

BRIDGE BANCORP INC  
Form 10-Q  
November 08, 2012

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended September 30, 2012

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Commission file number 001-34096

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**BRIDGE BANCORP, INC.**

(Exact name of registrant as specified in its charter)

NEW YORK

(State or other jurisdiction of incorporation or organization)

2200 MONTAUK HIGHWAY, BRIDGEHAMPTON, NEW YORK

(Address of principal executive offices)

11-2934195

(IRS Employer Identification Number)

11932

(Zip Code)

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Registrant's telephone number, including area code: (631) 537-1000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

There were 8,805,428 shares of common stock outstanding as of November 2, 2012.

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**BRIDGE BANCORP, INC.**

**PART I - FINANCIAL INFORMATION**

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**Item 1. Financial Statements****BRIDGE BANCORP, INC. AND SUBSIDIARIES****Consolidated Balance Sheets (unaudited)**

(In thousands, except share and per share amounts)

|  | <b>September 30,<br/>2012</b> | December 31,<br>2011 |
|--|-------------------------------|----------------------|
| <b>ASSETS</b>  |                               |                      |
| Cash and due from banks  | \$ 20,593                     | \$ 25,921            |
| Interest earning deposits with banks   | 7,264                         | 53,625               |
| Total cash and cash equivalents  | 27,857                        | 79,546               |
| Securities available for sale, at fair value   | 560,790                       | 441,439              |
| Securities held to maturity (fair value of \$216,083 and \$170,952, respectively)  | 212,879                       | 169,153              |
| Total securities   | 773,669                       | 610,592              |
| Securities, restricted   | 2,978                         | 1,660                |
| Loans held for sale  |                               | 2,300                |
| Loans held for investments   | 732,471                       | 612,143              |
| Allowance for loan losses  | (14,044)                      | (10,837)             |
| Loans, net   | 718,427                       | 601,306              |
| Premises and equipment, net  | 25,320                        | 24,171               |
| Accrued interest receivable  | 5,412                         | 4,940                |
| Goodwill   | 2,034                         | 2,034                |
| Core deposit intangible  | 265                           | 316                  |
| Other real estate owned  | 250                           |                      |
| Other assets   | 9,896                         | 10,593               |
| <b>Total Assets</b>  | <b>\$ 1,566,108</b>           | <b>\$ 1,337,458</b>  |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                               |                      |
| Demand deposits  | \$ 412,736                    | \$ 321,496           |
| Savings, NOW and money market deposits   | 737,219                       | 683,863              |
| Certificates of deposit of \$100,000 or more   | 125,563                       | 140,578              |
| Other time deposits  | 39,329                        | 42,248               |
| Total deposits   | 1,314,847                     | 1,188,185            |
| Federal funds purchased and Federal Home Loan Bank overnight borrowings  | 62,000                        |                      |
| Federal Home Loan Bank term advances   | 15,000                        |                      |
| Repurchase agreements  | 13,093                        | 16,897               |
| Junior subordinated debentures   | 16,002                        | 16,002               |
| Accrued interest payable   | 212                           | 319                  |
| Due to securities broker   | 17,874                        |                      |
| Other liabilities and accrued expenses   | 10,764                        | 9,068                |
| <b>Total Liabilities</b>   | <b>1,449,792</b>              | <b>1,230,471</b>     |
| <b>Commitments and Contingencies</b>   |                               |                      |
| <b>Stockholders equity:</b>  |                               |                      |
| Preferred stock, par value \$.01 per share (2,000,000 shares authorized; none issued)  |                               |                      |
| Common stock, par value \$.01 per share:   |                               |                      |
| Authorized: 20,000,000 shares; 8,721,132 and 8,374,917 shares issued, respectively; 8,709,994 and 8,345,399 shares outstanding, respectively | 87                            | 84                   |
| Surplus  | 59,969                        | 52,962               |

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|  |                     |                     |
|--|---------------------|---------------------|
| Retained earnings  | 55,732              | 52,228              |
| Less: Treasury Stock at cost, 11,138 and 29,518 shares, respectively                                     | (229)               | (715)               |
|  | <b>115,559</b>      | 104,559             |
| Accumulated other comprehensive income (loss):   |                     |                     |
| Net unrealized gain on securities, net of deferred income taxes of (\$2,669) and (\$3,774), respectively | 4,055               | 5,734               |
| Pension liability, net of deferred income taxes of \$2,119 and \$2,205, respectively                     | (3,176)             | (3,306)             |
| Net unrealized loss on cash flow hedge, net of deferred income taxes of \$81 and \$0, respectively       | (122)               |                     |
| <b>Total Stockholders' Equity</b>  | <b>116,316</b>      | 106,987             |
| <b>Total Liabilities and Stockholders' Equity</b>  | <b>\$ 1,566,108</b> | <b>\$ 1,337,458</b> |

See accompanying condensed notes to the Unaudited Consolidated Financial Statements.

## BRIDGE BANCORP, INC. AND SUBSIDIARIES

## Consolidated Statements of Income (unaudited)

(In thousands, except per share amounts)

|  | For the<br>Three Months Ended<br>September 30, |          | For the<br>Nine Months Ended<br>September 30, |           |
|--|--|----------|---|-----------|
|  | 2012   | 2011     | 2012  | 2011      |
| Interest income:   |  |          |   |           |
| Loans (including fee income)                                       | \$ 10,467                                      | \$ 9,555 | \$ 29,753                                     | \$ 26,074 |
| Mortgage-backed securities, CMOs and other asset-backed securities | 1,710  | 2,281    | 5,793   | 6,982     |
| State and municipal obligations                                    | 747  | 697      | 2,361   | 2,124     |
| U.S. GSE securities  | 579  | 712      | 2,164   | 1,526     |
| Corporate Bonds  | 153  | 177      | 473   | 550       |
| Deposits with banks  | 28   | 32       | 70  | 91        |
| Other interest and dividend income                                 | 23   | 17       | 68  | 53        |
| Total interest income  | 13,707   | 13,471   | 40,682  | 37,400    |
| Interest expense:  |  |          |   |           |
| Savings, NOW and money market deposits                             | 952  | 986      | 2,829   | 2,977     |
| Certificates of deposit of \$100,000 or more                       | 360  | 354      | 1,113   | 841       |
| Other time deposits  | 101  | 132      | 324   | 385       |
| Federal funds purchased and repurchase agreements                  | 97   | 136      | 323   | 405       |
| Federal home loan bank advances                                    | 38   |          | 46  |           |
| Junior subordinated debentures                                     | 341  | 341      | 1,024   | 1,025     |
| Total interest expense   | 1,889  | 1,949    | 5,659   | 5,633     |
| Net interest income  | 11,818   | 11,522   | 35,023  | 31,767    |
| Provision for loan losses  | 600  | 1,450    | 3,925   | 3,050     |
| Net interest income after provision for loan losses                | 11,218   | 10,072   | 31,098  | 28,717    |
| Non interest income:   |  |          |   |           |
| Service charges on deposit accounts                                | 827  | 776      | 2,492   | 2,342     |
| Fees for other customer services                                   | 854  | 761      | 2,179   | 1,816     |
| Title fee income   | 344  | 200      | 1,037   | 667       |
| Net securities gains   | 186  |          | 2,179   | 135       |
| Other operating income   | 24   | 29       | 101   | 85        |
| Total non interest income  | 2,235  | 1,766    | 7,988   | 5,045     |
| Non interest expense:  |  |          |   |           |
| Salaries and employee benefits                                     | 5,211  | 4,815    | 15,584  | 13,389    |
| Net occupancy expense  | 828  | 798      | 2,423   | 2,303     |
| Furniture and fixture expense                                      | 293  | 304      | 855   | 918       |
| FDIC assessments   | 190  | 134      | 542   | 635       |
| Acquisition costs  |  | 109      |   | 728       |
| Amortization of core deposit intangible                            | 16   | 16       | 51  | 24        |
| Cost of extinguishment of debt                                     |  |          | 158   |           |
| Other operating expenses   | 1,941  | 1,648    | 5,654   | 5,019     |
| Total non interest expense   | 8,479  | 7,824    | 25,267  | 23,016    |
| Income before income taxes   | 4,974  | 4,014    | 13,819  | 10,746    |
| Income tax expense   | 1,614  | 1,241    | 4,457   | 3,337     |
| Net income   | \$ 3,360                                       | \$ 2,773 | \$ 9,362                                      | \$ 7,409  |
| Basic earnings per share   | \$ 0.39  | \$ 0.41  | \$ 1.09                                       | \$ 1.12   |
| Diluted earnings per share   | \$ 0.39  | \$ 0.41  | \$ 1.09                                       | \$ 1.12   |

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*See accompanying condensed notes to the Unaudited Consolidated Financial Statements.*

**BRIDGE BANCORP, INC. AND SUBSIDIARIES**

**Consolidated Statements of Comprehensive Income (unaudited)**

(In thousands)

|  | For the<br>Three Months Ended<br>September 30, |          | For the<br>Nine Months Ended<br>September 30, |           |
|--|--|----------|---|-----------|
|  | 2012   | 2011     | 2012  | 2011      |
| Net Income   | \$ 3,360                                       | \$ 2,773 | \$ 9,362                                      | \$ 7,409  |
| Other comprehensive income (loss):   |  |          |   |           |
| Change in unrealized net gains on securities available for sale, net of reclassification and deferred income tax effects | (91)   | 1,631    | (1,679)                                       | 2,658     |
| Adjustment to pension liability, net of deferred income taxes  | 43   | 20       | 130   | 62        |
| Unrealized loss on cash flow hedge, net of deferred income taxes   | (102)  |          | (122)   |           |
| Total other comprehensive income (loss)  | (150)  | 1,651    | (1,671)                                       | 2,720     |
| Comprehensive income   | \$ 3,210                                       | \$ 4,424 | \$ 7,691                                      | \$ 10,129 |

*See accompanying condensed notes to the Unaudited Consolidated Financial Statements.*



**BRIDGE BANCORP, INC. AND SUBSIDIARIES**

**Consolidated Statements of Stockholders Equity (unaudited)**

(In thousands, except per share amounts)

|  | Common<br>Stock | Surplus   | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income | Total      |
|--|-----------------|-----------|----------------------|-------------------|---|------------|
| <b>Balance at January 1, 2012</b>                          | \$ 84           | \$ 52,962 | \$ 52,228            | \$ (715)          | \$ 2,428  | \$ 106,987 |
| Net income   |                 |           | 9,362                |                   |   | 9,362      |
| Shares issued under the dividend reinvestment plan ( DRP ) | 3               | 6,561     |                      |                   |   | 6,564      |
| Stock awards granted and distributed                       |                 | (580)     |                      | 580               |   |            |
| Stock awards forfeited                                     |                 | 6         |                      | (6)               |   |            |
| Vesting of stock awards                                    |                 |           |                      | (88)              |   | (88)       |
| Tax effect of stock plans                                  |                 | (10)      |                      |                   |   | (10)       |
| Share based compensation expense                           |                 | 1,030     |                      |                   |   | 1,030      |
| Cash dividend declared, \$0.69 per share                   |                 |           | (5,858)              |                   |   | (5,858)    |
| Other comprehensive income, net of deferred income taxes   |                 |           |                      |                   | (1,671)   | (1,671)    |
| <b>Balance at September 30, 2012</b>                       | \$ 87           | \$ 59,969 | \$ 55,732            | \$ (229)          | \$ 757  | \$ 116,316 |

|  | Common<br>Stock | Surplus   | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income | Total     |
|--|-----------------|-----------|----------------------|-------------------|---|-----------|
| Balance at January 1, 2011   | \$ 64           | \$ 19,751 | \$ 46,463            | \$ (2,325)        | \$ 1,767  | \$ 65,720 |
| Net income   |                 |           | 7,409                |                   |   | 7,409     |
| Shares issued under the dividend reinvestment plan ( DRP )                 | 2               | 2,971     |                      |                   |   | 2,973     |
| Shares issued in the acquisition of Hampton State Bank<br>(273,479 shares) | 3               | 5,847     |                      |                   |   | 5,850     |
| Stock awards granted and distributed                                       |                 | (387)     |                      | 387               |   |           |
| Stock awards forfeited   |                 | 39        |                      | (39)              |   |           |
| Vesting of stock awards  |                 |           |                      | (61)              |   | (61)      |
| Tax effect of stock plans  |                 | (1)       |                      |                   |   | (1)       |
| Share based compensation expense   |                 | 774       |                      |                   |   | 774       |
| Cash dividend declared, \$0.46 per share                                   |                 |           | (3,029)              |                   |   | (3,029)   |
| Other comprehensive income, net of deferred income taxes                   |                 |           |                      |                   | 2,720   | 2,720     |
| Balance at September 30, 2011  | \$ 69           | \$ 28,994 | \$ 50,843            | \$ (2,038)        | \$ 4,487  | \$ 82,355 |

See accompanying condensed notes to the Unaudited Consolidated Financial Statements.

## BRIDGE BANCORP, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows (unaudited)

(In thousands)

|   | For the<br>Nine Months Ended<br>September 30, |                  |
|---|---|------------------|
|   | 2012  | 2011             |
| <b>Cash flows from operating activities:</b>  |   |                  |
| Net Income  | \$ 9,362                                      | \$ 7,409         |
| Adjustments to reconcile net income to net cash provided by operating activities:                     |   |                  |
| Provision for loan losses   | 3,925   | 3,050            |
| Depreciation and amortization   | 1,313   | 1,370            |
| Net amortization on securities  | 3,696   | 1,574            |
| Amortization of core deposit intangible   | 51  | 24               |
| Share based compensation expense  | 1,030   | 774              |
| Net securities gains  | (2,179)                                       | (135)            |
| Increase in accrued interest receivable   | (472)   | (221)            |
| Decrease in other assets  | 244   | 1,083            |
| Increase in accrued expenses and other liabilities  | 2,905   | 1,467            |
| <b>Net cash provided by operating activities</b>  | <b>19,875</b>                                 | <b>16,395</b>    |
| <b>Cash flows from investing activities:</b>  |   |                  |
| Purchases of securities available for sale  | (388,698)                                     | (200,906)        |
| Purchases of securities, restricted   | (16,325)                                      | (140)            |
| Purchases of securities held to maturity  | (116,347)                                     | (69,315)         |
| Proceeds from sales of securities available for sale  | 67,077  | 14,084           |
| Redemption of securities, restricted  | 15,007  | 225              |
| Maturities, calls and principal payments of securities available for sale                             | 211,802                                       | 150,726          |
| Maturities, calls and principal payments of securities held to maturity                               | 76,662  | 46,653           |
| Net increase in loans   | (119,321)                                     | (57,015)         |
| Proceeds from loan sale   | 575   |                  |
| Purchase of premises and equipment  | (2,462)                                       | (1,625)          |
| Net cash acquired in business combination   |   | 2,309            |
| <b>Net cash used in investing activities</b>  | <b>(272,030)</b>                              | <b>(115,004)</b> |
| <b>Cash flows from financing activities:</b>  |   |                  |
| Net increase in deposits  | 126,662                                       | 181,602          |
| Net increase (decrease) in federal funds purchased and FHLB overnight borrowings                      | 62,000  | (7,000)          |
| Net increase (decrease) in FHLB term advances   | 15,000  | (5,016)          |
| Net (decrease) increase in repurchase agreements  | (3,804)                                       | 225              |
| Net proceeds from issuance of common stock  | 6,564   | 2,973            |
| Repurchase of surrendered stock from exercise of stock options and vesting of restricted stock awards | (88)  | (61)             |
| Excess tax expense from share based compensation  | (10)  | (1)              |
| Cash dividends paid   | (5,858)                                       | (4,496)          |
| <b>Net cash provided by financing activities</b>  | <b>200,466</b>                                | <b>168,226</b>   |
| Net (decrease) increase in cash and cash equivalents  | (51,689)                                      | 69,617           |
| Cash and cash equivalents at beginning of period  | 79,546  | 22,918           |
| <b>Cash and cash equivalents at end of period</b>   | <b>\$ 27,857</b>                              | <b>\$ 92,535</b> |
| <b>Supplemental Information-Cash Flows:</b>   |   |                  |
| Cash paid for:  |   |                  |
| Interest  | \$ 5,766                                      | \$ 5,652         |
| Income tax  | \$ 2,985                                      | \$ 2,644         |
| Noncash investing and financing activities:   |   |                  |
| Securities which settled in the subsequent period   | \$ 17,874                                     | \$ 1,429         |

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|  |    |       |    |        |
|--|----|-------|----|--------|
| Financing of sale of loans held for sale       | \$ | 1,725 | \$ |        |
| Acquisition of noncash assets and liabilities: |    |       |    |        |
| Fair value of assets acquired                  | \$ |       | \$ | 66,566 |
| Fair value of liabilities assumed              | \$ |       | \$ | 65,059 |

*See accompanying condensed notes to the Unaudited Consolidated Financial Statements.*

**BRIDGE BANCORP, INC. AND SUBSIDIARIES**

**CONDENSED NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**1. BASIS OF PRESENTATION**

Bridge Bancorp, Inc. (the Company) is a bank holding company incorporated under the laws of the State of New York. The Company's business currently consists of the operations of its wholly-owned subsidiary, The Bridgehampton National Bank (the Bank). The Bank's operations include its real estate investment trust subsidiary, Bridgehampton Community, Inc. (BCI), and a financial title insurance subsidiary, Bridge Abstract LLC (Bridge Abstract). In addition to the Bank, the Company has another subsidiary Bridge Statutory Capital Trust II which was formed in 2009. In accordance with current accounting guidance, the trust is not consolidated in the Company's financial statements.

The accompanying Unaudited Consolidated Financial Statements, which include the accounts of the Company and its wholly-owned subsidiary, the Bank, have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The Unaudited Consolidated Financial Statements included herein reflect all normal recurring adjustments that are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented. In preparing the interim financial statements, management has made estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expense during the reported periods. Such estimates are subject to change in the future as additional information becomes available or previously existing circumstances are modified. Actual future results could differ significantly from those estimates. The annualized results of operations for the nine months ended September 30, 2012 are not necessarily indicative of the results of operations that may be expected for the entire fiscal year. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). Certain reclassifications have been made to prior year amounts, and the related discussion and analysis, to conform to the current year presentation. These reclassifications did not have an impact on net income or total stockholders' equity. The Unaudited Consolidated Financial Statements should be read in conjunction with the Audited Consolidated Financial Statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

**2. EARNINGS PER SHARE**

Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) No. 260-10-45 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share (EPS). The restricted stock awards and restricted stock units granted by the Company contain nonforfeitable rights to dividends and therefore are considered participating securities. The two-class method for calculating basic EPS excludes dividends paid to participating securities and any undistributed earnings attributable to participating securities.

The computation of EPS for the three and nine months ended September 30, 2012 and 2011 is as follows:

**Three months ended,**

**Nine months ended,**

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| (In thousands, except per share data)  | September 30, |          | September 30, |          |
|--|---------------|----------|---------------|----------|
|  | 2012          | 2011     | 2012          | 2011     |
| Net Income   | \$ 3,360      | \$ 2,773 | \$ 9,362      | \$ 7,409 |
| Less: Dividends paid on and earnings allocated to participating securities     | (88)          | (79)     | (244)         | (217)    |
| Income attributable to common stock  | \$ 3,272      | \$ 2,694 | \$ 9,118      | \$ 7,192 |
| Weighted average common shares outstanding, including participating securities | 8,695         | 6,789    | 8,573         | 6,590    |
| Less: weighted average participating securities                                | (226)         | (194)    | (225)         | (192)    |
| Weighted average common shares outstanding                                     | 8,469         | 6,595    | 8,348         | 6,398    |
| Basic earnings per common share  | \$ 0.39       | \$ 0.41  | \$ 1.09       | \$ 1.12  |
| Income attributable to common stock  | \$ 3,272      | \$ 2,694 | \$ 9,118      | \$ 7,192 |
| Weighted average common shares outstanding                                     | 8,469         | 6,595    | 8,348         | 6,398    |
| Weighted average common equivalent shares outstanding                          | 1             | 1        | 1             | 1        |
| Weighted average common and equivalent shares outstanding                      | 8,470         | 6,596    | 8,349         | 6,399    |
| Diluted earnings per common share  | \$ 0.39       | \$ 0.41  | \$ 1.09       | \$ 1.12  |

There were 49,737 and 52,123 options outstanding at September 30, 2012 and September 30, 2011, respectively, that were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of common stock and were, therefore, antidilutive. The \$16.0 million in convertible trust preferred securities outstanding at September 30, 2012, were not included in the computation of diluted earnings per share because the assumed conversion of the trust preferred securities was antidilutive.

### 3. STOCK BASED COMPENSATION PLANS

The Compensation Committee of the Board of Directors determines stock options and restricted stock awarded under the Bridge Bancorp, Inc. Equity Incentive Plan ( Plan ) and the Company accounts for this Plan under the FASB ASC No. 718 and 505. On May 4, 2012, the stockholders of the Company approved the Company's 2012 Stock-Based Incentive Plan. The plan provides for the grant of stock-based and other incentive awards to officers, employees and directors of the Company.

No new grants of stock options were awarded during the nine months ended September 30, 2012 and September 30, 2011. There was no compensation expense attributable to stock options for the nine months ended September 30, 2012 and September 30, 2011, because all stock options were vested.

The intrinsic value for stock options is calculated based on the exercise price of the underlying awards and the market price of our common stock as of the reporting date. No stock options were exercised during the first nine months of 2012 and 2011. The intrinsic value of options outstanding and exercisable at September 30, 2012 and September 30, 2011 was \$16,000 and \$6,000, respectively.

A summary of the status of the Company's stock options as of and for the nine months ended September 30, 2012 is as follows:

|  | Number<br>of<br>Options | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value |
|--|-------------------------|--|---|---------------------------------|
| (Dollars in thousands, except per share amounts) |                         |  |   |                                 |
| Outstanding, December 31, 2011                   | 54,223                  | \$ 25.05                                 |   |                                 |
| Granted  |                         |  |   |                                 |
| Exercised  |                         |  |   |                                 |
| Forfeited  | (2,386)                 | \$ 25.27                                 |   |                                 |
| Expired  |                         |  |   |                                 |
| Outstanding, September 30, 2012                  | 51,837                  | \$ 25.04                                 | 3.58 years  | \$ 16                           |
| Vested and Exercisable, September 30, 2012       | 51,837                  | \$ 25.04                                 | 3.58 years  | \$ 16                           |
|  |                         |  |   |                                 |
|  | Number of<br>Options    | Exercise<br>Price                        |   |                                 |
| Range of Exercise Prices                         | 2,100                   | \$ 15.47                                 |   |                                 |
|  | 4,872                   | \$ 24.00                                 |   |                                 |
|  | 39,659                  | \$ 25.25                                 |   |                                 |
|  | 3,000                   | \$ 26.55                                 |   |                                 |
|  | 2,206                   | \$ 30.60                                 |   |                                 |

During the nine months ended September 30, 2012 and 2011, respectively, restricted stock awards of 21,993 and 13,688 shares were granted. These awards vest over approximately five years with a third vesting after years three, four and five. Compensation expense attributable to restricted stock awards was \$292,000 and \$912,000 for the three and nine months ended September 30, 2012, respectively, and \$228,000 and \$675,000 for the three and nine months ended September 30, 2011, respectively.

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A summary of the status of the Company's unvested restricted stock as of and for the nine months ended September 30, 2012 is as follows:

|                              | Shares   |    | Weighted<br>Average Grant-Date<br>Fair Value |
|------------------------------|----------|----|--|
| Unvested, December 31, 2011  | 211,371  | \$ | 21.56  |
| Granted                      | 21,993   | \$ | 19.82  |
| Vested                       | (30,100) | \$ | 21.44  |
| Forfeited                    | (230)    | \$ | 22.06  |
| Unvested, September 30, 2012 | 203,034  | \$ | 21.39  |

In April 2009, the Company adopted a Directors Deferred Compensation Plan. Under the Plan, independent directors may elect to defer all or a portion of their annual retainer fee in the form of restricted stock units. In addition, Directors receive a non-election retainer in the form of restricted stock units. These restricted stock units vest ratably over one year and have dividend rights but no voting rights. In connection with this Plan, the Company recorded expenses of approximately \$39,000 and \$118,000 for the three and nine months ended September 30, 2012, respectively, and \$34,000 and \$99,000 for the three and nine months ended September 30, 2011, respectively.

#### 4. SECURITIES

The following table summarizes the amortized cost and fair value of the available for sale and held to maturity investment securities portfolio at September 30, 2012 and December 31, 2011 and the corresponding amounts of unrealized gains and losses therein:

| (In thousands)  | September 30, 2012 |                              |                               |                            |
|---|--------------------|------------------------------|-------------------------------|----------------------------|
|   | Amortized<br>Cost  | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
| Available for sale:   |                    |                              |                               |                            |
| U.S. GSE securities   | \$ 150,215         | \$ 1,249                     | \$ (53)                       | \$ 151,411                 |
| State and municipal obligations                             | 69,250             | 1,390                        | (27)                          | 70,613                     |
| U.S. GSE residential mortgage-backed securities             | 24,107             | 1,733                        |                               | 25,840                     |
| U.S. GSE residential collateralized mortgage obligations    | 275,668            | 2,847                        | (626)                         | 277,889                    |
| U.S. GSE commercial collateralized mortgage obligations (1) | 9,132              | 307                          |                               | 9,439                      |
| Non Agency commercial mortgage-backed securities            | 4,960              | 48                           |                               | 5,008                      |
| Other Asset backed securities                               | 20,734             | 14                           | (158)                         | 20,590                     |
| Total available for sale                                    | 554,066            | 7,588                        | (864)                         | 560,790                    |
| Held to maturity:   |                    |                              |                               |                            |
| U.S. GSE securities   | 4,992              | 47                           |                               | 5,039                      |
| State and municipal obligations                             | 98,685             | 2,433                        | (39)                          | 101,079                    |
| U.S. GSE residential mortgage-backed securities             | 9,899              | 47                           |                               | 9,946                      |
| U.S. GSE residential collateralized mortgage obligations    | 61,152             | 848                          | (278)                         | 61,722                     |
| U.S. GSE commercial mortgage-backed securities              | 10,371             | 369                          |                               | 10,740                     |
| U.S. GSE commercial collateralized mortgage obligations     | 4,975              | 220                          |                               | 5,195                      |
| Corporate Bonds   | 22,805             | 137                          | (580)                         | 22,362                     |



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|                        |    |                |    |               |    |                |    |                |
|------------------------|----|----------------|----|---------------|----|----------------|----|----------------|
| Total held to maturity |    | <b>212,879</b> |    | <b>4,101</b>  |    | <b>(897)</b>   |    | <b>216,083</b> |
| Total securities       | \$ | <b>766,945</b> | \$ | <b>11,689</b> | \$ | <b>(1,761)</b> | \$ | <b>776,873</b> |

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| (In thousands)  | December 31, 2011 |                        |                         |                      |
|---|-------------------|------------------------|-------------------------|----------------------|
|   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| <b>Available for sale:</b>                                  |                   |                        |                         |                      |
| U.S. GSE securities   | \$ 130,708        | \$ 968                 | \$ (2)                  | \$ 131,674           |
| State and municipal obligations                             | 52,861            | 1,366                  | (8)                     | 54,219               |
| U.S. GSE residential mortgage-backed securities             | 67,317            | 3,667                  |                         | 70,984               |
| U.S. GSE residential collateralized mortgage obligations    | 175,878           | 3,493                  | (46)                    | 179,325              |
| U.S. GSE commercial collateralized mortgage obligations (1) | 5,167             | 70                     |                         | 5,237                |
| <b>Total available for sale</b>                             | <b>431,931</b>    | <b>9,564</b>           | <b>(56)</b>             | <b>441,439</b>       |
| <b>Held to maturity:</b>                                    |                   |                        |                         |                      |
| State and municipal obligations                             | 104,314           | 2,048                  | (5)                     | 106,357              |
| U.S. GSE residential collateralized mortgage obligations    | 42,081            | 1,104                  | (21)                    | 43,164               |
| Corporate Bonds   | 22,758            | 3                      | (1,330)                 | 21,431               |
| <b>Total held to maturity</b>                               | <b>169,153</b>    | <b>3,155</b>           | <b>(1,356)</b>          | <b>170,952</b>       |
| <b>Total securities</b>                                     | <b>\$ 601,084</b> | <b>\$ 12,719</b>       | <b>\$ (1,412)</b>       | <b>\$ 612,391</b>    |

(1) U.S. GSE commercial collateralized mortgage obligations represent securities with multi-family mortgage loans as the collateral.

The following table summarizes the amortized cost, fair value and maturities of the available for sale and held to maturity investment securities portfolio at September 30, 2012. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (In thousands)             | September 30, 2012 |                   |
|----------------------------|--------------------|-------------------|
|                            | Amortized Cost     | Fair Value        |
| <b>Maturity</b>            |                    |                   |
| <b>Available for sale:</b> |                    |                   |
| Within one year            | \$ 21,185          | \$ 21,261         |
| One to five years          | 55,332             | 56,991            |
| Five to ten years          | 137,666            | 139,072           |
| Beyond ten years           | 339,883            | 343,466           |
| <b>Total</b>               | <b>\$ 554,066</b>  | <b>\$ 560,790</b> |
| <b>Held to maturity:</b>   |                    |                   |
| Within one year            | \$ 46,758          | \$ 46,798         |
| One to five years          | 51,368             | 51,408            |
| Five to ten years          | 22,556             | 23,526            |
| Beyond ten years           | 92,197             | 94,351            |
| <b>Total</b>               | <b>\$ 212,879</b>  | <b>\$ 216,083</b> |

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Securities with unrealized losses at September 30, 2012 and December 31, 2011, aggregated by category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

| September 30, 2012<br>(In thousands)                     | Less than 12 months |                   | Greater than 12 months |                   |
|--|---------------------|-------------------|------------------------|-------------------|
|  | Fair Value          | Unrealized losses | Fair Value             | Unrealized losses |
| Available for sale:                                      |                     |                   |                        |                   |
| U.S. GSE securities                                      | \$ 27,928           | \$ 53             | \$                     |                   |
| State and municipal obligations                          | 9,601               | 27                |                        |                   |
| U.S. GSE residential collateralized mortgage obligations | 81,896              | 626               |                        |                   |
| Other Asset backed securities                            | 7,831               | 158               |                        |                   |
| Total available for sale                                 | 127,256             | 864               |                        |                   |
| Held to maturity:  |                     |                   |                        |                   |
| State and municipal obligations                          | 22,136              | 39                |                        |                   |
| U.S. GSE residential collateralized mortgage obligations | 26,402              | 278               |                        |                   |
| Corporate Bonds  |                     |                   | 17,419                 | 580               |
| Total held to maturity                                   | \$ 48,538           | \$ 317            | \$ 17,419              | \$ 580            |

| December 31, 2011<br>(In thousands)                      | Less than 12 months |                   | Greater than 12 months |                   |
|--|---------------------|-------------------|------------------------|-------------------|
|  | Fair Value          | Unrealized losses | Fair Value             | Unrealized losses |
| Available for sale:                                      |                     |                   |                        |                   |
| U.S. GSE securities                                      | \$ 7,196            | \$ 2              | \$                     |                   |
| State and municipal obligations                          | 4,283               | 8                 |                        |                   |
| U.S. GSE residential collateralized mortgage obligations | 7,672               | 46                |                        |                   |
| Total available for sale                                 | \$ 19,151           | \$ 56             | \$                     |                   |
| Held to maturity:  |                     |                   |                        |                   |
| State and municipal obligations                          | 7,011               | 5                 |                        |                   |
| U.S. GSE residential collateralized mortgage obligations | 4,810               | 21                |                        |                   |
| Corporate Bonds  | 4,664               | 336               | 12,006                 | 994               |
| Total held to maturity                                   | \$ 16,485           | \$ 362            | \$ 12,006              | \$ 994            |

*Other-Than-Temporary-Impairment*

Management evaluates securities for other-than-temporary impairment ( OTTI ) at least on a quarterly basis, and more frequently when economic or market conditions warrant. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model. Investment securities classified as available for sale or held-to-maturity are generally evaluated for OTTI under FASB ASC 320, *Accounting for Certain Investments in Debt and Equity Securities*. In determining OTTI under the FASB ASC 320 model, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: (1) OTTI related to credit loss, which must be recognized in the income statement and (2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

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At September 30, 2012, the majority of unrealized losses on available for sale securities are related to the Company's U.S. GSE residential collateralized mortgage obligations and the majority of unrealized losses on held to maturity securities are related to corporate bonds. The decrease in fair value of the U.S. GSE residential collateralized mortgage obligations and the corporate bond portfolio is attributable to changes in interest rates and not credit quality. Each issuer of corporate bonds has maintained their well capitalized status and continues to be reviewed periodically. The Company does not have the intent to sell these securities and it is more likely than not that it will not be required to sell the securities before their anticipated recovery. Therefore, the Company does not consider these securities to be other-than-temporarily impaired at September 30, 2012.

Proceeds from sales of securities available for sale were \$3.3 million for the three months ended September 30, 2012. There were no proceeds from sales of securities available for sale for the three months ended September 30, 2011. Proceeds from sales of securities available for sale were \$67.1 million and \$14.1 million for the nine months ended September 30, 2012 and 2011, respectively. Gross gains of \$0.2 million were realized on these sales during the three months ended September 30, 2012. There were no gross gains realized on sales during the three months ended September 30, 2011. Gross gains of \$2.2 million and \$0.1 million were realized on these sales during the nine months ended September 30, 2012 and 2011, respectively. Proceeds from calls of securities were \$44.5 million and \$86.9 million for the three months ended September 30, 2012 and 2011, respectively. Proceeds from calls of securities were \$153.0 million and \$114.1 million for the nine months ended September 30, 2012 and 2011, respectively.

Securities having a fair value of approximately \$299.4 million and \$287.8 million at September 30, 2012 and December 31, 2011, respectively, were pledged to secure public deposits and Federal Home Loan Bank and Federal Reserve Bank overnight borrowings. The Bank did not hold any trading securities during the nine months ended September 30, 2012 or the year ended December 31, 2011.

The Bank is a member of the Federal Home Loan Bank ( FHLB ) of New York. Members are required to own a particular amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. The Bank is a member of the Atlantic Central Banker's Bank ( ACBB ) and is required to own ACBB stock. The Bank is also a member of the Federal Reserve Bank ( FRB ) system and required to own FRB stock. FHLB, ACBB and FRB stock is carried at cost and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income. The Bank owned approximately \$3.0 million in FHLB, ACBB and FRB stock at September 30, 2012 and approximately \$1.7 million at December 31, 2011. These amounts were reported as restricted securities in the consolidated balance sheets.

## 5. ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS

FASB ASC No. 820-10 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC 820-10 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair values:

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

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

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

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Investment Securities: The estimated fair values are based on independent dealer quotations on nationally recognized securities exchanges, if available (Level 1). For securities where quoted prices are not available, fair value is based on matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2).

Derivatives: Represents an interest rate swap and the estimated fair values are based on valuation models using observable market data as of measurement date (Level 2).

Impaired Loans: At the time a loan is considered impaired, it is valued at the lower of cost or fair value. For loans that are collateral dependent, the fair value of the collateral is used to determine the fair value of the loan. The fair value of the collateral is determined based upon recent appraised values. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Adjustments may relate to location, square footage, condition, amenities, market rate of leases as well as timing of comparable sales. Such adjustments are generally capped at 15% of appraised value and typically result in a Level 3 classification of the inputs for determining fair value. The fair value of the loan is compared to the carrying value to determine if any write-down or specific reserve is required. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Appraisals for collateral-dependent impaired loans are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Company. Once received, the Credit Administration department reviews the assumptions and approaches utilized in the appraisal as

well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. On a quarterly basis, the Company compares the actual selling price of collateral that has been sold to the most recent appraised value to determine what additional adjustment should be made to the appraisal value to arrive at fair value. The most recent analysis performed indicated that a discount of 1-3% should be applied to residential properties with appraisals performed within 12 months and an appreciation of 3-17% should be applied to commercial properties with appraisals performed within 12 months.

**Loans Held For Sale:** Loans held for sale are carried at the lower of cost or fair values. The fair value of loans held for sale is determined using quoted prices for similar assets, adjusted for specific attributes of that loan or other observable market data, such as outstanding commitments from third party investors (Level 3).

Assets and liabilities measured on a recurring basis:

| (In thousands)  | Carrying Value | Quoted Prices In Active Markets for Identical Assets (Level 1) | Fair Value Measurements at September 30, 2012 Using: |   |
|---|----------------|--|--|---|
|   |                |  | Significant Other Observable Inputs (Level 2)        | Significant Unobservable Inputs (Level 3) |
| <b>Financial Assets:</b>                                    |                |  |  |   |
| Available for sale securities:                              |                |  |  |   |
| U.S. GSE securities   | \$ 151,411     |  | \$ 151,411   |   |
| State and municipal obligations                             | 70,613         |  | 70,613   |   |
| U.S. GSE residential mortgage-backed securities             | 25,840         |  | 25,840   |   |
| U.S. GSE residential collateralized mortgage obligations    | 277,889        |  | 277,889  |   |
| U.S. GSE commercial collateralized mortgage obligations (1) | 9,439          |  | 9,439  |   |
| Non Agency commercial mortgage-backed securities            | 5,008          |  | 5,008  |   |
| Other Asset backed securities                               | 20,590         |  | 20,590   |   |
| Total available for sale                                    | \$ 560,790     |  | \$ 560,790   |   |
| Derivatives   | \$ (203)       |  | \$ (203)   |   |

| (In thousands)  | Carrying Value | Quoted Prices In Active Markets for Identical Assets (Level 1) | Fair Value Measurements at December 31, 2011 Using: |   |
|---|----------------|--|---|---|
|   |                |  | Significant Other Observable Inputs (Level 2)       | Significant Unobservable Inputs (Level 3) |
| <b>Financial Assets:</b>                                    |                |  |   |   |
| Available for sale securities:                              |                |  |   |   |
| U.S. GSE securities   | \$ 131,674     |  | \$ 131,674  |   |
| State and municipal obligations                             | 54,219         |  | 54,219  |   |
| U.S. GSE residential mortgage-backed securities             | 70,984         |  | 70,984  |   |
| U.S. GSE residential collateralized mortgage obligations    | 179,325        |  | 179,325   |   |
| U.S. GSE commercial collateralized mortgage obligations (1) | 5,237          |  | 5,237   |   |
| Total available for sale                                    | \$ 441,439     |  | \$ 441,439  |   |

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- (1) U.S. GSE commercial collateralized mortgage obligations represent securities with multi-family mortgage loans as the collateral.



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Assets measured at fair value on a non-recurring basis are summarized below:

| (In thousands) | Carrying Value | Quoted Prices In Active Markets for Identical Assets (Level 1) | Fair Value Measurements at September 30, 2012 Using: |   |
|----------------|----------------|--|--|---|
|                |                |  | Significant Other Observable Inputs (Level 2)        | Significant Unobservable Inputs (Level 3) |
| Impaired loans | \$ 299         |  |  | \$ 299                                    |

  

| (In thousands)      | Carrying Value | Quoted Prices In Active Markets for Identical Assets (Level 1) | Fair Value Measurements at December 31, 2011 Using: |   |
|---------------------|----------------|--|---|---|
|                     |                |  | Significant Other Observable Inputs (Level 2)       | Significant Unobservable Inputs (Level 3) |
| Impaired loans      | \$ 1,868       |  |   | \$ 1,868                                  |
| Loans held for sale | 2,300          |  |   | 2,300                                     |

Impaired loans with allocated allowance for loan losses at September 30, 2012, had a carrying amount of \$0.3 million, which is made up of the outstanding balance of \$0.8 million, net of a valuation allowance of \$0.5 million. This resulted in an additional provision for loan losses of \$0.3 million that is included in the amount reported on the income statement. Impaired loans with allocated allowance for loan losses at December 31, 2011, had a carrying amount of \$1.9 million, which is made up of the outstanding balance of \$2.1 million, net of a valuation allowance of \$0.2 million. This resulted in an additional provision for loan losses of \$0.2 million that is included in the amount reported on the income statement.

Loans held for sale at December 31, 2011 had a carrying amount and outstanding balance of \$2.3 million. There was no valuation allowance at December 31, 2011. Charge-offs of \$0.9 million were incurred on loans transferred to loans held for sale at December 31, 2011. These loans were subsequently sold in January 2012 with no gain or loss incurred.

The Company used the following method and assumptions, not previously presented, in estimating the fair value of its financial instruments:

**Cash and Due from Banks and Federal Funds Sold:** Carrying amounts approximate fair value, since these instruments are either payable on demand or have short-term maturities. Cash on hand and non-interest due from bank accounts are Level 1 and interest bearing Cash Due from Banks and Federal Funds Sold are Level 2.

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

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Loans: The estimated fair values of real estate mortgage loans and other loans receivable are based on discounted cash flow calculations that use available market benchmarks when establishing discount factors for the types of loans resulting in a Level 3 classification. Exceptions may be made for adjustable rate loans (with resets of one year or less), which would be discounted straight to their rate index plus or minus an appropriate spread. All nonaccrual loans are carried at their current fair value. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price and therefore, while permissible for presentation purposed under ASC 825-10, do not conform with ASC 820-10.

Deposits: The estimated fair value of certificates of deposits are based on discounted cash flow calculations that use a replacement cost of funds approach to establishing discount rates for certificates of deposits maturities resulting in a Level 2 classification. Stated value is fair value for all other deposits resulting in a Level 1 classification.

Borrowed Funds: The estimated fair value of borrowed funds are based on discounted cash flow calculations that use a replacement cost of funds approach to establishing discount rates for funding maturities resulting in a Level 2 classification.

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Junior Subordinated Debentures: The estimated fair value is based on estimates using market data for similarly risk weighted items and takes into consideration the convertible features of the debentures into common stock of the Company which is an unobservable input resulting in a Level 3 classification.

Accrued Interest Receivable and Payable: For these short-term instruments, the carrying amount is a reasonable estimate of the fair value resulting in a Level 1 or 2 classification.

Off-Balance-Sheet Liabilities: The fair value of off-balance-sheet commitments to extend credit is estimated using fees currently charged to enter into similar agreements. The fair value is immaterial as of September 30, 2012 and December 31, 2011.

Fair value estimates are made at specific points in time and are based on existing on-and off-balance sheet financial instruments. Such estimates are generally subjective in nature and dependent upon a number of significant assumptions associated with each financial instrument or group of financial instruments, including estimates of discount rates, risks associated with specific financial instruments, estimates of future cash flows, and relevant available market information. Changes in assumptions could significantly affect the estimates. In addition, fair value estimates do not reflect the value of anticipated future business, premiums or discounts that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument, or the tax consequences of realizing gains or losses on the sale of financial instruments.

The estimated fair values and recorded carrying amounts of the Bank's financial instruments at September 30, 2012 and December 31, 2011 are as follows:

| (In thousands)  | Carrying Amount | Fair Value Measurements at September 30, 2012 Using:           |   |   | Total     |
|---|-----------------|--|---|---|-----------|
|   |                 | Quoted Prices In Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |           |
| <b>Financial assets:</b>  |                 |  |   |   |           |
| Cash and due from banks   | \$ 20,593       | \$ 20,593  | \$  | \$  | \$ 20,593 |
| Interest bearing deposits with banks                                    | 7,264           |  | 7,264   |   | 7,264     |
| Securities available for sale   | 560,790         |  | 560,790                                       |   | 560,790   |
| Securities restricted   | 2,978           | n/a  | n/a   | n/a                                       | n/a       |
| Securities held to maturity   | 212,879         |  | 216,083                                       |   | 216,083   |
| Loans, net  | 718,427         |  |   | 749,227                                   | 749,227   |
| Accrued interest receivable   | 5,412           |  | 2,952   | 2,460                                     | 5,412     |
| <b>Financial liabilities:</b>   |                 |  |   |   |           |
| Certificates of deposit   | 164,892         |  | 166,551                                       |   | 166,551   |
| Demand and other deposits   | 1,149,955       | 1,149,955  |   |   | 1,149,955 |
| Federal funds purchased and Federal Home Loan Bank overnight borrowings | 62,000          | 62,000   |   |   | 62,000    |
| Federal Home Loan Bank term advances                                    | 15,000          |  | 15,199  |   | 15,199    |
| Repurchase agreements   | 13,093          |  | 13,845  |   | 13,845    |
| Junior Subordinated Debentures  | 16,002          |  |   | 17,364                                    | 17,364    |
| Accrued interest payable  | 212             | 22   | 190   |   | 212       |



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| (In thousands)                       | At December 31, 2011 |            |
|--------------------------------------|----------------------|------------|
|                                      | Carrying Amount      | Fair Value |
| Financial assets:                    |                      |            |
| Cash and due from banks              | \$ 25,921            | \$ 25,921  |
| Interest bearing deposits with banks | 53,625               | 53,625     |
| Securities available for sale        | 441,439              | 441,439    |
| Securities restricted                | 1,660                | n/a        |
| Securities held to maturity          | 169,153              | 170,952    |
| Loans, net                           | 603,606              | 632,616    |
| Accrued interest receivable          | 4,940                | 4,940      |
| Financial liabilities:               |                      |            |
| Demand and other deposits            | 1,188,185            | 1,190,080  |
| Repurchase agreements                | 16,897               | 17,990     |
| Junior Subordinated Debentures       | 16,002               | 16,915     |
| Accrued interest payable             | 319                  | 319        |

## 6. LOANS

The following table sets forth the major classifications of loans:

| (In thousands)                                | September 30, 2012 | December 31, 2011 |
|---|--------------------|-------------------|
| Commercial real estate mortgage loans         | \$ 317,881         | \$ 283,917        |
| Multi-family mortgage loans                   | 60,395             | 21,402            |
| Residential real estate mortgage loans        | 142,816            | 141,027           |
| Commercial, financial, and agricultural loans | 159,530            | 116,319           |
| Real estate-construction and land loans       | 42,105             | 40,543            |
| Installment/consumer loans                    | 9,422              | 8,565             |
| Total loans                                   | 732,149            | 611,773           |
| Net deferred loan costs and fees              | 322                | 370               |
|   | 732,471            | 612,143           |
| Allowance for loan losses                     | (14,044)           | (10,837)          |
| Net loans                                     | \$ 718,427         | \$ 601,306        |

### Lending Risk

The principal business of the Bank is lending, primarily in commercial real estate mortgage loans, multi-family mortgage loans, residential real estate mortgage loans, construction loans, home equity loans, commercial and industrial loans, land loans and consumer loans. The Bank considers its primary lending area to be eastern Long Island in Suffolk County, New York, and a substantial portion of the Bank's loans are secured by real estate in this area. Accordingly, the ultimate collectability of such a loan portfolio is susceptible to changes in market and economic conditions in this region.

### Credit Quality Indicators

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The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt including repayment patterns, probable incurred losses, past loss experience, current economic conditions, and various types of concentrations of credit. Assigned risk rating grades are continuously updated as new information is obtained. Loans risk rated special mention, substandard and doubtful are reviewed on a quarterly basis. The Company uses the following definitions for risk rating grades:

Pass: Loans classified as pass include current loans performing in accordance with contractual terms, pools of homogenous residential real estate and installment/consumer loans that are not individually risk rated and loans which do not exhibit certain risk factors that require greater than usual monitoring by management.

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Special mention: Loans classified as special mention, while generally not delinquent, have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Bank's credit position at some future date.

Substandard: Loans classified as substandard have a well defined weakness or weaknesses that jeopardize the liquidation of the debt. There is a distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful: Loans classified as doubtful have all the weaknesses inherent in a substandard loan, and may also be at delinquency status and have defined weaknesses based on currently existing facts, conditions and values making collection or liquidation in full highly questionable and improbable.

The following table represents loans by class categorized by internally assigned risk grades as of September 30, 2012 and December 31, 2011:

| <b>September 30, 2012</b><br>(In thousands) | <b>Pass</b>       | <b>Special Mention</b> | <b>Grades:<br/>Substandard</b> | <b>Doubtful</b> | <b>Total</b>      |
|---|-------------------|------------------------|--------------------------------|-----------------|-------------------|
| Commercial real estate:                     |                   |                        |                                |                 |                   |
| Owner occupied                              | \$ 124,007        | \$ 11,360              | \$ 10,838                      | \$              | \$ 146,205        |
| Non-owner occupied                          | 159,793           | 8,953                  | 2,930                          |                 | 171,676           |
| Multi-Family                                | 60,395            |                        |                                |                 | 60,395            |
| Residential real estate:                    |                   |                        |                                |                 |                   |
| First lien                                  | 73,544            |                        | 1,336                          | 963             | 75,843            |
| Home equity                                 | 64,404            | 748                    | 1,821                          |                 | 66,973            |
| Commercial:                                 |                   |                        |                                |                 |                   |
| Secured                                     | 74,842            | 1,560                  | 5,589                          |                 | 81,991            |
| Unsecured                                   | 74,242            | 1,982                  | 1,303                          | 12              | 77,539            |
| Real estate construction and land loans     | 38,663            |                        | 3,442                          |                 | 42,105            |
| Installment/consumer loans                  | 9,285             | 26                     | 111                            |                 | 9,422             |
| <b>Total loans</b>                          | <b>\$ 679,175</b> | <b>\$ 24,629</b>       | <b>\$ 27,370</b>               | <b>\$ 975</b>   | <b>\$ 732,149</b> |

| <b>December 31, 2011</b><br>(In thousands) | <b>Pass</b>       | <b>Special Mention</b> | <b>Grades:<br/>Substandard</b> | <b>Doubtful</b> | <b>Total</b>      |
|--|-------------------|------------------------|--------------------------------|-----------------|-------------------|
| Commercial real estate:                    |                   |                        |                                |                 |                   |
| Owner occupied                             | \$ 120,662        | \$ 14,975              | \$ 9,839                       | \$              | \$ 145,476        |
| Non-owner occupied                         | 126,016           | 9,443                  | 2,982                          |                 | 138,441           |
| Multi-Family                               | 21,402            |                        |                                |                 | 21,402            |
| Residential real estate:                   |                   |                        |                                |                 |                   |
| First lien                                 | 64,725            |                        | 1,351                          | 1,223           | 67,299            |
| Home equity                                | 70,947            | 584                    | 1,972                          | 225             | 73,728            |
| Commercial:                                |                   |                        |                                |                 |                   |
| Secured                                    | 52,686            | 4,258                  | 3,208                          |                 | 60,152            |
| Unsecured                                  | 53,421            | 1,613                  | 1,124                          | 9               | 56,167            |
| Real estate construction and land loans    | 35,979            |                        | 4,314                          | 250             | 40,543            |
| Installment/consumer loans                 | 8,283             | 264                    | 18                             |                 | 8,565             |
| <b>Total loans</b>                         | <b>\$ 554,121</b> | <b>\$ 31,137</b>       | <b>\$ 24,808</b>               | <b>\$ 1,707</b> | <b>\$ 611,773</b> |





**Past Due and Nonaccrual Loans**

The following table represents the aging of the recorded investment in past due loans as of September 30, 2012 and December 31, 2011 by class of loans, as defined by ASC 310-10:

|  | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | ≥90 Days<br>Past Due<br>and<br>Accruing | Nonaccrual<br>Including 90<br>Days or<br>More Past<br>Due | Total Past<br>Due and<br>Nonaccrual | Current    | Total<br>Loans |
|--|------------------------------|------------------------------|---|---|-------------------------------------|------------|----------------|
| <b>September 30, 2012</b>                  |                              |                              |   |   |                                     |            |                |
| (In thousands)                             |                              |                              |   |   |                                     |            |                |
| Commercial real estate:                    |                              |                              |   |   |                                     |            |                |
| Owner occupied                             | \$                           | \$                           | \$ 470                                  | \$ 986  | \$ 1,456                            | \$ 144,749 | \$ 146,205     |
| Non-owner occupied                         |                              |                              |   |   |                                     | 171,676    | 171,676        |
| Multi-Family                               |                              |                              |   |   |                                     | 60,395     | 60,395         |
| Residential real estate:                   |                              |                              |   |   |                                     |            |                |
| First lien                                 |                              | 487                          |   | 964   | 1,451                               | 74,392     | 75,843         |
| Home equity                                | 1,407                        | 50                           |   | 1,196   | 2,653                               | 64,320     | 66,973         |
| Commercial:                                |                              |                              |   |   |                                     |            |                |
| Secured                                    | 50                           | 162                          |   | 123   | 335                                 | 81,656     | 81,991         |
| Unsecured                                  | 350                          |                              |   | 383   | 733                                 | 76,806     | 77,539         |
| Real estate construction and land<br>loans |                              |                              |   |   |                                     | 42,105     | 42,105         |
| Installment/consumer loans                 | 100                          |                              |   | 2   | 102                                 | 9,320      | 9,422          |
| Total loans                                | \$ 1,907                     | \$ 699                       | \$ 470                                  | \$ 3,654  | \$ 6,730                            | \$ 725,419 | \$ 732,149     |
| <br>                                       |                              |                              |   |   |                                     |            |                |
|  | 30-59<br>Days<br>Past Due    | 60-89<br>Days<br>Past Due    | ≥90 Days<br>Past Due<br>and<br>Accruing | Nonaccrual<br>Including 90<br>Days or More<br>Past Due    | Total Past<br>Due and<br>Nonaccrual | Current    | Total<br>Loans |
| <b>December 31, 2011</b>                   |                              |                              |   |   |                                     |            |                |
| (In thousands)                             |                              |                              |   |   |                                     |            |                |
| Commercial real estate:                    |                              |                              |   |   |                                     |            |                |
| Owner occupied                             | \$ 485                       | \$ 1,281                     | \$ 406                                  | \$ 449  | \$ 2,621                            | \$ 142,855 | \$ 145,476     |
| Non-owner occupied                         |                              |                              |   |   |                                     | 138,441    | 138,441        |
| Multi-Family                               |                              |                              |   |   |                                     | 21,402     | 21,402         |
| Residential real estate:                   |                              |                              |   |   |                                     |            |                |
| First lien                                 |                              |                              |   | 1,561   | 1,561                               | 65,738     | 67,299         |
| Home equity                                | 448                          | 255                          |   | 1,382   | 2,085                               | 71,643     | 73,728         |
| Commercial:                                |                              |                              |   |   |                                     |            |                |
| Secured                                    |                              |                              |   | 479   | 479                                 | 59,673     | 60,152         |
| Unsecured                                  |                              | 53                           |   | 40  | 93                                  | 56,074     | 56,167         |
| Real estate construction and land<br>loans |                              |                              |   | 250   | 250                                 | 40,293     | 40,543         |
| Installment/consumer loans                 | 1                            |                              | 5                                       |   | 6                                   | 8,559      | 8,565          |
| Total loans                                | \$ 934                       | \$ 1,589                     | \$ 411                                  | \$ 4,161  | \$ 7,095                            | \$ 604,678 | \$ 611,773     |

All loans 90 days or more past due that are still accruing interest represent loans that were acquired from Hamptons State Bank on May 27, 2011 and were recorded at fair value upon acquisition. These loans are considered to be accruing as management can reasonably estimate future cash flows on these acquired loans and expect to fully collect the carrying value of these loans. Therefore, the difference between the carrying value of these loans and their expected cash flows is being accreted into income.

**Impaired Loans**

As of September 30, 2012 and December 31, 2011, the Company had impaired loans as defined by FASB ASC No. 310, Receivables of \$8.8 million and \$9.0 million, respectively. For a loan to be considered impaired, management determines after review whether it is probable that the Bank will not be able to collect all amounts due according to the contractual terms of the loan agreement. Management applies its normal loan review procedures in making these judgments. Impaired loans include individually classified nonaccrual loans and troubled debt restructured ( TDR ) loans. For impaired loans, the Bank evaluates the impairment of the loan in accordance with FASB ASC 310-10-35-22. Impairment is determined based on the present value of expected future cash flows discounted at the loan s effective interest rate. For loans that are collateral dependent, the fair value of the collateral is used to determine the fair value of the loan. The fair value of the collateral is determined based upon recent appraised values. The fair value of the collateral or present value of expected cash flows is compared to the carrying value to determine if any write-down or specific loan

loss allowance allocation is required. These methods of fair value measurement for impaired loans are considered level 3 within the fair value hierarchy described in FASB ASC 820-10-50-5.

The following table represents impaired loans by class at September 30, 2012 and December 31, 2011:

| September 30, 2012<br>(In thousands)            | Recorded<br>Investment | Unpaid Principal<br>Balance | Related Allocated<br>Allowance |
|---|------------------------|-----------------------------|--------------------------------|
| <b>With no related allowance recorded:</b>      |                        |                             |                                |
| Commercial real estate:                         |                        |                             |                                |
| Owner occupied                                  | \$ 4,355               | \$ 4,420                    | \$                             |
| Non-owner occupied                              | 916                    | 916                         |                                |
| Residential real estate:                        |                        |                             |                                |
| First lien                                      | 1,301                  | 1,667                       |                                |
| Home equity                                     | 736                    | 1,095                       |                                |
| Commercial:                                     |                        |                             |                                |
| Secured   | 660                    | 660                         |                                |
| Unsecured                                       |                        |                             |                                |
| Real estate construction and land loans         |                        |                             |                                |
| Installment/consumer loans                      |                        |                             |                                |
| <b>Total with no related allowance recorded</b> | <b>\$ 7,968</b>        | <b>\$ 8,758</b>             | <b>\$</b>                      |
| <b>With an allowance recorded:</b>              |                        |                             |                                |
| Residential real estate - Home equity           | \$ 461                 | \$ 472                      | \$ 244                         |
| Commercial - Unsecured                          | 358                    | 381                         | 276                            |
| <b>Total with an allowance recorded:</b>        | <b>\$ 819</b>          | <b>\$ 853</b>               | <b>\$ 520</b>                  |
| <b>Total:</b>                                   |                        |                             |                                |
| Commercial real estate:                         |                        |                             |                                |
| Owner occupied                                  | \$ 4,355               | \$ 4,420                    | \$                             |
| Non-owner occupied                              | 916                    | 916                         |                                |
| Residential real estate:                        |                        |                             |                                |
| First lien                                      | 1,301                  | 1,667                       |                                |
| Home equity                                     | 1,197                  | 1,567                       | 244                            |
| Commercial:                                     |                        |                             |                                |
| Secured   | 660                    | 660                         |                                |
| Unsecured                                       | 358                    | 381                         | 276                            |
| Real estate construction and land loans         |                        |                             |                                |
| Installment/consumer loans                      |                        |                             |                                |
| <b>Total</b>                                    | <b>\$ 8,787</b>        | <b>\$ 9,611</b>             | <b>\$ 520</b>                  |

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| December 31, 2011<br>(In thousands)             | Recorded<br>Investment |  | Unpaid Principal<br>Balance |  | Related Allocated<br>Allowance |
|---|------------------------|--|-----------------------------|--|--------------------------------|
| <b>With no related allowance recorded:</b>      |                        |  |                             |  |                                |
| Commercial real estate:                         |                        |  |                             |  |                                |
| Owner occupied                                  | \$ 4,163               |  | \$ 4,206                    |  |                                |
| Non-owner occupied                              | 916                    |  | 916                         |  |                                |
| Residential real estate:                        |                        |  |                             |  |                                |
| First lien                                      | 338                    |  | 344                         |  |                                |
| Home equity                                     | 688                    |  | 860                         |  |                                |
| Commercial:                                     |                        |  |                             |  |                                |
| Secured   | 533                    |  | 533                         |  |                                |
| Unsecured                                       |                        |  |                             |  |                                |
| Real estate construction and land loans         | 250                    |  | 371                         |  |                                |
| Installment/consumer loans                      |                        |  |                             |  |                                |
| <b>Total with no related allowance recorded</b> | <b>\$ 6,888</b>        |  | <b>\$ 7,230</b>             |  |                                |
| <b>With an allowance recorded:</b>              |                        |  |                             |  |                                |
| Residential real estate - First lien            | \$ 1,223               |  | \$ 1,329                    |  | 76                             |
| Residential real estate - Home equity           | 693                    |  | 700                         |  | 29                             |
| Commercial - Secured                            | 219                    |  | 229                         |  | 162                            |
| <b>Total with an allowance recorded:</b>        | <b>\$ 2,135</b>        |  | <b>\$ 2,258</b>             |  | <b>267</b>                     |
| <b>Total:</b>                                   |                        |  |                             |  |                                |
| Commercial real estate:                         |                        |  |                             |  |                                |
| Owner occupied                                  | \$ 4,163               |  | \$ 4,206                    |  |                                |
| Non-owner occupied                              | 916                    |  | 916                         |  |                                |
| Residential real estate:                        |                        |  |                             |  |                                |
| First lien                                      | 1,561                  |  | 1,673                       |  | 76                             |
| Home equity                                     | 1,381                  |  | 1,560                       |  | 29                             |
| Commercial:                                     |                        |  |                             |  |                                |
| Secured   | 752                    |  | 762                         |  | 162                            |
| Unsecured                                       |                        |  |                             |  |                                |
| Real estate construction and land loans         | 250                    |  | 371                         |  |                                |
| Installment/consumer loans                      |                        |  |                             |  |                                |
| <b>Total</b>                                    | <b>\$ 9,023</b>        |  | <b>\$ 9,488</b>             |  | <b>267</b>                     |

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The following table represents the average recoded investment and interest income recognized for impaired loans by class for the three and nine months ended September 30, 2012 and 2011:

| (In thousands)                                  | Average<br>Recorded<br>Investment | Three months ended September 30, |                  | Average<br>Recorded<br>Investment | Interest Income<br>Recognized |
|---|-----------------------------------|----------------------------------|------------------|-----------------------------------|-------------------------------|
|   |                                   | 2012                             | 2011             |                                   |                               |
| <b>With no related allowance recorded:</b>      |                                   |                                  |                  |                                   |                               |
| Commercial real estate:                         |                                   |                                  |                  |                                   |                               |
| Owner occupied                                  | \$ 4,363                          | \$ 30                            | \$ 4,203         | \$ 38                             |                               |
| Non-owner occupied                              | 916                               | 15                               | 923              |                                   |                               |
| Residential real estate:                        |                                   |                                  |                  |                                   |                               |
| First lien                                      | 1,431                             | 7                                | 1,232            |                                   |                               |
| Home equity                                     | 737                               |                                  | 771              |                                   |                               |
| Commercial:                                     |                                   |                                  |                  |                                   |                               |
| Secured   | 540                               | 2                                | 273              | 2                                 |                               |
| Unsecured                                       |                                   |                                  |                  |                                   |                               |
| Real estate construction and land loans         |                                   |                                  | 3,162            |                                   |                               |
| Installment/consumer loans                      |                                   |                                  |                  |                                   |                               |
| <b>Total with no related allowance recorded</b> | <b>\$ 7,987</b>                   | <b>\$ 54</b>                     | <b>\$ 10,564</b> | <b>\$ 40</b>                      |                               |
| <b>With an allowance recorded:</b>              |                                   |                                  |                  |                                   |                               |
| Residential real estate - Home equity           | \$ 463                            | \$                               | \$ 693           | \$                                |                               |
| Commercial - Unsecured                          | 370                               |                                  | 236              |                                   |                               |
| <b>Total with an allowance recorded:</b>        | <b>\$ 833</b>                     | <b>\$</b>                        | <b>\$ 929</b>    | <b>\$</b>                         |                               |
| <b>Total:</b>                                   |                                   |                                  |                  |                                   |                               |
| Commercial real estate:                         |                                   |                                  |                  |                                   |                               |
| Owner occupied                                  | \$ 4,363                          | \$ 30                            | \$ 4,203         | \$ 38                             |                               |
| Non-owner occupied                              | 916                               | 15                               | 923              |                                   |                               |
| Residential real estate:                        |                                   |                                  |                  |                                   |                               |
| First lien                                      | 1,431                             | 7                                | 1,232            |                                   |                               |
| Home equity                                     | 1,200                             |                                  | 1,464            |                                   |                               |
| Commercial:                                     |                                   |                                  |                  |                                   |                               |
| Secured   | 540                               | 2                                | 273              | 2                                 |                               |
| Unsecured                                       | 370                               |                                  | 236              |                                   |                               |
| Real estate construction and land loans         |                                   |                                  | 3,162            |                                   |                               |
| Installment/consumer loans                      |                                   |                                  |                  |                                   |                               |
| <b>Total</b>                                    | <b>\$ 8,820</b>                   | <b>\$ 54</b>                     | <b>\$ 11,493</b> | <b>\$ 40</b>                      |                               |

| (In thousands)                                  | Nine months ended September 30,   |              |                               |                                   | Interest Income<br>Recognized |               |    |           |
|---|-----------------------------------|--------------|-------------------------------|-----------------------------------|-------------------------------|---------------|----|-----------|
|   | Average<br>Recorded<br>Investment | 2012         | Interest Income<br>Recognized | Average<br>Recorded<br>Investment |                               | 2011          |    |           |
| <b>With no related allowance recorded:</b>      |                                   |              |                               |                                   |                               |               |    |           |
| Commercial real estate:                         |                                   |              |                               |                                   |                               |               |    |           |
| Owner occupied                                  | \$                                | 4,387        | \$                            | 116                               | \$                            | 4,217         | \$ | 90        |
| Non-owner occupied                              |                                   | 916          |                               | 45                                |                               | 933           |    |           |
| Residential real estate:                        |                                   |              |                               |                                   |                               |               |    |           |
| First lien                                      |                                   | 1,481        |                               | 22                                |                               | 1,247         |    |           |
| Home equity                                     |                                   | 890          |                               |                                   |                               | 840           |    |           |
| Commercial:                                     |                                   |              |                               |                                   |                               |               |    |           |
| Secured   |                                   | 531          |                               | 12                                |                               | 273           |    | 2         |
| Unsecured                                       |                                   |              |                               |                                   |                               |               |    |           |
| Real estate construction and land loans         |                                   |              |                               |                                   |                               | 3,305         |    |           |
| Installment/consumer loans                      |                                   |              |                               |                                   |                               |               |    |           |
| <b>Total with no related allowance recorded</b> | \$                                | <b>8,205</b> | \$                            | <b>195</b>                        | \$                            | <b>10,815</b> | \$ | <b>92</b> |
| <b>With an allowance recorded:</b>              |                                   |              |                               |                                   |                               |               |    |           |
| Residential real estate - Home equity           | \$                                | 469          | \$                            |                                   | \$                            | 695           | \$ |           |
| Commercial - Unsecured                          |                                   | 387          |                               |                                   |                               | 239           |    |           |
| <b>Total with an allowance recorded:</b>        | \$                                | <b>856</b>   | \$                            |                                   | \$                            | <b>934</b>    | \$ |           |
| <b>Total:</b>                                   |                                   |              |                               |                                   |                               |               |    |           |
| Commercial real estate:                         |                                   |              |                               |                                   |                               |               |    |           |
| Owner occupied                                  | \$                                | 4,387        | \$                            | 116                               | \$                            | 4,217         | \$ | 90        |
| Non-owner occupied                              |                                   | 916          |                               | 45                                |                               | 933           |    |           |
| Residential real estate:                        |                                   |              |                               |                                   |                               |               |    |           |
| First lien                                      |                                   | 1,481        |                               | 22                                |                               | 1,247         |    |           |
| Home equity                                     |                                   | 1,359        |                               |                                   |                               | 1,535         |    |           |
| Commercial:                                     |                                   |              |                               |                                   |                               |               |    |           |
| Secured   |                                   | 531          |                               | 12                                |                               | 273           |    | 2         |
| Unsecured                                       |                                   | 387          |                               |                                   |                               | 239           |    |           |
| Real estate construction and land loans         |                                   |              |                               |                                   |                               | 3,305         |    |           |
| Installment/consumer loans                      |                                   |              |                               |                                   |                               |               |    |           |
| <b>Total</b>                                    | \$                                | <b>9,061</b> | \$                            | <b>195</b>                        | \$                            | <b>11,749</b> | \$ | <b>92</b> |

The Bank had \$0.3 million foreclosed real estate at September 30, 2012 and none at December 31, 2011, respectively.

### Troubled Debt Restructurings

The terms of certain loans were modified and are considered TDR. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan. The modification of these loans involved a loan to borrowers who were experiencing financial difficulties.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed to determine if that borrower is currently in payment default under any of its obligations or whether there is a probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company's internal underwriting policy.

The terms of certain other loans were modified during the quarter ending September 30, 2012 that did not meet the definition of a TDR. These loans have a total recorded investment as of September 30, 2012 of \$38.1 million. The modification of these loans involved a modification of the terms of loans to borrowers who were not experiencing financial difficulties or did not involve a concession to the borrower.

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The following table presents loans by class modified as troubled debt restructurings that occurred during the nine months ended September 30, 2012:

| (In thousands)                          | Number of<br>Contracts | For the Nine Months Ended<br>September 30, 2012        |  |
|---|------------------------|--|--|
|   |                        | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification Outstanding<br>Recorded Investment |
| <b>Troubled Debt Restructurings</b>     |                        |  |  |
| Commercial real estate:                 |                        |  |  |
| Owner occupied                          | 1                      | \$ 163   | \$ 161   |
| Non-owner occupied                      |                        |  |  |
| Multi-Family                            |                        |  |  |
| Residential real estate:                |                        |  |  |
| First lien                              |                        |  |  |
| Home equity                             |                        |  |  |
| Commercial:                             |                        |  |  |
| Secured                                 | 1                      | 387  | 387  |
| Unsecured                               | 1                      | 42   | 42   |
| Installment/consumer loans              |                        |  |  |
| Real estate construction and land loans |                        |  |  |
| Total loans                             | 3                      | \$ 592   | \$ 590   |

There were two loans modified as TDRs for which there was a payment default within twelve months following the modification. These loans have since been moved to non performing TDR and foreclosure proceedings have been initiated. A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

As of September 30, 2012 and December 31, 2011, the Company had \$1.8 million and \$2.0 million, respectively of nonaccrual TDR loans. As of September 30, 2012, one of the borrowers with loans totaling \$0.2 million is complying with the modified terms of the loans and is currently making payments. Another borrower with loans totaling \$1.0 million is past due but currently making payments. The remaining borrower with loans totaling \$0.6 million is currently in default and foreclosure proceedings have been initiated. The decrease in nonaccrual TDR loans at September 30, 2012 was due to the reclassification of a \$0.3 million nonaccrual TDR loan to a performing TDR as the borrower has made six months of consecutive payments in line with the restructured terms. In addition, there was a charge-off of \$0.3 million during the first quarter 2012 and an additional charge-off of \$0.2 million during the second quarter 2012. Total nonaccrual TDR loans are secured with collateral that has an appraised value of \$3.4 million. Furthermore, the Bank has no commitment to lend additional funds to these debtors.

In addition, the Company has seven borrowers with performing TDR loans of \$5.2 million at September 30, 2012 that are current and secured with collateral that has an appraised value of approximately \$12.3 million. At December 31, 2011, the Company had four borrowers with TDR loans of \$4.9 million that were current and secured with collateral that had an appraised value of approximately \$11.5 million as well as personal guarantees. Management believes that the ultimate collection of principal and interest is reasonably assured and therefore continues to recognize interest income on an accrual basis. In addition, the Bank has no commitment to lend additional funds to these debtors.

## 7. ALLOWANCE FOR LOAN LOSSES



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Management considers the accounting policy on the allowance for loan losses to be the most critical and requires complex management judgment as discussed below. The judgments made regarding the allowance for loan losses can have a material effect on the results of operations of the Company.

The allowance for loan losses is established and maintained through a provision for loan losses based on probable incurred losses inherent in the Bank's loan portfolio. Management evaluates the adequacy of the allowance on a quarterly basis. The allowance is comprised of both individual valuation allowances and loan pool valuation allowances.

The Bank monitors its entire loan portfolio on a regular basis, with consideration given to detailed analysis of classified loans, repayment patterns, probable incurred losses, past loss experience, current economic conditions, and various types of concentrations of credit. Additions to the allowance are charged to expense and realized losses, net of recoveries, are charged to the allowance.

Individual valuation allowances are established in connection with specific loan reviews and the asset classification process including the procedures for impairment testing under FASB ASC No. 310, *Receivables*. Such valuation, which includes a review of loans for which full collectibility in accordance with contractual terms is not reasonably assured, considers the estimated fair value of the underlying collateral less the costs to sell, if any, or the present value of expected future cash flows, or the loan's observable market value. Any shortfall that exists from this analysis results in a specific allowance for the loan. Pursuant to our policy, loan losses must be charged-off in the period the loans, or portions thereof, are deemed uncollectible. Assumptions and judgments by management, in conjunction with outside sources, are used to determine whether full collectibility of a loan is not reasonably assured. These assumptions and judgments are also used to determine the estimates of the fair value of the underlying collateral or the present value of expected future cash flows or the loan's observable market value. Individual valuation allowances could differ materially as a result of changes in these assumptions and judgments. Individual loan analyses are periodically performed on specific loans considered impaired. The results of the individual valuation allowances are aggregated and included in the overall allowance for loan losses.

Loan pool valuation allowances represent loss allowances that have been established to recognize the inherent risks associated with our lending activities, but which, unlike individual allowances, have not been allocated to particular problem assets. Pool evaluations are broken down into loans with homogenous characteristics by loan type and include commercial real estate mortgages, owner and non-owner occupied; multi-family mortgages; residential real estate mortgages, first lien and home equity; commercial loans, secured and unsecured; installment/consumer loans; and real estate construction and land loans. The determination of the adequacy of the valuation allowance is a process that takes into consideration a variety of factors. The Bank has developed a range of valuation allowances necessary to adequately provide for probable incurred losses inherent in each pool of loans. We consider our own charge-off history along with the growth in the portfolio as well as the Bank's credit administration and asset management philosophies and procedures, and concentrations in the portfolio when determining the allowances for each pool. In addition, we evaluate and consider the credit's risk rating which includes management's evaluation of: cash flow, collateral, guarantor support, financial disclosures, industry trends and strength of borrowers' management, the impact that economic and market conditions may have on the portfolio as well as known and inherent risks in the portfolio. Finally, we evaluate and consider the allowance ratios and coverage percentages of both peer group and regulatory agency data. These evaluations are inherently subjective because, even though they are based on objective data, it is management's interpretation of that data that determines the amount of the appropriate allowance. If the evaluations prove to be incorrect, the allowance for loan losses may not be sufficient to cover losses inherent in the loan portfolio, resulting in additions to the allowance for loan losses.

The Credit Risk Committee is comprised of members of both management and the Board of Directors. The adequacy of the allowance is analyzed quarterly, with any adjustment to a level deemed appropriate by the Credit Risk Committee, based on its risk assessment of the entire portfolio. Based on the Credit Risk Committee's review of the classified loans and the overall allowance levels as they relate to the entire loan portfolio at September 30, 2012, management believes the allowance for loan losses has been established at levels sufficient to cover the probable incurred losses in the Bank's loan portfolio. Future additions or reductions to the allowance may be necessary based on changes in economic, market or other conditions. Changes in estimates could result in a material change in the allowance. In addition, various regulatory agencies, as an integral part of the examination process, periodically review the allowance for loan losses. Such agencies may require the Bank to recognize adjustments to the allowance based on their judgments of the information available to them at the time of their examination.

The following table represents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment, as defined under ASC 310-10, and based on impairment method as of September 30, 2012 and December 31, 2011. Additionally, the following tables represent the changes in the allowance for loan losses for the nine month period ended September 30, 2012 and 2011, and the twelve month period ended December 31, 2011, by portfolio segment, as defined under ASC 310-10. The loan segment represents the categories that the Bank develops to determine its allowance for loan losses.



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| (In thousands)  | For the Three Months Ended September 30, 2012 |              |  |  |   |                            |    | Total      |
|---|---|--------------|--|--|---|----------------------------|----|------------|
|   | Commercial Real Estate Mortgage Loans         | Multi-Family | Residential Real Estate Mortgage Loans | Commercial, Financial and Agricultural Loans | Real Estate Construction and Land Loans | Installment/Consumer Loans |    |            |
| Allowance for Loan Losses:  |   |              |  |  |   |                            |    |            |
| Beginning balance   | \$ 4,447                                      | \$ 1,049     | \$ 2,879                               | \$ 3,570                                     | \$ 1,328                                | \$ 283                     | \$ | \$ 13,556  |
| Charge-offs   |   |              | (150)                                  |  |   |                            |    | (150)      |
| Recoveries  |   |              | 2                                      | 35   |   | 1                          |    | 38         |
| Provision   | 126   | 172          | 153                                    | 204  | (42)                                    | (13)                       |    | 600        |
| Ending Balance  | \$ 4,573                                      | \$ 1,221     | \$ 2,884                               | \$ 3,809                                     | \$ 1,286                                | \$ 271                     | \$ | \$ 14,044  |
|   | For the Nine Months Ended September 30, 2012  |              |  |  |   |                            |    |            |
| (In thousands)  | Commercial Real Estate Mortgage Loans         | Multi-Family | Residential Real Estate Mortgage Loans | Commercial, Financial and Agricultural Loans | Real Estate Construction and Land Loans | Installment/Consumer Loans |    | Total      |
| Allowance for Loan Losses:  |   |              |  |  |   |                            |    |            |
| Beginning balance   | \$ 3,530                                      | \$ 395       | \$ 2,280                               | \$ 2,895                                     | \$ 1,465                                | \$ 272                     | \$ | \$ 10,837  |
| Charge-offs   |   |              | (700)                                  | (102)  |   | (13)                       |    | (815)      |
| Recoveries  |   |              | 5                                      | 70   |   | 22                         |    | 97         |
| Provision   | 1,043   | 826          | 1,299                                  | 946  | (179)                                   | (10)                       |    | 3,925      |
| Ending Balance  | \$ 4,573                                      | \$ 1,221     | \$ 2,884                               | \$ 3,809                                     | \$ 1,286                                | \$ 271                     | \$ | \$ 14,044  |
| Ending balance: individually evaluated for impairment               | \$ 48   | \$           | \$ 244                                 | \$ 228                                       | \$                                      | \$                         | \$ | \$ 520     |
| Ending balance: collectively evaluated for impairment               | \$ 4,525                                      | \$ 1,221     | \$ 2,640                               | \$ 3,581                                     | \$ 1,286                                | \$ 271                     | \$ | \$ 13,524  |
| Loans   | \$ 317,881                                    | \$ 60,395    | \$ 142,816                             | \$ 159,530                                   | \$ 42,105                               | \$ 9,422                   | \$ | \$ 732,149 |
| Ending balance: individually evaluated for impairment               | \$ 5,271                                      | \$           | \$ 2,498                               | \$ 1,018                                     | \$                                      | \$                         | \$ | \$ 8,787   |
| Ending balance: collectively evaluated for impairment               | \$ 311,906                                    | \$ 60,395    | \$ 140,318                             | \$ 158,301                                   | \$ 41,813                               | \$ 9,422                   | \$ | \$ 722,155 |
| Ending balance: loans acquired with deteriorated credit quality (1) | \$ 704  | \$           | \$                                     | \$ 211                                       | \$ 292                                  | \$                         | \$ | \$ 1,207   |

(1) Includes loans acquired on May 27, 2011 from Hamptons State Bank.

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| (In thousands)  | For the Twelve Months Ended December 31, 2011 |              |  |  |   |                             |            | Total |
|---|---|--------------|--|--|---|-----------------------------|------------|-------|
|   | Commercial Real Estate Mortgage Loans         | Multi-Family | Residential Real Estate Mortgage Loans | Commercial, Financial and Agricultural Loans | Real Estate Construction and Land Loans | Installment/ Consumer Loans |            |       |
| Allowance for Loan Losses:  |   |              |  |  |   |                             |            |       |
| Beginning balance   | \$ 3,310                                      | \$ 133       | \$ 1,642                               | \$ 2,804                                     | \$ 185                                  | \$ 423                      | \$ 8,497   |       |
| Charge-offs   |   |              | (259)                                  | (372)  | (864)                                   | (186)                       | (1,681)    |       |
| Recoveries  |   |              | 6                                      | 96   |   | 19                          | 121        |       |
| Provision   | 220   | 262          | 891                                    | 367  | 2,144                                   | 16                          | 3,900      |       |
| Ending Balance  | \$ 3,530                                      | \$ 395       | \$ 2,280                               | \$ 2,895                                     | \$ 1,465                                | \$ 272                      | \$ 10,837  |       |
| Ending balance: individually evaluated for impairment               | \$  | \$           | \$ 105                                 | \$ 162                                       | \$                                      | \$                          | \$ 267     |       |
| Ending balance: collectively evaluated for impairment               | \$ 3,530                                      | \$ 395       | \$ 2,175                               | \$ 2,733                                     | \$ 1,465                                | \$ 272                      | \$ 10,570  |       |
| Loans   | \$ 283,917                                    | \$ 21,402    | \$ 141,027                             | \$ 116,319                                   | \$ 40,543                               | \$ 8,565                    | \$ 611,773 |       |
| Ending balance: individually evaluated for impairment               | \$ 5,079                                      | \$           | \$ 2,942                               | \$ 752                                       | \$ 250                                  | \$                          | \$ 9,023   |       |
| Ending balance: collectively evaluated for impairment               | \$ 278,202                                    | \$ 21,402    | \$ 138,085                             | \$ 115,364                                   | \$ 40,029                               | \$ 8,565                    | \$ 601,647 |       |
| Ending balance: loans acquired with deteriorated credit quality (1) | \$ 636  | \$           | \$                                     | \$ 203                                       | \$ 264                                  | \$                          | \$ 1,103   |       |

(1) Includes loans acquired on May 27, 2011 from Hamptons State Bank.

| (In thousands)             | For the Three Months Ended September 30, 2011 |              |  |  |   |                             |           | Total |
|----------------------------|---|--------------|--|--|---|-----------------------------|-----------|-------|
|                            | Commercial Real Estate Mortgage Loans         | Multi-Family | Residential Real Estate Mortgage Loans | Commercial, Financial and Agricultural Loans | Real Estate Construction and Land Loans | Installment/ Consumer Loans |           |       |
| Allowance for Loan Losses: |   |              |  |  |   |                             |           |       |
| Beginning balance          | \$ 2,923                                      | \$ 390       | \$ 2,444                               | \$ 2,938                                     | \$ 500                                  | \$ 299                      | \$ 9,494  |       |
| Charge-offs                |   |              | (100)                                  | (40)   | (614)                                   | (77)                        | (831)     |       |
| Recoveries                 |   |              | 2                                      | 45   |   | 2                           | 49        |       |
| Provision                  | 313   | (2)          | (66)                                   | (61)   | 1,207                                   | 59                          | 1,450     |       |
| Ending Balance             | \$ 3,236                                      | \$ 388       | \$ 2,280                               | \$ 2,882                                     | \$ 1,093                                | \$ 283                      | \$ 10,162 |       |

| (In thousands)             | For the Nine Months Ended September 30, 2011 |              |  |  |   |                             |          | Total |
|----------------------------|--|--------------|--|--|---|-----------------------------|----------|-------|
|                            | Commercial Real Estate Mortgage Loans        | Multi-Family | Residential Real Estate Mortgage Loans | Commercial, Financial and Agricultural Loans | Real Estate Construction and Land Loans | Installment/ Consumer Loans |          |       |
| Allowance for Loan Losses: |  |              |  |  |   |                             |          |       |
| Beginning balance          | \$ 3,310                                     | \$ 133       | \$ 1,642                               | \$ 2,804                                     | \$ 185                                  | \$ 423                      | \$ 8,497 |       |
| Charge-offs                |  |              | (259)                                  | (266)  | (764)                                   | (178)                       | (1,467)  |       |
| Recoveries                 |  |              | 5                                      | 64   |   | 13                          | 82       |       |
| Provision                  | (74)   | 255          | 892                                    | 280  | 1,672                                   | 25                          | 3,050    |       |

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|                |    |       |    |     |    |       |    |       |    |       |    |     |    |        |
|----------------|----|-------|----|-----|----|-------|----|-------|----|-------|----|-----|----|--------|
| Ending Balance | \$ | 3,236 | \$ | 388 | \$ | 2,280 | \$ | 2,882 | \$ | 1,093 | \$ | 283 | \$ | 10,162 |
|----------------|----|-------|----|-----|----|-------|----|-------|----|-------|----|-----|----|--------|

## 8. EMPLOYEE BENEFITS

The Bank maintains a noncontributory pension plan covering all eligible employees. The Bank uses a December 31st measurement date for this plan in accordance with FASB ASC 715-30 *Compensation Retirement Benefits Defined Benefit Plans Pension*. In September 2011, the Bank transferred all of the Plan assets out of the New York State Bankers Association Retirement System to the new Trustee, Bank of America, N.A.

The Bridgehampton National Bank Supplemental Executive Retirement Plan ( SERP ) provides benefits to certain employees, as recommended by the Compensation Committee of the Board of Directors and approved by the full Board of Directors, whose benefits under the Pension Plan are limited by the applicable provisions of the Internal Revenue Code. The benefit under the SERP is equal to the additional amount the employee would be entitled to under the Pension Plan and the 401(k) Plan in the absence of such Internal Revenue Code limitations. The assets of the SERP are held in a rabbi trust to maintain the tax-deferred status of the plan and are subject to the general, unsecured creditors of the Company. As a result, the assets of the trust are reflected on the Consolidated Balance Sheets of the Company. The effective date of the SERP was January 1, 2001.

There were no contributions made to the pension plan or the SERP during the nine months ended September 30, 2012. In accordance with the SERP, a retired executive received a distribution from the Plan totaling \$84,000 during the nine months ended September 30, 2012.

The Company's funding policy with respect to its benefit plans is to contribute at least the minimum amounts required by applicable laws and regulations.

The following table sets forth the components of net periodic benefit cost and other amounts recognized in Other Comprehensive Income:

| (In thousands)   | Three months ended September 30, |        |               |       | Nine months ended September 30, |        |               |        |
|--|----------------------------------|--------|---------------|-------|---------------------------------|--------|---------------|--------|
|  | Pension Benefits                 |        | SERP Benefits |       | Pension Benefits                |        | SERP Benefits |        |
|  | 2012                             | 2011   | 2012          | 2011  | 2012                            | 2011   | 2012          | 2011   |
| Service cost   | \$ 284                           | \$ 231 | \$ 30         | \$ 27 | \$ 847                          | \$ 687 | \$ 90         | \$ 81  |
| Interest cost  | 128                              | 121    | 13            | 15    | 380                             | 361    | 39            | 43     |
| Expected return on plan assets                             | (250)                            | (192)  |               |       | (744)                           | (569)  |               |        |
| Amortization of net loss                                   | 62                               | 26     | 1             |       | 186                             | 76     | 1             |        |
| Amortization of unrecognized prior service cost            | 3                                | 3      |               |       | 8                               | 7      |               |        |
| Amortization of unrecognized transition (asset) obligation |                                  |        | 7             | 7     |                                 |        | 21            | 21     |
| Net periodic benefit cost                                  | \$ 227                           | \$ 189 | \$ 51         | \$ 49 | \$ 677                          | \$ 562 | \$ 151        | \$ 145 |

## 9. SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

At September 30, 2012, December 31, 2011 and September 30, 2011, securities sold under agreements to repurchase totaled \$13.1 million, \$16.9 million, and \$16.6 million, respectively, and were secured by U.S. GSE, residential mortgage-backed securities and residential collateralized

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mortgage obligations with a carrying amount of \$17.6 million, \$22.5 million and \$23.7 million, respectively.

Securities sold under agreements to repurchase are financing arrangements with \$3.1 million maturing during the fourth quarter of 2012, and \$10.0 million maturing during the first quarter of 2015. At maturity, the securities underlying the agreements are returned to the Company. Information concerning the securities sold under agreements to repurchase is summarized as follows:

| (Dollars in thousands)         | For the nine months ended |                    | For the year ended |        |
|--------------------------------|---------------------------|--------------------|--------------------|--------|
|                                | <b>September 30, 2012</b> | September 30, 2011 | December 31, 2011  |        |
| Average daily balance          | \$ <b>13,018</b>          | \$ 16,573          | \$                 | 16,715 |
| Average interest rate          | <b>3.05%</b>              | 3.26%              |                    | 3.23%  |
| Maximum month-end balance      | \$ <b>16,722</b>          | \$ 17,012          | \$                 | 17,469 |
| Weighted average interest rate | <b>3.04%</b>              | 3.20%              |                    | 3.18%  |



## 10. FEDERAL HOME LOAN BANK ADVANCES

As of September 30, 2012, there was one term advance outstanding from the Federal Home Loan Bank for \$15.0 million with a fixed interest rate of 0.44% that will mature during the fourth quarter of 2012. The borrowing was collateralized by a blanket lien on residential mortgages. There were no overnight borrowings outstanding from the Federal Home Loan Bank as of September 30, 2012, September 30, 2011 or December 31, 2011.

## 11. JUNIOR SUBORDINATED DEBENTURES

In December 2009, the Company completed the private placement of \$16.0 million in aggregate liquidation amount of 8.50% cumulative convertible trust preferred securities (the "TPS"), through its wholly-owned subsidiary, Bridge Statutory Capital Trust II. The TPS have a liquidation amount of \$1,000 per security and are convertible into our common stock, at an effective conversion price of \$31 per share. The TPS mature in 30 years but are callable by the Company at par any time after September 30, 2014.

The Company issued \$16.0 million of junior subordinated debentures (the "Debentures") to the trust in exchange for ownership of all of the common security of the trust and the proceeds of the preferred securities sold by the trust. In accordance with current accounting guidance, the trust is not consolidated in the Company's financial statements, but rather the Debentures are shown as a liability. The Debentures bear interest at a fixed rate equal to 8.50% and mature on December 31, 2039. Consistent with regulatory requirements, the interest payments may be deferred for up to five years, and are cumulative. The Debentures have the same prepayment provisions as the TPS.

The Debentures are included in Tier I capital (with certain limitations applicable) under current regulatory guidelines and interpretations.

## 12. DERIVATIVES

The Company utilized interest rate swap agreements as part of its asset liability management strategy to help manage its interest rate risk position. The notional amount of the interest rate swap does not represent amounts exchanged by the parties. The amount exchanged is determined by reference to the notional amount and the other terms of the individual interest rate swap agreements.

An interest rate swap with a notional amount totaling \$15.0 million was entered into on June 28, 2012 and was designated as a cash flow hedge of certain Federal Home Loan Bank advances. The swap was determined to be fully effective during the period presented and therefore no amount of ineffectiveness has been included in net income. The aggregate fair value of the swaps is recorded in other assets with changes in fair value recorded in other comprehensive income (loss). The amount included in accumulated other comprehensive income (loss) would be reclassified to current earnings if the hedge transaction becomes probable of not occurring. The Company expects the hedges to remain fully effective during the remaining term of the swap.

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Summary information about the interest rate swap designated as a cash flow hedge as of September 30, 2012 is as follows:

| (Dollars in thousands)         |    | As of September 30, 2012 |
|--------------------------------|----|--------------------------|
| Notional amounts               | \$ | 15,000                   |
| Weighted average pay rates     |    | 0.99%                    |
| Weighted average receive rates |    | 0.46%                    |
| Weighted average maturity      |    | 4.74 years               |
| Unrealized gains (losses)      | \$ | (203)                    |

Interest expense recorded on this swap transaction totaled \$21,000 for the nine months ended September 30, 2012 and is reported as a component of interest expense on FHLB Advances.

**Cash Flow Hedge**

The following table presents the net gains (losses) recorded in accumulated other comprehensive income and the Consolidated Statements of Income relating to the cash flow derivative instruments for the nine months ended September 30, 2012.

| (In thousands)                 | Amount of gain<br>(loss) recognized<br>in OCI<br>(Effective Portion) | 2012<br>Amount of gain<br>(loss) reclassified<br>from OCI to<br>interest income | Amount of gain (loss)<br>recognized in other<br>non interest income<br>(Ineffective Portion) |
|--------------------------------|--|---|--|
| <b>Interest rate contracts</b> | \$ (122)   | \$  | \$   |

The following table reflects the cash flow hedge included in the Consolidated Balance Sheet as of September 30, 2012:

| (In thousands)                             | Notional<br>Amount | 2012<br>Fair<br>Value |
|--|--------------------|-----------------------|
| Included in other assets:                  |                    |                       |
| Interest rate swap related to FHLB Advance | \$ 15,000          | \$ (203)              |

**13. BUSINESS COMBINATIONS**

On February 8, 2011, the Company entered into a definitive merger agreement under which the Bank would acquire Hamptons State Bank ( HSB ). The HSB transaction closed on May 27, 2011 resulting in the addition of total acquired assets on a fair value basis of \$68.9 million, with loans of \$38.9 million, investment securities of \$24.2 million and deposits of \$56.9 million. The transaction augments the Bank's franchise in eastern Long Island and the combined entity serves customers through a network of 21 branches. Under the terms of the Agreement, each share of Hamptons State Bank common stock was converted into 0.3434 shares of the Company's common stock. The Company issued approximately 273,500 shares, with an aggregate value of \$5.85 million and recorded goodwill of \$2.03 million which is not tax deductible for tax purposes.

The acquisition was accounted for under the acquisition method of accounting in accordance with FASB ASC 805, Business Combinations. Accordingly, the assets acquired and liabilities assumed were recorded at their respective acquisition date fair values, and identifiable intangible assets were recorded at fair value. The operating results of the Company for the nine month period ended September 30, 2012, include the operating results of HSB.

The following summarizes the finalized fair value of the assets acquired and liabilities assumed on May 27, 2011:

| As Initially | Measurement<br>Period |
|--------------|-----------------------|
|--------------|-----------------------|

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| (In thousands)  | Reported         | Adjustments    | As Adjusted      |
|---|------------------|----------------|------------------|
| Cash and due from banks   | \$ 585           | \$             | \$ 585           |
| Interest earning deposits with banks                                    | 1,727            |                | 1,727            |
| Securities  | 24,159           |                | 24,159           |
| Loans   | 39,051           | (137)          | 38,914           |
| Premises and equipment  | 300              |                | 300              |
| Core deposit intangible   | 358              |                | 358              |
| Other assets  | 2,781            | 54             | 2,835            |
| <b>Total Assets Acquired</b>  | <b>\$ 68,961</b> | <b>\$ (83)</b> | <b>\$ 68,878</b> |
| Deposits  | \$ 56,940        | \$             | \$ 56,940        |
| Federal funds purchased and Federal Home Loan Bank overnight borrowings | 2,000            |                | 2,000            |
| Federal Home Loan Bank term advances                                    | 5,016            |                | 5,016            |
| Other liabilities and accrued expenses                                  | 1,103            |                | 1,103            |
| <b>Total Liabilities Assumed</b>  | <b>\$ 65,059</b> | <b>\$</b>      | <b>\$ 65,059</b> |
| <b>Net Assets Acquired</b>  | <b>3,902</b>     | <b>(83)</b>    | <b>3,819</b>     |
| <b>Consideration Paid</b>   | <b>5,853</b>     |                | <b>5,853</b>     |
| <b>Goodwill Recorded on Acquisition</b>                                 | <b>\$ 1,951</b>  | <b>\$ 83</b>   | <b>\$ 2,034</b>  |

#### 14. RECENT ACCOUNTING PRONOUNCEMENTS

In October 2012, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update No. 2012-04, Technical Corrections and Improvements ( ASU 2012-04 ). The amendments in this Update represent changes to clarify the Codification, correct unintended application of guidance, or make minor improvements to the Codification that are not expected to have a significant effect on current accounting practice or create a significant administrative cost to most entities. Additionally, the amendments will make the Codification easier to understand and the fair value measurement guidance easier to apply by eliminating inconsistencies and providing needed clarifications. The amendments in this Update that will not have transition guidance will be effective upon issuance for both public entities and nonpublic entities. For public entities, the amendments that are subject to the transition guidance will be effective for fiscal periods beginning after December 15, 2012. The Company does not anticipate the adoption of this ASU to have a material impact on the financials.

In August 2012, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update No. 2012-03, Technical Amendments and Corrections to SEC Sections ( ASU 2012-03 ). The accounting guidance includes amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 114, Technical Amendments Pursuant to SEC Release No. 33-9250, and Corrections Related to FASB Accounting Standards Update No. 2010-22. The accounting guidance is effective immediately and did not have a material impact on the Company.

In December 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update No. 2011-12, Comprehensive Income (Topic 220) Deferral of the Effective Date for Amendments to the Presentation of Reclassification of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05 . In order to defer only those changes in Update 2011-05 that relate to the presentation of reclassification adjustments, the paragraphs in this Update supersede certain pending paragraphs in Update 2011-05. The amendments are being made to allow the FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before Update 2011-05.

In September 2011, the FASB issued Accounting Standards Update No. 2011-8, Intangibles Goodwill and Other (Topic 350) Testing Goodwill for Impairment ( ASU 2011-8 ). ASU 2011-8 clarifies the guidance for goodwill impairment testing by allowing companies to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. The company would not be required to calculate the fair value of a reporting unit unless the company determines, based on a qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. ASU 2011-8 includes a number of events and circumstances for companies to consider in conducting the qualitative assessment. ASU 2011-8 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted. The Company has early adopted ASU 2011-8 for its annual impairment test for the year ended December 31, 2011 and it did not have a material impact on the Company.

In June 2011, the FASB issued Accounting Standards Update No.2011-5, Comprehensive Income (Topic 220) ( ASU 2011-5 ). ASU 2011-5 gives companies the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, the company is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-5 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in this guidance do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. ASU 2011-5 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Adoption of ASU 2011-5 did not have a material impact on the Company and the relevant disclosures were included in this document.

In May 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update No.2011-4, Fair Value Measurement and Disclosures (Topic 820) ( ASU 2011-4 ). ASU 2011-4 clarifies the guidance for determining fair value including some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. This Update results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with current accounting guidance. ASU 2011-4 is effective for interim and annual reporting periods ending on or after December 15, 2011. Adoption of AUS 2011-4 did not have a material impact on the Company and the relevant disclosures were included in this document.

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

### *Private Securities Litigation Reform Act Safe Harbor Statement*

This report may contain statements relating to the future results of the Company (including certain projections and business trends) that are considered forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995 (the PSLRA). Such forward-looking statements, in addition to historical information, which involve risk and uncertainties, are based on the beliefs, assumptions and expectations of management of the Company. Words such as expects, believes, should, plans, anticipates, will, potential, could, intend, may, project, would, estimated, assumes, likely, and variation of such similar expressions are intended to identify such forward-looking statements. Examples of forward-looking statements include, but are not limited to, possible or assumed estimates with respect to the financial condition, expected or anticipated revenue, and results of operations and business of the Company, including earnings growth; revenue growth in retail banking lending and other areas; origination volume in the consumer, commercial and other lending businesses; current and future capital management programs; non-interest income levels, including fees from the title abstract subsidiary and banking services as well as product sales; tangible capital generation; market share; expense levels; and other business operations and strategies. For this presentation, the Company claims the protection of the safe harbor for forward-looking statements contained in the PSLRA.

Factors that could cause future results to vary from current management expectations include, but are not limited to, changing economic conditions; legislative and regulatory changes, including increases in FDIC insurance rates; monetary and fiscal policies of the federal government; changes in tax policies; rates and regulations of federal, state and local tax authorities; changes in interest rates; deposit flows; the cost of funds; demands for loan products; demand for financial services; competition; changes in the quality and composition of the Bank's loan and investment portfolios; changes in management's business strategies; changes in accounting principles, policies or guidelines, changes in real estate values; a failure to realize or an unexpected delay in realizing, the growth opportunities and cost savings anticipated from the HSB merger; an unexpected increase in operating costs, customer losses and business disruptions; following the HSB merger; expanded regulatory requirements as a result of the Dodd-Frank Act, which could adversely affect operating results; and other factors discussed elsewhere in this report and factors set forth under Item 1A., Risk Factors, in our Annual Report on Form 10-K for the year ended December 31, 2011 and other factors discussed elsewhere in this report, and in quarterly and other reports filed by the Company with the Securities and Exchange Commission. The forward-looking statements are made as of the date of this report, and the Company assumes no obligation to update the forward-looking statements or to update the reasons why actual results could differ from those projected in the forward-looking statements.

### *Overview*

#### *Who We Are and How We Generate Income*

Bridge Bancorp, Inc. (the Company), a New York corporation, is a bank holding company formed in 1989. On a parent-only basis, the Company has had minimal results of operations. The Company is dependent on dividends from its wholly owned subsidiary, The Bridgehampton National Bank (the Bank), its own earnings, additional capital raised, and borrowings as sources of funds. The information in this report reflects principally the financial condition and results of operations of the Bank. The Bank's results of operations are primarily dependent on its net interest income, which is mainly the difference between interest income on loans and investments and interest expense on deposits and borrowings. The Bank also generates non interest income, such as fee income on deposit accounts, merchant credit and debit card processing programs, investment services, income from its title abstract subsidiary, and net gains on sales of securities and loans. The level of its non interest expenses, such as salaries and benefits, occupancy and equipment costs, other general and administrative expenses, expenses from its title insurance subsidiary, and income tax expense, further affects the Bank's net income. Certain reclassifications have been made to

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prior year amounts and the related discussion and analysis to conform to the current year presentation. These reclassifications did not have an impact on net income or total stockholders' equity.

### *Principal Products and Services and Locations of Operations*

The Bank operates twenty one branches in Suffolk County on eastern Long Island. Federally chartered in 1910, the Bank was founded by local farmers and merchants. For a century, the Bank has maintained its focus on building customer relationships in this market area. The mission of the Company is to grow through the provision of exceptional service to its customers, its employees, and the community. The Company strives to achieve excellence in financial performance and build long term shareholder value. The Bank engages in full service commercial and consumer banking business, including accepting time, savings and demand deposits from the consumers, businesses and local municipalities surrounding its branch offices. These deposits, together with funds generated from operations and borrowings, are invested primarily in: (1) commercial real estate loans; (2) home equity loans; (3) construction loans; (4) residential mortgage loans; (5) secured and unsecured commercial and consumer loans; (6) FHLB, FNMA, GNMA, FHLMC and non agency mortgage-backed securities, collateralized mortgage obligations and other asset backed securities; (7) New York State and



local municipal obligations; and (8) U.S government sponsored entity ( U.S. GSE ) securities. The Bank also offers the CDARS program, providing up to \$50.0 million of FDIC insurance to its customers. In addition, the Bank offers merchant credit and debit card processing, automated teller machines, cash management services, lockbox processing, online banking services, remote deposit capture, safe deposit boxes, individual retirement accounts and investment services through Bridge Investment Services, offering a full range of investment products and services through a third party broker dealer. Through its title insurance abstract subsidiary, the Bank acts as a broker for title insurance services. The Bank's customer base is comprised principally of small businesses, municipal relationships and consumer relationships.

#### *Quarterly Highlights*

- Net income of \$3.4 million and \$0.39 per diluted share for the third quarter 2012 compared to \$2.8 million or \$0.41 per diluted share for the third quarter of 2011. The Company's net income and earnings per share for the third quarter 2011 included \$0.1 million in acquisition costs, net of tax, associated with the HSB merger, which closed in May 2011.
- Returns on average assets and equity were 0.93% and 12.11%, respectively.
- Net interest income increased to \$11.8 million for the third quarter of 2012 compared to \$11.5 million in 2011.
- Net interest margin was 3.55% for the third quarter of 2012 compared to 4.04% for the 2011 period.
- Total loans at September 30, 2012 of \$732.5 million increased \$120.3 million or 19.7% over December 31, 2011.
- Total assets of \$1.57 billion at September 30, 2012, increased \$228.7 million or 17.1% compared to December 31, 2011.
- Deposits of \$1.31 billion increased \$126.7 million or 10.7% over December 31, 2011.
- Allowance for loan losses was 1.92% of total loans as of September 30, 2012 compared to 1.77% at December 31, 2011.
- Tier 1 Capital increased \$11.0 million or 9.3% to \$129.4 million as of September 30, 2012, compared to December 31, 2011.

- A cash dividend of \$0.23 per share was declared in October 2012 for the third quarter.

*Current Environment*

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ( Dodd-Frank Act ) was signed by the President. The Act permanently raised the current standard maximum deposit insurance amount to \$250,000. Section 331(b) of the Dodd-Frank Act required the FDIC to change the definition of the assessment base from which assessment fees are determined. The new definition for the assessment base is the average consolidated total assets of the insured depository institution less the average tangible equity of the insured depository institution. The new methodology became effective on April 1, 2011 and the Company recorded a reduction in its FDIC assessment fees of \$0.4 million in 2011. The financial reform legislation, among other things, created a new Consumer Financial Protection Bureau, tightened capital standards and resulted in new regulations that are expected to increase the cost of operations.

On June 12, 2012, the OCC, the Federal Reserve and the FDIC issued proposed rules that would revise capital calculations and requirements. More specifically, the agencies are proposing to revise the risk based and leverage capital requirements consistent with the Basel Committee on Banking Supervision ( Basel III ), implement a new common equity Tier 1 minimum capital requirement, increase the minimum Tier 1 capital requirement, implement a new supplementary leverage ratio, apply limits on capital distributions and certain discretionary incentive payments if the Bank does not hold a specified buffer of common equity Tier 1 capital in addition to the minimum risk based capital requirements, revise the advanced approaches risk based capital rules consistent with Basel III and revise the calculation of risk weighted assets to enhance risk sensitivity.

Since the second half of 2007 and continuing through 2010, the financial markets experienced significant volatility resulting from the continued fallout of sub-prime lending and the global liquidity crises. Various government initiatives along with eight rate cuts by the Federal Reserve totaling 500 basis points were designed to improve liquidity for the distressed financial markets. The objective of these efforts was to help consumers, reduce the potential surge of residential mortgage loan foreclosures and stabilize the banking system. Effective as of February 19, 2010, the Federal Reserve increased the discount rate 50 basis points to 0.75%. The Federal Reserve stated that this rate change was intended to normalize their lending facility and to step away from emergency lending to banks. From April 2010 through September 2012 the Federal Reserve decided to maintain the federal funds target rate between 0 and

25 basis points due to a continued national depressed housing market, tight credit markets and as an effort to foster employment. These actions have resulted in a prolonged low interest rate environment reducing yields on interest earning assets and compressing the Company's net interest margin. In June 2012, the FOMC lowered its expectations for employment and GDP growth. In September 2012, the FOMC noted that economic activity was increasing, the growth in unemployment has slowed and the housing market is beginning to show signs of improvement. However, the FOMC anticipates maintaining federal funds target rate at least through mid-2015 in order to support economic and job growth.

Growth and service strategies have the potential to offset the tighter net interest margin with volume as the customer base grows through expanding the Bank's footprint, while maintaining and developing existing relationships. Since 2007, the Bank has opened eight new branches. The recent branch openings move the Bank geographically westward and demonstrate its commitment to traditional growth through branch expansion. In May 2011, the Bank acquired HSB which increased the Bank's presence in an existing market with a branch located in the Village of Southampton. In July 2011, the Bank converted the former HSB customers to the Bank's core operating system. Management spent considerable time ensuring the transition progressed smoothly for HSB's former customers and shareholders. Management has demonstrated its ability to successfully integrate the former HSB customers and achieve expected cost savings while continuing to execute its business strategy. Management will continue to seek opportunities to expand its reach into other contiguous markets by network expansion, or through the addition of professionals with established customer relationships.

#### *Challenges and Opportunities*

Despite fiscal and monetary policy initiatives implemented to combat the recession, management continues operating in an unsettled economic environment. While recent news on employment appears positive, issues still linger regarding the recovery's strength and sustainability. Job creation remains a primary focus of the upcoming elections and the Federal Reserve Board's (the FRB) recent announcements regarding additional quantitative easing is an attempt, through monetary policy, to increase economic activity and create jobs. Locally, the economy appears stronger than other parts of New York and the nation; however, management remains cautious about the impact of the pending fiscal cliff, general election year uncertainty, and continuing problems in Europe.

The FRB's activities have heightened the challenges for the banking industry. Lower rates, while beneficial for certain segments of the economy, pose issues for others. Customers who rely on their savings to provide income have been impacted, and industry wide banks are seeing the returns on their loans and investments decline. This interest rate environment will, over time, compress margins and increase pressure on industry earnings. These circumstances warrant proactive management to mitigate interest rate and credit risk and overall profitability.

Like many in the banking industry, management is finding the current interest rate environment challenging as all aspects of banking are impacted by the FRB actions. Management is cautiously managing the types of loans it originates and investments it makes, while remaining prepared to deal with the eventuality of higher rates. Additionally, although asset quality measures remain strong, management continues to prudently assess its reserves in light of continued weakness in the overall economy.

During the nine months ended September 30, 2012, management continued to proactively manage its interest rate and credit risk. The Company repositioned its balance sheet, as the continuing low rate environment presented opportunities to exit certain positions in the bond portfolio. Securities aggregating \$67 million were sold at a net gain of \$2.2 million. A portion of the sales proceeds were used to repay borrowings with the balance available to fund future loan growth. Management believes this strategy was appropriate and prudent given current market indicators.

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The prospects of the financial services sector and the Company continue to be impacted by the final outcome of the implementation of the Dodd-Frank Act. This Act includes the repeal of Regulation Q, which prohibited the payment of interest on checking accounts, and the Durbin Amendment, which establishes fixed interchange fees and could impact future revenues and expenses. The Company is awaiting the expected new rules, regulations and related compliance and process changes and will expand its compliance resources appropriately. The proposed changes to calculating capital under Basel III may increase the complexity and level of capital requirements. The Bank continues to collaborate with its primary regulator to ensure compliance with current requirements and interpretations. It is the belief of management that its strong risk management culture is a primary reason for its long term success and management views the current challenges as opportunities to expand its business and deliver the promise of successful community banking to its customers and shareholders. Management must maintain its stringent underwriting standards and diligently monitor credit concentrations and exposures as the Company grows. Management needs to prudently price all products and structure its balance sheet for the eventuality of higher rates. Management seeks new sources of revenue while monitoring expenditures and identifying opportunities to achieve efficiencies. Finally, management must capitalize on current competitors' dislocations and distractions while investing in infrastructure and technology to be prepared for the evolving competitive landscape.

Corporate objectives for 2012 include: leveraging our expanding branch network to build customer relationships and grow loans and deposits; focusing on opportunities and processes that continue to enhance the customer experience at the Bank; improving operational efficiencies and prudent management of non-interest expense; and maximizing non-interest income through Bridge Abstract as well as other lines of business. Despite these issues, management believes there remain opportunities to grow its franchise. Management believes continued investments to generate core funding, quality loans and new sources of revenue, remain keys to continue creating long term shareholder value. Management remains committed to branch based banking and in June 2012, the Company opened its 21st branch in Ronkonkoma, near MacArthur Airport, a regional transportation hub. The Bank also received regulatory approval to open two additional branches in Suffolk County, NY: Hauppauge and Shelter Island. The Company expects to open these locations during the first quarter of 2013. The Company expects to pilot its new electronic banking platform in the fourth quarter of 2012. This will allow the Company to enhance the delivery of current technology, and more importantly, effectively deliver the next generation of products and services to its existing and new customer base. The ability to attract, retain, train and cultivate employees at all levels of the Company remains significant to meeting corporate objectives. The Company has made great progress toward the achievement of these objectives, and avoided many of the problems facing other financial institutions as a result of maintaining discipline in its underwriting, expansion strategies, investing and general business practices. The Company has capitalized on opportunities presented by the market and diligently seeks opportunities for growth and to strengthen the franchise. The Company recognizes the potential risks of the current economic environment and will monitor the impact of market events as we consider growth initiatives and evaluate loans and investments. Management and the Board have built a solid foundation for growth and the Company is positioned to adapt to anticipated changes in the industry resulting from new regulations and legislative initiatives.

### ***Critical Accounting Policies***

#### *Allowance for Loan Losses*

Management considers the accounting policy on the allowance for loan losses to be the most critical and requires complex management judgment as discussed below. The judgments made regarding the allowance for loan losses can have a material effect on the results of operations of the Company.

The allowance for loan losses is established and maintained through a provision for loan losses based on probable incurred losses inherent in the Bank's loan portfolio. Management evaluates the adequacy of the allowance on a quarterly basis. The allowance is comprised of both individual valuation allowances and loan pool valuation allowances. If the allowance for loan losses is not sufficient to cover actual loan losses, the Company's earnings could decrease.

The Bank monitors its entire loan portfolio on a regular basis, with consideration given to detailed analysis of classified loans, repayment patterns, probable incurred losses, past loss experience, current economic conditions, and various types of concentrations of credit. Additions to the allowance are charged to expense and realized losses, net of recoveries, are charged to the allowance.

Individual valuation allowances are established in connection with specific loan reviews and the asset classification process including the procedures for impairment testing under FASB Accounting Standard Codification (ASC) No. 310, Receivables. Such valuation, which includes a review of loans for which full collectibility in accordance with contractual terms is not reasonably assured, considers the estimated fair value of the underlying collateral less the costs to sell, if any, or the present value of expected future cash flows, or the loan's observable market value. Any shortfall that exists from this analysis results in a specific allowance for the loan. Pursuant to our policy, loan losses must be charged-off in the period the loans, or portions thereof, are deemed uncollectible. Assumptions and judgments by management, in conjunction with outside sources, are used to determine whether full collectibility of a loan is not reasonably assured. These assumptions and judgments are also used to

determine the estimates of the fair value of the underlying collateral or the present value of expected future cash flows or the loan's observable market value. Individual valuation allowances could differ materially as a result of changes in these assumptions and judgments. Individual loan analyses are periodically performed on specific loans considered impaired. The results of the individual valuation allowances are aggregated and included in the overall allowance for loan losses.

Loan pool valuation allowances represent loss allowances that have been established to recognize the inherent risks associated with our lending activities, but which, unlike individual allowances, have not been allocated to particular problem assets. Pool evaluations are broken down into loans with homogenous characteristics by loan type and include commercial real estate mortgages, owner and non-owner occupied; multi-family mortgages; residential real estate mortgages, first lien and home equity; commercial loans, secured and unsecured; installment/consumer loans; and real estate construction and land loans. The determination of the adequacy of the valuation allowance is a process that takes into consideration a variety of factors. The Bank has developed a range of valuation allowances necessary to adequately provide for probable incurred losses inherent in each pool of loans. We consider our own charge-off history along with the growth in the portfolio as well as the Bank's credit administration and asset management philosophies and procedures, and concentrations in the portfolio when determining the allowances for each pool. In addition, we evaluate and consider the credit's risk rating which includes management's evaluation of: cash flow, collateral, guarantor support, financial disclosures,

industry trends and strength of borrowers' management, the impact that economic and market conditions may have on the portfolio as well as known and inherent risks in the portfolio. Finally, we evaluate and consider the allowance ratios and coverage percentages of both peer group and regulatory agency data. These evaluations are inherently subjective because, even though they are based on objective data, it is management's interpretation of that data that determines the amount of the appropriate allowance. If the evaluations prove to be incorrect, the allowance for loan losses may not be sufficient to cover losses inherent in the loan portfolio, resulting in additions to the allowance for loan losses.

The Credit Risk Committee is comprised of members of both management and the Board of Directors. The adequacy of the allowance is analyzed quarterly, with any adjustment to a level deemed appropriate by the Credit Risk Committee, based on its risk assessment of the entire portfolio. Based on the Credit Risk Committee's review of the classified loans and the overall allowance levels as they relate to the entire loan portfolio at September 30, 2012, management believes the allowance for loan losses has been established at levels sufficient to cover the probable incurred losses in the Bank's loan portfolio. Future additions or reductions to the allowance may be necessary based on changes in economic, market or other conditions. Changes in estimates could result in a material change in the allowance. In addition, various regulatory agencies, as an integral part of the examination process, periodically review the allowance for loan losses. Such agencies may require the Bank to recognize adjustments to the allowance based on their judgments of the information available to them at the time of their examination.

#### *Acquired Loans*

Loans that were acquired from the acquisition of HSB on May 27, 2011 are recorded at fair value with no carryover of the related allowance for loan losses. After acquisition, losses are recognized by an increase in the allowance for loan losses. Determining fair value of the loans involves estimating the amount and timing of expected principal and interest cash flows to be collected on the loans and discounting those cash flows at a market interest rate. Some of the loans at time of acquisition showed evidence of credit deterioration since origination.

For purchased credit impaired loans, the excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable discount and is recognized into interest income over the remaining life of the loan. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the nonaccretable discount. The nonaccretable discount represents estimated future credit losses expected to be incurred over the life of the loan. Subsequent increases to the expected cash flows result in the reversal of a corresponding amount of the nonaccretable discount which is then reclassified as accretable discount and recognized into interest income over the remaining life of the loan using the interest method. Subsequent decreases to the expected cash flows require us to evaluate the need for an addition to the allowance for loan losses.

Purchased credit impaired loans that met the criteria for nonaccrual of interest prior to the acquisition may be considered performing upon acquisition, regardless of whether the customer is contractually delinquent, if management can reasonably estimate the timing and amount of the expected cash flows on such loans and if management expects to fully collect the new carrying value of the loans. As such, management may no longer consider the loans to be nonaccrual or nonperforming and may accrue interest on these loans, including the impact of any accretable discount.

#### *Net Income*

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Net income for the three months ended September 30, 2012 was \$3.4 million and \$0.39 per diluted share as compared to \$2.8 million and \$0.41 per diluted share for the same period in 2011. The 21.2% increase in net income reflects growth in net interest income, non interest income and lower credit costs, partially offset by increased operating expenses. Changes for the three months ended September 30, 2012 compared to September 30, 2011 include: (i) a \$0.3 million or 2.6% increase in net interest income as a result of growth in interest earning assets primarily related to loans; (ii) a \$0.9 million or 58.6% decrease in the provision for loan losses; (iii) a \$0.5 million or 26.6% increase in total non interest income as a result of net securities gains of \$0.2 million, higher service charges and fees for other customer services of \$0.1 million, and a \$0.1 million or 72.0% increase in title fee income; and (iv) an \$0.7 million or 8.4% increase in total non interest expense due to a \$0.4 million increase in salaries and employee benefits related to increased staffing levels, an increase of \$0.3 million in other operating expenses offset by a decrease of \$0.1 million acquisition costs associated with the HSB merger that were incurred during three months ended September 30, 2011. The effective income tax rate was 32.5% for the quarter ended September 30, 2012 compared to 30.9% for the same period last year.

Net income for the nine months ended September 30, 2012 was \$9.4 million and \$1.09 per diluted share as compared to \$7.4 million and \$1.12 per diluted share for the same period in 2011. Changes for the nine months ended September 30, 2012 compared to September 30, 2011 include: (i) a \$3.3 million or 10.2% increase in net interest income as a result of growth in interest earning assets primarily related to loans; (ii) a \$0.9 million or 28.7% increase in the provision for loan losses; (iii) a \$2.9 million or 58.3% increase in total non interest income as a result of net securities gains of \$2.2 million and higher service charges, fees for other customer services and title fee income of \$0.9 million; and (iv) a \$2.3 million or 9.8% increase in total non-interest expense due to (1) a \$2.2 million



increase in salaries and employee benefits related to increased staffing levels; (2) a \$0.6 million increase in other operating expenses, (3) a \$0.1 million decrease in FDIC assessment as a result of the new calculation of the deposit insurance assessment; (4) a \$0.7 million decline in acquisition costs associated with the HSB merger that was incurred during nine months ended September 30, 2011, and (5) a \$0.2 million increase as a result of the cost of extinguishment of debt. The effective income tax rate was 32.3% for the nine months ended September 30, 2012 compared to 31.1% for the same period last year.

#### *Analysis of Net Interest Income*

Net interest income, the primary contributor to earnings, represents the difference between income on interest earning assets and expenses on interest bearing liabilities. Net interest income depends upon the volume of interest earning assets and interest bearing liabilities and the interest rates earned or paid on them.

The following tables set forth certain information relating to the Company's average consolidated balance sheets and its consolidated statements of income for the periods indicated and reflect the average yield on assets and average cost of liabilities for the periods indicated. Such yields and costs are derived by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods shown. Average balances are derived from daily average balances and include nonaccrual loans. The yields and costs include fees, which are considered adjustments to yields. Interest on nonaccrual loans has been included only to the extent reflected in the consolidated statements of income. For purposes of this table, the average balances for investments in debt and equity securities exclude unrealized appreciation/depreciation due to the application of FASB ASC 320, *Investments - Debt and Equity Securities*.

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| (In thousands)  | Three months ended September 30, |           |                           |                    |           |                           |
|---|----------------------------------|-----------|---------------------------|--------------------|-----------|---------------------------|
|   | 2012                             |           |                           | 2011               |           |                           |
|   | Average<br>Balance               | Interest  | Average<br>Yield/<br>Cost | Average<br>Balance | Interest  | Average<br>Yield/<br>Cost |
| Interest earning assets:  |                                  |           |                           |                    |           |                           |
| Loans, net (1)  | \$ 676,846                       | \$ 10,467 | 6.15%                     | \$ 582,472         | \$ 9,555  | 6.51%                     |
| Mortgage-backed securities, CMOs and other<br>asset-backed securities | 345,934                          | 1,710     | 1.97                      | 278,916            | 2,281     | 3.24                      |
| Tax exempt securities (2)   | 138,339                          | 980       | 2.82                      | 125,403            | 1,070     | 3.39                      |
| Taxable securities  | 164,077                          | 864       | 2.09                      | 129,697            | 906       | 2.77                      |
| Deposits with banks   | 39,394                           | 28        | 0.28                      | 52,104             | 32        | 0.24                      |
| Total interest earning assets   | 1,364,590                        | 14,049    | 4.10                      | 1,168,592          | 13,844    | 4.70                      |
| Non interest earning assets:  |                                  |           |                           |                    |           |                           |
| Cash and due from banks   | 22,760                           |           |                           | 19,300             |           |                           |
| Other assets  | 48,718                           |           |                           | 46,865             |           |                           |
| Total assets  | \$ 1,436,068                     |           |                           | \$ 1,234,757       |           |                           |
| Interest bearing liabilities:   |                                  |           |                           |                    |           |                           |
| Savings, NOW and money market deposits                                | \$ 704,841                       | \$ 952    | 0.54%                     | \$ 615,629         | \$ 986    | 0.64%                     |
| Certificates of deposit of \$100,000 or more                          | 131,333                          | 360       | 1.09                      | 130,567            | 354       | 1.08                      |
| Other time deposits   | 40,381                           | 101       | 1.00                      | 45,170             | 132       | 1.16                      |
| Federal funds purchased and repurchase<br>agreements                  | 18,106                           | 97        | 2.13                      | 17,391             | 136       | 3.10                      |
| Federal Home Loan Bank term advances                                  | 15,000                           | 38        | 1.01                      |                    |           |                           |
| Junior Subordinated Debentures  | 16,002                           | 341       | 8.48                      | 16,002             | 341       | 8.45                      |
| Total interest bearing liabilities                                    | 925,663                          | 1,889     | 0.81                      | 824,759            | 1,949     | 0.94                      |
| Non interest bearing liabilities:                                     |                                  |           |                           |                    |           |                           |
| Demand deposits   | 391,968                          |           |                           | 325,975            |           |                           |
| Other liabilities   | 8,082                            |           |                           | 9,420              |           |                           |
| Total liabilities   | 1,325,713                        |           |                           | 1,160,154          |           |                           |
| Stockholders equity   | 110,355                          |           |                           | 74,603             |           |                           |
| Total liabilities and stockholders equity                             | \$ 1,436,068                     |           |                           | \$ 1,234,757       |           |                           |
| Net interest income/interest rate spread (3)                          |                                  | 12,160    | 3.29%                     |                    | 11,895    | 3.76%                     |
| Net interest earning assets/net interest margin<br>(4)                | \$ 438,927                       |           | 3.55%                     | \$ 343,833         |           | 4.04%                     |
| Ratio of interest earning assets to interest<br>bearing liabilities   |                                  |           | 147.42%                   |                    |           | 141.69%                   |
| Less: Tax equivalent adjustment                                       |                                  | (342)     |                           |                    | (373)     |                           |
| Net interest income   |                                  | \$ 11,818 |                           |                    | \$ 11,522 |                           |

(1) Amounts are net of deferred origination costs/ (fees) and the allowance for loan loss.

(2) The above table is presented on a tax equivalent basis.

(3) Net interest rate spread represents the difference between the yield on average interest earning assets and the cost of average interest bearing liabilities.

(4) Net interest margin represents net interest income divided by average interest earning assets.

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Nine months ended September 30,

| (In thousands)   | 2012            |           |                     | 2011            |           |                     |
|--|-----------------|-----------|---------------------|-----------------|-----------|---------------------|
|  | Average Balance | Interest  | Average Yield/ Cost | Average Balance | Interest  | Average Yield/ Cost |
| Interest earning assets:   |                 |           |                     |                 |           |                     |
| Loans, net (1)   | \$ 648,103      | \$ 29,753 | 6.13%               | \$ 543,157      | \$ 26,074 | 6.42%               |
| Mortgage-backed securities, CMOs and other asset-backed securities | 324,986         | 5,793     | 2.38                | 274,532         | 6,982     | 3.40                |
| Tax exempt securities (2)  | 140,884         | 3,165     | 3.00                | 115,340         | 3,262     | 3.78                |
| Taxable securities   | 181,061         | 3,005     | 2.22                | 102,238         | 2,129     | 2.78                |
| Deposits with banks  | 34,497          | 70        | 0.27                | 49,256          | 91        | 0.25                |
| Total interest earning assets                                      | 1,329,531       | 41,786    | 4.20                | 1,084,523       | 38,538    | 4.75                |
| Non interest earning assets:                                       |                 |           |                     |                 |           |                     |
| Cash and due from banks  | 21,978          |           |                     | 18,731          |           |                     |
| Other assets   | 49,441          |           |                     | 43,994          |           |                     |
| Total assets   | \$ 1,400,950    |           |                     | \$ 1,147,248    |           |                     |
| Interest bearing liabilities:                                      |                 |           |                     |                 |           |                     |
| Savings, NOW and money market deposits                             | \$ 715,310      | \$ 2,829  | 0.53%               | \$ 607,048      | \$ 2,977  | 0.66%               |
| Certificates of deposit of \$100,000 or more                       | 134,923         | 1,113     | 1.10                | 104,904         | 841       | 1.07                |
| Other time deposits  | 41,494          | 324       | 1.04                | 43,118          | 385       | 1.19                |
| Federal funds purchased and repurchase agreements                  | 25,363          | 323       | 1.70                | 16,976          | 405       | 3.19                |
| Federal Home Loan Bank term advances                               | 7,536           | 46        | 0.82                | 110             |           |                     |
| Junior Subordinated Debentures                                     | 16,002          | 1,024     | 8.55                | 16,002          | 1,025     | 8.56                |
| Total interest bearing liabilities                                 | 940,628         | 5,659     | 0.80                | 788,158         | 5,633     | 0.96                |
| Non interest bearing liabilities:                                  |                 |           |                     |                 |           |                     |
| Demand deposits  | 346,358         |           |                     | 282,705         |           |                     |
| Other liabilities  | 7,268           |           |                     | 7,256           |           |                     |
| Total liabilities  | 1,294,254       |           |                     | 1,078,119       |           |                     |
| Stockholders equity  | 106,696         |           |                     | 69,129          |           |                     |
| Total liabilities and stockholders equity                          | \$ 1,400,950    |           |                     | \$ 1,147,248    |           |                     |
| Net interest income/interest rate spread (3)                       |                 | 36,127    | 3.40%               |                 | 32,905    | 3.79%               |
| Net interest earning assets/net interest margin (4)                | \$ 388,903      |           | 3.63%               | \$ 296,365      |           | 4.06%               |
| Ratio of interest earning assets to interest bearing liabilities   |                 |           | 141.35%             |                 |           | 137.60%             |
| Less: Tax equivalent adjustment                                    |                 | (1,104)   |                     |                 | (1,138)   |                     |
| Net interest income  |                 | \$ 35,023 |                     |                 | \$ 31,767 |                     |

(1) Amounts are net of deferred origination costs/ (fees) and the allowance for loan loss.

(2) The above table is presented on a tax equivalent basis.

(3) Net interest rate spread represents the difference between the yield on average interest earning assets and the cost of average interest bearing liabilities.

(4) Net interest margin represents net interest income divided by average interest earning assets.

**Rate/Volume Analysis**

Net interest income can be analyzed in terms of the impact of changes in rates and volumes. The following table illustrates the extent to which changes in interest rates and in the volume of average interest earning assets and interest bearing liabilities have affected the Bank's interest income and interest expense during the periods indicated. Information is provided in each category with respect to (i) changes attributable to changes in volume (changes in volume multiplied by prior rate); (ii) changes attributable to changes in rates (changes in rates multiplied by prior volume); and (iii) the net changes. For purposes of this table, changes which are not due solely to volume or rate changes have been allocated to these categories based on the respective percentage changes in average volume and rate. Due to the numerous simultaneous volume and rate changes during the periods analyzed, it is not possible to precisely allocate changes between volume and rates. In addition, average earning assets include nonaccrual loans.

| (In thousands)   | Three months ended September 30,<br>2012 Over 2011<br>Changes Due To |            |            | Nine months ended September 30,<br>2012 Over 2011<br>Changes Due To |            |            |
|--|--|------------|------------|---|------------|------------|
|  | Volume   | Rate       | Net Change | Volume  | Rate       | Net Change |
| Interest income on interest earning assets:                        |  |            |            |   |            |            |
| Loans, net (1)   | \$ 3,807   | \$ (2,895) | \$ 912     | \$ 5,535  | \$ (1,856) | \$ 3,679   |
| Mortgage-backed securities, CMOs and other asset-backed securities | 2,475  | (3,046)    | (571)      | 1,675   | (2,864)    | (1,189)    |
| Tax exempt securities (2)  | 509  | (599)      | (90)       | 881   | (978)      | (97)       |
| Taxable securities   | 894  | (936)      | (42)       | 1,602   | (726)      | 876        |
| Federal funds sold   |  |            |            |   |            |            |
| Deposits with banks  | (27)   | 23         | (4)        | (32)  | 11         | (21)       |
| Total interest earning assets                                      | 7,658  | (7,453)    | 205        | 9,661   | (6,413)    | 3,248      |
| Interest expense on interest bearing liabilities:                  |  |            |            |   |            |            |
| Savings, NOW and money market deposits                             | 576  | (610)      | (34)       | 680   | (828)      | (148)      |
| Certificates of deposit of \$100,000 or more                       | 2  | 4          | 6          | 253   | 19         | 272        |
| Other time deposits  | (13)   | (18)       | (31)       | (14)  | (47)       | (61)       |
| Federal funds purchased and repurchase agreements                  | 35   | (74)       | (39)       | 218   | (300)      | (82)       |
| Federal Home Loan Bank Advances                                    | 38   |            | 38         | 21  | 25         | 46         |
| Junior subordinated debentures                                     |  |            |            |   | (1)        | (1)        |
| Total interest bearing liabilities                                 | 638  | (698)      | (60)       | 1,158   | (1,132)    | 26         |
| Net interest income  | \$ 7,020   | \$ (6,755) | \$ 265     | \$ 8,503  | \$ (5,281) | \$ 3,222   |

(1) Amounts are net of deferred origination costs/ (fees) and the allowance for loan loss.

(2) The above table is presented on a tax equivalent basis.

**Analysis of Net Interest Income for the Three Months ended September 30, 2012 and September 30, 2011**

Net interest income was \$11.8 million for the three months ended September 30, 2012 compared to \$11.5 million for the same period in 2011, an increase of \$0.3 million or 2.6%. Net interest margin declined to 3.55% for the quarter ended September 30, 2012, compared to 4.04% for the quarter ended September 30, 2011 as a result of the historically low market interest rates on repricing assets and liabilities offsetting strong deposit growth and higher loan demand. The total average interest earning assets increased \$196.0 million or 16.8%, yielding 4.10% and the overall funding cost was 0.57%, including demand deposits. The yield on interest earning assets decreased approximately 60 basis points which

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was partly offset by the cost of interest bearing liabilities, which decreased approximately 13 basis points during the third quarter of 2012 compared to 2011. The increase in average total deposits of \$151.2 million funded lower yielding securities, which grew \$114.3 million, and average net loans increased \$94.4 million from the comparable 2011 quarter.

For the three months ended September 30, 2012, average net loans grew by \$94.4 million or 16.2% to \$676.8 million as compared to \$582.5 million for the same period in 2011, driven by growth in commercial real estate mortgage loans, commercial, financial and agricultural loans, and multi-family mortgage loans. The Bank remains committed to growing loans with prudent underwriting, sensible pricing and limited credit and extension risk.

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For the three months ended September 30, 2012, average total securities increased by \$114.3 million or 21.4% to \$648.4 million as compared to \$534.0 million for the three months ended September 30, 2011. There were no federal funds sold for the three months ended September 30, 2012 or 2011. The average interest earning cash decreased by \$12.7 million to \$39.4 million for the three months ended September 30, 2012 as compared to \$52.1 million for the same period in 2011.

Average total interest bearing liabilities were \$925.7 million for the three months ended September 30, 2012 compared to \$824.8 million for the same period in 2011. The Bank grew deposits as a result of opening three new branches during 2011 as well as building new relationships in existing markets. The Bank continues to reduce interest rates on deposit products through prudent management of deposit pricing. The reduction in deposit rates resulted in a decrease in the cost of interest bearing liabilities to 0.81% for the three months ended September 30, 2012 from 0.94% for the same period in 2011. Since the Company's interest bearing liabilities generally reprice or mature more quickly than its interest earning assets, an increase in short term interest rates would initially result in a decrease in net interest income. Additionally, the large percentages of deposits in money market accounts reprice at short term market rates making the balance sheet more liability sensitive.

For the three months ended September 30, 2012, average total deposits increased by \$151.2 billion or 13.5% to \$1.3 billion from \$1.1 billion from the same period in 2011. Components of this increase include an increase in average balances in savings, NOW and money market accounts of \$89.2 million or 14.5% to \$704.8 million for the three months ended September 30, 2012 compared to \$615.6 million for the same period last year. Average balances in certificates of deposit of \$100,000 or more and other time deposits decreased \$4.0 million or 2.3% to \$171.7 million for 2012 as compared to \$175.7 million for the same period last year. Average balances in demand deposits increased \$66.0 million or 20.2% to \$392.0 million for 2012 as compared to \$326.0 million for the same period last year. Average public fund deposits comprised 15.5% of total average deposits during the three months ended September 30, 2012 and 16.3% of total average deposits for the same period in 2011. Average federal funds purchased and repurchase agreements increased \$0.7 million or 4.1% to \$18.1 million for the three months ended September 30, 2012 compared to \$17.4 million for the same period in the prior year. For the three months ended September 30, 2012 there was an average balance of \$15.0 million in FHLB term advances, compared to a zero balance for the same period last year.

Total interest income increased \$0.2 million or 1.8% to \$13.7 million, net of the tax equivalent adjustment on tax exempt securities interest income, for the three months ended September 30, 2012 from \$13.5 million for the same period in 2011. Interest income on loans increased \$0.9 million or 9.5% to \$10.5 million for the three months ended September 30, 2012 from \$9.6 million for the same period in 2011. The yield on average loans was 6.15% for 2012 as compared to 6.51% in 2011.

Interest income on investments in mortgage-backed, taxable and tax exempt securities decreased \$0.7 million to \$3.2 million for the three months ended September 30, 2012 compared to \$3.9 million for the same period in 2011. Interest income on securities included net amortization of premium of \$1.6 million and a tax equivalent adjustment of \$0.3 million in the 2012 compared to net amortization of premium of \$0.5 million and tax equivalent adjustment of \$0.4 million for the same period in 2011. The tax adjusted average yield on total securities was 2.18% for 2012 as compared to 3.16% in 2011.

Interest expense remained flat at \$1.9 million for the three months ended September 30, 2012 and the same period last year.

*Analysis of Net Interest Income for the Nine Months ended September 30, 2012 and September 30, 2011*

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Net interest income was \$35.0 million for the nine months ended September 30, 2012 compared to \$31.8 million for the same period in 2011, an increase of \$3.2 million or 10.2%. Net interest margin declined to 3.63% for the nine months ended September 30, 2012 compared to 4.06% for the nine months ended September 30, 2011 as a result of the historically low market interest rates on repricing assets and liabilities offsetting strong deposit growth and higher loan demand. The total average interest earning assets increased \$245.0 million or 22.6% to \$1.3 billion for the nine months ended September 30, 2012 compared to \$1.1 billion for the same period in 2011. The yield on interest earning assets decreased approximately 55 basis points which was partly offset by the cost of interest bearing liabilities, which decreased approximately 16 basis points during the first nine months of 2012 compared to 2011. The increase in average total deposits of \$200.3 million primarily funded lower yielding securities, which grew \$154.8 million, while average net loans increased \$104.9 million from the comparable 2011 period.

For the nine months ended September 30, 2012, average net loans grew by \$104.9 million or 19.3% to \$648.1 million as compared to \$543.2 million for the same period in 2011, driven by growth in commercial real estate mortgage loans, commercial, financial and agricultural loans, and multi-family mortgage loans. The Bank remains committed to growing loans with prudent underwriting, sensible pricing and limited credit and extension risk.

For the nine months ended September 30, 2012, average total securities increased by \$154.8 million or 31.5% to \$646.9 million as compared to \$492.1 million for the nine months ended September 30, 2011. There were no federal funds sold for the nine month

ended September 30, 2012 or 2011. The average interest earning cash decreased by \$14.8 million to \$34.5 million for the nine months ended September 30, 2012 as compared to \$49.3 million for the same period in 2011.

Average total interest bearing liabilities were \$940.6 million for the nine months ended September 30, 2012 compared to \$788.2 million for the same period in 2011. The Bank grew deposits as a result of opening three new branches during 2011 as well as building new relationships in existing markets and the HSB merger. The Bank continues to reduce interest rates on deposit products through prudent management of deposit pricing. The reduction in deposit rates resulted in a decrease in the cost of interest bearing liabilities to 0.80% for the nine months ended September 30, 2012 from 0.96% for the same period in 2011. Since the Company's interest bearing liabilities generally reprice or mature more quickly than its interest earning assets, an increase in short term interest rates would initially result in a decrease in net interest income. Additionally, the large percentages of deposits in money market accounts reprice at short term market rates making the balance sheet more liability sensitive.

For the nine months ended September 30, 2012, average total deposits increased by \$200.3 million or 19.3% to \$1.2 billion from \$1.0 billion for the same period in 2011. Components of this increase include an increase in average balances in savings, NOW and money market accounts of \$108.3 million or 17.8% to \$715.3 million for the nine months ended September 30, 2012 compared to \$607.0 million for the same period last year. Average balances in certificates of deposit of \$100,000 or more and other time deposits increased \$28.4 million or 19.2% to \$176.4 million for 2012 as compared to \$148.0 million for the same period last year. Average balances in demand deposits increased \$63.7 million or 22.5% to \$346.4 million for 2012 as compared to \$282.7 million for the same period last year. Average public fund deposits comprised 18.2% of total average deposits during the nine months ended September 30, 2012 and 19.2% of total average deposits for the same period in 2011. Average federal funds purchased and repurchase agreements increased \$8.4 million or 49.4% to \$25.4 million for the nine months ended September 30, 2012 as compared to \$17.0 million for the same period in the prior year. For the nine months ended September 30, 2012 the average balance of FHLB term advances was \$7.5 million, an increase of \$7.4 million from the same period last year.

Total interest income increased \$3.3 million or 8.8% to \$40.7 million, net of the tax equivalent adjustment on tax exempt securities interest income, for the nine months ended September 30, 2012 from \$37.4 million for the same period in 2011. Interest income on loans increased \$3.7 million or 14.1% to \$29.8 million for the nine months ended September 30, 2012 from \$26.1 million for the same period in 2011. The yield on average loans was 6.13% for 2012 as compared to 6.42% in 2011.

Interest income on investments in mortgage-backed, taxable and tax exempt securities decreased \$0.4 million to \$10.8 million for the nine months ended September 30, 2012 compared to \$11.2 million for the same period in 2011. Interest income on securities included net amortization of premium of \$3.7 million and a tax equivalent adjustment of \$1.1 million in the 2012 compared to net amortization of premium of \$1.6 million and a tax equivalent adjustment of \$1.1 million for the same period in 2011. The tax adjusted average yield on total securities was 2.47% for 2012 as compared to 3.36% in 2011.

Interest expense increased to \$5.7 million for the nine months ended September 30, 2012 compared to \$5.6 million for the same period last year.

#### *Provision and Allowance for Loan Losses*



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The Bank's loan portfolio consists primarily of real estate loans secured by commercial and residential real estate properties located in the Bank's principal lending area of Suffolk County which is located on the eastern portion of Long Island. The interest rates charged by the Bank on loans are affected primarily by the demand for such loans, the supply of money available for lending purposes, the rates offered by its competitors, the Bank's relationship with the customer, and the related credit risks of the transaction. These factors are affected by general and economic conditions including, but not limited to, monetary policies of the federal government, including the Federal Reserve Board, legislative policies and governmental budgetary matters.

Despite fiscal and monetary policy initiatives implemented to combat the recession, many signs still point toward economic weakness. The recovery has been tepid with a continuing overhang of foreclosed homes and a marked lack of job creation. During 2012, there was a negative change in the perception of the domestic and global economy. Statistically, job creation dramatically slowed and GDP forecasts have been reduced. Moreover, the budgetary problems that continue in Europe and other parts of the world have contributed to economic uncertainty. Globally, market interest rates have declined. Locally, foreclosure rates in Nassau and Suffolk counties have increased sharply over the prior year and the unemployment rate on Long Island has risen compared to 2011. Although the asset quality measures for the Bank remain strong, management continually assesses the allowance for loan losses in order to reasonably reserve against continued weakness in the overall economy.

Based on our continuing review of the overall loan portfolio, the current asset quality of the portfolio, the growth in the loan portfolio, net charge-offs, and macroeconomic factors, a provision for loan losses of \$0.6 million and \$3.9 million was recorded during the three and nine months ended September 30, 2012 compared to a provision for loan loss of \$1.5 million and \$3.1 million that was recorded

during the same periods in 2011. Net charge-offs were \$0.1 million for the quarter ended September 30, 2012 compared to \$1.6 million for the year ended December 31, 2011 and \$0.7 million for the quarter ended September 30, 2011. The ratio of allowance for loan losses to nonaccrual loans was 384%, 260% and 167%, at September 30, 2012, December 31, 2011, and September 30, 2011, respectively. The allowance for loan losses increased to \$14.0 million at September 30, 2012 as compared to \$10.8 million at December 31, 2011 and \$10.2 million at September 30, 2011. As a percentage of total loans, the allowance was 1.92% at September 30, 2012 compared to 1.77% at December 31, 2011 and 1.70% at September 30, 2011. In accordance with current accounting guidance, the acquired HSB loans were recorded at fair value, effectively netting estimated future losses against the loan balances. The allowance as a percentage of the Bank's originated loans was 1.99% at September 30, 2012. Management continues to carefully monitor the loan portfolio as well as real estate trends in Suffolk County and eastern Long Island. The Bank's consistent and rigorous underwriting standards preclude sub-prime lending, and management remains cautious about the potential for an indirect impact on the local economy and real estate values in the future.

Loans of approximately \$53.0 million or 7.2% of total loans at September 30, 2012 were categorized as classified loans compared to \$57.7 million or 9.4% at December 31, 2011 and \$56.3 million or 9.4% at September 30, 2011. Classified loans include loans with credit quality indicators with the internally assigned grades of special mention, substandard and doubtful. These loans are categorized as classified loans as management has information that indicates the borrower may not be able to comply with the present repayment terms. These loans are subject to increased management attention and their classification is reviewed on at least a quarterly basis.

At September 30, 2012, approximately \$34.1 million of classified loans were commercial real estate ( CRE ) loans which were well secured with real estate as collateral. Of the \$34.1 million of CRE loans, \$32.6 million were current and \$1.5 million were past due. In addition, all but \$2.1 million of the CRE loans have personal guarantees. At September 30, 2012, approximately \$4.9 million of classified loans were residential real estate loans with \$2.7 million current and \$2.2 million past due. Commercial, financial, and agricultural loans represented \$10.4 million of classified loans, of which \$9.7 million was current and \$0.7 million was past due. Approximately \$3.4 million of classified loans represented real estate construction and land loans, which were all current. All real estate construction and land loans are well secured with collateral. The remaining \$0.1 million in classified loans are consumer loans that are unsecured and demonstrate sufficient cash flow to pay the loans. There were no multi-family loans that were categorized as classified loans as of September 30, 2012 or December 31, 2011.

CRE loans, including multi-family loans, represented \$378.3 million or 51.7% of the total loan portfolio at September 30, 2012 compared to \$305.3 million or 49.9% at December 31, 2011 and \$287.8 million or 48.1% at September 30, 2011. The Bank's underwriting standards for CRE loans requires an evaluation of the cash flow of the property, the overall cash flow of the borrower and related guarantors as well as the value of the real estate securing the loan. In addition, the Bank's underwriting standards for CRE loans are consistent with regulatory requirements with original loan to value ratios less than or equal to 75%. The Bank considers charge-off history, delinquency trends, cash flow analysis, and the impact of the local economy on commercial real estate values when evaluating the appropriate level of the allowance for loan losses. Real estate values in our geographic markets increased significantly from 2000 through 2007. Commencing in 2008, following the financial crisis and significant downturn in the economy, real estate values began to decline. This decline continued into 2009 and appears to have stabilized in 2010. The estimated decline in residential and commercial real estate values range from 15-20% from the 2007 levels, depending on the nature and location of the real estate.

As of September 30, 2012 and December 31, 2011, the Company had impaired loans as defined by FASB ASC No. 310, Receivables of \$8.8 million and \$9.0 million, respectively. For a loan to be considered impaired, management determines after review whether it is probable that the Bank will not be able to collect all amounts due according to the contractual terms of the loan agreement. Management applies its normal loan review procedures in making these judgments. Impaired loans include individually classified nonaccrual loans and TDR loans. For impaired loans, the Bank evaluates the impairment of the loan in accordance with FASB ASC 310-10-35-22. Impairment is determined based on the present value of expected future cash flows discounted at the loan's effective interest rate. For loans that are collateral dependent, the fair value of the collateral is used to determine the fair value of the loan. The fair value of the collateral is determined based upon recent appraised values. The fair value of the collateral or present value of expected cash flows is compared to the carrying value to determine if any write-down or specific loan loss allowance allocation is required. These methods of fair value measurement for impaired loans are considered level 3 within the fair value hierarchy described in FASB ASC 820-10-50-5.

Impaired loans on nonaccrual decreased \$0.5 million to \$3.6 million or 0.50% of total loans at September 30, 2012 from \$4.1 million or 0.67% of total loans at December 31, 2011. Approximately \$1.8 million of the nonaccrual loans at September 30, 2012 and \$2.0 million at December 31, 2011, were troubled debt restructured loans. As of September 30, 2012, one of the borrowers with loans totaling \$0.2 million are complying with the modified terms of the loans and is currently making payments. Another borrower with loans totaling \$1.0 million is past due but is making payments. The remaining borrower with loans totaling \$0.6 million is currently in default and foreclosure proceedings have been initiated. The decrease in nonaccrual troubled debt restructured loans at June 30, 2012 was primarily due to one loan totaling \$0.3 million where the borrower has made six months of consecutive payments in accordance with the restructured terms and the loan is now a performing trouble debt restructure loan. In addition, one loan totaling \$0.3 million

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was charged off during the first quarter 2012 and an additional charge-off of \$0.2 million occurred during the second quarter 2012. Total nonaccrual troubled debt restructured loans is secured with collateral that has an appraised value of \$3.4 million. Approximately \$2.0 million of the nonaccrual loans at December 31, 2011 represented troubled debt restructured loans where the borrowers were complying with the modified terms of the loans and were currently making payments. Furthermore, the Bank has no commitment to lend additional funds to these debtors.

In addition, the Company had seven borrowers with performing TDR loans of \$5.2 million at September 30, 2012 that are secured with collateral that has an appraised value of approximately \$12.9 million. As of September 30, 2012, all loans are current and paying according to their terms. At December 31, 2011, the Company had four borrowers with TDR loans of \$4.9 million that were current and secured with collateral that had an appraised value of approximately \$11.5 million as well as personal guarantees. Management believes that the ultimate collection of principal and interest is reasonably assured and therefore continues to recognize interest income on an accrual basis. In addition, the Bank has no commitment to lend additional funds to these debtors.

The Bank had \$0.3 million foreclosed real estate at September 30, 2012 and none for December 31, 2011 and September 30, 2011, respectively.

The following table sets forth impaired loans by loan type:

| (In thousands)                               | September 30, 2012 | December 31, 2011 |
|--|--------------------|-------------------|
| Nonaccrual Loans:                            |                    |                   |
| Commercial real estate mortgage loans        | \$ 502             | \$ 449            |
| Multi-family mortgage loans                  |                    |                   |
| Residential real estate mortgage loans       | 1,197              | 1,156             |
| Commercial, financial and agricultural loans | 173                | 260               |
| Real estate construction and land loans      |                    | 250               |
| Installment/consumer loans                   |                    |                   |
| Total  | 1,872              | 2,115             |
| Restructured Loans - Nonaccrual:             |                    |                   |
| Commercial real estate mortgage loans        | 484                |                   |
| Multi-family mortgage loans                  |                    |                   |
| Residential real estate mortgage loans       | 963                | 1,786             |
| Commercial, financial and agricultural loans | 308                | 218               |
| Real estate construction and land loans      |                    |                   |
| Installment/consumer loans                   |                    |                   |
| Total  | 1,755              | 2,004             |
| Total Non-performing Loans                   | 3,627              | 4,119             |
| Restructured Loans - Performing:             |                    |                   |
| Commercial real estate mortgage loans        | 4,285              | 4,630             |
| Multi-family mortgage loans                  |                    |                   |
| Residential real estate mortgage loans       | 338                |                   |
| Commercial, financial and agricultural loans | 537                | 274               |
| Real estate construction and land loans      |                    |                   |
| Installment/consumer loans                   |                    |                   |
| Total  | 5,160              | 4,904             |
| Total Impaired Loans                         | \$ 8,787           | \$ 9,023          |

Restructured loans totaled \$7.0 million and \$6.9 million as of September 30, 2012 and December 31, 2011, respectively.



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The following table sets forth changes in the allowance for loan losses:

| (Dollars in thousands)   | <b>For the Nine<br/>Months Ended<br/>September 30, 2012</b> |         | <b>For the Year Ended<br/>December 31, 2011</b> |         |
|--|---|---------|---|---------|
| Allowance for loan losses balance at beginning of period                           | \$  | 10,837  | \$  | 8,497   |
| Charge-offs:   |   |         |   |         |
| Commercial real estate mortgage loans  |   |         |   |         |
| Multi-family mortgage loans  |   |         |   |         |
| Residential real estate mortgage loans   |   | 700     |   | 259     |
| Commercial, financial and agricultural loans                                       |   | 102     |   | 372     |
| Real estate construction and land loans  |   |         |   | 864     |
| Installment/consumer loans   |   | 13      |   | 186     |
| Total  |   | 815     |   | 1,681   |
| Recoveries:  |   |         |   |         |
| Commercial real estate mortgage loans  |   |         |   |         |
| Multi-family mortgage loans  |   |         |   |         |
| Residential real estate mortgage loans   |   | 5       |   | 6       |
| Commercial, financial and agricultural loans                                       |   | 70      |   | 96      |
| Real estate construction and land loans  |   |         |   |         |
| Installment/consumer loans   |   | 22      |   | 19      |
| Total  |   | 97      |   | 121     |
| Net charge-offs  |   | (718)   |   | (1,560) |
| Provision for loan losses charged to operations                                    |   | 3,925   |   | 3,900   |
| Balance at end of period   | \$  | 14,044  | \$  | 10,837  |
| Ratio of annualized net charge-offs during the period to average loans outstanding |   | (0.07)% |   | (0.28)% |

The following table sets forth the allocation of the total allowance for loan losses by loan type:

| (Dollars in thousands)                       | September 30, 2012 |   |    | December 31, 2011 |   |  |
|--|--------------------|---|----|-------------------|---|--|
|  | Amount             | Percentage<br>of Loans<br>to Total<br>Loans |    | Amount            | Percentage<br>of Loans<br>to Total<br>Loans |  |
| Commercial real estate mortgage loans        | \$ 4,573           | 43.4%                                       | \$ | 3,530             | 46.4%                                       |  |
| Multi-family mortgage loans                  | 1,221              | 8.2   |    | 395               | 3.5   |  |
| Residential real estate mortgage loans       | 2,884              | 19.5  |    | 2,280             | 23.1  |  |
| Commercial, financial and agricultural loans | 3,809              | 21.8  |    | 2,895             | 19.0  |  |
| Real estate construction and land loans      | 1,286              | 5.8   |    | 1,465             | 6.6   |  |
| Installment/consumer loans                   | 271                | 1.3   |    | 272               | 1.4   |  |
| Total  | \$ 14,044          | 100.0%                                      | \$ | 10,837            | 100.0%                                      |  |

***Non Interest Income***

Total non interest income increased \$0.5 million or 26.6% to \$2.2 million for the three months ended September 30, 2012 compared to \$1.8 million for the same period in 2011. The increase was the result of a \$0.2 million increase in net securities gains, a \$0.1 million increase in service charges on deposit accounts and fees for other customer services related to higher electronic banking and investment services income,

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and a \$0.1 million increase in title fee income related to Bridge Abstract.

Total non interest income increased \$2.9 million or 58.3% to \$8.0 million for the nine months ended September 30, 2012 compared to \$5.1 million for the same period in 2011. The increase was the result of a \$2.0 million increase in net securities gains, a \$0.5 million increase in service charges on deposit accounts and fees for other customer services related to higher electronic banking and investment services income, and a \$0.4 million increase in title fee income related to Bridge Abstract. The increase in net gains on

securities for the three months and nine months periods in 2012 was the result of \$67.1 million in securities sold with proceeds used to prepay higher rate borrowings including \$0.2 million in costs associated with the extinguishment of debt.

### *Non Interest Expense*

Total non interest expense increased \$0.7 million or 8.4% to \$8.5 million during the three months ended September 30, 2012 compared to \$7.8 million over the same period in 2011. Salaries and employees benefits increased \$0.4 million or 8.2% to \$5.2 million for the three months ended September 30, 2012 from \$4.8 million for the same period in 2011. The increase reflects additional positions to support the Company's expanding infrastructure and larger loan portfolio. Other operating expenses increased \$0.3 million to \$1.9 million as of September 30, 2012 as compared to \$1.6 million for the same period last year. FDIC assessments increased \$0.1 million or 41.8% to \$0.2 million for the three months ended September 30, 2012 compared to \$0.1 million for the same period last year. Non interest expense for the three months ended September 30, 2011, also included acquisition costs of \$0.1 million in connection with the HSB merger.

Total non interest expense increased \$2.3 million or 9.8% to \$25.3 million during the nine months ended September 30, 2012 compared to \$23.0 million over the same period in 2011. Salaries and employees benefits increased \$2.2 million or 16.4% to \$15.6 million for the nine months ended September 30, 2012 from \$13.4 million for the same period in 2011. The increase reflects additional positions to support the Company's expanding infrastructure and larger loan portfolio. Net occupancy expense and furniture and fixture expenses increased \$0.1 million. As of September 30, 2012 the Company incurred \$0.2 million in cost of extinguishment of debt due to the prepayment of a \$5.0 million repurchase agreement. Other operating expenses increased \$0.6 million to \$5.6 million as of September 30, 2012 as compared to \$5.0 million for the same period last year. FDIC assessments decreased \$0.1 million or 14.6% to \$0.5 million for the nine months ended September 30, 2012 compared to \$0.6 million for the same period last year. Non interest expense for the nine months ended September 30, 2011, also included acquisition costs of \$0.7 million in connection with the HSB merger.

### *Income Taxes*

The provision for income taxes increased \$0.4 million or 30.1% to \$1.6 million for the three months ended September 30, 2012 compared to \$1.2 million for the three months ended September 30, 2011 primarily due to higher pretax income. The effective tax rate for the three months ended September 30, 2012 increased to 32.5% from 30.1% for the same period last year. The increase in the effective rate was a result of a lower percentage of interest income from tax exempt securities and a higher federal statutory rate.

The provision for income taxes increased \$1.1 million or 33.6% to \$4.4 million for the nine months ended September 30, 2012 compared to \$3.3 million for the nine months ended September 30, 2011 primarily due to higher pretax income. The effective tax rate for the nine months ended September 30, 2012 increased to 32.3% from 31.1% for the same period last year. The increase in the effective rate was a result of a lower percentage of interest income from tax exempt securities and a higher federal statutory rate.

### *Financial Condition*

Total assets grew to \$1.566 billion, a 22.1% increase over the September 30, 2011 level of \$1.283 billion and 17.1% over the December 31, 2011 level of \$1.337 billion with all growth funded by deposits, borrowings and capital. This increase reflects strong organic growth in new and



existing markets.

Cash and due from banks decreased \$5.3 million and interest earning deposits with banks decreased \$46.4 million compared to December 31, 2011 as management invested excess capital and liquidity and continues to evaluate prudent strategies to deploy these funds to maximize returns while managing interest rate risk. Total securities increased \$164.4 million or 26.9% to \$776.6 million and net loans increased \$117.1 million or 19.5% to \$718.4 million compared to December 31, 2011 levels. The ability to grow the investment and loan portfolios, while minimizing interest rate risk sensitivity and maintaining credit quality, remains a strong focus of management. Total deposits grew \$126.7 million to \$1.315 billion at September 30, 2012 compared to \$1.188 billion at December 31, 2011. Demand deposits increased \$91.2 million to \$412.7 million as of September 30 2012 compared to \$321.5 million at December 31, 2011. Savings, NOW and money market deposits increased \$53.3 million to \$737.2 million at September 30, 2012 from \$683.9 million at December 31, 2011. Certificates of deposit of \$100,000 or more decreased \$15.0 million to \$125.6 million at September 30, 2012, from \$140.6 million at December 31, 2011. Other time deposits decreased \$2.9 million to \$39.3 million at September 30, 2012, from \$42.2 million at December 31, 2011. Federal Home Loan Bank term advances were \$15.0 million as of September 30, 2012. There were no Federal Home Loan Bank term advances as of December 31, 2011. Federal funds purchased and Federal Home Loan Bank overnight borrowings were \$62.0 million as of September 30, 2012. There were no federal funds purchased and Federal Home Loan Bank overnight borrowings as of December 31, 2011. Repurchase agreements decreased \$3.8 million to \$13.1 million at September 30, 2012 compared to \$16.9 million as of December 31, 2011 predominately due to the prepayment of a \$5.0 million Repurchase agreement in February 2012. Junior subordinated debenture remained at \$16.0 million as of September 30, 2012

compared to December 31, 2011. Other liabilities and accrued expenses increased \$19.5 million to \$28.6 million as of September 30, 2012 from \$9.1 million as of December 31, 2011 due to securities totaling \$17.9 million purchased in September 2012 which settled in October 2012. Stockholders' equity was \$116.3 million at September 30, 2012, an increase of \$9.3 million or 8.7% from December 31, 2011, reflecting the proceeds from the issuance of shares of common stock under the Dividend Reinvestment Plan of \$6.5 million, net income of \$9.4 million, and \$1.0 million related to stock based compensation plans, partially offset by \$5.8 million in declared cash dividends and a decrease in the net unrealized gains in securities of \$1.7 million. In October 2012, the Company declared a quarterly dividend of \$0.23 per share and continues its long term trend of uninterrupted dividends.

### *Liquidity*

The objective of liquidity management is to ensure the sufficiency of funds available to respond to the needs of depositors and borrowers, and to take advantage of unanticipated earnings enhancement opportunities for Company growth. Liquidity management addresses the ability of the Company to meet financial obligations that arise in the normal course of business. Liquidity is primarily needed to meet customer borrowing commitments, deposit withdrawals either on demand or contractual maturity, to repay other borrowings as they mature, to fund current and planned expenditures and to make new loans and investments as opportunities arise. The Company's principal sources of liquidity included cash and cash equivalents of \$7.7 million as of September 30, 2012, and dividends from the Bank. Cash available for distribution of dividends to shareholders of the Company is primarily derived from dividends paid by the Bank to the Company. For the nine months ended September 30, 2012, the Bank did not pay a cash dividend to the Company. Prior regulatory approval is required if the total of all dividends declared by the Bank in any calendar year exceeds the total of the Bank's net income of that year combined with its retained net income of the preceding two years. At September 30, 2012, the Bank had \$29.9 million of retained net income available for dividends to the Company. In the event that the Company subsequently expands its current operations, in addition to dividends from the Bank, it will need to rely on its own earnings, additional capital raised and other borrowings to meet liquidity needs. The Company made a capital contribution of \$5.0 million to the Bank during the nine months ended September 30, 2012.

The Bank's most liquid assets are cash and cash equivalents, securities available for sale and securities held to maturity due within one year. The levels of these assets are dependent upon the Bank's operating, financing, lending and investing activities during any given period. Other sources of liquidity include loan and investment securities principal repayments and maturities, lines of credit with other financial institutions including the Federal Home Loan Bank and Federal Reserve Bank, growth in core deposits and sources of wholesale funding such as brokered certificates of deposit. While scheduled loan amortization, maturing securities and short term investments are a relatively predictable source of funds, deposit flows and loan and mortgage-backed securities prepayments are greatly influenced by general interest rates, economic conditions and competition. The Bank adjusts its liquidity levels as appropriate to meet funding needs such as seasonal deposit outflows, loans, and asset and liability management objectives. Historically, the Bank has relied on its deposit base, drawn through its full-service branches that serve its market area and local municipal deposits, as its principal source of funding. The Bank seeks to retain existing deposits and loans and maintain customer relationships by offering quality service and competitive interest rates to its customers, while managing the overall cost of funds needed to finance its strategies.

The Bank's Asset/Liability and Funds Management Policy allows for wholesale borrowings of up to 25% of total assets. At September 30, 2012, the Bank had aggregate lines of credit of \$282.5 million with unaffiliated correspondent banks to provide short term credit for liquidity requirements. Of these aggregate lines of credit, \$262.5 million is available on an unsecured basis. As of September 30, 2012, the Bank had \$62.0 million outstanding in overnight borrowings. The Bank did not have any overnight borrowings outstanding as of December 31, 2011. The Bank also has the ability, as a member of the Federal Home Loan Bank (FHLB) system, to borrow against unencumbered residential and commercial mortgages owned by the Bank. The Bank also has a master repurchase agreement with the FHLB, which increases its borrowing capacity. As of September 30, 2012 and December 31, 2011, the Bank did not have any overnight borrowings outstanding under these lines. As of September 30, 2012, the Bank had \$15.0 million outstanding in FHLB advances. The Bank did not have outstanding FHLB advances as of December 31, 2011. As of September 30, 2012, the Bank had \$10.0 million of securities sold under agreements to repurchase outstanding with brokers and \$3.1 million outstanding with customers. The Bank had \$15.0 million of securities sold under agreements to repurchase outstanding as of December 31, 2011 with brokers and \$1.9 million outstanding with customers. In addition, the Bank has an approved broker relationship

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for the purpose of issuing brokered certificates of deposit. As of September 30, 2012 and December 31, 2011, the Bank had no brokered certificates of deposits.

Management continually monitors the liquidity position and believes that sufficient liquidity exists to meet all of our operating requirements. Based on the objectives determined by the Asset and Liability Committee, the Bank's liquidity levels may be affected by the use of short term and wholesale borrowings, and the amount of public funds in the deposit mix. The Asset and Liability Committee is comprised of members of senior management and the Board. Excess short term liquidity is invested overnight at the highest rate available at the Federal Reserve or in federal funds sold. The Bank invested \$5.8 million at the Federal Reserve as of September 30, 2012, \$52.6 million as of December 31, 2011, and \$75.1 million as of September 30, 2011. The Bank did not have overnight federal funds sold as of September 30, 2012, December 31, 2011, or September 30, 2011.

### *Capital Resources*

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can result in 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 Bank's assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification also are 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 (set forth in the following table) of total and Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes as of September 30, 2012, the Company and the Bank met all capital adequacy requirements. Since 2009, the Company has actively managed its capital position in response to its growth. During this period, the Company has raised capital through the following initiatives:

- In April 2009, the Company implemented a Dividend Reinvestment Plan ( DRP Plan ) and filed a registration statement on Form S-3 to register 600,000 shares of common stock with the Securities and Exchange Commission ( SEC ) pursuant to the DRP Plan. In April 2010, the Company increased the discount from 3% to 5%, and raised the quarterly optional cash purchase amount to \$50,000 under the DRP Plan. Proceeds from the issuance of common stock related to the DRP Plan for the nine months ended September 30, 2012, was \$6.5 million and for the twelve months ended December 31, 2011, was \$4.6 million. Since the inception of the DRP Plan in April 2009 through September 30, 2012, the Company has issued 654,127 shares of common stock and raised \$12.8 million in capital.
- In June 2009, the Company filed a shelf registration statement on Form S-3 to register up to \$50 million of securities with the SEC. Subsequently in July 2012, the registration of these shares has expired.
- In December 2009, the Company completed the private placement of \$16.0 million in aggregate liquidation amount of 8.50% cumulative convertible trust preferred securities (the TPS ), through its subsidiary, Bridge Statutory Capital Trust II. The TPS have a liquidation amount of \$1,000 per security and the TPS shares are convertible into our common stock, at an effective conversion price of \$31 per share. The TPS mature in 30 years but are callable by the Company at par any time after September 30, 2014. The Company issued \$16.0 million of Junior Subordinated Debentures (the Debentures ) to the trust in exchange for ownership of all of the common security of the trust and the proceeds of the preferred securities sold by the trust. In accordance with current accounting guidance, the trust is not consolidated in the Company's financial statements, but rather the Debentures are shown as a liability. The Debentures bear interest at a fixed rate equal to 8.50% and mature on December 31, 2039. Consistent with regulatory requirements, the interest payments may be deferred for up to 5 years, and are cumulative. The Debentures have the same prepayment provisions as the TPS. The Debentures may be included in Tier I capital (with certain limitations applicable) under current regulatory guidelines and interpretations.
- On May 27, 2011, the Company issued 273,479 shares of common stock, increasing capital by \$5.8 million, in connection with the acquisition of Hamptons State Bank.
- In November 2011, the Company filed a prospectus supplement under which it may from time to time sell up to \$10.0 million of its common stock pursuant to an at-the-market equity offering program. During 2011 the Company issued 30,220 shares of common stock and raised \$0.6 million in capital under this program.
- On December 20, 2011, the Company raised \$24.1 million in capital from the sale of 1,377,000 shares of common stock to selected institutional and other private investors in a registered direct offering.

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- On June 27, 2012, the Company filed a shelf registration statement on Form S-3 to register up to 800,000 of securities pursuant to the DRP Plan with the SEC.

Management believes that the current capital levels along with future retained earnings will allow the Bank to maintain a position exceeding required capital levels and which is sufficient to support Company growth. Additionally, the Company has the ability to issue additional common stock and/or preferred stock should the need arise.

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At September 30, 2012 and December 31, 2011, actual capital levels and minimum required levels for the Company and the Bank were as follows:

**Bridge Bancorp, Inc. (Consolidated)**

As of September 30,  
(Dollars in thousands)

|  | Actual     |       | 2012<br>For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |       |
|--|------------|-------|---------------------------------------|-------|--|-------|
|  | Amount     | Ratio | Amount                                | Ratio | Amount   | Ratio |
| Total Capital (to risk weighted assets)  | \$ 141,346 | 14.8% | \$ 76,512                             | 8.0%  | n/a  | n/a   |
| Tier 1 Capital (to risk weighted assets) | 129,365    | 13.5% | 38,256                                | 4.0%  | n/a  | n/a   |
| Tier 1 Capital (to average assets)       | 129,365    | 9.0%  | 57,328                                | 4.0%  | n/a  | n/a   |

As of December 31,  
(Dollars in thousands)

|  | Actual     |       | 2011<br>For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |       |
|--|------------|-------|---------------------------------------|-------|--|-------|
|  | Amount     | Ratio | Amount                                | Ratio | Amount   | Ratio |
| Total Capital (to risk weighted assets)  | \$ 128,226 | 16.2% | \$ 63,228                             | 8.0%  | n/a  | n/a   |
| Tier 1 Capital (to risk weighted assets) | 118,334    | 15.0% | 31,614                                | 4.0%  | n/a  | n/a   |
| Tier 1 Capital (to average assets)       | 118,334    | 9.3%  | 51,010                                | 4.0%  | n/a  | n/a   |

**Bridgely National Bank**

As of September 30,  
(Dollars in thousands)

|  | Actual     |       | 2012<br>For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |       |
|--|------------|-------|---------------------------------------|-------|--|-------|
|  | Amount     | Ratio | Amount                                | Ratio | Amount   | Ratio |
| Total Capital (to risk weighted assets)  | \$ 133,633 | 14.0% | \$ 76,496                             | 8.0%  | \$ 95,621  | 10.0% |
| Tier 1 Capital (to risk weighted assets) | 121,654    | 12.7% | 38,248                                | 4.0%  | 57,372   | 6.0%  |
| Tier 1 Capital (to average assets)       | 121,654    | 8.5%  | 57,320                                | 4.0%  | 71,650   | 5.0%  |

As of December 31,  
(Dollars in thousands)

|  | Actual     |       | 2011<br>For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |       |
|--|------------|-------|---------------------------------------|-------|--|-------|
|  | Amount     | Ratio | Amount                                | Ratio | Amount   | Ratio |
| Total Capital (to risk weighted assets)  | \$ 115,383 | 14.6% | \$ 63,213                             | 8.0%  | \$ 79,016  | 10.0% |
| Tier 1 Capital (to risk weighted assets) | 105,494    | 13.4% | 31,616                                | 4.0%  | 47,410   | 6.0%  |
| Tier 1 Capital (to average assets)       | 105,494    | 8.3%  | 51,001                                | 4.0%  | 63,751   | 5.0%  |

### ***Impact of Inflation and Changing Prices***

The Unaudited Consolidated Financial Statements and notes thereto presented herein have been prepared in accordance with U.S. generally accepted accounting principles, which require the measurement of financial position and operating results in terms of historical dollars without considering changes in the relative purchasing power of money over time due to inflation. The primary effect of inflation on the operations of the Company is reflected in increased operating costs. Unlike most industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, changes in interest rates have a more significant effect on the performance of a financial institution than do the effects of changes in the general rate of inflation and changes in prices. Changes in interest rates could adversely affect the Company's results of operations and financial condition. Interest rates do not necessarily move in the same direction, or in the same magnitude, as the prices of goods and services. Interest rates are highly sensitive to many factors, which are beyond the control of the Company, including the influence of domestic and foreign economic conditions and the monetary and fiscal policies of the United States government and federal agencies, particularly the Federal Reserve Bank.

### ***Recent Regulatory and Accounting Developments***

Refer to Note 14. Recent Accounting Pronouncements, of the Notes to the Consolidated Financial Statements for details related to recent regulatory and accounting developments.

## **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

### ***Asset/Liability Management***

Management considers interest rate risk to be the most significant market risk for the Company. Market risk is the risk of loss from adverse changes in market prices and rates. Interest rate risk is the exposure to adverse changes in the net income of the Company as a result of changes in interest rates.

The Company's primary earnings source is net interest income, which is affected by changes in the level of interest rates, the relationship between rates, the impact of interest rate fluctuations on asset prepayments, the level and composition of deposits and liabilities, and the credit quality of earning assets. The Company's objectives in its asset and liability management are to maintain a strong, stable net interest margin, to utilize its capital effectively without taking undue risks, to maintain adequate liquidity, and to reduce vulnerability of its operations to changes in interest rates.

The Company's Asset and Liability Committee evaluates periodically, but at least four times a year, the impact of changes in market interest rates on assets and liabilities, net interest margin, capital and liquidity. Risk assessments are governed by policies and limits established by senior management, which are reviewed and approved by the full Board of Directors at least annually. The economic environment continually presents uncertainties as to future interest rate trends. The Asset and Liability Committee regularly utilizes a model that projects net interest income based on increasing or decreasing interest rates, in order to be better able to respond to changes in interest rates.

At September 30, 2012, \$728.5 million or 93.8% of the Company's securities had fixed interest rates. Changes in interest rates affect the value of the Company's interest earning assets and in particular its securities portfolio. Generally, the value of securities fluctuates inversely with changes in interest rates. Increases in interest rates could result in decreases in the market value of interest earning assets, which could adversely affect the Company's stockholders' equity and its results of operations if sold. The Company is also subject to reinvestment risk associated with changes in interest rates. Changes in market interest rates could also affect the type (fixed-rate or adjustable-rate) and the amount of loans originated by the Company and the average life of loans and securities, which can impact the yields earned on the Company's loans and securities. Changes in interest rates may affect the average life of loans and mortgage related securities as well as the related accretion of discount or amortization of premium. In periods of decreasing interest rates, the average life of loans and securities held by the Company may be shortened to the extent increased prepayment activity occurs during such periods which, in turn, may result in the investment of funds from such prepayments in lower yielding assets. Under these circumstances the Company is subject to reinvestment risk to the extent that it is unable to reinvest the cash received from such prepayments at rates that are comparable to the rates on existing loans and securities. Additionally, increases in interest rates may result in decreasing loan prepayments with respect to fixed rate loans (and therefore an increase in the average life of such loans), may result in a decrease in loan demand, and make it more difficult for borrowers to repay adjustable rate loans.

The Company utilizes the results of a detailed and dynamic simulation model to quantify the estimated exposure to net interest income to sustained interest rate changes. Management routinely monitors simulated net interest income sensitivity over a rolling two-year horizon. The simulation model captures the seasonality of the Company's deposit flows and the impact of changing interest rates on the interest income received and the interest expense paid on all assets and liabilities reflected on the Company's consolidated balance



sheet. This sensitivity analysis is compared to the asset and liability policy limits that specify a maximum tolerance level for net interest income exposure over a one-year horizon given a 100 and 200 basis point upward shift in interest rates and a 100 basis point downward shift in interest rates. A parallel and pro rata shift in rates over a twelve-month period is assumed.

The following reflects the Company's net interest income sensitivity analysis at September 30, 2012:

| Change in Interest Rates in Basis Points<br>(Dollars in thousands) | September 30, 2012<br>Potential Change<br>in Net<br>Interest Income |          | December 31, 2011<br>Potential Change<br>in Net<br>Interest Income |          |
|--|---|----------|--|----------|
|  | \$ Change   | % Change | \$ Change  | % Change |
| 200  | \$ (1,129)  | (2.42)%  | \$ (1,968)   | (4.32)%  |
| 100  | \$ (417)  | (0.89)%  | \$ (926)   | (2.03)%  |
| Static   |   |          |  |          |
| (100)  | \$ (202)  | 0.43%    | \$ (16)  | (0.04)%  |

The preceding sensitivity analysis does not represent a Company forecast and should not be relied upon as being indicative of expected operating results. These hypothetical estimates are based upon numerous assumptions including, but not limited to, the nature and timing of interest rate levels and yield curve shapes, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, and reinvestment and replacement of asset and liability cash flows. While assumptions are developed based upon perceived current economic and local market conditions, the Company cannot make any assurances as to the predictive nature of these assumptions including how customer preferences or competitor influences may change.

Also, as market conditions vary from those assumed in the sensitivity analysis, actual results will also differ due to prepayment and refinancing levels likely deviating from those assumed, the varying impact of interest rate change caps or floors on adjustable rate assets, the potential effect of changing debt service levels on customers with adjustable rate loans, depositor early withdrawals, prepayment penalties and product preference changes and other internal and external variables. Furthermore, the sensitivity analysis does not reflect actions that management might take in responding to, or anticipating changes in interest rates and market conditions.

#### Item 4. Controls and Procedures

An evaluation was performed under the supervision and with the participation of the Company's management, including the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of September 30, 2012. Based on that evaluation, the Company's Principal Executive Officer and Principal Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this quarterly report. There has been no change in the Company's internal control over financial reporting during the quarter 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***

None.

***Item 1A. Risk Factors***

There is one additional risk factor described below in addition to the factors disclosed in Item 1A., Risk Factors, in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

***Recent Storm-Related Events May Have A Negative Impact on Future Earnings***

We are in the process of assessing the impact of the recent storm that occurred in late October. The storm resulted in considerable damage throughout our market area, and may have adversely affected the collateral of some of our borrowers and, to a lesser extent, their ability to repay their obligations to the Bank.

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

- (a) Not applicable.
- (b) Not applicable.
- (c) Not applicable.

**Item 3. Defaults upon Senior Securities**

Not applicable.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

Not applicable.

**Item 6. Exhibits and Reports on Form 8-K**

- 31.1 Certification of Principal Executive Officer pursuant to Rule 13a-14(a)
- 31.2 Certification of Principal Financial Officer pursuant to Rule 13a-14(a)
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350
- 101 The following financial statements from Bridge Bancorp, Inc.'s Quarterly Report on Form 10-Q for the Quarter Ended September 30, 2012, filed on November 8, 2012, formatted in XBRL: (i) Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011, (ii) Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2012 and 2011, (iii) Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2012 and 2011, (iv) Consolidated Statement of Stockholders' Equity for the Nine Months Ended September 30, 2012 and 2011, (v) Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2012 and 2011, and (vi) the Condensed Notes to Consolidated Financial Statements. (1)
- 101.INS XBRL Instance Document (1)

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|         |  |
|---------|--|
| 101.SCH | XBRL Taxonomy Extension Schema Document (1)                |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document (1)  |
| 101.LAB | XBRL Taxonomy Extension Labels Linkbase Document (1)       |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document (1) |
| 101.DEF | XBRL Taxonomy Extension Definitions Linkbase Document (1)  |

(1) Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

SIGNATURES

In accordance with the requirement of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BRIDGE BANCORP, INC.  
Registrant

November 8, 2012

/s/ Kevin M. O Connor  
Kevin M. O Connor  
President and Chief Executive Officer

November 8, 2012

/s/ Howard H. Nolan  
Howard H. Nolan  
Senior Executive Vice President, Chief Financial Officer