

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)

|  |  |
|--|--|
| <b>New Jersey</b><br>(State or other jurisdiction of<br>incorporation or organization) | <b>22-2491488</b><br>(I.R.S. Employer<br>Identification No.) |
|--|--|

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

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

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

| <b><u>Title of Each Class</u></b> | <b><u>Name of Exchange on which Registered</u></b> |
|-----------------------------------|--|
| 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  No .

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  No .

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No .

Indicate by check mark 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 .

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  Accelerated filer   
Non-accelerated filer  Smaller reporting company

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

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](http://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;

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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 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.

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**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 MARKET FOR REGISTRANT'S COMMON EQUITY RELATED STOCKHOLDER MATTERS  
5. 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<br>PER SHARE |
|-------------------------|----------|----------|-----------------------|
| 1 <sup>st</sup> QUARTER | \$ 13.55 | \$ 10.52 | \$ 0.05               |
| 2 <sup>nd</sup> QUARTER | 15.95    | 13.51    | 0.05                  |
| 3 <sup>rd</sup> QUARTER | 16.83    | 13.18    | 0.05                  |
| 4 <sup>th</sup> QUARTER | 16.49    | 13.45    | 0.05                  |

| 2011                    | HIGH     | LOW      | DIVIDEND<br>PER SHARE |
|-------------------------|----------|----------|-----------------------|
| 1 <sup>st</sup> QUARTER | \$ 14.20 | \$ 12.71 | \$ 0.05               |
| 2 <sup>nd</sup> QUARTER | 13.45    | 10.87    | 0.05                  |
| 3 <sup>rd</sup> QUARTER | 11.97    | 9.60     | 0.05                  |
| 4 <sup>th</sup> 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."

Table of Contents**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.

| <i>Index</i>                            | <i>Period Ending</i> |                 |                 |                 |                 |                 |
|---|----------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
|   | <b>12/31/07</b>      | <b>12/31/08</b> | <b>12/31/09</b> | <b>12/31/10</b> | <b>12/31/11</b> | <b>12/31/12</b> |
| 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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Table of Contents**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.

| (In thousands, except per share data)   | Years Ended December 31, |             |             |             |             |
|---|--------------------------|-------------|-------------|-------------|-------------|
|   | 2012                     | 2011        | 2010        | 2009        | 2008        |
| <b>Summary earnings:</b>  |                          |             |             |             |             |
| 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)  |
| <b>Per share data: (reflects a 5% stock dividend in 2009 except for cash dividends per share)</b> |                          |             |             |             |             |
| 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      | —           |
| <b>Balance sheet data (at period end):</b>  |                          |             |             |             |             |
| 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   |
| <b>Cash dividends:</b>  |                          |             |             |             |             |
| Common  | 1,774                    | 1,765       | 1,757       | 2,199       | 5,304       |
| Preferred   | 112                      | 824         | 1,126       | 1,218       | —           |

Selected performance ratios:

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|  |        |   |       |   |       |   |        |   |        |   |
|--|--------|---|-------|---|-------|---|--------|---|--------|---|
| 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<br>Balance | Income/<br>Expense<br>(FTE ) | Yield<br>(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<br>Balance | Income/<br>Expense<br>(FTE ) | Yield<br>(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<br>Balance | Income/<br>Expense<br>(FTE ) | Yield<br>(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:

| (In Thousands):           | Year Ended 2012 Compared with 2011 |             |                | Year Ended 2011 Compared with 2010 |             |                |
|---------------------------|------------------------------------|-------------|----------------|------------------------------------|-------------|----------------|
|                           | Difference due to Change In:       |             | Net Change In  | Change In                          |             | Net Change In  |
|                           | Volume                             | Rate        | Income/Expense | Volume                             | Rate        | Income/Expense |
| <b>ASSETS:</b>            |                                    |             |                |                                    |             |                |
| 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 )    |
| <b>LIABILITIES:</b>       |                                    |             |                |                                    |             |                |
| 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<br>One Year | After 1 But<br>Within 5 Years | After<br>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<br>Interest Rate | Adjustable<br>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:

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 a) 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.

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 b) 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.

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 c) 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.

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 d)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.

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.

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/<br>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:

|                      |          | % of<br>Loan<br>Category<br>To<br>Total |          | % of<br>Loan<br>Category<br>To<br>Total |          | % of<br>Loan<br>Category<br>To<br>Total |          | % of<br>Loan<br>Category<br>To<br>Total |         | % of<br>Loan<br>Category<br>To<br>Total |
|----------------------|----------|---|----------|---|----------|---|----------|---|---------|---|
| (In thousands)       | 2012     | Loans                                   | 2011     | Loans                                   | 2010     | Loans                                   | 2009     | Loans                                   | 2008    | 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.

| (In thousands)   | Years Ended December 31, |          |          |          |         |
|--|--------------------------|----------|----------|----------|---------|
|  | 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,<br>2012 | Number of<br>Relationships | December 31,<br>2011 | Number of<br>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,<br>2012 | Number of<br>Relationships | December 31,<br>2011 | Number of<br>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  |           |           | More Than | Total      |
|-------------------------------|------------|-----------|-----------|-----------|------------|
|                               | One Year   | 1-3 Years | 3-5 Years | 5 Years   |            |
| 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 |           |           | More Than |         |
|-------------------------------|-----------|-----------|-----------|-----------|---------|
|                               | One Year  | 1-3 Years | 3-5 Years | 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)<br>Change In<br>Interest<br>Rates<br>(Basis Points) | Estimated Increase/<br>Decrease in EVPE |            |          | EVPE as a Percentage of<br>Present Value of Assets (2) |                                       |          |
|--|---|------------|----------|--|---------------------------------------|----------|
|  | Estimated<br>EVPE (1)                   | Amount     | Percent  | EVPE<br>Ratio (3)                                      | Increase/(Decrease)<br>(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

Table of Contents**CONSOLIDATED STATEMENTS OF CONDITION**

| (In thousands, except share data)   | December 31,       |                    |
|---|--------------------|--------------------|
|   | 2012               | 2011               |
| <b>ASSETS</b>   |                    |                    |
| 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<br>(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              |
| <b>Total assets</b>   | <b>\$1,667,836</b> | <b>\$1,600,335</b> |
| <b>LIABILITIES</b>  |                    |                    |
| 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          |
| <b>SHAREHOLDERS' EQUITY</b>   |                    |                    |
| Preferred stock (no par value; authorized 500,000 shares;<br>no shares issued at December 31, 2012 and 14,341 shares issued<br>at December 31, 2011; liquidation preference of \$1,000 per share)   | —                  | 13,979             |
| Common stock (no par value; stated value \$0.83 per share;<br>authorized 21,000,000 shares; issued shares, 9,325,977 at<br>December 31, 2012 and 9,240,889 at December 31, 2011;<br>outstanding shares, 8,917,799 at December 31, 2012 and<br>8,832,711 at December 31, 2011) | 7,755              | 7,685              |

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|   |             |             |
|---|-------------|-------------|
| 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



Table of Contents**CONSOLIDATED STATEMENTS OF INCOME**

| (In thousands, except per share data)                | Years Ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2012                     | 2011     | 2010     |
| <b>INTEREST INCOME</b>                               |                          |          |          |
| 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   |
| <b>INTEREST EXPENSE</b>                              |                          |          |          |
| 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   |
| <b>OTHER INCOME</b>                                  |                          |          |          |
| 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   |
| <b>OPERATING EXPENSES</b>                            |                          |          |          |
| 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 |
| <b>EARNINGS PER COMMON SHARE</b>            |         |          |         |
| 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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Table of Contents**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<br>Per share data)                          | Preferred<br>Stock | Common<br>Stock | Surplus  | Treasury<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>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<br>other comprehensive income           |                    |                 |          |                   |                      | (24 )  | (24 )     |
| Issuance of restricted stock, 55,993<br>shares                    |                    | 47              | (47 )    |                   |                      |  | —         |
| Amortization of restricted stock                                  |                    |                 | 150      |                   |                      |  | 150       |
| Redemption of preferred stock,<br>7,172 shares                    | (7,172 )           |                 |          |                   |                      |  | (7,172 )  |
| Accretion of discount on<br>preferred stock                       | 559                |                 |          |                   | (559 )               |  | —         |
| Cash dividends declared on<br>common stock<br>(\$0.20 per share)  |                    |                 |          |                   | (1,757 )             |  | (1,757 )  |
| Cash dividends declared on<br>preferred stock                     |                    |                 |          |                   | (1,126 )             |  | (1,126 )  |
| Common stock option expense                                       |                    |                 | 332      |                   |                      |  | 332       |
| Sales of shares (dividend<br>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<br>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,<br>7,172 shares                    | (7,172 )           |                 |          |                   |                      |  | (7,172 )  |
| Accretion of discount on<br>preferred stock                       | 405                |                 |          |                   | (405 )               |  | —         |
| Cash dividends declared on<br>common stock<br>(\$0.20 per Share)  |                    |                 |          |                   | (1,765 )             |  | (1,765 )  |
| Cash dividends declared on<br>preferred stock                     |                    |                 |          |                   | (823 )               |  | (823 )    |
| Common stock option expense                                       |                    |                 | 362      |                   |                      |  | 362       |
| Sales of shares (dividend<br>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     |

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|   |          |         |          |           |          |         |           |
|---|----------|---------|----------|-----------|----------|---------|-----------|
| 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                                     |          | (109 )  |          |           |          |         | (109 )    |
| Accretion of discount on preferred stock                              | 362      |         |          |           | (362 )   |         | —         |
| Cash dividends declared on common stock (\$0.20 per share)            |          |         |          |           | (1,774 ) |         | (1,774 )  |
| Cash dividends declared on preferred stock                            |          |         |          |           | (112 )   |         | (112 )    |
| Common stock option expense   |          | 336     |          |           |          |         | 336       |
| Common stock options exercised and related tax benefits, 2,022 shares | 1        | 20      |          |           |          |         | 21        |
| Sales of shares (dividend reinvestment program), 46,803 shares        | 39       | 586     |          |           |          |         | 625       |
| Balance at December 31, 2012  |          |         |          |           |          |         |           |
| 8,917,799 common shares outstanding                                   | \$—      | \$7,755 | \$97,675 | \$(8,988) | \$21,316 | \$4,299 | \$122,057 |

See accompanying notes to consolidated financial statements

Table of Contents**CONSOLIDATED STATEMENTS OF CASH FLOWS**

| (In thousands)  | Years Ended December 31, |           |           |
|---|--------------------------|-----------|-----------|
|   | 2012                     | 2011      | 2010      |
| Operating activities:   |                          |           |           |
| Net income  | \$9,696                  | \$12,168  | \$7,664   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |           |           |
| Depreciation  | 2,946                    | 2,870     | 3,146     |
| Amortization of premium and accretion of discount on securities, net              | 2,261                    | 3,017     | 723       |
| Amortization of restricted stock  | 549                      | 258       | 150       |
| Provision for loan losses   | 8,275                    | 7,250     | 10,000    |
| Valuation allowance on other real estate owned                                    | 145                      | 865       | —         |
| Stock-based compensation expense  | 336                      | 362       | 332       |
| Deferred tax expense/(benefit)  | 14,349                   | 933       | (2,148 )  |
| Reversal of valuation allowance – deferred tax assets                             | —                        | (2,976 )  | —         |
| Impairment charges on securities  | —                        | —         | 941       |
| Gains on sale of securities, available for sale, net                              | (856 )                   | (1,037 )  | (124 )    |
| Gains on securities, held to maturity, net  | (2,954 )                 | —         | —         |
| Proceeds from sales of loans  | 83,773                   | 34,488    | 74,347    |
| Loans originated for sale   | (86,198 )                | (36,827 ) | (73,306 ) |
| Gain on loans sold  | (1,195 )                 | (502 )    | (1,041 )  |
| Loss on OREO sold   | 89                       | 203       | 18        |
| Loss on disposal of premises and equipment  | 19                       | —         | —         |
| Increase in cash surrender value of life insurance                                | (796 )                   | (907 )    | (782 )    |
| Gain on life insurance proceeds   | —                        | (403 )    | —         |
| Decrease in accrued interest receivable   | 214                      | 153       | 213       |
| (Increase)/decrease in other assets   | (14,147 )                | 2,368     | 2,556     |
| Increase/(decrease) in accrued expenses and other liabilities                     | 1,342                    | 178       | (736 )    |
| Net cash provided by operating activities   | 17,848                   | 22,461    | 21,953    |
| Investing activities:   |                          |           |           |
| Maturities of investment securities held to maturity                              | 45,461                   | 39,094    | 23,111    |
| Maturities of securities available for sale                                       | 77,829                   | 70,464    | 43,705    |
| Calls of investment securities held to maturity                                   | 136                      | 62,500    | 48,158    |
| Calls of securities available for sale  | 26,598                   | 45,360    | 162,484   |
| Sales of investment securities held to maturity                                   | 15,989                   | —         | —         |
| Sales of securities available for sale  | 35,087                   | 64,908    | 10,445    |
| Purchase of investment securities held to maturity                                | (17,373 )                | (62,587 ) | (122,770) |
| Purchase of securities available for sale, including FHLB and FRB stock           | (59,389 )                | (229,392) | (219,474) |
| Purchase of loans   | —                        | (10,893 ) | (943 )    |
| Net (increase)/decrease in loans  | (116,242)                | (106,391) | 38,550    |
| Sales of other real estate  | 2,898                    | 7,576     | 865       |
| Purchases of premises and equipment   | (1,054 )                 | (975 )    | (2,958 )  |
| Disposal of premises and equipment  | —                        | 861       | —         |
| Purchase of life insurance  | (2,996 )                 | —         | —         |
| Life insurance proceeds   | —                        | 1,088     | —         |

|   |       |           |           |
|---|-------|-----------|-----------|
| Net cash provided by/(used in) investing activities | 6,944 | (118,387) | (18,827 ) |
|---|-------|-----------|-----------|

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## Financing activities:

|  |           |          |          |
|--|-----------|----------|----------|
| Net increase in deposits   | 72,535    | 92,346   | 1,877    |
| Repayments of FHLB advances  | (5,462 )  | (6,446 ) | (12,373) |
| Redemption of preferred stock                                      | (14,341 ) | (7,172 ) | (7,172 ) |
| Repurchase of warrants   | (109 )    | —        | —        |
| Dividends paid on preferred stock                                  | (112 )    | (823 )   | (1,126 ) |
| Dividends paid on common stock                                     | (1,774 )  | (1,765 ) | (1,757 ) |
| Exercise of stock options  | 21        | —        | —        |
| Sale of common shares (Dividend Reinvestment Program)              | 625       | 152      | 140      |
| Net cash provided by/(used in) financing activities                | 51,383    | 76,292   | (20,411) |
| Net increase/(decrease) in cash and cash equivalents               | 76,175    | (19,634) | (17,285) |
| Cash and cash equivalents at beginning of year                     | 43,053    | 62,687   | 79,972   |
| Cash and cash equivalents at end of year                           | \$119,228 | \$43,053 | \$62,687 |
| Supplemental disclosures of cash flow information                  |           |          |          |
| Cash paid during the year for:                                     |           |          |          |
| Interest   | \$4,410   | \$7,072  | \$11,557 |
| Income taxes   | 7,410     | 2,919    | 5,164    |
| Transfer of securities to available for sale from held to maturity | 64,211    | —        | —        |
| Transfer of loans to loans held for sale                           | 13,749    | —        | —        |
| Transfer of loans to other real estate owned                       | 2,466     | 13,445   | 4,523    |
| Internally financed sale of other real estate owned                | 2,975     | 832      | —        |
| Acquisition of leased premises                                     | —         | 2,813    | 6,097    |

See accompanying notes to consolidated financial statements



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

***1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES***

**Principles of Consolidation and Organization:** The consolidated financial statements of Peapack-Gladstone Financial Corporation (the “Corporation”) are prepared on the accrual basis and include the accounts of the Corporation and its wholly-owned subsidiary, Peapack-Gladstone Bank (the “Bank”). The consolidated statements also include the Bank’s wholly-owned subsidiaries, PGB Trust & Investments of Delaware and Peapack-Gladstone Mortgage Group, Inc. Peapack-Gladstone Mortgage Group was merged into the Bank on December 31, 2010. While the following footnotes include the collective results of Peapack-Gladstone Financial Corporation and Peapack-Gladstone Bank, these footnotes primarily reflect the Bank’s and its subsidiaries’ activities. All significant intercompany balances and transactions have been eliminated from the accompanying consolidated financial statements.

**Business:** Peapack-Gladstone Bank, the subsidiary of the Corporation, provides a full range of banking and trust services to individual and corporate customers through its branch operations in central New Jersey. Trust services are also provided through its subsidiary, PGB Trust & Investments of Delaware. The Bank is subject to competition from other financial institutions, is regulated by certain federal and state agencies and undergoes periodic examinations by those regulatory authorities.

**Basis of Financial Statement Presentation:** The consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles. In preparing the financial statements, Management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the statement of condition and revenues and expenses for that period. Actual results could differ from those estimates. The significant estimates that are particularly subject to change include the adequacy of the allowance for loan losses, fair value of investment securities and other-than-temporary impairment on investment securities.

**Segment Information:** The Corporation’s business is conducted through its banking subsidiary and involves the delivery of loan and deposit products and trust services to customers. Management uses certain methodologies to allocate income and expense to the business segments.

The Banking segment includes commercial, commercial real estate, residential and consumer lending activities; deposit generation; operation of ATMs; telephone and internet banking services; merchant credit card services and customer support sales.

PGB Trust & Investments includes asset management services provided for individuals and institutions; personal trust services, including services as executor, trustee, administrator, custodian and guardian; corporate trust services including services as trustee for pension and profit sharing plans; and other financial planning and advisory services. This segment also includes the activity from the Delaware subsidiary.

**Cash and Cash Equivalents:** For purposes of the statements of cash flows, cash and cash equivalents include cash and due from banks, interest-earning deposits and federal funds sold. Generally, federal funds are sold for one-day periods. Cash equivalents are of original maturities of 90 days or less. Net cash flows are reported for customer loan and deposit transactions and overnight borrowings.

**Interest-Earning Deposits in Other Financial Institutions:** Interest-earning deposits in other financial institutions mature within one year and are carried at cost.

**Securities:** 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. Equity securities with readily determinable fair values are classified as available for sale. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage-backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

Management evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, Management considers the extent and duration of the unrealized loss and the financial condition and near-term prospects of the issuer. Management also assesses 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. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) other-than-temporary impairment related to credit loss, which must be recognized in the income statement and 2) other-than-temporary impairment related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

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**Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) Stock:** The Bank is a member of the FHLB system. Members are required to own a certain amount of stock, based on the level of borrowings and other factors. FHLB stock is carried at cost, classified as a restricted security and periodically evaluated for impairment based on ultimate recovery of par value. Cash dividends are reported as income.

The Bank is also a member of the Federal Reserve Bank and required to own a certain amount of stock. FRB stock is carried at cost and classified as a restricted security. Cash dividends are reported as income.

**Loans Held for Sale:** Mortgage loans originated and intended for sale in the secondary market are carried at fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged in earnings.

Mortgage loans held for sale are generally sold with servicing rights released; therefore, no servicing rights are recorded. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold.

Loans originated with the intent to hold and subsequently transferred to loans held for sale are carried at the lower of cost or fair value. These are loans that the Corporation no longer has the intent to hold for the foreseeable future.

**Loans:** Loans that Management has the intent and ability to hold for the foreseeable future or until maturity are stated at the principal amount outstanding. Interest on loans is recognized based upon the principal amount outstanding. Loans are stated at face value, less purchased premium and discounts and net deferred fees. Loan origination fees and certain direct loan origination costs are deferred and recognized over the life of the loan as an adjustment, on a level-yield method, to the loan's yield. The definition of recorded investment in loans includes accrued interest receivable, however, for the Corporation's loan disclosures, accrued interest was excluded as the impact was not material.

Loans are considered past due when they are not paid in accordance with contractual terms. The accrual of income on loans, including impaired loans, is discontinued if, in the opinion of Management, principal or interest is not likely to be paid in accordance with the terms of the loan agreement, or when principal or interest is past due 90 days or more and collateral, if any, is insufficient to cover principal and interest. All interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Payments received on nonaccrual loans are recorded as principal payments. A nonaccrual loan is returned to accrual status only when interest and principal payments are brought current and future payments are reasonably assured, generally when the Bank receives contractual payments for a minimum of six months. Commercial loans are generally charged off after an analysis is completed which indicates that collectability of the full principal balance is in doubt. Consumer loans are generally charged off after they become 120 days past due. Subsequent payments are credited to income only if collection of principal is not in doubt. If principal and interest payments are brought contractually current and future collectability is reasonably assured, loans are returned to accrual status. Nonaccrual mortgage loans are generally charged off when the value of the underlying collateral does not cover the outstanding principal balance. The majority of the Corporation's loans are secured by real estate in the State of New Jersey.

**Allowance for Loan Losses:** The allowance for loan losses is a valuation allowance for probably incurred credit losses. Loan losses are charged against the allowance when Management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in Management's

judgment, should be charged off.

The allowance consists of specific and general components. The specific component of the allowance related to loans that are individually classified as impaired.

A loan is impaired when, based on current information and events, it is probable that the Corporation will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors considered by Management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

All loans are individually evaluated for impairment when loans are classified as substandard by Management. If a loan is considered impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral less estimated disposition costs if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans are collectively evaluated for impairment while they are performing assets. If and when a residential mortgage is placed on nonaccrual status and in the process of collection, such as through a foreclosure action, then they are evaluated for impairment on an individual basis and the loan is reported, net, at the fair value of the collateral less estimated disposition costs.

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A troubled debt restructuring is a renegotiated loan with concessions made by the lender to a borrower who is experiencing financial difficulty. Troubled debt restructurings are impaired and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral, less estimated disposition costs. For troubled debt restructurings that subsequently default, the Corporation determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component of the allowance covers non-impaired loans and is based primarily on the Bank's historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experience by the Corporation on a weighted average basis over the previous three years. This actual loss experience is adjusted by other qualitative factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures and practices; experience, ability and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations.

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:

Primary Residential Mortgages. The Bank originates one to four family residential mortgage loans within or near its primary geographic market area. Loans are secured by first liens on the primary residence or investment property. 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.

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. 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.

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. 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.

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. 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.

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**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. 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.

**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. 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.

**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.

**Premises and Equipment:** Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation charges are computed using the straight-line method. Equipment and other fixed assets are depreciated over the estimated useful lives, which range from three to ten years. Premises are depreciated over the estimated useful life of 40 years, while leasehold improvements are amortized on a straight-line basis over the shorter of their estimated useful lives or the term of the lease. Expenditures for maintenance and repairs are expensed as incurred. The cost of major renewals and improvements are capitalized. Gains or losses realized on routine dispositions are recorded as other income or other expense.

**Other Real Estate Owned (OREO):** Other real estate owned is initially recorded at fair value, less costs to sell. When a property is acquired, the excess of the loan balance over the estimated fair value is charged to the allowance for loan losses. A valuation allowance is recorded through earnings for any subsequent decline in fair value and any gains or losses on the sale of properties are recorded through earnings. Operating costs after acquisition are expensed.

**Bank Owned Life Insurance (BOLI):** The Bank has purchased life insurance policies on certain key executives. BOLI is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

**Loan Commitments and Related Financial Instruments:** Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

**Income Taxes:** The Corporation files a consolidated Federal income tax return. Separate state income tax returns are filed for each subsidiary based on current laws and regulations.

The Corporation recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been included in its financial statements or tax returns. The measurement of deferred tax assets and liabilities is based on the enacted tax rates. Such tax assets and liabilities are adjusted for the effect of a change in tax rates in the period of enactment.

The Corporation recognizes a tax position as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50 percent likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded.

The Corporation is no longer subject to examination by the U.S. Federal tax authorities for years prior to 2009 or by New Jersey tax authorities for years prior to 2008.

The Corporation recognizes interest and/or penalties related to income tax matters in income tax expense.



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**Benefit Plans:** The Corporation has a 401(K) profit-sharing and investment plan, which covers substantially all salaried employees over the age of 21 with at least 12 months of service.

**Stock-Based Compensation:** Compensation cost is recognized for stock options and restricted stock awards issued to employees and non-employee directors, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the fair value of the Corporation's common stock at the date of grant is used for restricted stock awards. Compensation expense is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation expense is recognized on a straight-line basis over the requisite service period for the entire award. The stock options granted under these plans are exercisable at a price equal to the fair value of common stock on the date of grant and expire not more than ten years after the date of grant.

**Earnings Per Share ("EPS"):** In calculating earnings per share, there are no adjustments to net income available to common shareholders, which is the numerator of both the Basic and Diluted EPS. The weighted average number of shares outstanding used in the denominator for Diluted EPS is increased over the denominator used for Basic EPS by the effect of potentially dilutive common stock equivalents utilizing the treasury stock method. Common stock options outstanding are common stock equivalents, as are restricted stock until vested. Earnings and dividends per share are restated for all stock splits and stock dividends through the date of issuance of the financial statements.

The following table shows the calculation of both basic and diluted earnings per share for the years ended December 31, 2012, 2011 and 2010:

| (In thousands, except per share data)       | 2012      | 2011      | 2010      |
|---|-----------|-----------|-----------|
| Net income available to common shareholders | \$9,222   | \$10,940  | \$5,978   |
| Basic weighted average shares outstanding   | 8,780,973 | 8,741,209 | 8,784,655 |
| Plus: common stock equivalents              | 47,501    | 1,061     | 366       |
| Diluted weighted average shares outstanding | 8,828,474 | 8,742,270 | 8,785,021 |
| Earnings per share:                         |           |           |           |
| Basic                                       | \$1.05    | \$1.25    | \$0.68    |
| Diluted                                     | 1.05      | 1.25      | 0.68      |

Stock options and restricted stock totaling 546,950, 657,121 and 583,665 shares were not included in the computation of diluted earnings per share in the years ended December 31, 2012, 2011 and 2010, respectively, because they were considered antidilutive. These anti-dilutive shares include stock options, unvested restricted stock awards and, in 2011 and 2010, the warrant issued to the U.S. Treasury for 150,296 common shares.

**Loss Contingencies:** Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonable estimated. Management does not believe there are any such matters that will have a material effect on the financial statements.

**Restrictions on Cash:** Cash on hand or on deposit with the Federal Reserve Bank was required to meet regulatory reserve and clearing requirements.

**Comprehensive Income:** Comprehensive income consists of net income and the change during the period in the Corporation's net unrealized gains or losses on securities available for sale, net of tax, less adjustments for realized gains and losses, net amortization of the unrealized loss on securities transferred to held to maturity from available for sale and accretion of the non-credit component on certain held to maturity securities with other-than-temporary impairment charges in previous periods.

**Equity:** Stock dividends in excess of 20 percent are reported by transferring the par value of the stock issued from retained earnings to common stock. Stock dividends for 20 percent or less are reported by transferring the fair value, as of the ex-dividend date, of the stock issued from retained earnings to common stock and additional paid-in capital. Fractional share amounts are paid in cash with a reduction in retained earnings. Treasury stock is carried at cost.

**Reclassification:** Certain reclassifications have been made in the prior periods' financial statements in order to conform to the 2012 presentation and had no effect on the consolidated income statements or shareholders' equity.

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**New Accounting Policies:** Effective January 2012, the Corporation adopted ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (ASU 2011-04). ASU 2011-04 represents the converged guidance of the FASB and the International Accounting Standards Board (IASB) on fair value measurement. A variety of measures are included in the update intended to either clarify existing fair value measurement requirements, change particular principles requirements for measuring fair value or for disclosing information about fair value measurements. For many of the requirements, the FASB does not intend to change the application of existing requirements under Accounting Standards Codification (ASC) Topic 820, Fair Value Measurements. ASU 2011-04 was effective for interim and annual periods beginning after December 15, 2011. The adoption of this update did not have a material impact on the consolidated financial statements of the Company.

Effective January 2012, the Corporation adopted ASU No. 2011-05, *Presentation of Comprehensive Income* (ASU 2011-05). ASU 2011-05 is intended to increase the prominence of items reported in other comprehensive income and to facilitate convergence of accounting guidance in this area with that of the IASB. The amendments require that all nonowner changes in stockholders' equity be presented in a single continuous statement of comprehensive income or in two separate but consecutive statements.

In December 2011, the FASB issued ASU No. 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05* (ASU 2011-12). ASU 2011-12 defers the provisions of ASU 2011-05 that require the presentation of reclassification adjustments on the face of both the statement of income and statement of other comprehensive income. Amendments under ASU 2011-05 that were not deferred under ASU 2011-12 will be applied retrospectively for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of this update did not have a material impact on the Corporation's consolidated financial statements.

## **2. INVESTMENT SECURITIES HELD TO MATURITY**

On November 30, 2012, the Corporation sold its pooled trust preferred securities portfolio for total proceeds of \$16.0 million, which resulted in a net gain of \$2.9 million with related tax expense of \$1.2 million. The sale was approved by the Corporation's board of directors on November 16, 2012, following a strategic meeting focused on improving the Bank's capital ratios. In previous years, the Corporation had recorded \$51.0 million of credit other-than-temporary impairment on these securities. The sale of these securities resulted in a significant reduction in risk-weighted assets for regulatory capital purposes. In addition, the Corporation had a deferred tax asset totaling \$20.9 million, due to the previous other-than-temporary impairment recorded on these securities. As a result of the sale, the Corporation will realize this deferred tax asset and the overall deferred tax asset was reduced from \$26.7 million at December 31, 2011 to \$9.5 at December 31, 2012.

The Corporation evaluated and concluded that, as a result of the sale of the pooled trust preferred securities portfolio, it no longer had the intent to hold the remaining held to maturity securities to maturity and, therefore, transferred the remaining held to maturity securities to available for sale in December, 2012. The amortized cost and fair value of the securities on the date of transfer was \$64.2 million and \$65.9 million, respectively.

In addition, during the year, the Corporation received approximately \$84 thousand of proceeds on pooled trust preferred securities that were previously written off. The \$84 thousand was recorded as a gain on securities

transactions.

A summary of amortized cost and estimated fair value of investment securities held to maturity included in the consolidated statements of condition as of December 31, 2011 follows:

| (In thousands)                         | 2011              |                       | Gross<br>Unrecognized<br>Losses | Gross<br>Unrecognized<br>Losses | Fair<br>Value |
|--|-------------------|-----------------------|---------------------------------|---------------------------------|---------------|
|  | Amortized<br>Cost | Unrecognized<br>Gains |                                 |                                 |               |
| Mortgage-backed securities-residential | \$67,394          | \$ 1,393              | \$ (1                           | )                               | \$68,786      |
| State and political subdivisions       | 24,608            | 52                    | —                               |                                 | 24,660        |
| Trust preferred pooled securities      | 8,717             | 2,170                 | (4,906                          | )                               | 5,981         |
| Total                                  | \$100,719         | \$ 3,615              | \$ (4,907                       | )                               | \$99,427      |

Securities held to maturity having an approximate carrying value of \$44.9 million as of December 31, 2011 were pledged to secure public funds and for other purposes required or permitted by law.

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The following table presents the Corporation's investment securities held to maturity with continuous unrealized losses and the approximate fair value of these investments as of December 31, 2011.

| (In thousands)                         | 2011                          |                     |                     |                     |             |                     |
|--|-------------------------------|---------------------|---------------------|---------------------|-------------|---------------------|
|  | Duration of Unrecognized Loss |                     |                     |                     |             |                     |
|  | Less Than 12 Months           |                     | 12 Months or Longer |                     | Total       |                     |
|  | Approximate                   | Approximate         | Approximate         | Approximate         | Approximate | Approximate         |
|  | Fair Value                    | Unrecognized Losses | Fair Value          | Unrecognized Losses | Fair Value  | Unrecognized Losses |
| Mortgage-backed securities-residential | \$3,194                       | \$ (1 )             | \$ —                | \$ —                | \$3,194     | \$ (1 )             |
| Trust preferred pooled securities      | —                             | —                   | 2,729               | (4,906 )            | 2,729       | (4,906 )            |
| Total                                  | \$3,194                       | \$ (1 )             | \$ 2,729            | \$ (4,906 )         | \$5,923     | \$ (4,907 )         |

Management has determined that any unrecognized losses on the securities held to maturity at December 31, 2011, are temporary and due to interest rate fluctuations and/or volatile market conditions, rather than the creditworthiness of the issuers. The Corporation monitors creditworthiness of issuers periodically, including issuers of trust preferred securities on a quarterly basis. The Corporation does not have the intent to sell these securities and it is likely that it will not be required to sell the securities before their anticipated recovery. All mortgage-backed securities were issued by U.S. government-sponsored agencies.

The trust preferred pooled securities within the Corporation's held to maturity investment portfolio are collateralized by trust preferred securities issued primarily by individual bank holding companies, but also by insurance companies and real estate investment trusts. There has been little or no active trading in these securities for several years; therefore the Corporation believes in most cases it is more appropriate to estimate fair value using discounted cash flow analysis. As of December 31, 2008, to estimate fair value, and determine whether the securities were other-than-temporarily impaired, the Corporation retained and worked with a third party to review the issuers (the collateral) underlying each of the securities. Among the factors analyzed were the issuers' profitability, credit quality, asset mix, capital adequacy, leverage and liquidity position, as well as an overall assessment of credit, profitability and capital trends within the portfolio's issuer universe. These factors provided an assessment of the portion of the collateral of each security which was likely to default in future periods. The cash flows associated with the collateral likely to default, together with the cash flows associated with collateral which had already deferred or defaulted, were then eliminated. In addition, the Corporation assumed constant rates of default in excess of those based upon the historic performance of the underlying collateral. The resulting cash flows were then discounted to the current period to determine fair value for each security. The discount rate utilized was based on a risk-free rate (LIBOR) plus spreads appropriate for the product, which include consideration of liquidity and credit uncertainty.

Each quarter during 2011, to periodically assess the credit assumptions and related input data that could affect the fair value of each security, Management compared actual deferrals and defaults to the assumed deferrals and defaults included in the valuation model. As of December 31, 2011, the Corporation worked with a third party to model the securities and review its valuation. The modeling process and related assumptions were similar to the process and related assumptions employed as of December 31, 2008. In 2011, no additional impairment charges were recorded while \$581 thousand in impairment charges were recorded on three trust preferred pooled securities for the year ended December 31, 2010.

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The table below presents a rollforward for the periods ended December 31, 2012 and 2011 of the credit losses recognized in earnings:

| (In thousands)   | 2012     | 2011     | 2010     |
|--|----------|----------|----------|
| Beginning balance, January 1,  | \$51,073 | \$51,073 | \$50,492 |
| Additions to credit losses on securities for which no previous other-than-temporary impairment was recognized                                | —        | —        | —        |
| Increases to credit losses on securities for which other-than-temporary impairment was previously recognized                                 | —        | —        | 581      |
| Reductions for previous credit losses realized on securities sold during the period  | (51,073) | —        | —        |
| Reductions for previous credit losses related to securities the company now intends to sell or will be more likely than not required to sell | —        | —        | —        |
| Reductions for previous credit losses due to an increase in cash flows expected to be collected  | —        | —        | —        |
| Ending balance, December 31,   | \$—      | \$51,073 | \$51,073 |

Table of Contents**3. INVESTMENT SECURITIES AVAILABLE FOR SALE**

A summary of amortized cost and approximate fair value of investment securities available for sale included in the consolidated statements of condition as of December 31, 2012 and 2011 follows:

|  | 2012           |                          |                           |             |
|--|----------------|--------------------------|---------------------------|-------------|
|  | Amortized Cost | Gross Unrecognized Gains | Gross Unrecognized Losses | Fair Value  |
| (In thousands)                         |                |                          |                           |             |
| U.S. government-sponsored entities     | \$26,647       | \$ 200                   | \$ (2)                    | ) \$26,845  |
| Mortgage-backed securities-residential | 215,092        | 6,366                    | (18)                      | ) 221,440   |
| State and political subdivisions       | 49,262         | 1,372                    | (2)                       | ) 50,632    |
| Single-issuer trust preferred security | 2,999          | —                        | (710)                     | ) 5,351     |
| CRA investment fund                    | 3,000          | 62                       | —                         | 3,062       |
| Marketable equity securities           | 210            | 1                        | —                         | 211         |
| Total                                  | \$297,210      | \$ 8,001                 | \$ (732)                  | ) \$304,479 |

|  | 2011           |                          |                           |             |
|--|----------------|--------------------------|---------------------------|-------------|
|  | Amortized Cost | Gross Unrecognized Gains | Gross Unrecognized Losses | Fair Value  |
| (In thousands)                         |                |                          |                           |             |
| U.S. government-sponsored entities     | \$46,729       | \$ 149                   | \$ —                      | \$46,878    |
| Mortgage-backed securities-residential | 232,240        | 4,891                    | (147)                     | ) 236,984   |
| State and political subdivisions       | 28,539         | 1,314                    | (2)                       | ) 29,851    |
| Single-issuer trust preferred security | 2,999          | —                        | (832)                     | ) 5,207     |
| CRA investment fund                    | 3,000          | 40                       | —                         | 3,040       |
| Marketable equity securities           | 593            | 7                        | —                         | 600         |
| Total                                  | \$314,100      | \$ 6,401                 | \$ (981)                  | ) \$319,520 |

The amortized cost and approximate fair value of investment securities available for sale as of December 31, 2012, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or repay obligations with or without call or prepayment penalties. Securities not due at a single maturity, such as mortgage-backed securities, marketable equity securities and the CRA Investment Fund (included in other securities), are shown separately.

| Maturing in:                       |                |            |
|------------------------------------|----------------|------------|
| (In thousands)                     | Amortized Cost | Fair Value |
| One year or less                   | \$ 18,598      | \$ 18,603  |
| After one year through five years  | 11,830         | 12,078     |
| After five years through ten years | 18,938         | 20,062     |
| After ten years                    | 29,542         | 29,023     |
|                                    | 78,908         | 79,766     |

|  |            |            |
|--|------------|------------|
| Mortgage-backed securities-residential | 215,092    | 221,440    |
| CRA investment fund                    | 3,000      | 3,062      |
| Marketable equity securities           | 210        | 211        |
| Total                                  | \$ 297,210 | \$ 304,479 |

Securities available for sale having an approximated carrying value of \$63.8 million and \$8.7 million as of December 31, 2012 and December 31, 2011, respectively, were pledged to secure public funds and for other purposes required or permitted by law.

Proceeds on sales of securities available for sale totaled \$35.1 million, \$64.9 million and \$10.4 million in 2012, 2011 and 2010, respectively. Gross gains on sales of securities of \$864 thousand, \$1.2 million and \$224 thousand and gross losses on sales of securities of \$8 thousand, \$117 thousand and \$100 thousand were realized in 2012, 2011 and 2010, respectively. The net tax expense related to the net gains on securities sales were \$351 thousand, \$363 thousand and \$43 thousand in 2012, 2011 and 2010, respectively.



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The following table presents the Corporation's available for sale securities with continuous unrealized losses and the approximate fair value of these investments as of December 31, 2012 and 2011.

| (In thousands)                         | 2012                          |              |                     |              |             |              |
|--|-------------------------------|--------------|---------------------|--------------|-------------|--------------|
|  | Duration of Unrecognized Loss |              |                     |              |             |              |
|  | Less Than 12 Months           |              | 12 Months or Longer |              | Total       |              |
|  | Approximate                   | Approximate  | Approximate         | Approximate  | Approximate | Approximate  |
|  | Fair                          | Unrecognized | Fair                | Unrecognized | Fair        | Unrecognized |
|  | Value                         | Losses       | Value               | Losses       | Value       | Losses       |
| U.S. government sponsored entities     | \$4,998                       | \$ (2 )      | \$ —                | \$ —         | \$4,998     | \$ (2 )      |
| Mortgage-backed securities-residential | 8,433                         | (17 )        | 95                  | (1 )         | 8,528       | (18 )        |
| State and political subdivisions       | 1,290                         | (2 )         | —                   | —            | 1,290       | (2 )         |
| Single-issuer trust Preferred security | —                             | —            | 2,289               | (710 )       | 2,289       | (710 )       |
| Total                                  | \$14,721                      | \$ (21 )     | \$ 2,384            | \$ (711 )    | \$17,105    | \$ (732 )    |

| (In thousands)                         | 2011                          |              |                     |              |             |              |
|--|-------------------------------|--------------|---------------------|--------------|-------------|--------------|
|  | Duration of Unrecognized Loss |              |                     |              |             |              |
|  | Less Than 12 Months           |              | 12 Months or Longer |              | Total       |              |
|  | Approximate                   | Approximate  | Approximate         | Approximate  | Approximate | Approximate  |
|  | Fair                          | Unrecognized | Fair                | Unrecognized | Fair        | Unrecognized |
|  | Value                         | Losses       | Value               | Losses       | Value       | Losses       |
| Mortgage-backed securities-residential | \$32,931                      | \$ (120 )    | \$ 317              | \$ (27 )     | \$33,248    | \$ (147 )    |
| State and political subdivisions       | 736                           | (2 )         | —                   | —            | 736         | (2 )         |
| Single-issuer trust Preferred security | —                             | —            | 2,167               | (832 )       | 2,167       | (832 )       |
| Total                                  | \$33,667                      | \$ (122 )    | \$ 2,484            | \$ (859 )    | \$36,151    | \$ (981 )    |

Management believes that the unrealized losses on investment securities available for sale are temporary and due to interest rate fluctuations and/or volatile market conditions rather than the credit worthiness of the issuers. The Corporation does not intend to sell these securities nor is it likely that it will be required to sell the securities before their anticipated recovery.

At December 31, 2012, the unrealized loss of \$710 thousand is related to a single-issuer trust preferred security issued by a large bank holding company that has experienced declines in fair value on all its securities due to the turmoil in the financial markets and a merger. It was downgraded to below investment grade by Moody's and is currently rated Ba2. Management monitors the performance of the issuer on a quarterly basis to determine if there are any credit events that could result in deferral or default of the security. In spite of the credit downgrade, the fair value of this security at December 31, 2012, is higher than the fair value at December 31, 2011. Management believes the

depressed valuation is a result of the nature of the bond, a trust preferred security, and the bond's very low yield. At December 31 2012, Management does not intend to sell the security nor is it likely that it will be required to sell the security before its anticipated recovery.

No other-than-temporary impairment charges were recognized in 2012 or 2011; however, in 2010, the Corporation recognized a noncash charge of \$360 thousand related to an other-than-temporary impairment charge for seven equity securities with a cost of \$1.1 million.

#### 4. LOANS

The following table presents loans outstanding, by type of loan, as of December 31:

| (In thousands)               | 2012        | % of Total<br>Loans | 2011          | % of Total<br>Loans |   |
|------------------------------|-------------|---------------------|---------------|---------------------|---|
| Residential mortgage         | \$515,014   | 45.47               | % \$498,482   | 48.01               | % |
| Commercial mortgage          | 420,086     | 37.09               | 330,559       | 31.84               |   |
| Commercial loans             | 115,372     | 10.19               | 123,845       | 11.93               |   |
| Construction loans           | 9,328       | 0.83                | 13,713        | 1.32                |   |
| Home equity lines of credit  | 49,635      | 4.38                | 50,291        | 4.84                |   |
| Consumer loans, including    |             |                     |               |                     |   |
| fixed rate home equity loans | 21,188      | 1.87                | 19,439        | 1.87                |   |
| Other loans                  | 1,961       | 0.17                | 2,016         | 0.19                |   |
| Total loans                  | \$1,132,584 | 100.00              | % \$1,038,345 | 100.00              | % |

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Not included in the footnote tables are \$19 million of classified loans that were transferred to loans held for sale in December 2012. 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.

In determining an appropriate amount for the allowance, the Bank segments and evaluates the loan portfolio based on Federal call report codes. The following portfolio classes have been identified as of December 31:

| (In thousands)                             | 2012        | % of Total<br>Loans | 2011          | % of Total<br>Loans | % |
|--|-------------|---------------------|---------------|---------------------|---|
| Primary residential mortgage               | \$527,803   | 46.74               | % \$511,418   | 49.40               | % |
| Home equity lines of credit                | 49,635      | 4.40                | 50,394        | 4.87                |   |
| Junior lien loan on residence              | 11,893      | 1.05                | 13,053        | 1.26                |   |
| Multifamily property                       | 161,705     | 14.32               | 104,056       | 10.05               |   |
| Owner-occupied commercial<br>real estate   | 84,720      | 7.50                | 107,852       | 10.42               |   |
| Investment commercial real estate          | 242,586     | 21.48               | 186,998       | 18.06               |   |
| Commercial and industrial                  | 25,820      | 2.29                | 29,825        | 2.88                |   |
| Farmland                                   | 207         | 0.02                |               |                     |   |
| Agricultural production loans              | 14          | N/A                 | 18            | N/A                 |   |
| Commercial construction                    | 9,323       | 0.83                | 19,208        | 1.85                |   |
| Consumer and other                         | 15,480      | 1.37                | 12,516        | 1.21                |   |
| Total loans                                | \$1,129,186 | 100.00              | % \$1,035,338 | 100.00              | % |
| Net deferred fees                          | 3,398       |                     | 3,007         |                     |   |
| Total loans including<br>net deferred fees | \$1,132,584 |                     | \$1,038,345   |                     |   |

Included in the totals above for December 31, 2012 is \$543 thousand of unamortized discount as compared to \$691 thousand of unamortized discount for December 31, 2011.

In the ordinary course of business, the Corporation, through the Bank, may extend credit to officers, directors or their associates. These loans are subject to the Corporation's normal lending policy and Federal Reserve Bank Regulation O.

The following table shows the changes in loans to officers, directors or their associates:

| (In thousands)             | 2012    | 2011    |
|----------------------------|---------|---------|
| Balance, beginning of year | \$1,328 | \$1,183 |
| New loans                  | 1,636   | 793     |
| Repayments                 | (1,619) | (648)   |
| Balance, at end of year    | \$1,345 | \$1,328 |



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The following tables present the loan balances by portfolio segment, based on impairment method, and the corresponding balances in the allowance for loan losses as of December 31, 2012 and 2011:

**December 31, 2012**

| (In thousands)                        | Total<br>Loans<br>Individually<br>Evaluated<br>For<br>Impairment | Ending<br>ALLL<br>Attributable<br>To Loans<br>Individually<br>Evaluated<br>For<br>Impairment | Total<br>Loans<br>Collectively<br>Evaluated<br>For<br>Impairment | Ending<br>ALLL<br>Attributable<br>To Loans<br>Collectively<br>Evaluated<br>For<br>Impairment | Total<br>Loans      | Total<br>Ending<br>ALLL<br>Before<br>Allocation | Allocation<br>Of<br>Previous<br>Unallocated<br>ALLL | Total<br>Ending<br>ALLL |
|---------------------------------------|--|--|--|--|---------------------|---|---|-------------------------|
|                                       |  |  |  |  |                     |   |   |                         |
| Primary residential mortgage          | \$ 7,155   | \$ 148   | \$ 520,648   | \$ 2,789   | \$ 527,803          | \$ 2,937  | \$ 110  | \$ 3,047                |
| Home equity lines of credit           | 110  | —  | 49,525   | 257  | 49,635              | 257   | 10  | 267                     |
| Junior lien loan on residence         | 562  | 240  | 11,331   | 71   | 11,893              | 311   | 3   | 314                     |
| Multifamily property                  | —  | —  | 161,705  | 1,255  | 161,705             | 1,255   | 50  | 1,305                   |
| Owner-occupied commercial real estate | 4,724  | —  | 79,996   | 2,413  | 84,720              | 2,413   | 96  | 2,509                   |
| Investment commercial real estate     | 5,173  | 384  | 237,413  | 3,627  | 242,586             | 4,011   | 144   | 4,155                   |
| Commercial and industrial             | 423  | 41   | 25,397   | 733  | 25,820              | 774   | 29  | 803                     |
| Secured by farmland                   | —  | —  | 207  | 3  | 207                 | 3   | —   | 3                       |
| Agricultural production               | —  | —  | 14   | —  | 14                  | —   | —   | —                       |
| Commercial construction               | —  | —  | 9,323  | 231  | 9,323               | 231   | 9   | 240                     |
| Consumer and other                    | —  | —  | 15,480   | 89   | 15,480              | 89  | 3   | 92                      |
| Unallocated                           | —  | —  | —  | 454  | —                   | 454   | (454 )  | —                       |
| <b>Total ALLL</b>                     | <b>\$ 18,147</b>   | <b>\$ 813</b>  | <b>\$ 1,111,039</b>  | <b>\$ 11,922</b>   | <b>\$ 1,129,186</b> | <b>\$ 12,735</b>                                | <b>\$ —</b>   | <b>\$ 12,735</b>        |

Prior to December 31, 2012, the Company utilized the sum of all allowance amounts derived combined with a nominal unallocated allowance, as the primary indicator of the appropriate level of allowance for loan and lease

losses. During the fourth quarter of 2012, the Company refined its allowance calculation whereby it pro-ratably “allocated” the portion of the allowance that was previously deemed to be unallocated allowance to identified loan classes.

December 31, 2011

| (In thousands)                        | Total                                       |   | Ending ALLL                                       |   | Total              | Total           |
|---------------------------------------|---|---|---|---|--------------------|-----------------|
|                                       | Loans Individually Evaluated For Impairment | Loans Individually Evaluated For Impairment | Total Loans Collectively Evaluated For Impairment | Ending ALLL Attributable To Loans Collectively Evaluated For Impairment |                    |                 |
| Primary residential mortgage          | \$ 8,878                                    | \$ 345                                      | \$ 502,540  | \$ 2,069  | \$511,418          | \$2,414         |
| Home equity lines of credit           | 489   | —   | 49,905  | 204   | 50,394             | 204             |
| Junior lien loan on residence         | 680   | 9   | 12,373  | 55  | 13,053             | 64              |
| Multifamily property                  | 550   | 52  | 103,506   | 653   | 104,056            | 705             |
| Owner-occupied commercial real estate | 9,054                                       | 322   | 98,798  | 2,786   | 107,852            | 3,108           |
| Investment commercial real estate     | 5,986                                       | 509   | 181,012   | 3,672   | 186,998            | 4,181           |
| Commercial and industrial             | 576   | 51  | 29,249  | 1,240   | 29,825             | 1,291           |
| Agricultural production               | —   | —   | 18  | 1   | 18                 | 1               |
| Commercial construction               | —   | —   | 19,208  | 669   | 19,208             | 669             |
| Consumer and other                    | —   | —   | 12,516  | 78  | 12,516             | 78              |
| Unallocated                           | —   | —   | —   | 508   | —                  | 508             |
| <b>Total ALLL</b>                     | <b>\$ 26,213</b>                            | <b>\$ 1,288</b>                             | <b>\$ 1,009,125</b>                               | <b>\$ 11,935</b>  | <b>\$1,035,338</b> | <b>\$13,223</b> |

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Impaired loans include nonaccrual loans of \$11.7 million at December 31, 2012 and \$18.9 million at December 31, 2011. Impaired loans also include performing troubled debt restructured loans of \$6.4 million at December 31, 2012 and \$7.3 million at December 31, 2011. The allowance allocated to troubled debt restructured loans which are nonaccrual totaled \$240 thousand and \$280 thousand, as of December 31, 2012 and December 31, 2011, respectively. All accruing troubled debt restructured loans were paying in accordance with restructured terms as of December 31, 2012. The Corporation has not committed to lend additional amounts as of December 31, 2012 to customers with outstanding loans that are classified as loan restructurings.

The following tables present loans individually evaluated for impairment by class of loans as of December 31, 2012 and 2011:

| (In thousands)                                    | December 31, 2012        |                     |                   | Average Impaired Loans | Interest Income Recognized |
|---|--------------------------|---------------------|-------------------|------------------------|----------------------------|
|   | Unpaid Principal Balance | Recorded Investment | Specific Reserves |                        |                            |
| With no related allowance recorded:               |                          |                     |                   |                        |                            |
| Primary residential mortgage                      | \$8,605                  | \$ 6,148            | \$ —              | \$8,110                | \$ 384                     |
| Multifamily property                              | —                        | —                   | —                 | 185                    | 16                         |
| Owner-occupied commercial real estate             | 4,971                    | 4,724               | —                 | 9,575                  | 570                        |
| Investment commercial real estate                 | 336                      | —                   | —                 | 796                    | 51                         |
| Commercial and industrial                         | 432                      | 345                 | —                 | 640                    | 47                         |
| Home equity lines of credit                       | 110                      | 110                 | —                 | 221                    | 11                         |
| Junior lien loan on residence                     | 429                      | 235                 | —                 | 439                    | 30                         |
| Total loans with no related allowance             | \$14,883                 | \$ 11,562           | \$ —              | \$ 19,966              | \$ 1,109                   |
| With related allowance recorded:                  |                          |                     |                   |                        |                            |
| Primary residential mortgage                      | \$1,056                  | \$ 1,007            | \$ 148            | \$851                  | \$ 38                      |
| Multifamily property                              | —                        | —                   | —                 | —                      | —                          |
| Owner-occupied commercial real estate             | —                        | —                   | —                 | —                      | —                          |
| Investment commercial real estate                 | 5,183                    | 5,173               | 384               | 5,013                  | 251                        |
| Commercial and industrial                         | 78                       | 78                  | 41                | 92                     | 74                         |
| Junior lien loan on residence                     | 327                      | 327                 | 240               | —                      | 8                          |
| Commercial construction                           | —                        | —                   | —                 | 194                    | —                          |
| Total loans with related allowance                | \$6,644                  | \$ 6,585            | \$ 813            | \$6,150                | \$ 371                     |
| Total loans individually evaluated for impairment | \$21,527                 | \$ 18,147           | \$ 813            | \$26,116               | \$ 1,480                   |

| (In thousands)                      | December 31, 2011        |                     |                   | Average Impaired Loans | Interest Income Recognized |
|-------------------------------------|--------------------------|---------------------|-------------------|------------------------|----------------------------|
|                                     | Unpaid Principal Balance | Recorded Investment | Specific Reserves |                        |                            |
| With no related allowance recorded: |                          |                     |                   |                        |                            |
| Primary residential mortgage        | \$7,586                  | \$ 5,844            | \$ —              | \$4,721                | \$ 87                      |
| Multifamily property                | 312                      | 286                 | —                 | 243                    | —                          |

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|   |          |           |          |           |        |
|---|----------|-----------|----------|-----------|--------|
| Owner-occupied commercial real estate             | 10,630   | 7,049     | —        | 5,575     | 158    |
| Investment commercial real estate                 | 397      | 299       | —        | 322       | 20     |
| Commercial and industrial                         | 475      | 475       | —        | 433       | 24     |
| Home equity lines of credit                       | 595      | 489       | —        | 66        | 18     |
| Junior lien loan on residence                     | 682      | 555       | —        | 453       | 9      |
| Total loans with no related allowance             | \$20,677 | \$ 14,997 | \$ —     | \$ 11,813 | \$ 316 |
| With related allowance recorded:                  |          |           |          |           |        |
| Primary residential mortgage                      | \$3,083  | \$ 3,034  | \$ 345   | \$ 1,496  | \$ 99  |
| Multifamily property                              | 264      | 264       | 52       | 71        | 13     |
| Owner-occupied commercial real estate             | 2,020    | 2,005     | 322      | 1,254     | 66     |
| Investment commercial real estate                 | 5,979    | 5,687     | 509      | 2,865     | 373    |
| Commercial and industrial                         | 101      | 101       | 51       | 495       | 9      |
| Junior lien loan on residence                     | 138      | 125       | 9        | 128       | —      |
| Commercial construction                           | —        | —         | —        | 995       | —      |
| Total loans with related allowance                | \$11,585 | \$ 11,216 | \$ 1,288 | \$ 7,304  | \$ 560 |
| Total loans individually evaluated for impairment | \$32,262 | \$ 26,213 | \$ 1,288 | \$ 19,117 | \$ 876 |



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Cash basis interest income recognized during 2012, 2011 and 2010 was not material.

The following tables present the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of December 31, 2012 and 2011:

| (In thousands)                        | December 31, 2012 |   |
|---------------------------------------|-------------------|---|
|                                       | Nonaccrual        | Loans Past Due Over<br>90 Days and Still<br>Accruing Interest |
| Primary residential mortgage          | \$ 6,519          | \$ —  |
| Home equity lines of credit           | 110               | —   |
| Junior lien loan on residence         | 562               | —   |
| Multifamily property                  | —                 | —   |
| Owner-occupied commercial real estate | 4,317             | —   |
| Investment commercial real estate     | 224               | —   |
| Commercial and industrial             | —                 | —   |
| Consumer and other                    | —                 | —   |
| Total                                 | \$ 11,732         | \$ —  |

| (In thousands)                        | December 31, 2011 |   |
|---------------------------------------|-------------------|---|
|                                       | Nonaccrual        | Loans Past Due Over<br>90 Days and Still<br>Accruing Interest |
| Primary residential mortgage          | \$ 7,468          | \$ —  |
| Home equity lines of credit           | 489               | —   |
| Junior lien loan on residence         | 680               | —   |
| Multifamily property                  | 550               | —   |
| Owner-occupied commercial real estate | 8,641             | —   |
| Investment commercial real estate     | 1,037             | —   |
| Commercial and industrial             | —                 | 345   |
| Consumer and other                    | —                 | —   |
| Total                                 | \$ 18,865         | \$ 345  |

The following tables present the recorded investment in past due loans as of December 31, 2012 and 2011 by class of loans, excluding nonaccrual loans:

| (In thousands) | December 31, 2012 |               |                                     | Total<br>Past Due |
|----------------|-------------------|---------------|-------------------------------------|-------------------|
|                | 30-59<br>Days     | 60-89<br>Days | Greater Than<br>90 Days<br>Past Due |                   |
|                |                   |               |                                     |                   |

|                                       | Past<br>Due |        |    |            |
|---------------------------------------|-------------|--------|----|------------|
| Primary residential mortgage          | \$2,513     | \$ 203 | \$ | — \$ 2,716 |
| Home equity lines of credit           | 25          | —      |    | — 25       |
| Junior lien loan on residence         | 31          | —      |    | — 31       |
| Multifamily property                  | —           | —      |    | — —        |
| Owner-occupied commercial real estate | 407         | —      |    | — 407      |
| Investment commercial real estate     | 592         | —      |    | — 592      |
| Commercial and industrial             | 15          | —      |    | — 15       |
| Commercial construction               | —           | —      |    | — —        |
| Consumer and other                    | —           | —      |    | — —        |
| Total                                 | \$3,583     | \$ 203 | \$ | — \$ 3,786 |

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|                                       | December 31, 2011            |                           |                                     | Total     |
|---------------------------------------|------------------------------|---------------------------|-------------------------------------|-----------|
|                                       | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past Due | Greater Than<br>90 Days<br>Past Due |           |
| (In thousands)                        |                              |                           |                                     |           |
| Primary residential mortgage          | \$4,857                      | \$ 898                    | \$ —                                | \$ 5,755  |
| Home equity lines of credit           | 565                          | 19                        | —                                   | 584       |
| Junior lien loan on residence         | 399                          | —                         | —                                   | 399       |
| Multifamily property                  | 395                          | —                         | —                                   | 395       |
| Owner-occupied commercial real estate | 3,381                        | —                         | —                                   | 3,381     |
| Investment commercial real estate     | 242                          | —                         | —                                   | 242       |
| Commercial and industrial             | 368                          | —                         | 345                                 | 713       |
| Commercial construction               | 500                          | —                         | —                                   | 500       |
| Consumer and other                    | 8                            | —                         | —                                   | 8         |
| Total                                 | \$10,715                     | \$ 917                    | \$ 345                              | \$ 11,977 |

**Credit Quality Indicators:**

The Corporation categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Corporation analyzes loans individually by classifying the loans as to credit risk. The risk rating analysis of loans is performed (i) when the loan is initially underwritten, (ii) annually for loans in excess of \$500,000, (iii) on a random quarterly basis from either internal reviews with the Senior Credit Officer or externally through an independent loan review firm, or (iv) whenever Management otherwise identifies a potentially negative trend or issue relating to a borrower. The Corporation uses the following definitions for risk ratings:

**Special Mention:** Loans subject to special mention have a potential weakness that deserves Management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loans or of the institution's credit position at some future date.

**Substandard:** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful:** Loans classified as doubtful have all the weakness inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

The Corporation considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential and consumer loans, the Corporation evaluated credit quality primarily based on the delinquency status of the loan, which was previously presented.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.

The table below presents, based on the most recent analysis performed, the risk category of loans by class of loans for December 31, 2012 and 2011.

**December 31, 2012**

| (In thousands)                        | Pass        | Special<br>Mention | Substandard | Doubtful |
|---------------------------------------|-------------|--------------------|-------------|----------|
| Primary residential mortgage          | \$517,336   | \$3,152            | \$ 7,315    | \$ —     |
| Home equity lines of credit           | 49,525      | —                  | 110         | —        |
| Junior lien loan on residence         | 11,294      | 37                 | 562         | —        |
| Multifamily property                  | 161,229     | 476                | —           | —        |
| Owner-occupied commercial real estate | 73,809      | 334                | 10,577      | —        |
| Investment commercial real estate     | 216,394     | 13,237             | 12,955      | —        |
| Agricultural production loans         | 14          | —                  | —           | —        |
| Commercial and industrial             | 25,191      | 134                | 495         | —        |
| Secured by farmland                   | 207         | —                  | —           | —        |
| Commercial construction               | 3,999       | 5,324              | —           | —        |
| Consumer and other loans              | 15,480      | —                  | —           | —        |
| Total                                 | \$1,074,478 | \$22,694           | \$ 32,014   | \$ —     |

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| (In thousands)                        | Pass      | Special<br>Mention | Substandard | Doubtful |
|---------------------------------------|-----------|--------------------|-------------|----------|
| Primary residential mortgage          | \$496,815 | \$5,437            | \$ 9,166    | \$ —     |
| Home equity lines of credit           | 49,905    | —                  | 489         | —        |
| Junior lien loan on residence         | 12,244    | 129                | 680         | —        |
| Multifamily property                  | 102,948   | 163                | 945         | —        |
| Owner-occupied commercial real estate | 81,797    | 9,524              | 16,531      | —        |
| Investment commercial real estate     | 157,579   | 9,599              | 19,820      | —        |
| Agricultural production loans         | 18        | —                  | —           | —        |
| Commercial and industrial             | 28,020    | 835                | 970         | —        |
| Commercial construction               | 18,474    | 234                | 500         | —        |
| Consumer and other loans              | 12,021    | 495                | —           | —        |
| Total                                 | \$959,821 | \$26,416           | \$ 49,101   | \$ —     |

At December 31, 2012, \$18.1 million of the \$32.0 million of the substandard loans were also considered impaired as compared to December 31, 2011, when \$26.2 million of the \$49.1 million of the substandard loans were also considered impaired.

| (In thousands)                           | January 1,<br>2012<br>Beginning | Charge-Offs | Recoveries | Provision | December 31,<br>2012<br>Ending |
|--|---------------------------------|-------------|------------|-----------|--------------------------------|
|  | ALLL                            |             |            |           | ALLL                           |
| Primary residential mortgage             | \$ 2,414                        | \$ (1,676 ) | \$ 3       | \$ 2,306  | \$ 3,047                       |
| Home equity lines of credit              | 204                             | (91 )       | —          | 154       | 267                            |
| Junior lien loan on residence            | 64                              | (57 )       | 6          | 301       | 314                            |
| Multifamily property                     | 705                             | (492 )      | —          | 1,092     | 1,305                          |
| Owner-occupied commercial<br>real estate | 3,108                           | (4,047 )    | 299        | 3,149     | 2,509                          |
| Investment commercial real estate        | 4,181                           | (2,448 )    | 17         | 2,405     | 4,155                          |
| Agricultural production                  | 1                               | —           | —          | (1 )      | —                              |
| Commercial and industrial                | 1,291                           | (233 )      | 60         | (315 )    | 803                            |
| Secured by farmland                      | —                               | —           | —          | 3         | 3                              |
| Commercial construction                  | 669                             | (72 )       | —          | (357 )    | 240                            |
| Consumer and other                       | 78                              | (43 )       | 11         | 46        | 92                             |
| Unallocated                              | 508                             | —           | —          | (508 )    | —                              |
| Total ALLL                               | \$ 13,223                       | \$ (9,159 ) | \$ 396     | \$ 8,275  | \$ 12,735                      |

| (In thousands) | January 1,<br>2011<br>Beginning | Charge-Offs | Recoveries | Provision | December 31,<br>2011<br>Ending |
|----------------|---------------------------------|-------------|------------|-----------|--------------------------------|
|                | ALLL                            |             |            |           | ALLL                           |

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|                                   |           |           |          |          |           |
|-----------------------------------|-----------|-----------|----------|----------|-----------|
| Primary residential mortgage      | \$ 1,502  | \$ (763   | ) \$ —   | \$ 1,675 | \$ 2,414  |
| Home equity lines of credit       | 160       | (89       | ) —      | 133      | 204       |
| Junior lien loan on residence     | 228       | (13       | ) 14     | (165 )   | 64        |
| Multifamily property              | 303       | (75       | ) 8      | 469      | 705       |
| Owner-occupied commercial         |           |           |          |          |           |
| real estate                       | 2,777     | (3,405    | ) 40     | 3,696    | 3,108     |
| Investment commercial real estate | 4,759     | (3,287    | ) 48     | 2,661    | 4,181     |
| Agricultural production           | —         | —         | —        | 1        | 1         |
| Commercial and industrial         | 2,719     | (272      | ) 108    | (1,264 ) | 1,291     |
| Commercial construction           | 1,246     | (607      | ) 11     | 19       | 669       |
| Consumer and other                | 66        | (28       | ) 1      | 39       | 78        |
| Unallocated                       | 522       | —         | —        | (14 )    | 508       |
| Total ALLL                        | \$ 14,282 | \$ (8,539 | ) \$ 230 | \$ 7,250 | \$ 13,223 |

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A summary of changes in the allowance for loan losses for the year indicated follows:

|                              |          |
|------------------------------|----------|
| (In thousands)               | 2010     |
| Balance, beginning of year   | \$13,192 |
| Provision charged to expense | 10,000   |
| Loans charged-off            | (9,166 ) |
| Recoveries                   | 256      |
| Balance, end of year         | \$14,282 |

**Troubled Debt Restructurings:** The Corporation has allocated \$483 thousand and \$707 thousand of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2012 and December 31, 2011, respectively. There were no unfunded commitments to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

During the period ended December 31, 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the followings: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

The following table presents loans by class modified as troubled debt restructurings that occurred during the year ended December 31, 2012:

| (Dollars in thousands)            | Number of<br>Contracts | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
|-----------------------------------|------------------------|---|--|
| Primary residential mortgage      | 3                      | \$ 553  | \$ 553   |
| Junior lien on residence          | 1                      | 274   | 274  |
| Investment commercial real estate | 1                      | 2,648   | 2,648  |
| Total                             | 5                      | \$ 3,475  | \$ 3,475   |

The identification of the troubled debt restructured loans did not have a significant impact on the allowance for loan losses. In addition, there were no charge-offs as a result of the classification of these loans as troubled debt restructuring during the year ended December 31, 2012.

The primary residential mortgages were modified by reducing the interest rates or extending the maturity date. The junior lien on residence loan was modified through the deferral of certain scheduled principal payments. The owner-occupied commercial real estate loan was modified with rate reductions and revised amortization schedules and partial forgiveness of principal which had been previously charged off.

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The following table presents loans by class modified as troubled debt restructurings during the year ended December 31, 2012 for which there was a payment default during the same period:

| (Dollars in thousands)   | Number of<br>Contracts | Recorded<br>Investment |
|--------------------------|------------------------|------------------------|
| Junior lien on residence | 1                      | \$ 240                 |
| Total                    | 1                      | \$ 240                 |

The following table presents loans by class modified as troubled debt restructurings that occurred during the year ended December 31, 2011:

| (Dollars in thousands)                | Number of<br>Contracts | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
|---------------------------------------|------------------------|---|--|
| Primary residential mortgage          | 3                      | \$ 1,410  | \$ 1,410   |
| Owner-occupied commercial real estate | 1                      | 412   | 412  |
| Investment commercial real estate     | 1                      | 4,949   | 4,949  |
| Total                                 | 5                      | \$ 6,771  | \$ 6,771   |



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The residential mortgages were modified by extending the maturities longer than six months. Both of the commercial real estate loans were modified to an interest only basis pending the sale of the underlying collateral. The Bank did not forgive any principal or interest on any of these loans and expects to collect the full amount that is contractually owed.

The following table presents loans by class modified as troubled debt restructurings during the year ended December 31, 2011 for which there was a payment default during the same period:

| (Dollars in thousands)                | Number of<br>Contracts | Recorded<br>Investment |
|---------------------------------------|------------------------|------------------------|
| Owner-occupied commercial real estate | 1                      | \$ 412                 |
| Total                                 | 1                      | \$ 412                 |

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Corporation's internal underwriting policy. At the time a loan is restructured, the Bank performs a full re-underwriting analysis, which includes, at a minimum, obtaining current financial statements and tax returns, copies of all leases, and an updated independent appraisal of the property. A loan will continue to accrue interest if it can be reasonably determined that the borrower should be able to perform under the modified terms, that the loan has not been chronically delinquent (both to debt service and real estate taxes) or in nonaccrual status since its inception, and that there have been no charge-offs on the loan. Restructured loans with previous charge-offs would not accrue interest at the time of the troubled debt restructuring. At a minimum, six months of contractual payments would need to be made on a restructured loan before returning a loan to accrual status. Once a loan is classified as a TDR, the loan is reported as a TDR until the loan is paid in full, sold or charged-off. In rare circumstances, a loan may be removed from TDR status, if it meets the requirements of ASC 310-40-50-2.

**5. PREMISES AND EQUIPMENT**

The following table presents premises and equipment as of December 31,

| (In thousands)             | 2012    | 2011    |
|----------------------------|---------|---------|
| Land and land improvements | \$4,933 | \$4,943 |
| Buildings                  | 11,920  | 11,892  |
| Furniture and equipment    | 20,306  | 19,529  |
| Leasehold improvements     | 9,107   | 9,016   |
| Projects in progress       | 179     | 111     |
| Capital lease asset        | 8,911   | 8,911   |

|                                |          |          |
|--------------------------------|----------|----------|
|                                | 55,356   | 54,402   |
| Less: accumulated depreciation | 25,326   | 22,461   |
| Total                          | \$30,030 | \$31,941 |

The Corporation has included leases in premises and equipment as follows:

|                                |         |         |
|--------------------------------|---------|---------|
| (In thousands)                 | 2012    | 2011    |
| Land and buildings             | \$8,911 | \$8,911 |
| Less: accumulated depreciation | 1,207   | 666     |
| Total                          | \$7,704 | \$8,245 |

The Corporation recorded depreciation expense of \$2.9 million, \$2.9 million and \$3.1 million for the years ended December 31, 2012, 2011 and 2010, respectively.

The Corporation leases its corporate headquarters building under a capital lease. The lease arrangement requires monthly payments through 2025. Related depreciation expense and accumulated depreciation of \$400 thousand is included in 2012 results.

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In December 2011, the Corporation completed a sale-leaseback transaction involving its Gladstone property. The Corporation leased the majority of the building to house its branch. The lease arrangement requires monthly payments through 2031. The gain on the sale of \$764 thousand was deferred and will be accreted to income over the life of the lease. Payments began on January 1, 2012 and no expense is included in the 2011 results. Related depreciation expense and accumulated depreciation of \$141 thousand is included in 2012 results.

The following is a schedule by year of future minimum lease payments under capitalized leases, together with the present value of net minimum lease payments as of December 31, 2012:

(In thousands)

|   |         |
|---|---------|
| 2013  | \$638   |
| 2014  | 719     |
| 2015  | 760     |
| 2016  | 760     |
| 2017  | 833     |
| Thereafter                                  | 9,058   |
| Total minimum lease payments                | 12,768  |
| Less amount representing interest           | (3,857) |
| Present value of net minimum lease payments | \$8,911 |

**6. OTHER REAL ESTATE OWNED**

At December 31, 2012 and 2011, the Corporation had other real estate owned, net of valuation allowances, totaling \$3.5 million and \$7.1 million, respectively.

The following table shows the activity in other real estate owned, excluding the valuation allowance, for the years ended December 31,

|                            |         |         |
|----------------------------|---------|---------|
| (In thousands)             | 2012    | 2011    |
| Balance, beginning of year | \$8,002 | \$4,000 |
| OREO properties added      | 2,466   | 12,613  |
| Sales during year          | (5,962) | (8,611) |
| Balance, end of year       | \$4,506 | \$8,002 |

The following table shows the activity in the valuation allowance for the years ended December 31,

|                              |       |      |      |
|------------------------------|-------|------|------|
| (In thousands)               | 2012  | 2011 | 2010 |
| Balance, beginning of year   | \$865 | \$—  | \$—  |
| Additions charged to expense | 145   | 865  | —    |
| Direct writedowns            | —     | —    | —    |

Balance, end of year                \$1,010   \$865   \$ —

The following table shows expenses related to other real estate owned for the years ended December 31,

| (In thousands)                           | 2012  | 2011    | 2010  |
|--|-------|---------|-------|
| Net loss/(gain) on sales                 | \$89  | \$203   | \$ 19 |
| Provision for unrealized losses          | 145   | 865     | —     |
| Operating expenses, net of rental income | 356   | 179     | 28    |
| Total                                    | \$590 | \$1,247 | \$ 47 |

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The following table sets forth the details of total deposits as of December 31,

| (In thousands)                      | 2012        |         | 2011        |         |   |
|-------------------------------------|-------------|---------|-------------|---------|---|
|                                     | \$          | %       | \$          | %       |   |
| Noninterest-bearing demand deposits | \$298,095   | 19.66   | % \$297,459 | 20.60   | % |
| Interest-bearing Checking           | 346,877     | 22.87   | 341,180     | 23.63   |   |
| Savings                             | 109,686     | 7.23    | 92,322      | 6.39    |   |
| Money market                        | 583,197     | 38.46   | 516,920     | 35.80   |   |
| Certificates of deposit             | 173,572     | 11.45   | 196,011     | 13.58   |   |
| Brokered certificates of deposit    | 5,000       | 0.33    | —           | —       |   |
| Total deposits                      | \$1,516,427 | 100.00% | \$1,443,892 | 100.00% |   |

The scheduled maturities of time deposits as of December 31, 2012 are as follows:

| (In thousands) |            |
|----------------|------------|
| 2013           | \$ 109,866 |
| 2014           | 34,153     |
| 2015           | 15,638     |
| 2016           | 6,344      |
| 2017           | 12,571     |
| Total          | \$ 178,572 |

**8. FEDERAL HOME LOAN BANK ADVANCES AND OTHER BORROWINGS**

Advances from FHLB totaled \$12.2 million and \$17.7 million at December 31, 2012 and 2011, respectively, with a weighted average interest rate of 3.03 percent and 3.41 percent, respectively.

As of December 31, 2012 the Corporation did not have any advances with fixed maturity dates while at December 31, 2011 advances totaling \$1.0 million with a rate of 3.88 percent, had fixed maturity dates. At December 31, 2012, advances totaling \$218 thousand with a weighted average rate of 3.73 percent, were amortizing advances with monthly payments of principal and interest, while at December 31, 2011, advances totaling \$680 thousand with a weighted average rate of 3.73 percent, were amortizing advances with monthly payments of principal and interest. These advances are secured by blanket pledges of certain 1-4 family residential mortgages totaling \$59.3 million at December 31, 2012 and \$76.5 million at December 31, 2011.

Also at December 31, 2012, the Corporation had \$12.0 million in variable rate advances, with a weighted average rate of 3.01 percent, that are noncallable for one, two or three years and then callable quarterly with final maturities of five, seven or ten years from the original date of the advance, while at December 31, 2011, the Corporation had \$16.0 million in variable rate advances, with a weighted average rate of 3.45 percent. All of these advances are beyond their initial noncallable periods. These advances are secured by pledges of investment securities totaling \$15.0 million at December 31, 2012 and \$20.1 million at December 31, 2011.

The advances have prepayment penalties.

The scheduled principal repayments and maturities of advances as of December 31, 2012 are as follows:

|                |          |
|----------------|----------|
| (In thousands) |          |
| 2013           | \$218    |
| 2014           | —        |
| 2015           | —        |
| 2016           | —        |
| 2017           | 3,000    |
| Over 5 years   | 9,000    |
| Total          | \$12,218 |

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At December 31, 2012 and December 31, 2011 there were no overnight borrowings with the FHLB. 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.

### **9. FAIR VALUE**

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Corporation used the following methods and significant assumptions to estimate the fair value:

**Investment Securities:** The fair values for investment securities are determined by quoted market prices (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). The fair values of Level 3 investment securities (Trust Preferred Pooled Securities, held to maturity) are determined by Management based on non-binding broker quotes. Discussions are regularly held with third-party brokers and other third-party experts to validate the estimated fair value for these Level 3 securities.

**Loans Held for Sale, at Fair Value:** The fair value of loans held for sale is determined using quoted prices for similar assets, adjusted for specific attributes of that loan or other observable market data, such as outstanding commitments from third party investors (Level 2).

**Loans Held for Sale, at Lower of Cost or Fair Value:** The fair value of this category of loans held for sale is determined using the lower of book value or estimated sale price as calculated by a third-party broker for each loan (Level 2).

**Impaired Loans:** The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned: Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned (OREO) are measured at fair value, less costs to sell. Fair values are based on recent real estate appraisals. These appraisals may use a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by Management. Once received, a member of the Credit Department reviews the assumptions and approaches utilized in the appraisal, as well as, the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. Appraisals on collateral dependent impaired loans and other real estate owned (consistent for all loan types) are obtained on an annual basis, unless a significant change in the market or other factors warrants a more frequent appraisal. On an annual basis, Management compares the actual selling price of any collateral that has been sold to the most recent appraised value to determine what additional adjustment should be made to the appraisal value to arrive at fair value for other properties. The most recent analysis performed indicated that a discount up to 15 percent should be applied to appraisals on properties. The discount is determined based on the nature of the underlying properties, aging of appraisal and other factors. For each collateral-dependent impaired loan we consider other factors, such as certain indices or other market information, as well as property specific circumstances to determine if an adjustment to the appraised value is needed. In situations where there is evidence of change in value, the Bank will determine if there is need for an adjustment to the specific reserve on the collateral dependent impaired loans. When the Bank applies an interim adjustment, it generally shows the adjustment as an incremental specific reserve against the loan until it has received the full updated appraisal. As of December 31, 2012, all collateral-dependent impaired loans and other real estate owned valuations were supported by an appraisal less than 12 months old.



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The following table summarizes, for the periods indicated, assets measured at fair value on a recurring basis, including financial assets for which the Corporation has elected the fair value option:

| (In thousands)                 |  | December 31, 2012 | Fair Value Measurements Using   |   |  |
|--------------------------------|--|-------------------|---|---|--|
|                                |  |                   | Quoted<br>Prices In<br>Active<br>Markets<br>For<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets:                        |  |                   |   |   |  |
| Securities available for sale: |  |                   |   |   |  |
|                                | U.S. government-sponsored entities     | \$ 26,845         | \$ —  | \$ 26,845   | \$ —   |
|                                | Mortgage-backed securities-residential | 221,440           | —   | 221,440   | —  |
|                                | State and political subdivisions       | 50,632            | —   | 50,632  | —  |
|                                | Single-issuer trust preferred security | 2,289             | —   | 2,289   | —  |
|                                | CRA investment fund                    | 3,062             | 3,062   | —   | —  |
|                                | Marketable equity securities           | 211               | 211   | —   | —  |
|                                | Total                                  | \$ 304,479        | \$ 3,273  | \$ 301,206  | \$ —   |
|                                |  |                   |   |   |  |
| (In thousands)                 |  | December 31, 2011 |   |   |  |
| Assets:                        |  |                   |   |   |  |
| Securities available for sale: |  |                   |   |   |  |
|                                | U.S. government-sponsored entities     | \$ 46,878         | \$ —  | \$ 46,878   | \$ —   |
|                                | Mortgage-backed securities-residential | 236,984           | —   | 236,984   | —  |
|                                | State and political subdivisions       | 29,851            | —   | 29,851  | —  |
|                                | Single-issuer trust preferred security | 2,167             | —   | 2,167   | —  |
|                                | CRA investment fund                    | 3,040             | 3,040   | —   | —  |
|                                | Marketable equity securities           | 600               | 600   | —   | —  |
|                                | Total                                  | \$ 319,520        | \$ 3,640  | \$ 315,880  | \$ —   |

Residential loans held for sale, at fair value, totaled \$6.5 million and \$2.8 million as of December 31, 2012 and December 31, 2011, respectively, and were determined to be Level 2.

There were no transfers between Level 1 and Level 2 during the year ended December 31, 2012.

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The following table summarizes, for the periods indicated, assets measured at fair value on a non-recurring basis:

| (In thousands)                     | December 31, 2012 | Fair Value Measurements Using   |  |  |
|------------------------------------|-------------------|---|--|--|
|                                    |                   | Quoted<br>Prices<br>In<br>Active<br>Markets<br>For<br>Identical<br>Assets<br>(Level<br>1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets:                            |                   |   |  |  |
| Impaired loans:                    |                   |   |  |  |
| Primary residential mortgage       | \$ 346            | \$ —  | \$ —                                       | \$ 346   |
| Investment commercial real estate  | 160               |   |  | 160  |
| Loans held for sale:               |                   |   |  |  |
| Primary residential mortgage       | 592               | —   | 592  | —  |
| Multifamily                        | 282               | —   | 282  | —  |
| Owner-occupied commercial mortgage | 5,960             | —   | 5,960                                      | —  |
| Investment commercial real estate  | 6,652             | —   | 6,652                                      | —  |
| Commercial and industrial          | 263               | —   | 263  | —  |
| OREO                               | —                 |   |  | 1,990  |
| <br>                               |                   |   |  |  |
| (In thousands)                     | December 31, 2011 |   |  |  |
| Assets:                            |                   |   |  |  |
| Impaired loans:                    |                   |   |  |  |
| Primary residential mortgage       | \$ 1,462          | \$ —  | \$ —                                       | \$ 1,462   |
| Owner-occupied commercial mortgage | 1,303             | —   | —  | 1,303  |
| Investment commercial real estate  | 228               | —   | —  | 228  |
| Multifamily                        | 212               | —   | —  | 212  |
| Junior lien on residence           | 117               | —   | —  | 117  |
| OREO                               | 2,135             | —   | —  | 2,135  |

Impaired loans that are measured for impairment using the fair value of the collateral for collateral dependent loans, had a recorded investment of \$596 thousand, with a valuation allowance of \$90 thousand at December 31, 2012.

Impaired loans that are measured for impairment using the fair value of the collateral for collateral dependent loans, had a recorded investment of \$4.6 million, with a valuation allowance of \$1.3 million at December 31, 2011.

Loans totaling \$13.7 million were transferred to loans held for sale in December 2012 resulting in additional provision of \$4.1 million and a charge-off of \$5.4 million.

At both December 31, 2012 and 2011, OREO at fair value represents one commercial property. The Corporation recorded a valuation allowance of \$145 thousand and \$865 thousand during 2012 and 2011, respectively.

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The carrying amounts and estimated fair values of financial instruments at December 31, 2012 are as follows:

| (In thousands)                                      | Carrying<br>Amount | Fair Value Measurements at December 31, 2012<br>Using |           |           | Total       |
|---|--------------------|---|-----------|-----------|-------------|
|   |                    | Level 1   | Level 2   | Level 3   |             |
| <b>Financial assets</b>                             |                    |   |           |           |             |
| Cash and cash equivalents                           | \$119,228          | \$116,284   | \$2,944   | \$—       | \$119,228   |
| Securities available for sale                       | 304,479            | 211   | 304,268   | —         | 304,479     |
| FHLB and FRB stock                                  | 4,639              | —   | —         | —         | N/A         |
| Loans held for sale, at fair value                  | 6,461              | —   | 6,461     | —         | 6,461       |
| Loans held for sale, at lower of cost or fair value | 13,749             | —   | 13,749    | —         | 13,749      |
| Loans, net of allowance for loan losses             | 1,119,849          | —   | —         | 1,120,537 | 1,120,537   |
| Accrued interest receivable                         | 3,864              | —   | 958       | 2,906     | 3,864       |
| <b>Financial liabilities</b>                        |                    |   |           |           |             |
| Deposits  | \$1,516,427        | \$1,337,855   | \$180,505 | \$—       | \$1,518,360 |
| Federal Home Loan Bank advances                     | 12,218             | —   | 13,518    | —         | 13,518      |
| Accrued interest payable                            | 306                | 37  | 269       | —         | 306         |

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The carrying amounts and estimated fair values of financial instruments at December 31, 2011 are as follows:

| (In thousands)                          | December 31, 2011 |             |
|---|-------------------|-------------|
|   | Carrying Amount   | Fair Value  |
| Financial assets                        |                   |             |
| Cash and cash equivalents               | \$43,053          | \$43,053    |
| Investment securities, held to maturity | 100,719           | 99,427      |
| Securities available for sale           | 319,520           | 319,520     |
| FHLB and FRB stock                      | 4,569             | N/A         |
| Loans held for sale                     | 2,841             | 2,841       |
| Loans, net of allowance for loan losses | 1,025,122         | 1,034,541   |
| Accrued interest receivable             | 4,078             | 4,078       |
| Financial liabilities                   |                   |             |
| Deposits                                | \$1,443,892       | \$1,446,778 |
| Federal Home Loan Bank advances         | 17,680            | 19,100      |
| Accrued interest payable                | 460               | 460         |

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

**Cash and cash equivalents:** The carrying amounts of cash and short-term instruments approximate fair values and are classified as either Level 1 or Level 2.

**FHLB and FRB stock:** It is not practicable to determine the fair value of FHLB or FRB stock due to restrictions placed on its transferability.

**Loans:** For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

**Deposits:** The fair values disclosed for demand deposits (e.g., interest and noninterest checking, savings and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date, (i.e., the carrying amount) resulting in a Level 1 classification. The carrying amounts of variable-rate certificates of deposit approximate the fair values at the reporting date resulting in Level 2 classification. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

**Federal Home Loan Bank advances:** The fair values of the Corporation's long-term borrowings are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

Accrued interest receivable/payable: The carrying amounts of accrued interest approximate fair value resulting in a Level 2 or Level 3 classification.

Off-balance sheet instruments: Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material.

Table of Contents**10. OTHER OPERATING EXPENSES**

The following table presents the major components of other operating expenses for the years ended December 31,

| (In thousands)                 | 2012     | 2011     | 2010     |
|--------------------------------|----------|----------|----------|
| Trust department               | \$1,462  | \$1,542  | \$1,291  |
| Professional and legal fees    | 1,301    | 987      | 1,145    |
| FDIC insurance                 | 1,208    | 1,532    | 2,322    |
| Loan expense                   | 858      | 1,029    | 888      |
| Telephone                      | 647      | 765      | 787      |
| Advertising                    | 512      | 697      | 691      |
| Provision for ORE losses       | 145      | 865      | —        |
| Other operating expenses       | 5,135    | 4,381    | 3,833    |
| Total other operating expenses | \$11,268 | \$11,798 | \$10,957 |

**11. INCOME TAXES**

The income tax expense included in the consolidated financial statements for the years ended December 31, is allocated as follows:

| (In thousands)                  | 2012       | 2011    | 2010    |
|---------------------------------|------------|---------|---------|
| Federal:                        |            |         |         |
| Current expense                 | \$(7,942 ) | \$3,856 | \$4,752 |
| Deferred expense/(benefit)      | 12,887     | 1,364   | (1,874) |
| State:                          |            |         |         |
| Current expense                 | (3 )       | 1       | 627     |
| Deferred expense/(benefit)      | 1,463      | (431 )  | (306 )  |
| Reversal of valuation allowance | —          | (2,976) | 32      |
| Total income tax expense        | \$6,405    | \$1,814 | \$3,231 |

Total income tax expense differed from the amounts computed by applying the U.S. Federal income tax rate of 35 percent to income before taxes as a result of the following:

| (In thousands)                               | 2012    | 2011    | 2010    |
|--|---------|---------|---------|
| Computed "expected" tax expense              | \$5,635 | \$4,894 | \$3,813 |
| (Decrease)/increase in taxes resulting from: |         |         |         |

|                                  |         |         |         |
|----------------------------------|---------|---------|---------|
| Tax-exempt income                | (341 )  | (350 )  | (386 )  |
| State income taxes               | 949     | (2,200) | 229     |
| Bank owned life insurance income | (112 )  | (413 )  | (225 )  |
| Interest disallowance            | 16      | 23      | 33      |
| Stock-based compensation         | 58      | 65      | 61      |
| Rate adjustment                  | 200     | (100 )  | (100 )  |
| Other                            | —       | (105 )  | (194 )  |
| Total income tax expense         | \$6,405 | \$1,814 | \$3,231 |

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The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities as of December 31 are as follows:

| (In thousands)   | 2012     | 2011     |
|--|----------|----------|
| Deferred tax assets:   |          |          |
| Allowance for loan losses  | \$5,202  | \$5,402  |
| Valuation allowance for OREO losses  | 413      | 353      |
| Federal and state net operating loss carryforward                                | 6,739    | 274      |
| Lease adjustment   | 183      | 185      |
| Federal AMT credit carryforward  | 540      | —        |
| Post retirement benefits   | 475      | 253      |
| Prepaid alternative minimum assessment   | 283      | 283      |
| Contribution limitation  | 56       | 56       |
| Other-than-temporary impairment  | —        | 20,924   |
| Unrealized loss on market adjustment on other-than-temporary impaired securities | —        | 1,866    |
| State capital loss   | 19       | 21       |
| Stock option expense   | 282      | 212      |
| Nonaccrued interest  | 452      | 1,781    |
| Accrued compensation   | 319      | 204      |
| Capital leases   | 631      | 62       |
| Valuation allowance-other-than-temporary impairment state tax                    | —        | (12 )    |
| Total gross deferred tax assets  | \$15,594 | \$31,864 |
| Deferred tax liabilities:  |          |          |
| Bank premises and equipment, principally due to differences in depreciation      | \$1,394  | \$1,843  |
| Unrealized gain on securities available for sale                                 | 2,969    | 1,931    |
| Deferred loan origination costs and fees   | 1,315    | 1,090    |
| Deferred income  | 396      | 130      |
| Nonmonetary gain   | —        | 97       |
| Investment securities, principally due to the accretion of bond discount         | 27       | 42       |
| Other  | 15       | —        |
| Total gross deferred tax liabilities   | 6,116    | 5,133    |
| Net deferred tax asset   | \$9,478  | \$26,731 |

The net deferred tax asset includes the tax effect of \$12.5 million of federal net operating loss carryforwards that expire in 2032 and \$40.6 million of New Jersey net operating loss carryforwards that expire from 2014 through 2032.

During 2008, the Corporation recorded a \$56.1 million other-than-temporary impairment on its trust preferred pooled securities. The impairment was recorded at the Bank level and resulted in a deferred state tax benefit of approximately \$3.3 million. At December 31, 2008, the Corporation concluded that it was more likely than not that it would not realize this state tax benefit before the expiration of the net operating loss carryforward period and recorded a full valuation allowance against the state tax benefit. At the time, the analysis was based on numerous factors, including the State of New Jersey tax statutes, the ongoing performance and related forecasts of the Corporation and the Bank



and the status of the economy and its impact on the forecasts.

The Corporation concluded, during the third quarter of 2011, that it was more likely than not that the 2008 state tax benefit was realizable and as such reversed the full valuation allowance, which resulted in an income tax benefit recognized in the third quarter of \$3.0 million. The determination was based on the trends in state taxable income of the Bank and the five-year earnings forecast that was completed during the third quarter of 2011.

In 2012, the Corporation sold the pooled trust preferred securities resulting in a federal tax loss carryback refund claim of \$8.1 million. The remaining deferred tax asset for OTTI was converted to deferred tax assets relating to federal and state net operating loss carryforwards.

Based upon taxes paid and projected future taxable income, Management believes that it is more likely than not that the gross deferred tax assets will be realized.

At December 31, 2012 and 2011, the Corporation had no unrecognized tax benefits. The Corporation does not expect the amount of unrecognized tax benefits to significantly change in the next twelve months.

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The Corporation is subject to U.S. Federal income tax as well as New Jersey income tax. The Corporation is no longer subject to federal examination for tax years prior to 2009. The tax years of 2009, 2010 and 2011 remain open to federal examination. The Corporation is no longer subject to New Jersey examination for tax years prior to 2008. The tax years of 2008, 2009, 2010 and 2011 remain open for state examination.

**12. BENEFIT PLANS**

The Corporation sponsors a profit sharing plan and a savings plan under Section 401(K) of the Internal Revenue Code, covering substantially all salaried employees over the age of 21 with at least 12 months of service. Under the savings plan, the Corporation contributes three percent of salary for each employee regardless of the employees' contributions as well as partially matching employee contributions. In addition, the Corporation is contributing an enhanced benefit to employees who were previously in the defined benefit plan, which was discontinued in 2008. In 2012 and 2011, the enhanced benefit was approximately \$856 thousand and \$830 thousand, respectively. Expense for the savings plan totaled approximately \$1.8 million, \$1.9 million and \$1.7 million in 2012, 2011 and 2010, respectively.

Contributions to the profit sharing plan are made at the discretion of the Board of Directors and all funds are invested solely in Peapack-Gladstone Corporation common stock. The aggregate contribution to the profit sharing plan was \$200 thousand in 2012 and \$100 thousand in each of 2011 and 2010.

**13. STOCK-BASED COMPENSATION**

The Corporation's 2006 Long-Term Stock Incentive Plan and 2012 Long-Term Stock Incentive Plan and allow the granting of shares of the Corporation's common stock as incentive stock options, nonqualified stock options, restricted stock awards and stock appreciation rights to directors, officers, employees and independent contractors of the Corporation and its Subsidiaries. The total number initially available to grant in active plans was 620,000 shares. There are no shares remaining for issuance with respect to stock option plans approved in 1995, 1998 and 2002; however, options granted under those plans are still included in the numbers below. At December 31, 2012, there were 289,173 additional shares available for grant under the unexpired plans.

Options granted under the long-term stock incentive plans are, in general, exercisable not earlier than one year after the date of grant, at a price equal to the fair value of the common stock on the date of grant, and expire not more than ten years after the date of grant. Stock options may vest during a period of up to five years after the date of grant. Some options granted to officers at or above the senior vice president level were immediately exercisable at the date of grant. The Corporation has a policy of using new shares to satisfy option exercises.

Changes in options outstanding during 2012 were as follows:

|                                  | Number of<br>Options | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value<br>(In Thousands) |
|----------------------------------|----------------------|--|---|---|
| Balance, January 1, 2012         | 577,782              | \$ 23.45                                 |   |   |
| Granted during 2012              | 62,860               | 11.02                                    |   |   |
| Exercised during 2012            | (2,190 )             | 11.10                                    |   |   |
| Expired during 2012              | (13,300 )            | 25.35                                    |   |   |
| Forfeited during 2012            | (11,645 )            | 13.61                                    |   |   |
| Balance, December 31, 2012       | 613,507              | \$ 22.37                                 | 3.96 years  | \$ 561  |
| Vested and expected to vest (1)  | 585,222              | \$ 22.84                                 | 3.96 years  | \$ 214  |
| Exercisable at December 31, 2012 | 456,367              | \$ 25.54                                 | 2.57 years  | \$ 78   |

(1) The difference between the shares which are exercisable (fully vested) and those which are expected to vest is due to anticipated forfeitures.

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Corporation's closing stock price on the last trading day of 2012 and the exercise price, multiplied by the number of in-the-money options). The Corporation's closing stock price on December 31, 2012 was \$14.08.

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The aggregate intrinsic value of stock options exercised in 2012 was \$8 thousand. There were no options exercised during 2011 and 2010.

The per share weighted average fair value of stock options granted during 2012, 2011 and 2010 was \$3.91, \$3.88 and \$8.31, respectively, on the date of grant using the Black-Scholes Option-Pricing Model with the following weighted average assumptions:

|                         | <b>2012</b>    | 2011    | 2010    |
|-------------------------|----------------|---------|---------|
| Dividend yield          | <b>1.47%</b>   | 1.60%   | 1.30%   |
| Expected volatility     | <b>39%</b>     | 32%     | 72%     |
| Expected life           | <b>7 Years</b> | 7 Years | 7 Years |
| Risk-free interest rate | <b>1.43%</b>   | 2.08%   | 2.91%   |

For 2012, 2011 and 2010, the expected life of the option is the typical holding period of the Corporation's options before being exercised by the optionee. The risk-free interest rate is the rate on a seven-year treasury bond for 2012, 2011 and 2010. The volatility is the performance the stock has experienced in the last five years.

As of December 31, 2012, there was approximately \$481 thousand of unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Corporation's stock incentive plans. That cost is expected to be recognized over a weighted average period of 1.7 years.

The Corporation issued 36,263, 28,732 and 55,993 restricted stock awards in 2012, 2011 and 2010, respectively, at a fair value equal to the market price of the Corporation's common stock at the date of grant. The awards vest 40 percent after two years and 20 percent each year after until fully vesting on the fifth anniversary of the grant date; however awards to one executive were fully vested as of the date of his severance agreement in 2012. There were no forfeitures of restricted stock awards during 2012. There were 38,271 shares of restricted stock awards that vested during 2012. As of December 31, 2012, there was \$572 thousand of total unrecognized compensation cost related to nonvested shares, which is expected to vest over 1.8 years.

Changes in nonvested shares for 2012 were as follows:

|                          | Number of<br>Shares | Weighted<br>Average<br>Grant Date<br>Fair Value |
|--------------------------|---------------------|---|
| Balance, January 1, 2012 | 84,725              | \$ 13.46  |
| Granted during 2012      | 36,263              | 10.72   |

|                            |           |          |
|----------------------------|-----------|----------|
| Vested during 2012         | (38,271 ) | 12.13    |
| Balance, December 31, 2012 | 82,717    | \$ 12.87 |

#### ***14. COMMITMENTS AND CONTINGENCIES***

The Corporation, in the ordinary course of business, is a party to litigation arising from the conduct of its business. Management does not consider that these actions depart from routine legal proceedings and believes that such actions will not affect its financial position or results of its operations in any material manner. There are various outstanding commitments and contingencies, such as guarantees and credit extensions, including mostly variable-rate loan commitments of \$112.4 million and \$104.4 million at December 31, 2012 and 2011, respectively, which are not included in the accompanying consolidated financial statements. These commitments include unused commercial and home equity lines of credit.

The Corporation issues financial standby letters of credit that are irrevocable undertakings by the Corporation to guarantee payment of a specified financial obligation. Most of the Corporation's financial standby letters of credit arise in connection with lending relations and have terms of one year or less. The maximum potential future payments the Corporation could be required to make equals the contract amount of the standby letters of credit and amounted to \$3.5 million and \$3.6 million at December 31, 2012 and 2011, respectively. The fair value of the Corporation's liability for financial standby letters of credit was insignificant at December 31, 2012.

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For commitments to originate loans, the Corporation's maximum exposure to credit risk is represented by the contractual amount of those instruments. Those commitments represent ultimate exposure to credit risk only to the extent that they are subsequently drawn upon by customers. The Corporation uses the same credit policies and underwriting standards in making loan commitments as it does for on-balance-sheet instruments. For loan commitments, the Corporation would generally be exposed to interest rate risk from the time a commitment is issued with a defined contractual interest rate.

At December 31, 2012, the Corporation was obligated under non-cancelable operating leases for certain premises. Rental expense aggregated \$2.4 million, \$2.4 million and \$2.6 million for the years ended December 31, 2012, 2011 and 2010 respectively, which is included in premises and equipment expense in the consolidated statements of income.

The minimum annual lease payments under the terms of the operating lease agreements, as of December 31, 2012, were as follows:

(In thousands)

|            |          |
|------------|----------|
| 2013       | \$2,382  |
| 2014       | 2,129    |
| 2015       | 2,041    |
| 2016       | 1,762    |
| 2017       | 1,391    |
| Thereafter | 6,744    |
| Total      | \$16,449 |

The Corporation is also obligated under legally binding and enforceable agreements to purchase goods and services from third parties, including data processing service agreements.

## ***15. REGULATORY CAPITAL***

The Corporation through the Bank is subject to various regulatory capital requirements administered by the Federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Corporation and the Bank's consolidated financial statements. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required.

Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Corporation's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weighting and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios of Total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). At year-end 2012 and 2011, the Bank maintained capital levels which met or exceeded the levels required to be considered well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that Management believes have changed the institution's category.

To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the table.

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

| (In thousands)                           | Actual     |         | To Be Well<br>Capitalized Under<br>Prompt Corrective<br>Action Provisions |         | For Capital<br>Adequacy<br>Purposes |        |
|--|------------|---------|---|---------|-------------------------------------|--------|
|  | Amount     | Ratio   | Amount  | Ratio   | Amount                              | Ratio  |
| As of December 31, 2012:                 |            |         |   |         |                                     |        |
| Total capital (to risk-weighted assets)  | \$ 127,983 | 12.92 % | \$ 99,035   | 10.00 % | \$ 79,228                           | 8.00 % |
| Tier I capital (to risk-weighted assets) | 115,600    | 11.67   | 59,421  | 6.00    | 39,614                              | 4.00   |
| Tier I capital (to average assets)       | 115,600    | 7.18    | 80,507  | 5.00    | 64,406                              | 4.00   |
| As of December 31, 2011:                 |            |         |   |         |                                     |        |
| Total capital (to risk-weighted assets)  | \$ 131,993 | 13.50 % | \$ 97,737   | 10.00 % | \$ 78,190                           | 8.00 % |
| Tier I capital (to risk-weighted assets) | 119,764    | 12.25   | 58,642  | 6.00    | 39,095                              | 4.00   |
| Tier I capital (to average assets)       | 119,764    | 7.58    | 79,019  | 5.00    | 63,216                              | 4.00   |

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

| (In thousands)                           | Actual     |         | To Be Well<br>Capitalized Under<br>Prompt Corrective<br>Action Provisions |       | For Capital<br>Adequacy<br>Purposes |        |
|--|------------|---------|---|-------|-------------------------------------|--------|
|  | Amount     | Ratio   | Amount  | Ratio | Amount                              | Ratio  |
| As of December 31, 2012:                 |            |         |   |       |                                     |        |
| Total capital (to risk-weighted assets)  | \$ 129,587 | 13.08 % | \$ N/A  | N/A % | \$ 79,283                           | 8.00 % |
| Tier I capital (to risk-weighted assets) | 117,195    | 11.83   | N/A   | N/A   | 39,641                              | 4.00   |
| Tier I capital (to average assets)       | 117,195    | 7.27    | N/A   | N/A   | 64,438                              | 4.00   |
| As of December 31, 2011:                 |            |         |   |       |                                     |        |
| Total capital (to risk-weighted assets)  | \$ 134,541 | 13.76 % | \$ N/A  | N/A % | \$ 78,241                           | 8.00 % |
| Tier I capital (to risk-weighted assets) | 122,304    | 12.51   | N/A   | N/A   | 39,120                              | 4.00   |
| Tier I capital (to average assets)       | 122,304    | 7.73    | N/A   | N/A   | 63,261                              | 4.00   |



As fully described in Footnote 16, Preferred Stock, the Corporation redeemed the remaining portion of the preferred shares issued under the Treasury's Capital Purchase Program, repaying \$14.5 million on January 11, 2012. In association with this repayment, the Bank paid a \$14.5 million dividend to the Corporation on January 10, 2012. The dividend was specifically approved by the Bank's primary regulator.

## ***16. PREFERRED STOCK***

On January 9, 2009, as part of the U.S. Department of the Treasury (the "Treasury") Troubled Asset Relief Program ("TARP") Capital Purchase Program, the Corporation sold 28,685 shares of the Corporation's 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, no par value at an exercise price of \$28.63 per share, after adjusting for the five percent stock dividend declared on June 18, 2009, for an aggregate purchase price of \$28.7 million in cash, allocated \$1.6 million to warrants and \$27.1 million to preferred stock.

Cumulative dividends on the preferred shares accrue 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. If the Corporation redeems the preferred shares and the Treasury still owns the warrant, the Corporation could repurchase the warrant from the Treasury for its fair market value. Unless both the holder and the Corporation agree otherwise, the exercise of the warrant will be a net exercise (i.e., the holder does not pay cash but gives up shares with a market value at the time of exercise equal to the exercise price, resulting in a net settlement with significantly fewer than the 150,296 shares of common stock being issued).

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The Securities Purchase Agreement, pursuant to which the preferred shares and the warrant were sold, contains limitations on the payment of dividends on the common stock, including with respect to the payment of quarterly cash dividends in excess of \$0.16 per share, which was the amount of the last regular dividend declared by the Corporation prior to October 14, 2008 and on the Corporation's ability to repurchase its Common Stock. The Corporation is also subject to certain executive compensation limitations included in the Emergency Economic Stabilization Act of 2008 (the "EESA").

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 repurchase, 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. The Corporation's redemption of the shares was not subject to additional conditions or stipulations from the Treasury.

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 of approximately \$112 thousand. The Corporation's redemption of the shares was not subject to additional conditions or stipulations from the Treasury. As a result of the repurchase, the 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.

***17. BUSINESS SEGMENTS***

The Corporation assesses its results among two operating segments, Banking and PGB Trust and Investments. Management uses certain methodologies to allocate income and expense to the business segments. A funds transfer pricing methodology is used to assign interest income and interest expense. Certain indirect expenses are allocated to segments. These include support unit expenses such as technology and operations and other support functions. Taxes are allocated to each segment based on the effective rate for the period shown.

**Banking**

The Banking segment includes commercial, commercial real estate, residential and consumer lending activities; deposit generation; operation of ATMs; telephone and internet banking services; merchant credit card services and customer support and sales.

**PGB Trust & Investments**

PGB Trust & Investments includes asset management services provided for individuals and institutions; personal trust services, including services as executor, trustee, administrator, custodian and guardian; corporate trust services including services as trustee for pension and profit sharing plans; and other financial planning and advisory services.

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The following table presents the statements of income and total assets for the Corporation's reportable segments for the twelve months ended December 31, 2012, 2011 and 2010:

| (In thousands)                   | Twelve Months Ended December 31, 2012 |                            |              |
|----------------------------------|---------------------------------------|----------------------------|--------------|
|                                  | Banking                               | PGB Trust<br>& Investments | Total        |
| Net interest income              | \$ 47,955                             | \$ 3,448                   | \$ 51,403    |
| Noninterest income               | 8,545                                 | 12,758                     | 21,303       |
| Total income                     | 56,500                                | 16,206                     | 72,706       |
| Provision for loan losses        | 8,275                                 | —                          | 8,275        |
| Salaries and benefits            | 22,030                                | 5,565                      | 27,595       |
| Premises and equipment expense   | 8,889                                 | 578                        | 9,467        |
| Other noninterest expense        | 7,241                                 | 4,027                      | 11,268       |
| Total noninterest expense        | 46,435                                | 10,170                     | 56,605       |
| Income before income tax expense | 10,065                                | 6,036                      | 16,101       |
| Income tax expense               | 4,081                                 | 2,324                      | 6,405        |
| Net income                       | \$ 5,984                              | \$ 3,712                   | \$ 9,696     |
| Total assets at period end       | \$ 1,666,504                          | \$ 1,332                   | \$ 1,667,836 |

| (In thousands)                   | Twelve Months Ended December 31, 2011 |                            |              |
|----------------------------------|---------------------------------------|----------------------------|--------------|
|                                  | Banking                               | PGB Trust<br>& Investments | Total        |
| Net interest income              | \$ 45,394                             | \$ 3,521                   | \$ 48,915    |
| Noninterest income               | 5,748                                 | 10,968                     | 16,716       |
| Total income                     | 51,142                                | 14,489                     | 65,631       |
| Provision for loan losses        | 7,250                                 | —                          | 7,250        |
| Salaries and benefits            | 18,194                                | 5,036                      | 23,230       |
| Premises and equipment expense   | 8,717                                 | 654                        | 9,371        |
| Other noninterest expense        | 7,837                                 | 3,961                      | 11,798       |
| Total noninterest expense        | 41,998                                | 9,651                      | 51,649       |
| Income before income tax expense | 9,144                                 | 4,838                      | 13,982       |
| Income tax expense               | 153                                   | 1,661                      | 1,814        |
| Net income                       | \$ 8,991                              | \$ 3,177                   | \$ 12,168    |
| Total assets at period end       | \$ 1,599,007                          | \$ 1,328                   | \$ 1,600,335 |

| (In thousands)                 | Twelve Months Ended December 31, 2010 |                            |           |
|--------------------------------|---------------------------------------|----------------------------|-----------|
|                                | Banking                               | PGB Trust<br>& Investments | Total     |
| Net interest income            | \$ 46,291                             | \$ 3,599                   | \$ 49,890 |
| Noninterest income             | 4,076                                 | 10,039                     | 14,115    |
| Total income                   | 50,367                                | 13,638                     | 64,005    |
| Provision for loan losses      | 10,000                                | —                          | 10,000    |
| Salaries and benefits          | 17,570                                | 4,959                      | 22,529    |
| Premises and equipment expense | 8,861                                 | 763                        | 9,624     |

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|                                  |              |          |              |
|----------------------------------|--------------|----------|--------------|
| Other noninterest expense        | 6,984        | 3,973    | 10,957       |
| Total noninterest expense        | 43,415       | 9,695    | 53,110       |
| Income before income tax expense | 6,952        | 3,943    | 10,895       |
| Income tax expense               | 2,060        | 1,171    | 3,231        |
| Net income                       | \$ 4,892     | \$ 2,772 | \$ 7,664     |
| Total assets at period end       | \$ 1,504,098 | \$ 1,327 | \$ 1,505,425 |

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Table of Contents**18. ACCUMULATED OTHER COMPREHENSIVE INCOME**

The following is a summary of the accumulated other comprehensive income balances, net of tax, for the years ended December 31, 2012, 2011 and 2010:

| (In thousands)   | Balance at<br>December 31, 2011 | Current<br>Year Change | Balance at<br>December 31, 2012 |
|--|---------------------------------|------------------------|---------------------------------|
| Unrealized gains on securities<br>available for sale   | \$ 3,206                        | \$ 1,093               | \$ 4,299                        |
| Other-than-temporary impairment on<br>securities held to maturity and<br>securities transferred from<br>available for sale to held to maturity | (3,102)                         | ) 3,102                | —                               |
| Total  | \$ 104                          | \$ 4,195               | \$ 4,299                        |

| (In thousands)   | Balance at<br>December 31, 2010 | Current<br>Year Change | Balance at<br>December 31, 2011 |
|--|---------------------------------|------------------------|---------------------------------|
| Unrealized gains on securities<br>available for sale   | \$ 1,490                        | \$ 1,716               | \$ 3,206                        |
| Other-than-temporary impairment on<br>securities held to maturity and<br>securities transferred from<br>available for sale to held to maturity | (3,461)                         | ) 359                  | (3,102)                         |
| Total  | \$ (1,971)                      | ) \$ 2,075             | \$ 104                          |

| (In thousands)   | Balance at<br>December 31, 2009 | Current<br>Year Change | Balance at<br>December 31, 2010 |
|--|---------------------------------|------------------------|---------------------------------|
| Unrealized gains on securities<br>available for sale   | \$ 1,615                        | \$ (125)               | ) \$ 1,490                      |
| Other-than-temporary impairment on<br>securities held to maturity and<br>securities transferred from<br>available for sale to held to maturity | (3,562)                         | ) 101                  | (3,461)                         |
| Total  | \$ (1,947)                      | ) \$ (24)              | ) \$ (1,971)                    |

Table of Contents**19. CONDENSED FINANCIAL STATEMENTS OF PEAPACK-GLADSTONE FINANCIAL CORPORATION  
(PARENT COMPANY ONLY)****STATEMENTS OF CONDITION**

| (In thousands)   | December 31, |           |
|--|--------------|-----------|
|  | 2012         | 2011      |
| <b>Assets</b>  |              |           |
| Cash   | \$602        | \$1,420   |
| Interest-earning deposits  | 297          | 35        |
| Total cash and cash equivalents                                      | 899          | 1,455     |
| Securities available for sale  | 211          | 600       |
| Investment in subsidiary   | 120,461      | 120,426   |
| Other assets   | 610          | 509       |
| Total assets   | \$122,181    | \$122,990 |
| <b>Liabilities</b>   |              |           |
| Other liabilities  | \$124        | \$19      |
| Total liabilities  | 124          | 19        |
| <b>Shareholders' equity</b>  |              |           |
| Preferred stock  | —            | 13,979    |
| Common stock   | 7,755        | 7,685     |
| Surplus  | 97,675       | 96,323    |
| Treasury stock   | (8,988 )     | (8,988 )  |
| Retained earnings  | 21,316       | 13,868    |
| Accumulated other comprehensive income,<br>net of income tax benefit | 4,299        | 104       |
| Total shareholders' equity   | 122,057      | 122,971   |
| Total liabilities and shareholders' equity                           | \$122,181    | \$122,990 |

**STATEMENTS OF INCOME**

| (In thousands)   | Years Ended December 31, |         |         |
|--|--------------------------|---------|---------|
|  | 2012                     | 2011    | 2010    |
| <b>Income</b>  |                          |         |         |
| Dividend from Bank   | \$14,950                 | \$6,120 | \$8,663 |
| Other income   | 28                       | 76      | 166     |
| Impairment charges on securities   | —                        | —       | (360 )  |
| Securities gains/(losses), net   | 3                        | 20      | (19 )   |
| Total income   | 14,981                   | 6,216   | 8,450   |
| <b>Expenses</b>  |                          |         |         |
| Other expenses   | 352                      | 68      | 74      |
| Total expenses   | 352                      | 68      | 74      |
| Income before income tax expense and<br>equity in undistributed earnings of Bank | 14,629                   | 6,148   | 8,376   |
| Income tax (benefit)/expense   | (116 )                   | 16      | (124 )  |

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|   |          |          |         |
|---|----------|----------|---------|
| Net income before equity in undistributed earnings of Bank                  | 14,745   | 6,132    | 8,500   |
| (Dividends in excess of earnings)/ equity in undistributed earnings of Bank | (5,049 ) | 6,036    | (836 )  |
| 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 |

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Table of Contents**STATEMENTS OF CASH FLOWS**

| (In thousands)   | Years Ended December 31, |          |         |
|--|--------------------------|----------|---------|
|  | 2012                     | 2011     | 2010    |
| Cash flows from operating activities:                          |                          |          |         |
| Net income   | \$9,696                  | \$12,168 | \$7,664 |
| Undistributed loss/(earnings) of Bank                          | 5,049                    | (6,036 ) | 836     |
| (Gain)/loss on securities available for sale                   | (3 )                     | (20 )    | 379     |
| (Increase)/decrease in other assets                            | (101 )                   | 78       | (74 )   |
| Increase/(decrease) in other liabilities                       | 107                      | (44 )    | (52 )   |
| Net cash provided by operating activities                      | 14,748                   | 6,146    | 8,753   |
| Cash flows from investing activities:                          |                          |          |         |
| Proceeds from sales and calls of securities available for sale | 386                      | 1,108    | 2,237   |
| Net cash provided by investing activities                      | 386                      | 1,108    | 2,237   |
| Cash flows from financing activities:                          |                          |          |         |
| Redemption of preferred stock                                  | (14,341)                 | (7,172 ) | (7,172) |
| Repurchase of warrants   | (109 )                   | —        | —       |
| Cash dividends paid on preferred stock                         | (112 )                   | (823 )   | (1,126) |
| Cash dividends paid on common stock                            | (1,774 )                 | (1,765 ) | (1,757) |
| Exercise of stock options                                      | 21                       | —        | —       |
| Issuance of common shares (DRIP program)                       | 625                      | 152      | 140     |
| Net cash used in financing activities                          | (15,690)                 | (9,608 ) | (9,915) |
| Net (decrease)/increase in cash and cash equivalents           | (556 )                   | (2,354 ) | 1,075   |
| Cash and cash equivalents at beginning of period               | 1,455                    | 3,809    | 2,734   |
| Cash and cash equivalents at end of period                     | \$899                    | \$1,455  | \$3,809 |

**20. SUPPLEMENTAL DATA (unaudited)**

The following table sets forth certain unaudited quarterly financial data for the periods indicated:

## Selected 2012 Quarterly Data:

| (In thousands, except per share data) | March 31  | June 30   | September 30 | December 31 |
|---------------------------------------|-----------|-----------|--------------|-------------|
| Interest income                       | \$ 14,214 | \$ 14,102 | \$ 13,982    | \$ 13,792   |
| Interest expense                      | 1,323     | 1,199     | 1,132        | 1,033       |
| Net interest income                   | 12,891    | 12,903    | 12,850       | 12,759      |
| Provision for loan losses             | 1,500     | 1,500     | 750          | 4,525       |
| Trust fees                            | 3,176     | 3,259     | 2,918        | 2,929       |
| Securities gains/(losses), net        | 390       | 107       | 235          | 3,078       |
| Other income                          | 1,157     | 1,305     | 1,406        | 1,343       |

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|   |          |          |          |          |
|---|----------|----------|----------|----------|
| Operating expenses                          | 11,080   | 11,704   | 11,993   | 13,553   |
| Income before income tax expense            | 5,034    | 4,370    | 4,666    | 2,031    |
| Income tax expense                          | 1,951    | 1,647    | 1,834    | 973      |
| Net income                                  | 3,083    | 2,723    | 2,832    | 1,058    |
| Dividend and accretion on preferred stock   | 474      | —        | —        | —        |
| Net income available to common shareholders | \$ 2,609 | \$ 2,723 | \$ 2,832 | \$ 1,058 |
| Earnings per share-basic                    | \$ 0.30  | \$ 0.31  | \$ 0.32  | \$ 0.12  |
| Earnings per share-diluted                  | 0.30     | 0.31     | 0.32     | 0.12     |

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## Selected 2011 Quarterly Data:

| (In thousands, except per share data)       | March 31  | June 30   | September 30 | December 31 |
|---|-----------|-----------|--------------|-------------|
| Interest income                             | \$ 14,257 | \$ 14,099 | \$ 13,594    | \$ 14,101   |
| Interest expense                            | 2,036     | 1,916     | 1,699        | 1,485       |
| Net interest income                         | 12,221    | 12,183    | 11,895       | 12,616      |
| Provision for loan losses                   | 2,000     | 2,000     | 1,500        | 1,750       |
| Trust fees                                  | 2,718     | 2,829     | 2,555        | 2,584       |
| Securities gains/(losses), net              | 196       | 277       | 248          | 316         |
| Other income                                | 1,255     | 1,218     | 1,170        | 1,350       |
| Operating expenses                          | 11,243    | 11,035    | 10,573       | 11,548      |
| Income before income tax expense            | 3,147     | 3,472     | 3,795        | 3,568       |
| Income tax expense                          | 1,006     | 1,304     | (1,537)      | 1,041       |
| Net income                                  | 2,141     | 2,168     | 5,332        | 2,527       |
| Dividend and accretion on preferred stock   | 570       | 219       | 219          | 220         |
| Net income available to common shareholders | \$ 1,571  | \$ 1,949  | \$ 5,113     | \$ 2,307    |
| Earnings per share-basic                    | \$ 0.18   | \$ 0.22   | \$ 0.58      | \$ 0.26     |
| Earnings per share-diluted                  | 0.18      | 0.22      | 0.58         | 0.26        |

## Selected 2010 Quarterly Data:

| (In thousands, except per share data)       | March 31  | June 30   | September 30 | December 31 |
|---|-----------|-----------|--------------|-------------|
| Interest income                             | \$ 15,791 | \$ 15,450 | \$ 14,974    | \$ 14,707   |
| Interest expense                            | 3,243     | 2,963     | 2,612        | 2,214       |
| Net interest income                         | 12,548    | 12,487    | 12,362       | 12,493      |
| Provision for loan losses                   | 2,400     | 2,750     | 2,000        | 2,850       |
| Trust fees                                  | 2,364     | 2,686     | 2,254        | 2,598       |
| Securities gains/(losses), net              | —         | 2         | 126          | (4)         |
| Impairment charges                          | —         | —         | (360)        | (581)       |
| Other income                                | 1,108     | 1,098     | 1,203        | 1,621       |
| Operating expenses                          | 10,530    | 11,005    | 10,886       | 10,689      |
| Income before income tax expense            | 3,090     | 2,518     | 2,699        | 2,588       |
| Income tax expense                          | 965       | 762       | 793          | 711         |
| Net income                                  | 2,125     | 1,756     | 1,906        | 1,877       |
| Dividend and accretion on preferred stock   | 710       | 324       | 326          | 326         |
| Net income available to common shareholders | \$ 1,415  | \$ 1,432  | \$ 1,580     | \$ 1,551    |
| Earnings per share-basic                    | \$ 0.16   | \$ 0.16   | \$ 0.18      | \$ 0.18     |
| Earnings per share-diluted                  | 0.16      | 0.16      | 0.18         | 0.18        |

**Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

Item 9A. CONTROLS AND PROCEDURES

**Management's Evaluation of Disclosure Controls and Procedures**

The Corporation maintains "disclosure controls and procedures" which, consistent with Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended, is defined to mean controls and other procedures that are designed to ensure that information required to be disclosed in the reports that the Corporation files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and to ensure that such information is accumulated and communicated to the Corporation's management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

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The Corporation's management, with the participation of its Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Corporation's disclosure controls and procedures. Based on such evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer have concluded that the Corporation's disclosure controls and procedures are effective as of the end of the period covered by this Annual Report on Form 10-K.

The Corporation's Chief Executive Officer and Chief Financial Officer have also concluded that there have not been any changes in the Corporation's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting during the fourth quarter of 2012.

The Corporation's management, including the CEO and CFO, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, provides reasonable, not absolute, assurance that the objectives of the control system are met. The design of a control system reflects resource constraints; the benefits of controls must be considered relative to their costs. Because there are inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Corporation have been or will be detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns occur because of simple error or mistake. Controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events. There can be no assurance that any design will succeed in achieving its stated goals under all future conditions; over time, control may become inadequate because of changes in conditions or deterioration in the degree of compliance with the policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**Changes in Internal Control over Financial Reporting**

There have been no changes in the Corporation's internal control over financial reporting during the quarter ended December 31, 2012, that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

*Management's Report on Internal Control Over Financial Reporting*

The Corporation's management is responsible for establishing and maintaining adequate internal control over financial reporting. The Corporation's internal control over financial reporting is a process designed to provide reasonable assurance to the Corporation's management and board of Directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting

principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. In addition, 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.

As of December 31, 2012 management assessed the effectiveness of the Corporation's internal control over financial reporting based on the criteria for effective internal control over financial reporting established in *Internal Control-Integrated Framework*, issued by the Committee of Sponsoring Organizations ("COS") of the Treadway Commission. Management's assessment included an evaluation of the design of the Corporation's internal control over financial reporting and testing of the operating effectiveness of its internal control over financial reporting. Management reviewed the results of its assessment with the Audit and Risk Committee.

Based on this assessment, management determined that, as of December 31, 2012, the Corporation's internal control over financial reporting was effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

#### **Attestation Report of the Independent Registered Certified Public Accounting Firm**

Crowe Horwath LLP, the independent registered public accounting firm that audited the Corporation's December 31, 2012 consolidated financial statements included in this Annual Report on Form 10-K, has issued an audit report expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2012. The report is included in Item 8 under the heading "Report of Independent Registered Public Accounting Firm."

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**Item 9B. OTHER INFORMATION**

None.

PART III

**Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information set forth under the captions “Director Information,” “Corporate Governance” and “Section 16(a) Beneficial Ownership Reporting Compliance” in the 2013 Proxy Statement is incorporated herein by reference.

| Executive Officer        | Age | Date Became an Executive Officer | Current Position and Business Experience |
|--------------------------|-----|----------------------------------|--|
| Frank A. Kissel          | 62  | December 11, 1997                | Chairman of the Board                    |
| Douglas L. Kennedy       | 56  | October 9, 2012                  | Chief Executive Officer                  |
| Jeffrey J. Carfora       | 54  | March 30, 2009                   | Chief Financial Officer                  |
| Vincent A. Spero         | 47  | November 19, 2009                | Chief Lending Officer                    |
| Finn M.W. Caspersen, Jr. | 43  | January 1, 2008                  | General Counsel                          |
| Craig C. Spengeman       | 57  | December 11, 1997                | President and Chief Investment Officer   |

Mr. Kissel previously also held the Chief Executive Officer title until October 9, 2012 when the Chairman and Chief Executive Officer positions were split.

Mr. Kennedy joined the Bank in October 2012 as Chief Executive Officer. Previously Mr. Kennedy served as Executive Vice President and Market President at Capital One Bank and held key executive level positions with Summit Bank, Fleet Bank and North Fork Bank.

Mr. Spengeman has been in his current position for the past eight years.

Mr. Caspersen, Jr. was Senior Vice President and Chief Risk Officer from March 2004 until his appointment to General Counsel in 2008.

Mr. Spero joined the Bank in June 2008 as Senior Vice President and Senior Commercial Lender. Previously Mr. Spero served as Senior Vice President and Commercial Loan Team Leader at Lakeland Bank, a subsidiary of Lakeland Bancorp from May 2000 to May 2008.

Mr. Carfora previously served as a Transitional Officer with New York Community Bank from April 2007 until January 2008 as a result of a merger with PennFed Financial Services Inc. and Penn Federal Savings Bank (collectively referred to as "PennFed"). Previous to the merger Mr. Carfora served as Senior Executive Vice President and Chief Operating Officer of PennFed from October 2001 until April 2007.

**Item 11. EXECUTIVE  
COMPENSATION**

The information set forth under the captions "Executive Compensation," "Director Compensation" and "Compensation Committee Interlocks and Insider Participation" in the 2013 Proxy Statement is incorporated herein by reference.



Table of Contents**Item SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND  
12. RELATED STOCKHOLDER MATTERS**

The following table shows information at December 31, 2012 for all equity compensation plans under which shares of our common stock may be issued:

| PLAN CATEGORY   | NUMBER OF SECURITIES<br>TO BE ISSUED UPON<br>EXERCISE OF<br>OUTSTANDING OPTIONS |     | WEIGHTED-AVERAGE<br>EXERCISE PRICE OF<br>OUTSTANDING OPTIONS | NUMBER OF SECURITIES<br>REMAINING AVAILABLE<br>FOR FUTURE ISSUANCE<br>UNDER EQUITY<br>COMPENSATION PLANS<br>(EXCLUDING SECURITIES<br>REFLECTED IN COLUMN (a)) |
|---|---|-----|--|---|
|   | (a)   | (b) |  |   |
| EQUITY<br>COMPENSATION<br>PLANS APPROVED<br>BY SECURITY<br>HOLDERS        | 613,507   |     | \$22.37  | 289,173   |
| EQUITY<br>COMPENSATION<br>PLANS NOT<br>APPROVED BY<br>SECURITY<br>HOLDERS | N/A   |     | N/A  | N/A   |
| TOTAL   | 613,507   |     | \$22.37  | 289,173   |

The information set forth under the captions “Beneficial Ownership of Common Stock” and “Stock Ownership of Directors and Executive Officers” in the 2013 Proxy Statement is incorporated herein by reference.

**Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR  
INDEPENDENCE**

The information set forth under the captions “Transactions with Related Persons, Promoters and Certain Control Persons” and “Corporate Governance” in the 2013 Proxy Statement is incorporated herein by reference.

**Item 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information set forth under the captions “Independent Registered Public Accounting Firm” and “Audit Committee Pre-approval Procedures” in the 2013 Proxy Statement is incorporated herein by reference.



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**PART IV**

**Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

(a) Financial Statements and Schedules:

(1) Consolidated Financial Statements of Peapack-Gladstone Financial Corporation.

Report of Independent Registered Public Accounting Firm.

Consolidated Statements of Condition as of December 31, 2012 and 2011.

Consolidated Statements of Income for the years ended December 31, 2012, 2011 and 2010.

Consolidated Statements of Comprehensive Income for the years ended December 31, 2012, 2011 and 2010.

Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2012, 2011 and 2010

Consolidated Statements of Cash Flows for the years ended December 31, 2012, 2011 and 2010.

Notes to Consolidated Financial Statements.

The Consolidated Financial Statements of Peapack-Gladstone Financial Corporation as set forth in Item 8 of Part II of this Form 10-K for the year ended December 31, 2012 are incorporated by reference herein.

All financial statement schedules are omitted because they are either inapplicable or not required, or because the required information is included in the Consolidated Financial Statements or notes thereto contained in this 2012 Annual Report.

(b) Exhibits

(3) Articles of Incorporation and By-Laws:

A. Certificate of Incorporation as incorporated herein by reference to the Registrant's Form 10-Q Quarterly Report filed on November 9, 2009.

B. By-Laws of the Registrant as in effect on the date of this filing are incorporated herein by reference to the Registrant's Form 8-K Current Report filed on April 23, 2007 (SEC File No. 001-16197).

(10)

Material Contracts:

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A. “Change in Control Agreements” dated as of December 20, 2007 by and among the Corporation, the Bank and Frank A. Kissel, Craig C. Spengeman and Finn M. W. Caspersen, Jr. are incorporated by reference to Exhibits 10(A)1, 10(A)2 and 10(A)6 of the Registrant’s Form 10-K Annual Report for the year ended December 31, 2007 (SEC File No. 001-16197). +

B. “Split Dollar Plan for Senior Management” dated as of September 7, 2001 for Frank A. Kissel and Craig C. Spengeman is incorporated by reference to Exhibit 10 (I) of the Registrant’s Form 10-K Annual Report for the year ended December 31, 2003 (SEC File No. 001-16197). +

C. “Directors’ Retirement Plan” dated as of March 31, 2001 is incorporated by reference to Exhibit 10 (J) of the Registrant’s Form 10-K Annual Report for the year ended December 31, 2003 (SEC File No. 001-16197). +

D. “Directors’ Deferral Plan” dated as of March 31, 2001 is incorporated by reference to Exhibit 10 (K) of the Registrant’s Form 10-K Annual Report for the year ended December 31, 2003 (SEC File No. 001-16197). +

E. “Employment Agreements” dated as of January 1, 2008 by and among the Corporation, the Bank and Frank A. Kissel, Craig C. Spengeman and Finn M. W. Caspersen, Jr. are incorporated by reference to Exhibits 10(F)1, 10(F)2 and 10(F)6 of the Registrant’s Form 10-K Annual Report for the year ended December 31, 2007 (SEC File No. 001-16197). +

F. Peapack-Gladstone Financial Corporation 1998 Stock Option Plan for Outside Directors and Peapack-Gladstone Financial Corporation 2002 Stock Option Plan for Outside Directors, each as amended and restated through December 8, 2005, are incorporated by reference to Exhibit 10.1 and Exhibit 10.2 of the Registrant’s Form 8-K Current Report filed on December 14, 2005 (SEC File No. 001-16197). +

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G. Peapack-Gladstone Financial Corporation Amended and Restated 1998 Stock Option Plan and Peapack-Gladstone Financial Corporation Amended and Restated 2002 Stock Option Plan are incorporated by reference to Exhibit 10.1 and Exhibit 10.2 of the Registrant’s Form 8-K Current Report filed on January 13, 2006 (SEC File No. 001-16197). +

H. Peapack-Gladstone Financial Corporation 2006 Long-Term Stock Incentive Plan is incorporated by reference to Exhibit 10 of the Registrant’s Form 10-Q Quarterly Report filed on May 10, 2006 (SEC File No. 001-16197). +

I. (1) Form of Restricted Stock Agreement, incorporated by reference to Exhibit 10(I) (i) of the Registrant’s Form 10-K filed on March 15, 2012 (2) Form of Non-qualified Stock Option Agreement, (3) Form of Incentive Stock Option Agreement, (4) Form of Non-qualified Stock Option Agreement for Outside Directors under the Peapack-Gladstone Financial Corporation 2006 Long-Term Stock Incentive Plan. +

J. “Change in Control Agreement” dated as of September 28, 2009, by and among the Corporation, the Bank and Vincent A. Spero as incorporated herein by reference to Exhibit 10(K) of the Registrant’s Form 10-K filed on March 16, 2010. +

K. “Employment Agreement” dated as of June 2, 2008, by and among the Corporation, the Bank and Vincent A. Spero as incorporated herein by reference to Exhibit 10(L) of the Registrant’s Form 10-K filed on March 16, 2010. +

L. Peapack-Gladstone Financial Corporation 2012 Long-Term Stock Incentive Plan is incorporated by reference to Exhibit A to the Corporation’s definitive proxy statement filed on March 23, 2012. +

M. “Letter Agreement” dated as of October 4, 2012, by and among the Corporation, the Bank and Douglas L. Kennedy is incorporated herein by reference to Exhibit 99.2 of the Registrant’s Form 8-K filed on October 5, 2012. +

N. Separation Agreement and General Release dated December 31, 2012 between Robert M. Rogers, the Corporation, the Bank. +

+ Management contract and compensatory plan or arrangement.

(21)List of Subsidiaries:

(a) Subsidiaries of the Corporation:

| Name | Percentage of Voting          |                                |
|------|-------------------------------|--------------------------------|
|      | Jurisdiction of Incorporation | Securities Owned by the Parent |

Peapack-Gladstone Bank New Jersey 100%

(b) Subsidiaries of the Bank:

**Name**

|   |            |      |
|---|------------|------|
| PGB Trust and Investments of Delaware                 | Delaware   | 100% |
| BGP CRE Holdings, LLC                                 | New Jersey | 100% |
| BGP RRE Holdings, LLC                                 | New Jersey | 100% |
| BGP CRE Painter Farm, LLC                             | New Jersey | 100% |
| BGP CRE Heritage, LLC                                 | New Jersey | 100% |
| BGP CRE K&P Holdings, LLC                             | New Jersey | 100% |
| BGP CRE Office Property, LLC                          | New Jersey | 100% |
| Peapack-Gladstone Financial Services, Inc. (Inactive) | New Jersey | 100% |

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(23) Consent of Independent Registered Public Accounting Firm:

(23.1) Consent of Crowe Horwath LLP

(24)

Power of Attorney

(31.1) Certification of Douglas L. Kennedy, Chief Executive Officer of Peapack-Gladstone, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

(31.2) Certification of Jeffrey J. Carfora, Chief Financial Officer of Peapack-Gladstone, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Certification of Douglas L. Kennedy, Chief Executive Officer of Peapack-Gladstone and Jeffrey J. Carfora, Chief  
(32) Financial Officer of Peapack-Gladstone pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(99.1) TARP Principal Executive Officer and Principal Financial Officer Years Following First Fiscal Year Certification.

(100) Interactive Data File\*

\*As provided in Rule 406T of Regulation S-T, this information is deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 and 12 of the Securities Act of 1933 and is deemed not filed for the purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

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**SIGNATURES**

Pursuant to the requirements of section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Peapack-Gladstone Financial Corporation

By: /s/ Douglas L. Kennedy  
Douglas L. Kennedy

*Chief Executive Officer*

By: /s/ Jeffrey J. Carfora  
Jeffrey J. Carfora

*Executive Vice President and Chief Financial Officer*

Dated: March 15, 2013

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated.

| <b>Signature</b>   | <b>Title</b>   | <b>Date</b>    |
|--|--|----------------|
| /s/ Douglas L. Kennedy<br>Douglas L. Kennedy             | Chief Executive Officer and Director   | March 15, 2013 |
| /s/ Jeffrey J. Carfora<br>Jeffrey J. Carfora             | Executive Vice President and Chief Financial Officer<br>(Principal Financial Officer and Principal Accounting Officer) | March 15, 2013 |
| /s/ Frank A. Kissel<br>Frank A. Kissel                   | Chairman of the Board  | March 15, 2013 |
| /s/ Finn M.W. Caspersen, Jr.<br>Finn M.W. Caspersen, Jr. | Director, General Counsel  | March 15, 2013 |
| /s/ Anthony J. Consi II<br>Anthony J. Consi II           | Director   | March 15, 2013 |
| /s/ Edward A. Gramigna<br>Edward A. Gramigna             | Director   | March 15, 2013 |
| /s/ John D. Kissel<br>John D. Kissel                     | Director   | March 15, 2013 |
| /s/ James R. Lamb<br>James R. Lamb                       | Director   | March 15, 2013 |
| /s/ Edward A. Merton                                     | Director   | March 15, 2013 |



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|  |  |                |
|--|--|----------------|
| Edward A. Merton<br>/s/ F. Duffield Meyercord<br>F. Duffield Meyercord | Director   | March 15, 2013 |
| /s/ John R. Mulcahy<br>John R. Mulcahy                                 | Director   | March 15, 2013 |
| /s/ Philip W. Smith III<br>Philip W. Smith III                         | Director   | March 15, 2013 |
| /s/ Craig C. Spengeman<br>Craig C. Spengeman                           | Director, President of PGB Trust and Investments | March 15, 2013 |
| /s/ Beth Welsh<br>Beth Welsh   | Director   | March 15, 2013 |