Value Measurement, by removing, modifying and adding certain disclosure requirements. The amendments in this update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted. The Company adopted this guidance in the first quarter of 2020 and it did not have an impact on its consolidated financial statements and did not have a material impact on its disclosures.

ASU 2019-07, “Codification Updates to SEC Sections — Amendments to SEC Paragraphs Pursuant to SEC Final Rule Releases No. 33-10532, Disclosure Update and Simplification, and Nos. 33-10231 and 33-10442, Investment Company Reporting Modernization, and Miscellaneous Updates.” In 2018 the SEC issued Release No. 33-10532, Disclosure Update and Simplification, which amended certain disclosure requirements that had become redundant, outdated or superseded. In this Release, the SEC also referred certain of its disclosure requirements that overlap with, but require incremental information to,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 1 – Summary of Significant Accounting Policies (continued)

U.S. GAAP to the FASB for potential incorporation into its Accounting Standards Codification. After considering these referred disclosures the FASB issued this ASU, which the Company adopted as of September 30, 2019. The Company's adoption of this guidance did not have a material impact on its consolidated financial statements.

ASU 2020-04, "Facilitation of the Effects of Reference Rate Reform on Financial Reporting." In March 2020, the FASB issued this guidance which provides temporary optional expedients and exceptions to U.S. GAAP guidance on contract modifications and hedge accounting to ease the financial reporting burdens of the expected market transition from LIBOR and other interbank offered rates to alternative reference rates, such as the Secured Overnight Financing Rate ("SOFR"). For instance, entities can (1) elect not to apply certain modification accounting requirements to contracts affected by reference rate reform, if certain criteria are met. An entity that makes this election would not have to remeasure the contracts at the modification date or reassess a previous accounting determination. Entities can also (2) elect various optional expedients that would allow them to continue applying hedge accounting for hedging relationships affected by reference rate reform, if certain criteria are met. Finally, entities can (3) make a one-time election to sell and/or reclassify held-to-maturity debt securities that reference an interest rate affected by reference rate reform. ASU 2020-04 is effective March 12, 2020, through December 31, 2022. The Company will elect (1) above for all contract modifications that meet the stated criteria but does not expect this to have a material impact on our financial statements. As the Company currently does not utilize hedge accounting, (2) above is currently not applicable. The Company is currently evaluating whether to elect (3) above.

Note 2 – Business Combinations

Grand Bank, N.A. Acquisition

At the close of business on September 30, 2019, First Bank completed its acquisition of Grand Bank, N.A., ("Grand Bank"), a national association, previously headquartered in Hamilton Square, New Jersey. The acquisition of Grand Bank expanded First Bank's New Jersey presence in Mercer County through the addition of two full-service branches.

Grand Bank shareholders received 3,262,956 shares of the Company's common stock for each share of Grand Bank common stock they owned as of the effective date of the acquisition. The aggregate consideration paid to Grand Bank shareholders was \$18.4 million; however, the merger agreement also provided for, following the closing of the merger, the potential of additional compensation to the Grand Bank shareholders ("contingent consideration"). The contingent consideration would be due upon the occurrence of the sale of certain property previously owned by Grand Bank and acquired by First Bank in the merger. If the sale occurs prior to September 30, 2022, Grand Bank shareholders would be entitled to receive contingent consideration not to exceed \$2.4 million, payable in the form of First Bank common stock. Under business combination accounting the Company determined that, at the time of acquisition, the property had no value and deemed that no contingent consideration liability was required and is unlikely in the future. The contingent consideration will continue to be evaluated and measured at fair value with any changes in fair value recognized in earnings.

After purchase accounting adjustments, the addition of Grand Bank added \$190.2 million in assets, \$146.3 million in loans and \$170.9 million in deposits. There were no merger-related expenses during the three or six months ended June 30, 2020. For the three and six months ended June 30, 2019, merger-related expenses totaled \$110,000 and \$228,000, respectively, primarily related to legal expenses.

Note 3 – Other Comprehensive Income (Loss)

The components of accumulated other comprehensive income included in stockholders' equity are as follows:

| | <u>June 30, 2020</u> | <u>December 31, 2019</u> |
|------------------------------------------------------------------|----------------------|--------------------------|
| | (in thousands) | |
| Net unrealized gains on investment securities available for sale | \$ 1,184 | \$ 37 |
| Income tax effect | (321) | (10) |
| Accumulated other comprehensive income | <u>\$ 863</u> | <u>\$ 27</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 4 – Earnings Per Share

Basic earnings per share is calculated by dividing net income available to common stockholders by the weighted average common shares outstanding during the reporting period. Diluted earnings per share is derived similarly to basic earnings per share, except that the denominator of the calculation is increased to include the number of additional common shares that would have been outstanding if all potentially dilutive common shares, principally stock options and restricted stock, were issued during the reporting period utilizing the treasury stock method. There are no securities that could potentially dilute basic earnings per share that were not included in the computation of diluted earnings per share.

The following table presents a reconciliation of the calculation of basic and diluted earnings per share for the periods indicated:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------|---------------|---------------------------|---------------|
| | 2020 | 2019 | 2020 | 2019 |
| | (in thousands, except per share data) | | | |
| Net income available to common stockholders | \$ 4,117 | \$ 2,840 | \$ 7,350 | \$ 7,110 |
| Basic weighted average common shares outstanding | 19,652 | 18,670 | 19,984 | 18,654 |
| Effect of dilutive common stock equivalents | 93 | 284 | 182 | 297 |
| Diluted weighted average common shares outstanding | <u>19,745</u> | <u>18,954</u> | <u>20,166</u> | <u>18,951</u> |
| Basic earnings per share | \$ 0.21 | \$ 0.15 | \$ 0.37 | \$ 0.38 |
| Diluted earnings per share | \$ 0.21 | \$ 0.15 | \$ 0.36 | \$ 0.38 |
| Number of common stock equivalents excluded from the calculation of diluted earnings per share as the exercise prices were greater than the average price of the common stock | 874 | 673 | 785 | 660 |

Note 5 – Stock-Based Compensation

The Company has a stock-based compensation plan which allows for the grant of incentive options, non-qualified options and restricted stock to officers, employees and members of the Board of Directors. The following table presents the amount of awards authorized, cumulative granted awards, net of cancellations, and awards available for grant at June 30, 2020.

| | |
|-------------------------------------------------|------------------|
| Awards authorized | 1,580,222 |
| Cumulative granted awards, net of cancellations | <u>1,426,065</u> |
| Awards available for grant | <u>154,157</u> |

The Company issues shares from its authorized but unissued common stock to satisfy stock option exercises and restricted stock grants.

Stock-based compensation expense recognized in earnings for the three months ended June 30, 2020 and 2019 was \$290,000 and \$237,000, respectively, and for the six months ended June 30, 2020 and 2019 was \$530,000 and \$468,000, respectively.

Stock option activity under the Company's stock-based compensation plans for the six months ended June 30, 2020 and 2019 is summarized in the following tables:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (years) | Aggregate Intrinsic Value |
|-------------------------------|-----------------|---------------------------------------|-----------------------------------------------------------------|---------------------------------|
| Outstanding—December 31, 2019 | 874,955 | \$ 8.15 | | |
| Granted | 97,434 | 9.26 | | |
| Exercised | (84,500) | 5.07 | | |
| Forfeited | (4,821) | 12.16 | | |
| Expired | <u>(31,574)</u> | 8.01 | | |
| Outstanding—June 30, 2020 | <u>851,494</u> | <u>\$ 8.57</u> | <u>5.6</u> | <u>\$ 298,797</u> |
| Exercisable—June 30, 2020 | <u>673,002</u> | <u>\$ 8.00</u> | | |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 5 – Stock-Based Compensation (continued)

| | <u>Shares</u> | <u>Weighted Average Exercise Price</u> | <u>Weighted Average Remaining Contractual Life (years)</u> | <u>Aggregate Intrinsic Value</u> |
|-------------------------------|----------------|------------------------------------------------|----------------------------------------------------------------------------|------------------------------------------|
| Outstanding—December 31, 2018 | 819,217 | \$ 7.80 | | |
| Granted | 88,657 | 11.39 | | |
| Exercised | (17,500) | 5.49 | | |
| Forfeited | (12,610) | 11.90 | | |
| Expired | (2,268) | 8.85 | | |
| Outstanding—June 30, 2019 | <u>875,496</u> | <u>\$ 8.15</u> | <u>5.58</u> | <u>\$ 3,557,943</u> |
| Exercisable—June 30, 2019 | <u>692,391</u> | <u>\$ 7.00</u> | | |

All granted options have a vesting period of one to three years and a 10-year contractual term. The exercise price of each option was the closing market price on the date of the grant.

The aggregate intrinsic value in the preceding table represents the pre-tax intrinsic value calculated by multiplying the number of in-the-money shares by the difference between the Company's closing stock price on the last trading day of the current reporting period and the exercise price.

The fair values of option awards for the six months ended June 30, 2020 and 2019 were estimated at grant date using the Black-Scholes option pricing model with the following assumptions:

| | <u>Six Months Ended June 30,</u> | |
|---------------------|----------------------------------|-----------------|
| | <u>2020</u> | <u>2019</u> |
| Expected volatility | 25.26% - 33.33% | 26.27% - 26.66% |
| Dividend yield | 1.12% - 1.55% | 1.04% - 1.08% |
| Expected life | 5.0 - 6.0 years | 5.0 - 6.0 years |
| Risk-free rate | 0.36% - 1.44% | 2.34% - 2.51% |
| Fair value | \$1.94 - \$2.50 | \$2.68 - \$3.14 |

The following table provides other information about stock options outstanding and exercisable at June 30, 2020:

| <u>Range of Exercise Prices</u> | <u>Options Outstanding</u> | | | <u>Options Exercisable</u> | |
|-----------------------------------------|--------------------------------|----------------------------------------------------------------------------|------------------------------------------------|--------------------------------|------------------------------------------------|
| | <u>Options Outstanding</u> | <u>Weighted Average Remaining Contractual Life (years)</u> | <u>Weighted Average Exercise Price</u> | <u>Options Exercisable</u> | <u>Weighted Average Exercise Price</u> |
| \$0.00 - \$5.25 | 163,500 | | | 163,500 | |
| \$5.25 - \$6.49 | 123,501 | | | 123,501 | |
| \$6.49 - \$10.85 | 303,459 | | | 200,025 | |
| \$10.85 - \$14.40 | 261,034 | | | 185,976 | |
| Total | <u>851,494</u> | <u>5.6</u> | <u>\$ 8.57</u> | <u>673,002</u> | <u>\$ 8.00</u> |

Unrecognized compensation expense related to unvested stock options was \$381,000 as of June 30, 2020 and is expected to be recognized over a weighted average period of 1.6 years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 5 – Stock-Based Compensation (continued)

Restricted stock activity under the Company’s stock-based compensation plans for the six months ended June 30, 2020 and 2019 is summarized in the following tables:

| | <u>Restricted Shares</u> | <u>Weighted Average Grant Date Fair Value</u> | <u>Weighted Average Remaining Contractual Life (years)</u> |
|-------------------------------|------------------------------|-----------------------------------------------------------|----------------------------------------------------------------------------|
| Outstanding—December 31, 2019 | 81,187 | \$ 12.03 | |
| Granted | 87,389 | 9.50 | |
| Vested | (52,636) | 12.03 | |
| Forfeited | (662) | 11.54 | |
| Outstanding—June 30, 2020 | <u>115,278</u> | <u>\$ 10.12</u> | <u>1.8</u> |

| | <u>Restricted Shares</u> | <u>Weighted Average Grant Date Fair Value</u> | <u>Weighted Average Remaining Contractual Life (years)</u> |
|-------------------------------|------------------------------|-----------------------------------------------------------|----------------------------------------------------------------------------|
| Outstanding—December 31, 2018 | 49,649 | \$ 13.37 | |
| Granted | 66,863 | 11.48 | |
| Vested | (31,296) | 12.95 | |
| Forfeited | (2,454) | 12.42 | |
| Outstanding—June 30, 2019 | <u>82,762</u> | <u>\$ 12.01</u> | <u>4.3</u> |

All granted restricted stock awards have a vesting period of one to three years. Unrecognized compensation expense related to restricted stock was \$978,000 as of June 30, 2020 and is expected to be recognized over a weighted average period of 1.9 years.

Note 6 – Investment Securities

The amortized cost and fair value of investment securities available for sale are as follows as of the dates indicated, with gross unrealized gains and losses therein:

| | June 30, 2020 | | | |
|-------------------------------------------------|---------------------------|---------------------------------------|----------------------------------------|-----------------------|
| | <u>Amortized Cost</u> | <u>Gross Unrealized Gains</u> | <u>Gross Unrealized Losses</u> | <u>Fair Value</u> |
| | (in thousands) | | | |
| Investment securities available for sale | | | | |
| Residential mortgage-backed securities: | | | | |
| Issued by FNMA and FHLMC | \$ 40,449 | \$ 874 | \$ (19) | \$ 41,304 |
| Issued by GNMA | 5,024 | 126 | - | 5,150 |
| U.S. Treasury securities | 8,985 | 83 | - | 9,068 |
| Asset-backed securities | 1,921 | - | (77) | 1,844 |
| Corporate obligations | 9,194 | 197 | - | 9,391 |
| Total | <u>\$ 65,573</u> | <u>\$ 1,280</u> | <u>\$ (96)</u> | <u>\$ 66,757</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 6 – Investment Securities (continued)

| | December 31, 2019 | | | Fair Value |
|-------------------------------------------------|--------------------------|-------------------------------|--------------------------------|-------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | |
| | (in thousands) | | | |
| Investment securities available for sale | | | | |
| Residential mortgage-backed securities: | | | | |
| Issued by FNMA and FHLMC | \$ 27,948 | \$ 103 | \$ (76) | \$ 27,975 |
| Issued by GNMA | 3,848 | - | (40) | 3,808 |
| U.S. Treasury securities | 8,960 | 26 | (2) | 8,984 |
| Asset-backed securities | 2,130 | - | (44) | 2,086 |
| Corporate obligations | 4,539 | 70 | - | 4,609 |
| Total | \$ 47,425 | \$ 199 | \$ (162) | \$ 47,462 |

The amortized cost and fair value of investment securities held to maturity are as follows as of the dates indicated, with gross unrealized gains and losses therein:

| | June 30, 2020 | | | Fair Value |
|-------------------------------------------------|-----------------------|-------------------------------|--------------------------------|-------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | |
| | (in thousands) | | | |
| Investment securities held to maturity | | | | |
| Residential mortgage-backed securities: | | | | |
| Issued by FNMA and FHLMC | \$ 8,321 | \$ 155 | \$ (4) | \$ 8,472 |
| Issued by GNMA | 919 | 18 | - | 937 |
| Obligations of state and political subdivisions | 13,773 | 290 | - | 14,063 |
| Corporate obligations | 20,000 | 319 | (1) | 20,318 |
| Total | \$ 43,013 | \$ 782 | \$ (5) | \$ 43,790 |

| | December 31, 2019 | | | Fair Value |
|-------------------------------------------------|--------------------------|-------------------------------|--------------------------------|-------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | |
| | (in thousands) | | | |
| Investment securities held to maturity | | | | |
| Residential mortgage-backed securities: | | | | |
| Issued by FNMA and FHLMC | \$ 10,182 | \$ 27 | \$ (78) | \$ 10,131 |
| Issued by GNMA | 1,435 | - | - | 1,435 |
| Obligations of state and political subdivisions | 15,995 | 209 | - | 16,204 |
| Corporate obligations | 19,000 | 330 | - | 19,330 |
| Total | \$ 46,612 | \$ 566 | \$ (78) | \$ 47,100 |

The amortized cost, fair value and contractual maturities of investment securities available for sale and held to maturity are shown in the tables below. Certain of these securities have call features which allow the issuer to redeem the security prior to maturity at the issuer's discretion. Expected maturities may differ from contractual maturities because the underlying mortgages supporting mortgage-backed securities may be prepaid without penalties. Consequently, residential mortgage-backed securities are not presented by maturity category.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 6 – Investment Securities (continued)

| | June 30, 2020 | | | |
|-----------------------------------------|--------------------|------------------|------------------|------------------|
| | Available for Sale | | Held to Maturity | |
| | Amortized | Fair | Amortized | Fair |
| | Cost | Value | Cost | Value |
| | (in thousands) | | | |
| Due within one year | \$ 6,487 | \$ 6,519 | \$ 4,230 | \$ 4,248 |
| Due after one year through five years | 13,020 | 13,195 | 9,266 | 9,529 |
| Due after five years through ten years | 593 | 589 | 20,000 | 20,318 |
| Due after ten years | - | - | 277 | 286 |
| Residential mortgage-backed securities: | | | | |
| Issued by FNMA and FHLMC | 40,449 | 41,304 | 8,321 | 8,472 |
| Issued by GNMA | 5,024 | 5,150 | 919 | 937 |
| Total investment securities | <u>\$ 65,573</u> | <u>\$ 66,757</u> | <u>\$ 43,013</u> | <u>\$ 43,790</u> |

The unrealized losses, categorized by the length of time of continuous loss position, and the fair value of related investment securities available for sale are as follows, as of the dates indicated:

| | June 30, 2020 | | | | | | | | |
|-------------------------------------------------|------------------------|-----------------|----------------|---------------------|-----------------|----------------|-----------|-----------------|----------------|
| | Less than 12 months | | | 12 months or longer | | | Total | | |
| | Number | Fair | Unrealized | Number | Fair | Unrealized | Number | Fair | Unrealized |
| | of Issues | Value | Losses | of Issues | Value | Losses | of Issues | Value | Losses |
| | (dollars in thousands) | | | | | | | | |
| Investment securities available for sale | | | | | | | | | |
| Residential mortgage-backed securities: | | | | | | | | | |
| Issued by FNMA and FHLMC | 2 | \$ 3,136 | \$ (19) | - | \$ - | \$ - | 2 | \$ 3,136 | \$ (19) |
| Issued by GNMA | 2 | 508 | - | - | - | - | 2 | 508 | - |
| Asset-backed securities | - | - | - | 2 | 1,844 | (77) | 2 | 1,844 | (77) |
| Total | <u>4</u> | <u>\$ 3,644</u> | <u>\$ (19)</u> | <u>2</u> | <u>\$ 1,844</u> | <u>\$ (77)</u> | <u>6</u> | <u>\$ 5,488</u> | <u>\$ (96)</u> |

| | December 31, 2019 | | | | | | | | |
|-------------------------------------------------|------------------------|-----------------|---------------|---------------------|-----------------|-----------------|-----------|-----------------|-----------------|
| | Less than 12 months | | | 12 months or longer | | | Total | | |
| | Number | Fair | Unrealized | Number | Fair | Unrealized | Number | Fair | Unrealized |
| | of Issues | Value | Losses | of Issues | Value | Losses | of Issues | Value | Losses |
| | (dollars in thousands) | | | | | | | | |
| Investment securities available for sale | | | | | | | | | |
| Residential mortgage-backed securities: | | | | | | | | | |
| Issued by FNMA and FHLMC | - | \$ - | \$ - | 11 | \$11,505 | \$ (76) | 11 | \$11,505 | \$ (76) |
| Issued by GNMA | - | - | - | 7 | 3,618 | (40) | 7 | 3,618 | (40) |
| U.S. Treasury securities | 1 | 2,995 | (2) | - | - | - | 1 | 2,995 | (2) |
| Asset-backed securities | 1 | 702 | (3) | 1 | 1,384 | (41) | 2 | 2,086 | (44) |
| Total | <u>2</u> | <u>\$ 3,697</u> | <u>\$ (5)</u> | <u>19</u> | <u>\$16,507</u> | <u>\$ (157)</u> | <u>21</u> | <u>\$20,204</u> | <u>\$ (162)</u> |

The unrealized losses, categorized by the length of time of continuous loss position, and the fair value of related investment securities held to maturity are as follows, as of the dates indicated:

| | June 30, 2020 | | | | | | | | |
|-----------------------------------------------|------------------------|-----------------|---------------|---------------------|-------------|-------------|-----------|-----------------|---------------|
| | Less than 12 months | | | 12 months or longer | | | Total | | |
| | Number | Fair | Unrealized | Number | Fair | Unrealized | Number | Fair | Unrealized |
| | of Issues | Value | Losses | of Issues | Value | Losses | of Issues | Value | Losses |
| | (dollars in thousands) | | | | | | | | |
| Investment securities held to maturity | | | | | | | | | |
| Residential mortgage-backed securities: | | | | | | | | | |
| Issued by FNMA and FHLMC | 1 | \$ 988 | \$ (4) | - | \$ - | \$ - | 1 | \$ 988 | \$ (4) |
| Corporate obligations | 1 | 999 | (1) | - | - | - | 1 | 999 | (1) |
| Total | <u>2</u> | <u>\$ 1,987</u> | <u>\$ (5)</u> | <u>-</u> | <u>\$ -</u> | <u>\$ -</u> | <u>2</u> | <u>\$ 1,987</u> | <u>\$ (5)</u> |

| | December 31, 2019 | | | | | | | | |
|-----------------------------------------------|------------------------|-------------|-------------|---------------------|-----------------|----------------|-----------|-----------------|----------------|
| | Less than 12 months | | | 12 months or longer | | | Total | | |
| | Number | Fair | Unrealized | Number | Fair | Unrealized | Number | Fair | Unrealized |
| | of Issues | Value | Losses | of Issues | Value | Losses | of Issues | Value | Losses |
| | (dollars in thousands) | | | | | | | | |
| Investment securities held to maturity | | | | | | | | | |
| Residential mortgage-backed securities: | | | | | | | | | |
| Issued by FNMA and FHLMC | - | \$ - | \$ - | 9 | \$ 6,125 | \$ (78) | 9 | \$ 6,125 | \$ (78) |
| Total | <u>-</u> | <u>\$ -</u> | <u>\$ -</u> | <u>9</u> | <u>\$ 6,125</u> | <u>\$ (78)</u> | <u>9</u> | <u>\$ 6,125</u> | <u>\$ (78)</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 6 – Investment Securities (continued)

Investment securities with unrealized losses are evaluated quarterly to determine whether the losses are other than temporary. At June 30, 2020 and December 31, 2019, the Company determined that all unrealized losses were temporary in nature. In its evaluation, management considers: (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, (iii) the ability of the Company to hold its investment, and (iv) whether the Company will be required to sell the security before a recovery in fair value. The Company recorded no impairment losses for the periods presented.

There were no securities sold during the three or six months ended June 30, 2020 and 2019.

Investment securities with a fair value of \$20.2 million and \$16.6 million at June 30, 2020 and December 31, 2019, respectively, were pledged as collateral for municipal deposits and Federal Home Loan Bank (“FHLB”) borrowings.

Note 7 – Loans

The composition of loans is as follows as of the dates indicated:

| | June 30, 2020 | December 31, 2019 |
|-------------------------------------------------------------|-----------------------|--------------------------|
| | (in thousands) | |
| Commercial and industrial | \$ 428,494 | \$ 239,090 |
| Commercial real estate: | | |
| Owner-occupied | 392,096 | 395,995 |
| Investor | 689,891 | 673,300 |
| Construction and development | 131,791 | 105,709 |
| Multi-family | 132,942 | 119,005 |
| Residential real estate: | | |
| Residential mortgage and first lien home equity loans | 117,796 | 123,917 |
| Home equity—second lien loans and revolving lines of credit | 29,371 | 32,555 |
| Consumer and other | 40,230 | 35,810 |
| | <u>1,962,611</u> | <u>1,725,381</u> |
| Net deferred loan fees and costs | (7,604) | (1,807) |
| Total loans | <u>\$ 1,955,007</u> | <u>\$ 1,723,574</u> |

The following tables present the classes of the loan portfolio summarized by the aggregate “pass” rating and the classified ratings of “special mention” and “substandard” within the Company’s internal risk rating system. See the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2019, as filed with the FDIC for additional information about asset classification. There were no loans classified as “doubtful” or “loss” as of June 30, 2020 and December 31, 2019.

| | June 30, 2020 | | | |
|-------------------------------------------------------------|-----------------------|----------------------------|--------------------|---------------------|
| | Pass | Special Mention | Substandard | Total |
| | (in thousands) | | | |
| Commercial and industrial | \$ 411,855 | \$ 7,332 | \$ 9,307 | \$ 428,494 |
| Commercial real estate: | | | | |
| Owner-occupied | 380,108 | 8,366 | 3,622 | 392,096 |
| Investor | 687,809 | - | 2,082 | 689,891 |
| Construction and development | 126,367 | 4,961 | 463 | 131,791 |
| Multi-family | 129,881 | - | 3,061 | 132,942 |
| Residential real estate: | | | | |
| Residential mortgage and first lien home equity loans | 110,891 | 439 | 6,466 | 117,796 |
| Home equity—second lien loans and revolving lines of credit | 27,852 | 750 | 769 | 29,371 |
| Consumer and other | 40,172 | - | 58 | 40,230 |
| Total | <u>\$ 1,914,935</u> | <u>\$ 21,848</u> | <u>\$ 25,828</u> | <u>\$ 1,962,611</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 7 – Loans (continued)

| | December 31, 2019 | | | |
|-------------------------------------------------------------|--------------------------|----------------------------|--------------------|---------------------|
| | Pass | Special Mention | Substandard | Total |
| | (in thousands) | | | |
| Commercial and industrial | \$ 216,490 | \$ 7,983 | \$ 14,617 | \$ 239,090 |
| Commercial real estate: | | | | |
| Owner-occupied | 378,918 | 11,080 | 5,997 | 395,995 |
| Investor | 670,554 | 399 | 2,347 | 673,300 |
| Construction and development | 105,235 | - | 474 | 105,709 |
| Multi-family | 116,051 | - | 2,954 | 119,005 |
| Residential real estate: | | | | |
| Residential mortgage and first lien home equity loans | 118,706 | 312 | 4,899 | 123,917 |
| Home equity—second lien loans and revolving lines of credit | 31,243 | 768 | 544 | 32,555 |
| Consumer and other | 35,748 | - | 62 | 35,810 |
| Total | \$ 1,672,945 | \$ 20,542 | \$ 31,894 | \$ 1,725,381 |

The performance and credit quality of the loan portfolio is also monitored by analyzing the length of time a scheduled contractual payment is past due. The following tables present the classes of the loan portfolio summarized by past due status as of the dates indicated:

| | June 30, 2020 | | | | | | |
|----------------------------------------------------------------|------------------------------------|------------------------------------|------------------------------------------------------------|-------------------|---------------------------|--------------------------|---------------------|
| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due and Still Accruing | Nonaccrual | Total Past Due | Total Current | Total |
| | (in thousands) | | | | | | |
| Commercial and industrial | \$ 418 | \$ 212 | \$ 336 | \$ 6,817 | \$ 7,783 | \$ 420,520 | \$ 428,303 |
| Commercial real estate: | | | | | | | |
| Owner-occupied | 597 | 346 | 245 | 2,561 | 3,749 | 387,281 | 391,030 |
| Investor | 6 | 531 | - | 506 | 1,043 | 688,574 | 689,617 |
| Construction and development | - | - | - | - | - | 131,328 | 131,328 |
| Multi-family | 91 | - | - | 717 | 808 | 132,134 | 132,942 |
| Residential real estate: | | | | | | | |
| Residential mortgage and first lien home equity loans | 222 | 288 | - | 2,212 | 2,722 | 111,336 | 114,058 |
| Home equity—second lien loans and revolving lines of credit | 74 | 106 | - | 630 | 810 | 28,545 | 29,355 |
| Consumer and other | - | 776 | - | 58 | 834 | 39,396 | 40,230 |
| Total | \$ 1,408 | \$ 2,259 | \$ 581 | \$ 13,501 | \$ 17,749 | \$ 1,939,114 | \$ 1,956,863 |

Nonaccrual loans in the preceding table do not include purchased credit impaired (“PCI”) loans which were recorded at their fair value at acquisition and totaled \$5.7 million at June 30, 2020.

| | December 31, 2019 | | | | | | |
|----------------------------------------------------------------|------------------------------------|------------------------------------|------------------------------------------------------------|-------------------|---------------------------|--------------------------|---------------------|
| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due and Still Accruing | Nonaccrual | Total Past Due | Total Current | Total |
| | (in thousands) | | | | | | |
| Commercial and industrial | \$ 1,493 | \$ - | \$ 1,122 | \$ 12,985 | \$ 15,600 | \$ 223,278 | \$ 238,878 |
| Commercial real estate: | | | | | | | |
| Owner-occupied | 2,540 | 361 | - | 5,693 | 8,594 | 386,212 | 394,806 |
| Investor | - | 399 | - | 662 | 1,061 | 671,950 | 673,011 |
| Construction and development | - | - | - | - | - | 105,235 | 105,235 |
| Multi-family | 208 | - | 73 | 730 | 1,011 | 117,994 | 119,005 |
| Residential real estate: | | | | | | | |
| Residential mortgage and first lien home equity loans | 596 | 28 | - | 928 | 1,552 | 118,549 | 120,101 |
| Home equity—second lien loans and revolving lines of credit | 670 | - | - | 494 | 1,164 | 31,374 | 32,538 |
| Consumer and other | - | - | - | 61 | 61 | 35,749 | 35,810 |
| Total | \$ 5,507 | \$ 788 | \$ 1,195 | \$ 21,553 | \$ 29,043 | \$ 1,690,341 | \$ 1,719,384 |

Nonaccrual loans in the preceding table do not include PCI loans which were recorded at their fair value at acquisition and totaled \$6.0 million at December 31, 2019.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 7 – Loans (continued)

The total recorded investment in loans secured by residential real estate property that were in the process of foreclosure was \$1.8 million and \$1.3 million at June 30, 2020 and December 31, 2019, respectively. There was one foreclosed residential real estate property held by the Company at June 30, 2020 and December 31, 2019 with a carrying amount of \$379,000.

Loans totaling \$228.3 million and \$232.2 million at June 30, 2020 and December 31, 2019, respectively, were pledged as collateral for FHLB borrowings.

The outstanding principal balance and related carrying amount of PCI loans were as follows as of the dates indicated:

| | <u>June 30, 2020</u> | | <u>December 31, 2019</u> | |
|-------------------------------|-----------------------|--------|--------------------------|--------|
| | <u>(in thousands)</u> | | | |
| Outstanding principal balance | \$ | 12,401 | \$ | 15,241 |
| Carrying amount | | 5,748 | | 5,997 |

The following table presents the change in the accretable discount on PCI loans for the periods indicated:

| | <u>Accretable Discount</u> | | | |
|-----------------------------------------------|----------------------------|------------|--------------------------|------------|
| | <u>Six Months Ended</u> | | <u>Year Ended</u> | |
| | <u>June 30, 2020</u> | | <u>December 31, 2019</u> | |
| | <u>(in thousands)</u> | | | |
| Balance—beginning of period | \$ | 615 | \$ | 394 |
| Addition from acquisition of Grand Bank, N.A. | | - | | 566 |
| Accretion recorded to interest income | | (195) | | (345) |
| Balance—end of period | \$ | <u>420</u> | \$ | <u>615</u> |

Note 8 – Allowance for Loan Losses

The following tables present the activity in the allowance for loan losses by loan class for the periods indicated:

| | <u>Commercial real estate</u> | | | | | <u>Residential real estate</u> | | <u>Consumer and other</u> | <u>Total</u> |
|-----------------------------------------|----------------------------------|-----------------------|-----------------|-------------------------------------|---------------------|--------------------------------------------------------------|--------------------------------------------------------------------|---------------------------|--------------|
| | <u>Commercial and industrial</u> | <u>Owner-occupied</u> | <u>Investor</u> | <u>Construction and development</u> | <u>Multi-family</u> | <u>Residential mortgage and first lien home equity loans</u> | <u>Home equity-second lien loans and revolving lines of credit</u> | | |
| | | | | | | | | | |
| Three Months Ended June 30, 2020 | | | | | | | | | |
| Balance—beginning of period | \$ 4,875 | \$ 3,417 | \$ 7,438 | \$ 1,305 | \$ 1,374 | \$ 516 | \$ 183 | \$ 370 | \$ 19,478 |
| Charge offs | (988) | - | - | - | - | (71) | - | (3) | (1,062) |
| Recoveries | 5 | 1 | - | - | - | - | 40 | 2 | 48 |
| Provision for loan losses | 1,104 | 631 | 823 | 174 | 92 | 151 | (57) | 59 | 2,977 |
| Balance—end of period | \$ 4,996 | \$ 4,049 | \$ 8,261 | \$ 1,479 | \$ 1,466 | \$ 596 | \$ 166 | \$ 428 | \$ 21,441 |

| | <u>Commercial real estate</u> | | | | | <u>Residential real estate</u> | | <u>Consumer and other</u> | <u>Total</u> |
|-----------------------------------------|----------------------------------|-----------------------|-----------------|-------------------------------------|---------------------|--------------------------------------------------------------|--------------------------------------------------------------------|---------------------------|--------------|
| | <u>Commercial and industrial</u> | <u>Owner-occupied</u> | <u>Investor</u> | <u>Construction and development</u> | <u>Multi-family</u> | <u>Residential mortgage and first lien home equity loans</u> | <u>Home equity-second lien loans and revolving lines of credit</u> | | |
| | | | | | | | | | |
| Three Months Ended June 30, 2019 | | | | | | | | | |
| Balance—beginning of period | \$ 2,941 | \$ 3,097 | \$ 6,365 | \$ 959 | \$ 1,186 | \$ 417 | \$ 167 | \$ 384 | \$ 15,516 |
| Charge offs | (402) | (94) | - | - | - | - | - | - | (496) |
| Recoveries | 13 | 1 | - | - | - | - | 1 | - | 15 |
| Provision for loan losses | 1,388 | 374 | 276 | (101) | (118) | (27) | (14) | (57) | 1,721 |
| Balance—end of period | \$ 3,940 | \$ 3,378 | \$ 6,641 | \$ 858 | \$ 1,068 | \$ 390 | \$ 154 | \$ 327 | \$ 16,756 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 8 – Allowance for Loan Losses (continued)

| | Commercial real estate | | | | | Residential real estate | | Consumer and other | Total |
|---------------------------------------|---------------------------|----------------|----------|------------------------------|-----------------------------|-------------------------------------------------------|-------------------------------------------------------------|--------------------|-----------|
| | Commercial and industrial | Owner-occupied | Investor | Construction and development | Multi-family (in thousands) | Residential mortgage and first lien home equity loans | Home equity—second lien loans and revolving lines of credit | | |
| Six Months Ended June 30, 2020 | | | | | | | | | |
| Balance—beginning of period | \$ 4,437 | \$ 3,142 | \$ 6,631 | \$ 975 | \$ 1,123 | \$ 488 | \$ 140 | \$ 309 | \$ 17,245 |
| Charge offs | (1,642) | - | - | - | (51) | (75) | - | (7) | (1,775) |
| Recoveries | 15 | 2 | - | - | - | - | 43 | 2 | 62 |
| Provision for loan losses | 2,186 | 905 | 1,629 | 504 | 394 | 184 | (17) | 124 | 5,909 |
| Balance—end of period | \$ 4,996 | \$ 4,049 | \$ 8,260 | \$ 1,479 | \$ 1,466 | \$ 597 | \$ 166 | \$ 428 | \$ 21,441 |

| | Commercial real estate | | | | | Residential real estate | | Consumer and other | Total |
|---------------------------------------|---------------------------|----------------|----------|------------------------------|-----------------------------|-------------------------------------------------------|-------------------------------------------------------------|--------------------|-----------|
| | Commercial and industrial | Owner-occupied | Investor | Construction and development | Multi-family (in thousands) | Residential mortgage and first lien home equity loans | Home equity—second lien loans and revolving lines of credit | | |
| Six Months Ended June 30, 2019 | | | | | | | | | |
| Balance—beginning of period | \$ 2,456 | \$ 3,249 | \$ 6,152 | \$ 782 | \$ 1,473 | \$ 482 | \$ 186 | \$ 355 | 15,135 |
| Charge offs | (506) | (94) | (98) | - | - | - | - | - | (698) |
| Recoveries | 31 | 199 | - | - | - | - | 3 | - | 233 |
| Provision for loan losses | 1,959 | 24 | 587 | 76 | (405) | (92) | (35) | (28) | 2,086 |
| Balance—end of period | \$ 3,940 | \$ 3,378 | \$ 6,641 | \$ 858 | \$ 1,068 | \$ 390 | \$ 154 | \$ 327 | \$ 16,756 |

The recorded investment in loans and the allowance for loan losses by loan class are as follows at the dates indicated:

| | Loan Balances | | | | Allowance for Loan Losses Balances | | | |
|-------------------------------------------------------------|---------------------------------------|---------------------------------------|----------|--------------|---------------------------------------|---------------------------------------|---------|-----------|
| | Individually Evaluated For Impairment | Collectively Evaluated For Impairment | PCI (1) | Total | Individually Evaluated For Impairment | Collectively Evaluated For Impairment | PCI (1) | Total |
| | (in thousands) | | | | | | | |
| Commercial and industrial | \$ 6,816 | \$ 421,487 | \$ 191 | \$ 428,494 | \$ - | \$ 4,996 | \$ - | \$ 4,996 |
| Commercial real estate: | | | | | | | | |
| Owner-occupied | 3,071 | 387,959 | 1,066 | 392,096 | 37 | 4,012 | - | 4,049 |
| Investor | 506 | 689,111 | 274 | 689,891 | - | 8,261 | - | 8,261 |
| Construction and development | - | 131,328 | 463 | 131,791 | - | 1,479 | - | 1,479 |
| Multi-family | 717 | 132,225 | - | 132,942 | - | 1,466 | - | 1,466 |
| Residential real estate: | | | | | | | | |
| Residential mortgage and first lien home equity loans | 2,212 | 111,846 | 3,738 | 117,796 | - | 596 | - | 596 |
| Home equity—second lien loans and revolving lines of credit | 630 | 28,725 | 16 | 29,371 | - | 166 | - | 166 |
| Consumer and other | 61 | 40,169 | - | 40,230 | - | 428 | - | 428 |
| Total | \$ 14,013 | \$1,942,850 | \$ 5,748 | \$ 1,962,611 | \$ 37 | \$ 21,404 | \$ - | \$ 21,441 |

(1) Loans acquired with deteriorated credit quality are evaluated on an individual basis. In accordance with U.S. GAAP, at acquisition there was no carryover of the allowance for loan losses.

| | Loan Balances | | | | Allowance for Loan Losses Balances | | | |
|-------------------------------------------------------------|---------------------------------------|---------------------------------------|----------|--------------|---------------------------------------|---------------------------------------|---------|-----------|
| | Individually Evaluated For Impairment | Collectively Evaluated For Impairment | PCI (1) | Total | Individually Evaluated For Impairment | Collectively Evaluated For Impairment | PCI (1) | Total |
| | (in thousands) | | | | | | | |
| Commercial and industrial | \$ 12,986 | \$ 225,892 | \$ 212 | \$ 239,090 | \$ 961 | \$ 3,476 | \$ - | \$ 4,437 |
| Commercial real estate: | | | | | | | | |
| Owner-occupied | 6,214 | 388,592 | 1,189 | 395,995 | - | 3,142 | - | 3,142 |
| Investor | 661 | 672,350 | 289 | 673,300 | - | 6,631 | - | 6,631 |
| Construction and development | - | 105,235 | 474 | 105,709 | - | 975 | - | 975 |
| Multi-family | 730 | 118,275 | - | 119,005 | - | 1,123 | - | 1,123 |
| Residential real estate: | | | | | | | | |
| Residential mortgage and first lien home equity loans | 928 | 119,173 | 3,816 | 123,917 | - | 488 | - | 488 |
| Home equity—second lien loans and revolving lines of credit | 493 | 32,045 | 17 | 32,555 | - | 140 | - | 140 |
| Consumer and other | 67 | 35,743 | - | 35,810 | - | 309 | - | 309 |
| Total | \$ 22,079 | \$1,697,305 | \$ 5,997 | \$ 1,725,381 | \$ 961 | \$ 16,284 | \$ - | \$ 17,245 |

(1) Loans acquired with deteriorated credit quality are evaluated on an individual basis. In accordance with U.S. GAAP, at acquisition there was no carryover of the allowance for loan losses.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 8 – Allowance for Loan Losses (continued)

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due.

Impairment is measured on a loan-by-loan basis for commercial and industrial loans and commercial real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

The following tables summarize information regarding impaired loans by loan class as of the dates and for the periods indicated:

| | June 30, 2020 | | | December 31, 2019 | | |
|-------------------------------------------------------------|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| | (in thousands) | | | | | |
| Impaired loans without a valuation allowance: | | | | | | |
| Commercial and industrial | \$ 6,816 | \$ 7,022 | \$ - | \$ 11,741 | \$ 12,040 | \$ - |
| Commercial real estate: | | | | | | |
| Owner-occupied | 3,071 | 3,144 | - | 6,214 | 6,308 | - |
| Investor | 132 | 149 | - | 661 | 661 | - |
| Multi-family | 717 | 742 | - | 730 | 730 | - |
| Residential real estate: | | | | | | |
| Residential mortgage and first lien home equity loans | 2,212 | 2,307 | - | 928 | 933 | - |
| Home equity—second lien loans and revolving lines of credit | 630 | 638 | - | 493 | 493 | - |
| Consumer and other | 61 | 82 | - | 67 | 67 | - |
| Total | <u>\$ 13,639</u> | <u>\$ 14,084</u> | <u>\$ -</u> | <u>\$ 20,834</u> | <u>\$ 21,232</u> | <u>\$ -</u> |
| Impaired loans with a valuation allowance: | | | | | | |
| Commercial and industrial | \$ - | \$ - | \$ - | \$ 1,245 | \$ 1,245 | \$ 961 |
| Commercial real estate: | | | | | | |
| Investor | 374 | 407 | 37 | - | - | - |
| Total | <u>\$ 374</u> | <u>\$ 407</u> | <u>\$ 37</u> | <u>\$ 1,245</u> | <u>\$ 1,245</u> | <u>\$ 961</u> |
| Total impaired loans: | | | | | | |
| Commercial and industrial | \$ 6,816 | \$ 7,022 | \$ - | \$ 12,986 | \$ 13,285 | \$ 961 |
| Commercial real estate: | | | | | | |
| Owner-occupied | 3,071 | 3,144 | - | 6,214 | 6,308 | - |
| Investor | 506 | 556 | 37 | 661 | 661 | - |
| Multi-family | 717 | 742 | - | 730 | 730 | - |
| Residential real estate: | | | | | | |
| Residential mortgage and first lien home equity loans | 2,212 | 2,307 | - | 928 | 933 | - |
| Home equity—second lien loans and revolving lines of credit | 630 | 638 | - | 493 | 493 | - |
| Consumer and other | 61 | 82 | - | 67 | 67 | - |
| Total | <u>\$ 14,013</u> | <u>\$ 14,491</u> | <u>\$ 37</u> | <u>\$ 22,079</u> | <u>\$ 22,477</u> | <u>\$ 961</u> |

The impaired loans in the preceding table do not include \$5.7 million and \$6.0 million of PCI loans which were recorded at their fair value at acquisition, at June 30, 2020 and December 31, 2019, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 8 – Allowance for Loan Losses (continued)

| | <u>Three Months Ended June 30, 2020</u> | | | <u>Three Months Ended June 30, 2019</u> | | |
|-------------------------------------------------------------|-----------------------------------------|-----------------------------------|---------------------------------------------------|-----------------------------------------|-----------------------------------|---------------------------------------------------|
| | <u>Average Recorded Investment</u> | <u>Interest Income Recognized</u> | <u>Interest Income Recognized on a Cash Basis</u> | <u>Average Recorded Investment</u> | <u>Interest Income Recognized</u> | <u>Interest Income Recognized on a Cash Basis</u> |
| | <i>(in thousands)</i> | | | | | |
| Impaired loans without a valuation allowance: | | | | | | |
| Commercial and industrial | \$ 11,274 | \$ - | \$ - | \$ 1,062 | \$ - | \$ - |
| Commercial real estate: | | | | | | |
| Owner-occupied | 2,901 | 7 | - | 1,681 | - | - |
| Investor | 152 | - | - | 533 | - | - |
| Multi-family | 799 | - | - | 507 | - | - |
| Residential real estate: | | | | | | |
| Residential mortgage and first lien home equity loans | 2,319 | - | - | 1,218 | - | - |
| Home equity—second lien loans and revolving lines of credit | 624 | - | - | 237 | - | - |
| Consumer and other | 81 | - | - | 137 | 1 | 7 |
| Total | <u>\$ 18,150</u> | <u>\$ 7</u> | <u>\$ -</u> | <u>\$ 5,375</u> | <u>\$ 1</u> | <u>\$ 7</u> |
| Impaired loans with a valuation allowance: | | | | | | |
| Commercial and industrial | \$ 410 | \$ - | \$ - | \$ 149 | \$ - | \$ - |
| Commercial real estate: | | | | | | |
| Multi-family | - | - | - | 618 | - | - |
| Total | <u>\$ 410</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 767</u> | <u>\$ -</u> | <u>\$ -</u> |
| Total impaired loans: | | | | | | |
| Commercial and industrial | \$ 11,684 | \$ - | \$ - | \$ 1,211 | \$ - | \$ - |
| Commercial real estate: | | | | | | |
| Owner-occupied | 2,901 | 7 | - | 1,681 | - | - |
| Investor | 152 | - | - | 533 | - | - |
| Multi-family | 799 | - | - | 1,125 | - | - |
| Residential real estate: | | | | | | |
| Residential mortgage and first lien home equity loans | 2,319 | - | - | 1,218 | - | - |
| Home equity—second lien loans and revolving lines of credit | 624 | - | - | 237 | - | - |
| Consumer and other | 81 | - | - | 137 | 1 | 7 |
| Total | <u>\$ 18,560</u> | <u>\$ 7</u> | <u>\$ -</u> | <u>\$ 6,142</u> | <u>\$ 1</u> | <u>\$ 7</u> |

Average recorded investment in the preceding table does not include PCI loans which were recorded at their fair value at acquisition.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 8 – Allowance for Loan Losses (continued)

| | Six Months Ended June 30, 2020 | | | Six Months Ended June 30, 2019 | | |
|-------------------------------------------------------------|--------------------------------|----------------------------|--------------------------------------------|--------------------------------|----------------------------|--------------------------------------------|
| | Average Recorded Investment | Interest Income Recognized | Interest Income Recognized on a Cash Basis | Average Recorded Investment | Interest Income Recognized | Interest Income Recognized on a Cash Basis |
| | (in thousands) | | | | | |
| Impaired loans without a valuation allowance: | | | | | | |
| Commercial and industrial | \$ 11,338 | \$ - | \$ - | \$ 1,153 | \$ - | \$ - |
| Commercial real estate: | | | | | | |
| Owner-occupied | 2,741 | 14 | - | 1,326 | - | 120 |
| Investor | 154 | - | - | 332 | - | - |
| Multi-family | 794 | - | - | 388 | - | - |
| Residential real estate: | | | | | | |
| Residential mortgage and first lien home equity loans | 1,742 | - | - | 1,109 | - | - |
| Home equity–second lien loans and revolving lines of credit | 560 | - | - | 240 | - | - |
| Consumer and other | 82 | - | - | 171 | 2 | 7 |
| Total | <u>\$ 17,411</u> | <u>\$ 14</u> | <u>\$ -</u> | <u>\$ 4,719</u> | <u>\$ 2</u> | <u>\$ 127</u> |
| Impaired loans with a valuation allowance: | | | | | | |
| Commercial and industrial | \$ 412 | \$ - | \$ - | \$ 75 | \$ - | \$ - |
| Commercial real estate: | | | | | | |
| Multi-family | - | - | - | 1,378 | - | - |
| Total | <u>\$ 412</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 1,453</u> | <u>\$ -</u> | <u>\$ -</u> |
| Total impaired loans: | | | | | | |
| Commercial and industrial | \$ 11,750 | \$ - | \$ - | \$ 1,228 | \$ - | \$ - |
| Commercial real estate: | | | | | | |
| Owner-occupied | 2,741 | 14 | - | 1,326 | - | 120 |
| Investor | 154 | - | - | 332 | - | - |
| Multi-family | 794 | - | - | 1,766 | - | - |
| Residential real estate: | | | | | | |
| Residential mortgage and first lien home equity loans | 1,742 | - | - | 1,109 | - | - |
| Home equity–second lien loans and revolving lines of credit | 560 | - | - | 240 | - | - |
| Consumer and other | 82 | - | - | 171 | 2 | 7 |
| Total | <u>\$ 17,823</u> | <u>\$ 14</u> | <u>\$ -</u> | <u>\$ 6,172</u> | <u>\$ 2</u> | <u>\$ 127</u> |

Average recorded investment in the preceding table does not include PCI loans which were recorded at their fair value at acquisition.

Troubled Debt Restructured Loans

Impaired loans generally include nonaccrual loans but also include performing and nonperforming TDRs. From time to time, the Company may extend, restructure or otherwise modify the terms of existing loans, on a case-by-case basis, to remain competitive and retain certain borrowers, as well as assist other borrowers who may be experiencing financial difficulties. If a borrower is experiencing financial difficulties and a concession is made by way of a modification of terms the Company would not otherwise consider, the modified loan would be classified as a TDR.

TDRs are individually evaluated for impairment and are recorded at fair value. At June 30, 2020, TDRs totaling \$513,000 were on accruing status and one Commercial and Industrial loan totaling \$5.2 million was on nonaccruing status, compared to \$526,000 and \$5.9 million, respectively, at December 31, 2019. There was no related allowance for any TDR included within the allowance for loan losses as of June 30, 2020 and December 31, 2019.

There were no TDRs executed during the three or six months ended June 30, 2020 and 2019. One Commercial and Industrial TDR totaling \$5.2 million executed during the fourth quarter of 2019 is not performing in accordance with its amended terms and is on nonaccrual status at June 30, 2020. There were no other TDRs executed within the twelve months ended June 30, 2020 and 2019 that subsequently defaulted during the three or six months ended June 30, 2020 and 2019.

Note 9 – Subordinated Debentures

On May 29, 2020 the Company completed a \$30.0 million private placement of fixed-to-floating rate subordinated debentures. The notes have a maturity date of June 1, 2030 and carry a fixed interest rate of 5.50% for the first five years. Thereafter, the notes will pay interest at SOFR plus 5.38%. The notes include a right of prepayment, without penalty, on or after June 1, 2025. The subordinated debentures qualify as Tier II capital for regulatory capital purposes. The subordinated debentures, net, totaled \$29.5 million at June 30, 2020 and \$22.0 million at December 31, 2019, which includes \$525,000 of debt issuance costs at June 30, 2020 which are being amortized over the expected life of the May 29th issue. The average rate on our subordinated debentures

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 9 – Subordinated Debentures (continued)

was 6.59% and 6.86% for the three and six months ended June 30, 2020, compared to 7.27% and 7.28% for the three and six months ended June 30, 2019.

On June 30, 2020 the Company redeemed its outstanding \$22.0 million 6.75% fixed-to-floating rate subordinated debentures due May 1, 2025, without penalty. Since May 1, 2020 the interest paid on these debentures was based on 3-month LIBOR plus 5.30% or 6.74% through June 30, 2020.

Note 10 – Stockholders' Equity

During the six months ended June 30, 2020, the Company purchased 1,000,000 shares of treasury stock for an aggregate purchase price of \$7.9 million.

Note 11 – Goodwill and Other Intangible Assets

The Company's intangible assets consist of goodwill and core deposit intangibles, in connection with acquisitions, and loan servicing intangible assets for servicing rights retained in connection with the origination and sale of loans guaranteed by the Small Business Administration ("SBA loan servicing assets").

As a result of the Grand Bank acquisition at the close of business on September 30, 2019, the Company recorded an additional \$179,000 in goodwill and an additional core deposit intangible of \$343,000. The Company also acquired from Grand Bank additional SBA servicing assets with a fair value of \$543,000 at the time of the acquisition.

Goodwill is not amortized but is subject to annual tests for impairment or more often if events or circumstances indicate it may be impaired.

Core deposit intangibles are amortized on an accelerated basis using an estimated life of 10 years and are evaluated annually for impairment. An impairment loss will be recognized if the carrying amount of the intangible asset is not recoverable and exceeds fair value. The carrying amount of the intangible asset is not considered recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use of the asset.

Loan servicing rights are amortized over the period of the economic life of the assets arising from estimated net servicing revenues.

Based on the economic uncertainty created as a result of the COVID-19 health pandemic, the Company performed a quantitative assessment of goodwill as of June 30, 2020. Based on that assessment, the Company determined that the reporting unit's fair value was not less than its carrying amount at June 30, 2020.

The Company believes that the fair values of intangible assets were in excess of their carrying amounts and therefore there was no impairment to intangible assets at June 30, 2020.

Amortization expense of the core deposit intangibles was \$79,000 and \$73,000 for the three months ended June 30, 2020 and 2019, respectively, and \$162,000 and \$149,000 for the six months ended June 30, 2020 and 2019, respectively. The unamortized balance of the core deposit intangibles and the amount of goodwill at June 30, 2020 were \$1.2 million and \$16.3 million, respectively. The unamortized SBA loan servicing assets and mortgage loan servicing assets totaled \$699,000 at June 30, 2020.

Note 12 – Income Taxes

The Company accounts for income taxes under the liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets and liabilities are adjusted for the effects of the changes in tax laws and rates as of the date of enactment. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Increases or decreases in the valuation reserve are charged or credited to income tax expense.

As of June 30, 2020 and December 31, 2019, the Company had net deferred tax assets of \$10.1 million and \$10.4 million, respectively. These deferred tax assets can only be realized if the Company generates taxable income in the future. The Company regularly evaluates the realizability of deferred tax asset positions. In determining whether a valuation allowance is necessary, the level of taxable income in prior years is considered to the extent that carrybacks are permitted under current tax laws, as well as estimates of future pre-tax and taxable income and tax planning strategies that would, if necessary, be implemented. The Company expects to realize our deferred tax assets over the allowable carryback and/or carryforward periods. Therefore, no valuation allowance was deemed necessary against the deferred tax assets as of June 30, 2020 or December 31, 2019. However,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 12 – Income Taxes (continued)

if an unanticipated event occurred that materially changed pre-tax and taxable income in future periods, a valuation allowance may become necessary and could have a material effect on the Company's consolidated financial statements.

When tax returns are filed, some tax positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the consolidated statements of financial condition along with any associated interest and penalties that would be payable to the taxing authorities upon examination. The Company does not have uncertain tax positions that it deems material.

The Company's effective tax rate for the three and six months ended June 30, 2020 was 24.65% and 24.24%, respectively, compared to 33.02% and 25.81%, for the same periods, respectively, in 2019. In May and December 2019, New Jersey issued clarifying statements on the new tax legislation enacted in July 2018, specifically related to the combined income tax reporting for certain members of a commonly-controlled unitary business group. These statements provided clarity on the Company's New Jersey state tax liability and contributed to the increase in the Company's expected annual effective tax rate in 2019 above the effective tax rate recorded during 2018. The higher second quarter 2019 effective tax rate of 33.02% reflects a catch-up accrual to record additional state tax expense during the quarter ended June 30, 2019.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense. There were no interest or penalties recorded in income tax expense for the three or six months ended June 30, 2020 and 2019.

Note 13 – Commitments and Contingencies

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated statements of financial condition.

At June 30, 2020 and December 31, 2019, commitments to extend credit totaled \$230.9 million and \$232.4 million, respectively. At June 30, 2020 and December 31, 2019, the Company had outstanding financial and performance standby letters of credit of \$5.6 million and \$5.5 million, respectively. These letters of credit are primarily related to performance guarantees on real estate development.

In the ordinary course of business the Company is party to litigation involving collection matters, contract claims and other miscellaneous causes of action arising from its business. Management does not consider that any such proceedings depart from usual routine litigation.

Note 14 – Fair Value Measurements and Fair Values of Financial Instruments

Fair Value Measurement

The Company follows the guidance on fair value measurement in ASC 820-10-5, *Fair Value Measurement*, which establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value.

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective period-ends and have not been re-evaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period-end.

The fair value measurement 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:

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 14 – Fair Value Measurements and Fair Values of Financial Instruments (continued)

- 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.

Fair Value on a Recurring Basis

Investment Securities Available for Sale

The fair values of investment securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity or non-transferability, and such adjustments are based on available market evidence (Level 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Internal cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers, where available, are used to support the fair values of certain Level 3 investments.

Derivatives

The Company records all derivatives on the consolidated statements of financial condition at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. The Company currently only has interest rate derivatives resulting from a service provided to certain qualified borrowers in a loan related transaction and, therefore, are not used to manage interest rate risk in the Company's assets or liabilities. As such, all changes in fair value of the Company's derivatives are recognized directly in earnings. The fair value of the Company's derivatives is determined using discounted cash flow analysis using observable market-based inputs, which are considered Level 2 inputs.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy are presented in the following tables as of the dates indicated:

| | June 30, 2020 | | | |
|--------------------------------------------------|----------------------|---------------------------------------------------------------------------------------|----------------------------------------------------------------------|--------------------------------------------------------------|
| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | (in thousands) | | | |
| Investment securities available for sale: | | | | |
| Residential mortgage-backed securities: | | | | |
| Issued by FNMA and FHLMC | \$ 41,304 | \$ - | \$ 41,304 | \$ - |
| Issued by GNMA | 5,150 | - | 5,150 | - |
| U.S. Treasury securities | 9,068 | 9,068 | - | - |
| Asset-backed securities | 1,844 | - | 1,844 | - |
| Corporate obligations | 9,391 | - | 9,391 | - |
| Total securities available for sale | \$ 66,757 | \$ 9,068 | \$ 57,689 | \$ - |
| Derivative assets | 127 | - | 127 | - |
| Total | \$ 66,884 | \$ 9,068 | \$ 57,816 | \$ - |
| Derivative liabilities | \$ 127 | - | \$ 127 | - |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 14 – Fair Value Measurements and Fair Values of Financial Instruments (continued)

| | December 31, 2019 | | | |
|--------------------------------------------------|--------------------------|---------------------------------------------------------------------------------------|----------------------------------------------------------------------|--------------------------------------------------------------|
| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | (in thousands) | | | |
| Investment securities available for sale: | | | | |
| Residential mortgage-backed securities: | | | | |
| Issued by FNMA and FHLMC | \$ 27,975 | \$ - | \$ 27,975 | \$ - |
| Issued by GNMA | 3,808 | - | 3,808 | - |
| U.S. Treasury securities | 8,984 | 8,984 | - | - |
| Asset-backed securities | 2,086 | - | 2,086 | - |
| Corporate obligations | 4,609 | - | 4,609 | - |
| Total | \$ 47,462 | \$ 8,984 | \$ 38,478 | \$ - |

Fair Value on a Nonrecurring Basis

Impaired Loans

Impaired loans are generally measured 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 upon the expected proceeds. Impaired loans, excluding accruing TDRs, are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements.

Other Real Estate Owned

Other real estate owned and other repossessed assets are measured at fair value less costs to sell. Fair value is determined by sales agreements or appraisals by qualified licensed appraisers. Costs to sell are based on estimation per the terms and conditions of the sales agreements or appraisals. These assets are included as Level 3 fair values.

For assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy are presented in the following tables as of the dates indicated:

| | June 30, 2020 | | | |
|--------------------------------------|----------------------|---------------------------------------------------------------------------------------|----------------------------------------------------------------------|--------------------------------------------------------------|
| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | (in thousands) | | | |
| Impaired loans, collateral dependent | \$ 13,976 | \$ - | \$ - | \$ 13,976 |
| Other real estate owned | 1,142 | - | - | 1,142 |
| Total | \$ 15,118 | \$ - | \$ - | \$ 15,118 |

| | December 31, 2019 | | | |
|--------------------------------------|--------------------------|---------------------------------------------------------------------------------------|----------------------------------------------------------------------|--------------------------------------------------------------|
| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | (in thousands) | | | |
| Impaired loans, collateral dependent | \$ 21,118 | \$ - | \$ - | \$ 21,118 |
| Other real estate owned | 1,076 | - | - | 1,076 |
| Total | \$ 22,194 | \$ - | \$ - | \$ 22,194 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 14 – Fair Value Measurements and Fair Values of Financial Instruments (continued)

The following tables present quantitative information regarding Level 3 fair value measurements as of the dates indicated:

**Quantitative Information about Level 3 Fair Value Measurements
June 30, 2020**

| | Fair Value | Valuation Method | Unobservable Input | Range of Discount (3) | Weighted Average (3) |
|--------------------------------------|-------------------|------------------------------|------------------------------------|------------------------------|-----------------------------|
| | | | (dollars in thousands) | | |
| Impaired loans, collateral dependent | \$ 13,976 | Fair value of collateral (1) | Appraised Value (2) | 0% - 13% | 10% |
| Other real estate owned | 1,142 | Fair value of collateral (1) | Appraised Value (2) Sales Price | 6% - 14% | 8% |

**Quantitative Information about Level 3 Fair Value Measurements
December 31, 2019**

| | Fair Value | Valuation Method | Unobservable Input | Range of Discount (3) | Weighted Average (3) |
|--------------------------------------|-------------------|------------------------------|------------------------------------|------------------------------|-----------------------------|
| | | | (dollars in thousands) | | |
| Impaired loans, collateral dependent | \$ 21,118 | Fair value of collateral (1) | Appraised value (2) | 0% - 13% | 10% |
| Other real estate owned | 1,076 | Fair value of collateral (1) | Appraised value (2) Sales price | 6% - 14% | 8% |

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

(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

(3) The range and weighted average of qualitative factors such as economic conditions and estimated liquidation expenses are presented as a percentage of the appraised value.

Fair Value of Financial Instruments Not Recorded at Fair Value on a Recurring Basis

Accounting guidance requires the disclosure of the estimated fair value of certain financial instruments, including those financial instruments for which the Company did not elect the fair value option, and requires the use of an exit price notion when measuring the fair value of financial instruments for disclosure purposes. Estimated fair values have been determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret market data to develop estimates of fair value. The estimates presented are not necessarily indicative of amounts the Company could realize in a current market exchange. The use of alternative market assumptions and estimation methodologies could have a material effect on these estimates of fair value.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 14 – Fair Value Measurements and Fair Values of Financial Instruments (continued)

The carrying amounts and fair values of the Company’s balance sheet financial instruments are presented in the following tables as of the dates indicated:

| | June 30, 2020 | | | | |
|-------------------------------------------|----------------------------|-------------------------------------|---------------------------------------------------------------------------------------|----------------------------------------------------------------------|--------------------------------------------------------------|
| | Carrying Amount | Estimated Fair Value | Fair Value Measurements Using: | | |
| | | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | | | (in thousands) | | |
| Financial Assets: | | | | | |
| Cash and cash equivalents | \$ 124,157 | \$ 124,157 | \$ 124,157 | \$ - | \$ - |
| Interest bearing time deposits with banks | 7,160 | 7,227 | - | 7,227 | - |
| Investment securities available for sale | 66,757 | 66,757 | 9,068 | 57,689 | - |
| Investment securities held to maturity | 43,013 | 43,790 | - | 43,790 | - |
| Restricted investment in bank stocks | 6,585 | 6,585 | - | 6,585 | - |
| Other investments | 6,469 | 6,469 | - | 6,469 | - |
| Net loans (1) | 1,933,566 | 1,966,474 | - | 1,947,262 | 19,212 |
| Accrued interest receivable | 8,656 | 8,656 | - | 8,656 | - |
| Derivative assets | 127 | 127 | - | 127 | - |
| Financial Liabilities: | | | | | |
| Non-maturity deposits | 1,327,569 | 1,327,569 | - | 1,327,569 | - |
| Time deposits | 595,697 | 599,646 | - | 599,646 | - |
| Borrowings | 104,897 | 107,708 | - | 107,708 | - |
| Subordinated debentures | 29,475 | 30,170 | - | 30,170 | - |
| Accrued interest payable | 790 | 790 | - | 790 | - |
| Derivative liabilities | 127 | 127 | - | 127 | - |

(1) Level 2 for non-impaired loans and accruing TDRs; Level 3 for acquired PCI loans and impaired loans excluding accruing TDRs.

| | December 31, 2019 | | | | |
|-------------------------------------------|----------------------------|-------------------------------------|---------------------------------------------------------------------------------------|----------------------------------------------------------------------|--------------------------------------------------------------|
| | Carrying Amount | Estimated Fair Value | Fair Value Measurements Using: | | |
| | | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | | | (in thousands) | | |
| Financial Assets: | | | | | |
| Cash and cash equivalents | \$ 81,792 | \$ 81,792 | \$ 81,792 | \$ - | \$ - |
| Interest bearing time deposits with banks | 6,087 | 6,735 | - | 6,735 | - |
| Investment securities available for sale | 47,462 | 47,462 | 8,984 | 38,478 | - |
| Investment securities held to maturity | 46,612 | 47,100 | - | 47,100 | - |
| Restricted investment in bank stocks | 6,652 | 6,652 | - | 6,652 | - |
| Other investments | 6,388 | 6,388 | - | 6,388 | - |
| Net loans (1) | 1,706,329 | 1,747,034 | - | 1,720,445 | 26,589 |
| Accrued interest receivable | 4,810 | 4,810 | - | 4,810 | - |
| Financial Liabilities: | | | | | |
| Non-maturity deposits | 967,992 | 967,992 | - | 967,992 | - |
| Time deposits | 672,875 | 673,804 | - | 673,804 | - |
| Borrowings | 105,476 | 106,262 | - | 106,262 | - |
| Subordinated debentures | 21,964 | 22,132 | - | 22,132 | - |
| Accrued interest payable | 1,076 | 1,076 | - | 1,076 | - |

(1) Level 2 for non-impaired loans and accruing TDRs; Level 3 for acquired PCI loans and impaired loans excluding accruing TDRs.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 15 – Derivatives and Hedging Activities

Risk Management Objective of Using Derivatives

The Company is exposed to certain risk arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk primarily by managing the amount, sources, and duration of its assets and liabilities and the use of derivative financial instruments. The Company currently only has interest rate derivatives resulting from a service provided to certain qualified borrowers in a loan related transaction and, therefore, are not used to manage interest rate risk in the Company's assets or liabilities.

Non-designated Hedges

Derivatives not designated as hedges are not speculative and result from a service the Company provides to certain customers. The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by offsetting derivatives that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate derivatives associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer derivatives and the offsetting derivatives are recognized directly in earnings.

Tabular Disclosure of Fair Values of Derivative Instruments on the Consolidated Statements of Financial Condition

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Consolidated Statements of Financial Condition as of June 30, 2020. There were no derivative financial instruments as of December 31, 2019.

| Fair Values of Derivative Instruments | | | | | |
|----------------------------------------------------------------|--------------------------------------------------------|---------------|-------------------------------|--------------------------------------------------------|---------------|
| Derivative Assets | | | Derivative Liabilities | | |
| (in thousands) | | | | | |
| As of June 30, 2020 | | | As of June 30, 2020 | | |
| Notional Amount | Consolidated Statement of Financial Condition Location | Fair Value | Notional Amount | Consolidated Statement of Financial Condition Location | Fair Value |
| Derivatives not designated as hedging instruments | | | | | |
| \$ 4,280 | Other Assets | \$ 127 | \$ 4,280 | Other Liabilities | \$ 127 |
| Total derivatives not designated as hedging instruments | | \$ 127 | | | \$ 127 |
| Cash collateral | | - | | | - |
| Net Derivative Amounts | | <u>\$ 127</u> | | | <u>\$ 127</u> |

Credit-risk-related Contingent Features

The Company has agreements with each of its derivative counterparties that contain a provision where if the Company either defaults or is capable of being declared in default on any of its indebtedness, then the Company could also be declared in default on its derivative obligations.

As of June 30, 2020, the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was \$127,000. As of June 30, 2020, the Company has not posted any collateral related to these agreements. If the Company had breached any of these provisions at June 30, 2020, it could have been required to settle its obligations under the agreements at their termination value of \$127,000.

Note 16 – Leases

Effective January 1, 2019, the Company adopted ASU No. 2016-02 *Leases (Topic 842)* and all subsequent ASUs that modified Topic 842. For the Company, this ASU affected the accounting treatment for operating lease agreements in which the Company is the lessee by recognizing lease assets and liabilities in the consolidated statements of financial condition. All of the operating leases in which the Company is the lessee are comprised of real property primarily for branches and office space. At June 30, 2020, the Company's operating lease right-of-use assets and operating lease liabilities totaled \$7.4 million and \$7.8 million, respectively, and are carried in the consolidated statements of financial condition in other assets and other liabilities, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 16 – Leases (continued)

In adopting the guidance, the Company used the following practical expedients for transitional relief as provided for in a subsequent ASU:

- An entity need not reassess whether any expired or existing contract are or contain leases.
- An entity need not reassess the lease classification for any expired or existing leases.
- An entity need not reassess initial direct costs for any existing leases.
- An entity may elect to apply hindsight to leases that existed during the period from the beginning of the earliest period presented in the financial statements until the effective date.

The Company also elected not to include short-term leases (i.e., leases with initial terms of twelve months or less), or equipment leases (deemed immaterial) in the consolidated statements of financial condition as provided for in the guidance.

The following provides additional information about the Company’s operating leases:

At June 30, 2020:

| | |
|---------------------------------------|------------|
| Weighted average remaining lease term | 6.54 years |
| Weighted average discount rate | 3.28% |

Future minimum payments for the Twelve Months Ended:

(dollars in thousands)

| | |
|---------------|-------------------------|
| June 30, 2021 | \$ 1,736 |
| June 30, 2022 | 1,782 |
| June 30, 2023 | 1,568 |
| June 30, 2024 | 1,518 |
| June 30, 2025 | 1,423 |
| Thereafter | 3,395 |
| Total | <u><u>\$ 11,422</u></u> |

Six Months Ended June 30, 2020

| | |
|-----------------------------------------------------------|----------------------|
| Operating lease cost (cost resulting from lease payments) | <u><u>\$ 918</u></u> |
|-----------------------------------------------------------|----------------------|

(dollars in thousands)

Note 17 – Subsequent Events

Management has evaluated subsequent events through the date of issuance of the Consolidated Financial Statements and does not believe any events warrant recording or disclosure in these Consolidated Financial Statements.

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

The following management discussion and analysis of the Company's consolidated financial condition as of June 30, 2020 and the results of operations for the three and six months ended June 30, 2020 and 2019 ("MD&A") should be read in conjunction with the consolidated audited financial statements, including notes thereto, for the year ended December 31, 2019 included in the Company's Annual Report on Form 10-K as filed with the FDIC, and the other information therein. The consolidated statement of financial condition as of June 30, 2020, the consolidated statements of income, the consolidated statements of comprehensive income and the consolidated statements of changes in stockholders' equity for the three and six months ended June 30, 2020 and 2019, and the consolidated statements of cash flows for the six months ended June 30, 2020 and 2019 are unaudited. The consolidated statement of financial condition as of December 31, 2019 was derived from the audited consolidated statement of financial condition as of that date. The consolidated financial statements include, in the opinion of management, all adjustments considered necessary for a fair presentation of such data. As used in this Quarterly Report on Form 10-Q, "we," "us," "our," "the Bank" and "the Company" refer to First Bank and its consolidated subsidiaries, unless otherwise noted.

Cautionary Statement Concerning Forward-Looking Statements

This Quarterly Report on Form 10-Q contains certain forward-looking statements, either express or implied, within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include information regarding First Bank's future financial performance, business and growth strategy, projected plans and objectives, and related transactions, integration of acquired businesses, including Grand Bank, ability to recognize anticipated operational efficiencies, and other projections based on macroeconomic and industry trends, which are inherently unreliable due to the multiple factors that impact economic trends, and any such variations may be material. Such forward-looking statements are based on various facts and derived utilizing important assumptions, current expectations, estimates and projections about First Bank, any of which may change over time and some of which may be beyond First Bank's control. Statements preceded by, followed by or that otherwise include the words "believes," "expects," "anticipates," "intends," "projects," "estimates," "plans" and similar expressions or future or conditional verbs such as "will," "should," "would," "may" and "could" are generally forward-looking in nature and not historical facts, although not all forward-looking statements include the foregoing. Further, certain factors that could affect our future results and cause actual results to differ materially from those expressed in the forward-looking statements include, but are not limited to: whether First Bank can: successfully implement its growth strategy, including identifying acquisition targets and consummating suitable acquisitions, continue to sustain its internal growth rate, and provide competitive products and services that appeal to its customers and target markets; difficult market conditions and unfavorable economic trends in the United States generally, and particularly in the market areas in which First Bank operates and in which its loans are concentrated, including the effects of declines in housing markets; the negative impact of diseases and pandemics, such as the novel strain of coronavirus disease (COVID-19), on First Bank, its operations, customers, employees, credit quality, financial position, and liquidity; the length and extent of the economic contraction as a result of the COVID-19 pandemic, including an increase in unemployment levels and slowdowns in economic growth; changes in customer behavior due to changing business and economic conditions or legislative or regulatory initiatives; First Bank's level of nonperforming assets and the costs associated with resolving any problem loans including litigation and other costs; changes in market interest rates may increase funding costs and reduce earning asset yields thus reducing margin; the impact of changes in interest rates and the credit quality and strength of underlying collateral and the effect of such changes on the market value of First Bank's investment securities portfolio; increases in loan defaults and charge-off rates; decreases in the value of securities and other assets, adequacy of loan loss reserves, or deposit levels necessitating increased borrowing to fund loans and investments; operational risks, including, but not limited to, cybersecurity incidents, fraud, natural disasters and future pandemics; the extensive federal and state regulation, supervision and examination governing almost every aspect of First Bank's operations including changes in regulations affecting financial institutions in response to the COVID-19 pandemic, and the potential expenses associated with complying with such regulations; First Bank's ability to comply with applicable capital and liquidity requirements, including First Bank's ability to generate liquidity internally or raise capital on favorable terms, including continued access to the debt and equity capital markets; possible changes in trade, monetary and fiscal policies, laws and regulations and other activities of governments, agencies, and similar organizations. For discussion of these and other risks that may cause actual results to differ from expectations, please refer to "Forward-Looking Statements" and "Risk Factors" in First Bank's Annual Report on Form 10-K and any updates to those risk factors set forth in First Bank's subsequent joint proxy statement, Quarterly Reports on Form 10-Q, including in this Form 10-Q, or Current Reports on Form 8-K. If one or more events related to these or other risks or uncertainties materialize, or if First Bank's underlying assumptions prove to be incorrect, actual results may differ materially from what First Bank anticipates. Accordingly, you should not place undue reliance on any such forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made, and First Bank does not undertake any obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise, except as required by law. All forward-looking statements, expressed or implied, included in this communication are expressly qualified in their entirety by this cautionary statement. This cautionary statement should also be considered in connection with any subsequent written or oral forward-looking statements that First Bank or persons acting on First Bank's behalf may issue.

Business Overview

We are a New Jersey state-chartered commercial bank that began operations in 2007. We are headquartered in Hamilton, Mercer County, New Jersey, with total assets of \$2.30 billion, total loans of \$1.96 billion, total deposits of \$1.92 billion and total stockholders' equity of \$226.5 million at June 30, 2020. We provide lending, deposit and other financial products and services with an emphasis on commercial real estate and commercial and industrial loans to small to mid-sized businesses and individuals. Our existing and targeted markets are located in the corridor between New York City and Philadelphia. As of June 30, 2020, we operated eighteen full-service branches in Cinnaminson, Cranbury, Delanco, Denville, Ewing, Flemington, Hamilton, Hamilton Square, Lawrence, Mercerville, Pennington, Randolph, Somerset and Williamstown, New Jersey, and Doylestown, Treviso, Warminster and West Chester, Pennsylvania, and a loan production office in West Chester, Pennsylvania. We have a wholly-owned investment company subsidiary, FB Delaware Investment Company, Inc., a Delaware corporation, which was formed to manage an investment in commercial real estate. FB Delaware Investment Company, Inc. has in turn a wholly-owned New Jersey subsidiary, FB Preferred Capital, Inc., to hold and manage its commercial real estate loans. We also have several wholly-owned subsidiaries which hold foreclosed assets.

Based on the impact of the COVID-19 pandemic during the second quarter we worked with our affected borrowers offering payment relief in the form of loan deferrals as well as participating in the Small Business Administration's Paycheck Protection Program ("PPP"). This program was established by the Coronavirus Aid, Relief and Economic Securities Act ("CARES Act"), a specialized low-interest loan program. Through June 30, 2020 we submitted and received approval from the SBA for 1,128 PPP loans with a balance of \$190.5 million at June 30, 2020. We realized gross fees of \$6.9 million from the SBA from the origination of these loans. These fees, net of the associated direct origination costs of approximately \$519,000, are being amortized through interest income over the life of the PPP loans.

Second quarter 2020 results were highlighted by strong loan origination, double-digit net revenue growth, continued solid asset quality metrics and effective non-interest expense management despite the logistical and economic challenges resulting from the COVID-19 pandemic.

On May 29, 2020 we entered into a Subordinated Note Purchase Agreement with certain institutional accredited investors pursuant to which we sold and issued \$30.0 million in aggregate principal amount of 5.50% fixed-to-floating rate Subordinated Notes due June 1, 2030 (the "Notes") in a private placement. The Notes carry a fixed interest rate of 5.50% for the first five years. Thereafter, the Notes will pay interest at the 3-month Secured Overnight Financing Rate ("SOFR") plus 538 basis points. The Notes include a right of prepayment, without penalty, on or after June 1, 2025. The Notes qualify as Tier 2 capital for regulatory capital purposes.

On June 30, 2020 we redeemed our outstanding \$22.0 million 6.75% fixed-to-floating rate subordinated debentures due May 1, 2025, without penalty. Since May 1, 2020 the debentures repriced to the 3-month LIBOR rate as of April 1, 2020 plus 5.30%, or 6.74%, through June 30, 2020. The remaining net proceeds from the May 29th offering will be used for general corporate purposes.

On October 23, 2019, our Board of Directors authorized a share repurchase program allowing for the repurchase of up to 1.0 million shares of our common stock in the open market. We repurchased all of the approved 1.0 million shares of our common stock during the first half of 2020 for an aggregate purchase price of \$7.9 million, or an average price of \$7.88 per share. We currently have no plans to expand our authorization to repurchase shares of our common stock.

We believe our capital position is strong. We remain confident in our underlying strength and stability, and strategic direction to navigate the headwinds of the ongoing health pandemic. We have also taken the necessary steps to help protect our customers and employees while providing access to decision makers and maintaining access to our products and services.

Throughout this document we may refer to the impact, as we know it today, from COVID-19. Please see the specific "COVID-19 Response" disclosures under "Financial Condition" later in this section of this Form 10-Q.

It is difficult to determine how the ongoing pandemic will impact future demand for our products and services, future revenue, earnings, asset quality, capital reserves and dividend practices at this time. We continue to closely monitor and evaluate the nature and extent of COVID-19 to our business, consolidated results of operations and financial condition.

Financial service providers continue to be challenged by intense competition, changing customer demands, increased pricing pressures and the ongoing impact of new regulations and industry consolidation. This is more so for traditional loan and deposit services, due to continuous competitive pressures as both banks and nonbanks compete for customers with a broad array of banking, investment and capital market products. Despite these challenges, including COVID-19, and competition, our key strengths include establishing relationships and providing personalized service to attract high quality business to the Company. Highly focused personalized customer service provides a basis for differentiation in today's environment where banks and other financial service providers target the same customer. We remain committed to building customer relationships and delivering quality service to the banking markets we serve.

Critical Accounting Policies and Estimates

Our consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (“U.S. GAAP”). In the preparation of our consolidated financial statements we are required to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses as well as the disclosure of contingent assets and liabilities. Actual results could differ from those estimates. Our significant accounting policies are fundamental to understanding management’s discussion and analysis of our financial condition and results of operations.

We define our critical accounting policies as those accounting principles generally accepted in the U.S. that require us to make subjective estimates and judgments about matters that are uncertain and are likely to have a material impact on our financial condition and results of operations as well as the specific manner in which we apply those principles. We believe our accounting policies governing the determination of the fair value of acquired loans, determination of the allowance for loan losses, the assessment of other than temporary impairment of securities, intangible assets, derivative instruments and hedging activities, and the determination of income taxes are critical accounting policies.

We believe the critical accounting policies used in the preparation of our financial statements that require significant estimates and judgments are as follows:

Acquired Loans. Acquired loans are recorded at fair value with no carryover of the related allowance for loan losses at the time of acquisition. Determining the fair value of acquired loans involves estimating the amount and timing of principal and interest cash flows expected to be collected on the loans and discounting those cash flows at a market rate of interest.

Acquired loans determined to have evidence of deterioration in credit quality, which we refer to as purchased credit impaired (“PCI”) loans, are accounted for individually under Accounting Standards Codification (“ASC”) 310-30, *Accounting for Purchased Loans with Deteriorated Credit Quality*. Acquired loans that were not individually in the scope of ASC 310-30 because they did not meet the criteria above were either (i) pooled into groups of similar loans based on the borrower type, loan purpose, and collateral type and accounted for under ASC 310-30, or (ii) accounted for under ASC 310-20, *Nonrefundable Fees and Other Costs*.

For PCI loans, the excess of expected cash flows from acquired loans over the estimated fair value of acquired loans at acquisition is called the accretable discount and is recognized into interest income over the remaining life of the acquired loans using the interest method. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the non-accretable discount. The non-accretable discount represents estimated future credit losses expected to be incurred over the life of the acquired loans. Subsequent decreases to the expected cash flows require us to evaluate the need for an addition to the allowance for loan losses. Subsequent improvements in expected cash flows result in the reversal of a corresponding amount of the non-accretable discount which we can then reclassify as accretable discount that is recognized in interest income over the remaining life of the loan using the interest method. Our evaluation of the amount of future cash flows that we expect to collect takes into account actual credit performance of the acquired loans to date and our best estimates for the expected lifetime credit performance of the loans using currently available information. Charge offs of the principal amount on acquired loans would be first applied to the non-accretable discount portion of the fair value adjustment. To the extent that we experience a deterioration in credit quality in our expected cash flows subsequent to the acquisition of the loans, an allowance for loan losses would be established based on our estimate of future credit losses over the remaining life of the loans.

Recognition of income from PCI loans is dependent on having a reasonable expectation about the timing and amount of cash flows expected to be collected. We perform such an evaluation on a quarterly basis on our PCI loans. To the extent that we cannot reasonably estimate cash flows, interest income recognition is discontinued.

Principal and interest payments on PCI loans that were written down to \$0 at the acquisition date are reported in the consolidated statements of income as gains on recovery of acquired loans.

Allowance for Loan Losses. The allowance for loan losses represents our best estimate of probable credit losses inherent in the loan portfolio. The adequacy of our allowance for loan losses is evaluated regularly. The allowance for loan losses is based upon management’s assessment of several factors including an assessment of probable losses included in the portfolio, giving consideration to the size and composition of the loan portfolio, actual loan loss experience, level of delinquencies, detailed analysis of specific loans for which full collectability may not be assured, the existence and estimated net realizable value of any underlying collateral and guarantees securing the loans, and current economic and market conditions. Although management uses the best information available, the level of the allowance for loan losses remains an estimate which is subject to significant judgment and short-term change. Various regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses. Such agencies may require us to make additional provisions for loan losses based upon information available to them at the time of their examination. Furthermore, the majority of our loans are secured by real estate in New Jersey or Pennsylvania. Accordingly, the collectability of a substantial portion of the carrying value of our loan portfolio is susceptible to changes in local market conditions and may be adversely affected by declines in real estate values. Future

adjustments to the allowance for loan losses may be necessary due to economic, operating, regulatory and other conditions beyond our control. We believe that our allowance for loan losses is adequate to cover probable loan losses which are specifically identifiable as well as losses inherent in our portfolio which are probable but not specifically identifiable.

For PCI loans, our allowance for loan losses is estimated based upon our expected cash flows of those acquired loans. To the extent that we experience a deterioration in borrower credit quality resulting in a decrease in our expected cash flows subsequent to the acquisition of the loans, an allowance for loan losses would be established based on our estimate of future credit losses over the remaining life of the loans.

For acquired loans accounted for under ASC 310-20, we establish our allowance for loan losses through a provision for loan losses based upon an evaluation process that is similar to our evaluation process used for originated loans. This evaluation, which includes a review of loans on which full collectability may not be reasonably assured, considers, among other matters, the estimated fair value of the underlying collateral, economic conditions, historical net loan loss experience, carrying value of the loans and other factors that warrant recognition in determining our allowance for loan losses.

Assessment of Other Than Temporary Impairment. Certain of our assets are carried in the consolidated statements of financial condition at fair value or at the lower of cost or fair value. Valuation allowances are established when necessary to recognize impairment of such assets. We periodically perform analyses to test for impairment of various assets. In addition to our impairment analyses related to loans, other real estate owned (“OREO”) and other repossessed assets, another significant analysis is related to other than temporary declines in the value of our securities. We conduct a quarterly review and evaluation of the investment securities portfolio, restricted stocks and other investments to determine if the value of any security has declined below its carrying value and whether such decline is other than temporary. If such decline is deemed other than temporary, we would adjust the carrying value of the security by writing down the security to fair value through a charge to current period earnings. We recorded no impairment losses for the periods presented in this report.

Intangible Assets. Our intangible assets consist of goodwill, core deposit intangibles and loan servicing intangible assets. The initial recording of goodwill and other intangible assets requires subjective judgments concerning estimates of the fair value of the acquired assets and assumed liabilities. Goodwill is not amortized but is subject to annual tests for impairment or more often if events or circumstances indicate it may be impaired. The goodwill impairment analysis is generally a two-step test. However, we may first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. We are not required to calculate the fair value of the reporting unit if, based on a qualitative assessment, it is determined that it was more likely than not that the unit’s fair value was not less than its carrying amount. The first step compares the fair value of the reporting unit with its carrying amount, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not impaired; however, if the carrying amount of the reporting unit exceeds its fair value, an additional step must be performed. That additional step compares the implied fair value of the reporting unit’s goodwill with the carrying amount of that goodwill. The implied fair value of goodwill is determined in a manner similar to the amount of goodwill calculated in a business combination, i.e., by measuring the excess of the estimated fair value of the reporting unit, as determined in the first step above, over the aggregate estimated fair values of the individual assets, liabilities, and identifiable intangibles, as if the reporting unit was being acquired in a business combination at the impairment test date. An impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. The loss establishes a new basis in the goodwill and subsequent reversal of goodwill impairment losses are not permitted.

Based on the economic uncertainty created as a result of the COVID-19 health pandemic, the Company performed a quantitative assessment of goodwill as of June 30, 2020. Based on that assessment, the Company determined that the reporting unit’s fair value was not less than its carrying amount at June 30, 2020.

Core deposit intangibles are amortized on an accelerated basis using an estimated life of 10 years. The core deposit intangibles are evaluated annually for impairment in accordance with U.S. GAAP. An impairment loss will be recognized if the carrying amount of the intangible asset is not fully recoverable and exceeds fair value. The carrying amount of the intangible asset is not considered fully recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use of the asset.

We believe that the fair values of our intangible assets were in excess of their carrying amounts and therefore there was no impairment to intangible assets at June 30, 2020.

Derivative Instruments and Hedging Activities. FASB ASC 815, *Derivatives and Hedging* (“ASC 815”), provides the disclosure requirements for derivatives and hedging activities with the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how the entity accounts for derivative instruments and related hedged items, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance, and cash flows. Further, qualitative disclosures are required that explain the Company’s objectives and strategies for using derivatives, as well as quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

As required by ASC 815, the Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company enters into derivative contracts that are intended to economically hedge certain of its risk, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

In accordance with the FASB's fair value measurement guidance in ASU 2011-04, the Company made an accounting policy election to measure the credit risk of its derivative financial instruments that are subject to master netting agreements on a net basis by counterparty portfolio.

Income Taxes. We are primarily subject to the income tax laws of the United States and the State of New Jersey. We are also subject to other state income tax laws where we conduct our business. We account for income taxes by recognizing the amount of taxes payable or refundable for the current year and deferred tax assets and liabilities for estimated future tax consequences, which require judgment with respect to events that have been recognized in our consolidated financial statements or tax returns. Fluctuations in the actual outcome of future tax consequences, including the recoverability of deferred tax assets, could materially impact our consolidated financial condition or results of operations.

On July 1, 2018, New Jersey adopted legislation requiring a combined group to file combined unitary returns for tax years beginning in 2019 and thereafter. The New Jersey Division of Taxation issued technical bulletins to provide clarification related to certain members of the unitary group with the most recent bulletin issued in the fourth quarter of 2019. As a result, we revalued some of our deferred tax assets. We recorded a state deferred tax expense of approximately \$730,000 in the fourth quarter of 2019 from that revaluation. In 2020 a 1.5% surtax was added to the state's 9% Corporation Business tax rate. We believe that our state tax planning strategies, based on our current assessment, will continue to be beneficial in 2020 and project that our overall effective tax rate will be approximately 24-25%.

The U.S. Tax Cuts and Jobs Act (the "Tax Act") was signed into law on December 22, 2017, which introduced significant changes to U.S. income tax law. Effective January 1, 2018, the Tax Act reduced the U.S. statutory corporate income tax rate from 35% to 21%.

As of June 30, 2020, we had net deferred tax assets of \$10.1 million. Our net deferred tax asset position reflects the revaluation of our deferred tax assets to account for the impact of a lower federal income tax rate as well as the impact of the aforementioned New Jersey state tax legislation changes. These deferred tax assets can only be realized if we generate taxable income in the future. We regularly evaluate the realizability of our deferred tax asset positions. In determining whether a valuation allowance is necessary, we consider the level of taxable income in prior years to the extent that carrybacks are permitted under current tax laws, as well as estimates of future pre-tax and taxable income and tax planning strategies that would, if necessary, be implemented. We expect to realize our deferred tax assets over the allowable carryback and/or carryforward periods. Therefore, no valuation allowance was deemed necessary against our deferred tax assets as of June 30, 2020. However, if an unanticipated event occurred that materially changed pre-tax and taxable income in future periods, a valuation allowance may become necessary and could have a material effect on our consolidated financial statements.

Recent Authoritative Accounting Guidance

See Note 1 of the Notes to Consolidated Financial Statements located elsewhere in this document for a description of recent authoritative accounting guidance including, if applicable, the respective dates of adoption and effects on the Company's consolidated financial condition and results of operations.

Results of Operations

Net Income

Net income for the three months ended June 30, 2020 was \$4.1 million, an increase of \$1.3 million, or 45.0%, compared to \$2.8 million for the same period in 2019. Diluted earnings per share was \$0.21 for the three month period ended June 30, 2020 compared to \$0.15 for the same period in 2019. The increase in net income was due to higher net interest income, principally interest income on loans and lower deposit costs, higher non-interest income and a lower effective tax rate, partially offset by higher provision for loan losses and increased non-interest expense. The increase in diluted earnings per share for the comparable periods was due to greater net income partially offset by the increase in diluted weighted average shares outstanding. The increase

in diluted weighted average shares outstanding was primarily the result of the Grand Bank acquisition on September 30, 2019 offset somewhat by the treasury shares purchased in 2020.

Net income for the six months ended June 30, 2020 and 2019 was \$7.4 million and \$7.1 million, respectively, or \$0.36 and \$0.38 per diluted share, respectively. The increase in net income was \$240,000 or 3.4% and the decrease in diluted earnings per share was \$0.02 or 5.3% for the comparative periods. Diluted weighted average common shares outstanding were 1.2 million higher for the six months ended June 30, 2020 compared to the same period in 2019 due primarily to higher average shares outstanding from the Grand Bank acquisition. Approximately 1.7 million shares were issued in that acquisition. The increase in shares was partially offset by the 1.0 million treasury shares purchased during the six months ended June 30, 2020. The increase in net income for the six month comparative period was primarily due to the same reasons described for the three-month comparative period.

The annualized returns on average assets (“ROAA”) and average equity (“ROAE”) for the three months ended June 30, 2020 were 0.74% and 7.33%, respectively, compared with 0.64% and 5.64%, respectively, for the same period in the prior year. Annualized ROAA and ROAE for the six months ended June 30, 2020 were 0.69% and 6.49%, respectively, compared with 0.81% and 7.19% for the same period in the prior year.

We also calculate net income, diluted earnings per share, ROAA and ROAE on an adjusted basis. We believe that this and our other non-U.S.GAAP financial measures, when used in conjunction with GAAP financial measures, provide useful information about operating results, enhance the overall understanding of past financial performance and future prospects, and allow for greater transparency with respect to the key metrics we use in our financial and operational decision making. These calculations do not include, for example, merger-related expenses or other non-core business related items such as a change in tax law. During the current quarter the adjusted net income calculation was changed from the way it was calculated in previous periods. Gains on recovery of acquired loans are no longer removed from adjusted net income as management has determined that these amounts have become part of our core operations and should not be removed in our adjusted totals. Excluding the impact of merger-related expenses, adjusted net income for the second quarter of 2019 was \$2.9 million and adjusted diluted earnings per share was \$0.15, adjusted ROAA was 0.66%, and adjusted ROAE was 5.82%. Adjusted net income for the six months ended June 30, 2019 was \$7.3 million, or \$0.38 adjusted diluted earnings per share, adjusted ROAA of 0.83% and adjusted ROAE of 7.37%. There were no merger-related expenses or other significant events that required adjustment to our three or six month ended June 30, 2020 results.

The following tables provide the calculation and reconciliation of these non-U.S. GAAP financial measures. These measures should not be directly compared to similarly titled measures reported by other companies, as we cannot guarantee other companies present similar measures in the same way. We believe these measures are useful to management and investors in monitoring our results of operations.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|----------------------------------------------------|---------------------------------------|-----------------|---------------------------|-----------------|
| | 2020 | 2019 | 2020 | 2019 |
| | (in thousands, except for share data) | | | |
| Net income | \$ 4,117 | \$ 2,840 | \$ 7,350 | \$ 7,110 |
| Add: Merger-related expenses (1) | - | 87 | - | 180 |
| Adjusted net income | <u>\$ 4,117</u> | <u>\$ 2,927</u> | <u>\$ 7,350</u> | <u>\$ 7,290</u> |
| Diluted weighted average common shares outstanding | 19,744,575 | 18,954,171 | 20,165,726 | 18,950,589 |
| Average assets | \$ 2,251,396 | \$ 1,782,832 | \$ 2,150,312 | \$ 1,765,215 |
| Average equity | \$ 225,905 | \$ 201,796 | \$ 227,187 | \$ 199,442 |
| Adjusted diluted earnings per share | \$ 0.21 | \$ 0.15 | \$ 0.36 | \$ 0.38 |
| Adjusted return on average assets (2) | 0.74% | 0.66% | 0.69% | 0.83% |
| Adjusted return on average equity (2) | 7.33% | 5.82% | 6.51% | 7.37% |

(1) Items are tax-effected using a federal income tax rate of 21%.

(2) Annualized.

Net Interest Income

Our results of operations depend primarily on our net interest income, the largest and most significant component of our operating income. Net interest income is the difference between income on our interest earning assets and the expense on interest bearing liabilities, primarily deposits. Net interest income depends upon the relative amounts and types of interest earning assets and interest bearing liabilities, and the interest rate earned or paid on them. Net interest income is also impacted by changes in interest

rates and the shape of market yield curves. Net interest spread is the difference between the weighted average rate received on interest earning assets and the weighted average rate paid to fund those interest earning assets.

The following tables provide an analysis of net interest income by each major category of average interest earning assets and average interest bearing liabilities, and the related average interest yields and costs for the periods indicated. Average yields are derived by dividing annualized interest income by the average balance of the related assets, and average costs are derived by dividing annualized interest expense by the average balance of the related liabilities. The average interest yields and costs include fees, costs, premiums and discounts, which are considered adjustments to interest rates.

| | Three Months Ended June 30, | | | | | |
|-----------------------------------------------------------------------|------------------------------------|------------------|-----------------------------|----------------------------|------------------|-----------------------------|
| | 2020 | | | 2019 | | |
| | Average Balance | Interest | Average Rate (5) | Average Balance | Interest | Average Rate (5) |
| Interest earning assets | | | | | | |
| Investment securities (1) (2) | \$ 105,248 | \$ 704 | 2.69% | \$ 94,021 | \$ 637 | 2.72% |
| Loans (3) | 1,905,227 | 21,088 | 4.45% | 1,528,231 | 19,412 | 5.09% |
| Interest bearing deposits with banks, Federal funds sold and other | 120,343 | 73 | 0.24% | 52,338 | 318 | 2.44% |
| Restricted investment in bank stocks | 6,584 | 92 | 5.62% | 6,899 | 86 | 5.00% |
| Other investments | 6,457 | 38 | 2.37% | 6,278 | 46 | 2.94% |
| Total interest earning assets (2) | 2,143,859 | 21,995 | 4.13% | 1,687,767 | 20,499 | 4.87% |
| Allowance for loan losses | (20,000) | | | (15,848) | | |
| Non-interest earning assets | 127,537 | | | 110,913 | | |
| Total assets | \$ 2,251,396 | | | \$ 1,782,832 | | |
| Interest bearing liabilities | | | | | | |
| Interest bearing demand deposits | \$ 164,325 | \$ 131 | 0.32% | 144,699 | \$ 256 | 0.71% |
| Money market deposits | 531,535 | 1,138 | 0.86% | 346,277 | 1,419 | 1.64% |
| Savings deposits | 135,805 | 268 | 0.79% | 75,039 | 135 | 0.72% |
| Time deposits | 634,281 | 3,028 | 1.92% | 629,054 | 3,472 | 2.21% |
| Total interest bearing deposits | 1,465,946 | 4,565 | 1.25% | 1,195,069 | 5,282 | 1.77% |
| Borrowings | 104,109 | 550 | 2.12% | 115,685 | 636 | 2.21% |
| Subordinated debentures | 32,515 | 536 | 6.59% | 21,893 | 398 | 7.27% |
| Total interest bearing liabilities | 1,602,570 | 5,651 | 1.42% | 1,332,647 | 6,316 | 1.90% |
| Non-interest bearing deposits | 406,498 | | | 232,444 | | |
| Other liabilities | 16,423 | | | 15,945 | | |
| Stockholders' equity | 225,905 | | | 201,796 | | |
| Total liabilities and stockholders' equity | \$ 2,251,396 | | | \$ 1,782,832 | | |
| Net interest income/interest rate spread (2) | | 16,344 | 2.71% | | 14,183 | 2.97% |
| Net interest margin (2) (4) | | | 3.07% | | | 3.37% |
| Tax equivalent adjustment (2) | | (16) | | | (19) | |
| Net interest income | | <u>\$ 16,328</u> | | | <u>\$ 14,164</u> | |

(1) Average balance of investment securities available for sale is based on amortized cost.

(2) Interest and average rates are tax equivalent using a federal income tax rate of 21%.

(3) Average balances of loans include loans on nonaccrual status.

(4) Net interest income divided by average total interest earning assets.

(5) Annualized.

Six Months Ended June 30,

| | 2020 | | | 2019 | | |
|-----------------------------------------------------------------------|---------------------|------------------|------------------|---------------------|------------------|------------------|
| | Average Balance | Interest | Average Rate (5) | Average Balance | Interest | Average Rate (5) |
| Interest earning assets | | | | | | |
| Investment securities (1) (2) | \$ 98,553 | \$ 1,348 | 2.75% | \$ 96,604 | \$ 1,307 | 2.73% |
| Loans (3) | 1,824,020 | 42,251 | 4.66% | 1,502,766 | 38,080 | 5.11% |
| Interest bearing deposits with banks, Federal funds sold and other | 105,815 | 343 | 0.65% | 58,219 | 694 | 2.40% |
| Restricted investment in bank stocks | 6,549 | 202 | 6.20% | 6,328 | 193 | 6.15% |
| Other investments | 6,438 | 81 | 2.53% | 6,255 | 89 | 2.87% |
| Total interest earning assets (2) | <u>2,041,375</u> | <u>44,225</u> | 4.36% | <u>1,670,172</u> | <u>40,363</u> | 4.87% |
| Allowance for loan losses | (18,761) | | | (15,676) | | |
| Non-interest earning assets | 127,698 | | | 110,719 | | |
| Total assets | <u>\$ 2,150,312</u> | | | <u>\$ 1,765,215</u> | | |
| Interest bearing liabilities | | | | | | |
| Interest bearing demand deposits | \$ 162,643 | \$ 293 | 0.36% | \$ 149,617 | \$ 518 | 0.70% |
| Money market deposits | 487,550 | 2,628 | 1.08% | 337,319 | 2,708 | 1.62% |
| Savings deposits | 131,215 | 590 | 0.90% | 79,552 | 270 | 0.68% |
| Time deposits | 647,024 | 6,440 | 2.00% | 630,900 | 6,732 | 2.15% |
| Total interest bearing deposits | 1,428,432 | 9,951 | 1.40% | 1,197,388 | 10,228 | 1.72% |
| Borrowings | 103,269 | 1,109 | 2.16% | 104,000 | 1,100 | 2.13% |
| Subordinated debentures | 27,244 | 934 | 6.86% | 21,879 | 796 | 7.28% |
| Total interest bearing liabilities | <u>1,558,945</u> | <u>11,994</u> | 1.55% | <u>1,323,267</u> | <u>12,124</u> | 1.85% |
| Non-interest bearing deposits | 347,539 | | | 225,854 | | |
| Other liabilities | 16,641 | | | 16,652 | | |
| Stockholders' equity | 227,187 | | | 199,442 | | |
| Total liabilities and stockholders' equity | <u>\$ 2,150,312</u> | | | <u>\$ 1,765,215</u> | | |
| Net interest income/interest rate spread (2) | | 32,231 | 2.81% | | 28,239 | 3.02% |
| Net interest margin (2) (4) | | | 3.18% | | | 3.41% |
| Tax equivalent adjustment (2) | | (32) | | | (40) | |
| Net interest income | | <u>\$ 32,199</u> | | | <u>\$ 28,199</u> | |

(1) Average balances of investment securities available for sale are based on amortized cost.

(2) Interest and average rates are tax equivalent using a federal income tax rate of 21%.

(3) Average balances of loans include loans on nonaccrual status.

(4) Net interest income divided by average total interest earning assets.

(5) Annualized.

Rate/Volume Analysis

Changes in net interest income and margin result from the interaction between the volume and composition of interest earning assets, interest bearing liabilities and related yields and funding costs. The following tables demonstrate the impact on net interest income of changes in the volume of interest earning assets and interest bearing liabilities and changes in interest rates earned and paid for the periods presented.

**Three Months Ended June 30,
2020 versus 2019
Increase (Decrease)
Due to Change in (1)**

| | <u>Average Volume</u> | <u>Average Rate</u> | <u>Net Change</u> |
|--------------------------------------------------------------------|---------------------------|-------------------------|-----------------------|
| | (in thousands) | | |
| Interest income | | | |
| Investment securities (2) | \$ 75 | \$ (8) | \$ 67 |
| Loans | 4,384 | (2,708) | 1,676 |
| Interest bearing deposits with banks, Federal funds sold and other | 193 | (438) | (245) |
| Restricted investment in bank stocks | (4) | 10 | 6 |
| Other investments | 1 | (9) | (8) |
| Total interest income (2) | <u>4,649</u> | <u>(3,153)</u> | <u>1,496</u> |
| Interest expense | | | |
| Interest bearing demand deposits | 31 | (156) | (125) |
| Money market deposits | 568 | (849) | (281) |
| Savings deposits | 119 | 14 | 133 |
| Time deposits | 29 | (473) | (444) |
| Total interest bearing deposits | <u>747</u> | <u>(1,464)</u> | <u>(717)</u> |
| Borrowings | (62) | (24) | (86) |
| Subordinated debentures | 178 | (40) | 138 |
| Total interest expense | <u>863</u> | <u>(1,528)</u> | <u>(665)</u> |
| Net interest income (2) | <u>\$ 3,786</u> | <u>\$ (1,625)</u> | <u>\$ 2,161</u> |

(1) Changes in interest income or expense attributable to both changes in volume and changes in rate have been allocated in proportion to the relationship of the absolute dollar amount of change in each category.

(2) Tax equivalent using a federal income tax rate of 21%.

**Six Months Ended June 30,
2020 versus 2019
Increase (Decrease)
Due to Change in (1)**

| | <u>Average Volume</u> | <u>Average Rate</u> | <u>Net Change</u> |
|--------------------------------------------------------------------|---------------------------|-------------------------|-----------------------|
| | (in thousands) | | |
| Interest income | | | |
| Investment securities (2) | \$ 26 | \$ 15 | \$ 41 |
| Loans | 7,642 | (3,471) | 4,171 |
| Interest bearing deposits with banks, Federal funds sold and other | 349 | (700) | (351) |
| Restricted investment in bank stocks | 7 | 2 | 9 |
| Other investments | 3 | (11) | (8) |
| Total interest income (2) | <u>8,027</u> | <u>(4,165)</u> | <u>3,862</u> |
| Interest expense | | | |
| Interest bearing demand deposits | 42 | (267) | (225) |
| Money market deposits | 978 | (1,058) | (80) |
| Savings deposits | 213 | 107 | 320 |
| Time deposits | 169 | (461) | (292) |
| Total interest bearing deposits | <u>1,402</u> | <u>(1,679)</u> | <u>(277)</u> |
| Borrowings | (8) | 17 | 9 |
| Subordinated debentures | 186 | (48) | 138 |
| Total interest expense | <u>1,580</u> | <u>(1,710)</u> | <u>(130)</u> |
| Net interest income (2) | <u>\$ 6,447</u> | <u>\$ (2,455)</u> | <u>\$ 3,992</u> |

(1) Changes in interest income or expense attributable to both changes in volume and changes in rate have been allocated in proportion to the relationship of the absolute dollar amount of change in each category.

(2) Tax equivalent using a federal income tax rate of 21%.

Lower loan yields and subsequent lower deposit costs reflect the impact of the Federal Reserve lowering the targeted federal funds rate 150 basis points in response to rapidly deteriorating economic conditions due to the COVID-19 health pandemic. In addition, results for the three and six months ending June 30, 2020 also reflect the impact of the 75 basis points reduction in the federal funds rate during the second half of 2019. During the first six months of 2020 we have strengthened our liquidity position based on current economic conditions, primarily deposits from the PPP loan program. We are addressing pressure on net interest income levels and margin compression by aggressively lowering deposit rates based on our strong liquidity position.

Our net interest margin on a tax equivalent basis was 3.07% for the three months ended June 30, 2020, compared to 3.37% for the same period in 2019. The net interest margin is calculated by dividing net interest income by average interest earning assets. The decrease in the margin compared to the prior year quarter was primarily the result of a lower average rate on interest earning assets of 74 basis points. The decrease in average rate was primarily due to lower average rates on loans and interest bearing deposits with banks. Partially offsetting the impact of lower earning asset yields was the reduction in average rates on interest bearing liabilities, primarily deposits, of 48 basis points.

For the six months ended June 30, 2020, our net interest margin on a tax equivalent basis was 3.18%, compared to 3.41% for the same period in 2019. Similar to the three month period, the decrease in the margin compared to the prior year period was primarily the result of a lower average rate on interest earning assets of 51 basis points. The decrease in average rate was primarily due to lower average rates on loans. Partially offsetting the impact of lower earning asset yields was the 30 basis points reduction in average rates on interest bearing liabilities, primarily deposits.

Impacting our tax equivalent margin for the three and six months ended June 30, 2020 was the level of PPP loans booked during the second quarter of 2020, prepayment penalty fees and business combination accounting accretion. For the quarter ended June 30, 2020 average PPP loans were approximately \$140.2 million and total interest and fees were approximately \$1.1 million or a yield of approximately 3.11% on these PPP loans. Excluding these balances would have improved the average rate on interest earning assets by 7 basis points. Prepayment penalty fees contributed to the margin 4 basis points and 6 basis points, respectively, for the three and six months ended June 30, 2020, compared to 3 and 4 basis points, respectively, for the same periods in 2019. Business combination accounting accretion contributed 7 and 9 basis points, respectively, to the margin for the three and six months ended June 30, 2020 compared to 7 and 8 basis points, respectively, for the same periods in 2019. In addition, in the second quarter of 2020 we carried interest expense on our new subordinated debt issue as well as our original subordinated debt issue for one month, as the original subordinated debt was not redeemed until June 30, 2020. The negative impact to the margin for the three months ended June 30, 2020 related to carrying the additional interest expense was 2 basis points.

Net interest income on a tax equivalent basis increased \$2.2 million, or 15.2%, to \$16.3 million for the three months ended June 30, 2020, compared to \$14.2 million for the same period in 2019. Net interest income on a tax equivalent basis increased \$4.0 million, or 14.1%, to \$32.2 million for the six months ended June 30, 2020, compared to \$28.2 million for the same period in 2019. Compared to the three and six month periods ended June 30, 2019, net interest income rose primarily due to higher interest income on loans as a result of loan growth. Also contributing to the increase in net interest income was lower interest expense on interest bearing deposits, due primarily to a much lower interest rate environment. This increase was partially offset by a decrease in the average rate on loans.

For the three month comparative periods, total interest income on a tax equivalent basis rose \$1.5 million, or 7.3%, to \$22.0 million for 2020, from \$20.5 million for 2019. Average loans for the comparative three month period increased \$377.0 million, or 24.7%. For the six month comparative periods, interest income on a tax equivalent basis rose \$3.9 million, or 9.6%, to \$44.2 million for 2020, from \$40.4 million for 2019. Average loans for the comparative six month periods increased \$321.3 million or 21.4%. The increase in average loans for the three and six months ended June 30, 2020 was driven by both organic and acquired loan growth, primarily in commercial loans. A significant portion of the growth during the second quarter of 2020 was related to PPP loans.

Interest and fees on loans for the three months ended June 30, 2020 totaled \$21.1 million, an increase of \$1.7 million, or 8.6%, compared to \$19.4 million for the same period in 2019. Interest and fees on loans for the six months ended June 30, 2020 totaled \$42.3 million, an increase of \$4.2 million, or 11.0%, compared to a total of \$38.1 million for the same period in 2019. The average loan yield for the three months ended June 30, 2020 was 4.45% compared to 5.09% for the same period in 2019. The average loan yield for the six months ended June 30, 2020 was 4.66% compared to 5.11% for the same period in 2019. Our loan yield is affected by competitive market rates and terms, the level of variable and adjustable rate loans, repayment or repricing of higher fixed rate loans, prepayment penalty fees on paid-off loans, the level of nonaccrual loans and other factors. The increase in interest and fees on loans during the three and six months ended June 30, 2020 compared to the same periods in 2019 was due primarily to a higher volume of commercial loans, partially offset by lower average rates. Interest and fees on loans include the impact of average PPP loans for the second quarter of 2020 of about \$140.2 million which contributed about \$1.1 million in additional interest and fee income for the three and six months ended June 30, 2020.

Average investment securities were \$105.2 million for the three months ended June 30, 2020 compared to \$94.0 million for the same period in 2019, an increase of \$11.2 million or 11.9%. Average investment securities were \$98.6 million, an increase of

\$1.9 million or 2.0%, for the six months ended June 30, 2020 compared to \$96.6 million for the same period in 2019. The average tax equivalent yield on investment securities for the three months ended June 30, 2020 decreased 3 basis points to 2.69% compared to 2.72% for the same period in 2019. The average yield on investment securities for the six months ended June 30, 2020 increased 2 basis points to 2.75% compared to 2.73% for the same period in 2019. Interest income on a tax equivalent basis on investment securities increased \$67,000 for the three month comparative periods due primarily to increasing average investment security balances, partially offset by a lower average yield. For the six month comparative period investment securities interest income increased \$41,000 due primarily to modestly higher average balances and rates. During the first six months of 2020 we have increased the purchase of investment securities to enhance on balance sheet liquidity as well as reduce the significantly higher level of excess liquidity in the first half of the year. Investments purchased in the second quarter of 2020 reflect the much lower yield curve. We expect interest rates to remain lower for some time due to the impact on the economy from COVID-19. We believe that purchasing investments, even at much lower yields than just six months ago, is a better option as excess liquidity is yielding 30 basis points or lower and expected to be there for some time. Investment purchases have primarily been in liquid residential mortgage-back securities (“MBS”) product. Should the interest environment change notably from current levels, these securities could be sold to create liquidity with the proceeds potentially invested in a higher rate environment or for other earning asset opportunities.

Average interest bearing liabilities, primarily deposits, increased \$269.9 million, or 20.3%, to \$1.60 billion for the three months ended June 30, 2020, compared to \$1.33 billion for the same period in 2019. The cost of average interest bearing liabilities decreased 48 basis points to 1.42% for the three months ended June 30, 2020 compared to 1.90% for the same period in 2019. Interest expense on average interest bearing liabilities decreased \$665,000, or 10.5%, for the three months ended June 30, 2020 compared to the same period in 2019. The decrease in interest expense for the three month comparative period was due primarily to a significantly lower interest rate environment. For the comparative three month period there were higher average interest bearing deposits of \$270.9 million at generally much lower rates. Interest expense on average interest bearing liabilities decreased by \$130,000 or 1.1% for the six months ended June 30, 2020 compared to the same period in 2019. During the first six months of 2020 the cost of interest bearing deposits has declined 32 basis points. The aggressive lowering of deposit rates will be reflected in a declining cost of funds for the remainder of the year.

Participation in the PPP lending program, as well as solid core deposit growth related to new and existing commercial banking relationships, resulted in significant growth in non-interest bearing deposits during the first six months of 2020. Non-interest bearing deposit growth of \$183.3 million for the first six months of 2020 positively contributed to higher net interest income and a lower cost of deposits.

We continue to evaluate the key variables that will impact net interest income and our margin over the next several months. Our commercial loan pipeline continues to be sound. It is difficult to assess, however, as the health pandemic continues, what level of loan growth we can expect over the next several months. Recent asset quality metrics have been sound. That said, asset quality continues to be closely monitored as COVID-19 concerns remain and what that may mean to our borrowers and ultimately the level of nonperforming assets.

We remain focused on lowering our cost of deposits to help offset some of the impact of lower loan and other earning asset yields. Time deposit costs will continue to decline over the next several months. In the third quarter of 2020, for example, approximately \$239 million in time deposits will reprice lower. Based on current time deposit rates being offered the cost of these funds should reprice lower by about 180 basis points. The repricing of these time deposits should help reduce our cost of deposits and boost our margin over the next several months. We also continue to build lower cost commercial deposits, a key strategic objective in helping build a sustainable healthy net interest margin.

Provision for Loan Losses

We provide for loan losses by a charge to current income to maintain the allowance for loan losses at an adequate level to absorb probable losses inherent in our loan portfolio.

The provision for loan losses for the second quarter of 2020 was \$3.0 million compared to \$1.7 million for the same period in 2019. The provision for loan losses for the first six months of 2020 was \$5.9 million compared to \$2.1 million for the same period in 2019. The higher provision for loan losses for the three and six month comparative periods was primarily due to a qualitative assessment of challenging economic conditions at June 30, 2020 and the resultant uncertainty in relation to potential losses due to the COVID-19 pandemic. Also contributing to the higher provision for the three and six months ended 2020 were net loan charge offs of \$1.0 million and \$1.7 million, respectively.

Our asset quality for the comparative periods presented has remained sound. Our ratio of nonperforming loans to total loans was 0.72% at June 30, 2020 compared to 1.32% at December 31, 2019 and 0.94% at June 30, 2019. The allowance for loan losses to total loans ratio was 1.10% at June 30, 2020 compared to 1.00% at December 31, 2019 and 1.08% at June 30, 2019. The allowance for loan losses to nonperforming loans ratio was 152.25% at June 30, 2020 compared to 75.81% at December 31, 2019 and 115.13% at June 30, 2019. See “Allowance for Loan Losses” elsewhere in this MD&A for additional information.

Non-Interest Income

Non-interest income consists primarily of income from service charges and related fees on deposit and loan accounts, bank-owned life insurance (“BOLI”) and fees for other banking services. Gains on the sale of loans, gains on recovery of acquired loans and net investment securities gains or losses also contribute to our level of non-interest income. For the three and six months ended June 30, 2020, non-interest income represented 10.3% and 8.8%, respectively, of our total net revenue, defined as net interest income plus total non-interest income. That compares to 6.1% and 5.4%, respectively, of our net revenue for the same periods in 2019. With the recent addition of new customers, both organically and through acquisition, we expect the level of non-interest income to grow from service fees on deposit accounts in connection with our growth in deposits. With our focus on net interest income generation, non-interest income is expected to remain a minor portion of our net revenue.

Non-interest income totaled \$1.9 million for the three months ended June 30, 2020, compared to \$924,000 for the same period in 2019, an increase of \$956,000. The increase in non-interest income for the three months ended June 30, 2020 compared to the same period in 2019 was primarily a result of increases in loan fees, primarily loan swap fees, income from BOLI and gains on recovery of acquired loans. Loan fees, income from BOLI and gains on recovery of acquired loans increased \$500,000, \$318,000 and \$106,000, respectively, for the comparative three month periods. The increase in BOLI was primarily due to the redemption of certain life insurance policies. For the six months ended June 30, 2020, non-interest income totaled \$3.1 million compared to \$1.6 million for the same period in 2019, an increase of \$1.5 million. The increase in non-interest income for the six months ended June 30, 2020 compared to the same period in 2019 was primarily a result of the same factors as for the three month period.

Non-Interest Expense

Non-interest expense consists primarily of salaries and employee benefits, occupancy and equipment expense and other expenses related to conducting our operations and growing our business. Such other expenses primarily include data processing fees, marketing expenses, loan origination expenses and expenses associated with the management of problem assets, including OREO, and regulatory and professional fees. Non-interest expense may also include merger-related expenses in connection with strategic acquisitions.

For the three months ended June 30, 2020, non-interest expense totaled \$9.8 million, which was \$640,000 or 7.0% higher than the same prior year period. The increase was primarily due to increases in occupancy and equipment expense, other professional fees, salaries and employee benefits, legal fees and regulatory fees, partially offset by lower marketing and advertising, travel and entertainment costs and merger-related expenses. For the three months ended June 30, 2019, merger-related expenses totaled \$110,000 related to the Grand Bank acquisition. Excluding merger-related expenses, non-interest expense would have been \$750,000 or 8.3% higher for the comparable period. The increase in the current year period compared to the comparable period in the prior year was primarily due to the increased expenses associated with the additional staff, locations and other expenses associated with the Grand Bank acquisition.

For the six months ended June 30, 2020, non-interest expense totaled \$19.7 million, \$1.6 million or 8.6% higher than the prior year period. The increase for the six months ended June 30, 2020 compared to the same prior year period was also primarily due to the same factors as the three month period. Excluding merger-related expenses non-interest expense would have been \$1.8 million higher or 10.0%.

Our largest component of non-interest expense is salaries and employee benefits. Salaries and employee benefits expense totaled \$5.3 million for the three months ended June 30, 2020 compared to \$5.1 million for the same period in 2019. Salaries and employee benefits expense was \$10.7 million for the six months ended June 30, 2020, compared to \$10.2 million for the same period in 2019. The increase in salaries and employee benefits expense was \$171,000, or 3.3%, for the three month comparative period and \$475,000 or 4.6%, for the six month comparative period. The respective increases for the three and six month comparative periods was primarily due to additional staffing related to the Grand Bank acquisition and higher health insurance costs. Over the last 18 months we have made enhancements to the structure of our loan and retail business development teams, which resulted in personnel cost savings partially offsetting additional staffing from the Grand Bank acquisition. Our full-time equivalent staff was 209 at June 30, 2020 compared to 195 at June 30, 2019 and down from 216 at December 31, 2019. The timing of adding new hires in 2020 has been extended reflective of the current business environment. In addition, seasonal interns used generally from May to August have been significantly reduced based on the impact of COVID-19.

Occupancy and equipment expense consists primarily of rent, real estate taxes, maintenance costs and expenses associated with equipment. Occupancy and equipment expense increased \$265,000, or 20.7%, for the three months ended June 30, 2020 compared to the prior year period. Occupancy and equipment expense increased \$320,000, or 12.1%, for the six months ended June 30, 2020 compared to the prior year period. The increase in the three and six month comparative periods was primarily due to the new locations added in the Grand Bank acquisition and related costs as well as increased costs associated with repairs, maintenance and cleaning throughout all of our facilities.

Other professional fees for the three months ended June 30, 2020 totaled \$569,000, an increase of \$209,000, or 58.1%, from \$360,000 for the comparable 2019 period. Other professional fees increased \$238,000, or 30.2%, for the six months ended June 30, 2020 compared to the prior year period. The increase in other professional fees for the three and six month comparative periods was due, in part, to consultants used to assist our PPP lending activity.

Legal fees for the three months ended June 30, 2020 totaled \$235,000 and were \$108,000 or 85.0% higher for the same period in 2019. Legal fees for the six months ended June 30, 2020 totaled \$455,000 and were \$216,000 or 90.4% higher for the same period in 2019. The increase was due primarily to higher loan workout costs and corporate expenses reflective of a larger bank.

Regulatory fees for the three months ended June 30, 2020 totaled \$277,000, an increase of \$100,000 or 56.5% for the same period in 2019. Regulatory fees increased \$216,000, or 73.5% for the six months ended June 30, 2020 compared to the prior year period. Increased regulatory fees were due to our growth and the expiration of FDIC assessment credits received in 2019.

Partially offsetting certain higher expense categories were lower marketing and advertising, travel and entertainment costs and merger-related expenses. Based on the impact of the health pandemic the marketing budget was reduced significantly. For the three and six months ending June 30, 2020 marketing and advertising costs were \$144,000 and \$225,000 lower, respectively, compared to the same prior year periods. Travel and entertainment costs declined as most employees were working from home with strict traveling restraints imposed by New Jersey and Pennsylvania due to COVID-19. Travel and entertainment costs for the three and six months ending June 30, 2020 were \$122,000 and \$132,000 lower, respectively, compared to the three and six month comparative periods in the prior year.

Effective non-interest expense management, as reflected in our efficiency ratio below, will continue to be our focus in this COVID-19 interest rate environment which is negatively impacting net interest income and our margin. Cost saving initiatives recently initiated are expected to slow the growth of non-interest expense moving forward. Non-interest expense numbers for 2020 will reflect the full year's impact of the September 30, 2019 Grand Bank acquisition.

Our efficiency ratio for the three months ended June 30, 2020 was 53.64% compared to 59.76% for the same period in 2019. Our efficiency ratio for the six months ended June 30, 2020 was 55.77% compared to 60.07% for the same period in 2019. With our focus on efficiency we continue to believe we can maintain our efficiency ratio under our targeted goal of 60%. The efficiency ratio is a non-U.S. GAAP financial measure that we believe is widely followed in the banking industry and is useful to our management and investors in evaluating our financial performance, measures adjusted non-interest expense, which excludes merger-related expenses, as a percentage of adjusted total revenue. This measure should not be directly compared to similarly titled measures reported by other companies, as we cannot guarantee other companies present similar measures in the same way.

The following table provides a reconciliation between U.S. GAAP measures (net interest income, non-interest income and non-interest expense) and the related non-U.S. GAAP measures (adjusted non-interest expense) to derive the efficiency ratio measure for the periods presented:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------------------------------|--------------------------------|-----------------|------------------------------|------------------|
| | 2020 | 2019 | 2020 | 2019 |
| | (dollars in thousands) | | | |
| Non-interest expense | \$ 9,767 | \$ 9,127 | \$ 19,682 | \$ 18,127 |
| Less: Merger-related expenses | - | 110 | - | 228 |
| Adjusted non-interest expense (numerator) | <u>\$ 9,767</u> | <u>\$ 9,017</u> | <u>\$ 19,682</u> | <u>\$ 17,899</u> |
| Net interest income | \$ 16,328 | \$ 14,164 | \$ 32,199 | \$ 28,199 |
| Non-interest income | 1,880 | 924 | 3,094 | 1,597 |
| Total revenue | 18,208 | 15,088 | 35,293 | 29,796 |
| Efficiency ratio | 53.64% | 59.76% | 55.77% | 60.07% |

Income Tax Expense

We recorded income tax expense of \$1.3 million for the three months ended June 30, 2020, compared to \$1.4 million for the same period in 2019. We recorded income tax expense of \$2.4 million for the first six months of 2020 compared to \$2.5 million for the same period in 2019. Modestly lower income tax expense was driven by a lower effective tax rate even as pre-tax income was higher for the comparative periods. Our effective tax rate for the three months ended June 30, 2020 was 24.7% compared to 33.0% for the same period in 2019. Our effective tax rate for the six months ended June 30, 2020 was 24.2% compared to 25.8% for the same period in 2019.

In May and December 2019, New Jersey issued clarifying statements on the new tax legislation enacted in July 2018, specifically related to the combined income tax reporting for certain members of a commonly-controlled unitary business group. These statements provided clarity on our New Jersey state tax liability and negatively impacted our effective tax rate in the second quarter of 2019. Our effective tax rate was also impacted in 2019 by certain non-deductible merger-related expenses associated

with the Grand Bank acquisition. Our 2019 and 2020 effective tax rate were impacted by certain other non-deductible expenses, including certain stock option expenses and certain meals and entertainment expenses. Our effective tax rates for the comparative periods presented also reflect the ownership of tax exempt BOLI and tax-free municipal securities which help to lower our effective tax rate. We believe that our current state tax planning strategies remain beneficial. We project our 2020 annual effective tax rate to be between 24% and 25% based on our current interpretation of New Jersey tax law and actions we have taken to lower our annual effective tax rate. Excluding our tax planning strategies, discrete items and non-taxable income and non-deductible expenses our effective tax rate for the three and six months ending June 30, 2020 and 2019 would have been 29.3% and 30.1%, which is the combined federal and state statutory income tax rate for a New Jersey bank. New Jersey taxes include a 1.5% surcharge in 2020 and a 2.5% surcharge in 2019.

FINANCIAL CONDITION

ASSETS

Total assets grew from \$2.01 billion at December 31, 2019 to \$2.30 billion at June 30, 2020, an increase of \$289.0 million, or 14.4%. This increase was primarily attributable to growth in commercial loans, primarily PPP loans and interest bearing deposits with banks. Growth was funded primarily by increases in non-interest bearing deposits and, to a lesser extent, interest bearing deposits.

Loans

Our loan portfolio consists primarily of commercial real estate and commercial and industrial loans. Total loans, not including net deferred loan fees and costs, increased from \$1.72 billion at December 31, 2019 to \$1.96 billion at June 30, 2020, an increase of \$237.2 million, net, or 13.7%. Commercial loans grew \$242.1 million, while our consumer and other loan segments grew \$4.4 million. Our residential real estate portfolio decreased \$9.3 million. Loan growth for the first six months of 2020 includes \$190.5 million in PPP loans. Non-PPP loan growth for the first six months of 2020 totaled \$46.7 million.

Total loans as of June 30, 2020 includes \$7.6 million in net deferred loan fees and costs compared to \$1.8 million at December 31, 2019. Included in that number as of June 30, 2020 is \$5.6 million in remaining net fees associated with the PPP loan program. Net deferred fees for the PPP loans are accounted for consistent with other deferred fees and will be amortized over the life of these loans, which are primarily 24-months. Any remaining net deferred fees or costs on loans that are forgiven or paid off are realized at the time of forgiveness or pay-off.

The following table reflects the composition of the loan portfolio as of the dates indicated:

| | <u>June 30, 2020</u> | <u>December 31, 2019</u> |
|-------------------------------------------------------------|----------------------|--------------------------|
| | (in thousands) | |
| Commercial and industrial | \$ 428,494 | \$ 239,090 |
| Commercial real estate: | | |
| Owner-occupied | 392,096 | 395,995 |
| Investor | 689,891 | 673,300 |
| Construction and development | 131,791 | 105,709 |
| Multi-family | 132,942 | 119,005 |
| Residential real estate: | | |
| Residential mortgage and first lien home equity loans | 117,796 | 123,917 |
| Home equity—second lien loans and revolving lines of credit | 29,371 | 32,555 |
| Consumer and other | 40,230 | 35,810 |
| | <u>1,962,611</u> | <u>1,725,381</u> |
| Net deferred loan fees and costs | (7,604) | (1,807) |
| Total loans | <u>\$ 1,955,007</u> | <u>\$ 1,723,574</u> |

At June 30, 2020, total commercial loans represented 90.8% of total loans. We manage risk associated with our commercial loan portfolio through disciplined underwriting policies and procedures, diversification and loan monitoring practices. In addition to real estate collateral, the majority of our commercial loans are secured by business assets and many are supported by personal guarantees and other assets of the principals or borrowers.

Our commercial and industrial loans typically consist of loans for working capital needs of small- to mid-sized businesses. Commercial and industrial loans increased by \$189.4 million, or 79.2%, to \$428.5 million at June 30, 2020, compared to \$239.1 million at December 31, 2019. Commercial and industrial loan growth includes the impact of PPP loans totaling \$190.5 million across a wide variety of industry classifications.

Commercial real estate loans, the largest component of our loan portfolio, are composed of owner-occupied, investor, construction and development, and multi-family loans. We endeavor to maintain a diversified real estate portfolio to protect against a potential downturn in any one business sector. Commercial real estate loans increased \$52.7 million, or 4.1%, to \$1.35 billion at June 30, 2020 compared to \$1.29 billion at December 31, 2019. The two largest components of our commercial real

estate portfolio are investor and owner-occupied loans. Investor commercial real estate loans increased \$16.6 million while owner-occupied commercial real estate loans decreased \$3.9 million during the first six months of 2020. Construction and development loans increased \$26.1 million while multi-family loans grew \$13.9 million during the first half of 2020. Construction and development and multi-family loans represented 6.7% and 6.1% of total loans, respectively, at June 30, 2020 and December 31, 2019.

Residential real estate loans totaled \$147.2 million at June 30, 2020 compared to \$156.5 million at December 31, 2019, a decrease of \$9.3 million. Residential mortgage and first lien home equity loans declined \$6.1 million while home equity-second lien loans and revolving lines of credit declined \$3.2 million from December 31, 2019 to June 30, 2020.

Consumer and other loans totaled \$40.2 million and \$35.8 million at June 30, 2020 and December 31, 2019, respectively. Consumer and other loans represented 2.1% of total loans at the dates presented, respectively.

Loan growth, excluding PPP loans, totaled \$46.7 million in the first half of 2020. Our commercial loan pipeline remains sound, however, as a result of the current health pandemic, future loan growth remains difficult to project. Our focus now is to work with our current borrowers through this difficult time which includes forbearance agreements, while providing credit for existing and new borrower relationships. Commercial loan growth remains an important contributor to increasing profitability and enhancing shareholder value.

COVID – 19 Response

The COVID-19 pandemic continues to have a negative impact on the local economies in New Jersey and eastern Pennsylvania. Economic conditions have improved somewhat but headwinds remain and the uncertainty of the severity of COVID-19 moving forward creates significant economic uncertainty.

Throughout the pandemic crisis we have performed additional analyses to better understand the risks associated with the various segments of our loan portfolio. Our loan portfolio is well diversified by industry and asset class. We have limited or no direct loan exposure to the following industries that have been some of the hardest hit by the COVID-19 pandemic: oil and gas (energy), credit cards, airlines, cruise ships, movie theaters, casinos, large shopping malls and leveraged loans.

Forbearance Program

We continue to monitor and analyze our COVID-19 related financial hardship payment deferrals (COVID-19 deferrals) based on asset class and borrower type. Through July 31, 2020, we have granted COVID-19 deferrals, primarily for 90 days, for a total of 611 loans representing approximately \$434.2 million of existing loan balances. This excludes loans that requested deferrals but were subsequently paid off or loans that continued to make regular payments throughout their deferral period. As of July 31, 2020, 444 loans totaling \$310.0 million of these deferred loans have already come due for their first payment since their 90 day deferral was put in place. Out of the 444 loans, 383 loans or \$248.4 million have made a payment in full and we anticipate regular payments will continue on these loans. We are working with the remainder of these customers and expect the majority will also get back on track with normal payments or will take an additional 90 day deferral. Early results are positive with 80.13% of COVID-19 deferrals that came due by July 31, 2020 now paying as agreed. While these trends are positive, future results will be dependent on the pandemic and its impact on the local business conditions in New Jersey and Pennsylvania.

We have focused on proactively working with our borrowers in the industries hardest hit by the COVID-19 pandemic. Our hospitality and restaurant loan portfolios totaled \$160.9 million at June 30, 2020 or 8.23% of total loans. Hospitality loans totaling \$59.0 million have received a COVID-19 related deferral out of a total of \$74.9 million total loans, or 79%. Of these COVID-19 deferred loans, as of July 31, 2020, loans totaling \$45.8 million have already come due for their first payment since their 90 day deferral was put in place. Of the \$45.8 million in loans, \$35.8 million have made a payment in full and we anticipate regular payments will continue on these loans. We are in discussions with the remainder of these early deferrals about either additional deferral time, return to partial payment, or return to full repayment. The total remaining deferred portfolio in the hospitality industry is \$23.2 million. Restaurant loans totaling \$41.5 million have received a COVID-19 related deferral out of a total of \$86.0 million total loans or 48%. Of these COVID-19 deferred loans, as of July 31, 2020, loans totaling \$36.4 million have already come due for their first payment since their 90 day deferral was put in place. Of the \$36.4 million, \$35.5 million have made a payment in full and we anticipate regular payments will continue on these loans. The total remaining deferred portfolio in the restaurant industry is \$6.1 million. The total remaining deferred portfolio for these two industries is \$29.3 million or 1.49% of the total loans as of June 30, 2020.

Requests for deferrals have significantly decreased and as of the July 31, 2020 date, the portfolio of deferred loans was \$185.7 million or 9.48% of the total loans as of June 30, 2020, a reduction of \$248.5 million, or 57%, compared to the peak deferral portfolio of \$434.2 million. If the remainder of the deferrals behave in a similar way to the initial 71.41% that reached the end of their 90-day deferral period by July 31, 2020, the entire deferral portfolio would be \$86.3 million, or 4.40% of total loans as of June 30, 2020.

Consistent with industry regulatory guidance, borrowers that were otherwise current on loan payments that were granted COVID-19 related financial hardship payment deferrals will continue to be reported as current loans throughout the agreed upon deferral period, will continue to accrue interest and will not be required to be accounted for as a troubled debt restructuring. This will also apply to borrowers that request a second 90 day deferral request.

Paycheck Protection Program (PPP)

We are a significant participant in the PPP. Through June 30, 2020 we submitted and received approval from the SBA for 1,128 PPP loans with a balance of \$190.5 million at June 30, 2020. We realized gross fees of \$6.9 million from the SBA from the origination of these loans. These fees, net of the associated direct origination costs of approximately \$519,000, are being accreted through interest income over the life of the PPP loans. Additional PPP loans have been submitted and approved subsequent to June 30, 2020 bringing our total balance of PPP loans to \$190.9 million as of July 31, 2020.

Nonperforming Assets and Troubled Debt Restructured Loans

Nonperforming assets consist of loans on a nonaccrual basis, loans 90 days or more past due and still accruing, OREO and other repossessed assets.

The following table reflects the composition of our nonperforming assets as of the dates indicated:

| | <u>June 30, 2020</u> | <u>December 31, 2019</u> |
|-------------------------------------------------------------|------------------------|--------------------------|
| | (dollars in thousands) | |
| Nonaccrual loans: | | |
| Commercial and industrial | \$ 6,817 | \$ 12,985 |
| Commercial real estate: | | |
| Owner-occupied | 2,561 | 5,693 |
| Investor | 506 | 662 |
| Multi-family | 717 | 730 |
| Residential real estate: | | |
| Residential mortgage and first lien home equity loans | 2,212 | 928 |
| Home equity—second lien loans and revolving lines of credit | 630 | 494 |
| Consumer and other | 58 | 61 |
| Total nonaccrual loans | <u>13,501</u> | <u>21,553</u> |
| Loans past due 90 days or more and still accruing | 581 | 1,195 |
| Total nonperforming loans | <u>14,082</u> | <u>22,748</u> |
| Other real estate owned, net | 1,142 | 1,363 |
| Total nonperforming assets | <u>\$ 15,224</u> | <u>\$ 24,111</u> |
| Performing troubled debt restructured loans | <u>\$ 513</u> | <u>\$ 526</u> |
| Nonaccrual loans to total loans | 0.69% | 1.25% |
| Nonperforming loans to total loans | 0.72% | 1.32% |
| Nonperforming assets to total assets | 0.66% | 1.20% |

Nonaccrual loans in the preceding table do not include PCI loans which were recorded at their fair value at acquisition and totaled \$5.7 million and \$6.0 million at June 30, 2020 and December 31, 2019, respectively.

Nonperforming loans totaled \$14.1 million or 0.72% of total loans at June 30, 2020, compared to \$22.7 million or 1.32% of total loans at December 31, 2019. The decrease in nonperforming loans was primarily due to a nonperforming commercial loan relationship totaling \$8.2 million being paid in full during the first quarter of 2020 after a small partial charge off of \$80,000.

OREO, net, totaled \$1.1 million at June 30, 2020 compared to \$1.4 million at December 31, 2019. At June 30, 2020 and December 31, 2019 we had no other repossessed assets. Nonperforming assets as a percentage of total assets were 0.66% at June 30, 2020 and 1.20% at December 31, 2019.

With continued economic uncertainty we are closely monitoring credit trends, particularly in our commercial portfolios. As a result of strong credit risk management and disciplined underwriting standards we are confident that the credit risk in our loan portfolio continues to be well managed. We continue to actively work to reduce nonperforming loans to maximize the collection of principal and interest and we believe asset quality remains sound. While recent trends are positive regarding the level of delinquencies and level of problem loans we can provide no assurance in this COVID-19 environment that these trends will continue.

Allowance for Loan Losses

The allowance for loan losses (the “allowance”) is maintained at a level considered adequate to absorb losses inherent in the loan portfolio. The level of the allowance is based on our evaluation of estimated losses in the portfolio, after consideration of risk

characteristics of the loans and prevailing economic conditions. The methodology for evaluating the adequacy of the allowance consists of several significant criteria, which include a specific allowance for identified impaired loans and a general allowance allocated to segments of the portfolio and homogeneous categories of loans which possess similar risk characteristics. The evaluation process for determining the adequacy of the allowance for loan losses takes place quarterly.

The following table provides information regarding loans charged off, loan recoveries, the provision for loan losses and the allowance for loan losses for each of the periods presented:

| | Six Months Ended | | Year Ended |
|-------------------------------------------------------------|-------------------------------|------------------|---------------------|
| | June 30, | | December 31, |
| | 2020 | 2019 | 2019 |
| | (dollars in thousands) | | |
| Balance—beginning of period | \$ 17,245 | \$ 15,135 | \$ 15,135 |
| Loans charged off: | | | |
| Commercial and industrial | (1,642) | (506) | (1,564) |
| Commercial real estate: | | | |
| Owner-occupied | - | (94) | (94) |
| Investor | - | (98) | (98) |
| Multi-family | (51) | - | (377) |
| Residential real estate: | | | |
| Residential mortgage and first lien home equity loans | (75) | - | (4) |
| Consumer and other | (7) | - | (18) |
| Total charge offs | <u>(1,775)</u> | <u>(698)</u> | <u>(2,155)</u> |
| Recoveries of loans previously charged off: | | | |
| Commercial and industrial | 15 | 31 | 70 |
| Commercial real estate: | | | |
| Owner occupied | 2 | 199 | 201 |
| Residential real estate: | | | |
| Home equity—second lien loans and revolving lines of credit | 43 | 3 | 10 |
| Consumer and other | 2 | - | - |
| Total recoveries | <u>62</u> | <u>233</u> | <u>281</u> |
| Net charge offs | <u>(1,713)</u> | <u>(465)</u> | <u>(1,874)</u> |
| Provision for loan losses | 5,909 | 2,086 | 3,984 |
| Balance—end of period | <u>\$ 21,441</u> | <u>\$ 16,756</u> | <u>\$ 17,245</u> |
| Annualized net charge offs to average loans | 0.19% | 0.06% | 0.12% |
| Allowance for loan losses to period-end loans | 1.10% | 1.08% | 1.00% |
| Allowance for loan losses to nonperforming loans | 152.26% | 115.13% | 75.81% |

The allowance for loan losses was \$21.4 million at June 30, 2020, compared to \$17.2 million at December 31, 2019. The provision for loan losses totaled \$5.9 million and net charge offs totaled \$1.7 million for the six months ended June 30, 2020. The allowance for loans losses constituted 1.10% of total loans at June 30, 2020, compared to 1.00% at December 31, 2019. Excluding PPP loans, which were allocated a very small reserve due to the limited risk in this portfolio, the allowance was 1.20% of total loans at June 30, 2020. The increase in the allowance for loan losses as a percentage of total loans was principally due to a qualitative assessment of deteriorating economic conditions at June 30, 2020 and the resultant uncertainty in relation to potential losses due to the COVID-19 pandemic. Management believes that the allowance for loan losses at June 30, 2020 is adequate in relation to losses inherent in the loan portfolio.

Annualized net charge offs as a percentage of average loans were 0.19% for the six months ended June 30, 2020 compared to annualized net charge offs of 0.06% for the six months ended June 30, 2019. Our allowance for loan losses as a percentage of nonperforming loans was 152.25% at June 30, 2020, compared to 75.81% at December 31, 2019. The increase in the percentage as of June 30, 2020 compared to December 31, 2019 was primarily due to the decrease in nonaccrual loans as discussed above and the comparatively higher provision for loan losses during the first six months of 2020 due to the uncertainties associated with the impact of COVID-19.

Investment Securities

The investment securities portfolio is used principally to assist in managing liquidity, interest rate risk and regulatory capital, and to take advantage of market opportunities that provide favorable returns with limited credit risk.

Investment securities totaled \$109.8 million or 4.8% of total assets at June 30, 2020, compared to \$94.1 million or 4.7% of total assets at December 31, 2019, an increase of \$15.7 million or 16.7%. The increase was primarily due to purchases of residential MBS, and, to a lesser extent, corporate bonds, partially offset by maturities of obligations of state and political subdivisions (“municipal bonds”) and principal cash flows on residential MBS. Investment securities were purchased during the first six months of 2020 to increase on balance sheet liquidity and reduce lower yielding excess liquidity.

The following tables present the composition of our investment securities available for sale and held to maturity as of the dates indicated:

| | June 30, 2020 | | | |
|-------------------------------------------------|---------------------------|---------------------------------------|----------------------------------------|-----------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| (in thousands) | | | | |
| Investment securities available for sale | | | | |
| Residential mortgage-backed securities: | | | | |
| Issued by FNMA and FHLMC | \$ 40,449 | \$ 874 | \$ (19) | \$ 41,304 |
| Issued by GNMA | 5,024 | 126 | - | 5,150 |
| U.S. Treasury securities | 8,985 | 83 | - | 9,068 |
| Asset-backed securities | 1,921 | - | (77) | 1,844 |
| Corporate obligations | 9,194 | 197 | - | 9,391 |
| Total | \$ 65,573 | \$ 1,280 | \$ (96) | \$ 66,757 |

| | December 31, 2019 | | | |
|-------------------------------------------------|---------------------------|---------------------------------------|----------------------------------------|-----------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| (in thousands) | | | | |
| Investment securities available for sale | | | | |
| Residential mortgage-backed securities: | | | | |
| Issued by FNMA and FHLMC | \$ 27,948 | \$ 103 | \$ (76) | \$ 27,975 |
| Issued by GNMA | 3,848 | - | (40) | 3,808 |
| U.S. Treasury securities | 8,960 | 26 | (2) | 8,984 |
| Asset-backed securities | 2,130 | - | (44) | 2,086 |
| Corporate obligations | 4,539 | 70 | - | 4,609 |
| Total | \$ 47,425 | \$ 199 | \$ (162) | \$ 47,462 |

| | June 30, 2020 | | | |
|-------------------------------------------------|---------------------------|---------------------------------------|----------------------------------------|-----------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| (in thousands) | | | | |
| Investment securities held to maturity | | | | |
| Residential mortgage-backed securities: | | | | |
| Issued by FNMA and FHLMC | \$ 8,321 | \$ 155 | \$ (4) | \$ 8,472 |
| Issued by GNMA | 919 | 18 | - | 937 |
| Obligations of state and political subdivisions | 13,773 | 290 | - | 14,063 |
| Corporate obligations | 20,000 | 319 | (1) | 20,318 |
| Total | \$ 43,013 | \$ 782 | \$ (5) | \$ 43,790 |

| | December 31, 2019 | | | |
|-------------------------------------------------|---------------------------|---------------------------------------|----------------------------------------|-----------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| (in thousands) | | | | |
| Investment securities held to maturity | | | | |
| Residential mortgage-backed securities: | | | | |
| Issued by FNMA and FHLMC | \$ 10,182 | \$ 27 | \$ (78) | \$ 10,131 |
| Issued by GNMA | 1,435 | - | - | 1,435 |
| Obligations of state and political subdivisions | 15,995 | 209 | - | 16,204 |
| Corporate obligations | 19,000 | 330 | - | 19,330 |
| Total | \$ 46,612 | \$ 566 | \$ (78) | \$ 47,100 |

The carrying value of our available for sale (“AFS”) investment securities portfolio at June 30, 2020 was \$66.8 million, an increase of \$19.3 million from \$47.5 million at December 31, 2019. The increase was primarily due to purchases of residential MBS and, to a lesser extent, corporate bonds, partially offset by principal cash flows from residential MBS. As of June 30, 2020, the AFS portfolio had net unrealized gains of \$1.2 million compared to \$37,000 at December 31, 2019.

HTM investment securities totaled \$43.0 million at June 30, 2020, compared to \$46.6 million at December 31, 2019, a decrease of \$3.6 million or 7.7%. The decrease in HTM securities was due to the maturity of tax-free municipal bonds and principal cash flows from our HTM MBS portfolio.

We evaluate quarterly all securities with unrealized losses to determine whether the losses are other than temporary. At June 30, 2020 and December 31, 2019, we determined that all unrealized losses were temporary in nature.

Mortgage-Backed Securities

We held \$54.7 million and \$43.4 million (amortized cost) of MBS at June 30, 2020 and December 31, 2019, respectively, in our AFS and HTM securities portfolios. All of these MBS were issued by the Federal National Mortgage Association (“FNMA”), Federal Home Loan Mortgage Corp (“FHLMC”), or Government National Mortgage Association (“GNMA”). We generally purchase MBS with average lives of less than five years in the base case with limited extension risk in a +300 basis point rate scenario. MBS are expected to provide stable cash flows or liquidity in rising or falling interest rate environments through the monthly payment of principal and interest. Principal paydowns from the MBS portfolio totaled \$7.7 million for the six months ended June 30, 2020. Like all securities we own, MBS are sensitive to changes in interest rates, increasing and decreasing in market value as interest rates rise and fall. As interest rates rise, cash flows from MBS prepayments generally decline while the durations extend. On the other hand, when interest rates fall, prepayments generally increase, which may reduce the yield on MBS with reinvestment of the proceeds generally at lower yields.

We continue to monitor the impact of changes in interest rates, cash flows and duration to our investment portfolio’s performance and adjust our strategy accordingly within asset and liability objectives.

LIABILITIES

Deposits

Total deposits increased from \$1.64 billion at December 31, 2019 to \$1.92 billion at June 30, 2020, an increase of \$282.4 million, or 17.2%. Non-interest bearing demand deposits increased \$183.3 million, or 66.5%, while interest bearing deposits increased \$99.1 million, or 7.3%. Interest bearing deposit growth for the first six months of 2020 was primarily due to increases in money market account deposits of \$158.6 million and to a lesser extent a \$23.5 million increase in savings deposits. This increase was partially offset by a decrease of \$77.2 million in time deposits and a \$5.9 million decrease in interest bearing demand deposits. Included in our total deposits was \$86.0 million of brokered deposits at June 30, 2020 compared to \$70.7 million at December 31, 2019.

A significant amount of the deposit growth during the second quarter of 2020 related to PPP loan proceeds that were deposited at the Bank. We expect these balances will be reduced during the third quarter of 2020, however, the PPP program helped us attract over 200 brand new customers in which we can cultivate core operating account relationships over the next few months. Our strategic focus continues to emphasize increasing lower cost core deposits and recent strong deposit growth has been led by commercial deposits. Recent enhancements to our cash management suite of products coupled with the new relationships cultivated via the PPP program will provide additional opportunities to further increase our commercial deposit base. We remain optimistic in further expanding our core deposit base during the second half of 2020.

Borrowings

Borrowings consist of FHLB advances and Paycheck Protection Program Liquidity Facility (“PPPLF”) borrowings. We are a member of the FHLB of New York and use FHLB advances as an alternative source of funds for loan growth and to manage liquidity and interest rate risk. Our FHLB advances are collateralized by eligible investment securities and qualified commercial real estate loans. FHLB advances totaled \$102.3 million at June 30, 2020 compared to \$105.5 million at December 31, 2019. As of June 30, 2020 we have \$2.6 million in PPPLF borrowings, used to fund PPP loans when needed. We had no PPPLF borrowings as of December 31, 2019.

Subordinated Debentures

On May 29, 2020 we completed a \$30.0 million private placement of fixed-to-floating rate subordinated debentures. The notes have a maturity date of June 1, 2030 and carry a fixed interest rate of 5.50% for the first five years. Thereafter, the notes will pay interest at SOFR plus 5.38%. The notes include a right of prepayment, without penalty, on or after June 1, 2025. The subordinated debentures qualify as Tier II capital for regulatory capital purposes. Our subordinated debentures, net, totaled \$29.5 million at June 30, 2020 and \$22.0 million at December 31, 2019, which includes \$525,000 of debt issuance costs at June 30, 2020 which are being amortized over the expected life of the May 29th issue. The average rate on our subordinated debentures was 6.59% and 6.86% for the three and six months ended June 30, 2020, compared to 7.27% and 7.28% for the three and six months ended June 30, 2019.

On June 30, 2020 we redeemed our outstanding \$22.0 million 6.75% fixed-to-floating rate subordinated debentures due May 1, 2025, without penalty. Since May 1, 2020 the interest paid on these debentures was based on 3-month LIBOR plus 5.30% or 6.74% through June 30, 2020.

Liquidity

Our liquidity is a product of our operating, investing and financing activities. Our principal sources of funds include deposits, scheduled amortization and prepayments of loan principal, principal cash flows from mortgage-backed securities, and funds provided by operations. While scheduled loan payments and principal cash flows from residential MBS are relatively predictable sources of funds, deposit flow and loan prepayments are greatly influenced by general interest rates, economic conditions and competition.

As of June 30, 2020, our liquid assets (cash and cash equivalents and eligible unpledged securities) totaled \$170.7 million, or 7.4% of total assets, compared to \$125.9 million, or 6.3% of total assets, at December 31, 2019. Our cash and cash equivalents increased \$42.4 million from \$81.8 million at December 31, 2019, to \$124.2 million at June 30, 2020. The increase was primarily a result of deposit growth outpacing loan growth which enhanced our excess overnight liquidity position as of June 30, 2020. At June 30, 2020, our liquid assets remained at a level management deemed adequate to ensure that contractual liabilities, depositors' withdrawal requirements, customer credit needs and other operational requirements could be satisfied.

As a member of the FHLB, we are eligible to borrow funds up to 50% of total assets from the FHLB, subject to its collateral requirements. Based on available eligible securities and qualified commercial real estate loan collateral, as of June 30, 2020 we had the ability to borrow \$152.0 million. We have additional borrowing capacity of \$80.0 million through three correspondent banks. We also participate in the PPPLF with the Federal Reserve Bank of Philadelphia. The PPPLF is a facility which extends credit to banks that originate PPP loans, taking the loans as collateral at face value. At June 30, 2020 we had borrowed only \$2.6 million from this facility.

At June 30, 2020, our outstanding commitments to extend credit totaled \$230.9 million.

We have established reliable secondary sources of liquidity that we can use as needed. Liquidity is also supported by cash flows from our investment and loan portfolios. Based on projected loan and deposit growth, we expect liquidity to remain adequate to support our operations.

CAPITAL AND REGULATORY MATTERS

In October 2019 we implemented a share repurchase program. The share repurchase program allowed for the repurchase of up to 1.0 million shares of our common stock in the open market. We repurchased all of the approved 1.0 million shares of common stock during the first six months of 2020 for an aggregate purchase price of \$7.9 million or an average price of \$7.88 per share. We currently have no plans to expand our authorization to repurchase shares of our common stock.

Stockholders' Equity

Total stockholders' equity increased modestly from \$226.4 million at December 31, 2019 to \$226.5 million at June 30, 2020, an increase of \$57,000 or 0.03%. The increase was primarily the result of \$7.4 million in net income, stock option activity of \$958,000 and an increase in accumulated other comprehensive income of \$836,000, partially offset by the purchase of \$7.9 million in treasury stock and \$1.2 million in cash dividends during the first six months of 2020.

Our tangible stockholders' equity ratio was 9.12% as of June 30, 2020 and 10.44% as of December 31, 2019. Tangible stockholders' equity excludes intangible assets. The tangible stockholders' equity ratio is a non-U.S. GAAP financial measure that we believe provides management and investors with information that is useful in understanding our financial performance and condition. This measure should not be directly compared to similarly titled measures reported by other companies, as we cannot guarantee other companies present similar measures in the same way.

The following table provides a reconciliation and calculation of the non-U.S. GAAP tangible stockholders' equity ratio:

| | <u>June 30, 2020</u> | <u>December 31, 2019</u> |
|-------------------------------------------------|-------------------------------|--------------------------|
| | (dollars in thousands) | |
| Stockholders' equity | \$ 226,450 | \$ 226,393 |
| Less: Goodwill and other intangible assets, net | 18,192 | 18,336 |
| Tangible stockholders' equity (numerator) | <u>\$ 208,258</u> | <u>\$ 208,057</u> |
| | | |
| Total assets | \$ 2,300,594 | \$ 2,011,587 |
| Less: Goodwill and other intangible assets, net | 18,192 | 18,336 |
| Adjusted total assets (denominator) | <u>\$ 2,282,402</u> | <u>\$ 1,993,251</u> |
| | | |
| Tangible stockholders' equity ratio | 9.12% | 10.44% |

Accumulated Other Comprehensive Income (Loss)

Our accumulated other comprehensive income or loss position is impacted by net unrealized gains or losses on investment securities available for sale. Based on changes in the U.S. Treasury yield curve, AFS securities values moved higher at June 30, 2020 compared to December 31, 2019. At June 30, 2020, the AFS portfolio had net unrealized gains, net of tax, of \$863,000 compared to \$27,000 in unrealized gains, net of tax, at December 31, 2019.

Regulatory Capital

We are subject to various regulatory capital requirements administered by the federal banking agencies. Under capital adequacy guidelines and the regulatory framework for prompt corrective action we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices.

Effective January 1, 2015 (with some changes transitioned into full effectiveness over two to four years), we became subject to new capital requirements due to substantial amendments to the previous capital regulations. These amended regulations implemented the BASEL III regulatory capital reforms and changes required by the Dodd-Frank Act. The requirements created a required ratio for common equity Tier 1 ("CET1") capital, increased the leverage and Tier 1 capital ratios, changed the risk weight of certain assets for purposes of the risk-based capital ratios, created an additional capital conservation buffer over the required capital ratios and changed what qualifies as capital for purposes of meeting these various capital requirements.

Under the new capital regulations, the minimum capital ratios are: (i) a Tier 1 leverage ratio of 4.0%; (ii) CET1 capital of 4.5% of risk-weighted assets; (iii) Tier 1 capital of 6.0% of risk-weighted assets; and (iv) total capital of 8.0% of risk-weighted assets. CET1 generally consists of common stock and retained earnings, subject to applicable regulatory adjustments and deductions.

The required capital conservation buffer consists of additional CET1 capital greater than 2.5% of risk-weighted assets above the required minimum levels. We must maintain such buffer in order to avoid limitations on paying dividends, engage in share repurchases, and pay discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. This capital conservation buffer requirement was phased in over four years. At January 1, 2016 it started at 0.625% of risk-weighted assets and has increased by 0.625% until it was fully implemented in January 2019. The fully phased in capital conservation buffer is 2.5%. The regulatory prompt corrective action standards also changed effective January 1, 2016. Under these standards, in order to be considered well-capitalized, the Company must have: (i) a Tier 1 leverage ratio of 5.0%; (ii) CET1 capital of 6.5% of risk-weighted assets; (iii) Tier 1 capital of 8.0% of risk-weighted assets; and (iv) total risk-based capital of 10.0% of risk-weighted assets. Our capital amounts and classification are subject to qualitative adjustments by the regulators about components, risk weightings and other factors.

The following tables provide our regulatory capital amounts and ratios as well as the required regulatory minimums as of the dates indicated:

| | Actual | | Minimum For Capital Adequacy Purposes | | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|------------------------------|---------------|--------------|------------------------------------------------------|--------------|-------------------------------------------------------------------------------------------------|--------------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| At June 30, 2020 | | | | | | |
| Tier 1 leverage capital | \$ 206,543 | 9.26% | \$ 89,223 | 4.00% | \$ 111,529 | 5.00% |
| Common equity tier 1 capital | 206,543 | 10.37% | 89,644 | 4.50% | 129,486 | 6.50% |
| Tier 1 risk-based capital | 206,593 | 10.37% | 119,526 | 6.00% | 159,368 | 8.00% |
| Total risk-based capital | 257,643 | 12.93% | 159,368 | 8.00% | 199,210 | 10.00% |
| At December 31, 2019: | | | | | | |
| Tier 1 leverage capital | \$ 207,147 | 10.27% | \$ 80,716 | 4.00% | \$ 100,895 | 5.00% |
| Common equity tier 1 capital | 207,147 | 10.74% | 86,772 | 4.50% | 125,337 | 6.50% |
| Tier 1 risk-based capital | 207,147 | 10.74% | 115,695 | 6.00% | 154,260 | 8.00% |
| Total risk-based capital | 246,534 | 12.79% | 154,260 | 8.00% | 192,826 | 10.00% |

At June 30, 2020 and December 31, 2019, we were well-capitalized for regulatory purposes and met the requirements for maintaining the capital conservation buffer.

Some Specific Factors Affecting Future Results of Operations

Future movement of interest rates cannot be predicted with certainty. Our interest rate risk profile is positioned in such a way that moderate increases in interest rates likely will not have a significant impact on our results of operations. However, because overall future performance is dependent on many other factors, past performance is not necessarily an indication of future results.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

The Alternative Reference Rates Committee ("ARRC") has proposed that the Secured Overnight Funding Rate ("SOFR") replace USD-LIBOR. ARRC has proposed that the transition to SOFR from USD-LIBOR will take place by the end of 2021. The Company has material contracts that are indexed to USD-LIBOR. Industry organizations are currently working on the transition plan. The Company is currently monitoring this activity and evaluating the risks involved.

The Company manages interest rate risk by identifying and quantifying interest rate risk exposures through the use of net interest income simulation and economic value at risk ("EVE") models. Various assumptions are used to produce these analyses, including, but not limited to, the rates paid on interest bearing nonmaturity deposits relative to market interest rates, the level of new and existing business, loan and investment prepayment speeds, the shape of the yield curve and competitive pricing.

Interest Rate Sensitivity Analysis

The Company's simulation model measures the volatility of net interest income to changes in market interest rates by modeling interest income and interest expense dynamically over specified time periods under different interest rate scenarios. The table below sets forth the Company's exposure to interest rate risk as measured by the change in net interest income for the next twelve months with a static balance sheet under various interest rate shocks as of June 30, 2020 and December 31, 2019:

| | Net Interest Income | | | |
|-----------------------|------------------------|----------|-------------------|----------|
| | June 30, 2020 | | December 31, 2019 | |
| | Amount | % Change | Amount | % Change |
| | (dollars in thousands) | | | |
| Rate Shock (1) | | | | |
| + 400 | \$ 66,812 | (7.4%) | \$ 59,854 | (5.7%) |
| + 300 | 67,666 | (6.2%) | 60,758 | (4.2%) |
| + 200 | 68,513 | (5.1%) | 61,674 | (2.8%) |
| + 0 (Static) | 72,161 | - | 63,441 | - |
| - 200 | 71,970 | (0.3%) | 64,487 | 1.6% |

(1) Change in interest rates in basis points.

Economic Value At Risk

The Company's EVE model projects the Company's asset and liability cash flows to their maturity dates, discounting those cash flows at appropriate interest rates, and then aggregating the discounted cash flows. EVE is the estimated net present value of assets less the net present value of liabilities. Market rates are adjusted up and down in the model to calculate the various levels of EVE with interest rate changes. The variance in the economic value of equity is measured as a percentage of the present value of equity. The sensitivity of EVE to changes in the level of interest rates is a measure of potential market value risk. The Company uses the sensitivity of EVE principally to measure the exposure of equity to changes in interest rates over a relatively long time horizon. The table below sets forth the Company's exposure to interest rate risk as measured by the change in EVE under various interest rate shocks as of June 30, 2020 and December 31, 2019:

| | Economic Value of Equity | | | |
|-----------------------|--------------------------|----------|-------------------|----------|
| | June 30, 2020 | | December 31, 2019 | |
| | Amount | % Change | Amount | % Change |
| | (dollars in thousands) | | | |
| Rate Shock (1) | | | | |
| + 400 | \$ 243,729 | (11.0%) | \$ 222,830 | (18.9%) |
| + 300 | 251,351 | (8.2%) | 234,727 | (14.6%) |
| + 200 | 260,175 | (5.0%) | 247,223 | (10.0%) |
| + 0 (Static) | 273,855 | - | 274,808 | - |
| - 200 | 256,566 | (6.3%) | 275,834 | 0.4% |

(1) Change in interest rates in basis points.

All methods used to measure interest rate sensitivity involve the use of assumptions, which may tend to oversimplify the manner in which actual yields and costs respond to changes in market interest rates. Actual outcomes could differ significantly from the simulation outcomes. The Company's interest rate sensitivity should be reviewed in conjunction with the consolidated financial statements and notes thereto in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2019.

Item 4. Controls and Procedures.

(a) Evaluation of Disclosure Controls and Procedures.

First Bank's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934). Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were not effective as of June 30, 2020 as a result of the material weakness fully described in First Bank's Annual Report on Form 10-K for the fiscal year ended December 31, 2019. However, after giving full consideration to this material weakness, and the additional analyses and other procedures that we performed to ensure that our consolidated financial statements included in this Form 10-Q were prepared in accordance with U.S. GAAP, our management has concluded that our consolidated financial statements present fairly, in all material respects, our financial position, results of operations and cash flows for the periods disclosed in conformity with U.S. GAAP.

As previously described in Part II, Item 9A of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2019, management is implementing measures designed to ensure that control deficiencies contributing to the material weakness are remediated, such that these controls are designed, implemented, and operating effectively. The material weakness will not be considered remediated, however, until the applicable controls operate for a sufficient period of time and management has concluded, through testing, that these controls are operating effectively. Management expects the remediation of this material weakness will be completed during 2020.

(b) Changes in internal control over financial reporting.

Management has continued to remediate the underlying causes of the material weakness as disclosed in Part II, Item 9A of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2019. Other than the plan for remediation, there have been no changes in the Company's internal control over financial reporting during the quarter ended June 30, 2020 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

First Bank is party in the ordinary course of business to litigation involving collection matters, contract claims and other miscellaneous causes of action arising from their business. Management does not consider that any such proceedings depart from usual routine litigation, and in its judgment neither the Company's consolidated financial condition nor its results of operations will be affected materially by any present proceedings.

Item 1A. Risk Factors.

There have been no material changes to the risk factors disclosed in Item 1A. in First Bank's Annual Report on Form 10-K for the fiscal year ended December 31, 2019 as filed with the FDIC, other than the risk factors set forth below.

The outbreak of COVID-19 has and may continue to adversely impact our business and results of operations, and could have an adverse impact on our financial condition and capital levels, any of which could be material. Further, the continued spread of the outbreak could lead to a prolonged economic recession or other severe disruptions in the U.S. economy, may disrupt banking and other financial activity in the areas in which we operate and could potentially create widespread business continuity issues for us.

The continued spread of COVID-19 has had a significant economic impact on the communities in which we operate, our borrowers and depositors, and the national economy generally, including a severe curtailment of business activity and widespread levels of unemployment in the markets in which we operate. We expect this impact to worsen and last for a significant and indeterminate period. These developments have adversely affected our business and results of operations, and we believe they could adversely impact our financial condition and capital levels, the amounts of which cannot be determined and could be material. In particular, certain of our borrowers and depositors are in or have exposure to industries that have reduced or suspended operations, or are located in areas that have been subject to stay-at-home orders. A prolonged stay-at-home order, or any other continued decrease in economic activity as a result of COVID-19, would have a negative adverse impact on our borrowers and their financial condition, which could impact their ability to meet their financial obligations and could result in elevated levels of delinquencies, defaults, foreclosures and loan losses. In addition, Federal Reserve actions to combat the economic contraction caused by the COVID-19 pandemic, including the reduction of the targeted federal funds rate and quantitative easing programs, could, if prolonged, adversely affect our net interest income and margins, and our profitability. For additional information, please see the specific "COVID-19 Response" disclosure under "Financial Condition" of this Form 10-Q.

In addition, the COVID-19 pandemic could have a material impact on our operations. We rely upon our third-party vendors to conduct business and to process, record and monitor transactions. If any of these vendors are unable to continue to provide us with these services, it could negatively impact our ability to serve our customers. Furthermore, the outbreak could negatively impact our employees and customers' ability to engage in banking and other financial transactions and could create widespread business continuity issues for us. We also could be adversely affected if key personnel or a significant number of employees were to become unavailable due to the effects and restrictions of a COVID-19 outbreak in our market areas.

Further, we have face increased cybersecurity risks due to the shifting of a majority of our corporate office functions to operating remotely in regions impacted by stay-at-home orders. Increased levels of remote access create additional opportunities for cybercriminals to attempt to exploit vulnerabilities, and our employees may be more susceptible to phishing and social engineering attempts due to increased stress caused by the crisis and from balancing family and work responsibilities at home. In addition, our technological resources may be strained due to the number of remote users.

The extent to which the COVID-19 pandemic and any resultant economic downturn impacts our business, operations, and financial results is uncertain and will depend on numerous evolving factors that are outside our control and we may not be able to accurately predict, including the duration and scope of the pandemic and the governmental, business and individual actions taken in response to the pandemic and the impact of those actions on global economic activity.

Our participation in the SBA's PPP may expose us to reputational harm, increased litigation risk, as well as the risk that the SBA may not fund some or all of the guarantees associated with PPP loans.

As of July 31, 2020, we have originated loans aggregating \$190.9 million through the PPP. Lenders participating in the PPP have faced increased public scrutiny about their loan application process and procedures, and the nature and type of the borrowers receiving PPP loans. We depend on our reputation as a trusted and responsible financial services company to compete effectively in the communities that we serve, and any negative public or customer response to, or any litigation or claims that might arise out of our participation in the PPP and any other legislative or regulatory initiatives and programs that may be enacted in response to the COVID-19 pandemic, could adversely impact our business. Other larger banks have been subject to litigation regarding the process and procedures that such banks used in processing applications for the PPP, and we may be subject to the same or similar litigation. In addition, if the SBA determines that there is a deficiency in the manner in which a PPP loan was originated, funded, or serviced by us, the SBA may deny its liability under the guaranty, reduce the amount of the guaranty, or, if it has

already paid under the guaranty, seek recovery of any loss related to the deficiency from us.

Changes to or the discontinuation of LIBOR may adversely affect our business and results of operations.

The interest rates of certain of our loans and investment securities are indexed to LIBOR. The United Kingdom's Financial Conduct Authority, which is responsible for regulating LIBOR, has announced that the publication of LIBOR is not guaranteed beyond 2021 and it appears highly likely that LIBOR will be discontinued or modified by the end of 2021. At this time, no consensus exists as to which reference rate or rates or benchmarks may become acceptable alternatives to LIBOR, although the Alternative Reference Rates Committee, a group of market participants convened by the Federal Reserve Board and the Federal Reserve Bank of New York, has identified SOFR as the recommend alternative to LIBOR. Uncertainty as to the adoption, market acceptance or availability of SOFR, or other alternative reference rates, may adversely affect the value of LIBOR-based loans and investment securities in our portfolio. The implementation of a substitute index for the calculation of interest rates under our loan agreements may result in the incurrence of material expenses in effecting the transition and may result in disputes or litigation with customers over the appropriateness or comparability to LIBOR of the substitute index, any of which could have an adverse effect on our results of operations.

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

On May 20, 2020, 1,000 shares of Common Stock were issued to an officer of First Bank upon the exercise of outstanding options to purchase such shares having an average exercise price of \$5.00. The aggregate proceeds from such issuances were \$5,000. On June 17, 2020, 10,000 shares of Common Stock were issued to an officer of First Bank upon the exercise of outstanding options to purchase such shares having an exercise price of \$5.00. The aggregate proceeds from such issuances were \$50,000.

The table below summarizes the number of shares of the Company's common stock that were repurchased during the six months ended June 30, 2020.

| Month Ended | Total Number of Shares Purchased (1) | Average Price Paid Per Share | Maximum Number of Shares that May Yet Be Purchased under the Program |
|--------------------|---------------------------------------------|-------------------------------------|-----------------------------------------------------------------------------|
| January 31, 2020 | 50,000 | \$ 10.30 | 950,000 |
| February 29, 2020 | 63,010 | \$ 10.53 | 886,990 |
| March 31, 2020 | 329,126 | \$ 8.20 | 557,864 |
| April 30, 2020 | 430,170 | \$ 7.03 | 127,694 |
| May 31, 2020 | 127,694 | \$ 7.67 | - |
| Total | <u>1,000,000</u> | \$ 7.88 | |

(1) *As announced on October 23, 2019, the Board of Directors of the Company approved a stock repurchase program, authorizing the repurchase of up to an aggregate of 1.0 million shares of the Company's common stock. All shares were purchased under this program. The program allowed the Company to repurchase shares of common stock from time to time for cash in the open market or privately negotiated transactions or other transactions, as market and business conditions warrant and subject to applicable legal requirements. The stock repurchase program did not obligate the Company to repurchase any particular amount of common stock. The Company has exhausted the share repurchases under this program and currently does not have any other approved stock repurchase plans.*

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

None.

Item 6. Exhibits.

An Exhibit Index has been filed as part of this report and is incorporated herein by reference.

SIGNATURES

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

Date: August 10, 2020

FIRST BANK
(Registrant)

/s/ Stephen F. Carman
Stephen F. Carman
Executive Vice President, Treasurer
and Chief Financial Officer

Exhibit Index

| Exhibit No. | Description of Exhibit |
|-------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 2.1 | Agreement and Plan of Reorganization, dated March 19, 2019, between First Bank and Grand Bank, N.A. (incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K filed by the registrant with the FDIC on March 19, 2019) |
| 3.1 | First Restated Certificate of Incorporation of First Bank (incorporated by reference to Exhibit 3.1 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2019 filed by the registrant with the FDIC on March 27, 2020) |
| 3.2 | Amended and Restated Bylaws of First Bank (incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K filed by the registrant with the FDIC on February 19, 2020) |
| 31.1* | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2* | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1+ | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Rule 13a-14(b) or Rule 15d-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350 |
| * | Filed herewith |
| + | Furnished herewith |

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO RULE 13A-14(A) OR RULE 15D-14(A) AND SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002

I, Patrick L. Ryan, Chief Executive Officer of First Bank, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of First Bank;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 10, 2020

/s/ Patrick L. Ryan

Patrick L. Ryan
President and Chief Executive Officer
(Principal Executive Officer)

CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO RULE 13A-14(A) OR RULE 15D-14(A) AND SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002

I, Stephen F. Carman, Chief Financial Officer of First Bank, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of First Bank;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 10, 2020

/s/ Stephen F. Carman

Stephen F. Carman
Executive Vice President, Treasurer and Chief Financial Officer
(Principal Financial Officer)

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF SARBANES-OXLEY ACT OF 2002

Pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, in connection with the Quarterly Report on Form 10-Q of First Bank (the "Company") for the period ended June 30, 2020, as filed with the Federal Deposit Insurance Corporation on the date hereof (the "Report"), each of the undersigned officers of the Company, certifies, to the best knowledge and belief of the signatory, that the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as applicable; and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

The foregoing certification is being furnished solely pursuant to 18 U.S.C. Section 1350 and is not being filed as part of the Report or as a separate disclosure document.

Date: August 10, 2020

/s/ Patrick L. Ryan

Patrick L. Ryan
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Stephen F. Carman

Stephen F. Carman
Executive Vice President, Treasurer and Chief Financial Officer
(Principal Financial Officer)