PEAPACK GLADSTONE FINANCIAL CORP
Form 10-K
March 15, 2013

SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

**FORM 10-K**

**Annual Report Pursuant to Section 13 or 15(d)**

**of the Securities Exchange Act of 1934**

**For the Fiscal Year Ended December 31, 2012   Commission File No. 000-23537**

**PEAPACK-GLADSTONE FINANCIAL CORPORATION**

(Exact name of registrant as specified in its charter)

| **New Jersey** | **22-2491488** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| **500 Hills Drive, Suite 300<br>Bedminster, NJ** | **07921** |
|---|---|
| (Address of principal executive offices) | (Zip Code) |

**Registrant's telephone number (908) 234-0700**

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

| Title of Each Class | Name of Exchange on which Registered |
|---|---|
| Common Stock, No par value | NASDAQ Global Select Market |

**Securities registered pursuant to Section 12(g) of the Act:**

**NONE**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes o Noý.

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes o No ý.

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 ý No o.

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

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

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

Large accelerated filer o Accelerated filer ý
Non-accelerated filer o Smaller reporting company o

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

The aggregate market value of the shares held by unaffiliated stockholders was approximately $128,261,567 on June 30, 2012.

As of February 28, 2013, 8,972,288 shares of no par value Common Stock were outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Corporation's Definitive Proxy Statement for the Corporation's 2013 Annual Meeting of Shareholders (the "2013 Proxy Statement") are incorporated by reference into Parts II and III. The Corporation will file the 2013 Proxy Statement within 120 days of December 31, 2012.

**FORM 10-K**

**PEAPACK-GLADSTONE FINANCIAL CORPORATION**

**For the Year Ended December 31, 2012**

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**PART I**

**Item 1. BUSINESS**

*The disclosures set forth in this Form 10-K are qualified by Item 1A-Risk Factors and the section captioned "Cautionary Statement Concerning Forward-Looking Statements" in Item 7-Management's Discussion and Analysis of Financial Condition and Results of Operations of this report and other cautionary statements set forth elsewhere in this report.*

**The Corporation**

Peapack-Gladstone Financial Corporation (the "Corporation") is a bank holding company registered under the Bank Holding Company Act of 1956, as amended ("Holding Company Act"). The Corporation was organized under the laws of New Jersey in August 1997, by the Board of Directors of Peapack-Gladstone Bank (the "Bank"), its principal subsidiary, to become a holding company for the Bank. The Bank is a state chartered commercial bank founded in 1921 under the laws of the State of New Jersey. The Bank is a member of the Federal Reserve System. The Bank offers financial services through 23 full-service banking offices. The Bank maintains ten branches in Somerset County, six in Morris County, four in Hunterdon County, one in Middlesex County and two in Union County.

The Bank is primarily dedicated to providing quality, personalized financial, trust and investment services to individuals and small businesses.

Commercial loan customers of the Bank are business people, including merchants, architects, doctors, dentists, attorneys and building contractors as well as various service firms and other local retailers. Most forms of commercial lending are offered, including working capital lines of credit, term loans for fixed asset acquisitions, commercial mortgages and other forms of asset-based financing.

In addition to commercial lending activities, the Bank offers a wide range of consumer banking services, including: checking and savings accounts, money market and interest-bearing checking accounts, certificates of deposit, and individual retirement accounts held in certificates of deposit. The Bank also offers residential and construction mortgages, home equity lines of credit and other second mortgage loans. For children, the Bank offers a special pony club savings account. New Jersey Consumer Checking Accounts are offered to low income customers. In addition, the Bank provides foreign and domestic travelers' checks, cashier's checks and wire transfers. Automated teller machines are available at 23 locations. Via the automatic teller machine access card issued by the Bank, customers may pay for commodities at point-of-sale merchant locations. Internet banking is available to customers including an online bill

payment option. The Corporation has no foreign operations.

The Bank has a Trust and Investment Department, PGB Trust & Investments, which offers personal investment management services, personal trust administration services, estate settlement, income tax services, custodial services and other financial planning services. Since its inception in 1972, market value of trust assets under administration have increased to $2.30 billion. In December 2012, the Corporation formed PGB Trust & Investments of Delaware, a subsidiary of the Bank, and opened an office in Greenville, Delaware.

In October 2012, the Corporation hired a new CEO and following the hiring the Corporation has made personnel changes and has undertaken a strategic review of its operations. It is anticipated that the Corporation will in the future add more personnel, including bankers and marketing personnel, which is anticipated to add expense prior to the recognition of revenue from the added bankers and marketing personnel.

The information regarding business segments as set forth in Item 8 of Part II of this Form 10-K under Note 17 to the Corporation's Consolidated Financial Statements for the year ended December 31, 2012 is incorporated by reference herein.

The Corporation makes its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, and amendments to such reports, available free of charge on its website at www.pgbank.com. Also available on the website are the Corporation's Code of Business Conduct and Ethics, Corporate Governance Principles and charters for the Corporation's Audit Committee, Compensation Committee and Nominating Committee.

Employees

As of December 31, 2012, the Corporation employed 292 full-time equivalent persons. Management considers relations with employees to be satisfactory.

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**Principal Market Areas**

The Bank's principal market for its deposit gathering activities includes Somerset, Morris, Hunterdon, Middlesex and Union Counties. The area is composed of upper-income single-family homes, moderate-income properties, some low-income housing and several large corporate campuses. There are numerous small retail businesses in each of the towns as well as offices for various professionals, i.e. attorneys, architects, interior decorators, physicians, etc. A portion of the market area is bisected by Interstate Highways 287 and 78 where numerous corporate offices have relocated over the past 25 years.

The Bank has expanded its service areas from one office in 1968 to the present 23 full-service banking locations by steadily opening new branches. Most of the communities that the Bank serves are demographically similar and contiguous to the main office.

**Competition**

The market for banking and bank-related services is highly competitive. The Bank competes with other providers of financial services such as other bank holding companies, commercial and savings banks, savings and loan associations, credit unions, money market and mutual funds, mortgage companies, and a growing list of other local, regional and national institutions which offer financial services. Mergers between financial institutions within New Jersey and in neighboring states have added competitive pressure. The Bank competes by offering quality products and convenient services at competitive prices. In order to maintain and enhance its competitive position, the Bank regularly reviews its products, locations and new branching prospects.

**Governmental Policies and Legislation**

The banking industry is highly regulated. Statutory and regulatory controls increase a bank holding company’s cost of doing business and limit the options of its management to deploy assets and maximize income. Proposals to change the laws and regulations governing the operations and taxation of banks, bank holding companies and other financial institutions are frequently made in Congress, in state legislatures and before various bank regulatory agencies. The likelihood of any major changes and the impact such changes might have on the Corporation or the Bank is impossible to predict. The following discussion is not intended to be a complete list of all the activities regulated by the banking laws or of the impact of such laws and regulations on the Bank. It is intended only to briefly summarize some material provisions.

**The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010**

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") was signed into law on July 21, 2010. Generally, the Act is effective the day after it was signed into law, but different effective dates apply to specific sections of the law. The Act, among other things:

- Directed the Federal Reserve to issue rules limiting debit-card interchange fees for banks with more than $10 billion in assets;
- After a three-year phase-in period which begins January 1, 2013, removed trust preferred securities as a permitted component of Tier 1 capital for bank holding companies with assets of $15 billion or more, however, bank holding companies with assets of less than $15 billion will be permitted to include trust preferred securities that were issued before May 19, 2010 as Tier 1 capital (However, the currently proposed NPRs of the U.S. federal banking regulators may disallow this treatment, phased in over a 3 to 10 year period based on varying interpretations of the proposed rules);
- Provided for increase in the minimum reserve ratio for the deposit insurance fund from 1.15 percent to 1.35 percent and changes the basis for determining FDIC premiums from deposits to assets;
- Created a new Consumer Financial Protection Bureau ("CFPB") that has rulemaking authority for a wide range of consumer protection laws that would apply to all banks and would have broad powers to supervise and enforce consumer protection laws;
- Required public companies to give shareholders a non-binding vote on executive compensation at their first annual meeting following enactment and at least every three years thereafter and on "golden parachute" payments in connection with approvals of mergers and acquisitions unless previously voted on by shareholders;
- Directed federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of $1 billion, regardless of whether the company is publicly traded or not;

- Prohibited a depository institution from converting from a state to a federal charter or vice versa while it is the subject of a cease and desist order or other formal enforcement action or a memorandum of understanding with respect to a significant supervisory matter unless the appropriate federal banking agency gives notice of conversion to the federal or state authority that issued the enforcement action and that agency does not object within 30 days;
- Changed standards for Federal preemption of state laws related to federally chartered institutions and their subsidiaries;
- Provided mortgage reform provisions regarding a customer's ability to repay, requiring the ability to repay for variable-rate loans to be determined by using the maximum rate that will apply during the first five years of the loan term, and making more loans subject to provisions for higher cost loans, new disclosures, and certain other revisions;
- Created a Financial Stability Oversight Council that will recommend to the Federal Reserve increasingly strict rules for capital, leverage, liquidity, risk management and other requirements as companies grow in size and complexity;
- Made permanent the $250 thousand limit for federal deposit insurance and provides unlimited federal deposit insurance until January 1, 2013 for non-interest bearing demand transaction accounts at all insured depository institutions;
- Repealed the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transactions and other accounts; and
- Authorized de novo interstate branching, subject to non-discriminatory state rules, such as home office protection.

The Dodd-Frank Act also authorized the Securities and Exchange Commission ("SEC") to promulgate rules that would allow stockholders to nominate and solicit votes for their own candidates using a company's proxy materials. However, on July 21, 2011, the United States Court of Appeals for the District of Columbia Circuit struck down the SEC's proposed proxy access rules.

On June 20, 2012, the SEC adopted final rules regarding heightened independence requirements for Compensation Committee members. These rules require stock exchanges to adopt listing standards that address (i) independence of compensation committee members, (ii) the compensation committee's authority to retain compensation advisers, (iii) the compensation committee's consideration of the independence of any compensation advisers, and (iv) the compensation committee's responsibility for the appointment, compensation and oversight of the work of any compensation adviser. On September 25, 2012, the New York Stock Exchange and NASDAQ released proposed compensation committee and compensation committee adviser independence listing standards, and on January 11, 2013, the SEC approved these standards.

Effective October 1, 2011, interchange fees on debit card transactions are limited to a maximum of 21 cents per transaction plus 5 basis points of the transaction amount. A debit card issuer may recover an additional one cent per transaction for fraud prevention purposes if the issuer complies with certain fraud-related requirements prescribed by the Federal Reserve. Issuers that, together with their affiliates, have less than $10 billion in assets, such as the Bank, are exempt from the debit card interchange fee standards.

The CFPB took over responsibility over the principal federal consumer protection laws, such as the Truth in Lending Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act and the Truth in Saving Act, among others, on July 21, 2011. Institutions that have assets of $10 billion or less, such as the Bank, will continue to be supervised in this area by their primary federal regulators (in the case of the Bank, the Federal Reserve Board ("FRB")). The Act also gives the CFPB expanded data collecting powers for fair lending purposes for both small business and

mortgage loans, as well as expanded authority to prevent unfair, deceptive and abusive practices.

The CFPB continued to propose amendments to mortgage regulations in August and September of 2012, and in January 2013, the CFPB issued final rules for several of the regulations. On January 10, 2013, the CFPB issued a final rule amending Regulation Z to implement certain amendments to the Truth in Lending Act. The rule implements statutory changes that lengthen the time for which a mandatory escrow account established for a higher-priced mortgage loan must be maintained. The rule also exempts certain transactions from the statute's escrow requirement. The rule will become effective on June 1, 2013. Also on January 10, 2013, the CFPB issued a final rule implementing amendments to the Truth in Lending Act and the Real Estate Settlement Procedures Act. The rule amends Regulation Z by expanding the types of mortgage loans that are subject to the protections of the Home Ownership and Equity Protections Act of 1994 ("HOEPA"), revising and expanding the tests for coverage under HOEPA, and imposing additional restrictions on mortgages that are covered by HOEPA, including a pre-loan counseling requirement. The rule also amends Regulation Z and Regulation X by imposing other requirements related to homeownership counseling. The rule will become effective on January 10, 2014.

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On January 18, 2013, the CFPB amended Regulation B to implement changes to the Equal Credit Opportunity Act. The revisions to Regulation B require creditors to provide applicants with free copies of all appraisals and other written valuations developed in connection with an application for a loan to be secured by a first lien on a dwelling, and require creditors to notify applicants in writing that copies of appraisals will be provided to them promptly. The rule will become effective on January 18, 2014. On January 20, 2013, the CFPB amended Regulation Z to implement requirements and restrictions to the Truth in Lending Act concerning loan originator compensation, qualifications of, and registration or licensing of loan originators, compliance procedures for depository institutions, mandatory arbitration, and the financing of single-premium credit insurance. These amendments revise or provide additional commentary on Regulation Z’s restrictions on loan originator compensation, including application of these restrictions to prohibitions on dual compensation and compensation based on a term of a transaction or a proxy for a term of a transaction, and to recordkeeping requirements. This rule also establishes tests for when loan originators can be compensated through certain profits-based compensation arrangements. The amendments to § 1026.36(h) and (i) are effective on June 1, 2013, while the other provisions of the rule are effective on January 10, 2014.

Certain changes in the new mortgage rules promulgated by the CFPB would be applicable to the Bank and the Corporation. The CFPB is expected to issue additional final rules regarding mortgages in 2013.

The Dodd-Frank Act contains numerous other provisions affecting financial institutions of all types, many of which may have an impact on our operating environment in substantial and unpredictable ways. Consequently, the Dodd-Frank Act is likely to continue to increase our cost of doing business, it may limit or expand our permissible activities, and it may affect the competitive balance within our industry and market areas. The nature and extent of future legislative and regulatory changes affecting financial institutions, including as a result of the Dodd-Frank Act, remains very unpredictable at this time.

**Capital Requirements**

The Corporation’s wholly owned subsidiary is subject to risk-based capital guidelines for banks as adopted by the FRB. The minimum guideline for the ratio of total capital to risk-weighted assets is 8%. At least half of the total capital is to be comprised of common stock, retained earnings, minority interests in the equity accounts of consolidated subsidiaries, noncumulative perpetual preferred stock and a limited amount of qualifying cumulative perpetual preferred stock, less goodwill and certain other intangibles (“Tier 1 Capital”). The remainder may consist of other preferred stock, certain other instruments and a portion of the loan loss allowance. At December 31, 2012, the Bank’s Tier 1 Capital and Total Capital ratios were 11.67% and 12.92%, respectively.

In addition, the FRB has established minimum leverage ratio guidelines for banks. These guidelines provide for a minimum ratio of Tier 1 Capital to average total assets of 4% for banks that meet certain specified criteria, including having the highest regulatory rating. All other banks generally are required to maintain a leverage ratio of at least 4% plus an additional cushion of 100 to 200 basis points. The Bank's leverage ratio at December 31, 2012 was 7.18%.

**Basel III**

In December 2010, the Basel Committee released its final framework for strengthening international capital and liquidity regulation, now officially identified by the Basel Committee as “Basel III”. Basel III, when implemented by the U.S. banking agencies and fully phased-in, will require bank holding companies and their bank subsidiaries to maintain substantially more capital, with a greater emphasis on common equity.

The Basel III final capital framework, among other things, (i) introduces as a new capital measure “Common Equity Tier 1” (“CET1”), (ii) specifies that Tier 1 capital consists of CET1 and “Additional Tier 1 capital” instruments meeting specified requirements, (iii) defines CET1 narrowly by requiring that most adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expands the scope of the adjustments as compared to existing regulations.

When fully phased in on January 1, 2019, Basel III requires banks to maintain (i) as a newly adopted international standard, a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% “capital conservation buffer” (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7%), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total (that is, Tier 1 plus Tier 2) capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) as a newly adopted international standard, a minimum leverage ratio of 3%, calculated as the ratio of Tier 1 capital to balance sheet exposures plus certain off-balance sheet exposures (computed as the average for each quarter of the month-end ratios for the quarter).

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Basel III also provides for a "countercyclical capital buffer," generally to be imposed when national regulators determine that excess aggregate credit growth becomes associated with a buildup of systemic risk, that would be a CET1 add-on to the capital conservation buffer in the range of 0% to 2.5% when fully implemented (potentially resulting in total buffers of between 2.5% and 5%). The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

Upon implementation of the Basel III final framework, banking institutions will be required to meet the following minimum capital ratios:

- 3.5% CET1 to risk-weighted assets.
- 4.5% Tier 1 capital to risk-weighted assets.
- 8.0% Total capital to risk-weighted assets.

The Basel III final framework provides for a number of new deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1.

Implementation of the deductions and other adjustments to CET1 is scheduled to begin on January 1, 2014 and will be phased-in over a five-year period (20% per year). The implementation of the capital conservation buffer will begin on January 1, 2016 at 0.625% and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

On January 7, 2013, the Basel Committee released the revised Basel III Liquidity Coverage Ratio ("LCR"). The revised LCR standards allow banks to use a broader range of liquid assets to meet their liquidity buffer and reduce some of the run-off assumptions that banks must make in calculating their net cash outflows. The revised standards also clarify that banks may dip below the minimum LCR requirement during periods of stress. The Basel Committee expects national regulators to implement the LCR on a phased-in basis beginning on January 1, 2015. Though the FRB has expressed its intent to implement some version of the LCR and other Basel III liquidity standards in the United States, the scope and timing of U.S. implementation currently is unclear.

The Basel Committee is considering further amendments to Basel III, including the imposition of additional capital surcharges on globally systemically important financial institutions. In addition to Basel III, Dodd-Frank requires or permits the Federal banking agencies to adopt regulations affecting banking institutions' capital requirements in a number of respects, including potentially more stringent capital requirements for systemically important financial

institutions.

The FRB and the FDIC were part of a joint proposal in June 2012 seeking comment on three notices of proposed rulemaking (“NPR”) that would revise and replace the agencies’ current capital rules in connection with the Basel accords. The two NPRs discussed below concern capital issues of significant importance to the Bank and, under certain circumstances, the Company. The third NPR, which relates to advanced approaches and market risk capital rules, is not applicable to the organization’s current operations.

The first NPR relates to Basel III and proposes to revise risk-based and leverage capital requirements, including the implementation of new common equity Tier 1 capital requirements and a higher minimum Tier 1 capital requirement. Also included in the NPR are proposed limitations on capital distributions and certain discretionary bonus payments for any banking organization not holding a specified buffer of common equity Tier 1 capital in excess of its minimum risk-based capital requirement. Revisions to the prompt correction action framework and the tangible common equity definition are also included in the NPR. The other NPR applicable to the organization’s operations proposes a standardized approach for risk-weighted assets to enhance risk sensitivity and to address certain weaknesses identified over recent years, including methods for determining risk-weighted assets for residential mortgages, securitization exposures and counterparty credit risk. The proposed changes in the two NPRs would be applicable to the Bank and the Corporation (as long as the Corporation’s assets continue to exceed $500 million).

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The comment period for these NPRs ended on October 22, 2012. Since Basel III was intended to be implemented beginning January 1, 2013, the regulators intended to finalize the rules by that date. However, on November 9, 2012, the federal agencies that proposed the NPRs announced that they do not expect that any of the proposed rules would become effective on January 1, 2013. Moreover, the announcement did not indicate the likely new effective date.

**FDICIA**

Pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”), each federal banking agency has promulgated regulations, specifying the levels at which a financial institution would be considered “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critically undercapitalized,” and to take certain mandatory and discretionary supervisory actions based on the capital level of the institution. The regulations implementing these provisions of FDICIA provide that a bank is defined to be “well capitalized” if it maintains a leverage ratio of at least 5%, a risk-adjusted Tier 1 capital ratio of at least 6% and a risk-adjusted total capital ratio of at least 10% and is not otherwise in a “troubled condition” as specified by its appropriate federal regulatory agency. A bank is defined to be “adequately capitalized” if it meets other minimum capital requirements. In addition, a depository institution will be considered “undercapitalized” if it fails to meet any minimum required measure, “significantly undercapitalized” if it is significantly below such measure and “critically undercapitalized” if it fails to maintain a level of tangible equity equal to not less than 2% of total assets. A depository institution may be deemed to be in a capitalization category that is lower than is indicated by its actual capital position if it receives an unsatisfactory examination rating.

**Insurance Funds Legislation**

The Bank’s deposits are insured up to applicable limits by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation (the “FDIC”). The Deposit Insurance Fund is the successor to the Bank Insurance Fund and the Savings Association Insurance Fund, which were merged in 2006. Under the FDIC’s risk-based system, insured institutions are assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors with less risky institutions paying lower assessments on their deposits.

On November 12, 2009, the FDIC issued a final rule that required insured depository institutions to prepay, on December 30, 2009, their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012, together with their quarterly risk-based assessment for the third quarter 2009. The Bank paid approximately $8.8 million in assessments as of December 31, 2009 of which approximately $8.3 million was recorded as a prepaid asset. Prepaid assessments are to be applied against the actual quarterly assessments until exhausted, and may not be applied to any special assessments that may occur in the future. Any unused prepayments will be returned to the Bank on June 30, 2013. The balance of the prepaid FDIC assessment fees at December 31, 2011 was $4.8 million.

In February 2011, as required by the Dodd Frank Act, the FDIC approved a final rule that revised the assessment base to consist of average consolidated total assets during the assessment period minus the average tangible equity during the assessment period. In addition, the final revisions eliminated the adjustment for secured borrowings, including Federal Home Loan Bank advances, and made certain other changes to the impact of unsecured borrowings and brokered deposits on an institution's deposit insurance assessment. The final rule also revised the assessment rate schedule to provide initial base assessment rates ranging from 5 to 35 basis points and total base assessment rates ranging from 2.5 to 45 basis points after adjustment. The final rule became effective on April 1, 2011.

As previously noted above, the Dodd-Frank Act makes permanent the $250 thousand limit for federal deposit insurance. It also provided unlimited federal deposit insurance through December 31, 2012 for non-interest bearing demand transaction accounts and IOLTAs at all insured depository institutions. This provision lapsed at the beginning of 2013. Deposits held in noninterest-bearing transaction accounts are now aggregated with any interest-bearing deposits the owner may hold in the same ownership category, and the combined total will be insured up to at least $250 thousand.

The FDIC has authority to further increase insurance assessments. A significant increase in insurance premiums may have an adverse effect on the operating expenses and results of operations of the Bank. Management cannot predict what insurance assessment rates will be in the future.

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**Troubled Asset Relief Capital Purchase Program**

In response to the financial crises affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, on October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the “EESA”) was signed into law. Pursuant to the EESA, the U.S. Treasury was given the authority to, among other things, purchase up to $700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets.

On October 14, 2008, the Secretary of the U.S. Department of the Treasury announced that the Treasury will purchase equity stakes in a wide variety of banks and thrifts. Under the program, known as the Troubled Asset Relief Program Capital Purchase Program (the “TARP Capital Purchase Program”), from the $700 billion authorized by the EESA, the Treasury made $250 billion of capital available to U.S. financial institutions in the form of preferred stock. In conjunction with the purchase of preferred stock, the Treasury received, from participating financial institutions, warrants to purchase common stock with an aggregate market price equal to 15% of the preferred investment. Participating financial institutions were required to adopt the Treasury’s standards for executive compensation and corporate governance for the period during which the Treasury holds equity issued under the TARP Capital Purchase Program.

The Corporation entered into a Securities Purchase Agreement with the Treasury that provides for our participation in the TARP Capital Purchase Program. On January 9, 2009, the Corporation issued and sold to the Treasury 28,685 shares of the Corporation Fixed Rate Cumulative Perpetual Preferred Stock, with a liquidation preference of $1 thousand per share, and a ten-year warrant to purchase up to 150,296 shares of the Corporation’s common stock at an exercise price of $28.63 per share.

On January 6, 2010 and March 2, 2011, the Corporation redeemed 25 percent of the preferred shares issued under the Treasury’s CPP, each time repaying approximately $7.2 million to the Treasury, including accrued and unpaid dividends. On January 11, 2012, the Corporation redeemed the remaining 50 percent of the preferred shares issued under the Treasury’s CPP, repaying approximately $14.5 million to the Treasury, including accrued and unpaid dividends. Upon redemption of the final preferred shares, the Corporation’s participation in the CPP ended, and the Corporation is no longer subject to the requirements of the CPP, including certain limits on executive compensation. The Corporation repurchased the warrant from the Treasury on April 5, 2012.

**Restrictions on the Payment of Dividends**

The holders of the Corporation's common stock are entitled to receive dividends, when, as and if declared by the Board of Directors of the Corporation out of funds legally available. The only statutory limitation is that such dividends may not be paid when the Corporation is insolvent. Since the principal source of income for the Corporation will be dividends on Bank common stock paid to the Corporation by the Bank, the Corporation's ability to pay dividends to its shareholders will depend on whether the Bank pays dividends to it. As a practical matter, restrictions on the ability of the Bank to pay dividends act as restrictions on the amount of funds available for the payment of dividends by the Corporation. As a New Jersey chartered commercial bank, the Bank is subject to the restrictions on the payment of dividends contained in the New Jersey Banking Act of 1948, as amended (the "Banking Act"). Under the Banking Act, the Bank may pay dividends only out of retained earnings, and out of surplus to the extent that surplus exceeds 50% of stated capital. Under the Financial Institutions Supervisory Act, the FDIC has the authority to prohibit a state-chartered bank from engaging in conduct that, in the FDIC's opinion, constitutes an unsafe or unsound banking practice. Under certain circumstances, the FDIC could claim that the payment of a dividend or other distribution by the Bank to the Corporation constitutes an unsafe or unsound practice. The Corporation is also subject to FRB policies, which may, in certain circumstances, limit its ability to pay dividends. The FRB policies require, among other things, that a bank holding company maintain a minimum capital base and serve as a source of strength to its subsidiary bank. The FRB by supervisory letters has advised holding corporations that it is has supervisory concerns when the level of dividends is too high and would seek to prevent dividends if the dividends paid by the holding company exceeded its earnings. The FRB would most likely seek to prohibit any dividend payment that would reduce a holding company's capital below these minimum amounts.

**Holding Company Supervision**

The Corporation is a bank holding company within the meaning of the Holding Company Act. As a bank holding company, the Corporation is supervised by the FRB and is required to file reports with the FRB and provide such additional information as the FRB may require.

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The Holding Company Act prohibits the Corporation, with certain exceptions, from acquiring direct or indirect ownership or control of more than five percent of the voting shares of any company which is not a bank and from engaging in any business other than that of banking, managing and controlling banks or furnishing services to subsidiary banks, except that it may, upon application, engage in, and may own shares of companies engaged in, certain businesses found by the FRB to be so closely related to banking "as to be a proper incident thereto." The Holding Company Act requires prior approval by the FRB of the acquisition by the Corporation of more than five percent of the voting stock of any additional bank. Satisfactory capital ratios, Community Reinvestment Act ratings and anti-money laundering policies are generally prerequisites to obtaining federal regulatory approval to make acquisitions. The policy of the FRB provides that a bank holding company is expected to act as a source of financial strength to its subsidiary bank and to commit resources to support the subsidiary bank in circumstances in which it might not do so absent that policy. Acquisitions through the Bank require the approval of the FRB and the New Jersey Department of Banking and Insurance ("NJDOBI").

**Temporary Liquidity Guarantee Program**

On November 21, 2008, the Board of Directors of the FDIC adopted a final rule relating to the Temporary Liquidity Guarantee Program ("TLG Program"), Under the TLG Program (as amended on March 17, 2009) the FDIC (i) guaranteed through the earlier of maturity or December 31, 2012, certain newly issued senior unsecured debt issued by participating institutions on or after October 14, 2008, and before October 31, 2009 (the "Debt Guarantee Program") and (ii) provide full FDIC deposit insurance coverage for non-interest bearing transaction deposit accounts, Negotiable Order of Withdrawal ("NOW") accounts paying less than or equal to 0.5 percent interest per annum and Interest on Lawyers Trust Accounts ("IOLTAs") held at participating FDIC- insured institutions through June 30, 2010 (the "TAG Program"). On April 13, 2010, the FDIC announced a second extension of the TAG Program until December 31, 2010. Coverage under the TLG Program was available for the first 30 days without charge. The fee assessment for coverage of senior unsecured debt ranges from 50 basis points to 100 basis points per annum, depending on the initial maturity of the debt. The fee assessment for deposit insurance coverage ranges from 15 to 25 basis points based upon the Bank's CAMELS rating by the FRB on amounts in covered accounts exceeding $250,000.

We elected to participate in both the Debt Guarantee Program and the TAG Program. We have not issued debt under the Debt Guarantee Program. Effective January 1, 2013, both Programs expired.

**Sarbanes-Oxley Act of 2002**

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act") added new legal requirements for public companies affecting corporate The Sarbanes-Oxley Act provides for, among other things:

- a prohibition on personal loans made or arranged by the issuer to its directors and executive officers (except for loans made by a bank subject to Regulation O);
- independence requirements for audit committee members;
- independence requirements for company auditors;
- certification of financial statements within the Annual Report on Form 10-K and Quarterly Reports on Form 10-Q by the chief executive officer and the chief financial officer;
- the forfeiture by the chief executive officer and the chief financial officer of bonuses or other incentive-based compensation and profits from the sale of an issuer's securities by such officers in the twelve month period following initial publication of any financial statements that later require restatement due to corporate misconduct;
- disclosure of off-balance sheet transactions;
- two-business day filing requirements for insiders filing on Form 4;
- disclosure of a code of ethics for financial officers and filing a Current Report on Form 8-K for a change in or waiver of such code;
- the reporting of securities violations "up the ladder" by both in-house and outside attorneys;
- restrictions on the use of non-GAAP financial measures in press releases and SEC filings;
- the formation of a public accounting oversight board;
- various increased criminal penalties for violations of securities laws;
- an assertion by management with respect to the effectiveness of internal control over financial reporting; and

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- a report by the company's external auditor on management's assertion and the effectiveness of internal control over financial reporting.

Each of the national stock exchanges, including the National Association of Securities Dealers Automated Quotations (NASDAQ) Global Select Market where the Corporation's securities are listed, have implemented corporate governance listing standards, including rules strengthening director independence requirements for boards, and requiring the adoption of charters for the nominating and audit committees. As noted above, in 2012, the SEC adopted rules under the Dodd-Frank Act requiring the stock exchanges to adopt rules addressing the independence of Compensation Committee members and consideration of the independence of compensation advisers, and each of the exchanges, including the NASDAQ Global Select Market, have adopted such rules.

**USA PATRIOT Act**

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

Regulations implementing the due diligence requirements, require minimum standards to verify customer identity and maintain accurate records, encourage cooperation among financial institutions, federal banking agencies, and law enforcement authorities regarding possible money laundering or terrorist activities, prohibit the anonymous use of "concentration accounts," and requires all covered financial institutions to have in place an anti-money laundering compliance program. Federal and state banking agencies have strictly enforced various anti-money laundering and suspicious activity reporting requirements using formal and informal enforcement tools to cause banks to comply with these provisions.

The Anti Money Laundering Act amended the Bank Holding Company Act and the Bank Merger Act to require the federal banking agencies to consider the effectiveness of any financial institution involved in a proposed merger transaction in combating money laundering activities when reviewing an application under these acts.

**Gramm-Leach-Bliley Act**

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

- allows bank holding companies meeting management, capital and Community Reinvestment Act standards to engage in a substantially broader range of non-banking activities than was previously permissible, including insurance underwriting;
- allows insurers and other financial services companies to acquire banks;
- removes various restrictions that previously applied to bank holding company ownership of securities firms and mutual fund advisory companies; and
- establishes the overall regulatory structure applicable to bank holding companies that also engage in insurance and securities operations.

If a bank holding company elects to become a financial holding company, it files a certification, effective in 30 days, and thereafter may engage in certain financial activities without further approvals. The Corporation has not elected to become a financial holding company.

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

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**Item 1A. RISK FACTORS**

The material risks and uncertainties that management believes affect the Corporation are described below. These risks and uncertainties are not the only ones affecting the Corporation. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair the Corporation's business operations. This report is qualified in its entirety by these risk factors. If any one or more of the following risks actually occur, the Corporation's financial condition and results of operations could be materially and adversely affected.

**The Dodd-Frank Wall Street Reform and Consumer Protection Act may affect our business activities, financial position and profitability by increasing our regulatory compliance burden and associated costs, placing restrictions on certain products and services, and limiting our future capital raising strategies.**

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which implements significant changes in the financial regulatory landscape and will impact all financial institutions, including the Corporation and the Bank. The Act has and is likely to continue to increase our regulatory compliance burden.

Among the Act's significant regulatory changes, it created the CFPB that is empowered to promulgate new consumer protection regulations and revise existing regulations in many areas of consumer protection. The CFPB has exclusive authority to issue regulations, orders and guidance to administer and implement the objectives of federal consumer protection laws. Moreover, the Act permits states to adopt stricter consumer protection laws and state attorney generals may enforce consumer protection rules issued by the CFPB. The Act also changes the scope of federal deposit insurance coverage, and increases the FDIC assessment payable by the Bank. The CFPB and these other changes have increased, and will continue to increase, our regulatory compliance burden and costs and may restrict the financial products and services we offer to our customers.

The Act also imposed more stringent capital requirements on bank holding companies by, among other things, imposing leverage ratios on bank holding companies and prohibiting new trust preferred issuances from counting as Tier I capital. These restrictions may limit our future capital strategies. The Act also increases regulation of derivatives and hedging transactions, which could limit our ability to enter into, or increase the costs associated with, interest rate and other hedging transactions.

Although certain provisions of the Act, such as required direct supervision by the CFPB, will not apply to banking organizations with less than $10 billion of assets, such as the Corporation and the Bank, the changes resulting from the legislation will impact our business. New consumer protection rules issued by the CFPB will apply to us. These changes will require us to invest significant management attention and resources to evaluate and make necessary

changes.

**Negative developments in the financial services industry and U.S. and global credit markets may adversely impact our operations and results.**

Uncertainty in the financial markets in general with the expectation of the general economic downturn continued in 2012 and may continue through 2013. Loan portfolio performances have deteriorated at many institutions resulting from, amongst other factors, a weak economy and a decline in the value of the collateral supporting their loans. The competition for our deposits has increased significantly due to liquidity concerns at many of these same institutions. Stock prices of bank holding companies, like ours, have been negatively affected by the current condition of the financial markets, as has our ability, if needed, to raise capital or borrow in the debt markets compared to recent years. As a result, there is potential for new federal or state laws and regulations regarding lending and funding practices and liquidity standards, and financial institution regulatory agencies are expected to be very aggressive in responding to concerns and trends identified in examinations, including the expected issuance of many formal enforcement actions. Negative developments in the financial services industry and the impact of new legislation in response to those developments could negatively impact our operations by restricting our business operations, including our ability to originate or sell loans, and adversely impact our financial performance.

Much of our business is with customers located within Morris, Somerset, Middlesex, Union and Hunterdon Counties and contiguous counties. Our business loans are generally made to small to mid-sized businesses, most of whose success depends on the regional economy. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities. Adverse economic and business conditions in our market area could reduce our growth rate, affect our borrowers' ability to repay their loans and, consequently, adversely affect our financial condition and performance. Further, we place substantial reliance on real estate as collateral for our loan portfolio. A sharp downturn in real estate values in our market area could leave many of our loans under-secured, which could adversely affect our earnings.

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**If our allowance for loan losses were not sufficient to cover actual loan losses, our earnings would decrease.**

We maintain an allowance for loan losses based on, among other things, national and regional economic conditions, and historical loss experience and delinquency trends among loan types. However, we cannot predict loan losses with certainty and we cannot assure you that charge-offs in future periods will not exceed the allowance for loan losses. In addition, regulatory agencies, as an integral part of their examination process, review our allowance for loan losses and may require additions to the allowance based on their judgment about information available to them at the time of their examination. Factors that require an increase in our allowance for loan losses could reduce our earnings.

**Changes in interest rates may adversely affect our earnings and financial condition.**

Our net income depends primarily upon our net interest income. Net interest income is the difference between interest income earned on loans, investments and other interest-earning assets and the interest expense incurred on deposits and borrowed funds.

Different types of assets and liabilities may react differently, and at different times, to changes in market interest rates. We expect that we will periodically experience “gaps” in the interest rate sensitivities of our assets and liabilities. That means either our interest-bearing liabilities will be more sensitive to changes in market interest rates than our interest-earning assets, or vice versa. When interest-bearing liabilities mature or reprice more quickly than interest-earning assets, an increase in market rates of interest could reduce our net interest income. Likewise, when interest-earning assets mature or reprice more quickly than interest-bearing liabilities, falling interest rates could reduce our net interest income. We are unable to predict changes in market interest rates, which are affected by many factors beyond our control, including inflation, recession, unemployment, money supply, domestic and international events and changes in the United States and other financial markets.

**We may not be able to continue to grow our business, which may adversely impact our results of operations.**

Our business strategy calls for continued expansion. Our ability to continue to grow depends, in part, upon our ability to open new branch locations, successfully attract deposits to existing and new branches, and identify favorable loan and investment opportunities. We expect to add personnel to assist in this growth. In the event that we do not continue to grow, or the new personnel do not produce sufficient new revenues, our results of operations could be adversely impacted.

**We may not be able to manage our growth, which may adversely impact our financial results.**

As part of our expansion strategy, we plan to hire new personnel and to open new branches in our existing and target markets. However, we may be unable to identify attractive locations on terms favorable to us or to hire qualified management. In addition, the organizational and overhead costs may be greater than we anticipated. Moreover, we may not be able to obtain the regulatory approvals necessary to open new branches. New branches and new business expansion efforts may take longer than expected to reach profitability, and we cannot assure that they will become profitable. The additional costs of adding new personnel and/or starting new branches may adversely impact our financial results.

Our ability to manage growth successfully will depend on whether we can continue to fund this growth while maintaining cost controls and asset quality, as well as on factors beyond our control, such as national and regional economic conditions and interest rate trends. If we are not able to control costs and maintain asset quality, such growth could adversely impact our earnings and financial condition.

The Corporation is required by Federal regulatory authorities to maintain adequate levels of capital to support its operations. The Corporation may at some point need to raise additional capital to support continued growth. The Corporation's ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside the Corporation's control, and on its financial performance. Accordingly, the Corporation cannot assure you of its ability to raise additional capital if needed or on terms acceptable to the Corporation. If the Corporation cannot raise additional capital when needed, the ability to further expand its operations could be materially impaired.

**Our exposure to credit risk could adversely affect our earnings and financial condition.**

There are certain risks inherent in making loans. These risks include interest rate changes over the time period in which loans may be repaid, risks resulting from changes in the economy, risks inherent in dealing with borrowers and, in the case of a loan backed by collateral, risks resulting from uncertainties about the future value of the collateral.

**Competition from other financial institutions in originating loans and attracting deposits may adversely affect our profitability.**

We face substantial competition in originating loans. This competition comes principally from other banks, savings institutions, mortgage banking companies and other lenders. Many of our competitors enjoy advantages, including greater financial resources and higher lending limits, a wider geographic presence, and more accessible branch office locations.

In attracting deposits, we face substantial competition from other insured depository institutions such as banks, savings institutions and credit unions, as well as institutions offering uninsured investment alternatives, including money market funds. Many of our competitors enjoy advantages, including greater financial resources, more aggressive marketing campaigns, better brand recognition and more branch locations. These competitors may offer higher interest rates than we do, which could decrease the deposits that we attract or require us to increase our rates to retain existing deposits or attract new deposits. Increased deposit competition could adversely affect our ability to generate the funds necessary for lending operations and increase our cost of funds.

We also compete with non-bank providers of financial services, such as brokerage firms, consumer finance companies, insurance companies and governmental organizations, which may offer more favorable terms. Some of our non-bank competitors are not subject to the same extensive regulations that govern our operations. As a result, such non-bank competitors may have advantages over us in providing certain products and services. This competition may reduce or limit our margins on banking services, reduce our market share and adversely affect our earnings and financial condition.

**Government regulation significantly affects our business.**

The banking industry is extensively regulated. Banking regulations are intended primarily to protect depositors, and the FDIC deposit insurance funds, not the shareholders of the Corporation. We are subject to regulation and supervision by the New Jersey Department of Banking and Insurance and the Federal Reserve Bank. Regulatory requirements affect our lending practices, capital structure, investment practices, dividend policy and growth. The bank regulatory agencies possess broad authority to prevent or remedy unsafe or unsound practices or violations of law. We are subject to various regulatory capital requirements, which involve both quantitative measures of our assets and liabilities and qualitative judgments by regulators regarding risks and other factors. Failure to meet minimum capital requirements or comply with other regulations could result in actions by regulators that could adversely affect our ability to pay dividends or otherwise adversely impact operations. In addition, changes in laws, regulations and regulatory practices affecting the banking industry may limit the manner in which we conduct our business. Such changes may adversely affect us, including our ability to offer new products and services, obtain financing, attract deposits, make loans and achieve satisfactory spreads and may impose additional costs on us.

The Bank is also subject to a number of Federal laws, which, among other things, require it to lend to various sectors of the economy and population, and establish and maintain comprehensive programs relating to anti-money laundering and customer identification. The Bank's compliance with these laws will be considered by the Federal banking regulators when reviewing bank merger and bank holding company acquisitions or commencing new activities or making new investments in reliance on the Gramm-Leach-Bliley Act. As a public company, we are also subject to the corporate governance standards set forth in the Sarbanes-Oxley Act, as well as any rules or regulations promulgated by the SEC or the NASDAQ Stock Market.

**Higher FDIC deposit insurance premiums and assessments could adversely affect our financial condition.**

FDIC insurance premiums increased substantially in 2009 and we may have to pay significantly higher FDIC premiums in the future. Market developments have significantly depleted the insurance fund of the FDIC and reduced the ratio of reserves to insured deposits. The FDIC adopted a revised risk-based deposit insurance assessment schedule on February 27, 2009, which raised regular deposit insurance premiums. On May 22, 2009, the FDIC also implemented a five basis point special assessment of each insured depository institution’s total assets minus Tier 1 capital as of June 30, 2009, but no more than 10 basis points times the institution’s assessment base for the second quarter of 2009, collected by the FDIC on September 30, 2009. The amount of this special assessment for the Bank was $672 thousand. Additional special assessments may be imposed by the FDIC for future quarters at the same or higher levels.

The Dodd-Frank Act revised the assessment rate schedule to provide initial base assessment rates ranging from five to 35 basis points and total base assessment rates ranging from 2.5 to 45 basis points. These changes, along with the use of all of our remaining FDIC insurance assessment credits in early 2009, may cause the premiums charged by the FDIC to increase. These actions could significantly increase our noninterest expense in 2013 and in future periods.

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**We are subject to liquidity risk.**

Liquidity risk is the potential that we will be unable to meet our obligations as they become due, capitalize on growth opportunities as they arise, or pay regular dividends because of an inability to liquidate assets or obtain adequate funding in a timely basis, at a reasonable cost and within acceptable risk tolerances.

Liquidity is required to fund various obligations, including credit commitments to borrowers, mortgage and other loan originations, withdrawals by depositors, repayment of borrowings, dividends to shareholders, operating expenses and capital expenditures.

Liquidity is derived primarily from retail deposit growth and retention; principal and interest payments on loans; principal and interest payments; sale, maturity and prepayment of investment securities; net cash provided from operations and access to other funding sources.

Our access to funding sources in amounts adequate to finance our activities could be impaired by factors that affect us specifically or the financial services industry in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity due to a market downturn or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a severe disruption of the financial markets or negative views and expectations about the prospects for the financial services industry as a whole as banking organizations face turmoil and domestic and worldwide credit markets deteriorate.

**Our information systems may experience a security breach, computer virus, or disruption of service.**

We rely heavily on communications and information systems to conduct our business, and provide customers with various products and services, including the ability to bank online. Despite positioning our communications and information systems environment to be capable of controlling, monitoring and proactively preventing security breaches, our network could become vulnerable to unauthorized access, computer viruses, phishing schemes and other security problems. We may be required to spend significant capital and other resources to protect against the threat of security breaches and computer viruses, or to alleviate problems caused by security breaches or viruses. To the extent that our activities or the activities of our customers involve the storage and transmission of confidential information, security breaches and viruses could expose us to claims, litigation and other possible liabilities. Any failure, interruption, or breach in security or operational integrity of our systems could also result in failures or disruptions in our general ledger, deposit, loan, and other systems, and could subject us to additional regulatory scrutiny. Any inability to prevent security breaches or computer viruses could also cause existing customers to lose confidence in our systems and could adversely affect our reputation.

**The price of our common stock may fluctuate.**

The price of our common stock on the NASDAQ Global Select Market constantly changes and recently, given the uncertainty in the financial markets, has fluctuated widely. We expect that the market price of our common stock will continue to fluctuate. Holders of our common stock will be subject to the risk of volatility and changes in prices.

Our common stock price can fluctuate as a result of a variety of factors, many of which are beyond our control. These factors include:

- quarterly fluctuations in our operating and financial results;
- operating results that vary from the expectations of management, securities analysts and investors;
- changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;
- events negatively impacting the financial services industry which result in a general decline in the market valuation of our common stock;
- announcements of material developments affecting our operations or our dividend policy;
- future sales of our equity securities;
- new laws or regulations or new interpretations of existing laws or regulations applicable to our business;
- changes in accounting standards, policies, guidance, interpretations or principles; and
- general domestic economic and market conditions.

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In addition, recently the stock market generally has experienced extreme price and volume fluctuations, and industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes or credit loss trends, could also cause our stock price to decrease regardless of our operating results.

**Our ability to pay dividends to our common shareholders is limited.**

Since the principal source of income for the Corporation is dividends paid to the Corporation by the Bank, the Corporation's ability to pay dividends to its shareholders will depend on whether the Bank pays dividends to it. As a practical matter, restrictions on the ability of the Bank to pay dividends act as restrictions on the amount of funds available for the payment of dividends by the Corporation. As a New Jersey-chartered commercial bank, the Bank is subject to the restrictions on the payment of dividends contained in the New Jersey Banking Act of 1948, as amended. Under the Banking Act, the Bank may pay dividends only out of retained earnings, and out of surplus to the extent that surplus exceeds 50% of stated capital. The Corporation is also subject to FRB policies, which may, in certain circumstances, limit its ability to pay dividends. The FRB policies require, among other things, that a bank holding company maintain a minimum capital base and the FRB in supervisory guidance has cautioned bank holding companies about paying out too much of their earnings in dividends and has stated that banks should not pay out more in dividends than they earn. The FRB would most likely seek to prohibit any dividend payment that would reduce a holding company's capital below these minimum amounts.

**We may lose lower-cost funding sources.**

Checking, savings, and money market deposit account balances and other forms of customer deposits can decrease when customers perceive alternative investments, such as the stock market, as providing a better risk/return tradeoff. If customers move money out of bank deposits and into other investments, we could lose a relatively low cost source of funds, increasing our funding costs and reducing our net interest income and net income.

**There may be changes in accounting policies or accounting standards.**

Our accounting policies are fundamental to understanding our financial results and condition. Some of these policies require use of estimates and assumptions that may affect the value of our assets or liabilities and financial results. We identified our accounting policies regarding the allowance for loan losses, goodwill and other intangible assets, and income taxes to be critical because they require management to make difficult, subjective and complex judgments about matters that are inherently uncertain. Under each of these policies, it is possible that materially different amounts would be reported under different conditions, using different assumptions, or as new information becomes available.

From time to time the Financial Accounting Standards Board (“FASB”) and the SEC change the financial accounting and reporting standards that govern the form and content of our external financial statements. In addition, accounting standard setters and those who interpret the accounting standards (such as the FASB, SEC, banking regulators and our independent auditors) may change or even reverse their previous interpretations or positions on how these standards

should be applied. Changes in financial accounting and reporting standards and changes in current interpretations may be beyond our control, can be hard to predict and could materially impact how we report our financial results and condition. In certain cases, we could be required to apply a new or revised standard retroactively or apply an existing standard differently (also retroactively) which may result in our restating prior period financial statements in material amounts.

**We encounter continuous technological change.**

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success depends, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on our business and, in turn, our financial condition and results of operations.

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**We are subject to operational risk.**

We face the risk that the design of our controls and procedures, including those to mitigate the risk of fraud by employees or outsiders, may prove to be inadequate or are circumvented, thereby causing delays in detection of errors or inaccuracies in data and information. Management regularly reviews and updates our internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of our controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on our business, results of operations and financial condition.

We may also be subject to disruptions of our systems arising from events that are wholly or partially beyond our control (including, for example, computer viruses or electrical or telecommunications outages), which may give rise to losses in service to customers and to financial loss or liability. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as we are) and to the risk that our (or our vendors') business continuity and data security systems prove to be inadequate.

Our performance is largely dependent on the talents and efforts of highly skilled individuals. There is intense competition in the financial services industry for qualified employees. In addition, we face increasing competition with businesses outside the financial services industry for the most highly skilled individuals. Our business operations could be adversely affected if we were unable to attract new employees and retain and motivate our existing employees.

**There may be claims and litigation pertaining to fiduciary responsibility.**

From time to time as part of the Corporation's normal course of business, customers make claims and take legal action against the Corporation based on its actions or inactions. If such claims and legal actions are not resolved in a manner favorable to the Corporation, they may result in financial liability and/or adversely affect the market perception of the Corporation and its products and services. This may also impact customer demand for the Corporation's products and services. Any financial liability or reputation damage could have a material adverse effect on the Corporation's business, which, in turn, could have a material adverse effect on its financial condition and results of operations.

**Item 1B. UNRESOLVED STAFF COMMENTS**

None.

**Item 2. PROPERTIES**

The Corporation owns 10 branches and leases 12 branches. The Corporation leases an administrative and operations office building in Bedminster, New Jersey, a data center in Bedminster, New Jersey and a trust office in Bethlehem, Pennsylvania, and Greenville, Delaware.

**Item 3. LEGAL PROCEEDINGS**

In the normal course of its business, lawsuits and claims may be brought against the Corporation and its subsidiaries. There is no currently pending or threatened litigation or proceedings against the Corporation or its subsidiaries, which assert claims that if adversely decided, we believe would have a material adverse effect on the Corporation.

Item 4. MINE SAFETY DISCLOSURE

Not applicable.

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PART II

## Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Common Stock of Peapack-Gladstone Financial Corporation is traded on the NASDAQ Global Select Market under the symbol of PGC. The following table sets forth, for the periods indicated, the reported high and low sale prices on known trades and cash dividends declared per share by the Corporation.

| 2012 | HIGH | LOW | DIVIDEND PER SHARE |
|---|---|---|---|
| 1st QUARTER | $13.55 | $10.52 | $ 0.05 |
| 2nd QUARTER | 15.95 | 13.51 | 0.05 |
| 3rd QUARTER | 16.83 | 13.18 | 0.05 |
| 4th QUARTER | 16.49 | 13.45 | 0.05 |

| 2011 | HIGH | LOW | DIVIDEND PER SHARE |
|---|---|---|---|
| 1st QUARTER | $14.20 | $12.71 | $ 0.05 |
| 2nd QUARTER | 13.45 | 10.87 | 0.05 |
| 3rd QUARTER | 11.97 | 9.60 | 0.05 |
| 4th QUARTER | 11.06 | 9.71 | 0.05 |

Future dividends payable by the Corporation will be determined by the Board of Directors after consideration of earnings and financial condition of the Corporation, need for capital and such other matters as the Board of Directors deems appropriate. The payment of dividends is subject to certain restrictions, see Part I, Item 1, “Description of Business - Restrictions on the Payment of Dividends.”

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**Performance Graph**

The following graph compares the cumulative total return on a hypothetical $100 investment made on December 31, 2007 in (a) the Corporation's common stock; (b) the Russell 3000 Stock Index, and (c) the Keefe, Bruyette & Woods KBW 50 Index (top 50 U.S. banks). The graph is calculated assuming that all dividends are reinvested during the relevant periods. The graph shows how a $100 investment would increase or decrease in value over time, based on dividends (stock or cash) and increases or decreases in the market price of the stock.

| | ***Period Ending*** | | | | | |
|---|---|---|---|---|---|---|
| ***Index*** | **12/31/07** | **12/31/08** | **12/31/09** | **12/31/10** | **12/31/11** | **12/31/12** |
| Peapack-Gladstone Financial Corporation | 100.00 | 111.26 | 56.82 | 59.42 | 49.77 | 66.11 |
| Russell 3000 | 100.00 | 62.69 | 80.46 | 94.08 | 95.05 | 110.65 |
| KBW Bank | 100.00 | 52.46 | 51.52 | 63.56 | 48.83 | 64.95 |

On December 31, 2012, the last reported sale price of the Common Stock was $14.08. Also, on February 28, 2013, there were approximately 759 shareholders of record.

**Issuer Purchases of Equity Securities**

None.

**Sales of Unregistered Securities**

None.

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**Item 6. SELECTED FINANCIAL DATA**

The following is selected consolidated financial data for the Corporation and its subsidiaries for the years indicated. This information is derived from the historical consolidated financial statements and should be read in conjunction with the consolidated financial statements and notes.

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| (In thousands, except per share data) | 2012 | 2011 | 2010 | 2009 | 2008 |
| Summary earnings: | | | | | |
| Interest income | $56,090 | $56,051 | $60,922 | $66,007 | $71,917 |
| Interest expense | 4,687 | 7,136 | 11,032 | 17,659 | 25,597 |
| Net interest income | 51,403 | 48,915 | 49,890 | 48,348 | 46,320 |
| Provision for loan losses | 8,275 | 7,250 | 10,000 | 9,700 | 2,400 |
| Net interest income after provision for loan losses | 43,128 | 41,665 | 39,890 | 38,648 | 43,920 |
| Other income, exclusive of securities gains, net | 17,493 | 15,679 | 14,932 | 13,729 | 14,382 |
| Securities gains, net | 3,810 | 1,037 | 124 | 69 | 483 |
| Impairment charges on securities | — | — | (941) | — | (56,146) |
| Other expenses | 48,330 | 44,399 | 43,110 | 42,266 | 37,285 |
| Income/(loss) before income tax expense | 16,101 | 13,982 | 10,895 | 10,180 | (34,646) |
| Income tax expense/(benefit) | 6,405 | 1,814 | 3,231 | 3,054 | (12,586) |
| Net income/(loss) | 9,696 | 12,168 | 7,664 | 7,126 | (22,060) |
| Dividends on preferred stock and accretion | 474 | 1,228 | 1,686 | 1,493 | — |
| Net income/(loss) available to common shareholders | $9,222 | $10,940 | $5,978 | $5,633 | $(22,060) |
| | | | | | |
| Per share data: (reflects a 5% stock dividend in 2009 except for cash dividends per share) | | | | | |
| Earnings/(loss) per share-basic | $1.05 | $1.25 | $0.68 | $0.64 | $(2.53) |
| Earnings/(loss) per share-diluted | 1.05 | 1.25 | 0.68 | 0.64 | (2.53) |
| Cash dividends declared | 0.20 | 0.20 | 0.20 | 0.26 | 0.64 |
| Book value end-of-period | 13.87 | 12.47 | 11.03 | 10.57 | 9.64 |
| | | | | | |
| Basic weighted average shares outstanding | 8,780,973 | 8,741,209 | 8,784,655 | 8,715,419 | 8,707,327 |
| Common stock equivalents (dilutive) | 47,501 | 1,061 | 366 | 50,838 | — |
| | | | | | |
| Balance sheet data (at period end): | | | | | |
| Total assets | $1,667,836 | $1,600,335 | $1,505,425 | $1,512,353 | $1,385,425 |
| Investment securities held to maturity | — | 100,719 | 140,277 | 89,459 | 51,731 |
| Securities available to sale | 304,479 | 319,520 | 275,076 | 272,484 | 168,641 |
| FHLB and FRB stock, at cost | 4,639 | 4,569 | 4,624 | 5,315 | 4,902 |
| Total loans | 1,132,584 | 1,038,345 | 932,497 | 983,537 | 1,052,982 |
| Allowance for loan losses | 12,735 | 13,223 | 14,282 | 13,192 | 9,688 |
| Total deposits | 1,516,427 | 1,443,892 | 1,351,546 | 1,349,669 | 1,237,888 |
| Total shareholders’ equity | 122,057 | 122,971 | 117,716 | 119,509 | 83,894 |
| Trust assets under administration (market value) | 2,303,612 | 1,957,146 | 1,940,404 | 1,856,229 | 1,804,629 |
| Cash dividends: | | | | | |
| Common | 1,774 | 1,765 | 1,757 | 2,199 | 5,304 |
| Preferred | 112 | 824 | 1,126 | 1,218 | — |

Selected performance ratios:

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Return on average total assets | 0.61 | % | 0.79 | % | 0.52 | % | 0.49 | % | (1.62 | ) |
| Return on average common shareholders' equity | 8.03 | | 10.74 | | 6.26 | | 6.26 | | (20.74 | ) |
| Dividend payout ratio | 19.24 | | 16.13 | | 29.39 | | 39.05 | | (24.04 | ) |
| Equity to assets ratio | 7.25 | | 7.64 | | 7.83 | | 7.99 | | 7.81 | |
| | | | | | | | | | | |
| Net interest margin | 3.50 | | 3.47 | | 3.64 | | 3.58 | | 3.68 | |
| Non-interest expenses to average assets | 3.04 | | 2.90 | | 2.91 | | 2.90 | | 2.74 | |
| Non-interest income to average assets | 1.34 | | 1.09 | | 0.95 | | 0.95 | | (3.03 | ) |
| | | | | | | | | | | |
| Asset quality ratios (at period end): | | | | | | | | | | |
| Nonperforming loans to total loans | 1.04 | % | 1.85 | % | 2.01 | % | 1.19 | % | 0.51 | % |
| Nonperforming assets to total assets | 0.91 | | 1.65 | | 1.51 | | 0.80 | | 0.48 | |
| Allowance for loan losses to nonperforming loans | 108.55 | | 68.83 | | 76.05 | | 112.25 | | 179.64 | |
| Allowance for loan losses to total loans | 1.12 | | 1.27 | | 1.53 | | 1.34 | | 0.92 | |
| Net charge-offs to average loans | 0.80 | | 0.86 | | 0.93 | | 0.61 | | 0.02 | |

Plus other real estate owned

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| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2012 | 2011 | 2010 | 2009 | 2008 |
| Liquidity and capital ratios: | | | | | |
| Average loans to average deposits | 76.39% | 70.15% | 72.22% | 78.74% | 85.01% |
| Total shareholders' equity to total assets | 7.32 | 7.68 | 7.82 | 7.90 | 6.06 |
| Average common shareholders' equity to average assets | 7.22 | 6.66 | 6.43 | 6.17 | 7.81 |
| Total capital to risk-weighted assets | 13.08 | 13.76 | 14.16 | 13.71 | 10.05 |
| Tier 1 capital to risk-weighted assets | 11.83 | 12.51 | 12.91 | 12.45 | 9.11 |
| Tier 1 leverage ratio | 7.27 | 7.73 | 7.96 | 7.93 | 6.15 |

## Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

***OVERVIEW:*** The following discussion and analysis is intended to provide information about the financial condition and results of operations of Peapack-Gladstone Financial Corporation and its subsidiary on a consolidated basis and should be read in conjunction with the consolidated financial statements and the related notes and supplemental financial information appearing elsewhere in this report.

Peapack-Gladstone Financial Corporation (the "Corporation" or the "Company"), formed in 1997, is the parent holding company for Peapack-Gladstone Bank (the "Bank"), formed in 1921, a commercial bank operating 23 branches in Somerset, Hunterdon, Morris, Middlesex and Union counties.

For the year ended December 31, 2012, Peapack-Gladstone Financial Corporation recorded net income of $9.7 million, and diluted earnings per share of $1.05. Several strategic steps were taken during the fourth quarter of 2012 that we believe have positioned the Company well for the future. These strategic initiatives have strengthened the Corporation's core operating base as it embarks on a plan to grow its core lending, retail, and wealth advisory businesses, while maintaining and enhancing its high levels of customer service. The 2012 fourth quarter included the following strategic initiatives:

- The position of Chairman and CEO was split when Doug Kennedy joined the Company as CEO in early October 2012. Frank Kissel remained as Chairman of the Board. Professional, legal, and other costs totaling approximately $336 thousand were recorded in connection with the CEO search.
- Approximately $19 million of classified loans were transferred to loans held for sale and are being marketed for sale. The transfer of these loans to held for sale resulted in an additional provision for loan losses of $4.0 million and charge-offs of $5.4 million.
- The Company's Pooled Trust Preferred Securities portfolio was sold, resulting in a $2.9 million gain. This transaction also resulted in a significant reduction in risk-weighted assets for regulatory capital purposes and the realization of a large portion of the Company's deferred tax assets, with the monetization of much of that to occur in 2013. As part of this, $260 thousand of additional tax expense needed to be recorded, which was related to the realization of the deferred tax assets to be carried-back to the prior two years at a slightly lower tax rate compared to the tax rate as recorded.
- All of the Company's remaining Held to Maturity securities were transferred to Available for Sale.
- The organization and set-up of PGB Trust & Investments of Delaware was completed just prior to year end, resulting in legal fees of approximately $74 thousand.
- Staffing and organizational restructuring coupled with various resignations, retirements, and position eliminations, resulted in the recording of a $965 thousand severance accrual.

Additionally, the fourth quarter of 2012 included $175 thousand of costs and fee waivers as a result of Hurricane Sandy.

In January 2012, the Corporation repurchased the remaining $14.4 million of the preferred stock sold to the U.S. Treasury in the Capital Purchase Program ("CPP"), and in April 2012 paid $110,000 to the Treasury to repurchase the Warrant previously issued in January 2009 under the CPP. The Warrant allowed purchase of up to 150,296 shares of the Corporation's common stock.

Peapack-Gladstone Financial Corporation's common stock trades on the National Association of Securities Dealers Automated Quotations (NASDAQ) Global Select Market under the symbol "PGC."

***CRITICAL ACCOUNTING POLICIES AND ESTIMATES:*** Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon the Corporation's consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires the Corporation to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Note 1 to the Corporation's Audited Consolidated Financial Statements for the year ended December 31, 2012, contains a summary of the Corporation's significant accounting policies.

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Management believes that the Corporation's policy with respect to the methodology for the determination of the allowance for loan losses involves a higher degree of complexity and requires Management to make difficult and subjective judgments, which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumption or estimates could materially impact results of operations. This critical policy and its application are periodically reviewed with the Audit Committee and the Board of Directors.

The provision for loan losses is based upon Management's evaluation of the adequacy of the allowance, including an assessment of known and inherent risks in the portfolio, giving consideration to the size and composition of the loan portfolio, actual loan loss experience, level of delinquencies, detailed analysis of individual loans for which full collectability may not be assured, the existence and estimated fair 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 the Corporation's allowance for loan losses. Such agencies may require the Corporation to make additional provisions for loan losses based upon information available to them at the time of their examination. Furthermore, the majority of the Corporation's loans are secured by real estate in the State of New Jersey. Accordingly, the collectability of a substantial portion of the carrying value of the Corporation's loan portfolio is susceptible to changes in local market conditions and may experience continuing adverse economic conditions. Future adjustments to the provision for loan losses and allowance for loan losses may be necessary due to economic, operating, regulatory and other conditions beyond the Corporation's control.

The Corporation accounts for its securities in accordance with "Accounting for Certain Investments in Debt and Equity Securities," which was codified into Accounting Standards Codification ("ASC") 320. Debt securities are classified as held to maturity and carried at amortized cost when Management has the positive intent and ability to hold them to maturity. Debt securities are classified as available for sale when they might be sold before maturity due to changes in interest rates, prepayment risk, liquidity or other factors. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax.

Securities are evaluated on at least a quarterly basis to determine whether a decline in value is other-than-temporary. To determine whether a decline in value is other-than-temporary, Management considers the reasons underlying the decline, the near-term prospects of the issuer, the extent and duration of the decline and whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. "Other-than-temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be other-than-temporary, the amount of the impairment is split into two components – other-than-temporary impairment related to credit loss, which must be recognized through earnings. No impairment charges were recognized in 2012 or 2011. For equity securities, the entire amount of impairment is recognized through earnings.

***EARNINGS SUMMARY***: The Corporation recorded net income of $9.7 million for the year ended December 31, 2012, and diluted earnings per share, including the effect of the preferred dividend, of $1.05 compared to net income of $12.2 million and diluted earnings per share, including the effect of the preferred dividend, of $1.25 for the year ended December 31, 2011.

These results produced a return on average assets of 0.61 percent and 0.79 percent in 2012 and 2011, respectively, and a return on average common shareholders' equity of 8.03 percent in 2012 and 10.74 percent in 2011.

Earnings for the year ended December 31, 2012 were reduced by the effects of the strategic initiatives detailed in the "Overview" section above.

Earnings for the 2011 year were benefitted by a state income tax benefit of $2.99 million related to the reversal of a valuation allowance previously recorded in 2008. Circumstances and projections indicated that the deferred tax asset would be realized in future periods and it was, in fact, realized upon the sale of the Pooled Trust Preferred Securities portfolio in the fourth quarter of 2012, as noted previously in the "Overview" section.

***NET INTEREST INCOME:*** The primary source of the Corporation's operating income is net interest income, which is the difference between interest and dividends earned on earning assets and fees earned on loans, and interest paid on interest-bearing liabilities. Earning assets include loans to individuals and businesses, investment securities, interest-earning deposits and federal funds sold. Interest-bearing liabilities include interest-bearing checking, savings and time deposits, Federal Home Loan Bank advances and other borrowings. Net interest income is determined by the difference between the yields earned on earning assets and the rates paid on interest-bearing liabilities ("Net Interest Spread") and the relative amounts of earning assets and interest-bearing liabilities. The Corporation's net interest spread is affected by regulatory, economic and competitive factors that influence interest rates, loan demand and deposit flows and general levels of nonperforming assets.

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Net interest income, on a fully tax-equivalent basis, was $52.0 million in 2012, an increase of $2.5 million, or 5 percent, from 2011's levels. The Corporation's net interest margin for 2012 and 2011 was 3.50 percent and 3.47 percent, respectively, reflecting an increase of three basis points. Net interest income and net interest margin reflected increases for 2012 when compared to 2011, as the positive effect of increased loans, funded by reduced lower yielding investment securities and increased lower cost core deposits, was partially offset by the effect of lower market yields, which compressed asset yields more than deposit costs.

In 2012, interest income on earning assets, on a fully tax-equivalent basis, increased $23 thousand at $56.7 million compared to 2011. Interest income remained relatively constant due to the increase in loan volumes which counteracted the decreases in rates earned on loans and investments and the decrease in investment volumes. Average earning assets for 2012 totaled $1.49 billion compared to $1.43 billion for 2011, an increase of $58.4 million or 4 percent. The average rate earned on earning assets was 3.81 percent in 2012, compared to 3.96 percent in 2011, a decline of 15 basis points. The decline in the average rates on earning assets was due to continued decreases to already very low market rates for all loan types in 2012. In 2012, average investment securities totaled $350.4 million, a decrease of $58.9 million compared to 2011. The average yield was 2.40 percent for 2012. Average loan balances increased $129.0 million, or 13 percent, during 2012 to $1.09 billion from $965.7 million in 2011. The average yield on total loans was 4.40 percent and 4.84 percent in 2012 and 2011, respectively, a decrease of 44 basis points. During 2012, the average yield on the residential mortgage portfolio declined 49 basis points to 3.85 percent from 4.34 percent in 2011. The average yield on the commercial mortgage loan portfolio was 5.08 percent in 2012, declined 46 basis points from 2011, while the average yield on commercial loans was 4.97 percent, declining 38 basis points in 2012. The average yield on home equity lines remained relatively constant when compared to 2011 at 3.20 percent for 2012 and 3.23 percent for 2011. Average rates declined during the year due to lower market rates and competitive pressure experienced during 2012.

For the years ended December 31, 2012 and 2011, average interest-bearing liabilities totaled $1.17 billion and $1.16 billion, respectively, reflecting an increase of $9.3 million or 1 percent from the average balance in 2011, while the average rate paid declined to 0.40 percent for 2012 from 0.61 percent for 2011. The decline in the average rate on interest-bearing liabilities was due to the sustained low in-market rates in 2012 coupled with targeted growth of lower-costing core deposits and continued run-off of higher-paying certificates of deposit.

The Corporation's interest-bearing checking accounts continued to grow during 2012, and averaged $336.2 million for the year, an increase of $17.8 million, or 6 percent, from 2011. During 2012, the average rate paid on interest-bearing checking accounts was 0.11 percent, a decrease of 22 basis points from the average rates paid in 2011 of 0.33 percent. For the years ended December 31, 2012 and 2011, noninterest-bearing checking accounts averaged $296.3 million and $243.9 million, respectively, increasing $52.4 million or 21 percent from 2011's levels. Checking account growth is due to the Corporation's relationship orientation as the Corporation has successfully focused on business and personal core deposit generation, particularly checking; establishing municipal relationships within its market territory; and growth in deposits associated with its commercial mortgage and commercial loan growth. In 2012, average money market accounts totaled $510.6 million, compared to $519.7 million in 2011, decreasing $9.1 million or 2 percent, from 2011. The decline in the Corporation's money market deposits can be attributed to the lower rates on these products, which averaged 0.20 percent and 0.39 percent for the years ended December 31, 2012 and 2011, respectively. Average certificates of deposit declined $19.0 million, or 9 percent, as the Corporation has opted not to pay higher rates on maturing certificates of deposit and average rates declined 17 basis points from the 2011 year to

the 2012 year.

During 2012, the average balance of borrowings was $25.3 million compared to $22.6 million during 2011, an increase of $2.7 million or 12 percent, due to the increase in overnight borrowings in 2012 to $10.2 million. As the result of regular principal repayments and maturities on Federal Home Loan Bank advances during 2012, the average of these borrowings declined to $15.1 million from $21.7 million in 2011. The average rates paid on total borrowings was 2.17 percent during 2012 compared to 3.28 percent during 2011, a decrease of 111 basis points. The average rates paid on the Corporation's overnight borrowings during 2012 was 0.38 percent compared to 0.35 percent during 2011, while the average rates paid on Federal Home Loan Bank advances was 3.37 percent and 3.41 percent in 2012 and 2011, respectively.

The average balance on capital lease obligations rose $2.7 million from 2011, as the Corporation added a capital lease obligation on its Gladstone property at the end of 2011. The average rate on capital lease obligations during 2012 was 4.75 percent compared to 4.99 percent in 2011, declining 24 basis points from 2011.

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The following table compares the average balance sheets, net interest spreads and net interest margins for the years ended December 31, 2012, 2011 and 2010 (on a fully tax-equivalent basis-"FTE"):

**Year Ended December 31, 2012**

| (In thousands except yield information) | Average Balance | Income/ Expense (FTE ) | Yield (FTE) |
|---|---|---|---|
| Assets: | | | |
| Interest-earnings assets: | | | |
| Investments: | | | |
| Taxable (1) | $303,599 | $7,033 | 2.32 % |
| Tax-exempt(1)(2) | 46,780 | 1,363 | 2.91 |
| Loans held for sale | 2,487 | 123 | 4.94 |
| Loans (2)(3) | 1,094,696 | 48,112 | 4.40 |
| Federal funds sold | 100 | — | 0.10 |
| Interest-earning deposits | 41,303 | 98 | 0.24 |
| Total interest-earning assets | 1,488,965 | $56,729 | 3.81 % |
| Noninterest-earning assets: | | | |
| Cash and due from banks | 6,506 | | |
| Allowance for loan losses | (13,942 ) | | |
| Premises and equipment | 31,049 | | |
| Other assets | 77,048 | | |
| Total noninterest-earning assets | 100,661 | | |
| Total assets | $1,589,626 | | |
| Liabilities and shareholders' equity: | | | |
| Interest-bearing deposits: | | | |
| Checking | $336,228 | $379 | 0.11 % |
| Money markets | 510,633 | 1,022 | 0.20 |
| Savings | 101,068 | 70 | 0.07 |
| Certificates of deposit | 188,918 | 2,237 | 1.18 |
| Total interest-bearing deposits | 1,136,847 | 3,708 | 0.33 |
| Borrowed funds | 25,277 | 548 | 2.17 |
| Capital lease obligation | 9,067 | 431 | 4.75 |
| Total interest-bearing liabilities | 1,171,191 | 4,687 | 0.40 % |
| Noninterest-bearing liabilities: | | | |
| Demand deposits | 296,250 | | |
| Accrued expenses and other liabilities | 6,977 | | |
| Total noninterest-bearing liabilities | 303,227 | | |
| Shareholders' equity | 115,208 | | |
| Total liabilities and shareholders' equity | $1,589,626 | | |
| Net interest income | | $52,042 | |
| Net interest spread | | | 3.41 % |
| Net interest margin (4) | | | 3.50 % |

1. Average balances for available for sale securities are based on amortized cost.
2. Interest income is presented on a tax-equivalent basis using a 35 percent federal tax rate.
3. Loans are stated net of unearned income and include nonaccrual loans.
4. Net interest income on a tax-equivalent basis as a percentage of total average interest-earning assets.

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Year Ended December 31, 2011

| (In thousands except yield information) | Average Balance | Income/ Expense (FTE ) | Yield (FTE) |
|---|---|---|---|
| Assets: | | | |
| Interest-earnings assets: | | | |
| Investments: | | | |
| Taxable (1) | $369,905 | $8,351 | 2.26 % |
| Tax-exempt(1)(2) | 39,338 | 1,439 | 3.66 |
| Loans held for sale | 880 | 56 | 6.41 |
| Loans (2)(3) | 965,716 | 46,716 | 4.84 |
| Federal funds sold | 100 | — | 0.23 |
| Interest-earning deposits | 54,664 | 144 | 0.26 |
| Total interest-earning assets | 1,430,603 | $56,706 | 3.96 % |
| Noninterest-earning assets: | | | |
| Cash and due from banks | 8,260 | | |
| Allowance for loan losses | (14,561 ) | | |
| Premises and equipment | 33,015 | | |
| Other assets | 73,263 | | |
| Total noninterest-earning assets | 99,977 | | |
| Total assets | $1,530,580 | | |
| Liabilities and shareholders' equity: | | | |
| Interest-bearing deposits: | | | |
| Checking | $318,446 | $1,045 | 0.33 % |
| Money markets | 519,702 | 2,010 | 0.39 |
| Savings | 86,818 | 205 | 0.24 |
| Certificates of deposit | 207,892 | 2,815 | 1.35 |
| Total interest-bearing deposits | 1,132,858 | 6,075 | 0.54 |
| Borrowed funds | 22,622 | 742 | 3.28 |
| Capital lease obligation | 6,397 | 319 | 4.99 |
| Total interest-bearing liabilities | 1,161,877 | 7,136 | 0.61 % |
| Noninterest-bearing liabilities: | | | |
| Demand deposits | 243,850 | | |
| Accrued expenses and other liabilities | 7,954 | | |
| Total noninterest-bearing liabilities | 251,804 | | |
| Shareholders' equity | 116,899 | | |
| Total liabilities and shareholders' equity | $1,530,580 | | |
| Net interest income | | $49,570 | |
| Net interest spread | | | 3.35 % |
| Net interest margin (4) | | | 3.47 % |

1. Average balances for available for sale securities are based on amortized cost.
2. Interest income is presented on a tax-equivalent basis using a 35 percent federal tax rate.
3. Loans are stated net of unearned income and include nonaccrual loans.

4. Net interest income on a tax-equivalent basis as a percentage of total average interest-earning assets.

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Year Ended December 31, 2010

| (In thousands except yield information) | Average Balance | Income/ Expense (FTE ) | Yield (FTE) |
|---|---|---|---|
| Assets: | | | |
| Interest-earnings assets: | | | |
| Investments: | | | |
| Taxable (1) | $329,605 | $9,315 | 2.83 % |
| Tax-exempt(1)(2) | 34,985 | 1,607 | 4.59 |
| Loans held for sale | — | — | — |
| Loans (2)(3) | 958,472 | 50,529 | 5.27 |
| Federal funds sold | 174 | 1 | 0.23 |
| Interest-earning deposits | 64,182 | 149 | 0.23 |
| Total interest-earning assets | 1,387,418 | $61,601 | 4.44 % |
| Noninterest-earning assets: | | | |
| Cash and due from banks | 8,567 | | |
| Allowance for loan losses | (14,070 ) | | |
| Premises and equipment | 31,826 | | |
| Other assets | 69,309 | | |
| Total noninterest-earning assets | 95,632 | | |
| Total assets | $1,483,050 | | |
| Liabilities and shareholders' equity: | | | |
| Interest-bearing deposits: | | | |
| Checking | $258,995 | $1,586 | 0.61 % |
| Money markets | 510,331 | 3,619 | 0.71 |
| Savings | 77,023 | 289 | 0.38 |
| Certificates of deposit | 266,134 | 4,286 | 1.61 |
| Total interest-bearing deposits | 1,112,483 | 9,780 | 0.88 |
| Borrowed funds | 29,552 | 1,046 | 3.54 |
| Capital lease obligation | 3,637 | 206 | 5.64 |
| Total interest-bearing liabilities | 1,145,672 | 11,032 | 0.96 % |
| Noninterest-bearing liabilities: | | | |
| Demand deposits | 214,753 | | |
| Accrued expenses and other liabilities | 6,490 | | |
| Total noninterest-bearing liabilities | 221,243 | | |
| Shareholders' equity | 116,135 | | |
| Total liabilities and shareholders' equity | $1,483,050 | | |
| Net interest income | | $50,569 | |
| Net interest spread | | | 3.48 % |
| Net interest margin (4) | | | 3.64 % |

1. Average balances for available for sale securities are based on amortized cost.
2. Interest income is presented on a tax-equivalent basis using a 35 percent federal tax rate.
3. Loans are stated net of unearned income and include nonaccrual loans.

4. Net interest income on a tax-equivalent basis as a percentage of total average interest-earning assets.

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***RATE/VOLUME ANALYSIS:*** The effect of volume and rate changes on net interest income (on a tax-equivalent basis) for the periods indicated are shown below:

| | Year Ended 2012 Compared with 2011 | | | Year Ended 2011 Compared with 2010 | | |
|---|---|---|---|---|---|---|
| (In Thousands): | Difference due to Change In: Volume | Rate | Net Change In Income/ Expense | Change In Income/ Volume | Rate | Net Change In Income/ Expense |
| ASSETS: | | | | | | |
| Investments | $ (1,050) | $ (344) | $ (1,394) | $ 2,161 | $ (3,293) | $ (1,132) |
| Loans | 5,801 | (4,405) | 1,396 | 539 | (4,352) | (3,813) |
| Loans held for sale | 80 | (13) | 67 | 56 | — | 56 |
| Federal funds sold | — | — | — | (1) | — | (1) |
| Interest-earning deposits | (35) | (11) | (46) | (23) | 18 | (5) |
| Total interest income | $ 4,796 | $ (4,773) | $ 23 | $ 2,732 | $ (7,627) | $ (4,895) |
| LIABILITIES: | | | | | | |
| Checking | $ 5 | $ (671) | $ (666) | $ 251 | $ (791) | $ (540) |
| Money market | (35) | (953) | (988) | 43 | (1,652) | (1,609) |
| Savings | 30 | (165) | (135) | 30 | (115) | (85) |
| Certificates of deposit | (244) | (334) | (578) | (848) | (623) | (1,471) |
| Borrowed funds | (185) | (9) | (194) | (267) | (37) | (304) |
| Capital lease obligation | 127 | (15) | 112 | 139 | (26) | 113 |
| Total interest expense | $ (302) | $ (2,147) | $ (2,449) | $ (652) | $ (3,244) | $ (3,896) |
| Net interest income | $ 5,098 | $ (2,626) | $ 2,472 | $ 3,384 | $ (4,383) | $ (999) |

***INVESTMENT SECURITIES HELD TO MATURITY:*** Investment securities are those securities that the Corporation has both the ability and intent to hold to maturity. These securities are carried at amortized cost. As noted in the "Overview" section above, in December 2012, the Corporation transferred its entire held to maturity securities portfolio, with amortized cost of approximately $64.2 million and fair value of $65.9 million, to available for sale. The Corporation's investment securities held to maturity totaled at amortized cost $100.7 million at December 31, 2011.

The carrying value of investment securities held to maturity for the years ended December 31, 2011 and 2010 are shown below:

| (In Thousands) | 2011 | 2010 |
|---|---|---|
| U.S. treasury and U.S. government-sponsored entities | $— | $45,485 |
| Mortgage-backed securities-residential | 67,394 | 67,745 |
| State and political subdivision | 24,608 | 17,671 |
| Trust preferred pooled securities | 8,717 | 9,376 |
| Total | $100,719 | $140,277 |

***INVESTMENT SECURITIES AVAILABLE FOR SALE:*** Investment securities available for sale are used as a part of the Corporation's liquidity and interest rate risk management strategies, and they may be sold in response to changes in interest rates, liquidity needs, prepayment speeds and/or other factors. These securities are carried at estimated fair value, and unrealized changes in fair value are recognized as a separate component of shareholders' equity, net of income taxes. Realized gains and losses are recognized in income at the time the securities are sold.

At December 31, 2012, the Corporation had investment securities available for sale with a fair value of $304.5 million, compared with $319.5 million at December 31, 2011. Net unrealized gains (net of income tax) of $4.3 million and $3.2 million were included in shareholders' equity at December 31, 2012 and 2011, respectively.

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The carrying value of investment securities available for sale for the years ended December 31, 2012, 2011 and 2010 are shown below:

| (In Thousands) | 2012 | 2011 | 2010 |
|---|---|---|---|
| U.S. treasury and U.S. government-sponsored entity bonds | $26,845 | $46,878 | $51,135 |
| Mortgage-backed securities-residential (principally U.S. government-sponsored entities) | 221,440 | 236,984 | 202,090 |
| State and political subdivision | 50,632 | 29,851 | 16,613 |
| Single-issuer trust preferred security | 2,289 | 2,167 | 3,001 |
| CRA investment fund | 3,062 | 3,040 | 1,499 |
| Marketable equity securities | 211 | 600 | 738 |
| Total | $304,479 | $319,520 | $275,076 |

The following table presents the contractual maturities and yields of debt securities available for sale, stated at fair value, as of December 31, 2012:

| (In Thousands) | Within 1 Year | After 1 But Within 5 Years | After 5 But Within 10 Years | After 10 Years | Total |
|---|---|---|---|---|---|
| U.S. treasury and U.S. government-sponsored entity bonds | $— | $— | $2,841 | $24,004 | $26,845 |
| | — % | — % | 2.45 % | 1.27 % | 1.39 % |
| Mortgage-backed securities-residential (1) | $20 | $1,911 | $94,088 | $125,421 | $221,440 |
| | 5.05 % | 2.89 % | 2.28 % | 2.02 % | 2.14 % |
| State and political subdivisions (2) | $18,603 | $12,078 | $17,221 | $2,730 | $50,632 |
| | 1.02 % | 2.16 % | 3.82 % | 4.51 % | 2.40 % |
| Single-issuer trust preferred security (1) | $— | $— | $— | $2,289 | $2,289 |
| | — % | — % | — % | 1.12 % | 1.12 % |
| Total | $18,623 | $13,989 | $114,150 | $154,444 | $301,206 |
| | 1.02 % | 2.26 % | 2.51 % | 1.92 % | 2.10 % |

(1) Shown using stated final maturity

(2) Yields presented on a fully tax-equivalent basis.

Federal funds sold and interest-earning deposits are an additional part of the Corporation's liquidity and interest rate risk management strategies. The combined average balance of these investments during 2012 was $41.4 million compared to $54.8 million in 2011.

***LOANS:*** The loan portfolio represents the largest portion of the Corporation’s earning assets and is an important source of interest and fee income. Loans are primarily originated in the State of New Jersey.

At December 31, 2012, total loans were $1.13 billion, compared to $1.04 billion at December 31, 2011, an increase of $94.2 million or 9 percent. The Company has been successful in originating high-quality loans due to its customer service levels, turnaround time and competitive pricing. Residential mortgage loans totaled $515.0 million at December 31, 2012, an increase of $16.5 million, or 3 percent, from 2011 and was attributable to originations retained in the portfolio that have outpaced loan paydowns. During this period of lower interest rates, refinance activity has generally been robust and many of these loans have been retained in portfolio; however, the Corporation does sell certain of its longer duration loan production as a source of noninterest income and as part of its interest rate risk management strategy in the lower rate environment. In 2012, commercial mortgages increased $89.5 million or 27 percent to $420.1 million due primarily to borrowers looking to refinance multi-family and other commercial mortgages held by other institutions. Construction loans totaled $9.3 million and $13.7 million at December 31, 2012 and 2011, respectively, declining $4.4 million or 32 percent as the Bank continued to decrease its exposure in construction lending. Commercial loans totaled $115.4 million at December 31, 2012, declining $8.5 million or 7 percent in 2012. Home equity lines of credit declined $656 thousand, or 1 percent, while consumer loans increased $1.7 million, or 9 percent.

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The Corporation also transferred $19 million of classified loans to loans held for sale in December 2012 as these loans are being marketed for sale. Upon transfer, the Corporation recorded a charge-off on these loans totaling $5.4 million. These loans are disclosed as loans held for sale, at lower of cost or fair value, on the consolidated statements of condition as of December 31, 2012 with a balance of $13.7 million.

The following table presents an analysis of outstanding loans by loan type, net of unamortized discounts and deferred loan origination costs, as of December 31,

| (In Thousands) | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| Residential mortgage | $515,014 | $498,482 | $419,653 | $452,641 | $505,150 |
| Commercial mortgage | 420,086 | 330,559 | 288,183 | 279,595 | 274,640 |
| Commercial loans | 115,372 | 123,845 | 131,408 | 120,554 | 143,188 |
| Commercial-construction | 9,328 | 13,713 | 25,367 | 64,816 | 66,785 |
| Home equity lines of credit | 49,635 | 50,291 | 45,775 | 38,728 | 31,054 |
| Consumer and other loans | 23,149 | 21,455 | 22,111 | 27,203 | 32,165 |
| Total loans | $1,132,584 | $1,038,345 | $932,497 | $983,537 | $1,052,982 |

The following table presents the contractual repayments of the loan portfolio, by loan type, at December 31, 2012:

| (In Thousands) | Within One Year | After 1 But Within 5 Years | After 5 Years | Total |
|---|---|---|---|---|
| Residential mortgage | $192,958 | $ 225,533 | $96,523 | $515,014 |
| Commercial mortgage | 107,640 | 254,140 | 58,306 | 420,086 |
| Commercial loans | 54,672 | 57,136 | 3,564 | 115,372 |
| Commercial-construction | 9,328 | — | — | 9,328 |
| Home equity lines of credit | 49,635 | — | — | 49,635 |
| Consumer and other loans | 10,817 | 9,466 | 2,866 | 23,149 |
| Total loans | $425,050 | $ 546,275 | $161,259 | $1,132,584 |

The following table presents the loans, by loan type, that have a predetermined interest rate and an adjustable interest rate due after one year at December 31, 2012:

| (In Thousands) | Predetermined Interest Rate | Adjustable Interest Rate |
|---|---|---|
| Residential mortgage | $ 286,410 | $ 124,580 |
| Commercial mortgage | 37,510 | 396,164 |
| Commercial loans | 5,365 | 7,973 |
| Commercial construction | 800 | 2,450 |

| | | |
|---|---|---|
| Consumer loans | 17,153 | — |
| Total loans | $ 347,238 | $ 531,167 |

The Corporation has not made nor invested in subprime loans or "Alt-A" type mortgages. At December 31, 2012, there were no commitments to lend additional funds to borrowers whose loans are classified as nonperforming.

***DEPOSITS:*** At December 31, 2012, the Corporation reported total deposits of $1.52 billion, an increase of $72.5 million, or 5.0 percent, from the balance reported at December 31, 2011. The Corporation's strategy is to fund earning asset growth with core deposits, which is an important factor in the generation of net interest income. Total average deposits for 2012 increased $56.4 million, or 4.1 percent, over 2011 average levels. Over that period, the Company saw growth in average noninterest-bearing checking balances, growth in average interest-bearing checking, and growth in savings. Average money market account balances declined slightly. The Company has successfully focused on:

- Business and personal core deposit generation, particularly checking;
- Municipal relationships within its market territory; and
- Growth in deposits associated with its commercial mortgage and commercial loan growth.

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Average certificates of deposit (CDs) declined in 2012 from 2011's levels. These higher-cost CDs were replaced with lower-cost, more stable core deposits.

The following table sets forth information concerning the composition of the Corporation's average deposit base and average interest rates paid for the following years:

| (In Thousands) | 2012 | | 2011 | | 2010 | |
|---|---|---|---|---|---|---|
| Noninterest-bearing demand | $296,250 | — % | $243,850 | — % | $214,753 | — % |
| Checking | 336,228 | 0.11 | 318,446 | 0.33 | 258,995 | 0.61 |
| Savings | 101,068 | 0.07 | 86,818 | 0.24 | 77,023 | 0.38 |
| Money markets | 510,633 | 0.20 | 519,702 | 0.39 | 510,331 | 0.71 |
| Certificates of deposit | 188,918 | 1.18 | 207,892 | 1.35 | 266,134 | 1.61 |
| Total deposits | $1,433,097 | 0.26% | $1,376,708 | 0.44% | $1,327,236 | 0.74% |

Certificates of deposit $100,000 and over are generally purchased by local municipal governments or individuals for periods of one year or less. The following table shows the remaining maturity for certificates of deposit of $100,000 or more as of December 31, 2012 (in thousands):

| | |
|---|---|
| Three months or less | $11,153 |
| Over three months through six months | 29,902 |
| Over six months through twelve months | 18,421 |
| Over twelve months | 9,265 |
| Total | $68,741 |

***FEDERAL HOME LOAN BANK ADVANCES AND OTHER BORROWINGS:*** At December 31, 2012 and 2011, Federal Home Loan Bank (FHLB) advances totaled $12.2 million and $17.7 million, respectively, with a weighted average interest rate of 3.03 percent and 3.41 percent, respectively. The Corporation considers FHLB advances an added source of funding, and accordingly, may execute transactions from time to time as an additional part of Corporation's liquidity and interest rate risk management strategies. The FHLB advances outstanding at December 31, 2012 have varying maturities, call dates and interest rates, as well as prepayment penalties. There were no overnight borrowings at December 31, 2012 and 2011.

***ALLOWANCE FOR LOAN LOSSES AND RELATED PROVISION***: The allowance for loan losses was $12.7 million at December 31, 2012 compared to $13.2 million at December 31, 2011. At December 31, 2012, the allowance for loan losses as a percentage of total loans outstanding was 1.12 percent compared to 1.27 percent at December 31, 2011. The provision for loan losses was $8.3 million for 2012, $7.3 million for 2011 and $10.0 million for 2010. The decline in the allowance as a percentage of loans in 2012 is primarily due to lower specific and general reserves attributable to reduced levels of non-performing, impaired and classified loans.

In determining an appropriate amount for the allowance, the Bank segments and evaluates the loan portfolio based on Federal call report codes, which are based on collateral. The following portfolio classes have been identified:

a) Primary Residential Mortgages. The Bank originates one to four family residential mortgage loans within or near its primary geographic market area. When reviewing residential mortgage loan applications, the Bank obtains detailed verifiable information regarding income, assets and indebtedness, a credit report, and an independent appraisal of the property to be mortgaged. The Bank makes residential mortgage loans up to 80% of the appraised value and up to 95% with private mortgage insurance. The Bank uses lower loan to value ratios for large loans and loans on either second (vacation) homes or investment property. The Bank's underwriting guidelines include (i) minimum credit report scores of 680 and (ii) a maximum debt to income ratio of 40% if the loan to value is 70% or higher and 45% if the loan to value is less than 70%. The Bank may consider an exception to any guideline if the remaining characteristics of the application are sufficiently strong to compensate. The Bank retains in its portfolio residential mortgage loans with maturities of up to 15 years while loans with longer maturities are sold to third party financial institutions. The Bank does not originate, purchase or carry any sub-prime mortgage loans.

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Primary risk characteristics associated with residential mortgage loans typically involve major living or lifestyle changes to the borrower, including unemployment or other loss of income; unexpected significant expenses, such as for major medical issues or catastrophic events; divorce or death. In addition, residential mortgage loans that have adjustable rates could expose the borrower to higher debt service requirements in a rising interest rate environment. Further, real estate value could drop significantly and cause the value of the property to fall below the loan amount, creating additional potential exposure for the Bank.

Bank management believes that the underwriting guidelines previously described address the primary risk characteristics. Further, the Bank has dedicated staff and system resources to monitor and collect on any potentially problematic residential mortgage loans.

b) Home Equity Lines of Credit. The Bank provides revolving lines of credit against one to four family residences within or near its primary geographic market. When reviewing residential mortgage loan applications, the Bank obtains detailed verifiable information regarding income, assets and indebtedness, a credit report, and an independent appraisal of the property to be mortgaged. For home equity lines of credit, the Bank utilizes the same underwriting standards as for primary residential mortgages. Primary risk characteristics associated with home equity lines of credit typically involve major living or lifestyle changes to the borrower, including unemployment or other loss of income; unexpected significant expenses, such as for major medical issues or catastrophic events; divorce or death. In addition, home equity lines of credit typically are made with variable or floating interest rates, such as the Prime Rate, which could expose the borrower to higher debt service requirements in a rising interest rate environment. Further, real estate value could drop significantly and cause the value of the property to fall below the loan amount, creating additional potential exposure for the Bank.

Bank management believes that the underwriting guidelines previously described address the primary risk characteristics. Further, the Bank has dedicated staff and system resources to monitor and collect on any potentially problematic home equity lines of credit.

c) Junior Lien Loan on Residence. The Bank provides junior lien loans (“JLL”) against one to four family properties within or near its primary geographic market area. Junior liens loans can be either in the form of an amortizing home equity loan or a revolving home equity line of credit. These loans are subordinate to a first mortgage which may be from another lending institution. The Bank will require that the mortgage securing the JLL be no more junior than a second lien position. The Bank will evaluate these applications in the same manner as it underwrites primary residential mortgages. The combined first mortgage and junior lien loan must be no more than 80% of the appraised value of the property when the combined debt is less than or equal to $800,000. For JLL amounts where the combined debt exceeds $800,000, the maximum loan-to-value ratio is 65%. Primary risk characteristics associated with junior lien loans typically involve major living or lifestyle changes to the borrower, including unemployment or other loss of income; unexpected significant expenses, such as for major medical issues or catastrophic events; divorce or death. Further, real estate value could drop significantly and cause the value of the property to fall below the loan amount, creating additional potential exposure for the Bank.

Bank management believes that the underwriting guidelines previously described address the primary risk characteristics. Further, the Bank has dedicated staff and system resources to monitor and collect on any potentially problematic junior lien loans.

d) Multifamily and Commercial Real Estate Loans. The Bank provides mortgage loans for multifamily properties (i.e. buildings which have five or more residential units) and other commercial real estate that is either owner occupied or managed as an investment property. Commercial real estate properties primarily include office and medical buildings, retail space, and warehouse or flex space. Some properties are considered "mixed use" as they are a combination of building types, such as an apartment building that may also have retail space. In these cases the Bank determines which component provides the majority of the rental income for the property and utilizes that component for the loan classification.

The terms and conditions of all commercial mortgage loans are tailored to the specific attributes of the borrower, the property or project, and any guarantors. In the case of multifamily and investment commercial real estate properties, the Bank reviews, among other things, the nature of and diversity of the underlying tenants and leases, the resources and experience of the sponsor, and the condition and location of the subject property. With an owner occupied property, a detailed credit assessment is also made of the operating business. While the Bank's policy allows loan to value ratios of up to 80% of an appraised value, the majority of the loans are originated at loan to value ratios of 70% or lower. Commercial mortgage loans are generally made on a fixed rate basis with periodic rate resets every five or seven years over an underlying market index. The Bank requires an independent appraisal, a property conditions assessment from an engineering firm, and appropriate environmental due diligence.

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Multifamily loans are expected to be repaid from the cash flow of the underlying property so the collective amount of rents must be sufficient to cover all operating expenses, property management and maintenance, taxes and debt service. Increases in vacancy rates, interest rates or other changes in general economic conditions can all have an impact on the borrower and their ability to repay the loan. Commercial real estate loans are generally considered to have a higher degree of credit risk than multifamily loans as they may be dependent on the ongoing success and operating viability of a fewer number of tenants who are occupying the property and who may have a greater degree of exposure to economic conditions. To mitigate this risk, the Bank will require a standby assignment of leases, greater direct recourse to the owners, and a risk appropriate interest rate and loan structure. In underwriting a commercial mortgage loan, the Bank evaluates the property's historical operating income as well as its projected sustainability and generally requires a minimum debt service coverage ratio that provides for an adequate cushion for unexpected or uncertain future events such as the potential impact of changes in interest rates, vacancy levels and lease rates.

e) Commercial and Industrial Loans. The Bank provides lines of credit and term loans to operating companies for business purposes. The loans are generally secured by business assets such as accounts receivable, inventory and equipment. When underwriting business loans, among other things, the bank evaluates the historical profitability and debt servicing capacity of the borrowing entity and the financial resources and character of the principal owners and guarantors.

Commercial and industrial loans are typically repaid first by the cash flow generated by the borrower's business operation. The primary risk characteristics are specific to the underlying business and its ability to generate sustainable profitability and resulting positive cash flow. Factors that may influence a business's profitability include, but are not limited to, demand for its products or services, quality and depth of management, degree of competition, regulatory changes, and general economic conditions. Commercial and industrial loans are generally secured by business assets; however, the ability of the Bank to foreclose and realize sufficient value from the assets is often highly uncertain. To mitigate the risk characteristics of commercial and industrial loans, the Bank will often require more frequent reporting requirements from the borrower in order to better monitor its business performance.

f) Agricultural Production. These are loans to finance agricultural production and other loans to farmers.

g) Commercial Construction. The Bank has substantially wound down its commercial construction lending activity given the current economic environment. New construction loans would be considered only to experienced and reputable local builders and developers that have the capital and liquidity to carry a project to completion and stabilization and for projects that are supported by either a permanent take-out or acceptable executed leases or sales contracts. When evaluating a construction loan request, the Bank will also review the construction plans and drawings, costs estimates from architects, and an independent appraisal. Construction loans typically have a 12-24 month period of interest only and at a maximum 70% loan-to-value ratio. Construction loans are considered riskier than commercial financing on improved and established commercial real estate. The risk of potential loss increases if the original cost estimates or time to complete are significantly off.

h) Consumer and Other. These are loans to individuals for household, family and other personal expenditures as well as obligations of states and political subdivisions in the U.S. This also represents all other loans that cannot be

categorized in any of the previous mentioned loan segments.

The provision was based upon Management's review and evaluation of the size and composition of the loan portfolio, actual loan loss experience, level of delinquencies, general market and economic conditions, detailed analysis of individual loans for which full collectability may not be assured, and the existence and fair value of the collateral and guarantees securing the loans. Although Management used 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 the Corporation's allowance for loan losses. Such agencies may require the Corporation to make additional provisions for loan losses based upon information available to them at the time of their examination. Furthermore, the majority of the Corporation's loans are secured by real estate in the State of New Jersey. Accordingly, the collectability of a substantial portion of the carrying value of the Corporation's loan portfolio is susceptible to changes in market conditions in the state and may be adversely affected should real estate values decline further or New Jersey experience continuing adverse economic conditions. Future adjustments to the allowance may be necessary due to economic, operating, regulatory and other conditions beyond the Corporation's control.

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The following table presents the loan loss experience, by loan type, during the periods ended December 31, of the years indicated:

| (In Thousands) | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| Allowance for loan losses at | | | | | |
| Beginning of year | $13,223 | $14,282 | $13,192 | $9,688 | $7,500 |
| Loans charged-off during the period: | | | | | |
| Residential mortgage | 1,676 | 763 | 450 | 861 | 7 |
| Commercial mortgage | 6,987 | 6,767 | 198 | 1,393 | — |
| Commercial and construction | 305 | 879 | 8,330 | 3,957 | 214 |
| Home equity lines of credit | 91 | 89 | — | 15 | 17 |
| Consumer and other | 100 | 41 | 188 | 51 | 1 |
| Total loans charged-off | 9,159 | 8,539 | 9,166 | 6,277 | 239 |
| Recoveries during the period: | | | | | |
| Residential mortgage | 3 | — | — | — | — |
| Commercial mortgage | 316 | 96 | 15 | — | 12 |
| Commercial and construction | 60 | 119 | 239 | 73 | — |
| Home equity lines of credit | — | — | — | — | 12 |
| Consumer and other | 17 | 15 | 2 | 8 | 3 |
| Total recoveries | 396 | 230 | 256 | 81 | 27 |
| Net charge-offs | 8,763 | 8,309 | 8,910 | 6,196 | 212 |
| Provision charge to expense | 8,275 | 7,250 | 10,000 | 9,700 | 2,400 |
| Allowance for loan losses at end of year | $12,735 | $13,223 | $14,282 | $13,192 | $9,688 |
| | | | | | |
| Ratios: | | | | | |
| Allowance for loan losses/total loans | 1.12 % | 1.27 % | 1.53 % | 1.34 % | 0.92 % |
| Allowance for loan losses/ | | | | | |
| Total nonperforming loans | 108.55 | 68.83 | 76.05 | 112.25 | 179.64 |

The following table shows the allocation of the allowance for loan losses and the percentage of each loan category, by collateral type, to total loans as of December 31, of years indicated:

| (In thousands) | 2012 | % of Loan Category To Total Loans | 2011 | % of Loan Category To Total Loans | 2010 | % of Loan Category To Total Loans | 2009 | % of Loan Category To Total Loans | 2008 | % of Loan Category To Total Loans |
|---|---|---|---|---|---|---|---|---|---|---|
| Residential | $3,388 | 52.2 | $2,682 | 55.0 | $1,890 | 52.5 | $2,023 | 46.0 | $2,627 | 50.9 |
| Commercial and other | 9,255 | 46.4 | 9,955 | 43.8 | 11,804 | 46.3 | 10,889 | 47.3 | 6,753 | 46.3 |
| Consumer | 92 | 1.4 | 78 | 1.2 | 66 | 1.2 | 280 | 6.7 | 308 | 2.8 |
| Unallocated | — | N/A | 508 | N/A | 522 | N/A | — | N/A | — | N/A |
| Total | $12,735 | 100.0 | $13,223 | 100.0 | $14,282 | 100.0 | $13,192 | 100.0 | $9,688 | 100.0 |

The portion of the allowance for loan losses allocated to loans collectively evaluated for impairment, commonly referred to as general reserves, was $11.9 million at both December 31, 2012 and at December 31, 2011. General reserves at December 31, 2012 exceeded the amount charged off during 2012 and represent 1.07 percent of loans collectively evaluated for impairment as of the end of the year. At December 31, 2011, general reserves were 1.18 percent of loans collectively evaluated for impairment.

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The residential and multi-family portfolios experienced growth of approximately $74 million when comparing December 31, 2012 to December 31, 2011. These portfolios generally carry a lower allocation of the general allowance for loan losses. In addition, the Corporation experienced an increase in the non-owner occupied commercial real estate loan portfolio during 2012, which increased by approximately $55.6 million. The commercial real estate portfolio generally carries a higher allocation of general allowance for loan losses. These increases were offset by the continued decline in the owner occupied commercial real estate, commercial and construction portfolios which have historically carried a higher allowance of the general allowance for loan losses.

The allowance for loan losses as a percentage of nonperforming loans increased, as the level of nonperforming loans also decreased during the year. Nonperforming loans are specifically evaluated for impairment. Also, Management commonly records partial charge-offs of the excess of the principal balance over the net realizable value of collateral for collateral dependent impaired loans; as a result, the allowance for loan losses does not always change proportionately with changes in nonperforming loans. Management charged off $3.5 million on loans identified as collateral-dependent impaired loans during 2012.

During the fourth quarter of 2012, approximately $19 million of classified loans were transferred to loans held for sale and are being marketed for sale. The transfer of these loans to held for sale resulted in an additional provision for loan losses of $4.0 million and charge-offs of $5.4 million.

***ASSET QUALITY***:

The following table presents various asset quality data for the years indicated. These tables do not include loans held for sale.

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| (In thousands) | 2012 | 2011 | 2010 | 2009 | 2008 |
| Loans past due 30-89 days | $3,786 | $11,632 | $5,475 | $6,015 | $8,728 |
| Troubled debt restructured loans | $9,316 | $11,104 | $7,157 | $11,123 | $— |
| Loans past due 90 days or more and still accruing interest | $— | $345 | $666 | $496 | $— |
| Nonaccrual loans | 11,732 | 18,865 | 18,114 | 11,256 | 5,393 |
| Total nonperforming loans | 11,732 | 19,210 | 18,780 | 11,752 | 5,393 |
| Other real estate owned | 3,496 | 7,137 | 4,000 | 360 | 1,211 |
| Total nonperforming assets | $15,228 | $26,347 | $22,780 | $12,112 | $6,604 |

| Ratios: | | | | | |
|---|---|---|---|---|---|
| Total nonperforming loans/total loans | 1.04 % | 1.85 % | 2.01 % | 1.19 % | 0.51 % |
| Total nonperforming loans/total assets | 0.70 | 1.20 | 1.25 | 0.78 | 0.39 |
| Total nonperforming assets/total assets | 0.91 | 1.65 | 1.51 | 0.80 | 0.48 |

Due to the continued weakness in the housing markets and economic environment during 2012, some borrowers have found it difficult to make their loan payments under contractual terms. In certain of these cases, the Corporation has chosen to grant concessions and modify certain loan terms for a limited period of time.

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The following table presents the troubled debt restructured loans, by collateral, at December 31, 2012 and 2011:

| (Dollars in thousands) | December 31, 2012 | Number of Relationships | December 31, 2011 | Number of Relationships |
|---|---|---|---|---|
| Primary residential mortgage | $ 1,159 | 6 | $ 1,608 | 4 |
| Junior lien loan on residence | 240 | 1 | — | — |
| Multifamily property | — | — | — | — |
| Owner-occupied commercial real estate | 2,544 | 2 | 3,738 | 3 |
| Investment commercial real estate | 4,949 | 1 | 5,249 | 2 |
| Commercial and industrial | 424 | 3 | 509 | 3 |
| Total | $ 9,316 | 13 | $ 11,104 | 12 |

At December 31, 2012 and 2011, $2.9 million and $3.8 million, respectively, of troubled debt restructured loans are also included in nonaccrual loans above. All troubled debt restructured loans are considered and included in impaired loans at December 31, 2012 and had specific reserves of $723 thousand. At December 31, 2011, all troubled debt restructured loans are considered and included in impaired loans and had specific reserves of $986 thousand.

Except as set forth above, the Corporation does not have any potential problem loans that causes Management to have serious doubts as to the ability of such borrowers to comply with the present loan repayment terms and which may result in disclosure of such loans.

Impaired loans include non-accrual loans of $11.7 million and $18.9 million at December 31, 2012 and 2011, respectively. Impaired loans also include commercial mortgage troubled debt restructured loans of $7.5 million at December 31, 2012 and $5.4 million at December 31, 2011.

The following table presents impaired loans, by collateral type, at December 31, 2012 and 2011.

| (Dollars in thousands) | December 31, 2012 | Number of Relationships | December 31, 2011 | Number of Relationships |
|---|---|---|---|---|
| Primary residential mortgage | $ 7,155 | 28 | $ 8,878 | 25 |
| Home equity lines of credit | 110 | 2 | 489 | 3 |
| Junior lien loan on residence | 562 | 5 | 680 | 4 |
| Multifamily property | — | — | 550 | 2 |
| Owner-occupied commercial real estate | 4,724 | 9 | 9,054 | 11 |
| Investment commercial real estate | 5,173 | 2 | 5,986 | 3 |
| Commercial and industrial | 423 | 3 | 576 | 4 |
| Total | $ 18,147 | 49 | $ 26,213 | 52 |

| | | |
|---|---|---|
| Specific reserves, included in the allowance for loan losses | $ 813 | $ 1,288 |

***CONTRACTUAL OBLIGATIONS***: The following table shows the significant contractual obligations of the Corporation by expected payment period, as of December 31, 2012:

| (In thousands) | Less Than One Year | 1-3 Years | 3-5 Years | More Than 5 Years | Total |
|---|---|---|---|---|---|
| Loan commitments | $ 112,431 | $ — | $ — | $ — | $ 112,431 |
| Long-term debt obligations | 218 | — | 3,000 | 9,000 | 12,218 |
| Operating lease obligations | 2,382 | 4,170 | 3,153 | 6,744 | 16,449 |
| Capital lease obligations | 638 | 1,479 | 1,593 | 9,058 | 12,768 |
| Purchase obligations | 187,830 | — | — | — | 187,830 |
| Total contractual obligations | $ 303,499 | $ 5,649 | $ 7,746 | $ 24,802 | $ 341,696 |

Long-term debt obligations include borrowings from the Federal Home Loan Bank with defined terms. The table reflects scheduled repayments of principal.

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Leases represent obligations entered into by the Corporation for the use of land and premises. The leases generally have escalation terms based upon certain defined indexes. Common area maintenance charges may also apply and are adjusted annually based on the terms of the lease agreements.

Purchase obligations represent legally binding and enforceable agreements to purchase goods and services from third parties and consist of contractual obligations under data processing service agreements. The Corporation also enters into various routine rental and maintenance contracts for facilities and equipment. These contracts are generally for one year.

***OFF-BALANCE SHEET ARRANGEMENTS***: The following table shows the amounts and expected maturities of significant commitments, consisting primarily of letters of credit, as of December 31, 2012.

| (In thousands) | Less Than One Year | 1-3 Years | 3-5 Years | More Than 5 Years | Total |
|---|---|---|---|---|---|
| Financial letters of credit | $ 747 | $ — | $ 61 | $ — | $808 |
| Performance letters of credit | 1,975 | — | — | — | 1,975 |
| Commercial letters of credit | 481 | 275 | — | — | 756 |
| Total letters of credit | $ 3,203 | $ 275 | $ 61 | $ — | $3,539 |

Commitments under standby letters of credit, both financial and performance, do not necessarily represent future cash requirements, in that these commitments often expire without being drawn upon.

***OTHER INCOME***: The Corporation recorded total other income of $21.3 million in 2012, reflecting an increase of $4.6 million or 27 percent over 2011 levels. The increase in 2012 was attributable to increases in trust fees, gain on loans sold and net securities gains, offset in part by a decrease in bank owned life insurance income and service charges and fees. The Corporation realized trust fees totaling $12.3 million in 2012, an increase of $1.6 million or 15 percent, over the levels in 2011. This increase is attributable to an increase in trust business, including higher margin business, an increase in the average fair value of assets under administration, on which the investment management fees are based, and an increase in the fee schedule. The average fair value of assets under administration for 2012 increased to $2.13 billion compared to $1.95 billion for 2011, as the result of improving values in the markets as well as new business activity. The fair value of assets under administration as of December 31, 2012 was $2.30 billion.

Income from service charges and fees of $2.8 million were recorded in 2012, a decrease of $152 thousand or 5 percent, from the levels in 2011, which is attributable to a decrease in account service charges, such as overdraft charges, as customers have been managing their accounts more diligently. In 2012, the Corporation recorded income of $1.1 million related to Bank Owned Life Insurance (BOLI) policies, compared to $1.4 million in 2011, a decrease of $364 thousand or 25 percent, primarily due to proceeds on a life insurance policy received during 2011 due to the passing of a former officer.

Gain on loans sold (on residential first mortgage loans sold at origination) totaled $1.2 million for 2012, compared to $502 thousand for 2011. The increase was principally due to higher residential mortgage loan origination volumes in 2012, as well as a balance sheet management decision to retain less loans in portfolio.

In 2012 and 2011, net gains on sales of securities totaled $3.8 million and $1.0 million, respectively. As noted previously in the "Overview" section, in 2012, the Corporation sold the entire pooled trust preferred security portfolio for a net gain of $2.9 million, also resulting in the realization of a large portion of the Company's deferred tax assets and the reduction of risk-weighted assets for regulatory capital purposes. The Corporation also strategically sold investments during 2012 to reduce prepayment risk and/or interest rate risk and/or to benefit future yield or current capital.

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***OPERATING EXPENSES***: The following table presents the major components of operating expenses:

| (In thousands) | 2012 | 2011 | 2010 |
|---|---|---|---|
| Salaries and benefits | $27,595 | $23,230 | $22,529 |
| Premises and equipment | 9,467 | 9,371 | 9,624 |
| Trust department | 1,462 | 1,542 | 1,291 |
| Professional and legal fees | 1,301 | 987 | 1,145 |
| FDIC assessment | 1,208 | 1,532 | 2,322 |
| Loan expense | 858 | 1,029 | 888 |
| Telephone | 647 | 765 | 787 |
| Advertising | 512 | 697 | 691 |
| Stationery and supplies | 381 | 416 | 450 |
| Postage | 370 | 373 | 357 |
| Provision for ORE losses | 145 | 865 | — |
| Other operating expenses | 4,384 | 3,592 | 3,026 |
| Total operating expense | $48,330 | $44,399 | $43,110 |

Operating expenses totaled $48.3 million in 2012, compared to $44.4 million in 2011, resulting in an increase of $3.9 million, or 9 percent.

Salaries and benefits expense, which accounts for the largest portion of operating expenses, totaled $27.6 million in 2012, reflecting an increase of $4.4 million or 19 percent, when compared to 2011. Commissions on residential loan originations for 2012 were $300 thousand higher than 2011's level, due to greater loan origination volume in 2012. In the fourth quarter of 2012, as noted in the "Overview" section, the Corporation recorded a $965 thousand severance accrual associated with organizational and staff restructuring. The valuation of post retirement benefits for non-employee directors contributed an additional $473 thousand of expense in 2012 due to an increase in the estimated future benefit amounts and lower market rates used in discounting such benefits. The Company's medical insurance expense increased nearly $150 thousand in 2012 from 2011's level, due principally to higher rates. The valuation of post retirement life insurance benefits for officers contributed an additional $200 thousand of expense in 2012 due to additional individuals covered during the year when $3 million of Bank Owned Life Insurance was purchased, coupled with lower market rates used in discounting such benefits. In 2012, in addition to the normal salary increases and the additional compensation associated with additions to staff including the new CEO, the Corporation saw increases in bonus and profit sharing accruals.

In 2012, premises and equipment expense totaled $9.5 million compared to $9.4 million in 2011, an increase of $96 thousand, or 1 percent. 2012 included certain operational expenses related to Hurricane Sandy.

Trust department expense totaled $1.5 million in 2012, decreasing $80 thousand, or 5 percent, from 2011 as the result of cost savings provided by a new research provider.

Professional and legal fees increased $314 thousand, or 32 percent, from $987 thousand in 2011 to $1.3 million in 2012, due primarily to fees associated with the CEO search and fees associated with the set-up of PGB Trust & Investments of Delaware.

The FDIC assessment expense decreased $324 thousand, or 21 percent, to $1.2 million in 2012 from $1.5 million in 2011. The Corporation's assessments declined due to a regulatory change in the calculation of assessments in effect for all of 2012 vs. nine months for 2011.

Loan expense totaled $858 thousand in 2012, decreasing $171 thousand, or 17 percent, when compared to 2011 expense due to lower expenses associated with problem loans. Telephone expense declined slightly in 2012 due in part to credits received related to new and/or renegotiated service, agreements, and/or contracts. Advertising expense declined in 2012 as less focus was placed on print advertising and more focus on less expensive online methods. Provision for Other Real Estate Owned expense was $145 thousand in 2012 compared to $865 thousand in 2011, as one large REO property required an $865 thousand write-down based on its appraisal near the end of 2011.

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Other operating expenses increased $792 thousand in 2012 to $4.4 million from $3.6 million in 2011. Additional expenses related to a new, more robust on-line banking system; greater expenses related to Other Real Estate Owned properties; increased director fees due to the CEO Search, as well as general fee increases; greater debit card expense due to greater usage; and increased insurance expenses, all contributed to the net increase.

The Corporation strives to operate in an efficient manner and control costs; however, given its plans to grow its core businesses, it expects higher operating expenses in 2013 compared to prior periods. The Corporation also anticipates that revenue and related profitability associated with these plans will lag expenses by several quarters.

***INCOME TAXES***: For the year ended December 31, 2012, income tax expense was $6.4 million compared to income tax expense of $1.8 million for the same period of 2011. The effective tax rate for the year ended December 31, 2012 was 39.78 percent compared to 12.97 percent for the year ended December 31, 2011. Included in income tax expense for 2011 was the reversal of a previously recorded valuation allowance of $3.0 million (or 21.37 percent of pretax income) against net state tax benefits related to security impairment charges recorded in the year ended December 31, 2008. Circumstances and projections indicated that this deferred tax asset would be realized in future periods. In addition, 2012 included approximately $260 thousand of additional tax expense related to the realization of the deferred tax assets to be carried-back to the prior two years at a slightly lower tax rate compared to the tax rate as recorded.

***RESULTS OF OPERATIONS 2011 COMPARED TO 2010***: The Corporation recorded net income of $12.2 million for the year ended December 31, 2011, and diluted earnings per share, including the effect of the preferred dividend, of $1.25 compared to net income of $7.7 million and diluted earnings per share, including the effect of the preferred dividend, of $0.68 for the year ended December 31, 2010. These results produced a return on average assets of 0.79 percent and 0.52 percent in 2011 and 2010, respectively, and a return on average common shareholders' equity of 10.74 percent in 2011 and 6.26 percent in 2010.

In 2011, the Corporation recorded a lower provision for loan losses, higher trust fee income, gains from the ongoing strategic sales of securities and a one-time state tax benefit, when compared to 2010. These positive effects were partially offset by decreased net interest income and a provision for losses on other real estate owned ("OREO").

In 2011, net interest income, on a fully tax-equivalent basis, declined 2 percent to $49.6 million from $50.6 million in 2010. The Corporation's net interest margin for 2011 was 3.47 percent, decreasing 17 basis points from 3.64 percent in 2010.

Interest income on earning assets, on a fully tax-equivalent basis, declined $4.9 million to $56.7 million for 2011 compared to 2010, primarily due to the lower rates earned on earning assets. An increase in the volume of earning

assets mitigated some of this decline. For the years ended December 31, 2011 and 2010, average earning assets totaled $1.43 billion and $1.39 billion, respectively, an increase of $43.2 million or 3 percent from the average balance in 2010. The average rate earned on earning assets was 3.96 percent in 2011, compared to 4.44 percent in 2010, a decline of 48 basis points. The decline in the average rate on earning assets was due to the sustained low market rates in 2011 coupled with growth in lower-yielding, but less risky and shorter duration investment securities and interest-earning deposits. Average investment securities increased $44.7 million to $409.2 million in 2011 compared to 2010. The average yield for 2011 was 2.39 percent. Average loan balances increased during 2011 to $965.7 million from $958.5 million in 2010, an increase of $7.2 million. In 2011, the average yield on total loans decreased 43 basis points to 4.84 percent from 5.27 percent in 2010. The average yield on the residential mortgage portfolio declined in 2011 to 4.34 percent from 4.87 percent in 2010. The average yield on the commercial mortgage loan portfolio declined 58 basis points during 2011 to 5.54 percent and the average yield on commercial loans also declined to 5.35 percent. The average yield on home equity lines remained relatively constant from 2010 at 3.23 percent for 2011 and 3.21 percent for 2010. Average rates declined during the year due to lower market rates and competitive pressure experienced during 2011.

For the years ended December 31, 2011 and 2010, average interest-bearing liabilities totaled $1.16 billion and $1.15 billion, respectively, reflecting an increase of $16.2 million or 1 percent from the average balance in 2010, while the average rate paid declined to 0.61 percent for 2011 from 0.96 percent for 2010. The decline in the average rate on interest-bearing liabilities was due to the sustained low in market rates in 2011 coupled with targeted growth of lower-costing core deposits and continued run-off of higher-paying certificates of deposit.

During 2011, the Corporation experienced continued growth in interest-bearing checking accounts, which grew an average of $59.5 million, or 23 percent, from 2010. For 2011, noninterest-bearing checking accounts grew $29.1 million to $243.9 million from 2010’s levels. Checking account growth is due to the Corporation’s relationship orientation – for many years, the Corporation has successfully focused on business and personal core deposit generation, particularly checking; establishing municipal relationships within its market territory; and growth in deposits associated with its commercial mortgage and commercial loan growth. Average money market accounts rose $9.4 million, or 2 percent, from 2010. The Corporation’s money market growth slowed during 2011 as rates declined on these products. The Corporation opted not to pay higher rates on maturing certificates of deposit and as a result, average certificates of deposit declined $58.2 million, or 22 percent. During 2011, the average rates on certificates of deposit declined 26 basis points from 2010.

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The average balance of borrowings was $22.6 million in 2011, declining $6.9 million as the result of regular principal repayments and maturities on Federal Home Loan Bank advances, as well as the early prepayment of a $3.0 million advance. The average rate paid on borrowings was 3.28 percent during 2011 compared to 3.54 percent during 2010, a decrease of 26 basis points. The average balance on capital lease obligations rose $2.8 million from 2010, as the Corporation's capital lease obligation related to its corporate headquarters was outstanding for all of 2011 compared to approximately half of 2010. The average rate on the capital lease obligations declined 65 basis points from 2010 to 4.99 percent during 2011.

In 2011, the Corporation recorded total other income of $16.7 million, an increase of $2.6 million or 18 percent over 2010 levels and was attributable to increases in trust fees, service charges, bank owned life insurance and net securities gains, offset in part by a loss on the sale of an OREO property and lower gains on loans sold at origination. The year ended December 31, 2010 also included impairment charges on several equity and trust preferred pooled securities.

Trust fees totaled $10.7 million in 2011, an increase of $785 thousand or 8 percent, over the levels in 2010. This increase is attributable to an increase in trust business, including higher margin business, an increase in the average market value of assets under administration, on which the investment management fees are based, partially offset by a reduction of certain fees earned on placement of funds in money market instruments, due to the reduced interest rate environment. The average market value of assets under administration for 2011 increased to $1.95 billion compared to $1.89 billion for 2010, as the result of improving values in the markets as well as new business activity. As of December 31, 2011, the market value of assets under administration was $1.96 billion.

Income from service charges and fees of $2.9 million were recorded in 2011, an increase of $110 thousand or 4 percent, over the levels in 2010, principally attributable to increased core deposit accounts and activity from such account holders. In 2011, income of $1.4 million related to Bank Owned Life Insurance (BOLI) policies was recorded, compared to $863 thousand in 2010, an increase of $564 thousand or 65 percent, primarily due to proceeds on a life insurance policy received due to the passing of a former officer. The Corporation retained certain longer duration loans in portfolio during 2011 and this was reflected in a $539 thousand decrease in gain on loans sold at origination. Also, a $250 thousand loss on sale of an OREO property was included in other income during 2011.

In 2011 and 2010, net gains on sales of securities totaled $1.0 million and $124 thousand, respectively. The Corporation strategically sold investments during 2011 to reduce prepayment risk and/or interest rate risk and/or to benefit future yield or current capital. During the second half of 2010, the Corporation recorded two other-than-temporary non-cash impairment charges, $360 thousand on its equity portfolio and $581 thousand on three trust preferred pooled securities.

In 2011, operating expenses totaled $44.4 million, compared to $43.1 million in 2010, an increase of $1.3 million, or 3 percent. Salaries and benefits expense totaled $23.2 million in 2011, an increase of $701 thousand, or 3 percent, when compared to 2010, due to the increased costs of additional staff for the Corporation to keep up with the increased

regulatory burden on financial institutions, normal salary increases and increased benefit costs, partially offset by various operational efficiencies. The Corporation’s full-time equivalent staff was 295 and 284 at December 31, 2011 and 2010, respectively.

In 2011, premises and equipment expense totaled $9.4 million compared to $9.6 million in 2010, a decrease of $253 thousand, or 3 percent and was due to certain operational efficiencies in 2011 offset by certain one-time expenses due to the move to a new administration building in 2010.

In 2011 and 2010, the FDIC assessment expense totaled $1.5 million and $2.3 million, respectively, decreasing $790 thousand, or 34 percent. The Corporation’s assessments declined due to a regulatory change in the calculation of assessments. Trust expense increased $251 thousand, or 19 percent, from 2010 totaling $1.5 million in 2011, as 2011 included a full year of the costs of a major system upgrade, which improved efficiencies in maintaining client information as well as provided increased capacity for additional services. Professional and legal fees totaled $987 thousand in 2011, decreasing $158 thousand, or 14 percent, over 2010 expense due to certain one-time expenses in 2010. In 2011, loan expense totaled $1.0 million, increasing $141 thousand, or 16 percent, over 2010 expense due to higher expenses associated with problem loans. In 2011, the Corporation recorded a provision for losses on other real estate owned of $865 thousand, while there was no such provision in 2010. When compared to 2010, other operating expenses in 2011 included: a $192 thousand prepayment penalty on the early payoff of an above market rate FHLB advance; greater expense associated with debit cards and internet and bill pay due to increased activity in 2011; and increased expenses associated with OREO. The Corporation strives to operate in an efficient manner and control costs as a means of producing increased earnings and enhancing shareholder value.

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***CAPITAL RESOURCES:*** A solid capital base provides the Corporation with the ability to support future growth and financial strength. Maintaining a strong capital position supports the Corporation's goal of providing shareholders an attractive and stable long-term return on investment.

At December 31, 2012, the Corporation's common equity to total assets ratio was 7.32 percent, up from 6.81 percent at December 31, 2011. Also at December 31, 2012, the Corporation's Tier 1 and total capital ratios were 11.83 percent and 13.08 percent, respectively, and its capital leverage ratio was 7.27 percent at December 31, 2012, all above the levels necessary to be considered well capitalized under regulatory guidelines applicable to banks.

On January 9, 2009, under the U.S. Department of the Treasury (the "Treasury") Capital Purchase Program ("CPP"), the Corporation sold 28,685 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, having a liquidation preference of $1,000 per share, and a ten-year warrant to purchase up to 150,296 shares of the Corporation's common stock at an exercise price of $28.63 per share, for an aggregate purchase price of $28.7 million. Cumulative dividends on the Preferred Shares accrued on the liquidation preference at a rate of 5 percent per annum for the first five years, and at a rate of 9 percent per annum thereafter. Subject to the approval of the Board of Governors of the Federal Reserve System, the Preferred Shares are redeemable at the option of the Corporation at 100 percent of their liquidation preference.

On January 6, 2010 and March 2, 2011, the Corporation redeemed 25 percent of the preferred shares issued under the Treasury's CPP, each time repaying approximately $7.2 million to the Treasury, including accrued and unpaid dividends of approximately $51 thousand and $17 thousand, respectively. As a result of the repurchases, the accretion related to the preferred stock was accelerated and approximately $330 thousand and $246 thousand was recorded as a reduction to retained earnings in the first quarters of 2010 and 2011, respectively.

On January 11, 2012, the Corporation redeemed the remaining 50 percent of the preferred shares, repaying approximately $14.5 million to the Treasury, including accrued and unpaid dividends of approximately $112 thousand. Accretion related to the preferred stock was accelerated and approximately $362 thousand was recorded as a reduction to retained earnings in the first quarter of 2012.

The 150,296 common share warrant remained outstanding after the redemption; however, the Corporation paid $109 thousand to the U.S. Treasury on April 5, 2012 to repurchase it.

Management believes the Corporation's capital position and capital ratios are adequate.

***LIQUIDITY:*** Liquidity refers to an institution's ability to meet short-term requirements including loan fundings, deposit withdrawals and maturing obligations, as well as long-term obligations, including potential capital expenditures. Principal sources of liquidity include cash, temporary investments, securities available for sale, deposit inflows and loan repayments.

Management actively monitors and manages the Corporation's liquidity position and believes it is sufficient to meet future needs. Cash and cash equivalents, including federal funds sold and interest-earning deposits, totaled $112.4 million at December 31, 2012. In addition, the Corporation has $304.5 million in securities designated as available for sale at December 31, 2012. These securities can be sold in response to liquidity concerns. In addition, the Corporation generates significant liquidity from scheduled and unscheduled principal repayments of loans and mortgage-backed securities.

Another source of liquidity is borrowing capacity. At December 31, 2012, unused short-term or overnight borrowing commitments totaled $487.9 million from the FHLB and $27.8 million from correspondent banks.

***EFFECTS OF INFLATION AND CHANGING PRICES:*** The financial statements and related financial data presented herein have been prepared in terms of historical dollars without considering changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than do general levels of inflation.

***PGB TRUST AND INVESTMENTS***: Since its inception in 1972, PGB Trust and Investments, a division of the Bank, has served in the roles of executor and trustee and has provided wealth management, investment management, custodial, tax, retirement and financial services to its growing client base. Officers from PGB Trust and Investments are available to provide advice and services at the Corporate Headquarters in Bedminster, at three branch locations, Clinton, Morristown and Summit, New Jersey, and at the Bank's new subsidiary, PGB Trust & Investments of Delaware in Greenville, Delaware.

The market value of assets under administration at December 31, 2012 was $2.30 billion. Fee income generated by PGB Trust Investments was $12.3 million, $10.7 million and $9.9 million in 2012, 2011 and 2010, respectively.

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***CAUTIONARY STATEMENT CONCERNING FORWARD LOOKING STATEMENTS***: The foregoing contains forward-looking statements within the meaning of the Private Securities litigation Reform Act of 1995. Such statements are not historical facts and include expressions about management's confidence and strategies and management's expectations about new and existing programs and products, investments, relationships, opportunities and market conditions. These statements may be identified by such forward-looking terminology as "expect", "look", "believe", "anticipate", "may", or similar statements or variations of such terms. Actual results may differ materially from such forward-looking statements. Factors that may cause results to differ materially from such forward-looking statements include, but not limited to

- a continued or unexpected decline in the economy, in particular in our New Jersey market area;
- declines in value in our investment portfolio;
- higher than expected increases in our allowance for loan losses;
- higher than expected increases in loan losses or in the level of nonperforming loans;
- unexpected changes in interest rates;
- inability to successfully grow our business;
- inability to manage our growth;
- a continued or unexpected decline in real estate values within our market areas;
- legislative and regulatory actions (including the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act and related regulations) subject us to additional regulatory oversight which may result in increased compliance costs;
- successful cyber attacks against our IT infrastructure or that of our IT providers;
- higher than expected FDIC insurance premiums;
- lack of liquidity to fund our various cash obligations;
- reduction in our lower-cost funding sources;
- our inability to adapt to technological changes;
- claims and litigation pertaining to fiduciary responsibility, environmental laws and other matters; and
- other unexpected material adverse changes in our operations or earnings.

The Corporation undertakes no duty to update any forward-looking statement to conform the statement to actual results or changes in the Corporation's expectations. Although we believe that the expectations reflected in the forward-looking statements are reasonable, the Corporation cannot guarantee future results, levels of activity, performance or achievements.

## Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

***ASSET/LIABILITY MANAGEMENT***: The Corporation's Asset/Liability Committee (ALCO) is responsible for developing, implementing and/or monitoring asset/liability management strategies and reports and advising the Board of Directors on such, as well as the related level of interest rate risk. In this regard, interest rate risk simulation models are prepared on a quarterly basis. These models have the ability to demonstrate balance sheet gaps, and predict changes to net interest income and economic/market value of portfolio equity under various interest rate scenarios.

ALCO is generally authorized to manage interest rate risk through management of capital and management of cash flows and duration of assets and liabilities, including sales and purchases of assets, as well as additions of wholesale

borrowings.

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

- Actively market adjustable-rate and/or shorter-term residential mortgage loans;
- Actively market commercial mortgage loans, which tend to have shorter terms and higher interest rates than residential mortgage loans, and which generate customer relationships that can result in higher core deposit accounts;
- Actively sell longer duration mortgages in the current low rate environment;
- Actively market core deposit relationships, which are generally longer duration liabilities;
- Closely monitor and actively manage the investment portfolio, including management of duration, prepayment and interest rate risk; and
- Maintain adequate levels of capital.

At this time, the Corporation is not engaged in hedging through the use of derivatives nor does it use interest rate caps and floors.

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As noted above, ALCO uses simulation modeling to analyze the Corporation's net interest income sensitivity, as well as the Corporation's economic value of portfolio equity under various interest rate scenarios. The model is based on the actual maturity and repricing characteristics of rate sensitive assets and liabilities. The model incorporates certain prepayment and interest rate assumptions, which management believes to be reasonable as of December 31, 2012. The model assumes changes in interest rates without any proactive change in the balance sheet by management. In the model, the forecasted shape of the yield curve remains static as of December 31, 2012.

In an immediate and sustained 200 basis point increase in market rates at December 31, 2012, net interest income for 2013 would decline approximately 6 percent while net interest income for 2014 would improve approximately 3 percent, compared to a flat interest rate scenario.

In an immediate and sustained 100 basis point decrease in market rates at December 31, 2012, net interest income would decline approximately 5 percent for 2013 and 7 percent for 2014, compared to a flat interest rate scenario.

The table below shows the estimated changes in the Corporation's economic value of portfolio equity ("EVPE") that would result from an immediate parallel change in the market interest rates at December 31, 2012.

| (Dollars in thousands) | | Estimated Increase/ Decrease in EVPE | | EVPE as a Percentage of Present Value of Assets (2) | |
|---|---|---|---|---|---|
| Change In Interest Rates (Basis Points) | Estimated EVPE (1) | Amount | Percent | EVPE Ratio (3) | Increase/(Decrease) (basis points) |
| +300 | $156,284 | $(14,222) | (8.34)% | 10.10% | (12.5) |
| +200 | 167,753 | (2,753) | (1.61) | 10.54 | 31.4 |
| +100 | 171,554 | 1,048 | 0.61 | 10.52 | 29.5 |
| Flat interest rates | 170,506 | — | — | 10.23 | — |
| -100 | 153,995 | (16,511) | (9.68) | 9.16 | (106.6) |
| -200 | 143,482 | (27,024) | (15.85) | 8.52 | (171.0) |
| -300 | 145,168 | (25,338) | (14.86) | 8.60 | (162.5) |

(1) EVPE is the discounted present value of expected cash flows from assets and liabilities.
(2) Present value of assets represents the discounted present value of incoming cash flows on interest-earning assets.
(3) EVPE ratio represents EVPE divided by the present value of assets.

Certain shortcomings are inherent in the methodologies used in determining interest rate risk. Simulation modeling requires making certain assumptions that may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. In this regard, the modeling assumes that the composition of our interest-sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and assume

that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration or repricing of specific assets and liabilities. Accordingly, although the information provides an indication of our interest rate risk exposure at a particular point in time, such measurements are not intended to and do not provide a precise forecast of the effect of changes in market interest rates on our net interest income and will differ from actual results.

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## Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

We have audited the accompanying consolidated statements of condition of Peapack-Gladstone Financial Corporation as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2012. We also have audited Peapack-Gladstone Financial Corporation's internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Peapack-Gladstone Financial Corporation's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Controls Over Financial Reporting located in Item 9A. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed 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. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Peapack-Gladstone Financial Corporation as of December 31, 2012 and 2011, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Peapack-Gladstone Financial Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

**/s/ Crowe Horwath LLP**

Livingston, New Jersey

March 15, 2013

**CONSOLIDATED STATEMENTS OF CONDITION**

| (In thousands, except share data) | December 31, 2012 | 2011 |
|---|---|---|
| ASSETS | | |
| Cash and due from banks | $6,733 | $7,097 |
| Federal funds sold | 100 | 100 |
| Interest-earning deposits | 112,395 | 35,856 |
| Total cash and cash equivalents | 119,228 | 43,053 |
| Investment securities held to maturity (fair value of $99,427 in 2011) | — | 100,719 |
| Securities available for sale | 304,479 | 319,520 |
| FHLB and FRB stock, at cost | 4,639 | 4,569 |
| Loans held for sale, at fair value | 6,461 | 2,841 |
| Loans held for sale, at lower of cost or fair value | 13,749 | — |
| Loans | 1,132,584 | 1,038,345 |
| Less: allowance for loan losses | 12,735 | 13,223 |
| Net loans | 1,119,849 | 1,025,122 |
| Premises and equipment | 30,030 | 31,941 |
| Other real estate owned | 3,496 | 7,137 |
| Accrued interest receivable | 3,864 | 4,078 |
| Bank owned life insurance | 31,088 | 27,296 |
| Deferred tax assets, net | 9,478 | 26,731 |
| Other assets | 21,475 | 7,328 |
| **Total assets** | $1,667,836 | $1,600,335 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-bearing demand deposits | $298,095 | $297,459 |
| Interest-bearing deposits: | | |
| Checking | 346,877 | 341,180 |
| Savings | 109,686 | 92,322 |
| Money market accounts | 583,197 | 516,920 |
| Certificates of deposit $100,000 and over | 68,741 | 71,783 |
| Certificates of deposit less than $100,000 | 109,831 | 124,228 |
| Total deposits | 1,516,427 | 1,443,892 |
| Federal home loan bank advances | 12,218 | 17,680 |
| Capital lease obligation | 8,971 | 9,178 |
| Accrued expenses and other liabilities | 8,163 | 6,614 |
| Total liabilities | 1,545,779 | 1,477,364 |
| SHAREHOLDERS' EQUITY | | |
| Preferred stock (no par value; authorized 500,000 shares; no shares issued at December 31, 2012 and 14,341 shares issued at December 31, 2011; liquidation preference of $1,000 per share) | — | 13,979 |
| Common stock (no par value; stated value $0.83 per share; authorized 21,000,000 shares; issued shares, 9,325,977 at December 31, 2012 and 9,240,889 at December 31, 2011; outstanding shares, 8,917,799 at December 31, 2012 and 8,832,711 at December 31, 2011) | 7,755 | 7,685 |

| | | |
|---|---|---|
| Surplus | 97,675 | 96,323 |
| Treasury stock at cost (408,178 shares at December 31, 2012 and 2011) | (8,988 ) | (8,988 ) |
| Retained earnings | 21,316 | 13,868 |
| Accumulated other comprehensive income, net | 4,299 | 104 |
| Total shareholders' equity | 122,057 | 122,971 |
| Total liabilities and shareholders' equity | $1,667,836 | $1,600,335 |

See accompanying notes to consolidated financial statements

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**CONSOLIDATED STATEMENTS OF INCOME**

| | Years Ended December 31, | | |
|---|---|---|---|
| (In thousands, except per share data) | 2012 | 2011 | 2010 |
| INTEREST INCOME | | | |
| Loans, including fees | $48,010 | $46,628 | $50,455 |
| Loans held for sale | 123 | 56 | N/A |
| Securities held to maturity: | | | |
| Taxable | 1,648 | 2,066 | 2,037 |
| Tax-exempt | 187 | 354 | 467 |
| Securities available for sale: | | | |
| Taxable | 5,385 | 6,285 | 7,278 |
| Tax-exempt | 639 | 518 | 535 |
| Interest-earning deposits | 98 | 144 | 150 |
| Total interest income | 56,090 | 56,051 | 60,922 |
| INTEREST EXPENSE | | | |
| Checking accounts | 379 | 1,045 | 1,586 |
| Savings and money market accounts | 1,092 | 2,215 | 3,908 |
| Certificates of deposit over $100,000 | 900 | 1,060 | 1,620 |
| Other certificates of deposit | 1,337 | 1,755 | 2,666 |
| Overnight and short-term borrowings | 39 | 3 | — |
| Federal Home Loan Bank advances | 509 | 739 | 1,046 |
| Capital lease obligation | 431 | 319 | 206 |
| Total interest expense | 4,687 | 7,136 | 11,032 |
| Net interest income before provision for loan losses | 51,403 | 48,915 | 49,890 |
| Provision for loan losses | 8,275 | 7,250 | 10,000 |
| Net interest income after provision for loan losses | 43,128 | 41,665 | 39,890 |
| OTHER INCOME | | | |
| Trust fees | 12,282 | 10,686 | 9,901 |
| Service charges and fees | 2,756 | 2,908 | 2,798 |
| Bank owned life insurance | 1,064 | 1,427 | 863 |
| Gain on loans sold | 1,195 | 502 | 1,041 |
| Other income | 196 | 156 | 329 |
| Other-than-temporary impairment loss: | | | |
| Total impairment charges on securities | — | — | (941 ) |
| Loss recognized in other comprehensive income | — | — | — |
| Net impairment loss recognized in earnings | — | — | (941 ) |
| Securities gains, net | 3,810 | 1,037 | 124 |
| Total other income | 21,303 | 16,716 | 14,115 |
| OPERATING EXPENSES | | | |
| Salaries and employee benefits | 27,595 | 23,230 | 22,529 |
| Premises and equipment | 9,467 | 9,371 | 9,624 |
| Other operating expenses | 11,268 | 11,798 | 10,957 |
| Total operating expenses | 48,330 | 44,399 | 43,110 |
| Income before income tax expense | 16,101 | 13,982 | 10,895 |
| Income tax expense | 6,405 | 1,814 | 3,231 |
| Net income | 9,696 | 12,168 | 7,664 |
| Dividends on preferred stock and accretion | 474 | 1,228 | 1,686 |

| | | | |
|---|---|---|---|
| Net income available to common shareholders | $9,222 | $10,940 | $5,978 |
| EARNINGS PER COMMON SHARE | | | |
| Basic | $1.05 | $1.25 | $0.68 |
| Diluted | 1.05 | 1.25 | 0.68 |

See accompanying notes to consolidated financial statements

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**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2012 | 2011 | 2010 |
| (Dollars in thousands) | | | |
| Net income | $9,696 | $12,168 | $7,664 |
| Other comprehensive income: | | | |
| Unrealized gains on available for sale securities: | | | |
| Unrealized holding gains arising during the period | 1,020 | 4,003 | 4 |
| Adjustment for held to maturity transferred to available for sale | — | — | — |
| Other-than-temporary impairment on available for sale | 1,685 | — | (360) |
| Less: Reclassification adjustment for gains included in net income | 856 | 1,037 | 124 |
| | 1,849 | 2,966 | (232) |
| Tax effect | (756) | (1,250) | 107 |
| Net of tax | 1,093 | 1,716 | (125) |
| | | | |
| Unrealized losses on the noncredit, other-than temporarily impaired held to maturity securities and on securities transferred from available for sale to held to maturity, including accretion | 8,204 | 146 | 152 |
| Less: Reclassification adjustment for gains included in net income | 2,954 | — | — |
| | 5,250 | 146 | 152 |
| Tax effect | (2,148) | (213) | (51) |
| Net of tax | 3,102 | 359 | 101 |
| | | | |
| Total comprehensive income | $13,891 | $14,243 | $7,640 |

See accompanying notes to consolidated financial statements

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CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

| (In thousands, except Per share data) | Preferred Stock | Common Stock | Surplus | Treasury Stock | Retained Earnings | Accumulated Other Comprehensive Income/(Loss) | Total |
|---|---|---|---|---|---|---|---|
| Balance at January 1, 2010 8,723,488 common shares outstanding | $27,359 | $ 7,593 | $95,021 | $(8,988) | $471 | $(1,947) | $119,509 |
| Net income 2010 | | | | | 7,664 | | 7,664 |
| Net change in accumulated other comprehensive income | | | | | | (24) | (24) |
| Issuance of restricted stock, 55,993 shares | | 47 | (47) | | | | — |
| Amortization of restricted stock | | | 150 | | | | 150 |
| Redemption of preferred stock, 7,172 shares | (7,172) | | | | | | (7,172) |
| Accretion of discount on preferred stock | 559 | | | | (559) | | — |
| Cash dividends declared on common stock ($0.20 per share) | | | | | (1,757) | | (1,757) |
| Cash dividends declared on preferred stock | | | | | (1,126) | | (1,126) |
| Common stock option expense | | | 332 | | | | 332 |
| Sales of shares (dividend reinvestment program), 11,379 shares | | 10 | 130 | | | | 140 |
| Balance at December 31, 2010 8,790,860 common shares outstanding | 20,746 | 7,650 | 95,586 | (8,988) | 4,693 | (1,971) | 117,716 |
| Net income 2011 | | | | | 12,168 | | 12,168 |
| Net change in accumulated other comprehensive income | | | | | | 2,075 | 2,075 |
| Issuance of restricted stock, 28,732 shares | | 24 | (24) | | | | — |
| Amortization of restricted stock | | | 258 | | | | 258 |
| Redemption of preferred stock, 7,172 shares | (7,172) | | | | | | (7,172) |
| Accretion of discount on preferred stock | 405 | | | | (405) | | — |
| Cash dividends declared on common stock ($0.20 per Share) | | | | | (1,765) | | (1,765) |
| Cash dividends declared on preferred stock | | | | | (823) | | (823) |
| Common stock option expense | | | 362 | | | | 362 |
| Sales of shares (dividend reinvestment program), 13,119 shares | | 11 | 141 | | | | 152 |
| Balance at December 31, 2011 8,832,711 common shares outstanding | 13,979 | 7,685 | 96,323 | (8,988) | 13,868 | 104 | 122,971 |
| Net income 2012 | | | | | 9,696 | | 9,696 |

| | | | | | |
|---|---|---|---|---|---|
| Net change in accumulated other comprehensive income | | | | 4,195 | 4,195 |
| Issuance of restricted stock, 36,263 shares | | 30 | (30 ) | | — |
| Amortization of restricted stock | | | 549 | | 549 |
| Redemption of preferred stock, 14,341 shares | (14,341) | | | | (14,341 ) |
| Warrant repurchase 150,296 shares | | &nbs | | | |