

SCIENTIFIC GAMES CORP
Form 4
March 22, 2017

FORM 4

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

OMB APPROVAL

OMB Number: 3235-0287
Expires: January 31, 2005
Estimated average burden hours per response... 0.5

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
Potts Larry

2. Issuer Name and Ticker or Trading Symbol
SCIENTIFIC GAMES CORP
[SGMS]

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

(Last) (First) (Middle)

3. Date of Earliest Transaction (Month/Day/Year)
03/20/2017

___ Director ___ 10% Owner
 Officer (give title below) ___ Other (specify below)
SVP & Chief Compliance Officer

C/O SCIENTIFIC GAMES CORPORATION, 6650 S. EL CAMINO ROAD

(Street)

4. If Amendment, Date Original Filed(Month/Day/Year)

6. Individual or Joint/Group Filing(Check Applicable Line)
 Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

LAS VEGAS, NV 89118

(City) (State) (Zip)

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)	4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)	5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Ownership (Instr. 4)
				(A) or (D)	Price		
Class A Common Stock	03/20/2017		M	4,101	A \$ 0	128,661	D
Class A Common Stock	03/20/2017		F	1,517	D \$ 21.56	127,144	D
					(1)		

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

Persons who respond to the collection of information contained in this form are not required to respond unless the form

SEC 1474 (9-02)

displays a currently valid OMB control number.

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)	5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)	6. Date Exercisable and Expiration Date (Month/Day/Year)	7. Title and Amount of Underlying Securities (Instr. 3 and 4)	8. Price or Value of Underlying Securities (Instr. 3 and 4)
Restricted Stock Units	(2)	03/20/2017		M	4,101	(2) (2)	Common Stock	4,101

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
Potts Larry C/O SCIENTIFIC GAMES CORPORATION 6650 S. EL CAMINO ROAD LAS VEGAS, NV 89118			SVP & Chief Compliance Officer	

Signatures

/s/ McLaurin Files, attorney-in-fact for Larry Potts

03/22/2017

__Signature of Reporting Person

Date

Explanation of Responses:

* If the form is filed by more than one reporting person, see Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Represents the satisfaction of tax withholding obligations upon the vesting of restricted stock units.

Represents vesting of one-fourth of restricted stock units granted on June 21, 2016. The balance of the award is scheduled to vest in three equal installments as to 4,102 shares on each of March 20, 2018, 2019 and 2020. Each unit converts into a share of common stock on a one-for-one basis.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, see Instruction 6 for procedure.

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number.

ckground-color:#ccee; padding-left:2px; padding-top:2px; padding-bottom:2px; padding-right:2px;">

\$

—

Commercial Business

3,257

3,359

431

3,422

2

3,376

50

Commercial Real Estate

3,905

3,905

71

4,796

55

4,376

169

Mortgage Warehouse Lines

—

—

—

—

—

—

Subtotal
7,162

7,264

502

8,218

57

7,752

219

Residential Real Estate

—

—

—

—

—

Consumer:

Loans to Individuals

—

—

—

—

—

Other

—

—

—

—

Explanation of Responses:

—

Subtotal

—

—

—

—

—

—

—

With an allowance:

\$
7,162

\$
7,264

\$
502

\$
8,218

\$
57

Explanation of Responses:

\$
7,752

\$
219

Total:

Construction
104

104

—

104

2

118

6

Commercial Business
4,139

4,438

Explanation of Responses:

431

4,444

30

4,577

133

Commercial Real Estate

6,711

6,944

71

7,353

82

7,246

243

Mortgage Warehouse Lines

—

—

—

—

—

Explanation of Responses:

—

—

Residential Real Estate

1,162

1,242

—

1,149

—

742

—

Consumer

408

483

—

409

—

413

—

Total

\$

12,524

Explanation of Responses:

\$
13,211

\$
502

\$
13,459

\$
114

\$
13,096

\$
382

21

Impaired Loans Receivables (By Class)

December 31, 2017

(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no allowance:			
Commercial:			
Construction	\$232	\$232	\$ —
Commercial Business	1,271	1,419	—
Commercial Real Estate	1,348	1,372	—
Mortgage Warehouse Lines	—	—	—
Subtotal	2,851	3,023	—
Residential Real Estate	69	123	—
Consumer:			
Loans to Individuals	368	438	—
Other	—	—	—
Subtotal	368	438	—
With no allowance	\$3,288	\$3,584	\$ —
With an allowance:			
Commercial:			
Construction	\$—	\$—	\$ —
Commercial Business	3,462	3,464	592
Commercial Real Estate	4,955	5,748	92
Mortgage Warehouse Lines	—	—	—
Subtotal	8,417	9,212	684
Residential Real Estate	—	—	—
Consumer:			
Loans to Individuals	—	—	—
Other	—	—	—
Subtotal	—	—	—
With an allowance	\$8,417	\$9,212	\$ 684
Total:			
Construction	232	232	—
Commercial Business	4,733	4,883	592
Commercial Real Estate	6,303	7,120	92
Mortgage Warehouse Lines	—	—	—
Residential Real Estate	69	123	—
Consumer	368	438	—
Total	\$11,705	\$12,796	\$ 684

Impaired Loans Receivables (By Class)

(Dollars in thousands)	Three Months Ended September 30, 2017		Nine Months Ended September 30, 2017	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no allowance:				
Commercial:				
Construction	\$231	\$ 3	\$201	\$ 9
Commercial Business	693	25	725	123
Commercial Real Estate	2,880	18	2,808	128
Mortgage Warehouse Lines	—	—	—	—
Subtotal	3,804	46	3,734	260
Residential Real Estate	76	—	166	—
Consumer:				
Loans to Individuals	366	—	332	—
Other	—	—	—	—
Subtotal	366	—	332	—
With no allowance:	\$4,246	\$ 46	\$4,232	\$ 260
With an allowance:				
Commercial:				
Construction	\$—	\$ —	\$114	\$ —
Commercial Business	3,045	44	2,745	171
Commercial Real Estate	3,092	44	2,764	129
Mortgage Warehouse Lines	—	—	—	—
Subtotal	6,137	88	5,623	300
Residential Real Estate	—	—	100	—
Consumer:				
Loans to Individuals	—	—	—	—
Other	—	—	—	—
Subtotal	—	—	—	—
With an allowance:	\$6,137	\$ 88	\$5,723	\$ 300
Total:				
Construction	231	3	315	9
Commercial Business	3,738	69	3,470	294
Commercial Real Estate	5,972	62	5,572	257
Mortgage Warehouse Lines	—	—	—	—
Residential Real Estate	76	—	266	—
Consumer	366	—	332	—
Total	\$10,383	\$ 134	\$9,955	\$ 560

Purchased Credit-Impaired Loans

Purchased credit-impaired loans (“PCI”) are loans acquired at a discount that are due in part to credit quality. On April 11, 2018, as part of the NJCB acquisition, the Company acquired purchased credit-impaired loans with loan balances totaling \$1.1 million and fair values totaling \$881,000. The following table presents additional information regarding purchased credit-impaired loans at September 30, 2018 and December 31, 2017:

(Dollars in thousands)	September 30, December 31,	
	2018	2017
Outstanding balance	\$ 2,050	\$ 998
Carrying amount	\$ 1,745	\$ 864

Changes in accretable discount for purchased credit-impaired loans for the three and nine months ended September 30, 2018 and September 30, 2017 were as follows:

(Dollars in thousands)	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Balance at beginning of period	\$233	\$171	\$126	\$30
Acquisition of impaired loans	—	—	168	—
Transfer from non-accretable discount	—	—	—	161
Accretion of discount	(34)	(23)	(95)	(43)
Balance at end of period	\$199	\$148	\$199	\$148

Consumer Mortgage Loans Secured by Residential Real Estate in Process of Foreclosure

The following table summarizes the recorded investment in consumer mortgage loans secured by residential real estate in the process of foreclosure (dollars in thousands):

September 30, 2018	December 31, 2017
Number Recorded of loans	Number of Recorded Investment loans
4	1
\$ 821	\$ 77

At September 30, 2018, there was one residential property with a fair value of \$1.1 million held in other real estate owned. At December 31, 2017, there were no residential properties held in other real estate owned.

Troubled Debt Restructurings

In the normal course of business, the Bank may consider modifying loan terms for various reasons. These reasons may include as a retention strategy to compete in the current interest rate environment or to re-amortize or extend a loan term to better match the loan’s repayment stream with the borrower’s cash flow. A modified loan would be considered a troubled debt restructuring (“TDR”) if the Bank grants a concession to a borrower and has determined that the borrower is troubled (i.e., experiencing financial difficulties).

If the Bank restructures a loan to a troubled borrower, the loan terms (i.e., interest rate, payment, amortization period and maturity date) may be modified in various ways to enable the borrower to cover the modified debt service payments based on current financial statements and cash flow adequacy. If a borrower’s hardship is thought to be temporary, then modified terms may only be offered for that time period. Where possible, the Bank would attempt to obtain additional collateral and/or secondary repayment sources at the time of the restructuring in order to put the Bank in the best possible position if the borrower is not able to meet the modified terms. The Bank will not offer modified terms if it believes that modifying the loan terms will only delay an inevitable permanent default. In evaluating whether a restructuring constitutes a troubled debt restructuring, applicable guidance requires that a creditor must separately conclude that the restructuring constitutes a concession and the borrower is experiencing financial difficulties.

There were two commercial real estate loans with an aggregate pre- and post-modified recorded investment of \$1.0 million and one commercial business loan with a pre- and post-modified recorded investment of \$135,000 that were each modified as a TDR during the three and nine months ended September 30, 2018. There was one commercial real estate loan with a pre- and post-modification recorded investment of \$2.3 million that was modified as a TDR during the nine months ended September 30, 2017. There were no troubled debt restructurings that subsequently defaulted within twelve months of restructuring during the nine months ended September 30, 2018. There were no troubled debt restructuring that defaulted within twelve months of restructuring during the nine months ended September 30, 2017.

(6) Revenue from Contracts with Customers

All of the Company's revenue from contracts with customers in the scope of ASC 606 is recognized within non-interest income. The following table presents the Company's sources of non-interest income for the three and nine months ended September 30, 2018 and 2017. Items outside the scope of ASC 606 are noted as such.

(Dollars in thousands)	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Service charges on deposits:				
Overdraft fees	\$96	\$ 71	\$257	\$ 222
Other	77	71	219	223
Interchange income	119	118	294	257
Other income - in scope	89	84	418	213
Income on BOLI ⁽¹⁾	152	131	425	391
Net gains on sales of loans ⁽¹⁾	1,292	1,329	3,425	3,936
Loan servicing fees ⁽¹⁾	174	143	482	426
Net gains (losses) on sales and calls of securities ⁽¹⁾	—	24	12	128
Gain from bargain purchase ⁽¹⁾	—	—	184	—
Other income ⁽¹⁾	155	145	366	489
	\$2,154	\$ 2,116	\$6,082	\$ 6,285

⁽¹⁾ Not within the scope of ASC 606

A description of the Company's revenue streams accounted for under ASC 606 follows:

Service Charges on Deposit Accounts: The Company earns fees from its deposit account customers for transaction-based, account maintenance and overdraft services. Transaction-based fees, which include services such as ATM use fees, stop payment charges, statement rendering and ACH fees, are recognized at the time the transaction is executed as that is the point in time the Company fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer's account balance.

Interchange Income: The Company earns interchange fees from debit cardholder transactions conducted through the Visa payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder.

Other Income: The Company earns other fees from the execution of and receipt of wire transfers for customers, the rental of safe deposit boxes and fees for other services provided to customers. These fees are recognized at the time the transaction is executed or the service is provided as that is the point in time the Company fulfills the customer's request.

Gain or Loss on Sales of OREO: The Company records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. The Company generally does not finance the sale of OREO to the buyer; however, in determining the gain or loss on the sale, the Company adjusts the transaction price and related gain or loss on sale if a significant financing component is present. There were no sales of OREO during the three and nine months ended September 30, 2018 or 2017.

(7) Share-Based Compensation

The Company's share-based incentive plans ("Stock Plans") authorize the issuance of an aggregate of 485,873 shares of the Company's common stock (as adjusted for stock dividends) pursuant to awards that may be granted in the form of stock options to purchase common stock ("Options") and awards of shares of common stock ("Stock Awards").

As of September 30, 2018, there were 55,136 shares of common stock available for future grants under the Stock Plans.

The following table summarizes stock option activity during the nine months ended September 30, 2018:

(Dollars in thousands, except share amounts)	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2018	142,005	\$ 7.86		
Granted	10,450	18.30		
Exercised	(9,307)	7.01		
Outstanding at September 30, 2018	143,148	\$ 8.68	4.2	\$ 1,721
Exercisable at September 30, 2018	124,132	\$ 7.48	3.5	\$ 1,641

The fair value of each option and the significant weighted average assumptions used to calculate the fair value of the options granted for the nine months ended September 30, 2018 were as follows:

Fair value of options granted \$5.93

Risk-free rate of return 2.46 %

Expected option life in years 7

Expected volatility 31.35 %

Expected dividends 1.18 %

Share-based compensation expense related to options was \$45,000 and \$44,000 for the nine months ended September 30, 2018 and 2017, respectively. As of September 30, 2018, there was approximately \$82,000 of unrecognized compensation cost related to non-vested stock options.

The following table summarizes the activity in non-vested restricted shares for the nine months ended September 30, 2018:

(Dollars in thousands, except share amounts)	Number of Shares	Average Grant-Date Fair Value
Outstanding at January 1, 2018	150,745	\$ 11.87
Granted	62,150	20.19
Vested	(65,345)	16.76
Non-vested at September 30, 2018	147,550	\$ 13.21

Share-based compensation expense related to stock grants was \$714,000 and \$695,000 for the nine months ended September 30, 2018 and 2017, respectively. As of September 30, 2018, there was approximately \$1.8 million of unrecognized compensation cost related to non-vested stock grants.

(8) Benefit Plans

The Bank has a 401(k) plan that covers substantially all employees with six months or more of service. The Bank's 401(k) plan permits all eligible employees to make contributions to the plan up to the IRS salary deferral limit. The Bank's contributions to the 401(k) plan are expensed as incurred.

The Company also provides retirement benefits to certain employees under supplemental executive retirement plans. The plans are unfunded and the Company accrues actuarially determined benefit costs over the estimated service period of the employees in the plans. The Company recognizes the over-funded or under-funded status of a defined benefit post-retirement plan as an asset or liability on its balance sheet and recognizes changes in that funded status in the year in which the changes occur, through comprehensive income. At September 30, 2018 and December 31, 2017, the Company's President and Chief Executive Officer was the only eligible participant in the supplemental executive retirement plans.

In connection with the benefit plans, the Bank has life insurance policies on the lives of its executives, directors and employees. The Bank is the owner and beneficiary of these policies. The cash surrender values of these policies totaled approximately \$28.6 million and \$25.1 million at September 30, 2018 and December 31, 2017, respectively.

The components of net periodic expense for the Company's supplemental executive retirement plans for the three and nine months ended September 30, 2018 and 2017 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2018	2017	2018	2017
Service cost	\$53	\$67	\$140	\$178
Interest cost	43	39	114	117
Actuarial gain recognized	(15)	(32)	(45)	(75)
Total	\$81	\$74	\$209	\$220

(9) Other Comprehensive Income (Loss) and Accumulated Other Comprehensive Loss

Other comprehensive income (loss) is the total of (1) net income (loss) and (2) all other changes in equity from non-shareholder sources, which are referred to as other comprehensive income (loss). The components of accumulated other comprehensive loss, and the related tax effects, are as follows:

	September 30, 2018		
(Dollars in thousands)	Before-Tax Amount	Income Tax Effect	Net-of-Tax Amount
Net unrealized holding losses on investment securities available for sale	\$(2,598)	\$ 624	\$(1,974)
Unrealized impairment loss on held to maturity security	(501)	119	(382)
Gains on unfunded pension liability	244	(69)	175
Accumulated other comprehensive loss	\$(2,855)	\$ 674	\$(2,181)
	December 31, 2017		
(Dollars in thousands)	Before-Tax Amount	Income Tax Effect	Net-of-Tax Amount
Net unrealized holding losses on investment securities available for sale	\$(571)	\$ 137	\$(434)
Unrealized impairment loss on held to maturity security	(501)	119	(382)

Explanation of Responses:

Edgar Filing: SCIENTIFIC GAMES CORP - Form 4

Gains on unfunded pension liability	111	(31)	80
Accumulated other comprehensive loss	\$(961)	\$ 225	\$ (736)

27

Changes in the components of accumulated other comprehensive loss are as follows and are presented net of tax for the three and nine months ended September 30, 2018 and 2017:

(Dollars in thousands)	Unrealized Holding Gains/ (Losses) on Available for Sale Securities	Unrealized Impairment Loss on Held to Maturity Security	Unfunded Pension Liability	Accumulated Other Comprehensive Loss
Balance - July 1, 2018	\$ (1,587)	\$ (382)	\$ 122	\$ (1,847)
Other comprehensive income (loss) before reclassifications	(387)	—	64	(323)
Amounts reclassified from accumulated other comprehensive income	—	—	(11)	(11)
Reclassification adjustment for gains realized in income	—	—	—	—
Other comprehensive loss	(387)	—	53	(334)
Balance - September 30, 2018	\$ (1,974)	\$ (382)	\$ 175	\$ (2,181)
Balance - July 1, 2017	\$ 77	\$ (331)	\$ 39	\$ (215)
Other comprehensive income before reclassifications	11	—	—	11
Amounts reclassified from accumulated other comprehensive income	—	—	(19)	(19)
Reclassification adjustment for gains realized in income	(7)	—	—	(7)
Other comprehensive income (loss)	4	—	(19)	(15)
Balance - September 30, 2017	\$ 81	\$ (331)	\$ 20	\$ (230)

(Dollars in thousands)	Unrealized Holding Gains/ (Losses) on Available for Sale Securities	Unrealized Impairment Loss on Held to Maturity Security	Unfunded Pension Liability	Accumulated Other Comprehensive Loss
Balance January 1, 2018	\$ (434)	\$ (382)	\$ 80	\$ (736)
Other comprehensive income (loss) before reclassifications	(1,531)	—	128	(1,403)
Amounts reclassified from accumulated other comprehensive income	—	—	(33)	(33)
Reclassification adjustment for gains realized in income	(9)	—	—	(9)
Other comprehensive income (loss)	(1,540)	—	95	(1,445)
Balance September 30, 2018	\$ (1,974)	\$ (382)	\$ 175	\$ (2,181)
Balance January 1, 2017	\$ (334)	\$ (331)	\$ 65	\$ (600)
Other comprehensive income before reclassifications	470	—	—	470
Amounts reclassified from accumulated other comprehensive income	—	—	(45)	(45)

Explanation of Responses:

Edgar Filing: SCIENTIFIC GAMES CORP - Form 4

Reclassification adjustment for gains realized in income	(55)	—	—	(55)	
Other comprehensive income (loss)	415	—	(45)	370		
Balance September 30, 2017	\$ 81		\$ (331)	\$ 20	\$ (230)

28

(10) Recent Accounting Pronouncements

ASU 2018-15 - Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40)

In August 2018, the FASB issued ASU 2018-15, “Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement,” to help entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement (hosting arrangement) by providing guidance for determining when the arrangement includes a software license.

The amendments in this Update align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal use software license). The accounting for the service element of a hosting arrangement that is a service contract is not affected by the amendments in this Update.

The amendments in this ASU also require the entity (customer) to expense the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement. The term of the hosting arrangement includes the non-cancellable period of the arrangement plus periods covered by (1) an option to extend the arrangement if the customer is reasonably certain to exercise that option, (2) an option to terminate the arrangement if the customer is reasonably certain not to exercise the termination option, and (3) an option to extend (or not to terminate) the arrangement in which exercise of the option is in the control of the vendor. The entity also is required to apply the existing impairment guidance in Subtopic 350-40 to the capitalized implementation costs as if the costs were long-lived assets.

The amendments in this ASU also require the entity to present the expense related to the capitalized implementation costs in the same line item in the statement of income as the fees associated with the hosting element (service) of the arrangement and classify payments for capitalized implementation costs in the statement of cash flows in the same manner as payments made for fees associated with the hosting element. The entity is also required to present the capitalized implementation costs in the statement of financial position in the same line item that a prepayment for the fees of the associated hosting arrangement would be presented.

The Company is currently evaluating the potential impact, if any, of adopting this ASU on its financial statements. The provisions of this ASU are effective for fiscal years beginning after December 15, 2019.

ASU 2018-14 - Compensation - Retirement Benefits - Defined Benefit Plans - General (Subtopic 715-20)

In August 2018, the FASB issued ASU 2018-14 - “Compensation - Retirement Benefits - Defined Benefit Plans - General (Subtopic 715-20),” which consist of amendments to the disclosure framework project to improve the effectiveness of disclosures in the notes to the financial statements. The amendments in this Update modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans.

The following disclosure requirements are removed from Subtopic 715-20:

1. The amounts in accumulated other comprehensive income expected to be recognized as components of net periodic benefit cost over the next fiscal year;
2. The amount and timing of plan assets expected to be returned to the employer;
3. The disclosures related to the June 2001 amendments to the Japanese Welfare Pension Insurance Law.
4. Related party disclosures about the amount of future annual benefits covered by insurance and annuity contracts and significant transactions between the employer or related parties and the plan;
5. For nonpublic entities, the reconciliation of the opening balances to the closing balances of plan assets measured on a recurring basis in Level 3 of the fair value hierarchy. However, nonpublic entities will be required to disclose separately the amounts of transfers into and out of Level 3 of the fair value hierarchy and purchases of Level 3 plan

assets; and

29

For public entities, the effects of a one-percentage point change in assumed health care cost trend rates on the (a) 6. aggregate of the service and interest cost components of net periodic benefit costs and (b) benefit obligation for postretirement health care benefits.

The following disclosure requirements are added to Subtopic 715-20:

1. The weighted-average interest crediting rates for cash balance plans and other plans with promised interest crediting rates; and
2. An explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period.

The amendments in this ASU also clarify the disclosure requirements in paragraph 715-20-50-3, which state that the following information for defined benefit pension plans should be disclosed:

1. The projected benefit obligation (“PBO”) and fair value of plan assets for plans with PBOs in excess of plan assets; and
2. The accumulated benefit obligation (“ABO”) and fair value of plan assets for plans with ABOs in excess of plan assets.

The amendments in this ASU remove disclosures that no longer are considered cost beneficial, clarify the specific requirements of disclosures and add disclosure requirements identified as relevant. Although narrow in scope, the amendments are considered an important part of the FASB’s efforts to improve the effectiveness of disclosures in the notes to financial statements by applying concepts in the Concepts Statement.

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2020. The Company does not expect the adoption of this guidance to have a material impact on the Company’s consolidated financial statements.

ASU 2018-13 - Fair Value Measurement (Topic 820)

In August 2018 the FASB issued ASU 2018-13, “Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement,” which modifies the disclosure requirements on fair value measurements. The following disclosure requirements that are applicable to public entities were removed from Topic 820:

1. The amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy;
2. The policy for timing of transfers between levels; and
3. The valuation process for Level 3 fair value measurements.

The following disclosure requirements were modified in Topic 820:

1. In lieu of a roll-forward for Level 3 fair value measurements, a nonpublic entity is required to disclose transfers into and out of Level 3 of the fair value hierarchy and purchases and issues of Level 3 assets and liabilities;
For investments in certain entities that calculate net asset value, an entity is required to disclose the timing of
2. liquidation of an investee’s assets and the date when restrictions from redemption might lapse only if the investee has communicated the timing to the entity or announced the timing publicly; and
3. The amendments clarify that the measurement uncertainty disclosure is to communicate information about the uncertainty in measurement as of the reporting date.

The following disclosure requirements were added to Topic 820; however, the disclosures are not required for nonpublic entities:

The changes in unrealized gains and losses for the period included in other comprehensive income for recurring
1. Level 3 fair value measurements held at the end of the reporting period; and

30

The range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements. For certain unobservable inputs, an entity may disclose other quantitative information (such as the 2. median or arithmetic average) in lieu of the weighted average if the entity determines that other quantitative information would be a more reasonable and rational method to reflect the distribution of unobservable inputs used to develop Level 3 fair value measurements.

In addition, the amendments eliminate “at a minimum” from the phrase “an entity shall disclose at a minimum” to promote the appropriate exercise of discretion by entities when considering fair value measurement disclosures and to clarify that materiality is an appropriate consideration of entities and their auditors when evaluating disclosure requirements.

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those years. The Company does not expect the adoption of this guidance to have a material impact on the Company’s consolidated financial statements.

ASU 2018-11 - Leases - Targeted Improvements (Topic 842)

In July, 2018 the FASB issued ASU 2018-11, “Leases-Targeted Improvements,” which provides an additional (and optional) transition method for a cumulative effect adjustment. The additional transition method allows entities to initially apply the new lease standard at the adoption date (January 1, 2019 for calendar-year-end public business entities) and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. This additional transition method changes only when an entity is required to initially apply the transition requirements of the new leases standard; it does not change how those requirements apply. An entity’s reporting for the comparative periods presented in the financial statements in which it adopts the new lease standard will continue to be in accordance with current U.S. GAAP (Topic 840, Leases).

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those years. The Company is evaluating the impact of this ASU in connection with the evaluation of the impact of the adoption of ASU 2016-02-, “Leases.”

ASU 2018-07 - Compensation - Stock Compensation (Topic 718)

In June 2018, the FASB issued ASU 2018-07, “Compensation-Stock Compensation,” which expands the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from non-employees.

The amendments specify that Topic 718 applies to all share-based payment transactions in which a grantor acquires goods or services to be used or consumed in a grantor’s own operations by issuing share-based payment awards. The amendment also clarifies that Topic 718 does not apply to share-based payments used to effectively provide (1) financing to the issuer or (2) awards granted in conjunction with selling goods or services to customers as part of a contract accounted for under Topic 606, “Revenue from Contracts with Customers.”

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those years. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes the interim period.

The Company does not expect the adoption of this guidance to have a material impact on the Company’s consolidated financial statements.

ASU 2017-08 - Premium Amortization on Purchased Callable Debt Securities

In March 2017, the FASB issued ASU 2017-08, "Premium Amortization on Purchased Callable Debt Securities," which shortens the amortization period for premiums on purchased callable debt securities to the earliest call date (i.e., yield-to-earliest call amortization) rather than amortizing over the full contractual term. The ASU does not change the accounting for securities held at a discount.

The amendments apply to callable debt securities with explicit, non-contingent call features that are callable at fixed prices and on preset dates. If a security may be prepaid based upon prepayments of the underlying loans and not because the issuer exercised a date specific call option, it is excluded from the scope of the new standard. However, for instruments with contingent call features, once the contingency is resolved and the security is callable at a fixed price and preset date, the security is within the scope of the amendments. Further, the amendments apply to all premiums on callable debt securities, regardless of how they were generated.

The amendments require companies to reset the effective yield using the payment terms of the debt security if the call option is not exercised on the earliest call date. If the security has additional future call dates, any excess of the amortized cost basis over the amount repayable by the issuer at the next call date should be amortized to the next call date.

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those years. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes the interim period.

The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

ASU 2017-04 - Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment

In January 2017, the FASB issued ASU 2017-04, "Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment," which simplifies how all entities assess goodwill for impairment by eliminating Step 2 from the goodwill impairment test. As amended, the goodwill impairment test will consist of one step comparing the fair value of a reporting unit with its carrying amount. An entity should recognize a goodwill impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. The primary goal of this ASU is to simplify the goodwill impairment test and provide cost savings for all entities by removing the requirement to determine the fair value of individual assets and liabilities in order to calculate a reporting unit's "implied" goodwill under current U.S. GAAP.

For the Company, the provisions of this ASU are effective for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. The amendments should be adopted prospectively. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017.

The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

ASU 2016-13 - Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments," which requires credit losses on most financial assets to be measured at amortized cost and certain other instruments to be measured using an expected credit loss model (referred to as the current expected credit loss ("CECL") model).

Under this model, entities will estimate credit losses over the entire contractual term of the instrument (considering estimated prepayments but not expected extensions or modifications unless reasonable expectation of a troubled debt restructuring exists) from the date of initial recognition of that instrument.

The ASU also replaces the current accounting model for purchased credit impaired loans and debt securities. The allowance for credit losses for purchased financial assets with a more-than-insignificant amount of credit deterioration since origination (“PCD assets”) should be determined in a similar manner to other financial assets measured on an amortized cost basis. Upon initial recognition, the allowance for credit losses is added to the purchase price (“gross up approach”) to determine the initial amortized cost basis. The subsequent accounting for PCD assets will use the CECL model described above.

The ASU made certain targeted amendments to the existing impairment model for available-for-sale (“AFS”) debt securities. For an AFS debt security for which there is neither the intent nor a more-likely-than-not requirement to sell, an entity will record credit losses as an allowance rather than a write-down of the amortized cost basis.

For the Company, the provisions of this ASU are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for all entities as of the fiscal year beginning after December 15, 2018, including interim periods within those fiscal years.

The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

ASU 2016-02 - Leases

In February 2016, the FASB issued ASU 2016-02 “Leases.” From the lessee’s perspective, the new standard establishes a right-of-use (“ROU”) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement for a lessee. From the lessor’s perspective, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn’t convey risks and rewards or control, an operating lease results.

The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. A modified retrospective transition approach is required for lessors for sales-type, direct financing and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available.

The Company is currently evaluating the impact of the adoption of this guidance on its consolidated financial statements and has determined that the provisions of ASU 2016-02 will result in an increase in assets to recognize the present value of the lease obligations (right-of-use assets) with a corresponding increase in liabilities. The initial measurement of the right-of-use asset and the corresponding liability will be affected by certain key assumptions, such as expectations of renewals or extensions of leases and the interest rate to be used to discount the future lease obligations. The Company has completed a review and inventory of its lease portfolio and expects to implement lease accounting software to account for the leases by the end of the fourth quarter of 2018. The total impact of the new standard will be affected by any new leases that are executed, leases that are terminated prior to the effective date and any leases with changes to key assumptions or expectations, such as renewals and extensions and discount rates. The Company is evaluating the effective date transition method as described in ASU 2018-11.

(11) Fair Value Disclosures

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

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

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

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

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

methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

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

Interest Rate Lock Derivatives. Interest rate lock commitments do not trade in active markets with readily observable prices. The fair value of an interest rate lock commitment is estimated based upon the forward sales price that is obtained in the best efforts commitment at the time the borrower locks in the interest rate on the loan and the probability that the locked rate commitment will close.

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

Other Real Estate Owned. Foreclosed properties are adjusted to fair value less estimated selling costs at the time of foreclosure in preparation for transfer from portfolio loans to other real estate owned ("OREO"), thereby establishing a new accounting basis. The Company subsequently adjusts the fair value of the OREO, utilizing Level 3 inputs on a non-recurring basis to reflect partial write-downs based on the observable market price, current appraised value of the asset or other estimates of fair value. The fair value of other real estate owned is determined using appraisals, which may be discounted based on management's review and changes in market conditions.

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

September 30, 2018

(Dollars in thousands)	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Securities available for sale:				
U.S. Treasury securities and obligations of U.S. Government sponsored entities ("GSE") and agencies	\$998	\$2,917	\$	-\$3,915
Residential collateralized mortgage obligations - GSE	—	44,269	—	44,269
Residential mortgage backed securities - GSE	—	14,562	—	14,562
Obligations of state and political subdivisions	—	23,332	—	23,332
Trust preferred debt securities - single issuer	—	1,406	—	1,406
Corporate debt securities	16,380	11,437	—	27,817
Other debt securities	—	15,891	—	15,891
Interest rate lock derivative	—	120	—	120
Total	\$17,378	\$113,934	\$	-\$131,312

(Dollars in thousands)	December 31, 2017			
	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Securities available for sale:				
U.S. Treasury securities and obligations of U.S. Government sponsored entities ("GSE") and agencies	\$—	\$1,967	\$—	—\$1,967
Residential collateralized mortgage obligations - GSE	—	27,325	—	27,325
Residential mortgage backed securities - GSE	—	14,288	—	14,288
Obligations of state and political subdivisions	—	19,720	—	19,720
Trust preferred debt securities - single issuer	—	2,349	—	2,349
Corporate debt securities	16,080	11,603	—	27,683
Other debt securities	—	12,126	—	12,126
Interest rate lock derivative	—	135	—	135
Total	\$16,080	\$89,513	\$—	—\$105,593

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Assets and liabilities subject to fair value adjustments (impairment) on a nonrecurring basis for the nine months ended September 30, 2018 and the twelve months ended December 31, 2017 were as follows:

(Dollars in thousands)	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
September 30, 2018				
Impaired loans	\$—	—\$	—\$9,992	\$9,992
Other real estate owned	—	—	1,460	1,460
December 31, 2017				
Impaired loans	\$—	—\$	—\$8,313	\$8,313

Impaired loans measured at fair value and included in the above table at September 30, 2018 consisted of 21 loans having an aggregate recorded investment of \$10.5 million and specific loan loss allowance of \$502,000. Impaired loans measured at fair value and included in the above table at December 31, 2017 consisted of 14 loans having an aggregate balance of \$9.0 million with specific loan loss allowance of \$684,000.

The following table presents additional qualitative information about assets measured at fair value on a nonrecurring basis, where there was evidence of impairment, and for which the Company has utilized Level 3 inputs to determine fair value:

(Dollars in thousands)	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
September 30, 2018				
Impaired loans	\$ 9,992	Appraisal of collateral ⁽¹⁾	Appraisal adjustments ⁽²⁾	2.9% - 69% (14.15%)
Other real estate owned	\$ 1,460	Appraisal of collateral (1)	Appraisal adjustments ⁽²⁾	47% - 80% (63.5%)
December 31, 2017				
Impaired loans	\$ 8,313	Appraisal of collateral ⁽¹⁾	Appraisal adjustments ⁽²⁾	0.5%-100% (28.2%)

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

⁽²⁾ Includes qualitative adjustments by management and estimated liquidation expenses.

The following is a summary of fair value versus carrying value of all of the Company's financial instruments. For the Company and the Bank, as with most financial institutions, the bulk of assets and liabilities are considered financial instruments. Many of

35

the financial instruments lack an available trading market as characterized by a willing buyer and willing seller engaging in an exchange transaction. Therefore, significant estimations and present value calculations were used for the purpose of this note. Changes in assumptions could significantly affect these estimates.

The estimated fair values and carrying amounts of financial assets and liabilities as of September 30, 2018 and December 31, 2017 were as follows:

	September 30, 2018				
(Dollars in thousands)	Carrying Value	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Fair Value
Cash and cash equivalents	\$19,264	\$19,264	\$ —	\$ —	—\$19,264
Securities available for sale	131,192	17,378	113,814	—	131,192
Securities held to maturity	91,379	—	91,220	—	91,220
Loans held for sale	4,362	—	4,681	—	4,681
Loans, net	873,273	—	—	876,773	876,773
SBA servicing asset	895	—	1,016	—	1,016
Interest rate lock derivative	120	—	120	—	120
Accrued interest receivable	3,652	—	3,652	—	3,652
FHLB stock	5,175	—	5,175	—	5,175
Deposits	(941,677)	—	(939,054)	—	(939,054)
Borrowings	(99,475)	—	(99,475)	—	(99,475)
Redeemable subordinated debentures	(18,577)	—	(12,797)	—	(12,797)
Accrued interest payable	(927)	—	(927)	—	(927)

	December 31, 2017				
(Dollars in thousands)	Carrying Value	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Fair Value
Cash and cash equivalents	\$18,754	\$18,754	\$ —	\$ —	—\$18,754
Securities available for sale	105,458	16,080	89,378	—	105,458
Securities held to maturity	110,267	—	111,865	—	111,865
Loans held for sale	4,254	—	4,539	—	4,539
Loans, net	781,893	—	—	784,064	784,064
SBA servicing asset	726	—	1,016	—	1,016
Interest rate lock derivative	135	—	135	—	135
Accrued interest receivable	3,478	—	3,478	—	3,478
FHLB stock	1,490	—	1,490	—	1,490
Deposits	(922,006)	—	(920,732)	—	(920,732)
Borrowings	(20,500)	—	(20,500)	—	(20,500)
Redeemable subordinated debentures	(18,557)	—	(12,326)	—	(12,326)
Accrued interest payable	(804)	—	(804)	—	(804)

Loan commitments and standby letters of credit as of September 30, 2018 and December 31, 2017 were based on fees charged for similar agreements; accordingly, the estimated fair value of loan commitments and standby letters of credit was nominal.

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

This discussion and analysis of the operating results for the three and nine months ended September 30, 2018 and financial condition at September 30, 2018 is intended to help readers analyze the accompanying financial statements, notes and other supplemental information contained in this quarterly report. Results of operations for the three and nine month periods ended September 30, 2018 are not necessarily indicative of results to be attained for any other periods.

This discussion and analysis should be read in conjunction with the consolidated financial statements, notes and tables included elsewhere in this Quarterly Report on Form 10-Q for the three and nine month periods ended September 30, 2018 (this "Form 10-Q") and Part II, Item 7 of the Company's Form 10-K (Management's Discussion and Analysis of Financial Condition and Results of Operation) for the year ended December 31, 2017, as filed with the SEC on March 19, 2018.

General

Throughout the following sections, the "Company" refers toST Constitution Bancorp and, as the context requires, its wholly-owned subsidiary, 1ST Constitution Bank (the "Bank"), and the Bank's wholly-owned subsidiaries,^{T1} Constitution Investment Company of New Jersey, Inc., FCB Assets Holdings, Inc., 204 South Newman Street Corp. and 249 New York Avenue, LLC. 1ST Constitution Capital Trust II ("Trust II"), a subsidiary of the Company, is not included in the Company's consolidated financial statements as it is a variable interest entity and the Company is not the primary beneficiary. Trust II, a subsidiary of the Company, was created in May 2006 to issue trust preferred securities to assist the Company in raising additional capital.

The Company is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. The Company was organized under the laws of the State of New Jersey in February 1999 for the purpose of acquiring all of the issued and outstanding stock of the Bank, a full-service commercial bank that began operations in August 1989, thereby enabling the Bank to operate within a bank holding company structure. The Company became an active bank holding company on July 1, 1999. Other than its ownership interest in the Bank, the Company currently conducts no other significant business activities.

The Bank operates 20 branches and manages an investment portfolio through its subsidiary, 1ST Constitution Investment Company of New Jersey, Inc. FCB Assets Holdings, Inc., a subsidiary of the Bank, is used by the Bank to manage and dispose of repossessed real estate.

On April 11, 2018, the Company and the Bank completed the merger of NJCB with and into the Bank. See Note 2 - Acquisition of New Jersey Community Bank - for further information.

When used in this Form 10-Q, the words "the Company," "we," "our," and "us" refer to 1st Constitution Bancorp and its wholly-owned subsidiaries, unless we indicate otherwise.

Forward-Looking Statements

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

Factors that may cause actual results to differ from those results expressed or implied, include, but are not limited to, those listed under “Business”, “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017, which was filed with the SEC on March 19, 2018, such as the overall economy and the interest rate environment; the ability of customers to repay their obligations; the adequacy of the allowance for loan losses; competition; significant changes in accounting, tax or regulatory practices and requirements; certain interest rate risks; risks associated with investments in mortgage-backed securities; risks associated with speculative construction lending; and risks associated with safeguarding information technology systems. Other risks and uncertainties that could cause actual results to differ from those described above include, but are not limited to, the inability to retain NJCB’s customers and employees.

Although management has taken certain steps to mitigate any negative effect of the aforementioned items, significant unfavorable changes could severely impact the assumptions used and could have an adverse effect on profitability. The Company undertakes no obligation to publicly revise any forward-looking statements to reflect anticipated or unanticipated events or circumstances occurring after the date of such statements, except as required by law.

RESULTS OF OPERATIONS

Three and Nine Months Ended September 30, 2018 Compared to Three and Nine Months Ended September 30, 2017

Summary

The Company reported net income of \$4.0 million and diluted earnings per share of \$0.46 for the three months ended September 30, 2018 compared to \$2.5 million, or \$0.30 per diluted share, for the three months ended September 30, 2017.

For the nine months ended September 30, 2018, the Company reported net income of \$8.7 million, or \$1.02 per diluted share, compared to net income of \$6.4 million, or \$0.76 per diluted share, for the nine months ended September 30, 2017.

Return on average assets and return on average equity were 1.34% and 12.89%, respectively, for the three months ended September 30, 2018 compared to return on average assets and return on average equity of 0.94% and 8.94%, respectively, for the three months ended September 30, 2017. Return on average assets and return on average equity were 1.03% and 9.94%, respectively, for the nine months ended September 30, 2018 compared to return on average assets and return on average equity of 0.83% and 7.87%, respectively, for the nine months ended September 30, 2017. Book value and tangible book value per share were \$14.73 and \$13.26, respectively, at September 30, 2018 compared

to \$13.81 and \$12.27, respectively, at December 31, 2017.

On April 11, 2018, the Company completed the merger of NJCB with and into the Bank (the “NJCB merger”). As a result of the NJCB merger, merger related expenses of \$2.1 million were incurred primarily in the second quarter of 2018 and the after-tax effect of the merger expenses reduced net income for the nine months ended September 30, 2018 by \$1.6 million. The acquisition method of accounting for the business combination resulted in the recognition of a gain from the bargain purchase of \$184,000 and no goodwill.

For the nine months ended September 30, 2018, net income was \$8.7 million and Adjusted Net Income, which is net income excluding the after-tax effect of the merger expenses and the gain from the bargain purchase, was \$10.1 million compared to net income of \$6.4 million for the nine months ended September 30, 2017. There were no merger related expenses incurred for the three and nine months ended September 30, 2017. For the nine months ended September 30, 2018, diluted earnings per share were \$1.02 and Adjusted Net Income per diluted share was \$1.18 compared to diluted earnings per share of \$0.76 for the nine months ended September 30, 2017.

38

Adjusted Net Income, Adjusted Net Income per diluted share, adjusted return on average assets and adjusted return on average equity are non-U.S. GAAP financial measures. These non-U.S. GAAP financial measures should be considered in addition to, but not as a substitute for, the Company's U.S. GAAP financial results. A reconciliation of these non-U.S. GAAP financial measures to the U.S. GAAP financial results is set forth below. Management believes that the presentation of these non-U.S. GAAP financial measures of the Company may be helpful to readers in understanding the Company's financial performance without including the financial impact of the NJCB merger when comparing the Company's income statement for the three and nine-month periods ended September 30, 2018 and 2017.

The following table reflects the reconciliation of non-U.S. GAAP measures for the three and nine months ended September 30, 2018 and 2017:

(Dollars in thousands, except per share data)	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Adjusted Net Income				
Net income	\$4,011	\$2,485	\$8,735	\$6,353
Adjustments:				
Merger-related expenses	—	—	2,141	—
Gain from bargain purchase	—	—	(184)	—
Income tax effect of adjustments ⁽¹⁾	—	—	(568)	—
Adjusted Net Income ⁽²⁾	\$4,011	\$2,485	\$10,124	\$6,353
Adjusted Net Income per diluted share				
Adjusted net income			\$10,124	\$6,353
Diluted shares outstanding			8,565,401	8,309,363
Adjusted Net Income per diluted share			\$1.18	\$0.76
Adjusted return on average assets				
Adjusted Net Income			\$10,124	\$6,353
Average assets			1,132,045	1,021,645
Adjusted return on average assets			1.20	% 0.83 %
Adjusted return on average equity				
Adjusted net income			\$10,124	\$6,353
Average equity			117,484	107,871
Return on average equity			11.52	% 7.87 %
Book value and tangible book value per share				
Shareholders' equity			\$123,774	111,610
Less: goodwill and intangible assets			12,294	12,591
Tangible shareholders' equity			111,480	99,019
Shares outstanding			8,404,292	8,069,560
Book value per share			\$14.73	\$13.83
Tangible book value per share			\$13.26	\$12.27

(1) Tax effected at an income tax rate of 30.09%, less the impact of non-deductible merger expenses and the non-taxable gain from the bargain purchase.

(2) There were no non-U.S. GAAP adjustments for the three months ended September 30, 2018 and the three and nine-month periods ended September 30, 2017.

THIRD QUARTER 2018 HIGHLIGHTS

Return on average assets and return on average equity were 1.34% and 12.89%, respectively.

Book value per share and tangible book value per share were \$14.73 and \$13.26, respectively, at September 30, 2018.

Net interest income was \$11.4 million and the net interest margin was 4.09% on a tax equivalent basis.

A provision for loan losses of \$225,000 and net charge-offs of \$458,000 were recorded.

Total loans were \$881.5 million at September 30, 2018 and included \$68.9 million of loans acquired in the NJCB merger. Commercial business, commercial real estate and construction loans totaled \$626.6 million and included \$56.0 million of loans acquired in the NJCB merger. Excluding the loans acquired in the NJCB merger, commercial business, commercial real estate and construction loans totaled \$565.8 million and increased \$27.6 million, or 5.1%, compared to \$538.2 million at December 31, 2017 and increased \$52.8 million, or 10.3%, compared to \$513.0 million at September 30, 2017.

There were no merger related expenses incurred in the third quarter of 2018.

Non-performing assets were \$9.3 million, or 0.78% of assets, and included \$2.5 million of OREO at September 30, 2018.

Earnings Analysis

The Company's results of operations depend primarily on net interest income, which is primarily affected by the market interest rate environment, the shape of the U.S. Treasury yield curve and the difference between the yield on interest-earning assets and the rate paid on interest-bearing liabilities. Other factors that may affect the Company's operating results are general and local economic and competitive conditions, government policies and actions of regulatory authorities.

Net Interest Income

Net interest income, the Company's largest and most significant component of operating income, is the difference between interest and fees earned on loans and other earning assets and interest paid on deposits and borrowed funds. This component represented 84.1% of the Company's net revenues (defined as net interest income plus non-interest income) for the three months ended September 30, 2018 compared to 81.6% of net revenues for the three months ended September 30, 2017. Net interest income also depends upon the relative amount of average interest-earning assets, average interest-bearing liabilities and the interest rate earned or paid on them, respectively.

The following table sets forth the Company's consolidated average balances of assets and liabilities and shareholders' equity, as well as interest income and interest expense on related items, and the Company's average yield or rate for the three and nine months ended September 30, 2018 and 2017. The average rates are derived by dividing interest income and interest expense by the average balance of assets and liabilities, respectively.

(Dollars in thousands)	Three months ended September 30, 2018			Three months ended September 30, 2017		
	Average Balance	Interest	Average Yield	Average Balance	Interest	Average Yield
Assets:						
Interest-earning assets:						
Federal funds sold/short-term investments	\$ 11,953	\$ 36	1.19 %	\$ 12,383	\$ 25	0.80 %
Investment securities:						
Taxable	151,115	1,060	2.81	142,353	846	2.38
Tax-exempt ⁽¹⁾	73,621	625	3.40	89,034	781	3.51
Total investment securities	224,736	1,685	3.00	231,387	1,627	2.81
Loans: ⁽²⁾						
Commercial real estate	377,719	4,901	5.08	272,548	3,573	5.13
Mortgage warehouse lines	180,430	2,504	5.43	174,610	1,901	4.26
Construction	142,365	2,406	6.61	123,822	1,895	5.99
Commercial business	106,717	1,496	5.51	107,158	1,326	4.86
Residential real estate	46,777	530	4.53	42,436	445	4.19
Loans to individuals	24,655	306	4.92	22,379	228	4.04
Loans held for sale	3,203	38	4.75	3,715	37	3.98
All other loans	1,061	12	4.43	1,526	11	2.82
Total loans	882,927	12,193	5.41	748,194	9,416	4.93
Total interest-earning assets	1,119,616	\$ 13,914	4.88 %	991,964	\$ 11,068	4.39 %
Non-interest earning assets:						
Allowance for loan losses	(8,388)			(7,770)		
Cash and due from bank	5,767			5,371		
Other assets	70,527			59,328		
Total non-interest earning assets	67,906			56,929		
Total assets	\$ 1,187,522			\$ 1,048,893		
Liabilities and shareholders' equity:						
Interest-bearing liabilities:						
Money market and NOW accounts	\$ 338,783	\$ 499	0.58 %	\$ 324,940	\$ 358	0.44 %
Savings accounts	194,223	371	0.76	208,548	338	0.64
Certificates of deposit	230,490	984	1.69	158,737	508	1.27
Other borrowed funds	63,429	349	2.18	27,533	113	1.63
Redeemable subordinated debentures	18,557	184	3.97	18,557	134	2.89
Total interest-bearing liabilities	845,482	\$ 2,387	1.12 %	738,315	\$ 1,451	0.78 %
Non-interest bearing liabilities:						
Demand deposits	211,291			193,937		
Other liabilities	7,329			6,395		
Total non-interest bearing liabilities	218,620			200,332		
Shareholders' equity	123,420			110,246		
Total liabilities and shareholders' equity	\$ 1,187,522			\$ 1,048,893		
Net interest spread ⁽³⁾			3.76 %			3.61 %
Net interest income and net interest margin ⁽⁴⁾		\$ 11,527	4.09 %		\$ 9,617	3.85 %

(1) Tax equivalent basis, using federal tax rate of 21% in 2018 and 34% in 2017.

(2) Loan origination fees are considered an adjustment to interest income. For the purpose of calculating loan yields, average loan balances include non-accrual loans with no related interest income and the average balance of loans held for sale.

(3) The net interest spread is the difference between the average yield on interest-earning assets and the average rate paid on interest-bearing liabilities.

(4) The net interest margin is equal to net interest income divided by average interest-earning assets.

Edgar Filing: SCIENTIFIC GAMES CORP - Form 4

(Dollars in thousands)	Nine Months Ended September 30, 2018			Nine Months Ended September 30, 2017		
	Average Balance	Interest	Average Yield	Average Balance	Interest	Average Yield
Assets:						
Interest-earning assets:						
Federal funds sold/short-term investments	\$21,287	\$208	1.31 %	\$30,199	\$183	0.81 %
Investment securities:						
Taxable	146,003	2,915	2.66	141,662	2,500	2.35
Tax-exempt ⁽¹⁾	76,872	1,922	3.33	92,341	2,409	3.48
Total investment securities	222,875	4,837	2.89	234,003	4,909	2.79
Loans: ⁽²⁾						
Commercial real estate	349,423	13,391	5.05	253,793	10,088	5.24
Mortgage warehouse lines	157,422	6,318	5.35	155,755	5,014	4.29
Construction	135,049	6,548	6.48	111,436	4,817	5.78
Commercial business	110,101	4,391	5.33	109,335	4,006	4.90
Residential real estate	45,955	1,517	4.35	42,136	1,335	4.18
Loans to individuals	23,386	780	4.40	22,428	701	4.12
Loans held for sale	3,067	101	4.39	4,408	165	4.99
All other loans	1,132	32	3.73	1,828	35	2.52
Total loans	825,535	33,078	5.31	701,119	26,161	4.94
Total interest-earning assets	1,069,697	\$38,123	4.73 %	965,321	\$31,253	4.29 %
Non-interest earning assets:						
Allowance for loan losses	(8,295)			(7,646)		
Cash and due from bank	5,782			5,234		
Other assets	64,861			58,736		
Total non-interest earning assets	62,348			56,324		
Total assets	\$1,132,045			\$1,021,645		
Liabilities and shareholders' equity:						
Interest-bearing liabilities:						
Money market and NOW accounts	\$362,048	\$1,437	0.53 %	\$329,089	\$1,032	0.42 %
Savings accounts	208,780	1,079	0.69	210,056	992	0.63
Certificates of deposit	180,250	2,026	1.50	147,109	1,327	1.21
Other borrowed funds	36,407	576	2.12	20,494	349	2.28
Redeemable subordinated debentures	18,557	508	3.65	18,557	380	2.73
Total interest-bearing liabilities	806,042	\$5,626	0.93 %	725,305	\$4,080	0.75 %
Non-interest bearing liabilities:						
Demand deposits	199,953			181,892		
Other liabilities	8,566			6,577		
Total non-interest bearing liabilities	208,519			188,469		
Shareholders' equity	117,484			107,871		
Total liabilities and shareholders' equity	\$1,132,045			\$1,021,645		
Net interest spread ⁽³⁾			3.80 %			3.54 %
Net interest income and net interest margin ⁽⁴⁾		\$32,497	4.06 %		\$27,173	3.76 %

(1) Tax equivalent basis, using federal tax rate of 21% in 2018 and 34% in 2017.

(2) Loan origination fees are considered an adjustment to interest income. For the purpose of calculating loan yields, average loan balances include non-accrual loans with no related interest income and the average balance of loans held for sale.

Explanation of Responses:

(3) The net interest spread is the difference between the average yield on interest-earning assets and the average rate paid on interest-bearing liabilities.

(4) The net interest margin is equal to net interest income divided by average interest-earning assets.

42

Three months ended September 30, 2018 compared to three months ended September 30, 2017

Net interest income was \$11.4 million for the quarter ended September 30, 2018 and increased \$2.0 million, or 21.7%, compared to net interest income of \$9.4 million for the third quarter of 2017. The tax equivalent net interest margin was 4.09% for the third quarter of 2018 compared to 3.85% for the third quarter of 2017.

Total interest income was \$13.8 million for the three months ended September 30, 2018 compared to \$10.8 million for the three months ended September 30, 2017. This increase was due primarily to the \$134.7 million increase in average loans, reflecting growth primarily of commercial real estate, mortgage warehouse lines and construction loans. The growth of average loans also included average loans of approximately \$70.7 million from the NJCB merger.

Average interest-earning assets were \$1.12 billion and \$992.0 million for the third quarters of 2018 and 2017, respectively.

For the third quarters of 2018 and 2017, the tax-equivalent yield on interest-earning assets was 4.88% and 4.39%, respectively. The higher yield on average interest-earning assets for the third quarter of 2018 reflected primarily the higher yield earned on the loan portfolio. The 100 basis point increase in the Federal Reserve's targeted federal funds rate and the corresponding increase in the Prime Rate since September 2017 have had a positive effect on the yields of construction, commercial business, home equity and warehouse loans with variable interest rate terms for the third quarter of 2018.

Interest expense on average interest-bearing liabilities was \$2.4 million, with an interest cost of 1.12%, for the third quarter of 2018 compared to \$1.5 million, with an interest cost of 0.78%, for the third quarter of 2017. The \$936,000 increase in interest expense on interest-bearing liabilities for the third quarter of 2018 reflected primarily higher deposit interest costs due to higher short-term market interest rates in the third quarter of 2018 compared to the third quarter of 2017 and an increase of \$107.2 million in average interest-bearing liabilities. The increase in interest expense also reflects the increase in certificates of deposit and short-term borrowings, which generally have higher interest cost than other types of interest-bearing deposits.

Average interest-bearing liabilities increased \$107.2 million, or 14.5%, to \$845.5 million for the three months ended September 30, 2018 from \$738.3 million for the same three months of 2017 due primarily to increases in money market and NOW accounts, certificates of deposit and other borrowed funds. Money market and NOW accounts averaged \$338.8 million for the third quarter of 2018 compared to \$324.9 million for the third quarter of 2017, which represented an increase of \$13.8 million, or 4.3%. Average certificates of deposit increased \$71.8 million, or 45.2%, for the third quarter of 2018 compared to the third quarter of 2017. Average other borrowed funds increased \$35.9 million, or 130.4%, for the third quarter of 2018 compared to the same period of 2017. The majority of the growth in average interest-bearing deposits resulted from the NJCB merger. The increase in average other borrowed funds was primarily due to additional short-term borrowings to fund the organic growth in average loans.

The increase in average non-interest bearing demand deposits of \$17.4 million provided the Company with additional funding to support the organic growth in average loans.

The net interest margin, on a tax-equivalent basis, increased to 4.09% for the three months ended September 30, 2018 compared to 3.85% for the comparable period in 2017 due primarily to the higher yield on average interest-earning assets, which more than offset the increase in the average cost of interest-bearing liabilities. The higher tax-equivalent yield earned on average interest-earning assets reflected the growth of loans, the increase in loans as a percentage of earning assets and the higher interest rate environment in the third quarter of 2018 compared to the third quarter of 2017.

Nine Months Ended September 30, 2018 compared to Nine Months Ended September 30, 2017

For the nine months ended September 30, 2018, net interest income increased \$5.7 million, or 21.6%, to \$32.1 million compared to \$26.4 million for the comparable period in 2017. The tax equivalent net interest margin was 4.06% for the nine months ended September 30, 2018 compared to 3.76% for the nine months ended September 30, 2017.

Total interest income was \$37.7 million for the nine months ended September 30, 2018 compared to \$30.5 million for the nine months ended September 30, 2017. This increase was due primarily to the \$124.4 million increase in average loans, reflecting growth primarily of commercial real estate and construction loans. The growth of average loans also included average loans of approximately \$44.2 million from the NJCB merger.

Average interest-earning assets increased \$104.4 million to \$1.07 billion for the nine months ended September 30, 2018 compared to \$965.3 million for the same period in 2017. This increase was due primarily to the \$124.4 million increase in average loans, which was partially offset by a decline of \$8.9 million in average federal funds sold and a decline of \$11.1 million in average investment securities.

43

For the nine months ended September 30, 2018 and 2017, the tax-equivalent yield on interest-earning assets was 4.73% and 4.29%, respectively. The higher yield on average interest-earning assets for the nine months ended September 30, 2018 reflected primarily the higher yield earned on the loan portfolio. The 100 basis point increase in the Federal Reserve's targeted federal funds rate and the corresponding increase in the Prime Rate since September 2017 have had a positive effect on the yields of construction, commercial business, home equity and warehouse loans with variable interest rate terms for the first nine months of 2018.

Interest expense on average interest-bearing liabilities was \$5.6 million, with an interest cost of 0.93%, for the nine months ended September 30, 2018 compared to \$4.1 million, with an interest cost of 0.75%, for the same period in the prior year. The \$1.5 million increase in interest expense on interest-bearing liabilities reflected primarily higher deposit interest costs due to higher short-term market interest rates in the first nine months of 2018 compared to the same period in the prior year and an increase of \$80.7 million in average interest-bearing liabilities.

Average interest-bearing liabilities increased \$80.7 million, or 11.1%, to \$806.0 million for the nine months ended September 30, 2018 from \$725.3 million for the same nine months of 2017 due primarily to increases in money market and NOW accounts, certificates of deposit and other borrowed funds. The majority of the growth of average deposits resulted from the NJCB merger. The increase in average interest-bearing liabilities was used to partially fund the growth of average loans.

The increase in average non-interest bearing demand deposits of \$18.1 million provided the Company with additional funding to support the growth of average loans.

The net interest margin, on a tax-equivalent basis, increased to 4.06% for the nine months ended September 30, 2018 compared to 3.76% for the comparable period in 2017 due primarily to the higher yield on average interest-earning assets. The higher tax-equivalent yield earned on average interest-earning assets reflected the growth of loans, the increase in loans as a percentage of earning assets and the higher interest rate environment in the first nine months of 2018 compared to the same period in 2017.

Provision for Loan Losses

Management considers a complete review of the following specific factors in determining the provisions for loan losses: historical losses by loan category, the level of non-accrual loans and problem loans as identified through internal review and classification, collateral values and the growth, size and risk elements of the loan portfolio. In addition to these factors, management takes into consideration current economic conditions and local real estate market conditions.

In general, over the last five years, the Company experienced an improvement in loan credit quality and achieved a steady resolution of non-performing loans and assets related to the severe recession, which was reflected in the current level of non-performing loans at September 30, 2018. Net charge-offs of commercial business and commercial real estate loans in 2018 and 2017 have declined significantly from prior periods, which has resulted in a reduction of the historical loss factors for these segments of the loan portfolio that were applied by management to estimate the allowance for loan losses at September 30, 2018.

Three months ended September 30, 2018 compared to three months ended September 30, 2017

During the third quarter of 2018, the Company recorded a provision for loan losses of \$225,000, charge-offs of \$459,000 and recoveries of loans previously charged-off of \$1,000 compared to a provision for loan losses of

\$150,000, charge-offs of \$61,000 and recoveries of loans previously charged-off of \$6,000 recorded for the third quarter of 2017. The allowance for loan losses was \$8.3 million, or 0.94% of loans, at September 30, 2018 compared to \$7.8 million, or 1.01% of loans, at September 30, 2017. The increase in the allowance for loan losses was due primarily to the increase in loans and the change in the mix of loans from September 30, 2017 to September 30, 2018.

Management believes that the current economic conditions in New Jersey and surrounding areas and the current operating conditions for the Company are generally positive, which were considered in management's evaluation of the adequacy of the allowance for loan losses.

Nine Months Ended September 30, 2018 compared to Nine Months Ended September 30, 2017

For the nine months ended September 30, 2018, the Company recorded a provision for loan losses of \$675,000 compared to \$450,000 recorded for the first nine months of 2017. The provision for loan losses for the first nine months of 2018 reflected charge-offs of \$499,000 and recoveries of previously charged-off loans of \$76,000 compared to charge-offs of \$162,000 and recoveries of previously charged-off loans of \$20,000 for the nine months ended September 30, 2017. The higher provision for

loan losses recorded for the first nine months of 2018 was due primarily to the growth of commercial real estate, construction and commercial business loans and the change in the mix of loans in the loan portfolio.

Non-Interest Income

Three months ended September 30, 2018 compared to three months ended September 30, 2017

Total non-interest income was \$2.2 million for the third quarter of 2018, an increase of \$38,000, or 1.8%, compared to \$2.1 million for the third quarter of 2017. Other income increased \$47,000 due primarily to higher debit card interchange income and customer service fees, which more than offset a decline of \$37,000 in gain on sales of loans.

Gains on sales of loans was \$1.3 million for each of the third quarters of 2018 and 2017. The Company originates and sells commercial loans guaranteed by the Small Business Administration (“SBA”) and residential mortgage loans in the secondary market. SBA guaranteed commercial lending activity and loan sales vary from period to period. For the third quarter of 2018, \$7.6 million of SBA loans were sold and gains of \$590,000 were recorded compared to \$5.8 million of SBA loans sold and gains of \$520,000 recorded for the third quarter of 2017. Residential mortgage loans totaling \$25.0 million were sold and \$702,000 of gains were recorded for the third quarter of 2018 compared to \$28.9 million of residential mortgage loans sold and \$809,000 of gains recorded for the third quarter of 2017. Management believes that the lower amounts of residential mortgage loans sold and gains recorded for the third quarter of 2018 were due primarily to lower residential mortgage lending activity as a result of higher mortgage interest rates in 2018 compared to 2017.

Service charges on deposit accounts increased \$31,000 during the third quarter of 2018 compared to the third quarter of 2017 due primarily to deposit accounts acquired in the NJCB merger.

Non-interest income also includes income from BOLI, which was \$152,000 for the three months ended September 30, 2018 compared to \$131,000 for the three months ended September 30, 2017. The majority of the increase in income from BOLI was directly related to the increase of \$4.0 million in BOLI as a result of the NJCB merger.

Nine Months Ended September 30, 2018 compared to Nine Months Ended September 30, 2017

Total non-interest income was \$6.1 million for the nine months ended September 30, 2018, a decrease of \$203,000, or 3.2%, compared to \$6.3 million for the comparable period of 2017. The decrease was due primarily to the \$511,000 decline in gain on the sales of loans, which was partially offset by the \$184,000 gain from the bargain purchase related to the NJCB merger.

Gain on the sales of loans decreased \$511,000 to \$3.4 million for the nine months ended September 30, 2018 compared to \$3.9 million for the nine months ended September 30, 2017. The Bank sells commercial business loans guaranteed by the SBA and residential mortgage loans in the secondary market. For the nine months ended September 30, 2018, sales of SBA loans were \$15.8 million, which generated gain on sales of loans of \$1.4 million, compared to sales of SBA loans of \$11.8 million, which generated gain on sales of loans of \$1.1 million, for the nine months ended September 30, 2017.

For the nine months ended September 30, 2018, the Bank's residential mortgage banking operation sold \$69.7 million of residential mortgage loans, which generated gain on sales of loans of \$2.0 million. For the nine months ended September 30, 2017, the Bank's residential mortgage banking operation sold \$92.3 million of residential mortgage loans, which generated gain on sales of loans of \$2.8 million. Management believes the decrease in residential lending activity and gain on sales of loans was due to the lower volume of residential lending and loans sold in 2018 as a result of higher mortgage interest rates in 2018 compared to 2017.

The Bank also generates non-interest income from a variety of fee-based services. These include safe deposit box fees, wire transfer fees and automated teller machine fees for non-Bank customers. The other income component of non-interest income increased to \$1.6 million for the nine months ended September 30, 2018 compared to \$1.4 million for the nine months ended September 30, 2017. The increase in other income for the first nine months of 2018 was due primarily to higher debit card interchange fee income, customer service charges and SBA loan servicing income.

Non-Interest Expenses

For the three months ended September 30, 2018, non-interest expenses were \$7.9 million compared to \$7.6 million for the three months ended September 30, 2017, an increase of \$277,000, or 3.6%. For the nine months ended September 30, 2018, non-interest expenses were \$25.8 million compared to \$23.0 million for the same period in 2017. The increase in non-interest expenses during the third quarter of 2018 reflected primarily an increase in expenses related to the operations of the former NJCB, which was partially offset by a decline in regulatory, professional and consulting fees. The increase in non-interest expenses for the nine months ended September 30, 2018 were due primarily to merger related expenses of \$2.1 million and expenses related to the operations of the former NJCB.

The following table presents the major components of non-interest expenses for the three and nine months ended September 30, 2018 and 2017:

(Dollars in thousands)	Three months ended		Nine months ended September	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Salaries and employee benefits	\$4,900	\$4,617	\$14,714	\$13,882
Occupancy expense	907	865	2,604	2,604
Data processing expenses	331	338	1,009	983
Equipment expense	295	258	841	768
Marketing	52	42	231	182
Telephone	97	96	299	292
Regulatory, professional and consulting fees	413	625	1,369	1,762
Insurance	91	96	293	269
Supplies	65	68	231	193
FDIC insurance expense	105	95	381	255
Other real estate owned expenses	73	11	75	26
Merger-related expenses	—	—	2,141	—
Amortization of intangible assets	94	96	281	289
Other expenses	471	410	1,321	1,449
Total	\$7,894	\$7,617	\$25,790	\$22,954

Three months ended September 30, 2018 compared to three months ended September 30, 2017

Non-interest expenses were \$7.9 million for the third quarter of 2018, an increase of \$277,000, compared to \$7.6 million for the third quarter of 2017.

Salaries and employee benefits, which represent the largest portion of non-interest expenses, increased by \$283,000, or 6.1%, to \$4.9 million for the three months ended September 30, 2018 compared to \$4.6 million for the three months ended September 30, 2017. The increase in salaries and employee benefits was due primarily to salaries for former NJCB employees who joined the Company, merit increases and increases in employee benefits expenses.

Occupancy expense increased by \$42,000 to \$907,000 for the third quarter of 2018 compared to \$865,000 for the same quarter in 2017 due primarily to the addition of the two former NJCB branch offices in the second quarter of 2018.

Regulatory, professional and consulting fees decreased \$212,000, or 33.9%, to \$413,000 for the three months ended September 30, 2018 from \$625,000 for the same period of 2017 due primarily to lower legal and consulting fees related to loan collections and litigation expenses.

FDIC insurance expense increased modestly for the three months ended September 30, 2018 compared to the same period of 2017 due to the internal growth of assets and the increase in assets as a result of the NJCB merger.

Other operating expenses increased \$61,000 for the three months ended September 30, 2018 compared to the same period of 2017 due primarily to increases in postage and business development expenses.

Nine Months Ended September 30, 2018 compared to Nine Months Ended September 30, 2017

Non-interest expenses were \$25.8 million for the nine months ended September 30, 2018 and increased \$2.8 million, or 12.4%, compared to \$23.0 million for the nine months ended September 30, 2017.

Salaries and employee benefits, which represent the largest portion of non-interest expenses, increased by \$832,000, or 6.0%, to \$14.7 million for the nine months ended September 30, 2018 compared to \$13.9 million for the nine months ended September 30, 2017. The increase in salaries and employee benefits was due primarily to salaries for former NJCB employees who joined the Company, merit increases and increases in employee benefits expenses.

Data processing expenses increased \$26,000 to \$1.0 million for the nine months ended September 30, 2018 compared to \$983,000 for the same period in 2017 as a result of separate NJCB data processing costs incurred from the date of the merger through the date of the core operating system conversion on June 15, 2018.

Marketing expenses were \$231,000 for the nine months ended September 30, 2018, an increase of \$49,000 compared with \$182,000 for the same period of 2017. The majority of the increase was directly related to marketing of the Bank's products and services to the former customers of NJCB.

Regulatory, professional and consulting fees decreased \$393,000, or 22.3%, to \$1.4 million for the nine months ended September 30, 2018 from \$1.8 million for the same period of 2017 due primarily to lower legal and consulting fees related to loan collections and litigation expenses.

Supplies increased \$38,000 to \$231,000 for the nine months ended September 30, 2018 compared to \$193,000 for the same period in 2017. The majority of the increase was related to the NJCB merger.

FDIC insurance expense increased \$126,000, or 49.4%, for the nine months ended September 30, 2018 compared to the same period of 2017 due primarily to the internal growth of assets and the increase in assets as a result of the NJCB merger.

Merger expenses of \$2.1 million related to the NJCB merger were incurred in the first nine months of 2018.

The Company recorded other expenses of \$1.3 million for the nine months ended September 30, 2018, a decrease of \$128,000 compared to \$1.4 million for the nine months ended September 30, 2017. The decrease in other expenses was due primarily to the absence in the 2018 period of any write-off of deferred loan origination costs, which were approximately \$500,000 for the first nine months of 2017.

Income Taxes

Three months ended September 30, 2018 compared to three months ended September 30, 2017

Income tax expense was \$1.4 million for the third quarter of 2018, resulting in an effective tax rate of 26.2%, compared to income tax expense of \$1.2 million for the third quarter of 2017, which resulted in an effective tax rate of 33.1%. The decline in income tax expense and the effective tax rate for the third quarter of 2018 was due principally to the enactment of the Tax Cuts and Jobs Act ("Tax Act") in December 2017, which reduced the maximum federal corporate income tax rate from 35% to 21% effective January 1, 2018. Partially offsetting the lower federal corporate income tax rate was the enactment of legislation by the State of New Jersey in July 2018, which increased the corporate income tax rate to 11.5% from 9% for taxable income of \$1.0 million or more effective January 1, 2018 and resulted in a 2% higher effective tax rate for the third quarter of 2018.

Nine Months Ended September 30, 2018 compared to Nine Months Ended September 30, 2017

Income tax expense was \$3.0 million for the nine months ended September 30, 2018, resulting in an effective tax rate of 25.4%, compared to income tax expense of \$2.9 million for the comparable period in 2017, which resulted in an effective tax rate of 31.5%. The decline in the effective tax rate for the first nine months of 2018 was due principally to the enactment of the Tax Act in December 2017, which reduced the maximum federal corporate income tax rate from 35% to 21% effective January 1, 2018. Partially offsetting the lower federal corporate income tax rate was the enactment of legislation by the State of New Jersey in July 2018, which increased the corporate income tax rate to 11.5% from 9% for taxable income of \$1.0 million or more effective January 1, 2018 and resulted in a 2% higher effective tax rate for the first nine months of 2018.

47

Financial Condition

September 30, 2018 Compared with December 31, 2017

Total consolidated assets were \$1.2 billion at September 30, 2018 and increased \$113.2 million from total consolidated assets of \$1.08 billion at December 31, 2017 due primarily to a \$91.6 million increase in total loans and an increase of \$6.8 million in investment securities. In general, the increase in assets was funded primarily by a \$19.7 million increase in deposits and a \$79.0 million increase in overnight borrowings. The NJCB merger contributed approximately \$83.8 million to the increase in assets at September 30, 2018.

Cash and Cash Equivalents

Cash and cash equivalents totaled \$19.3 million at September 30, 2018 compared to \$18.8 million at December 31, 2017, an increase of \$510,000. To the extent that the Bank does not utilize funds for loan originations or securities purchases, the cash is invested in overnight deposits at the Federal Reserve Bank of New York.

Loans Held for Sale

Loans held for sale were \$4.4 million at September 30, 2018 compared to \$4.3 million at December 31, 2017. The amount of loans held for sale varies from period to period due to changes in the amount and timing of sales of residential mortgage loans and SBA guaranteed commercial loans.

Investment Securities

Investment securities represented approximately 18.7% of total assets at September 30, 2018 and approximately 20.0% of total assets at December 31, 2017. Total investment securities increased \$6.8 million to \$222.6 million at September 30, 2018 from \$215.7 million at December 31, 2017. Purchases of investment securities totaled \$33.0 million during the nine months ended September 30, 2018, and proceeds from sales, calls, maturities and payments totaled \$34.9 million during this same period.

Securities available for sale are investments that may be sold in response to changing market and interest rate conditions or for other business purposes. Activity in this portfolio is undertaken primarily to manage liquidity and interest rate risk and to take advantage of market conditions that create economically attractive returns. At September 30, 2018, securities available for sale were \$131.2 million, an increase of \$25.7 million, or 24.4%, compared to securities available for sale of \$105.5 million at December 31, 2017.

At September 30, 2018, the securities available for sale portfolio had net unrealized losses of \$2.6 million compared to net unrealized losses of \$571,000 at December 31, 2017. These net unrealized losses were reflected, net of tax, in shareholders' equity as a component of accumulated other comprehensive loss. The increase in the net unrealized loss in the first nine months of 2018 was due principally to the increase in market interest rates during the period.

Securities held to maturity, which are carried at amortized historical cost, are investments for which there is the positive intent and ability to hold to maturity. At September 30, 2018, securities held to maturity were \$91.4 million, a decrease of \$18.9 million from \$110.3 million at December 31, 2017. The fair value of the held to maturity portfolio was \$91.2 million at September 30, 2018.

Loans

The loan portfolio, which represents the Company's largest asset, is a significant source of both interest and fee income. Elements of the loan portfolio are subject to differing levels of credit and interest rate risk. The Company's primary lending focus continues to be the financing of mortgage warehouse lines, construction loans, commercial business loans, owner-occupied commercial mortgage loans and commercial real estate loans on income-producing assets.

48

The following table represents the components of the loan portfolio at September 30, 2018 and December 31, 2017:

(Dollars in thousands)	September 30, 2018		December 31, 2017	
	Amount	%	Amount	%
Commercial real estate	\$376,003	43 %	\$308,924	39 %
Mortgage warehouse lines	182,791	21	189,412	24
Construction loans	144,601	16	136,412	17
Commercial business	105,996	12	92,906	12
Residential real estate	47,565	5	40,494	5
Loans to individuals	24,073	3	21,025	3
All other	174	—	183	—
Total loans	881,203	100%	789,356	100%
Deferred loan costs, net	335		550	
Total loans, including deferred loan costs, net	\$881,538		\$789,906	

Total loans increased by \$91.6 million, or 11.6%, to \$881.5 million at September 30, 2018 compared to \$789.9 million at December 31, 2017 due, in part, to an increase of \$67.1 million in commercial real estate loans, an \$8.2 million increase in construction loans and a \$13.1 million increase in commercial business loans, which more than offset a decline of \$6.6 million in mortgage warehouse lines. The NJCB merger contributed \$68.9 million to the increase in loans at September 30, 2018.

Mortgage warehouse lines' outstanding balances decreased \$6.6 million to \$182.8 million at September 30, 2018 compared to \$189.4 million at December 31, 2017, reflecting a decreased level of residential mortgage originations by the Bank's mortgage banking customers that was due primarily to the increase in residential mortgage interest rates, which reduced the level of mortgage refinancing activity.

The Bank's mortgage warehouse funding group provides revolving lines of credit that are available to licensed mortgage banking companies. The warehouse line of credit is used by the mortgage banker to finance the origination of one-to-four family residential mortgage loans that are pre-sold to the secondary mortgage market, which includes state and national banks, national mortgage banking firms, insurance companies and government-sponsored enterprises, including the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association. On average, an advance under the warehouse line of credit remains outstanding for a period of less than 30 days, with repayment coming directly from the sale of the loan into the secondary mortgage market. The Bank collects interest and a transaction fee at the time of repayment. The Bank funded \$2.6 billion of residential mortgages through customers' warehouse lines of credit during the first nine months of 2018 compared to \$2.6 billion during the first nine months of 2017.

Commercial business loans increased \$13.1 million, or 14.1%, to \$106.0 million at September 30, 2018 from \$92.9 million at December 31, 2017. Commercial business loans consist primarily of loans to small and middle market businesses and are typically working capital loans used to finance inventory, receivables or equipment needs. Business assets of the commercial borrower are generally pledged as collateral for these loans.

Commercial real estate loans increased \$67.1 million, or 21.7%, to \$376.0 million at September 30, 2018 from \$308.9 million at December 31, 2017. Commercial real estate loans consist primarily of loans to businesses collateralized by real estate employed in the business and loans to finance investor owned income-producing properties.

Construction loans totaled \$144.6 million at September 30, 2018 compared to \$136.4 million at December 31, 2017. Construction financing is provided to businesses to expand their facilities and operations and to real estate developers for the acquisition, development and construction of residential properties and income-producing properties. First mortgage construction loans are made to developers and builders for single family homes or multi-family buildings

that are presold or are to be sold or leased on a speculative basis. The Bank lends to developers and builders with established relationships, successful operating histories and sound financial resources.

The Bank also finances the construction of individual, owner-occupied single-family homes. These loans are made to qualified individual borrowers and are generally supported by a take-out commitment from a permanent lender.

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

Non-Performing Assets

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

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

At September 30, 2018, non-performing loans decreased by \$353,000 to \$6.8 million from \$7.1 million at December 31, 2017 and the ratio of non-performing loans to total loans decreased to 0.77% at September 30, 2018 compared to 0.90% at December 31, 2017. During the first nine months of 2018, \$2.2 million of non-performing loans were resolved and \$2.5 million of loans were placed on non-accrual. In the first quarter of 2017, the Bank was notified that a shared national credit syndicated loan in which it was a participant in a \$4.3 million facility had further deteriorated. As of the date of notification, the Bank downgraded the loan, which had a balance of \$4.0 million at that time, and placed it on non-accrual. In the first quarter of 2018, the Bank was notified by federal bank regulators that this loan had been upgraded from doubtful to substandard. The balance of this loan was \$2.9 million at September 30, 2018.

The major segments of non-accrual loans consist of commercial business, commercial real estate and residential real estate loans, which are in the process of collection. The table below sets forth non-performing assets and risk elements in the Bank's portfolio for the periods indicated.

(Dollars in thousands)	September 30, 2018	December 31, 2017		
Non-performing loans:				
Loans 90 days or more past due and still accruing	\$ —	\$ —		
Non-accrual loans	6,761	7,114		
Total non-performing loans	6,761	7,114		
Other real estate owned	2,515	—		
Total non-performing assets	9,276	7,114		
Performing troubled debt restructurings	4,018	3,728		
Performing troubled debt restructurings and total non-performing assets	\$ 13,294	\$ 10,842		
Non-performing loans to total loans	0.77	%	0.90	%
Non-performing loans to total loans excluding mortgage warehouse lines	0.97	%	1.18	%
Non-performing assets to total assets	0.78	%	0.66	%
Non-performing assets to total assets excluding mortgage warehouse lines	0.92	%	0.80	%
Total non-performing assets and performing troubled debt restructurings to total assets	1.11	%	1.00	%
Non-performing loans to total loans decreased to 0.77% at September 30, 2018 from 0.90% at December 31, 2017 due primarily to the increase in loans. Non-performing assets represented 0.78% of total assets at September 30, 2018 compared to 0.66% of total assets at December 31, 2017.				

Non-performing assets increased by \$2.2 million to \$9.3 million at September 30, 2018 from \$7.1 million at December 31, 2017. In addition to the increase in non-performing loans, OREO increased \$2.5 million from December 31, 2017 to September 30, 2018. OREO at September 30, 2018 was comprised of one residential property with a carrying value of \$1.1 million acquired in the NJCB merger, land with a carrying value of \$93,000 and a commercial real estate property that was foreclosed in the third quarter of 2018 with a fair value of \$1.3 million. There was no OREO at December 31, 2017.

At September 30, 2018, the Bank had twelve loans totaling \$7.3 million that were troubled debt restructurings. Four of these loans totaling \$3.3 million are included in the above table as non-accrual loans and the remaining eight loans totaling \$4.0 million were performing. At December 31, 2017, the Bank had ten loans totaling \$5.5 million that were troubled debt restructurings. Two of

these loans totaling \$1.8 million are included in the above table as non-accrual loans and the remaining eight loans totaling \$3.7 million were performing.

In accordance with U.S. GAAP, the excess of cash flows expected at acquisition over the initial investment in the purchase of a credit impaired loan is recognized as interest income over the life of the loan. At September 30, 2018, there was one purchased credit impaired loan for \$506,000 that was not classified as a non-performing loan. At December 31, 2017, there were no loans acquired with evidence of deteriorated credit quality that were not classified as non-performing loans.

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

In most cases, the Company's collateral is real estate. If the collateral is foreclosed upon, the real estate is carried at fair market value less the estimated selling costs. The amount, if any, by which the recorded amount of the loan exceeds the fair market value of the collateral, less estimated selling costs, is a loss that is charged to the allowance for loan losses at the time of foreclosure or repossession. Resolution of a past-due loan through foreclosure can be delayed if the borrower files a bankruptcy petition because a collection action cannot be continued unless the Company first obtains relief from the automatic stay provided by the United States Bankruptcy Reform Act of 1978, as amended.

Allowance for Loan Losses and Related Provision

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

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

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

Management reviews the adequacy of the allowance on at least a quarterly basis to ensure that the provision for loan losses has been charged against earnings in an amount necessary to maintain the allowance at a level that is adequate based on management's assessment of probable estimated losses. The Company's methodology for assessing the adequacy of the allowance for loan losses consists of several key elements and is consistent with U.S. GAAP and interagency supervisory guidance. The allowance for loan losses methodology consists of two major components. The first component is an estimation of losses associated with individually identified impaired loans,

which follows ASC Topic 310. The second major component is an estimation of losses under ASC Topic 450, which provides guidance for estimating losses on groups of loans with similar risk characteristics. The Company's methodology results in an allowance for loan losses that includes a specific reserve for impaired loans, an allocated reserve and an unallocated portion.

51

When analyzing groups of loans, the Company follows the Interagency Policy Statement on the Allowance for Loan and Lease Losses. The methodology considers the Company's historical loss experience adjusted for changes in trends, conditions and other relevant factors that affect repayment of the loans as of the evaluation date. These adjustment factors, known as qualitative factors, include:

- Delinquencies and non-accruals;
- Portfolio quality;
- Concentration of credit;
- Trends in volume of loans;
- Quality of collateral;
- Policy and procedures;
- Experience, ability and depth of management;
- Economic trends - national and local; and
- External factors - competition, legal and regulatory.

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

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

The specific allowance for impaired loans is established for specific loans that have been identified by management as being impaired. These loans are considered to be impaired primarily because the loans have not performed according to payment terms and there is reason to believe that repayment of the loan principal in whole, or in part, is unlikely. The specific portion of the allowance is the total amount of potential unconfirmed losses for these individual impaired loans. To assist in determining the fair value of loan collateral, the Company often utilizes independent third-party qualified appraisal firms, which employ their own criteria and assumptions that may include occupancy rates, rental rates and property expenses, among others.

The second category of reserves consists of the allocated portion of the allowance. The allocated portion of the allowance is determined by taking pools of outstanding loans that have similar characteristics and applying historical loss experience for each pool. This estimate represents the potential unconfirmed losses within the portfolio.

Individual loan pools are created for commercial business loans, commercial real estate loans, construction loans, warehouse lines of credit and various types of loans to individuals. The historical estimation for each loan pool is then adjusted to account for current conditions, current loan portfolio performance, loan policy or management changes or any other qualitative factor that may cause future losses to deviate from historical levels.

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

The following discusses the risk characteristics of each of our loan portfolios.

Commercial Business

The Company offers a variety of commercial loan services, including term loans, lines of credit and loans secured by equipment and receivables. A broad range of short-to-medium term commercial loans, both secured and unsecured, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition and development of real estate and improvements) and the purchase of equipment and machinery. Commercial business loans are granted based on the borrower's ability to generate cash flow to support its debt obligations and other cash related expenses. A borrower's ability to repay commercial business loans is substantially dependent on the success of the business itself and on the quality of its management. As a general practice, the Company takes, as collateral, a security interest in any available real estate, equipment, inventory, receivables or other personal property of its borrowers, although the Company occasionally makes commercial business loans on an unsecured basis. Generally, the Company requires personal guarantees of its commercial business loans to offset the risks associated with such loans.

Much of the Company's lending is in northern and central New Jersey. As a result of this geographic concentration, a significant broad-based deterioration in economic conditions in the New Jersey and the New York City metropolitan area could have a material adverse impact on the Company's loan portfolio. A prolonged decline in economic conditions in our market area could restrict borrowers' ability to pay outstanding principal and interest on loans when due. The value of assets pledged as collateral may decline and the proceeds from the sale or liquidation of these assets may not be sufficient to repay the loan.

Commercial Real Estate

Commercial real estate loans are made to businesses to expand their facilities and operations and to real estate operators to finance the acquisition of income producing properties. The Company's loan policy requires that borrowers have sufficient cash flow to meet the debt service requirements and the value of the property meets the loan-to-value criteria set in the loan policy. The Company monitors loan concentrations by borrower, by type of property and by location and other criteria.

The Company's commercial real estate portfolio is largely secured by real estate collateral located in the State of New Jersey. Conditions in the real estate markets in which the collateral for the Company's loans are located strongly influence the level of the Company's non-performing loans. A decline in the New Jersey real estate market could adversely affect the Company's loan portfolio. Decreases in local real estate values would adversely affect the value of property used as collateral for the Company's loans. Adverse changes in the economy also may have a negative effect on the ability of our borrowers to make timely repayments of their loans.

Construction Financing

Construction financing is provided to businesses to expand their facilities and operations and to real estate developers for the acquisition, development and construction of residential and commercial properties. First mortgage construction loans are made to developers and builders primarily for single family homes and multi-family buildings that are presold or are to be sold or leased on a speculative basis.

The Company lends to builders and developers with established relationships, successful operating histories and sound financial resources. Management has established underwriting and monitoring criteria to minimize the inherent risks of real estate construction lending. The risks associated with speculative construction lending include the borrower's

inability to complete the construction process on time and within budget, the sale or rental of the project within projected absorption periods and the economic risks associated with real estate collateral. Such loans may include financing the development and/or construction of residential subdivisions. This activity may involve financing land purchases and infrastructure development (i.e., roads, utilities, etc.) as well as construction of residences or multi-family dwellings for subsequent sale by the developer/builder. Because the sale or rental of developed properties is integral to the success of developer business, loan repayment may be especially subject to the volatility of real estate market values.

Mortgage Warehouse Lines of Credit

The Company's mortgage warehouse funding group provides revolving lines of credit that are available to licensed mortgage banking companies. The warehouse line of credit is used by the mortgage banker to originate one-to-four family residential mortgage loans that are pre-sold to the secondary mortgage market, which includes state and national banks, national mortgage banking firms, insurance companies and government-sponsored enterprises, including the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association. On average, an advance under

the warehouse line of credit remains outstanding for a period of less than 30 days, with repayment coming directly from the sale of the loan into the secondary mortgage market. Interest and a transaction fee are collected by the Company at the time of repayment.

As a separate class of the total loan portfolio, the warehouse loan portfolio is individually analyzed as a whole for allowance for loan losses purposes. Warehouse lines of credit are subject to the same inherent risks as other commercial lending, but the overall degree of risk differs. While the Company's loss experience with this type of lending has been non-existent since the product was introduced in 2008, there are other risks unique to this lending that still must be considered in assessing the adequacy of the allowance for loan losses. These unique risks may include, but are not limited to, (i) credit risks relating to the mortgage bankers that borrow from us, (ii) the risk of intentional misrepresentation or fraud by any of such mortgage bankers, (iii) changes in the market value of mortgage loans originated by the mortgage banker, the sale of which is the expected source of repayment of the borrowings under a warehouse line of credit, due to changes in interest rates during the time in warehouse or (iv) unsalable or impaired mortgage loans so originated, which could lead to decreased collateral value and the failure of a purchaser of the mortgage loan to purchase the loan from the mortgage banker.

Consumer

The Company's consumer loan portfolio is comprised of residential real estate loans, home equity loans and other loans to individuals. Individual loan pools are created for the various types of loans to individuals. The principal risk is that the borrower becomes unemployed or has a significant reduction in income.

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

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

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

Edgar Filing: SCIENTIFIC GAMES CORP - Form 4

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

(Dollars in thousands)	Nine months ended	Year ended	Nine months ended
	September 30, 2018	December 31, 2017	September 30, 2017
Balance, beginning of period	\$ 8,013	\$ 7,494	\$ 7,494
Provision charged to operating expenses	675	600	450
Loans charged off:			
Residential real estate loans	—	(101)	(101)
Commercial business and commercial real estate	(473)	(61)	(61)
Loans to individuals	(7)	—	—
All other loans	(19)	—	—
Total loans charged off	(499)	(162)	(162)
Recoveries:			
Commercial business and commercial real estate	75	64	16
Loans to individuals	1	4	4
All other loans	—	13	—
Total recoveries	76	81	20
Net charge offs	(423)	(81)	(142)
Balance, end of period	\$ 8,265	\$ 8,013	\$ 7,802
Loans:			
At period end	\$ 881,538	\$ 789,906	\$ 771,982
Average during the period	825,535	717,010	701,119
Net (charge offs) recoveries to average loans outstanding	(0.05)%	(0.01)%	(0.02)%
Net (charge offs) recoveries to average loans outstanding, excluding mortgage warehouse loans	(0.06)%	(0.01)%	(0.03)%
Allowance for loan losses to:			
Total loans at period end	0.94 %	1.01 %	1.01 %
Total loans at period end excluding mortgage warehouse loans	1.06 %	1.19 %	1.20 %
Non-performing loans	122.25 %	112.64 %	119.83 %

The following table represents the allocation of the allowance for loan losses (“ALL”) among the various categories of loans and certain other information as of September 30, 2018 and December 31, 2017, respectively. The total allowance is available to absorb losses from any portfolio of loans.

(Dollars in thousands)	September 30, 2018				December 31, 2017			
	Amount	As a % of Loan Class	Loans % of Loans		Amount	As a % of Loan Class	Loans % of Loans	
Commercial real estate loans	\$3,357	0.89%	43 %		\$2,949	0.95%	39 %	
Commercial Business	1,687	1.59	12		1,720	1.85	12	
Construction loans	1,721	1.19	16		1,703	1.25	17	
Residential real estate loans	367	0.77	5		392	0.97	5	
Loans to individuals	156	0.65	3		114	0.54	3	
Subtotal	7,288	1.04	79		6,878	1.15	76	

Explanation of Responses:

Edgar Filing: SCIENTIFIC GAMES CORP - Form 4

Mortgage warehouse lines	832	0.46	21	852	0.45	24
Unallocated reserves	145	—	—	283	—	—
Total	\$8,265	0.94%	100%	\$8,013	1.01%	100%

55

During the first nine months of 2018, the Company recorded a provision for loan losses of \$675,000, charge-offs of \$499,000 and recoveries of loans previously charged-off of \$76,000 compared to a provision for loan losses of \$450,000, charge-offs of \$162,000 and recoveries of loans previously charged-off of \$20,000 recorded for the first nine months of 2017. For the three and nine months ended September 30, 2018, \$441,000 of the charge-offs was related to the foreclosure of one commercial real estate loan in the third quarter of 2018. The higher provision for loan losses recorded for the first nine months of 2018 was due primarily to the growth of commercial real estate loans and the change in the mix of loans in the loan portfolio.

At September 30, 2018, the allowance for loan losses was \$8.3 million, or 0.94% of loans, compared to \$8.0 million, or 1.01% of loans, at December 31, 2017 and \$7.8 million, or 1.01% of loans, at September 30, 2017. The allowance for loan losses was 122% of non-performing loans at September 30, 2018 compared to 113% of non-performing loans at December 31, 2017 and 120% of non-performing loans at September 30, 2017. The decrease in the allowance as a percentage of loans was due primarily to acquisition accounting for the NJCB merger, which resulted in the NJCB loans being recorded at their fair value and included a credit risk adjustment discount of approximately \$1.6 million.

Management believes that the quality of the loan portfolio remains sound, considering the economic climate in the State of New Jersey and the New York City metropolitan area and that the allowance for loan losses is adequate in relation to credit risk exposure levels and the estimated incurred and inherent losses in the loan portfolio.

Deposits

Deposits, which include demand deposits (interest bearing and non-interest bearing), savings deposits and time deposits, are a fundamental and cost-effective source of funding. The flow of deposits is influenced significantly by general economic conditions, changes in market interest rates and competition. The Company offers a variety of products designed to attract and retain customers, with the Company's primary focus on the building and expanding of long-term relationships.

The following table summarizes deposits at September 30, 2018 and December 31, 2017:

(Dollars in thousands)	September 30, 2018	December 31, 2017
Demand		
Non-interest bearing	\$ 211,492	\$ 196,509
Interest bearing	334,552	372,133
Savings	189,747	215,197
Certificates of deposit	205,886	138,167
Total	\$ 941,677	\$ 922,006

At September 30, 2018, total deposits were \$941.7 million, an increase of \$19.7 million, or 2.1%, from \$922.0 million at December 31, 2017. The NJCB merger contributed \$82.7 million of deposits at September 30, 2018. Total deposits, excluding the NJCB deposits, declined \$63.0 million during the first nine months of 2018. Municipal deposits, primarily interest bearing demand deposits and savings deposits, declined approximately \$43.2 million from the end of 2017. As a result of the Tax Act, a number of the Bank's municipal customers experienced significant advance payments in December 2017 for real estate taxes that were due in 2018. This was due to income tax planning considerations by individuals. As the Bank's municipal customers expended these additional funds in the first nine months of 2018, their deposit balances declined from the levels at December 31, 2017. Management believes that the Bank's liquidity resources are adequate to meet any future outflow of deposits. The balance of the outflow of interest bearing demand deposits and savings deposits was due to the routine movement of customers' funds.

Borrowings

Borrowings are mainly comprised of Federal Home Loan Bank (“FHLB”) borrowings and overnight funds purchased. These borrowings are primarily used to fund asset growth not supported by deposit generation. At September 30, 2018, the Company had \$99.5 million of short-term borrowings from the FHLB compared to \$20.5 million of short-term borrowings from the FHLB at December 31, 2017.

56

Liquidity

At September 30, 2018, the amount of liquid assets and the Bank's access to off-balance sheet liquidity remained at a level management deemed adequate to ensure that contractual liabilities, depositors' withdrawal requirements and other operational and customer credit needs could be satisfied.

Liquidity management refers to the Company's ability to support asset growth while satisfying the borrowing needs and deposit withdrawal requirements of customers. In addition to maintaining liquid assets, factors such as capital position, profitability, asset quality and availability of funding affect a bank's ability to meet its liquidity needs. On the asset side, liquid funds are maintained in the form of cash and cash equivalents, federal funds sold, investment securities held to maturity maturing within one year, securities available for sale and loans held for sale. Additional asset-based liquidity is derived from scheduled loan repayments as well as investment repayments of principal and interest. Investment securities and loans may also be pledged to the FHLB to collateralize additional borrowings. On the liability side, the primary source of liquidity is the ability to generate core deposits. Long-term and short-term borrowings are used as supplemental funding sources when growth in the core deposit base does not keep pace with that of interest-earning assets.

The Bank has established a borrowing relationship with the FHLB that further supports and enhances liquidity. The FHLB provides member banks with a fully secured line of credit of up to 50 percent of a bank's quarter-end total assets. Under the terms of this facility, the Bank's total credit exposure to the FHLB cannot exceed 50 percent of its total assets, or \$596.2 million, at September 30, 2018. In addition, the aggregate outstanding principal amount of the Bank's advances, letters of credit, the dollar amount of the FHLB's minimum collateral requirement for off-balance sheet financial contracts and advance commitments cannot exceed 30 percent of the Bank's total assets, unless the Bank obtains approval from the FHLB's Board of Directors or its Executive Committee. These limits are further restricted by a member's ability to provide eligible collateral to support its obligations to the FHLB as well as the ability to meet the FHLB's stock requirement. At September 30, 2018, the Bank pledged collateral to the FHLB to support additional borrowing capacity of \$68.0 million. The Bank also maintains unsecured federal funds lines of \$46.0 million with two correspondent banks, all of which were unused and available at September 30, 2018.

The Consolidated Statements of Cash Flows present the changes in cash from operating, investing and financing activities. At September 30, 2018, the balance of cash and cash equivalents was \$19.3 million.

Net cash provided by operating activities totaled \$12.2 million for the nine months ended September 30, 2018 compared to net cash provided by operating activities of \$16.4 million for the nine months ended September 30, 2017. A source of funds is net income from operations adjusted for activity related to loans originated for sale and sold, the provision for loan losses, depreciation and amortization expenses and net amortization of premiums and discounts on securities. Net cash provided by operating activities for the nine months ended September 30, 2018 was lower than net cash provided by operating activities for the nine months ended September 30, 2017 due primarily to higher net proceeds from the origination and sale of loans of approximately \$9.4 million in the first nine months of 2017. Partially offsetting this lower cash flow from operations in the 2018 period was the net increase in accrued expenses and other liabilities compared to the net decrease in accrued expenses and other liabilities in the 2017 period.

Net cash used in investing activities totaled \$21.7 million for the nine months ended September 30, 2018 compared to \$40.2 million for the nine months ended September 30, 2017. The loans and securities portfolios are a source of liquidity, providing cash flows from maturities and periodic payments of principal. The primary use of cash from investing activities for the first nine months of 2018 was a net increase in loans of \$19.4 million compared to a net increase in loans of \$47.8 million for the first nine months of 2017. Net cash of \$996,000 was used in the NJCB merger. For the nine months ended September 30, 2018 and 2017, payments and maturities of investment securities totaled \$34.9 million and \$46.4 million, respectively. Cash was used to purchase investment securities of \$33.0 million for the nine months ended September 30, 2018 compared to purchases of \$46.2 million of investment securities for the nine months ended September 30, 2017. There were no sales of investment securities in the nine months ended September 30, 2018 and proceeds from the sale of investment securities totaled \$8.6 million for the nine months ended September 30, 2017.

Net cash provided by financing activities was \$10.0 million for the nine months ended September 30, 2018 compared to \$24.6 million for the nine months ended September 30, 2017. The primary source of funds for the 2018 period was the increase in short-term borrowings of \$79.0 million, which was partially offset by the decrease in deposits of \$67.6 million. Cash dividends of \$1.5 million were paid in the first nine months of 2018. The primary source of funds for the nine months ended September 30, 2017 was the increase in deposits of \$35.3 million. Management believes that the Company's and the Bank's liquidity resources are adequate to provide for the Company's and the Bank's planned operations.

Shareholders' Equity and Dividends

Shareholders' equity increased by \$12.1 million, or 10.9%, to \$123.8 million at September 30, 2018 from \$111.7 million at December 31, 2017. Shareholders' equity increased \$12.1 million due primarily to the issuance of 249,785 shares of common stock with a fair value of \$5.5 million in connection with the NJCB merger and an increase of \$7.2 million in retained earnings, which was partially offset by a \$1.4 million increase in accumulated other comprehensive loss.

The Company began declaring and paying cash dividends on its common stock in September 2016 and has declared and paid a cash dividend for each quarter since then. The timing and the amount of the payment of future cash dividends, if any, on the Company's common stock will be at the discretion of the Company's Board of Directors and will be determined after consideration of various factors, including the level of earnings, cash requirements, regulatory capital and financial condition.

The Company's common stock is quoted on the Nasdaq Global Market under the symbol "FCCY."

On January 21, 2016, the Board of Directors of the Company authorized a common stock repurchase program. Under the common stock repurchase program, the Company may repurchase in open market or privately negotiated transactions up to five percent (5%) of its common stock outstanding on the date of approval of the stock repurchase program, which limitation is adjusted for any subsequent stock dividends. This repurchase program replaced the repurchase program authorized on August 3, 2005.

Disclosure of repurchases of shares of common stock of the Company that were made during the quarter ended September 30, 2018 is set forth under Part II, Item 2 of this report, "Unregistered Sales of Equity Securities and Use of Proceeds."

Capital Resources

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

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of Common Equity Tier 1, Total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined) and Tier I capital to average assets (Leverage ratio, as defined). As of September 30, 2018 and December 31, 2017, the Company and the Bank met all capital adequacy requirements to which they are subject.

To be categorized as adequately capitalized, the Company and the Bank must maintain minimum Common Equity Tier 1, Total capital to risk-weighted assets, Tier 1 capital to risk-weighted assets and Tier I leverage capital ratios as set forth in the below table. As of September 30, 2018 and December 31, 2017, the Bank's capital ratios exceeded the regulatory standards for well-capitalized institutions. Certain bank regulatory limitations exist on the availability of the Bank's assets for the payment of dividends by the Bank without prior approval of bank regulatory authorities.

In July 2013, the Federal Reserve Board and the Federal Deposit Insurance Corporation (“FDIC”) approved revisions to their capital adequacy guidelines and prompt corrective action rules that implemented and addressed the revised standards of Basel III and addressed relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Federal Reserve Board’s final rules and the FDIC’s interim final rules (which became final in April 2014 with no substantive changes) apply to all depository institutions, top-tier bank holding companies with total consolidated assets of \$500 million or more (which was subsequently increased to \$1 billion or more in May 2015) and top-tier savings and loan holding companies (“banking organizations”). Among other things, the rules established a Common Equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets) and increased the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets). Banking organizations are also required to have a total capital ratio of at least 8% and a Tier 1 leverage ratio of at least 4%.

The rules also limited a banking organization’s ability to pay dividends, engage in share repurchases or pay discretionary bonuses if the banking organization does not hold a “capital conservation buffer” consisting of 2.5% of Common Equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The rules became effective for the Company and the Bank on January 1, 2015. The capital conservation buffer requirement began phasing in on

58

January 1, 2016 at 0.625% of Common Equity Tier 1 capital to risk-weighted assets and increases by that amount each year until fully implemented in January 2019 at 2.5% of Common Equity Tier 1 capital to risk-weighted assets. As of January 1, 2018, the Company and the Bank were required to maintain a capital conservation buffer of 1.875%.

Management believes that the Company's and the Bank's capital resources are adequate to support the Company's and the Bank's current strategic and operating plans.

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

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provision	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
As of September 30, 2018						
Common equity Tier 1 (CET1)	\$113,463	10.43 %	\$48,961	4.50 %	N/A	N/A
Total capital to risk-weighted assets	139,728	12.84 %	87,041	8.00 %	N/A	N/A
Tier 1 capital to risk-weighted assets	131,463	12.08 %	65,281	6.00 %	N/A	N/A
Tier 1 leverage capital	131,463	11.19 %	47,001	4.00 %	N/A	N/A
As of December 31, 2017						
Common equity Tier 1 (CET1)	\$99,839	10.19 %	\$44,106	4.50 %	N/A	N/A
Total capital to risk-weighted assets	125,852	12.84 %	78,411	8.00 %	N/A	N/A
Tier 1 capital to risk-weighted assets	117,839	12.02 %	58,808	6.00 %	N/A	N/A
Tier 1 leverage capital	117,839	11.23 %	41,987	4.00 %	N/A	N/A

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

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provision	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
As of September 30, 2018						
Common equity Tier 1 (CET1)	\$131,535	12.10 %	\$48,936	4.50 %	\$70,685	6.50 %
Total capital to risk-weighted assets	139,800	12.86 %	86,996	8.00 %	108,746	10.00 %
Tier 1 capital to risk-weighted assets	131,535	12.10 %	65,247	6.00 %	86,996	8.00 %
Tier 1 leverage capital	131,535	11.19 %	47,001	4.00 %	58,752	5.00 %
As of December 31, 2017						
Common equity Tier 1 (CET1)	\$115,031	11.74 %	\$44,106	4.50 %	\$63,709	6.50 %
Total capital to risk-weighted assets	123,044	12.55 %	78,411	8.00 %	98,014	10.00 %
Tier 1 capital to risk-weighted assets	115,031	11.74 %	58,808	6.00 %	78,411	8.00 %
Tier 1 leverage capital	115,031	10.96 %	41,987	4.00 %	52,484	5.00 %

Interest Rate Sensitivity Analysis

The largest component of the Company's total income is net interest income, and the majority of the Company's financial instruments are composed of interest rate-sensitive assets and liabilities with various terms and maturities. The primary objective of management is to maximize net interest income while minimizing interest rate risk. Interest rate risk is derived from timing differences and the magnitude of relative changes in the repricing of assets and liabilities, loan prepayments, deposit withdrawals and differences in lending and funding rates. Management actively seeks to monitor and control the mix of interest rate-sensitive assets and interest rate-sensitive liabilities.

Under the interest rate risk policy established by the Company's Board of Directors, the Company established quantitative guidelines with respect to interest rate risk and how interest rate shocks are projected to affect net interest income and the economic value of equity. Based on, the current monetary policy of the Federal Reserve Board and recent communications from the Federal Reserve Board, management believes that it is more likely that market interest rates may increase than decrease over the intermediate term. Summarized below is the projected effect of a parallel shift of an increase of 200 and 300 basis points, respectively, in market interest rates on net interest income and the economic value of equity.

Based upon the current interest rate environment, as of September 30, 2018, sensitivity to interest rate risk was as follows:

(Dollars in thousands)	Next 12 Months				Economic Value	
	Net Interest		Income		of Equity ⁽²⁾	
Interest Rate Change in Basis Points ⁽¹⁾	Dollar	\$	%	Dollar	\$	%
	Amount	Change	Change	Amount	Change	Change
+300	\$49,988	\$3,592	7.74 %	\$170,564	\$(3,613)	(2.07)%
+200	48,797	2,401	5.18 %	172,381	(1,796)	(1.03)%
—	46,396	—	— %	174,177	—	— %

⁽¹⁾ Assumes an instantaneous and parallel shift in interest rates at all maturities.

⁽²⁾ Economic value of equity is the discounted present value of expected cash flows from assets, liabilities and off-balance sheet contracts.

The Company employs many assumptions to calculate the impact of changes in interest rates on assets and liabilities, and actual results may not be similar to projections due to several factors, including the timing and frequency of rate changes, market conditions and the shape of the yield curve. Actual results may also differ due to management's actions, if any, in response to changing rates. In calculating these exposures, the Company utilized an interest rate simulation model that is validated by third-party reviewers periodically.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's Asset Liability Committee ("ALCO") is responsible for developing, implementing and monitoring asset liability management strategies and advising the Company's Board of Directors on such strategies, as well as the related level of interest rate risk. Interest rate risk simulation models are prepared on a quarterly basis. These models demonstrate balance sheet gaps and predict changes to net interest income and the economic market value of equity under various interest rate scenarios.

ALCO is generally authorized to manage interest rate risk through the management of capital, cash flows and duration of assets and liabilities, including sales and purchases of assets, as well as additions of borrowings and other sources of medium or longer-term funding.

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

- Actively market commercial business loan originations, which tend to have adjustable rate features and which generate customer relationships that can result in higher core deposit accounts;
- Actively market commercial mortgage loan originations, which tend to have shorter maturity terms and higher interest rates than residential mortgage loans and which generate customer relationships that can result in higher core deposit accounts;
- Actively market core deposit relationships, which are generally longer duration liabilities;
- Utilize short term and long-term certificates of deposit and/or borrowings to manage liability duration;
- Closely monitor and actively manage the investment portfolio, including management of duration, prepayment and interest rate risk;
- Maintain adequate levels of capital; and
- Utilize loan sales and/or loan participations.

ALCO uses simulation modeling to analyze the Company's net interest income sensitivity as well as the Company's economic value of portfolio equity under various interest rate scenarios. The model is based on the actual maturity and estimated 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 September 30, 2018. 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 remained static as of September 30, 2018.

In an immediate and sustained 200 basis point increase in market interest rates at September 30, 2018, net interest income for year 1 would increase approximately 5.2%, when compared to a flat interest rate scenario.

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 assumes 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.

Model simulation results indicate the Company is asset sensitive, which indicates the Company's net interest income should increase in a rising rate environment. Management believes the Company's interest rate risk position is balanced and reasonable.

Explanation of Responses:

Item 4. Controls and Procedures

The Company has established disclosure controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and is accumulated and communicated to management, including the principal executive officer and principal financial officer, to allow timely decisions regarding required disclosure.

The Company's principal executive officer and principal financial officer, with the assistance of other members of management, have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this quarterly report. Based upon such evaluation, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures are effective as of the end of the period covered by this quarterly report.

Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports it files under the Exchange Act is accumulated and communicated to management, including the principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. 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. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

The Company's principal executive officer and principal financial officer have concluded that there was no change in the Company's internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) that occurred during the quarter ended September 30, 2018 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company may, in the ordinary course of business, become a party to litigation involving collection matters, contract claims and other legal proceedings relating to the conduct of its business. Management is not aware of any material pending legal proceedings against the Company which, if determined adversely, would have a material adverse effect on the Company's financial condition or results of operations.

Item 1A. Risk Factors

There has been no material change in the risk factors previously disclosed under the heading "Risk Factors" within the Company's Form 10-K for the year ended December 31, 2017.

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

Issuer Purchases of Equity Securities

On January 21, 2016, the Board of Directors of the Company authorized a common stock repurchase program. Under this common stock repurchase program, the Company may repurchase in open market or privately negotiated transactions up to five percent (5%) of its common stock outstanding on the date of approval of the stock repurchase program, which limitation is adjusted for any subsequent stock dividends. The Company's common stock repurchase program covers a maximum of 396,141 shares of common stock of the Company, representing 5% of the outstanding common stock of the Company on January 21, 2016, as adjusted for subsequent common stock dividends. There were no repurchases under the plan during the third quarter of 2018.

The following table provides common stock repurchases made by or on behalf of the Company during the three months ended September 30, 2018.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased As Part of Publicly Announced Plan or Program	Maximum Number of Shares That May Yet be Purchased Under the Plan or Program
Beginning				
July 1, 2018	—	\$	—	394,141
Ending				
July 31, 2018	—	\$	—	394,141
August 1, 2018	—	\$	—	394,141
August 31, 2018	—	\$	—	394,141
September 1, 2018	—	\$	—	394,141
September 30, 2018	—	\$	—	394,141
Total	—	\$	—	394,141

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits.

- 3(i)(A) Certificate of Incorporation of the Company (conformed copy) (incorporated by reference to Exhibit 3(i)(A) to the Company's Form 10-K (SEC File No. 000-32891) filed with the SEC on March 27, 2009)
- 3(ii)(A) By-laws of the Company, as amended (conformed copy) (incorporated by reference to Exhibit 3(ii)(A) to the Company's Form 8-K filed with the SEC on March 23, 2016)
- 31.1 * Certification of Robert F. Mangano, principal executive officer of the Company, pursuant to Securities Exchange Act Rule 13a-14(a)
- 31.2 * Certification of Stephen J. Gilhooly, principal financial officer of the Company, pursuant to Securities Exchange Act Rule 13a-14(a)
- 32 * Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of The Sarbanes-Oxley Act of 2002, signed by Robert F. Mangano, principal executive officer of the Company, and Stephen J. Gilhooly, principal financial officer of the Company

101.INS *XBRL Instance Document

101.SCH *XBRL Taxonomy Extension Schema Document

101.CAL *XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF *XBRL Taxonomy Extension Definition Linkbase Document

101.LAB *XBRL Taxonomy Extension Label Linkbase Document

101.PRE *XBRL Taxonomy Extension Presentation Linkbase Document

* Filed herewith.

SIGNATURES

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

1ST CONSTITUTION BANCORP

Date: November 7, 2018 By: /s/ ROBERT F. MANGANO
Robert F. Mangano
President and Chief Executive Officer
(Principal Executive Officer)

Date: November 7, 2018 By: /s/ STEPHEN J. GILHOOLY
Stephen J. Gilhooly
Senior Vice President, Treasurer and Chief Financial Officer
(Principal Financial Officer)