TOWNEBANK

2006 Annual Report

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BUSINESS PROFILE

TowneBank (the "Company") was organized in 1998 under the laws of the Commonwealth of Virginia to engage in a general commercial and retail banking business and began operations on April 8, 1999. TowneBank places special emphasis on serving the financial needs of small and medium size businesses, professional concerns and individuals in the Greater Hampton Roads area where it concentrates primarily in the Chesapeake, Norfolk, Portsmouth, and Virginia Beach markets and, with the 2004 affiliation with Harbor Bank, on the Virginia Peninsula. The Company offers a full range of banking and related financial services, including checking, savings, certificates of deposit and other depository services, as well as commercial, real estate and consumer loan services. The Company provides residential and commercial mortgages, including brokerage services. Additionally, the Company provides title insurance services, investment and asset management services, and a full line of commercial and consumer insurance products, including employee health insurance benefits. Through GSH Residential Real Estate Corporation, the Company offers complete residential real estate services including real estate sales, relocation, property management, mortgage, title and related settlement services. The Company is a community oriented and locally owned institution that focuses on providing a high level of responsive and personalized services to its members, delivered in the context of a strong, direct relationship between the member and the Company.

CORPORATE MISSION STATEMENT

TowneBank will be a relationship and friendship driven local bank focused on the basic human values that will serve to create a warm sense of belonging and financial well-being among our family of members.

We will offer a competitive array of business and personal financial services, delivered only with the highest ethical standards. Our commitment to exquisite service for our members will lead to our ability to create a reasonable rate of return for our shareholders, a bright future for our dedicated bankers, and a leadership role for our bank in promoting the social, cultural and economic well-being of our community.

TOWNEBANK
SELECTED FINANCIAL HIGHLIGHTS

Period Ended December 31,	2006	2005	2006/2005 Increase/(Decrease)	
(Dollars in thousands, except per share data)				
Results of Operations:				
Net interest income	$ 77,042	$ 62,443	$ 14,599	23.38%
Noninterest income (1)	35,561	34,076	1,485	4.36%
Noninterest expenses	76,043	66,948	9,095	13.59%
Provision for loan losses	2,572	2,364	208	8.80%
Net income	21,786	17,680	4,106	23.22%
Net income per common share - basic	0.93	0.79	0.14	17.72%
Net income per common share - diluted	0.86	0.74	0.12	16.22%
Period End Data:				
Total assets	$ 2,194,585	$ 1,803,182	$ 391,403	21.71%
Total assets - tangible	2,137,537	1,747,320	390,217	22.33%
Earning assets	2,009,906	1,625,125	384,781	23.68%
Loans (net of unearned income and deferred costs)	1,641,826	1,264,492	377,334	29.84%
Allowance for loan losses	19,670	17,071	2,599	15.22%
Goodwill and other intangibles	57,048	55,862	1,186	2.12%
Noninterest bearing deposits	453,351	417,061	36,290	8.70%
Interest bearing deposits	1,251,348	1,050,664	200,684	19.10%
Total deposits	1,704,699	1,467,725	236,974	16.15%
Shareholders' equity	230,017	211,986	18,031	8.51%
Shareholders' equity - tangible	172,969	156,124	16,845	10.79%
Book value per share	9.75	9.21	0.54	5.85%
Book value per share - tangible	7.33	6.78	0.54	8.10%
Dividends paid per share, as restated for 3% stock dividend distributed September 2005	0.230	0.126	0.10	82.54%
Daily Average Balances:				
Total assets	$ 1,981,403	$ 1,629,425	$ 351,978	21.60%
Total assets - tangible	1,923,968	1,573,697	350,271	22.26%
Earning assets	1,784,736	1,457,050	327,686	22.49%
Loans (net of unearned income and deferred costs)	1,438,927	1,180,150	258,777	21.93%
Allowance for loan losses	18,191	15,873	2,318	14.60%
Goodwill and other intangibles	57,435	55,728	1,707	3.06%
Noninterest bearing deposits	434,490	389,658	44,832	11.51%
Interest bearing deposits	1,148,157	916,818	231,339	25.23%
Total deposits	1,582,647	1,306,476	276,171	21.14%
Shareholders' equity	220,932	202,811	18,121	8.93%
Shareholders' equity - tangible	163,497	147,083	16,414	11.16%
Key Ratios:				
Return on average assets	1.10%	1.09%	0.01%	0.92%
Return on average tangible assets	1.13%	1.12%	0.01%	0.89%
Return on average equity	9.86%	8.72%	1.14%	13.07%
Return on average tangible equity	13.33%	12.02%	1.31%	10.90%
Net interest margin	4.32%	4.29%	0.03%	0.70%
Efficiency ratio	67.53%	69.36%	(1.83%)	(2.64%)
Average earning assets/total average assets	90.07%	89.42%	0.65%	0.73%
Average loans/average deposits	90.92%	90.33%	0.59%	0.65%
Average noninterest deposits/total average deposits	27.45%	29.83%	(2.38%)	(7.98%)
Allowance for loan losses/period end loans	1.20%	1.35%	(0.15%)	(11.11%)
Period end shareholders' equity/period end total assets	10.48%	11.76%	(1.28%)	(10.88%)

Notes:

The above data is retroactively restated for the mergers accounted for on a pooling of interests basis (described in Note 1 of the Company's Annual Report) and to reflect the 2-for-1 stock split effective February 15, 2002, the 3-for-2 stock split effective June 17, 2004, and the 3% stock dividend distributed on September 16, 2005.

(1) Excludes investment securities gains and losses

TOWNEBANK
SELECTED FINANCIAL HIGHLIGHTS

Period Ended December 31,	2004	2003	2002
(Dollars in thousands, except per share data)			
Results of Operations:			
Net interest income	$ 44,443	$ 25,997	$ 23,028
Noninterest income (1)	19,260	15,592	12,092
Noninterest expenses	43,617	29,100	25,253
Provision for loan losses	2,604	2,762	2,639
Net income	11,280	6,620	5,501
Net income per common share - basic	0.56	0.42	0.38
Net income per common share - diluted	0.53	0.40	0.38
Period End Data:			
Total assets	$1,448,359	$ 931,873	$ 763,899
Total assets - tangible	1,398,031	930,262	762,928
Earning assets	1,302,157	861,666	702,474
Loans (net of unearned income and deferred costs)	1,111,001	664,926	509,413
Allowance for loan losses	14,999	8,976	6,877
Goodwill and other intangibles	50,328	1,611	971
Noninterest bearing deposits	325,161	211,104	158,507
Interest bearing deposits	801,058	552,004	464,641
Total deposits	1,126,219	763,108	623,148
Shareholders' equity	188,521	80,641	70,841
Shareholders' equity - tangible	138,193	79,030	69,870
Book value per share	8.40	5.04	4.56
Book value per share - tangible	6.16	4.94	4.50
Dividends paid per share, as restated for 3% stock dividend distributed September 2005	0.065	0.032	-
Daily Average Balances:			
Total assets	$1,281,919	$ 842,667	$ 659,108
Total assets - tangible	1,241,472	841,164	658,086
Earning assets	1,152,830	778,214	613,483
Loans (net of unearned income and deferred costs)	954,535	580,633	459,241
Allowance for loan losses	13,148	7,788	5,487
Goodwill and other intangibles	40,447	1,503	1,022
Noninterest bearing deposits	288,124	183,258	110,701
Interest bearing deposits	730,244	510,497	418,200
Total deposits	1,018,368	693,755	528,901
Shareholders' equity	145,998	76,016	62,355
Shareholders' equity - tangible	105,551	74,513	61,333
Key Ratios:			
Return on average assets	0.88%	0.79%	0.83%
Return on average tangible assets	0.91%	0.79%	0.84%
Return on average equity	7.73%	8.71%	8.82%
Return on average tangible equity	10.69%	8.88%	8.97%
Net interest margin	3.86%	3.34%	3.75%
Efficiency ratio	68.47%	69.97%	71.90%
Average earning assets/total average assets	89.93%	92.35%	93.08%
Average loans/average deposits	93.73%	83.69%	86.83%
Average noninterest deposits/total average deposits	28.29%	26.42%	20.93%
Allowance for loan losses/period end loans	1.35%	1.35%	1.35%
Period end shareholders' equity/period end total assets	13.02%	8.65%	9.27%

Notes:

The above data is retroactively restated for the mergers accounted for on a pooling of interests basis (described in Note 1 of the Company's Annual Report) and to reflect the 2-for-1 stock split effective February 15, 2002, the 3-for-2 stock split effective June 17, 2004, and the 3% stock dividend distributed on September 16, 2005.

(1) Excludes investment securities gains and losses

Certified Public Accountants
Specialized Services
Business Solutions

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
TowneBank

We have audited the accompanying consolidated balance sheets of ***TowneBank*** and subsidiaries (Bank) as of December 31, 2006 and 2005, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2006. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Bank's internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 26, 2007 expressed an unqualified opinion on management's assessment of internal control over financial reporting and an unqualified opinion on the effectiveness of internal control over financial reporting.

Goodman + Company, LLP

Norfolk, Virginia
February 26, 2007

One Commercial Place, Suite 800
Norfolk, VA 23510
ph: 757.624.5100
fax: 757.624.5233
www.goodmanco.com

Internal Control over Financial Reporting

The management of TowneBank (the "Company") is responsible for the preparation and fair presentation of the financial statements and other financial information contained in this report. The accompanying consolidated financial statements were prepared in conformity with accounting principles generally accepted in the United States of America and include, as necessary, best estimates and judgements by management. Management also prepared other information in the Annual Report and is responsible for its accuracy and consistency with the consolidated financial statements. The management of TowneBank is responsible for establishing and maintaining adequate internal control over financial reporting, and for its compliance with laws and regulations relating to safety and soundness designated by the Federal Deposit Insurance Corporation ("FDIC"). TowneBank's internal control system was designed to provide reasonable assurance to the Company's management and Board of Directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

TowneBank maintains systems of controls that it believes are reasonably designed to provide management with timely and accurate information about TowneBank's operations. The system of internal controls includes, but is not limited to, maintaining internal audit and compliance functions, establishing formal written policies, procedures and codes of conduct, training personnel, and segregating key duties and functions, where appropriate.

The Audit Committee of the Board of Directors participates in the adequacy of the system of internal controls and financial reporting. The Audit Committee consists of directors who are independent from TowneBank. They meet regularly with management, the internal auditor, and the independent auditors to review the scope of their work and findings.

TowneBank's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2006. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control – Integrated Framework. Based on our assessment we believe that, as of December 31, 2006, the Company's internal control over financial reporting is effective based on those criteria and that the Company complied with the FDIC's safety and soundness laws and regulations over the course of the year ended December 31, 2006.

Financial Statements

Management of TowneBank is responsible for the preparation, integrity, and fair presentation of its published consolidated financial statements as of December 31, 2006, and for the year then ended, The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, and as such, include amounts, some of which are based on judgements and estimates of management.

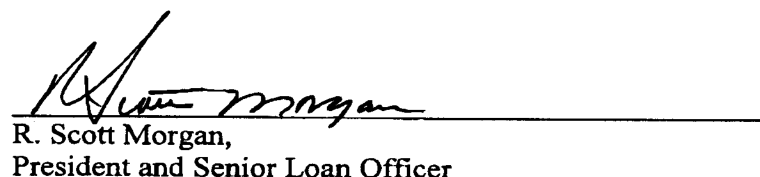
Compliance with Laws and Regulations

Management is also responsible for compliance with the federal and state laws and regulations concerning dividend restrictions and federal laws and regulations concerning loans to insiders designated by the FDIC as safety and soundness laws and regulations. Management assessed its compliance with the designated laws and regulations relating to safety and soundness. Based on this assessment, management believes that the Company complied, in all significant respects, with the designated laws and regulations relating to safety and soundness for the year ended December 31, 2006.

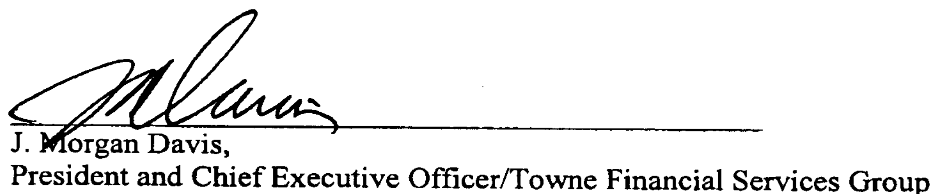
Goodman & Company, LLP, the registered public accounting firm that performed TowneBank's financial statement audit, has issued an attestation report on our assessment of the Company's internal controls over financial reporting. A copy of this report, which is combined with the report expressing an opinion on the consolidated financial statements, precedes.

February 26, 2007

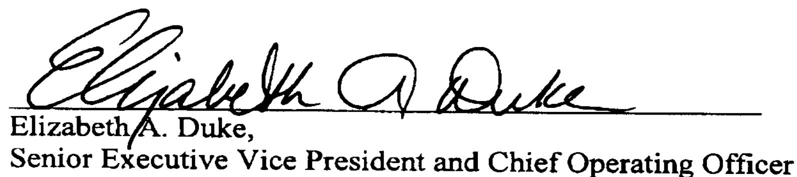
G. Robert Aston, Jr.,
Chairman of the Board and Chief Executive Officer



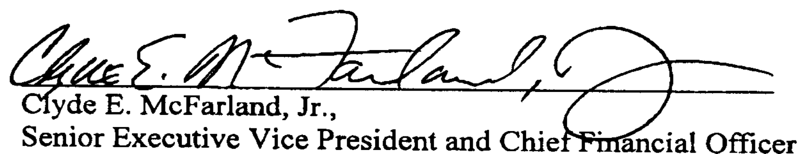
R. Scott Morgan,
President and Senior Loan Officer



J. Morgan Davis,
President and Chief Executive Officer/Towne Financial Services Group



Elizabeth A. Duke,
Senior Executive Vice President and Chief Operating Officer



Clyde E. McFarland, Jr.,
Senior Executive Vice President and Chief Financial Officer

TOWNEBANK
CONSOLIDATED BALANCE SHEETS
(dollars in thousands, except share data)
December 31, 2006 and 2005

ASSETS	2006	2005
Cash and due from banks	$ 45,448	$ 46,099
Interest bearing deposits in financial institutions	5,324	8,564
Federal funds sold	829	14,895
Total Cash and Cash Equivalents	51,601	69,558
Securities available-for-sale, at fair value	255,674	273,423
Securities held-to-maturity, at amortized cost	89,536	36,184
Total Securities	345,210	309,607
Mortgage loans held for sale	16,717	27,773
Loans, net of unearned income and deferred costs	1,641,826	1,264,492
Less: allowance for loan losses	(19,670)	(17,071)
Net Loans	1,622,156	1,247,421
Premises and equipment, net	67,226	64,062
Goodwill	51,245	49,701
Other intangibles	5,803	6,161
Other assets	34,627	28,899
TOTAL ASSETS	$ 2,194,585	$ 1,803,182
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest bearing demand	$ 453,351	$ 417,061
Interest bearing:		
Demand and money market accounts	498,431	487,737
Savings	21,868	24,100
Certificates of deposit:		
Less than $100,000	312,009	248,876
$100,000 and more	419,040	289,951
Total Deposits	1,704,699	1,467,725
Advances from the Federal Home Loan Bank of Atlanta	142,363	41,751
Convertible subordinated capital debentures	42,469	43,095
Repurchase agreements and other borrowings	34,674	10,517
Total Borrowings	219,506	95,363
Other liabilities	40,363	28,108
TOTAL LIABILITIES	1,964,568	1,591,196
Preferred stock, $5.00 par value		
Authorized and unissued shares - 2,000,000	-	-
Common stock, $1.667 par value		
Authorized shares - 45,000,000		
Issued and outstanding shares 23,601,356 in 2006		
and 23,011,526 in 2005	39,343	38,360
Capital surplus	159,023	154,573
Retained earnings	30,734	21,433
Accumulated other comprehensive income (loss)	917	(2,380)
TOTAL SHAREHOLDERS' EQUITY	230,017	211,986
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 2,194,585	$ 1,803,182

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

TOWNEBANK
CONSOLIDATED STATEMENTS OF INCOME
(dollars in thousands, except per share data)
For the Years Ended December 31, 2006, 2005 and 2004

	2006	2005	2004
INTEREST INCOME:			
Loans, including fees	$ 111,032	$ 79,369	$ 55,125
Investment securities	13,723	7,163	5,440
Interest bearing deposits in financial institutions and federal funds sold	368	1,526	65
Mortgage loans held for sale	1,217	1,421	987
Total interest income	126,340	89,479	61,617
INTEREST EXPENSE:			
Deposits	41,382	22,084	12,728
Advances from the Federal Home Loan Bank of Atlanta	4,688	2,539	2,825
Convertible subordinated capital debentures	2,274	2,110	1,529
Repurchase agreements and other borrowings	954	303	92
Total interest expense	49,298	27,036	17,174
Net interest income	77,042	62,443	44,443
PROVISION FOR LOAN LOSSES	2,572	2,364	2,604
Net interest income after provision for loan losses	74,470	60,079	41,839
NONINTEREST INCOME:			
Residential mortgage brokerage income, net	8,846	8,808	6,881
Real estate brokerage and property management income, net	6,333	7,493	-
Insurance commissions and other title fees and income, net	9,782	8,458	5,160
Service charges on deposit accounts	5,479	4,370	3,909
Credit card merchant fees, net	1,417	1,136	906
Other income	3,704	3,811	2,404
Gain/(loss) on securities available-for-sale	(1,740)	14	12
Total noninterest income	33,821	34,090	19,272
NONINTEREST EXPENSE:			
Salaries and employee benefits	46,285	40,553	27,364
Occupancy	6,837	6,063	3,568
Furniture and equipment	4,538	3,945	2,898
Other expenses	18,383	16,387	9,787
Total noninterest expense	76,043	66,948	43,617
Income before income tax expense	32,248	27,221	17,494
Provision for income tax expense	10,462	9,541	6,214
Net income	$ 21,786	$ 17,680	$ 11,280
Net income per share			
Basic	$ 0.93	$ 0.79	$ 0.56
Diluted	$ 0.86	$ 0.74	$ 0.53

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

TOWNEBANK

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(dollars in thousands, except share data)

For the Years Ended December 31, 2006, 2005 and 2004

	Common		Capital	Retained	Accumulated Other Comprehensive	Comprehensive	
	Shares	Amount	Surplus	Earnings	Income (Loss)	Income (Loss)	Total
Balance, December 31, 2003	**15,528,087**	**$ 25,880**	**$ 43,502**	**$ 11,191**	**$ 68**		**$ 80,641**
Comprehensive Income:							
Net Income - 2004	-	-	-	11,280	-	$ 11,280	11,280
Accumulated other comprehensive loss							
Unrealized holding loss on securities available-for-sale arising during the year, net of tax benefit of $524	-	-	-	-	(974)	(974)	(974)
Total comprehensive income	-	-	-	-	-	**$ 10,306**	-
Payment of cash dividend	-	-	-	(1,044)	-		(1,044)
Issuance of common stock - stock compensation plans	299,948	499	1,386	-	-		1,885
Issuance of common stock	5,953,975	9,932	86,801	-	-		96,733
Balance, December 31, 2004	**21,782,010**	**$ 36,311**	**$ 131,689**	**$ 21,427**	**$ (906)**		**$ 188,521**
Comprehensive Income:							
Net Income - 2005	-	-	-	17,680	-	$ 17,680	17,680
Accumulated other comprehensive loss							
Unrealized holding loss on securities available-for-sale arising during the year, net of tax benefit of $791	-	-	-	-	(1,474)	(1,474)	(1,474)
Total comprehensive income		-	-	-	-	**$ 16,206**	-
Payment of cash dividend	-	-	-	(2,891)	-		(2,891)
Distribution of stock dividend	669,259	1,115	13,639	(14,783)	-		(29)
Issuance of common stock - stock				-	-		-
compensation plans	279,568	466	2,854	-	-		3,320
Director's deferred compensation	(125,709)	(210)	(1,818)	-	-		(2,028)
Issuance of common stock	406,398	678	8,209				8,887
Balance, December 31, 2005	**23,011,526**	**$ 38,360**	**$ 154,573**	**$ 21,433**	**$ (2,380)**		**$ 211,986**
Comprehensive Income:							
Net Income - 2006	-	-	-	21,786	-	$ 21,786	21,786
Accumulated other comprehensive gain							
Unrealized holding gain on securities available-for-sale arising during the year, net of tax expense of $1,775	-	-	-	-	3,297	3,297	3,297
Total comprehensive income	-	-	-	-	-	**$ 25,083**	-
Payment of cash dividend	-	-	-	(5,418)	-		(5,418)
Declaration of cash dividend	-	-	-	(7,127)	-		(7,127)
Issuance of common stock - stock compensation plans	478,878	797	2,325	-	-		3,122
Director's deferred compensation	(32,749)	(55)	(618)	-	-		(673)
Issuance of common stock	143,701	241	2,743	60	-		3,044
Balance, December 31, 2006	**23,601,356**	**$ 39,343**	**$ 159,023**	**$ 30,734**	**$ 917**		**$ 230,017**

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

TOWNEBANK

CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in thousands, except share data)
For the Years Ended December 31, 2006, 2005 and 2004

OPERATING ACTIVITIES:	2006	2005	2004
Net income	$ 21,786	$ 17,680	$ 11,280
Adjustments to reconcile net income to net cash from operating activities:			
Net amortization/(accretion) of securities	(553)	2,066	1,891
Investment securities (gains)/losses	1,804	(14)	(12)
Depreciation, amortization, and other intangible amortization	6,366	4,846	4,379
Provision for loan losses	2,572	2,364	2,604
Restricted stock awards accrual	761	690	415
Stock issued - postretirement, monthly stock purchase, and dividend reinvestment plans	603	984	5,286
Net (increase) decrease in loans held for sale	11,056	(8,589)	(549)
Changes in:			
Interest receivable	(1,912)	(3,041)	(1,584)
Other assets	(5,174)	469	(3,045)
Interest payable	(2,142)	(1,096)	(503)
Other liabilities	34,038	13,727	(6,877)
Net cash from operating activities	69,205	30,086	13,285
INVESTING ACTIVITIES:			
Purchase of available-for-sale securities	(249,606)	(138,588)	(28,018)
Purchase of held-to-maturity securities	(53,729)	(25,775)	(4,886)
Sale of available-for-sale securities	201,371	14,110	40,632
Proceeds from maturities, calls and prepayments of securities	70,276	6,486	8,768
Net increase in loans	(377,560)	(154,036)	(209,577)
Net purchase of premises and equipment	(7,953)	(13,149)	(13,769)
Cash acquired in business acquisition	348	1,761	15,708
Net cash from investing activities	(416,853)	(309,191)	(191,142)
FINANCING ACTIVITIES:			
Net increase in deposit accounts	236,974	340,890	125,704
Net change in borrowings	96,705	(26,529)	24,536
Proceeds from issuance of common stock	1,430	407	34,158
Cash dividends paid	(5,418)	(2,891)	(1,044)
Net cash from financing activities	329,691	311,877	183,354
Change in cash and cash equivalents	(17,957)	32,772	5,497
Cash and cash equivalents at beginning of year	69,558	36,786	31,289
Cash and cash equivalents at end of year	$ 51,601	$ 69,558	$ 36,786
Supplemental cash flow information:			
Cash paid for interest	$ 47,156	$ 25,940	$ 16,671
Cash paid for income taxes	$ 10,357	$ 7,800	$ 4,200
Noncash financing and investing activities:			
Net unrealized gain/(loss) on available-for-sale securities	$ 3,297	$ (1,474)	$ (974)
Common stock issued in connection with business acquisition	$ 2,351	$ 7,876	$ 57,961
Common stock issued in connection with stock-based compensation plans	$ 3,122	$ -	$ 983
Common stock issued in connection with conversion of convertible subordinated capital debentures	$ 349	$ 193	$ 798

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

1. ORGANIZATION AND BUSINESS COMBINATIONS:

Organization: TowneBank (the "Company") was organized and incorporated under the laws of the Commonwealth of Virginia on September 1, 1998. The Company commenced operations on April 8, 1999, once its charter was obtained from the Virginia State Corporation Commission, Bureau of Financial Institutions.

On December 29, 1999, the Company established TowneBank Investment Corporation with a capitalization of $14 million. TowneBank Investment Corporation acquires and holds investments for the Company. On July 10, 2006, TowneBank Investment Corporation (99%) and TowneBank (1%) established a new subsidiary, Towne Investments, LLC, which in turn acquired a 99.99% interest in Charter Facilities Funding V, LLC. This structure was used to participate in the New Markets Tax Credit program by which the federal government encourages investments in economically disadvantaged communities by providing federal income tax credits.

On October 1, 2000, TowneBank acquired Hampton Roads Funding Corporation ("HRFC"), a mortgage origination business headquartered in Virginia Beach, Virginia. HRFC was renamed TowneBank Mortgage and became a division of the Company. In early 2007, TowneBank entered into an agreement with William E. Wood & Associates to form Towne Mortgage, LLC, a mortgage brokerage and mortgage lending business. This agreement supersedes a previously existing 5-year consulting agreement with principals of William E. Wood & Associates.

The Company purchased Lawyers Escrow and Title Insurance Company ("LET") on January 1, 2001. On May 1, 2001, the Company acquired Kellam-Eaton-Huey Insurance Agency and Kellam-Eaton-Huey Financial Services, Inc. (collectively "KEH"), and on July 31, 2001, the Company acquired The Chesapeake Agency ("TCA"). Subsequently, the KEH entities and TCA were merged into Towne Insurance Agency, Inc. ("Towne Insurance"), a wholly owned subsidiary of TowneBank. LET operates as a wholly owned subsidiary of Towne Insurance. On July 1, 2004, Towne Insurance acquired West & Johnson Insurance, and on January 9, 2006, TowneBank announced the addition of the Brooks Agency, Inc. ("Brooks"), which operates out of Williamsburg, Virginia, as a division of Towne Insurance. The acquisition of these insurance entities allows TowneBank to offer title insurance services, a full line of commercial and consumer insurance products and financial services.

On May 6, 2002, the Company organized TowneBank Commercial Mortgage, LLC as a wholly owned subsidiary of the Company and began offering commercial mortgage brokerage services.

On March 7, 2003, the Company acquired Benefit Design Group ("BDG"), a company that specializes in employee benefit services, as a wholly owned subsidiary of TowneBank. Through the BDG acquisition, the Company also owns 50% of BeneFlex Management, LLC ("BeneFlex"), a subsidiary of BDG. BeneFlex is a third party administrator of flexible spending accounts, sometimes referred to as cafeteria plans or Section 125 plans, for various local businesses.

In early 2004, the Company entered into an agreement with the Ken Wren Group to form Towne Investment Group ("Towne Investment"), a division of TowneBank. As a provider of investment and asset management services, the members of Towne Investment have over 70 years of combined experience and began providing services for the Company on January 30, 2004. Assets under management on December 31, 2006 totaled $491.47 million compared to $401.15 million for 2005.

After the close of business on March 19, 2004, the acquisition between Harbor Bank and TowneBank became effective. Shareholders of Harbor Bank received three shares of TowneBank stock for each share of Harbor Bank stock in a tax-free exchange under a fixed exchange ratio, considering the effect of the three-for-two split and the 3% stock dividend.

On January 7, 2005, TowneBank closed the acquisition of GSH Residential Real Estate Corporation ("GSH"). GSH retained its trade name and continues to carry on its business in substantially the same manner as before the transaction as a wholly owned subsidiary of TowneBank. The Company provides complete residential real estate services to its product line, which includes real estate sales, relocation, property management, mortgage, title and related settlement services.

During February 2005, the Company established Towne Financial Services to facilitate corporate governance for operations of the non-bank divisions.

On January 1, 2007, Towne Insurance closed on the acquisition of The Frieden Agency, Inc., an employee benefit affiliate of The Frieden Agency which is southeastern Virginia's leading provider of employee benefit and individual health insurance programs. The agreement was announced in December 2006. The Frieden Agency, Inc., a wholly owned subsidiary of Towne Insurance, will combine efforts with BDG to further their position in the industry of employee benefit services.

2. ACCOUNTING POLICIES:

Basis of presentation: The consolidated financial statements of TowneBank include the accounts of the Company and its wholly owned subsidiaries: TowneBank Investment Corporation; Towne Investments, LLC; Towne Insurance Agency, Inc.; TowneBank Commercial Mortgage, LLC; Benefit Design Group; and GSH. The accompanying consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America and prevailing practices of the banking industry. All significant intercompany balances and transactions have been eliminated in consolidation. The following is a summary of the significant accounting and reporting policies used in preparing the consolidated financial statements.

Estimates: The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make 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 revenues and expenses during the reporting periods. Actual results could differ from those estimates and assumptions.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, deferred income taxes, fair value estimates, and goodwill and other intangibles.

Cash and cash equivalents: For purposes of reporting cash flows, the Company considers cash and due from banks, interest bearing deposits in financial institutions, and federal funds sold as cash and cash equivalents. Generally, federal funds and securities purchased under agreements to resell are purchased and sold for one-day periods. The Company is required to maintain average reserve balances in cash with the Federal Reserve Bank. Required reserves were $864,000 and $2.04 million at December 31, 2006 and 2005, respectively.

Investment securities: Investment securities are classified in three categories and accounted for as follows:

a. Debt securities that the Company has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.

b. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings. The Company had no securities in this class during the periods reported on the financial statements.

c. Debt and equity securities not classified as either held-to-maturity or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized holding gains and losses excluded from earnings and reported as other comprehensive income, a separate component of shareholders' equity, until realized.

Gains and losses on sales of securities are computed based on specific identification of the adjusted cost of each security and included in noninterest income but not in operating income. Amortization of premiums and accretion of discounts are computed by the effective yield method and included in interest income. Other-than-temporary declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost, if any, are included in earnings as realized losses.

Loans: Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or pay-off, generally are stated at the amount of unpaid principal less net deferred fees and costs on originated loans, unearned income, and participation interests sold to other lending institutions. Interest on loans is accrued and credited to income based upon the principal amount outstanding. Fees collected and costs incurred in connection with loans originated are deferred and recognized as interest income over the term of the loan as an adjustment of yield.

Allowance for loan losses: A loan is considered impaired, based on current information and events, if it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement.

The measurement of impaired loans is generally based on the present value of expected future cash flows discounted at the historical effective interest rate, except that all collateral-dependent loans are measured for impairment based on the fair value of the collateral.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures.

Management periodically evaluates the adequacy of the allowance for loan losses in order to maintain the allowance at a level that is sufficient to absorb probable credit losses. Management's evaluation of the adequacy of the allowance is based on a review of the known and inherent risks in the loan portfolio, including adverse circumstances that may affect the ability of the borrower to repay interest and/or principal, the estimated value of collateral, and an analysis of the levels and trends of delinquencies, charge-offs, and the internal risk ratings within various loan categories. Such factors as the level and trend of interest rates and the condition of the national and local economies are also considered. In addition, losses incurred by similarly situated banks are considered.

Various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance based on their judgments of information available to them at the time of their examination.

The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. Increases and decreases in the allowance due to changes in the measurement of impaired loans, if applicable, are included in the provision for loan losses. Loans continue to be classified as impaired unless they are brought fully current and the collection of scheduled interest and principal is considered probable.

When a loan or portion of a loan is determined to be uncollectible, the portion deemed uncollectible is charged against the allowance and subsequent recoveries, if any, are credited to the allowance. Management's ongoing evaluation of the adequacy of the allowance for loan losses includes historical loss experience internally and that of peer banks.

A geographic concentration exists within TowneBank's loan portfolio as most of the Company's business activity is with customers in the Hampton Roads area of Virginia. There were no significant concentrations to any one customer; however, the Company has a concentration in residential construction and acquisition and development loans.

Loans held for sale: Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

Premises and equipment: Premises and equipment are stated at cost, less accumulated depreciation. Leasehold improvements are amortized over the lives of the respective leases or the estimated useful life of the leasehold improvement, whichever is less.

For financial reporting purposes, depreciation is computed by the straight-line method over the estimated useful lives of the assets. For income tax purposes, the modified cost recovery system is used. Costs of maintenance and repairs are charged to expense as incurred. Costs of replacing structural parts of major units are considered individually and are expensed or capitalized as the facts dictate.

Fixed assets may be retired and disposed of by sale, trade, abandonment, or through a casualty loss such as a fire or storm. At retirement, the cost of the asset and its related accumulated depreciation are removed from the accounts. The type of disposal will determine the specific treatment of the asset.

Long-lived assets: The Company classifies an asset as held-for-sale using the criteria specified by Statement of Financial Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Among other things, those criteria specify that (a) the asset must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets and (b) the sale of the asset must be probable, and its transfer expected to qualify for recognition as a completed sale, within one year, with certain exceptions.

If an asset classified as held-for-sale is reclassified as held and used, the reclassified asset is measured as the lower of its (a) carrying value before being classified as held-for-sale adjusted for any depreciation (amortization expense) that would have been recognized had the asset been continuously classified as held and used or (b) fair value at the date the asset is reclassified as held and used.

Goodwill and other intangibles: Goodwill is not subject to amortization, but is subject to an annual assessment for impairment by applying a fair value based test as required by Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* ("SFAS 142"). Additionally, under SFAS 142, acquired intangible assets are separately recognized if the benefit of the asset can be sold, transferred, licensed, rented, or exchanged, and amortized over their useful life.

Goodwill is tested for impairment by reportable segment on an annual basis, or more often if events or circumstances indicate there may be impairment. Testing is conducted in two steps: identifying the potential impairment and then if necessary, identifying the amount of impairment. The first step compares the fair value of the reporting segment to its carrying amount. If the fair value is less than the carrying amount, a second test is conducted by comparing the implied fair value of segment goodwill with the carrying amount of that goodwill. If the carrying amount exceeds the implied fair value, an impairment loss is recognized in an amount equal to that excess.

As discussed in Note 23, the Company has three reportable segments and uses the same segments for testing goodwill. The goodwill impairment testing for 2006 indicated that none of the Company's goodwill was impaired. Note 6 provides additional information related to goodwill and other intangibles and to the carrying amounts by reportable segment.

Transfers of financial assets: Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the asset has been isolated from the company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred asset, and (3) the company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Credit related financial instruments: In the ordinary course of business, the Company has entered into commitments to extend credit including commitments under credit card arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded. They are considered in calculating the provision for loan losses.

Rate lock commitments: TowneBank enters into commitments to originate loans whereby the interest rate on the loan is determined prior to funding (rate lock commitments). As required by Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS No. 133"), rate lock commitments related to the origination of mortgage loans held for sale and the corresponding forward loan sale commitments are considered to be derivatives. The commitments are generally for periods of 60 days and are at market rates.

In order to mitigate the risk from interest rate fluctuations the Company enters into forward loan sale commitments on a "best efforts" basis while the loan is in the pipeline. All of the gain on sales generated from mortgage banking activities is recorded in the financials at the time the loan is closed. At December 31, 2006, commitments totaled $38.48 million compared to $72.04 million at December 31, 2005.

Income recognition on impaired and nonaccrual loans: Loans, including impaired loans, are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. If a loan or a portion of a loan is classified as doubtful or is partially charged off, the loan is generally classified as nonaccrual. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccrual, if repayment in full of principal and/or interest is unlikely.

While a loan is classified as nonaccrual and the probability of collecting the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to principal outstanding. When the probability of collecting the recorded loan balance is expected, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate.

Cash interest receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance by the borrower in accordance with the contractual terms of interest and principal.

Advertising costs: Advertising costs are expensed as incurred.

Organization and start-up costs: Organization and start-up costs are expensed as incurred.

Segment information: Public business enterprises are required to report certain information about operating segments in their annual financial statements and in condensed financial statements of interim periods issued to shareholders. They are also required to report related disclosures and descriptive information about products and services provided by significant segments, geographic areas, and major customers, differences between the measurements used in reporting segment information and those used in the enterprise's general-purpose financial statements, and changes in the measurement of segment amounts from period to period.

Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief executive officer in deciding how to allocate resources and in assessing performance. The Company has determined that it has three operating segments.

Its primary business segment is providing commercial and consumer financial services to customers located in the single geographic area of Hampton Roads, Virginia, and surrounding communities. The various products are those generally offered by community banks, credit unions, and savings and loan associations, and the allocation of resources is based on the overall performance of the institution versus the individual branches or products. The Company's second segment is a realty service business and combines the operations of GSH with TowneBank Mortgage and LET to provide residential real estate services, originations of a variety of mortgage loans, and commercial and residential title insurance. The Company's third segment is a full service insurance agency which provides individual and commercial insurance products and employee benefit services using nationally recognized carriers.

Mergers and acquisitions: Mergers and acquisitions are accounted for using the purchase method, as required by Statement of Financial Standards No. 141, *Business Combinations*. Under this method, the cost of the acquired entity will be allocated to the assets acquired and liabilities assumed based on their fair values at the date of acquisition. The excess of the cost over the fair value of the acquired net assets is recognized as goodwill.

Income taxes: The Company uses the liability method in accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities that result in future taxable or deductible amounts. The effect on deferred taxes of a change in tax rates is recognized in the year of enactment and is measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized in the near term.

Comprehensive income: Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income or loss. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with the operating net income or loss, are components of comprehensive income or loss. The only component of other comprehensive income or loss consists of unrealized gains and losses on available-for-sale securities.

Stock-based compensation: TowneBank has a stock-based employee compensation plan, which is described more in Note 14. The Company accounts for the plan using the fair value method, according to Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* ("SFAS 123"), which requires that compensation cost relating to stock-based payment transactions be recognized in the financial statements. The scope of SFAS 123R includes stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. The compensation cost will be measured based on the fair value of the instruments issued.

The Company is applying the modified prospective transition method requiring that the compensation cost for the unvested portion of previously issued awards that are outstanding at the date of adoption be recorded and included in the determination of net income. Accordingly, net income for the year ended December 31, 2006 includes the compensation cost for the nonvested portion of outstanding awards granted before January 1, 2003 in addition to the compensation cost for awards granted after that date. The following table illustrates the effect on net income and earnings per share for the comparative periods ended December 31, 2005 and 2004 as if the fair value based method had been applied to all outstanding and unvested awards.

Years ended December 31, (Dollars in thousands, except per share data)	**2005**	**2004**
Net income, as reported	$ 17,680	$ 11,280
ADD: Stock-based employee compensation expense included in reported net income, net of related tax effects	210	79
LESS: Total stock-based employee compensation expense determined under fair value based method for all stock options, net of related tax effects	(394)	(264)
Pro forma net income	$ 17,496	$ 11,095
Earnings per share		
Basic - As reported	$ 0.79	$ 0.56
Basic - Pro forma	0.75	0.55
Diluted - As reported	0.74	0.53
Diluted - Pro forma	0.70	0.52

Stock splits and stock dividend: On April 29, 2004, the Board of Directors approved an amendment to the Articles of Incorporation of the Company to increase the number of authorized shares of Common Stock from 30,000,000 to 45,000,000 shares, to reduce the par value of each share from $2.50 to $1.667 per share, and effect a three-for-two stock split distributed on June 17, 2004 to shareholders of record on May 17, 2004. On July 27, 2005, the Company's Board of Directors announced a special 3% stock dividend payable on September 16, 2005 to shareholders of record on August 26, 2005.

All share and per share amounts included in the accompanying consolidated financial statements and footnotes have been restated for all periods presented to reflect the stock splits and stock dividend.

Earnings per share: Basic earnings per share are computed by dividing earnings available to common shareholders by the weighted-average number of common shares outstanding for the year less the average number of nonvested restricted stock awards. Diluted earnings per share reflect the potential dilution from the issuance of additional shares of common stock caused by the exercise of stock options and restricted stock awards. Also considered in the calculation is the impact of the convertible subordinated capital debentures on earnings available to shareholders and weighted-average common shares outstanding.

Dividends: The Company is subject to regulatory dividend restrictions. On January 28, 2004, the Company declared a special annual cash dividend of $0.065 per common share payable to shareholders of record on February 27, 2004. The dividend represented 15.77% of 2003 net income and was paid March 15, 2004 in the amount of $1.04 million.

On January 26, 2005, the Company declared a special shareholder cash dividend bonus of $0.126 per common share, as restated for the 2005, 3% stock dividend, payable on March 14, 2005 to shareholders of record on February 25, 2005. The dividend represented 25.63% of 2004 net income.

On January 25, 2006, the Company declared a special shareholder cash dividend bonus of $0.23 per common share, payable to shareholders of record on February 24, 2006. The dividend represents 30% of 2005 net income and was paid on March 10, 2006 in the amount of $5.42 million.

On November 22, 2006, the Company declared a special shareholder cash dividend bonus of $0.30 per common share payable on January 16, 2007 to shareholders of record on December 20, 2006. The total dividend paid was $7.13 million.

Declaration of future annual cash dividends will depend on the earnings of the Company, its capital position and other factors.

Recent accounting pronouncements:

In February 2006, the FASB issued FASB Statement 155, *Accounting for Certain Hybrid Financial Instruments – an amendment of FASB Statements No. 133 and 140* ("SFAS 155"), which eliminates an exemption from application of Statement 133 so that similar instruments are accounted for similarly regardless of the form of the instruments. SFAS 155 also provides for an election to measure fair value at acquisition, issuance, or at a remeasurement event on an instrument-by-instrument basis. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of a fiscal year that begins after September 15, 2006. The adoption of this standard is currently not expected to have a material impact on the Company's consolidated results of operations and financial position in the foreseeable future.

In March 2006, the FASB issued FASB Statement 156, *Accounting for Servicing of Financial Assets – an amendment of FASB Statement No. 140* ("SFAS 156"), which amends Statement 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. SFAS 156 is effective as of the beginning of its first fiscal year that begins after September 15, 2006. The adoption of this standard is currently not expected to have a material impact on the Company's consolidated results of operations and financial position in the foreseeable future.

In September 2006, the FASB issued FASB Statement 157, *Fair Value Measurements* ("SFAS 157"), which establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurement. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is reviewing the literature and will apply the statement as appropriate.

In September 2006, the FASB issued FASB Statement 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plan – an amendment of FASB Statements No. 87, 88, 106, and 132(R)* ("SFAS 158"), which requires employers to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS 158 is effective for employers of publicly traded equity securities as of the end of the fiscal year ending after December 15, 2006. The adoption of this standard is currently not expected to have a material impact on the Company's consolidated results of operations and financial position in the foreseeable future.

In February 2007, the FASB issued FASB Statement 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115* ("SFAS 159"), which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value and also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is reviewing the literature and will apply the statement as appropriate.

3. INVESTMENT SECURITIES:

Available-for-sale securities
The aggregate carrying and fair values of available-for-sale securities (dollars in thousands) were:

Securities Available-for-Sale

December 31, 2006	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency securities	$ 127,865	$ 605	$ (127)	$ 128,343
Municipal securities	3,749	101	-	3,850
Corporate obligations	605	-	-	605
Total debt securities	132,219	706	(127)	132,798
Other investments	126	-	(38)	88
Federal Home Loan Bank Stock	10,013	-	-	10,013
Mortgage-backed securities	111,905	1,054	(184)	112,775
Total equity securities	122,044	1,054	(222)	122,876
Total available-for-sale securities	$ 254,263	$ 1,760	$ (349)	$ 255,674

December 31, 2005	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency securities	$ 253,314	$ -	$ (3,523)	$ 249,791
U.S. Treasury notes	999	-	(1)	998
Municipal securities	3,750	63	(13)	3,800
Corporate obligations	605	3	-	608
Total debt securities	258,668	66	(3,537)	255,197
Other investments	242	-	(43)	199
Federal Home Loan Bank Stock	4,781	-	-	4,781
Collateralized mortage-backed obligations	-	-	-	-
Mortgage-backed securities	13,392	11	(157)	13,246
Total equity securities	18,415	11	(200)	18,226
Total available-for-sale securities	$ 277,083	$ 77	$ (3,737)	$ 273,423

Federal Home Loan Bank of Atlanta (“FHLB”) stock is stated at cost, as this is a restricted security without a readily determinable fair value.

For the year ended December 31, 2006, proceeds from securities available-for-sale amounted to $168.93 million and resulted in losses of $1.80 million. The tax benefit charged against the loss amounted to $631,000.

For the years ended December 31, 2005 and 2004, proceeds from securities available-for-sale amounted to $5.32 million and $250,000 and resulted in gains of $14,000, and $12,000, respectively. The tax expense charged against income for these gains amounted to $5,000 and $4,000 for the years ended December 31, 2005 and 2004, respectively.

Held-to-maturity securities

The aggregate carrying and market values of held-to-maturity investment securities (dollars in thousands) were:

Securities Held-to-Maturity

December 31, 2006	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	$ 3,993	$ -	$ (9)	$ 3,984
Trust Preferred	5,520	693	-	6,213
Municipal bonds	16,694	14	(191)	16,517
Industrial revenue bonds	63,329	-	-	63,329
Total held-to-maturity securities	$ 89,536	$ 707	$ (200)	$ 90,043

December 31, 2005	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	$ 3,948	$ -	$ (14)	$ 3,934
Trust Preferred	5,517	691	-	6,208
Municipal bonds	15,603	-	(277)	15,326
Industrial revenue bonds	11,116	-	-	11,116
Total held-to-maturity securities	$ 36,184	$ 691	$ (291)	$ 36,584

Maturities of investment securities

The amortized cost and estimated fair value of investment securities, by contractual maturity (including mortgage-backed securities), are shown in the following table (dollars in thousands). Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

December 31, 2006	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 5,904	$ 5,892	$ 10,948	$ 10,922
Due after one year through five years	63,046	62,876	30,443	30,272
Due after 5 years through 10 years	49,325	49,554	2,524	2,522
Due after 10 years	125,849	127,251	45,621	46,327
	244,124	245,573	89,536	90,043
Federal Home Loan Bank Stock	10,013	10,013	-	-
Other equity securities	126	88	-	-
	$ 254,263	$ 255,674	$ 89,536	$ 90,043

Pledged securities

At December 31, 2006 and 2005, the Company had investment securities with carrying values of $64.20 million and $45.30 million, respectively, pledged to secure federal, state, and municipal deposits. Additionally, the Company had $75.56 million and $10.02 million in investment securities pledged to secure borrowings from the FHLB and FRB, respectively, at December 31, 2006. Comparatively, the Company had $18.40 million and $4.94 million in investment securities pledged to secure borrowings from the FHLB and FRB, respectively, at December 31, 2005. The Company also had $15.07 million in investment securities pledged against repurchase agreements with commercial customers at December 31, 2006 compared to $19.79 million at December 31, 2005.

Reconciliation to net unrealized gains/(losses)

The following is a reconciliation of the reclassification adjustment and the tax effect component of other comprehensive income to net unrealized gains/(losses) (dollars in thousands):

Years ended December 31,	2006	2005	2004
Unrealized gains (losses) on securities:			
Unrealized holding gains (losses) arising during the period	$ 3,332	$ (2,251)	$ (1,486)
Reclassification adjustment for (gains) losses on available-for-sale securities included in income	1,740	(14)	(12)
Total other comprehensive income (loss) before income tax (expense) benefit	5,072	(2,265)	(1,498)
Income tax (expense) benefit	(1,775)	791	524
Net unrealized gains (losses)	$ 3,297	$ (1,474)	$ (974)

Unrealized losses
The following tables show the Company's gross unrealized losses and fair values, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position (dollars in thousands).

December 31, 2006	**Less than 12 months**		**12 months or more**		**Total**	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
US Treasury obligations and direct obligations of US government agencies	$ 9,965	$ 36	$ 25,903	$ 100	$ 35,868	$ 136
Municipal securities	-	-	13,910	191	13,910	191
Federal agency mortgage backed securities	7,804	42	5,219	142	13,023	184
Subtotal, debt securities	$ 17,769	$ 78	$ 45,032	$ 433	$ 62,801	$ 511
Other investments, including common stock	-	-	87	38	87	38
Total temporarily impaired securities	$ 17,769	$ 78	$ 45,119	$ 471	$ 62,888	$ 549

December 31, 2005	**Less than 12 months**		**12 months or more**		**Total**	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
US Treasury obligations and direct obligations of US government agencies	$ 120,054	$ 862	$ 129,669	$ 2,677	$ 249,723	$ 3,539
Municipal securities	16,274	268	1,049	21	17,323	289
Federal agency mortgage backed securities	3,172	53	3,664	104	6,836	157
Subtotal, debt securities	$ 139,500	$ 1,183	$ 134,382	$ 2,802	$ 273,882	$ 3,985
Other investments, including common stock	-	-	83	43	83	43
Total temporarily impaired securities	$ 139,500	$ 1,183	$ 134,465	$ 2,845	$ 273,965	$ 4,028

U.S. Treasury obligations: The unrealized losses on the Company's investments in U.S. Treasury obligations and direct obligations of U.S. government agencies were caused by interest rate fluctuations. At December 31, 2006, nine such securities experienced total unrealized losses of $136,000. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Because the securities in this category are government agencies with AAA credit ratings and have average maturities of three years or less, the Company considers these unrealized losses to be temporary in nature at year end.

Municipal securities: The unrealized losses on the Company's municipal securities were caused by interest rate fluctuations. At December 31, 2006, 13 such securities experienced total unrealized losses of $191,000. Based on the credit quality of the issuer and the Company's ability and intent to hold these securities until a market price recovery or maturity, the Company does not consider these investments other than temporarily impaired.

Federal agency mortgage-backed securities: The Company's unrealized losses on investments in federal agency mortgage-backed securities were caused by interest rate fluctuations. At December 31, 2006, 11 such securities experienced total unrealized losses of $184,000. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Because the securities are government agencies and the Company has the ability and intent to hold them for a period of time sufficient to allow for an anticipated recovery, they are not considered to be other than temporarily impaired.

Corporate obligations: The Company did not have any unrealized losses on investments in corporate obligations at December 31, 2006.

Other investments, including common stock: The unrealized losses on the Company's investments in other investments, including common stock, were caused by interest rate fluctuations. At December 31, 2006, one such equity security experienced a total unrealized loss of $39,000. The severity and duration of this unrealized loss will fluctuate with interest rates and market condition in the local economy and credit ratings of the offering agencies. The Company monitors this security and has the ability and intent to hold the investment to allow for an anticipated recovery.

Portfolio Restructure

On October 12, 2006, the Company sold $168.7 million in agency securities and purchased $95.77 million in agency securities and $99.36 million in agency mortgage-backed securities to restructure the investment portfolio to take advantage of the current yield curve environment.

4. LOANS AND ALLOWANCE FOR LOAN LOSSES:

TowneBank grants commercial, real estate, and consumer loans to customers throughout its lending area. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' abilities to honor their contracts is dependent upon the economic environment of the lending area. Of total loans, $109.65 million were pledged as collateral to secure overnight borrowings with the FHLB.

A summary of loan balances by major classification (dollars in thousands) follows:

December 31,	2006	2005
Real estate loans:		
Residential 1 - 4 family	$ 362,034	$ 297,452
Commercial	364,657	275,027
Construction	529,933	377,246
Multifamily	17,919	8,247
Total real estate loans	1,274,543	957,972
Commercial loans	306,437	256,776
Consumer installment loans:		
Personal installment	41,784	30,160
Credit cards and revolving credit	18,885	19,382
Total consumer installment loans	60,669	49,542
Agriculture loans	177	202
Loans, net of unearned income and deferred costs	$ 1,641,826	$ 1,264,492

Unearned loan income was $1.10 million in excess of deferred loan costs at December 31, 2006, and was $830,000 at December 31, 2005. There were $636,000 and $213,000 in nonaccrual loans at December 31, 2006 and 2005. The Company would have earned $214,000 in 2006 and $107,000 in 2005 if interest on the loans had been accrued. Such income would not have been material for 2004.

Transactions affecting the allowance for loan losses for the periods (dollars in thousands) were:

Years ended December 31,	**2006**	**2005**	**2004**
Balance, beginning of year	$ 17,071	$ 14,999	$ 8,976
Loans charged off			
Residential 1-4 family	(7)	(5)	(59)
Construction	(6)	(3)	(120)
Commercial	(153)	(483)	(933)
Consumer	(48)	(65)	(104)
Total	(214)	(556)	(1,216)
Loans recovered			
Residential 1-4 family	32	60	4
Construction	-	16	28
Commercial	176	117	581
Consumer	33	71	113
Total	241	264	726
Net loans recovered (charged off)	27	(292)	(490)
Provision for loan losses	2,572	2,364	2,604
Harbor Bank allowance at date of merger	-	-	3,909
Balance, end of year	$ 19,670	$ 17,071	$ 14,999

It is the opinion of management that the allowance was adequate at December 31, 2006, based on conditions reasonably known to management; however, the allowance may be increased or decreased in the future based on loan balances outstanding, changes in internally generated credit quality ratings of the loan portfolio, changes in general economic conditions, or other risk factors.

5. PREMISES, EQUIPMENT AND LEASES:

A summary of the cost and accumulated depreciation of premises and equipment (dollars in thousands) follows:

December 31,	**2006**	**2005**
Land and improvements	$ 11,324	$ 11,214
Buildings and improvements	30,303	25,437
Autos	2,508	2,240
Computer and communication equipment	5,244	5,100
Equipment	7,337	6,689
Furniture and fixtures	15,778	13,140
Leasehold improvements	9,672	8,115
Construction in progress	205	3,646
	82,371	75,581
Less accumulated depreciation	(15,145)	(11,519)
	$ 67,226	$ 64,062

Depreciation and leasehold amortization expense for the years ended December 31, 2006, 2005 and 2004, was $4.38 million, $3.79 million and $2.66 million, respectively. In connection with construction of the Williamsburg branch, the Company capitalized $58,000 of interest in 2005. The Company did not capitalize any interest in 2006 because the construction was completed early in the year. The capitalized interest for 2005 is included in construction in progress.

Various TowneBank facilities and equipment are leased under noncancellable operating leases with initial remaining terms in excess of one year. In addition to minimum rentals, certain leases have escalation clauses and include provisions for additional payments to cover taxes, insurance, and maintenance. The effects of the scheduled rent increases, which are included in the minimum lease payments, are recognized on a straight-line basis over the lease term. Rental expense was $3.75 million for 2006, compared to $3.22 million for 2005 and $1.67 million for 2004. Future minimum lease payments, by year and in the aggregate, under noncancellable operating facilities leases were as follows at December 31, 2006 (dollars in thousands):

2007	$ 3,134
2008	2,893
2009	2,620
2010	2,212
2011	2,115
Thereafter	9,121
	$ 22,095

The Company leases various facilities to others under noncancellable operating leases, most of which have options for renewal. In addition to minimum rentals, certain leases have escalation clauses and include provisions for additional payments to cover taxes, insurance, and maintenance.

Rental income for the year ended December 31, 2006 was $260,000 compared to $252,000 for 2005 and $151,000 for 2004. Future minimum rental income, by year and in the aggregate, under noncancellable operating leases were as follows at December 31, 2006 (dollars in thousands):

2007	$ 79
2008	63
2009	33
2010	29
2011	17
Thereafter	-
	$ 221

6. GOODWILL AND OTHER INTANGIBLES:

The gross carrying amount and accumulated depreciation for the Company's goodwill and other intangible assets at December 31, 2006 and 2005 follows:

(Dollars in thousands)	December 31, 2006 Gross carrying amount	2006 Accumulated Amortization	2005 Gross carrying amount	2005 Accumulated Amortization
Goodwill	$ 51,245	$ -	$ 49,701	$ -
Intangible assets subject to amortization				
Core deposit intangible	3,677	1,244	3,677	799
Non-compete agreements	625	200	625	88
Pendings and listings	145	145	145	145
Property management contracts	620	383	620	226
Customer lists	1,374	239	696	73
Covenants and expirations	215	84	215	62
Total	6,656	2,295	5,978	1,393
Intangible assets not subject to amortization				
Trade name	500	-	500	-
Title plant	942	-	1,076	-
Total	1,442	-	1,576	-
Total goodwill and other intangibles	$ 59,343	$ 2,295	$ 57,255	$ 1,393

Goodwill and intangible assets with an indefinite life are subject to impairment testing at least annually or more often if events or circumstances suggest potential impairment. Other acquired intangible assets determined to have a finite life are amortized over their estimated useful life in a manner that best reflects the economic benefits of the intangible asset. Intangible assets with a finite life are periodically reviewed for other than temporary impairment. $134,000 of impairment loss was recorded on the title plant asset due to obsolescence.
The aggregate amortization expense for intangible assets with definite lives for the year ended December 31, 2006 was $902,000 compared to $1.13 million for 2005 and $378,000 for 2004.

The estimated aggregate annual amortization expense for each of the five years subsequent to December 31, 2006 are as follows: 2007, $1.01 million; 2008, $974,000; 2009, $857,000; 2010, $802,000; 2011, $802,000.

During 2006, the Company recorded a $134,000 impairment of title plant due to obsolescence. Also during 2006, the Company recorded $678,000 in intangible assets for the acquisition of Brooks, all of which were intangibles with definite lives and consisted entirely of customer lists with an amortization period of 8 years. These intangibles were added to the Insurance segment.

During 2005, the Company recorded $2.33 million in intangible assets for the acquisition of GSH. Of the total, $1.39 million were intangibles with definite lives, consisting of $625,000 in non-compete agreements with a weighted-average amortization period of approximately seven and a half years, $620,000 in property management contracts with an amortization period of five years, $79,000 in pendings with an amortization period of five months, $66,000 in listings with an amortization period of six months, and $443,000 in title plant, which is tested for impairment as described in Note 2. The remaining intangibles have indefinite lives and total $500,000, consisting solely of trade names. These intangibles were added to the Realty segment.

Changes in the carrying amount of goodwill related to each of the Company's segments for the two-year period ended December 31, 2006 are as follows (dollars in thousands):

	Bank	Realty	Insurance	Consolidated Totals
Balance, December 31, 2004	45,206	228	485	45,919
Additions to goodwill	-	4,615	10	4,625
Reclassification to intangibles	(600)	-	-	(600)
Other adjustments	(243)	-	-	(243)
Balance, December 31, 2005	$ 44,363	$ 4,843	$ 495	$ 49,701
Additions to goodwill	-	-	1,544	1,544
Balance, December 31, 2006	$ 44,363	$ 4,843	$ 2,039	$ 51,245

7. INCOME TAXES:

The provision for income taxes charged to operations (dollars in thousands) consists of the following:

Years ended December 31,	**2006**	**2005**	**2004**
Current income tax expense	$ (11,314)	$ (11,318)	$ (6,160)
Deferred income tax (expense) benefit	852	1,777	(54)
Income tax expense	$ (10,462)	$ (9,541)	$ (6,214)

Differences between income tax expense calculated at the statutory rate, and that shown on the Consolidated Statements of Income are summarized (dollars in thousands) as follows:

Years ended December 31,	**2006**	**2005**	**2004**
Federal income tax expense at statutory rate	$ (11,287)	$ (9,527)	$ (6,123)
State income tax expense	(75)	(93)	(20)
Tax advantaged income	498	188	94
Tax credits	663	-	-
Other	(261)	(109)	(165)
Income tax expense	$ (10,462)	$ (9,541)	$ (6,214)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of deferred tax assets and deferred tax liabilities (dollars in thousands) are as follows:

December 31,	2006	2005
Deferred tax assets:		
Allowance for loan losses	$ 6,491	$ 5,581
Unrealized loss on securities available-for-sale	-	1,281
Noncompete and intangibles	-	96
Other	769	355
Accrued expenses	442	307
Deferred compensation	2,548	1,992
Total deferred tax assets	10,250	9,612
Deferred tax liabilities:		
Loan fees	1,343	1,117
Depreciation	4,292	3,760
Noncompete and intangibles	1,361	14
Unrealized gain on securities available-for-sale	681	-
Total deferred tax liabilities	7,677	4,891
Net deferred tax assets	$ 2,573	$ 4,721

The Company's federal income tax returns have been examined and settled with the Internal Revenue Service through 2004.

8. COMMITMENTS:

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk, which have not been recognized in the balance sheet. The contract amount of these instruments reflects the extent of the Company's involvement or "credit risk."

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. Unless noted otherwise, collateral or other security is required to support financial instruments with credit risk.

Contractual amounts (dollars in thousands) are as follows:

December 31,	2006	2005
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	$ 1,008,079	$ 777,017
Standby letters of credit	25,793	23,199
	$ 1,033,872	$ 800,216

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the counter-party. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, income-producing commercial properties and real estate.

Standby letters of credit are conditional commitments issued by the Company to guarantee performance of a customer to a third party. The letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit have expiration dates within 2007. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral supporting those commitments is generally held, if deemed necessary. Additionally, the Company had $146.16 million in mortgage loans sold to investors with various recourse and warranty provisions.

The Company provides an allowance for estimated losses from such provisions that management considered adequate at December 31, 2006. Management does not anticipate any material losses will arise from additional disbursements of the aforementioned lines or standby letters of credit.

9. DEPOSITS:

A summary of time deposits by maturity, at December 31, 2006, is as follows (dollars in thousands):

2007	$ 676,074
2008	36,642
2009	13,277
2010	2,056
2011 and thereafter	3,000
	$ 731,049

At year-end 2006, the Company had a total of $473.23 million in no-penalty time deposits. Officers and directors, and their respective companies, in which the officers and directors have a financial interest, have deposit relationships with the Company. Related party deposits amounted to approximately $54.14 million and $38.83 million at December 31, 2006 and 2005, respectively.

10. ADVANCES FROM THE FEDERAL HOME LOAN BANK OF ATLANTA:

Advances from the FHLB for the years ended December 31, 2006, 2005, and 2004 are summarized as follows (dollars in thousands):

	2006	2005	2004
Balance outstanding at end of year	$ 142,363	$ 41,751	$ 67,929
Average balance outstanding	82,295	45,203	67,601
Maximum outstanding at any month-end	142,363	56,915	99,515
Average interest rate during the year	5.70%	5.62%	4.18%
Average interest rate at end of year	5.61%	5.80%	4.51%

The scheduled maturity dates, call dates and related fixed interest rates on advances from the FHLB at December 31, 2006 are summarized as follows (dollars in thousands):

Maturity Date	Interest Rate	Call Date	Outstanding Amount
2/9/2010	6.45%	2/9/2007	$ 25,000
11/10/2010	5.43%	2/12/2007	8,000
4/15/2008	3.30%	-	627
7/9/2008	2.92%	-	2,291
6/29/2011	5.17%	-	945
1/11/2007	5.50%	-	105,500
			$ 142,363

At December 31, 2006 and 2005, the Company had a $516.01 million and $223.74 million unused line of credit with the FHLB, respectively. The FHLB advances are secured by certain investment securities with an aggregate carrying value of approximately $75.56 million and a blanket floating line on 1-4 family and multifamily mortgages with a carrying value of $109.65 million at December 31, 2006.

Total interest expense on FHLB advances for the years ended December 31, 2006, 2005 and 2004 was $4.69 million, $2.54 million, and $2.83 million, respectively.

11. CONVERTIBLE SUBORDINATED CAPITAL DEBENTURES:

TowneBank has three different convertible subordinated capital debentures, as described below. The first is the Series I Towne Investment Note, the second is the assumed obligation of the Harbor Bank Bonds, and the third is the Series II Towne Investment Note. At year-end 2006, all three debentures accrued and paid interest. Collectively, interest expense for the year ended December 31, 2006, was $2.27 million. Total convertible subordinated capital debentures at December 31, 2006 were $42.47 million and included a convertible debenture premium of $829,000 recorded as part of the Harbor Bank acquisition.

In early March 2002, TowneBank offered Series I Towne Investment Units ("Series I units") to existing shareholders and customers in a subscription offering. Each Series I unit consists of 84.97 shares of common stock priced at $11.77 per share and $1,000 in the aggregate, and one 15-year 6% convertible subordinated capital note in the principal amount of $1,000. Beginning in May 2004, the unit's note and equity began trading separately. The convertible subordinated notes are convertible into common stock at the discretion of the note holder at a conversion price of $14.38 per share (equal to a conversion rate of 69.54 shares per $1,000 principal amount of notes).

The Company sold 22,498 units, for aggregate proceeds of $45.0 million in the offering, and closed the offering during April 2002, which resulted in $22.5 million in convertible subordinated capital notes. At year-end 2006, the Company had $21.82 million in Series I convertible subordinated notes. The Company may redeem the notes in whole or in part after May 15, 2009, at the Company's option and with the approval of the FDIC, at 100% of the principal amount, together with accrued interest to the date of redemption.

During 2002, recently acquired Harbor Bank offered Harbor Investment Units ("Harbor units") in a subscription offering. Each Harbor unit originally consisted of 51.5 shares of common stock priced at $19.42 per share ($1,000 in the aggregate) and one 6% convertible subordinated bond (a "Harbor Bond") in the principal amount of $1,000 that matures November 30, 2017. Harbor Bank sold 4,250 Harbor units, for an aggregate amount of approximately $8.5 million, and closed the offering in November 2002.

At the close of business March 19, 2004, TowneBank assumed the obligations of Harbor Bank under the outstanding Harbor Bonds. Considering the three-for-two stock split distributed on June 17, 2004 and the 3% stock dividend distributed on September 16, 2005, TowneBank common stock will be issued upon conversion of the bonds at a conversion price of $8.51 per $1,000 principal amount of bonds (equal to a conversion rate of 117.51 shares per $1,000 principal of bonds). At year-end 2006, the Company had $3.58 million in Harbor Bonds.

The Harbor Bonds may be redeemed in whole or in part after November 30, 2009, at the Company's option and with the approval of the FDIC, at 100% of the principal amount, together with accrued interest to the date of redemption.

During August 2004, TowneBank raised $48.95 million through the sale of Series II Towne Investment Units (“Series II units”) to existing shareholders and customers in a subscription offering. Each Series II unit consisted of 82.4 shares of common stock priced at $24.27 per share and $2,000 in the aggregate, and one 15-year, 6.25% convertible subordinated capital note in the principal amount of $1,000.

The note is convertible into common stock at a conversion price of $29.42 per share (equal to a conversion rate of 33.99 shares per $1,000 principal amount of notes). The Company sold 16,316 units and closed the offering in August 2004, resulting in $16.32 million in Series II convertible subordinated notes. The common stock and notes were issued separately in early October 2004. The note began accruing interest on October 1, 2004, and the first interest payment was made on May 15, 2005. At year-end 2006, the Company had $16.24 million in Series II convertible subordinated notes. The Company may redeem the notes in whole or in part after November 15, 2009, at the Company’s option and with the approval of the FDIC, at 100% of the principal amount, together with accrued interest to the date of redemption.

12. SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE AND OTHER BORROWINGS:

Repurchase agreements and other borrowings totaled $34.67 million at December 31, 2006. The total is comprised of $7.17 million in securities sold under agreements to repurchase and $27.50 million in federal funds purchased. Repurchase agreements are classified as secured borrowings and generally mature within one business day from the transaction date. They are reflected at the amount of cash received in connection with the transaction. Federal funds purchased are overnight, unsecured borrowings. The Company did not utilize such borrowings before 2006. Information concerning securities sold under agreements to repurchase and federal funds purchased is summarized as follows (dollars in thousands):

	2006	2005	2004
Balance outstanding at end of year	$ 34,674	$ 10,517	$ 10,021
Average balance outstanding	18,462	10,294	8,761
Maximum outstanding at any month-end	34,674	13,290	13,291
Average interest rate during the year	5.07%	2.94%	1.00%
Average interest rate at end of year	5.42%	3.84%	1.85%

13. EMPLOYEE 401(K) PLAN:

TowneBank has a defined contribution 401(k) plan. All employees who are 18 years of age and have completed one quarter of service are eligible to participate. Employees employed on the plan’s effective date of July 1, 1999 did not have to satisfy age and service requirements. Under the plan, employees may contribute a percentage of their annual salary, subject to statutory limitations, and the Company will contribute 100% of the employees’ contributions up to 6%.

Employees employed on the plan's effective date are 100% vested, employees entering the plan subsequent to this date vest 33%, 66% and 100% after the first, second or third year of service, respectively. The Company may also make an additional discretionary contribution.

Company contributions will not exceed the maximum amount deductible annually for income tax purposes. The Company made no discretionary contributions for the years ended December 31, 2006, 2005 and 2004. The Company made matching contributions of $2.207 million, $1.92 million and $1.53 million for the years ended December 31, 2006, 2005 and 2004, respectively. The Company's matching contribution is in the form of the Company's stock.

14. STOCK COMPENSATION PLAN:

In 1999, the Company adopted a stock option plan that authorizes the reservation of up to 1,480,000 shares of common stock and provides for granting of incentive and non-statutory options and restricted stock awards. In 2002, the plan was amended, increasing the number of shares available under the plan to 2,000,000. In 2004, the plan was amended again; increasing the number of shares reserved for issuance to 2,900,000 and allowing for an additional annual increase in the number of shares, effective as of January 1, 2005 and each January 1 of the four successive years thereafter. As a result, the maximum number of shares reserved under the plan as of such date(s) is equal to 20% of the fully diluted number of shares of the Company's common stock outstanding as of such date(s) or such lesser number of shares as the Compensation Committee of the Board of Directors (the "Compensation Committee") shall define.

On February 23, 2005, the Compensation Committee increased the shares available under the plan to 4,982,652 shares of Company stock. On January 25, 2006, the Compensation Committee increased the shares available under the plan to 5,130,257 shares of Company stock. On January 31, 2007, the Compensation Committee increased the shares available under the plan to 5,249,986 shares of Company stock. The Company has a policy of issuing new shares to satisfy share option exercises and restricted stock award vestings.

Stock options: For stock options granted under the plan, the stock option price cannot be less than the fair market value of the stock on the date granted. The Compensation Committee determines the exercise price for certain awards, and it can be based on future service. An option's maximum term is ten years from the date of grant. Options and awards granted under the plan are subject to vesting requirements ranging from two to ten years. The following two tables summarize the Company's stock option activity and related information.

	2006		2005		2004	
	Number	Weighted-Average Exercise Price	Number	Weighted-Average Exercise Price	Number	Weighted-Average Exercise Price
Options outstanding, beginning balance	1,885,359	$8.29	1,932,255	$6.58	1,609,755	$5.53
Granted	72,472	21.01	171,135	21.46	184,627	8.41
Options (at fair value) assumed in merger transaction	-	-	-	-	369,937	3.24
Exercised	(466,170)	3.45	(218,031)	3.50	(232,064)	3.69
Forfeited	(97,035)	10.15	-	-	-	-
Options outstanding, ending balance	1,394,626	$10.44	1,885,359	$8.29	1,932,255	$6.58
Options exercisable at December 31,	877,311	$6.33	1,281,908	$4.47	1,408,020	$3.76

	Number	Weighted-Average Exercise Price
Unvested stock options, December 31, 2005	562,919	$16.60
Granted	72,472	21.01
Vested	(100,931)	16.30
Forfeited	(16,355)	11.65
Unvested stock options, December 31, 2006	518,105	$17.43

For the years ended December 31, 2006, 2005, and 2004, the weighted average grant date fair value of stock options granted was $9.13, $9.07, and $9.50, respectively. For the same periods, the total intrinsic value of options exercised was $7.75 million, $1.65 million, and $3.96 million, respectively. Additional information pertaining to options outstanding at December 31, 2006 follows:

	Number	Weighted - Average Exercise Price	Aggregate Intrinsic Value	Weighted - Average Remaining Contractual Life
Options outstanding	1,394,626	$ 10.44	$ 13,243,907	4.83 years
Options exercisable	877,311	$ 6.33	$ 11,744,910	3.37 years

In December 2004, the FASB issued SFAS No. 123(R), which replaced SFAS 123 and superseded APB 25. SFAS 123(R) eliminated the use of the intrinsic value method of accounting and required the recognition of costs related to stock-based compensation in the financial statements over the award's vesting period. The Company adopted the statement's requirements using the modified prospective method, which required companies to expense employee stock-based compensation using the fair value recognition provisions of SFAS 123 for all employee awards granted, modified, or settled after the statement's effective date, January 1, 2003. At December 31, 2006, the Company included costs totaling $740,000 in net income compared to $355,000 for 2005 and $148,000 for 2004.

Under the fair value method, stock-based employee compensation expense is measured on the date of grant using an option pricing model with market assumptions. The Company uses the Black-Scholes option-pricing method with the following weighted-average assumptions. The weighted-average risk-free interest rate assumption is based on interest rates ranging from 2.81% to 5.04%.

Years ended December 31,	2006	2005
Dividend yield	0.60%	0.60%
Expected life	8.62 years	10 years
Expected volatility	38%	38%
Risk-free interest rate	4.07%	4.50%

Such option valuation models require the input of highly subjective assumptions. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

Cash received from exercises of stock options for the year ended December 31, 2006 was $1.47 million. The actual tax benefit realized for the tax deductions from stock option exercises for the year ended December 31, 2006 was $3.63 million compared to $2.65 million for 2005, and $1.24 million for 2004.

Restricted stock awards (RSAs): Under the plan, grantees of restricted stock awards have full voting rights on the shares and are entitled to receive cash or stock dividends. RSAs granted under the plan are subject to vesting requirements ranging from three to ten years. The shares are subject to forfeiture if vesting and other contractual provision requirements are not met.

Following is a summary of the Company's restricted stock award activity and related information for the year ended December 31, 2006. The weighted-average price is the weighted-average fair value at the date of grant.

	Number	Weighted-Average Price
Unvested RSAs, beginning balance	282,657	$ 12.04
Granted	12,708	21.64
Vested	(66,379)	11.75
Unvested RSAs, ending balance	228,986	$ 12.65

Compensation expense related to the awards for the years ended December 31, 2006, 2005, and 2004 were $762,000, $690,000, and $416,000, respectively. The total fair value of awards vested during 2006, 2005, and 2004 was $780,000, $466,000, and $152,000, respectively. As of December 31, 2006, there was $2.33 million of total unrecognized compensation cost related to unvested restricted stock awards; that cost is expected to be recognized over a period of 3.76 years.

All share data has been retroactively restated to reflect the two-for-one stock split approved by the Company's Board of Directors on January 30, 2002, the three-for-two stock split approved by the Board of Directors on April 29, 2004, and the 3% stock dividend approved by the Board of Directors on July 27, 2005.

Yearly summaries
During 2004, the Company issued 39,165 common shares at an average price of approximately $19.79 per share as its matching 401(k) plan contribution, and 10,338 shares for its directors' compensation plan at an average price of $19.97 per share. A total of 232,064 common shares were issued as a result of the exercise of stock options granted to employees. Of the total exercised, 146,260 were related to the grant to employees in conjunction with its formation at $3.24 per share, and 34,505 shares were related to incentive stock options granted at a $3.08 exercise price, 324 shares were related to incentive stock options granted at a $3.39 exercise price. Further, 46,170 shares were related to incentive stock options granted at a $4.78 exercise price, and 4,803 shares were related to incentive stock options granted at $11.65 per share. During the year, a total of 2,431 shares were canceled in order to exercise stock options.

During 2005, the Company did not issue any common shares in connection with its matching 401(k) plan contribution and its directors' compensation plan. Instead, the Company went out into the market and acquired 57,219 shares at an average price of $22.28 per share and 22,747 shares at an average price of $21.78 per share for use in the respective plans. A total of 218,031 common shares were issued as a result of the exercise of stock options granted to employees. Of the total exercised, 84,043 were related to the grant to employees in conjunction with its formation at $3.24 per share, and 1,003 shares were related to incentive stock options granted at a $4.78 exercise price, 8,829 shares were related to incentive stock options granted at an $11.65 exercise price. Further, 124,002 shares were related to incentive stock options granted at a $3.08 exercise price, and 154 shares were related to incentive stock options granted at $3.39 per share. During the year, a total of 7,512 shares were canceled in order to exercise stock options.

During 2006, the Company did not issue any common shares in connection with its matching 401(k) plan contribution and its directors' compensation plan. Instead, the Company went out into the market and acquired 96,335 shares at an average price of $21.02 per share and 38,414 shares at an average price of $20.37 per share for use in the respective plans. A total of 466,170 common shares were issued as a result of the exercise of stock options granted to employees. Of the total exercised, 287,395 were related to the grant to employees in conjunction with its formation at $3.24 per share, and 1,300 shares were related to incentive stock options granted at a $4.78 exercise price, 12,392 shares were related to incentive stock options granted at an $11.65 exercise price. Further, 163,925 shares were related to incentive stock options granted at a $3.08 exercise price, and 1,158 shares were related to incentive stock options granted at $18.77 per share. During the year, a total of 20,301 shares were canceled in order to exercise stock options.

All share data has been retroactively restated to reflect both stock splits and the 3% stock dividend.

15. EMPLOYMENT AGREEMENTS:

The Company has employment agreements with key management officers. These agreements set forth terms of employment, including salary and other benefits, in addition to severance, non-compete, non-solicitation and change of control provisions, and automatically renew for additional periods unless either the Company or officer gives written notice to terminate prior to the expiration of the initial term.

16. OTHER EXPENSES:

Following is a summary of other expenses (dollars in thousands):

Years ended December 31,	2006	2005	2004
Advertising and marketing	$ 3,316	$ 3,310	$ 1,439
Telephone and postage	1,777	1,758	1,104
Stationery and office supplies	1,712	1,420	1,010
Outside processing	1,601	1,395	1,117
Professional fees	1,421	1,443	948
Directors' expense	1,326	712	701
Charitable contributions	1,289	564	380
Amortization expense of intangibles and origination costs	1,169	1,169	375
Other	1,166	1,533	527
Software expense	1,057	932	651
Bank franchise tax/SCC fees	963	920	535
Travel/meals/entertainment	963	696	504
FDIC and other insurance	623	535	496
	$ 18,383	$ 16,387	$ 9,787

17. STOCK PURCHASE PLAN, DIVIDEND REINVESTMENT PLAN AND DIVIDEND RESTRICTIONS:

On March 26, 2003, the Board of Directors approved and adopted the TowneBank Member Stock Purchase and Dividend Reinvestment Plan. The plan is designed to raise additional capital for the Company by providing a convenient and cost-effective way for shareholders, customers and employees of the Company to purchase shares of TowneBank stock.

In connection with the plan, the Board of Directors authorized the Company to reserve and offer for sale up to 3,000,000 shares of common stock from authorized and unissued common stock. For the year ended December 31, 2006, the Company did not issue any shares in connection with the monthly stock purchase plan. Instead the Company went out into the open market and acquired 231,006 shares at an average price of $21.01 per share. For the year ended December 31, 2006, the Company issued 30,614 shares and also went out into the open market and acquired 116,111 shares at an average price of $21.92 per share for use in the dividend reinvestment plan.

The Company, as a Virginia banking corporation, may pay cash dividends only out of retained earnings. Regulatory authorities may limit payments of cash dividends by any bank with retained earnings, when it is determined that such a limitation is in the public interest and is necessary to ensure financial soundness of the bank.

On March 26, 2003, the Board approved a special cash dividend in the amount $0.032 per common share, restated for the 2005 3% stock dividend, for shareholders of record on April 25, 2003, representing 9.23% of 2002 net income. This dividend represents the first cash dividend for the Company since opening on April 8, 1999. The dividend was paid on May 8, 2003 in the amount of $508,000.

On January 28, 2004, the Company declared a special annual cash dividend of $0.065 per common share, restated for the 2005 3% stock dividend, payable on March 15, 2004 to shareholders of record on February 27, 2004. The dividend, representing 15.77% of 2003 net income was paid on March 15, 2004 in the amount of $1.044 million.

On January 26, 2005, the Company declared a special shareholder cash dividend of $0.126 per common share payable on March 14, 2005 to shareholders of record on February 25, 2005. The dividend is the third for the Company since opening in April 1999 and represents 25.63%, or $2.891 million, of the Company's 2004 earnings.

On January 25, 2006, the Company declared a special shareholder cash dividend bonus of $0.23 per common share, payable on March 10, 2006 to shareholders of record on February 24, 2006. The dividend represents 30% of 2005 net income.

On November 22, 2006, the Company declared a special shareholder cash dividend bonus of $0.30 per common share payable on January 16, 2007 to shareholders of record on December 20, 2006. The total dividend paid was $7.13 million.

Declaration of future annual cash dividends will depend on the earnings of the Company, its capital position and other factors.

18. REGULATORY CAPITAL REQUIREMENTS:

The Company is subject to various regulatory capital requirements. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices.

The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by the regulation to ensure capital adequacy require the Company 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 December 31, 2006, that the Company meets all capital adequacy requirements to which it is subject. As of December 31, 2006, $42.47 million of subordinated convertible debt is included within total risk-based capital.

As of December 31, 2006, the most recent notification from the Federal Deposit Insurance Corporation categorized the Company as "well-capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well-capitalized," the Company must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios, as set forth in the table below. There are no conditions or events since that notification that management believes have changed the Company's category. A summary of the Company's required and actual capital components follows (dollars in thousands):

As of December 31, 2006:	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Action Provisions	
	Amount	Ratio %	Amount	Ratio %	Amount	Ratio %
Total risk-based capital (to risk-weighted assets)	$ 234,152	12.46%	$ 150,360	8.00%	$ 187,950	10.00%
Tier 1 capital (to risk-weighted assets)	$ 172,013	9.15%	$ 75,180	4.00%	$ 112,770	6.00%
Tier 1 leverage ratios (to average assets)	$ 172,013	8.29%	$ 82,963	4.00%	$ 103,704	5.00%

As of December 31, 2005:	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Action Provisions	
	Amount	Ratio %	Amount	Ratio %	Amount	Ratio %
Total risk-based capital (to risk-weighted assets)	$ 218,627	14.52%	$ 120,434	8.00%	$ 150,542	10.00%
Tier 1 capital (to risk-weighted assets)	$ 158,461	10.53%	$ 60,217	4.00%	$ 90,325	6.00%
Tier 1 leverage ratios (to average assets)	$ 158,461	9.14%	$ 69,334	4.00%	$ 86,667	5.00%

19. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS:

Statement of Financial Accounting Standard No. 107, *Disclosures About Fair Value of Financial Instruments* ("SFAS 107"), requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows.

The derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. SFAS 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The following methods and assumptions were used by the Company in estimating fair value for its financial instruments, as defined by SFAS 107:

Cash and due from banks, interest bearing deposits in financial institutions, and federal funds sold: The carrying amount approximates fair value.

Securities available-for-sale: Fair values are based on published market prices or dealer quotes. The carrying amount of the FHLB stock approximates fair value. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Securities held-to-maturity: Fair values are based on published market prices or dealer quotes.

Loans held for sale: Fair values of loans held for sale are based on commitments on hand from investors or, if commitments have not yet been obtained, prevailing market rates.

Loans: For credit card and other loan receivables with short-term and/or variable characteristics, the total receivable outstanding approximates fair value. The fair value of other loans is estimated by discounting the future cash flows using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

Interest receivable and interest payable: The carrying amount approximates fair value.

Deposits: The fair value of noninterest bearing deposits and deposits with no defined maturity is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounting the future cash flows using the current rates at which similar deposits would be made.

Advances from the Federal Home Loan Bank of Atlanta: The fair value of advances from the FHLB is determined using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar products.

Convertible subordinated capital debentures: The fair values of the convertible subordinated capital debentures are estimated using discounted contractual cash flows based on the Company's incremental rate of borrowing that would be currently available for similar types of borrowing arrangements.

Repurchase agreements: For these short-term instruments, the carrying amount approximates fair value.

Federal funds purchased: For these short-term instruments, the carrying amount approximates fair value.

Commitments to extend and standby letters of credit: It is not practical to separately estimate the fair values for off-balance-sheet credit commitments, including standby letters of credit and guarantees written, due to the lack of cost-effective and reliable measurement methods for these instruments.

Derivative financial instruments: Fair values for on-balance sheet commitments to originate loans held for sale are based on fees currently charged to enter into similar agreements and, for fixed-rate commitments, also consider the difference between current levels of interest rates and the committed rates.

The estimated fair values of the Company's financial instruments required to be disclosed under SFAS 107 (dollars in thousands) are as follows:

December 31,	2006		2005	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Cash and due from banks	$ 45,448	$ 45,448	$ 46,099	$ 46,099
Interest bearing deposits in financial institutions	5,324	5,324	8,564	8,564
Federal funds sold	829	829	14,895	14,895
Securities available-for-sale	255,674	255,674	273,423	273,423
Securities held-to-maturity	89,536	90,043	36,184	36,584
Mortgage loans held for sale	16,717	16,717	27,773	27,773
Loans, net	1,622,156	1,623,535	1,247,421	1,252,817
Interest receivable	10,581	10,581	8,669	8,669
Deposits	1,704,699	1,702,236	1,467,725	1,470,423
Advances from the Federal Home Loan Bank of Atlanta	142,363	141,103	41,751	39,768
Convertible subordinated capital debentures	42,469	36,716	43,095	40,800
Repurchase agreements and other borrowings	34,674	34,674	10,517	10,517
Interest payable	5,329	5,329	3,187	3,187

20. LEGAL CONTINGENCIES:

Various legal claims can arise from time to time in the normal course of the Company's business. There were no significant asserted claims or assessments at December 31, 2006. Management was not aware of any unasserted claims or assessments that may be probable of assertion at December 31, 2006.

21. BORROWING ARRANGEMENTS:

The Company is a member of the Federal Home Loan Bank of Atlanta and may borrow funds based on criteria established by the FHLB. The FHLB may call these borrowings if the adjusted collateral balance falls below the borrowing level. At December 31, 2006, the Company could borrow an additional $516.01 million, if collateral acceptable to the FHLB was provided. The balance at December 31, 2006, was $142.36 million. The borrowing arrangements available from the FHLB could be either short or long-term depending on its related cost and needs of the Company.

In addition, federal funds lines with other financial institutions were available at December 31, 2006 for short-term funding needs. Further, the Company had loan participation lines and reverse repurchase agreements with various financial institutions available at December 31, 2006, which provide potential additional funding.

22. QUARTERLY FINANCIAL DATA (UNAUDITED):

Summarized unaudited quarterly financial data for the years ended December 31, 2006 and 2005, is as follows (dollars in thousands, except per share data):

2006:	Fourth	Third	Second	First
Interest income	$ 35,799	$ 33,333	$ 29,970	$ 27,238
Interest expense	14,737	13,604	11,322	9,635
Provision for loan losses	754	831	487	500
Noninterest income	7,103	8,911	9,488	8,319
Noninterest expense	19,049	19,354	19,142	18,498
Income before income tax expense	8,362	8,455	8,507	6,924
Income tax expense	2,127	2,937	2,960	2,438
Net income	$ 6,235	$ 5,518	$ 5,547	$ 4,486
Net income per common share				
Basic	$ 0.26	$ 0.24	$ 0.24	$ 0.19
Diluted	$ 0.25	$ 0.22	$ 0.22	$ 0.18
Comprehensive income	$ 8,579	$ 7,017	$ 5,044	$ 4,443

2005:	Fourth	Third	Second	First
Interest income	$ 26,070	$ 23,514	$ 20,859	$ 19,035
Interest expense	8,592	7,478	5,830	5,135
Provision for loan losses	537	831	496	500
Noninterest income	8,623	9,217	8,740	7,510
Noninterest expense	18,015	17,771	16,566	14,596
Income before income tax expense	7,549	6,651	6,707	6,314
Income tax expense	2,584	2,425	2,384	2,147
Net income	$ 4,965	$ 4,226	$ 4,323	$ 4,167
Net income per common share				
Basic	$ 0.22	$ 0.19	$ 0.19	$ 0.19
Diluted	$ 0.20	$ 0.18	$ 0.17	$ 0.17
Comprehensive income	$ 4,041	$ 3,836	$ 5,260	$ 3,069

23. SEGMENT REPORTING:

TowneBank has three reportable segments: a traditional full service community bank, a full service realty business, and a full service insurance agency. During the first quarter of 2005, the Company modified the composition of its reportable segments to include GSH. In prior periods, the Company had a mortgage reportable segment, which was restructured, and is now the realty segment as discussed further below. Prior period amounts in this report have been restated to conform.

The community bank segment provides loan and deposit services to retail and commercial customers throughout Greater Hampton Roads, Virginia and includes the operations of TowneBank Commercial Mortgage and Towne Investment Group.

The realty segment combines the operations of GSH with TowneBank Mortgage and LET to provide residential real estate services, originations of a variety of mortgage loans, and commercial and residential title insurance. Mortgage loans are originated and sold principally in the secondary market through purchase commitments from investors that subject the Company to only *de minimis* market risk. The insurance segment provides full service commercial and retail insurance and employee benefit services through Towne Insurance and Benefit Design Group.

The realty segment experiences fluctuations in revenue due to the variability of demand in the local housing market; revenues tend to demonstrate a seasonal variability. The Company began providing real estate brokerage services in 2005 through its acquisition of GSH. In addition to increasing the overall profitability, the realty operations help offset reduced net interest margins in periods of falling interest rates when demand increases for new mortgage loans and refinancings. In periods of rising rates, consumer demand for new mortgages and refinancings decrease, which in turn may adversely affect the results of the realty division. Because interest rates depend on factors outside management's control, management cannot eliminate the interest rate risk associated with the realty operations.

The Company began providing insurance services in 2001 through the acquisition of several agencies and acquired West & Johnson in July 2004 and Brooks in January 2006. The future performance of this segment will depend upon the successful integration of the agencies with each other and the Company, integration of the respective customer bases and further development of products and services offered.

The Company's reportable segments are service based. The bank segment offers a distribution and referral network for the realty and insurance services, and the realty and insurance divisions offer a similar network for the bank segment due largely to overlapping geographic markets. A major distinction is the source of income. The realty and insurance businesses are fee-based businesses, while the bank segment is driven principally by net interest income. Segment profit and loss is measured by net income after income tax. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. Intersegment transactions are recorded at cost and eliminated as part of the consolidation process. Because of the interrelationships of the various segments, the information presented is not indicative of how the segments would perform if they operated as independent entities.

Information about reportable segments and reconciliation of such information to the consolidated financial statements as of and for the years ended December 31, 2006 and 2005 follows (dollars in thousands).

Year ended December 31, 2006	Bank	Realty	Insurance	Intersegment Elimination	Consolidated Totals
Net interest income (expense)	$ 77,110	$ 602	$ -	$ (670)	$ 77,042
Provision for loan losses	2,572	-	-	-	2,572
Net interest income (expense) after provision for loan losses	74,538	602	-	(670)	74,470
Residential mortgage brokerage income, net	351	8,846	-	(351)	8,846
Real estate brokerage and property management income, net	-	6,665	-	(332)	6,333
Insurance commissions and other title fees and income, net	-	3,517	6,265	-	9,782
Other noninterest income	8,285	469	106	-	8,860
Noninterest expense	52,349	17,925	5,769	-	76,043
Income before income tax	30,825	2,174	602	(1,353)	32,248
Income tax expense (benefit)	9,636	821	245	(240)	10,462
Net income	$ 21,189	$ 1,353	$ 357	$ (1,113)	$ 21,786
Net income as percentage of total	97.26%	6.21%	1.64%	(5.11%)	100.00%
Assets	$ 2,205,921	$ 41,171	$ 18,656	$ (71,163)	$ 2,194,585
Efficiency ratio	59.84%	89.18%	90.55%	-	67.53%

Year ended December 31, 2005	Bank	Realty	Insurance	Intersegment Elimination	Consolidated Totals
Net interest income (expense)	$ 62,227	$ 835	$ -	$ (619)	$ 62,443
Provision for loan losses	2,364	-	-	-	2,364
Net interest income (expense) after provision for loan losses	59,863	835	-	(619)	60,079
Residential mortgage brokerage income, net	442	8,808	-	(442)	8,808
Real estate brokerage and property management income, net	-	7,880	-	(387)	7,493
Insurance commissions and other title fees and income, net	-	3,756	4,702	-	8,458
Other noninterest income	8,410	620	301	-	9,331
Noninterest expense	45,218	17,320	4,410	-	66,948
Income before income tax	23,497	4,579	593	(1,448)	27,221
Income tax expense (benefit)	7,976	1,704	152	(291)	9,541
Net income	$ 15,521	$ 2,875	$ 441	$ (1,157)	$ 17,680
Net income as percentage of total	87.79%	16.26%	2.49%	(6.54%)	100%
Assets	$ 1,802,099	$ 51,240	$ 6,804	$ (56,961)	$ 1,803,182
Efficiency ratio	63.63%	79.09%	88.15%	-	69.36%

24. COMMISSION EXPENSES:

Income from residential mortgage brokerage income, real estate brokerage and property management, and insurance commissions and other title fees and income are presented on the Company's consolidated income statement net of commission expenses.

The Company presents residential mortgage brokerage income net of commission expense. For the year ended December 31, 2006, commission expense totaled $7.26 million, compared to $9.49 million in 2005, and $7.35 million in 2004.

Real estate brokerage and property management income is also presented net of commission expense. Commission expense was $12.01 million for the year ended December 31, 2006, compared to $13.65 million for 2005. The Company did not offer real estate brokerage and property management services before 2005; therefore no income or expense is reported in prior periods.

Also presented net of commission expense are insurance commission and other title fees and income. For the year ended December 31, 2006, commission expense totaled $1.34 million, compared to $804,000 in 2005, and $719,000 in 2004.

25. EARNINGS PER SHARE:

The following summarizes information related to the computation of basic and diluted earnings per share for the years ended December 31, 2006, 2005 and 2004 (dollars in thousands, except per share data):

	2006	2005	2004
Basic			
Net income available to shareholders, as reported	$ 21,786	$ 17,680	$ 11,280
Average common shares outstanding	23,356,687	22,231,652	20,003,763
Basic earnings per share amount	$ 0.93	$ 0.79	$ 0.56
Diluted			
Net income available to shareholders, as reported	$ 21,786	$ 17,680	$ 11,280
Add: interest applicable to 6% subordinated debt, net of tax (1)	990	1,002	1,043
Net income available to shareholders, for diluted EPS	22,776	18,682	12,323
Average common shares outstanding	23,356,687	22,231,652	20,003,763
Add EPS impact of:			
stock compensation plans, net of tax benefit	1,147,196	948,459	1,080,391
6% convertible subordinated debentures (2)	1,938,188	1,959,196	2,063,208
Average diluted shares outstanding	26,442,071	25,139,307	23,147,362
Diluted earnings per share amount	$ 0.86	$ 0.74	$ 0.53

(1) Annualized interest on both 6% convertible subordinated capital debentures (net of tax) was added to net income as this interest would not be paid if the debentures were converted to common stock.

(2) Shares assumed to have been converted since the beginning of the period.

In addition, the Series II convertible subordinated capital notes entitle the holders to convert their notes into 551,930 shares of common stock. These shares were not included in the computation of diluted earnings per share, as the effect would have been anti-dilutive.

26. OTHER RELATED PARTY TRANSACTIONS:

Loans are made to the Company's executive officers and directors and their associates during the ordinary course of business. The aggregate amount of loans to such related parties totaled $67.28 million, $50.06 million and $50.39 million as of December 31, 2006, 2005 and 2004, respectively. During 2006, new advances on all commitments to such parties totaled $18.39 million and repayments amounted to $12.98 million. In addition at December 31, 2006, the Company had $19.67 million in unfunded commitments to extend credit to such related parties.

The Company rents space for various financial centers from affiliated companies. Rent expense related to these leases was $1.32 million, $1.01 million, and $500,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

In October 2000, in connection with the acquisition of HRFC, TowneBank entered into consulting and non-competition agreements with four individuals, two of which are directors of the Company. The agreements continued through December 31, 2006. Total amounts expensed under this arrangement with directors were $1.48 million, $2.14 million and $1.72 million for the years ended December 31, 2006, 2005 and 2004, respectively.

In the ordinary course of business TowneBank acquired certain goods and services from companies associated with Company directors. Amounts paid to these companies during the years ended December 31, 2006, 2005 and 2004 approximated $1.46 million, $4.28 million, and $659,000, respectively. The increase from 2004 to 2005 is largely attributable to payments made to W.M. Jordan Company, Inc. ("WM Jordan") in connection with the construction of the Williamsburg branch office in Williamsburg, Virginia. The President and Chief Executive Officer of W.M. Jordan is a director of the Company. Payments made to W.M. Jordan for the construction of the building totaled $3.10 million for the year ended December 31, 2005.

27. MERGERS AND ACQUISITIONS:

Brooks Agency, Inc.: On January 9, 2006, TowneBank announced the addition of the Brooks Agency, Inc., as a division of Towne Insurance. The merger was accounted for under the purchase method of accounting, and accordingly, the results of operations for Brooks have been included in the consolidated financial statements since that date. The Brooks Agency is an independent insurance agency operating in Williamsburg, Virginia and serving customers throughout Hampton Roads. Through this acquisition, the Company adds to its existing insurance and bond services.

The aggregate purchase price of $2.350 million was adjusted from $2.5 million during the third quarter of 2006 and consisted of common stock. In accordance with the merger agreement, Brooks shareholders received 115,951 TowneBank common shares. The shares were valued at $20.27 per share, determined by an average market price of TowneBank's common shares. Including other capitalized merger costs and $189,000 in net assets acquired, the Company recorded $1.544 million in goodwill and $678,000 in intangible assets.

GSH Residential Real Estate Corporation: On January 7, 2005, TowneBank finalized the acquisition of GSH Residential Real Estate Corporation and acquired 100% of the voting equity interests. The results of GSH's operations have been included in the consolidated financial statements since that date. GSH retained its trade name and continues to carry on its business in substantially the same manner as before the transaction as a wholly owned subsidiary of TowneBank.

GSH has locations in Virginia, specifically Chesapeake, Hampton, Newport News, Norfolk, Smithfield, Virginia Beach, and Williamsburg. It also has one location in Kitty Hawk, North Carolina. Its main office is based in Virginia Beach. Through this acquisition, TowneBank added complete residential real estate services to its product line, which includes real estate sales, relocation, property management, mortgage, title, and related settlement services.

The aggregate purchase price was $7.99 million, which consisted of common stock valued at $7.88 million and direct acquisition costs of $111,000. In accordance with the acquisition agreement, GSH shareholders received 367,380 TowneBank common shares, as adjusted for the 3% stock dividend.

The shares were valued at $21.44 per share, determined by an average market price of TowneBank's common shares. Based on the aggregate purchase price and net assets acquired of $2.012 million, the Company recorded $3.883 million in goodwill, $2.33 million in intangible assets, and $487,000 in deferred income taxes. The Company also assumed $728,000 in liabilities.

The following condensed balance sheet of GSH discloses the amounts assigned to each major asset and liability caption at the acquisition date:

(Dollars in thousands)	January 7, 2005
ASSETS	
Cash and cash equivalents	$ 3,880
Premises and equipment, net	542
Goodwill	3,883
Identifiable intangible assets	2,333
Other assets	1,546
Total assets acquired	12,184
LIABILITIES	
Total deposits	1,666
Total borrowed funds	98
Other liabilities	2,433
Total liabilities assumed	4,197
Net assets acquired	$ 7,987

The following table presents unaudited pro forma results of operations for the year ended December 31, 2005 and 2004 as though TowneBank and GSH had combined at the beginning of the respective periods. The pro forma financial information does not necessarily reflect the results of operations that would have occurred had the Company and GSH existed as a single entity during both periods.

(Dollars in thousands, except per share data)	Year ended December 31,	
	2005	2004
Net interest income	$ 62,443	$ 44,443
Net income	$ 17,680	$ 12,067
Basic earnings per share	$ 0.79	$ 0.59

28. NON-GAAP RECONCILIATIONS:

The Company presents return on average assets, return on average tangible assets, return on average equity, and return on average tangible equity. Management excludes the balance of goodwill and other intangible assets from its calculation of return on average tangible assets and return on average tangible equity. This adjustment allows management to review the core operating result and core capital position of the Company. This is consistent with the treatment by bank regulatory agencies, which exclude goodwill and intangibles from their calculation of risk-based capital ratios.

Years ended December 31,	**2006**	**2005**
Return on average assets (GAAP basis)	1.10%	1.09%
Impact of excluding average goodwill and other intangibles and amortization	0.03%	0.03%
Return on average tangible assets	1.13%	1.12%
Return on average equity (GAAP basis)	9.86%	8.72%
Impact of excluding average goodwill and other intangibles and amortization	3.47%	3.30%
Return on average tangible equity	13.33%	12.02%

The Company presents book value (period ended shareholders' equity divided by the period ended common shares outstanding) and tangible book value. In calculating tangible book value, the Company excludes goodwill and other intangible assets allowing management to review the core capital position of the Company. This adjustment allows management to review the core capital position of the Company.

	Per share	
Years ended December 31,	**2006**	**2005**
Book value (GAAP basis)	$ 9.75	$ 9.21
Impact of excluding average goodwill and other intangibles and amortization	(2.42)	(2.43)
Tangible book value	$ 7.33	$ 6.78

When computing the efficiency ratio (noninterest expense divided by the sum of net interest income and noninterest income, excluding securities gains or losses), management excludes the gains and losses on securities because of the uncertainty of the amount of gain or loss recognized.

Years ended December 31,	**2006**	**2005**
Efficiency ratio (GAAP basis)	68.59%	69.35%
Impact of excluding securities gains/(losses)	(1.06%)	0.01%
Efficiency ratio, as reported	67.53%	69.36%

29. SUBSEQUENT EVENTS:

On January 1, 2007, Towne Insurance closed on the acquisition of The Frieden Agency, Inc., an employee benefit affiliate of The Frieden Agency which is southeastern Virginia’s leading provider of employee benefit and individual health insurance programs. The agreement was announced in December 2006. The Frieden Agency, Inc., a wholly owned subsidiary of Towne Insurance, will combine efforts with BDG to further their position in the industry of employee benefit services.

On February 28, 2007, the Company announced that its Board of Directors declared its first quarterly shareholder cash dividend of $0.08 per common share payable on April 16, 2007 to shareholders of record on April 2, 2007. Previously, the Bank paid annual special cash dividends.

FORWARD-LOOKING STATEMENTS

The following discussion contains certain forward-looking statements with respect to the plans, objectives, future performance and business of TowneBank (the "Company"). These forward-looking statements involve certain risks and uncertainties and are based on the beliefs and assumptions of the management of the Company. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include, among others, the following: (1) competitive pressures in the banking industry may increase significantly; (2) changes in the interest rate environment may reduce margins and/or the volumes and values of loans made or held as well as the value of other financial assets held; (3) general economic conditions, either nationally or regionally, may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and/or a reduced demand for credit or other services; (4) changes in the legislative or regulatory environment, including changes in accounting standards, may adversely affect the businesses in which the Company is engaged; (5) costs or difficulties related to the integration of the business of the Company and the businesses it has acquired may be greater than expected; (6) expected cost savings associated with pending or recently completed acquisitions may not be fully realized or realized within the expected time frame; (7) changes in business conditions; (8) changes in the securities market; or (9) changes in The Company's local economy with regards to the Company's market area and its heavy concentration of U.S. military bases and related personnel.

TowneBank does not undertake and specifically disclaims any obligation to publicly release the result of any revisions, which may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

OVERVIEW

The following discussion provides information about the major components of the results of operations and financial condition and the liquidity and capital resources for the Company. It is provided pursuant to the requirements of Guide 3, promulgated by the Securities and Exchange Commission. This discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements and Notes to Consolidated Financial Statements.

The Company was initially capitalized through a public offering of its common stock, at $3.24 per share, adjusted for the stock splits in 2002 and 2004 and the stock dividend in 2005. The initial offering, which took place in late 1998, resulted in an initial capitalization of $37.3 million, providing a strong capital base with which to begin operations. To support the fast-paced growth of the Company, additional capital was raised in March 2002 and August 2004 through the respective offerings of the Series I and Series II Investment Units. Refer to Note 12 of the Notes to Consolidated Financial Statements for more information on both offerings.

Net interest income, provision for loan losses, and noninterest income sources impact the Company's operating results. Noninterest income includes loan fees, deposits service charges, income generated by the Company's subsidiaries and divisions, and gains on securities available-for-sale. Other operating expenses such as salaries and employee benefits, occupancy expense, advertising and marketing expense, and taxes also impact operating results.

ANALYSIS OF RESULTS OF OPERATIONS

Results of Operations: The Company reported net income for the years ended December 31, 2006, 2005, and 2004 of $21.79 million, $17.68 million, and $11.28 million, respectively. Basic net income per share was $0.93, $0.79, and $0.56 for the years ended December 31, 2006, 2005, and 2004, respectively. Return on average assets was 1.10%, 1.09%, and 0.88% for the years ended December 31, 2006, 2005, and 2004, respectively, while return on average equity was 9.86%, 8.72%, and 7.73%. Tangible return on average assets was 1.13% for the year ended 2006, while it was 1.12% and 0.91% for 2005 and 2004, respectively.

We attribute the Company's performance to growth in the interest margin, which was positively impacted by continued growth in average earning assets coupled with steady increases in the Prime interest rate ("Prime") effected by the Federal Reserve. The January 7, 2005 GSH acquisition impacted noninterest expenses and such impact should be taken into account when reviewing the information presented in the following discussion and analysis.

The Company's operating margin, calculated by dividing income before taxes by operating revenue (net interest income plus noninterest income excluding securities gains/losses), has shown improvement over comparative periods. It was 28.64% for the year ended December 31, 2006 while it was 28.20% and 27.46% for 2005 and 2004, respectively.

Net Interest Income: Net interest income is a major component of the Company's earnings and is impacted by the market interest rates and the mix and volume of earning assets and interest bearing liabilities. The Company's management team strives to maximize net interest income through prudent balance sheet administration, maintaining appropriate risk levels as determined by the Company's Asset and Liability Committee ("ALCO") and the Board of Directors. The yields and rates in this discussion and in the following tables have been computed based upon interest income and expense adjusted to a fully taxable equivalent basis using a 35% federal marginal tax rate for all periods shown.

For 2006, the net interest income and margin were affected by the four interest rate increases brought about by the Federal Reserve Board in the first six months of 2006. The Federal Reserve Board raised short term interest rates 100 basis points in the first six months of 2006.

Net interest income was $77.42 million for the year ended December 31, 2006, displaying an increase of 23.64% over 2005. The primary factors contributing to our increase in net interest income were loan growth and the aforementioned rate increases. As of December 31, 2006, 53.19 % of our loan portfolio consisted of loans that are set to reprice monthly.

Net interest margin, defined as net interest income as a percentage of average earning assets, increased 4 basis points in 2006 over the year ended December 31 2005, from 4.30% to 4.34%. Net interest income was 44.44 million for the year ended December 31, 2004, while net interest margin was 3.86% for the same time period.

Total average earning assets for the year ended December 31, 2006 were $1.785 billion, which was an increase of $327.7 million over 2005. Loan growth represented 78% of that increase. The yield on earning assets increased 95 basis points to 7.10% in 2006 from 6.15% in 2005. For the same period ended 2005, total average earning assets increased $304.2 million over 2004, and the yield increased 81 basis points from 5.34% in 2004.

Total average interest bearing liabilities for the year ended 2006 were up $1.295 billion, over 2005, reflecting an increase of $276 million and an average cost of funds increase of 116 basis points. The increase in balances is attributable to the growth in the deposit base and in overnight borrowings. The average increase in the cost of funds is attributable to the market rates increase as well as the continuing change in mix of non-interest bearing deposits to interest bearing deposits, in addition to the increase in overnight borrowings to support the tremendous loan growth the Company has experienced in 2006.

The cost rate of average convertible subordinated capital debentures for 2006 increased 46 basis points, from 4.86% in 2005. This increase is due to the one-time adjustment in 2005 of the premium recorded in connection with the Harbor Bank acquisition. This adjustment occurred during the second quarter of 2005, as part of the review of goodwill and other intangibles, and reduced interest expense by $176,000. Excluding this adjustment, the average cost of the debentures would have been 5.27% for the year ended December 31, 2005.

For 2005, total average interest bearing liabilities increased $176.5 million over 2004, and the cost of average interest bearing liabilities increased 61 basis points in 2005 from 2.05% in 2004.

The purpose of volume and rate analysis is to describe the impact on interest income resulting from changes in average balances and average interest rates from those in effect during the previous year. The following tables include average balances, interest income and expense, average yields and costs and volume and rate analysis.

(Dollars in thousands)	Year ended December 31,								
	2006			2005			2004		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate (1)	Average Balance	Interest Income/ Expense	Average Yield/ Rate (1)	Average Balance	Interest Income/ Expense	Average Yield/ Rate (1)
Assets:									
Loans (net of unearned income and deferred costs), excluding nonaccrual loans	$ 1,438,927	$ 111,032	7.72%	$ 1,180,150	$ 79,369	6.73%	$ 954,535	$ 55,125	5.78%
Taxable investment securities	280,647	12,145	4.33%	192,636	6,536	3.39%	172,127	5,440	3.16%
Tax-exempt investment securities	40,097	1,958	4.88%	17,711	801	4.52%	-	-	-
Interest bearing deposits	7,397	368	4.97%	43,058	1,526	3.54%	5,066	65	1.28%
Mortgage loans held for sale	17,668	1,217	6.89%	23,495	1,421	6.05%	21,102	987	4.68%
Total earning assets	1,784,736	126,720	7.10%	1,457,050	89,653	6.15%	1,152,830	61,617	5.34%
Less: allowance for loan losses	(18,191)			(15,873)			(13,148)		
Total nonearning assets	214,858			188,248			142,237		
Total assets	$ 1,981,403			$ 1,629,425			$ 1,281,919		
Liabilities and Equity:									
Interest bearing deposits									
Demand and money market	$ 478,947	$ 12,680	2.65%	$ 438,356	$ 7,053	1.61%	$ 357,907	$ 2,775	0.78%
Savings	23,181	307	1.32%	24,967	198	0.79%	23,474	113	0.48%
Certificates of deposit	646,029	28,395	4.40%	453,495	14,891	3.28%	348,863	9,983	2.86%
Total interest bearing deposits	1,148,157	41,382	3.60%	916,818	22,142	2.42%	730,244	12,871	1.76%
Borrowings	100,757	5,642	5.60%	55,506	2,784	5.02%	76,691	2,774	3.62%
Convertible subordinated capital debentures	42,760	2,274	5.32%	43,395	2,110	4.86% (4)	32,258	1,529	4.74%
Total interest bearing liabilities	1,291,674	49,298	3.82%	1,015,719	27,036	2.66%	839,193	17,174	2.05%
Noninterest bearing liabilities									
Demand deposits	434,490			389,658			288,124		
Other noninterest bearing liabilities	34,307			21,237			8,604		
Total liabilities	1,760,471			1,426,614			1,135,921		
Shareholders' equity	220,932			202,811			145,998		
Total liabilities and equity	$ 1,981,403			$ 1,629,425			$ 1,281,919		
Net interest income (tax-equivalent basis)		$ 77,422			$ 62,617			$ 44,443	
Tax-equivalent basis adjustment		(380)			(174)			-	
Net interest income		$ 77,042			$ 62,443			$ 44,443	
Interest rate spread (2)			3.28%			3.49%			3.29%
Interest expense as a percent of average earning assets			2.76%			1.86%			1.49%
Net interest margin (tax-equivalent basis) (3)			4.34%			4.30%			3.86%
Total cost of deposits			2.61%			1.69%			1.26%

(1) Yields and interest income are presented on a taxable-equivalent basis using the federal statutory tax rate of 35 percent.
(2) Interest rate spread is the average yield earned on earning assets less the average rate paid on interest bearing liabilities.
(3) Net interest margin is net interest income expressed as a percentage of average earning assets.
(4) Excluding the one-time adjustment to the debenture premium of $176,000, the average cost of these debentures would be 5.27%.

(Dollars in thousands)	2006 vs 2005 Increase (Decrease) Due to Changes In			2005 vs 2004 Increase (Decrease) Due to Changes In		
	Volume	Rate (1)	Total	Volume	Rate (1)	Total
Assets:						
Loans (net of unearned income and deferred costs), excluding nonaccrual loans	$ 18,937	$ 12,726	$ 31,663	$ 14,293	$ 9,951	$ 24,244
Taxable investment securities	3,499	2,110	5,609	1,277	446	1,723
Tax-exempt investment securities	1,088	69	1,157	-	-	-
Interest bearing deposits	(1,605)	447	(1,158)	1,183	278	1,461
Loans held for sale	(384)	180	(204)	121	313	434
Total earning assets	21,535	15,532	37,067	16,874	10,988	27,862
Liabilities & Equity:						
Interest bearing deposits:						
Demand and money market accounts	706	4,921	5,627	740	3,538	4,278
Savings	(15)	124	109	8	77	85
Certificates of deposit	7,513	5,991	13,504	3,290	1,618	4,908
Total interest bearing deposits	8,204	11,036	19,240	4,038	5,233	9,271
Borrowings	2,501	357	2,858	(890)	900	10
Convertible subordinated capital debentures	(31)	195	164	540	41	581
Total interest bearing liabilities	10,674	11,588	22,262	3,688	6,174	9,862
Net interest income (tax equivalent basis)	$ 10,861	$ 3,944	$ 14,805	$ 13,186	$ 4,814	$ 18,000

(1) Variances caused by the change in rate times the change in balances are allocated to rate.

Provision for Loan Losses: A provision for loan losses is charged against earnings in order to establish and maintain the allowance for loan losses at a level that reflects management's evaluation of the risk inherent in the portfolio. The amount of the provision is principally a function of the Company's net loan growth while in its initial development stages. Due to the relative age of its loan portfolio, the Company has not experienced losses or material levels of nonperforming or adverse internally classified loans. Management includes continuing assessments of nonperforming and "watch list" loans, analytical reviews of loan loss experience (including internal and peer) in relation to outstanding loans, and management's judgment with respect to current and expected economic conditions and their impact on the existing loan portfolio. The provision for loan losses recorded by the Company in 2006, 2005, and 2004 was $2.57 million, $2.36 million and $2.60 million, respectively.

The current year provision for loan losses resulted from providing for net growth in the loan portfolio during 2006 and estimated inherent losses. Net recoveries were $27,000 for 2006. Net charge-offs were $292,000 and $490,000 for 2005 and 2004, respectively. The allowance for loan losses was 1.20% of loans outstanding at December 31, 2006, compared to 1.35% for 2005 and 2004.

Noninterest Income: Total noninterest income for the year ended December 31, 2006 was $33.82 million, or $269,000 and 0.79% less than 2005. Included in noninterest income were losses on securities available-for-sale of $1.74 million for 2006 and gains on securities available-for-sale of $14,000 for 2005. Excluding the 2006 loss on securities available-for-sale, the increase of noninterest income over 2005 was 4.36%, or $1.49 million.

Total noninterest income for the year ended December 31, 2005 was $34.09 million representing a 76.89% increase over the year 2004 amount of $19.27 million. The 2005 increase over 2004 in noninterest income is attributable to growth in all categories of income, resulting from the overall growth of the Company's customer base, growth in mortgage brokerage and insurance services, and the addition of real estate and property management services. Management intends to place continued emphasis on the expansion and development of fee income. Noninterest income, excluding securities gains or losses, for the year ended December 31, 2006 was 31.58% of total operating income compared with 35.30% for 2005.

The following table provides an analysis of noninterest income.

(Dollars in thousands)				2006/2005 Increase/(Decrease)		2005/2004 Increase	
Year ended December 31,	**2006**	**2005**	**2004**	**Amount**	**%**	**Amount**	**%**
Residential mortgage brokerage income, net	$ 8,846	$ 8,808	$ 6,881	$ 38	0.43%	$ 1,927	28.00%
Real estate brokerage and property management income, net	6,333	7,493	-	(1,160)	(15.48%)	7,493	n/m
Insurance commissions and other title fees and income, net	9,782	8,458	5,160	1,324	15.65%	3,298	63.91%
Service charges on deposit accounts	5,479	4,370	3,909	1,109	25.38%	461	11.79%
Credit card merchant fees, net	1,417	1,136	906	281	24.74%	230	25.39%
Other income				-			
Towne Investment income, net	877	652	226	225	34.51%	426	188.50%
Service fees on loans	870	1,036	946	(166)	(16.02%)	90	9.51%
Other	810	586	531	224	38.23%	55	10.36%
Commerical mortgage brokerage fees, net	392	402	307	(10)	(2.49%)	95	30.94%
CSV on life insurance policies	312	519	235	(207)	(39.88%)	284	120.85%
Other title fees and income	222	242	159	(20)	(8.26%)	83	52.20%
Other real estate income	221	374	-	(153)	(40.91%)	374	n/m
Total other income	3,704	3,811	2,404	(107)	(2.81%)	1,407	58.53%
Noninterest income before securities gain/(loss)	35,561	34,076	19,260	1,485	4.36%	14,816	76.93%
Gain/(loss) on securities available-for-sale	(1,740)	14	12	(1,754)	n/m	2	16.67%
Total noninterest income	$ 33,821	$ 34,090	$ 19,272	$ (269)	(0.79%)	$ 14,818	76.89%

n/m not meaningful

The Company's operations are divided into three reportable business segments: traditional full service community banking, realty, and insurance. Refer to Note 23 in the Notes to Consolidated Financial Statements for a full discussion of these segments and results of operations.

For the year ended December 31, 2006, the community bank segment represented 97.26%, or $21.19 million of total consolidated net income for the Company compared with 87.79% or $15.52 million for the year ended December 31, 2005. The bank segment provides loan and deposit services to retail and commercial customers throughout Greater Hampton Roads, Virginia and includes the operations of TowneBank Commercial Mortgage and Towne Investment Group.

For the year ended December 31, 2006, the realty segment represented 6.21%, or $1.35 million of total consolidated net income for the Company compared with 16.26%, or $2.88 million for the year ended December 31, 2005. Residential mortgage brokerage income reflects the stabilization of local housing activity and the current interest rate environment.

In periods of rising rates, consumer demand for new mortgages and refinancings decreases, which may in turn adversely affect the results of the realty division. However, such a decrease will be offset by the increase in interest income earned by the Company.

As an operating segment, insurance represented $357,000, or 1.64% of 2006 consolidated net income compared with $441,000, or 2.49% of consolidated net income for the year ended 2005. Insurance commissions and other title fees and income increased $1.32 million, or 15.65% when comparing 2006 with 2005, reflecting continued development and increasing volume. The performance of this segment depends upon the successful integration of current and future agencies with each other, and the Company, integration of the respective customer bases, and further development of products and services offered.

The increase in service charges on deposit accounts reflects growth of the Company's customer base and deposits. Growth in credit card merchant fees reflects the development of this service and growth in commercial accounts.

Other income consists of income generated by TowneBank Commercial Mortgage and Towne Investment Group and is presented net of commission expenses. Compared to year ended 2005, the Company experienced growth of 34.51%, or $225,000 in Towne Investment income, net of commission expenses for the year ended December 31, 2006. Also included in other income are loan service fees, other real estate income, and other title fees and income, all of which reflected decreases in 2006 when compared to 2005.

Included in noninterest income for the year ended December 31, 2006 is a loss on securities available-for-sale of $1.74 million. For the years ended December 31, 2005 and 2004, the Company included gains on securities available-for-sale of $14,000 and $12,000, respectively, in noninterest income. For more information, refer to Note 3 of the Notes to Consolidated Financial Statements and the Securities discussion following in this Management's Discussion and Analysis.

Noninterest Expense: Total noninterest expense for 2006 was $76.04 million, which was $9.10 million and 13.59% higher than 2005. The primary components of 2006 noninterest expense were salaries and employee benefits of $46.29 million, occupancy expenses of $6.84 million, furniture and equipment expenses of $4.54 million and other expenses of $18.38 million. The increase in noninterest expense reflects the 2005 addition of GSH, servicing a larger customer base in 2006, and an increased number of service facilities and product and service offerings. Total noninterest expense for the year ended December 31, 2005 was $66.95 million compared with $43.62 million for the year ended December 31, 2004, representing a 53.49% increase. Total noninterest expense to total operating revenue, excluding securities gains and losses was 67.53% for the year ended December 31, 2006 compared with 69.36% for 2005 and 68.47% for 2004.

The following table provides an analysis of noninterest expense.

(Dollars in thousands)				2006/2005 Increase/(Decrease)		2005/2004 Increase	
Year ended December 31,	**2006**	**2005**	**2004**	**Amount**	**%**	**Amount**	**%**
Salaries and benefits	$ 46,285	$ 40,553	$ 27,364	$ 5,732	14.13%	$ 13,189	48.20%
Occupancy	6,837	6,063	3,568	774	12.77%	2,495	69.93%
Furniture and equipment	4,538	3,945	2,898	593	15.01%	1,047	36.13%
Other expenses							
Advertising and marketing	3,316	3,310	1,439	6	0.18%	1,871	130.02%
Telephone and postage	1,777	1,758	1,104	19	1.08%	654	59.24%
Stationery and office supplies	1,712	1,420	1,010	292	20.56%	410	40.59%
Outside processing	1,601	1,395	1,117	206	14.77%	278	24.89%
Professional fees	1,421	1,443	948	(22)	(1.52%)	495	52.22%
Directors' expense	1,326	712	701	614	86.24%	11	1.57%
Charitable contributions	1,289	564	380	725	128.55%	184	48.42%
Amortization expense of intangibles and origination costs	1,169	1,169	375	-	-	794	211.73%
Other	1,167	1,533	527	(366)	(23.87%)	1,006	190.89%
Software expense	1,057	932	651	125	13.41%	281	43.16%
Bank franchise tax/SCC fees	963	920	535	43	4.67%	385	71.96%
Travel/Meals/Entertainment	963	696	504	267	38.36%	192	38.10%
FDIC and other insurance	623	535	496	88	16.45%	39	7.86%
Total other expenses	18,384	16,387	9,787	1,996	12.18%	6,600	67.44%
Total noninterest expense	$ 76,043	$ 66,948	$ 43,617	$ 9,095	13.59%	$ 23,331	53.49%

Salaries and employee benefits expense for the year ended December 31, 2006 increased 14.13% or $5.732 million, over 2005, due to the addition of employees to create and service customer growth. Salaries and benefits expense for the year ended December 31, 2005 was $40.55 million for the year, up 48.20% or $13.19 million, over 2004.

The number of full time equivalent employees, excluding GSH sales agents, was 607 at December 31, 2006, as compared to 567 and 456 at December 31, 2005 and 2004, respectively. GSH sales agents are independent contractors and not included as TowneBank employees. Total operating revenue, excluding securities gains and losses per full time equivalent employee was $186,000, $170,000 and $140,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

Occupancy expense totaled $6.84 million for the year ended December 31, 2006, representing an increase of $774,000 or 12.77% over comparative 2005. Occupancy expense for 2005 was $6.06 million or 69.93% over the 2004 amount of $3.57 million. The increase from 2004 to 2005 is due to the acquisition of additional facilities through the 2005 acquisition of GSH as well as the relocation of the mortgage division headquarters to a larger office, the establishment of the Norfolk region, and the opening of a new office in Williamsburg.

Furniture and equipment expense was $4.54 million for 2006, or $593,000 and 15.03% higher than 2005. Furniture and equipment expense was $3.95 million for 2005, or $1.05 million and 36.13% higher than 2004. The increase since 2004 was due to additional product offerings, the addition of equipment to handle customer base growth, and the opening of additional offices and service locations.

Other expenses for 2006 were $18.38 million, which was $1.996 million and 12.18% higher than the 2005 amount of $16.39 million. The increase reflects the growth in customer base and the resulting expenses incurred to support customer service. Other expenses for 2005 were $6.60 million and 67.44% higher than the 2004 amount of $9.79 million. See Note 16 in the Notes to Consolidated Financial Statements for more information.

Income Taxes: Income taxes for the year ended December 31, 2006, were $10.46 million, which was $921,000 higher than the 2005 amount of $9.541 million and $4.25 million higher that the 2004 amount of $6.21 million. The effective tax rate for 2006 was 32.44%, versus 35.05% for 2005 and 35.52% for 2004. The 2006 effective tax rate was reduced by tax advantaged income and tax credits. Refer to Note 7 in the Notes to Consolidated Financial Statements for a discussion regarding the components of the statutory rate and the deferred tax composition.

ANALYSIS OF FINANCIAL CONDITION

OVERVIEW

The Company's total assets increased $391.40 million, or 21.71%, to $2.19 billion for the year ended December 31, 2006 from $1.80 billion for comparative 2005. Growth was supported by growth in the loan portfolio, which increased $377.33 million, or 29.84%, to $1.64 billion at December 31, 2006, from $1.26 billion at December 31, 2005.

The Company's total average assets were $1.98 billion for 2006, reflecting an increase of $351.98 million or 21.60% compared to the 2005 average of $1.63 billion. Total average assets for 2005 increased $347.51 million, or 27.11%, compared to the 2004 average of $1.28 billion. The major balance sheet categories with increases in average balances were loans, up $258.78 million, or 21.93%, and securities, which increased $110.4 million, or 52.48%. Average earning assets were $1.785 billion in 2006, reflecting an increase of $327.7 million, or 22.49%, compared to 2005. The Company's average total deposits were $1.583 billion in 2006; reflecting growth of $276.2 million, or 21.14%, compared to 2005.

The categories of deposits with the highest average growth rates in 2006 were noninterest bearing demand deposits, which increased $44.83 million, or 11.51% and certificates of deposit, which increased $192.53 million or 42.46%. The growth in average balances during 2006 is attributable to market share gains and reflects the Company's expansion into the Norfolk and Williamsburg markets.

Loans Held for Sale: At December 31, 2006, the Company held $16.72 million in loans originated and intended for sale in the secondary market, compared with $27.77 million for the year ended December 31, 2005. The decrease from 2005 to 2006 is attributable to lower volume of loan closings in December 2006 compared to December 2005. Average loans held for sale were 0.99% and 1.61% of average earning assets for the years ended December 31, 2006 and 2005, respectively. The majority of loans held for sale have been pre-committed to investors, minimizing interest rate risk for the Company.

Securities: The Company's investment portfolio, as of December 31, 2006, totaled $345.21 million, reflecting a balance of $255.67 million in securities available-for-sale and $89.54 million of securities held-to-maturity. Average securities were 17.97% and 14.44% of average earning assets for 2006 and 2005, respectively.

During the fourth quarter of 2006, the Company sold $168.7 million in agency securities and purchased $95.77 million in agency securities and $99.36 million in agency mortgage-backed securities to restructure the investment portfolio to take advantage of the current yield curve environment. The transaction is expected to increase the investment portfolio earnings for 2007. During the fourth quarter of 2005, the Company sold $5.32 million in securities, which resulted in a gain of $14,000.

The Company's available-for-sale portfolio consisted of treasuries, agency securities, municipal bonds, mortgage backed securities and equity securities, while the held-to-maturity portfolio consisted of trust preferred corporate debt, treasuries, municipal bonds, and industrial revenue bonds. The Company's investment activities are governed internally by a written, board-approved investment policy, which is carried out by the Company's ALCO. The ALCO meets regularly to review the economic environment, assess current activities for appropriateness and establish investment strategies.

Investment strategies are established by the ALCO in consideration of the interest rate cycle, balance sheet mix, actual and anticipated loan demand, funding options and the overall interest rate sensitivity of the Company. In general, the investment portfolio is managed in a manner appropriate with the attainment of the following goals: (i) to provide a sufficient margin of liquid assets to cover unanticipated deposit and loan fluctuations, seasonal funds flow variations and overall funds management objectives; (ii) to provide eligible securities to secure public funds, trust deposits, and repurchase agreements as prescribed by law; and (iii) to earn the maximum return on funds invested that is commensurate with meeting the requirements of (i) and (ii).

The following tables provide information regarding the composition of the Company's securities portfolio at the end of 2006 with selected maturities and yields. For more information, refer to Note 3 of the Notes to Consolidated Financial Statements.

Year ended December 31,	2006			2005			2004		
(Dollars in thousands)	Amortized Cost	Estimated Fair Value	Weighted Average Yield	Amortized Cost	Estimated Fair Value	Weighted Average Yield	Amortized Cost	Estimated Fair Value	Weighted Average Yield
Securities Available-for-Sale:									
U.S. agency securities	$ 127,865	$ 128,343	5.31%	$ 253,314	$ 249,791	3.61%	$ 135,922	$ 134,209	2.65%
U.S. Treasury notes	-	-	-	999	998	2.60%	992	990	2.60%
Municipal securities	3,749	3,850	6.90%	3,750	3,800	5.07%	3,751	3,863	5.07%
Corporate obligations	605	605	9.63%	605	607	9.63%	711	720	9.48%
Other investments	126	88	-	242	199	-	318	294	-
Federal Home Loan Bank stock	10,013	10,013	5.90%	4,781	4,781	4.60%	5,533	5,533	3.75%
Mortgage-backed securities	111,905	112,775	5.66%	13,392	13,247	4.65%	12,926	13,151	4.71%
Total securities available-for-sale	$ 254,263	$ 255,674	5.52%	$ 277,083	$ 273,423	3.70%	$ 160,153	$ 158,760	2.94%
Securities Held-to-Maturity:									
U.S. Treasury securities	3,993	3,984	4.17%	3,948	3,934	4.17%	999	992	1.65%
Trust preferred	5,520	6,213	8.96%	5,517	6,208	9.00%	5,514	6,268	9.01%
Municipal bonds	16,694	16,517	3.36%	15,603	15,326	3.30%	4,885	4,856	3.49%
Industrial revenue bonds	63,329	63,329	4.26%	11,116	11,116	4.75%	-	-	-
Total securities held-to-maturity	89,536	90,043	4.72%	36,184	36,584	4.73%	11,398	12,116	6.06%
Total Portfolio	$ 343,799	$ 345,717	5.22%	$ 313,267	$ 310,007	3.82%	$ 171,551	$ 170,876	3.14%

Maturities of Securities at December 31, 2006

(Dollars in thousands)	Available-for-sale			Held-to-maturity		
	Amortized Cost	Fair Market Value	Weighted Average Yield	Amortized Cost	Fair Market Value	Weighted Average Yield
U.S. Treasury & U.S. agency securities						
Due in one year or less	$ 5,002	$ 5,002	2.49%	$ 3,993	$ 3,984	4.17%
After one year through five years	61,068	60,964	5.25%	-	-	-
After five years through ten years	46,982	47,272	5.58%	-	-	-
Municipal securities	14,813	15,105	5.72%			
Due in one year or less	-	-	-	1,955	1,938	2.65%
After one year through five years	-	-	-	11,109	10,938	3.26%
After five years through ten years	-	-	-	530	528	4.04%
After ten years	3,749	3,850	5.07%	3,100	3,113	4.08%
Mortgage backed securities						
Due in one year or less	901	889	3.08%	-	-	-
After one year through five years	1,977	1,912	4.03%	-	-	-
After five years through ten years	2,344	2,282	4.55%	-	-	-
After ten years	106,683	107,692	5.74%	-	-	-
Corporate securities						
After ten years	605	605	9.63%	-	-	-
Trust preferred						
After ten years	-	-	-	5,520	6,213	8.96%
Industrial revenue bonds						
Due in one year or less	-	-	-	5,000	5,000	4.29%
After one year through five years	-	-	-	19,334	19,334	4.03%
After five years through ten years	-	-	-	1,995	1,995	4.44%
After ten years	-	-	-	37,000	37,000	4.37%
Other securities						
No stated maturity	10,139	10,101	5.90%	-	-	-
Total Portfolio	$ 254,263	$ 255,674	5.50%	$ 89,536	$ 90,043	4.38%

Loan Portfolio: The Company's loan portfolio, net of the allowance for loan losses, totaled $1.62 billion as of December 31, 2006. The average loan portfolio, net of unearned income and deferred costs and excluding average nonaccrual loans, was 80.62% and 81.00% of average earning assets for the years ended December 31, 2006 and 2005, respectively. Lending activities represent the primary source of income for the Company. The predominant market area for these loans is the Greater Hampton Roads area. The following tables provide the balance and composition of the loan portfolio by major classification.

(Dollars in thousands)

December 31,	2006	2005	2004	2003	2002
Real estate loans:					
Residential 1-4 family	$ 362,034	$ 297,452	$ 278,660	$ 171,044	$ 123,780
Commercial	364,657	275,027	253,597	144,374	118,766
Construction	529,933	377,246	279,591	151,809	104,339
Multifamily	17,919	8,247	11,716	5,662	7,297
Total real estate loans	1,274,543	957,972	823,564	472,889	354,182
Commercial Loans	306,437	256,776	237,504	152,014	117,247
Consumer installment loans:					
Personal	41,784	30,160	33,045	24,565	23,390
Credit lines	18,885	19,382	16,659	14,808	13,950
Total consumer installment loans	60,669	49,542	49,704	39,373	37,340
Agriculture loans	177	202	229	650	644
Loans, net of unearned income and deferred costs	$ 1,641,826	$ 1,264,492	$ 1,111,001	$ 664,926	$ 509,413

December 31,	2006	2005	2004	2003	2002
Real estate loans:					
Residential 1-4 family	22.05%	23.52%	25.08%	25.72%	24.30%
Commercial	22.21%	21.75%	22.83%	21.71%	23.31%
Construction	32.28%	29.83%	25.17%	22.83%	20.48%
Multifamily	1.09%	0.65%	1.05%	0.85%	1.43%
Total real estate loans	77.63%	75.75%	74.13%	71.12%	69.53%
Commercial Loans	18.66%	20.31%	21.38%	22.86%	23.02%
Consumer installment loans:					
Personal	2.54%	2.39%	2.97%	3.69%	4.59%
Credit lines	1.15%	1.53%	1.50%	2.23%	2.74%
Total consumer installment loans	3.71%	3.92%	4.47%	5.92%	7.33%
Agriculture loans	-	0.02%	0.02%	0.10%	0.13%
Loans, net of unearned income and deferred costs	100.00%	100.00%	100.00%	100.00%	100.00%

Below is a table that provides the maturity and sensitivity of the loan portfolio at December 31, 2006.

(Dollars in thousands)	Due in one year or less	Due after one year through five years	Due after five years	Totals	Due after one year	
					Fixed Rates	Adjustable Rates
Real estate loans:						
Residential 1-4 family	$ 210,929	$ 60,033	$ 91,072	$ 362,034	$ 125,919	$ 25,186
Commercial	110,357	146,432	107,868	364,657	253,384	916
Construction	473,148	48,985	7,800	529,933	56,207	578
Multifamily	3,217	8,881	5,821	17,919	14,512	190
Total real estate loans	797,651	264,331	212,561	1,274,543	450,022	26,870
Commercial Loans	187,809	87,024	31,604	306,437	118,479	149
Consumer installment loans:						
Personal	12,775	25,058	3,951	41,784	29,009	-
Credit lines	16,437	2,448	-	18,885	2,448	-
Total consumer installment loans	29,212	27,506	3,951	60,669	31,457	-
Agriculture loans	177	-	-	177	-	-
Loans, net of unearned income and deferred costs	$ 1,014,849	$ 378,861	$ 248,116	$ 1,641,826	$ 599,958	$ 27,019

Allowance for Loan Losses: The allowance for loan losses at December 31, 2006, 2005 and 2004 was $19.67, $17.07 and $15.0 million, respectively. The purpose of the allowance is to provide for potential losses inherent in the loan portfolio. Since risks to the loan portfolio include general economic trends as well as conditions affecting individual borrowers, the allowance is an estimate. Management considers the Company's internal risk grading, historical loan loss experience (of the Company and its peers), the size and composition of the loan portfolio, the value and adequacy of collateral and guarantor agreements, non-performing credits, and current and anticipated economic conditions in determining the adequacy of the allowance, which may necessitate adjustments to management's estimate. The allowance was equal to 1.20% of total loans outstanding at December 31, 2006, compared with 1.35% for 2005 and 2004.

The following table provides a summary of the activity in the allowance for loan losses.

(Dollars in thousands) Year ended December 31,	2006	2005	2004	2003	2002
Balance beginning of period	$ 17,071	$ 14,999	$ 8,976	$ 6,877	$ 4,641
Loans charged-off:					
Residential 1-4 family	(7)	(5)	(59)	(59)	(201)
Construction	(6)	(3)	(120)	(28)	(45)
Commercial	(153)	(483)	(933)	(505)	(177)
Consumer	(48)	(65)	(104)	(206)	(40)
Total	(214)	(556)	(1,216)	(798)	(463)
Loans recovered:					
Residential 1-4 family	32	60	4	94	10
Construction	-	16	28	-	-
Commercial	176	117	581	18	21
Consumer	33	71	113	23	29
Total	241	264	726	135	60
Net loans (charged-off)/recovered	27	(292)	(490)	(663)	(403)
Provision for loan losses	2,572	2,364	2,604	2,762	2,639
Harbor Bank allowance at date of merger	-	-	3,909	-	-
Balance end of period	$ 19,670	$ 17,071	$ 14,999	$ 8,976	$ 6,877
Nonperforming assets:					
Nonperforming loans	$ 636	$ 213	$ 309	$ 203	$ 833
Foreclosed property	400	400	400	150	84
Total nonperforming assets	$ 1,036	$ 613	$ 709	$ 353	$ 917
Loans past due 90 days accruing interest	$ 459	$ 145	$ 14	$ 53	$ 132
Asset Quality Ratios					
Allowance for loan losses to nonperforming loans	30.93x	80.15x	48.54x	44.21x	8.26x
Allowance for loan losses to period end loans	1.20%	1.35%	1.35%	1.35%	1.35%
Nonperforming loans to period end loans	0.04%	0.02%	0.03%	0.03%	0.16%
Nonperforming assets to period end assets	0.05%	0.03%	0.05%	0.04%	0.12%
Net (charge-offs)/recoveries to average loans	-	(0.02%)	(0.05%)	(0.11%)	(0.09%)

Allocation of the Allowance for Loan Losses: In addition to internal and other factors, the Company also reviews peer data in determining the adequacy of the allowance. The Company's total allowance for loan losses at December 31, 2006 was $19.67 million, of which all was allocated to specific loan categories. Management anticipates that the specific and loan type allocations will increase over time and the reserves set aside for perceived and anticipated trends known to management will decrease as the loan portfolio ages and other information used in the allocation methodology changes with actual experience of the loan portfolio performance.

The following table provides a breakdown of the allowance for loan losses among the various loan types.

(Dollars in thousands) December 31,	2006	2005	2004	2003
Real estate loans:				
Residential 1-4 family	$ 3,242	$ 3,055	$ 2,814	$ 1,664
Commercial	3,520	3,018	2,738	1,506
Construction	5,116	4,139	3,019	1,584
Multifamily	155	82	115	53
Total real estate loans	12,033	10,294	8,686	4,807
Commercial Loans	6,207	5,539	5,082	3,197
Consumer installment loans:				
Personal	972	741	806	590
Credit lines	455	493	420	368
Total consumer installment loans	1,427	1,234	1,226	958
Agriculture loans	3	4	5	14
Total	$ 19,670	$ 17,071	$ 14,999	$ 8,976

In years prior to 2003, the Company's total allowance was not allocated as it did not have internally classified or past due loans that warranted specific reserves. In the opinion of management, the allowance was adequate at December 31, 2006, based on known conditions. However, the allowance may be increased or decreased in the future based on loan balances outstanding, changes in internally generated credit quality ratings of the loan portfolio, and changes in general economic conditions and other risk factors.

Allowance for Loan Losses Policy and Methodology: The allowance for loan losses is established through a provision for loan losses charged against earnings. The level of the allowance for loan losses is based on management's evaluation of the risk inherent in the loan portfolio at the balance sheet date and changes in the nature and volume of loan activity and peer bank reviews. This evaluation includes a review of loans for which collection may not be reasonably assured. It considers internal risk grades, the estimated fair value of the underlying collateral, current economic conditions, historical loan loss experience (internal and of peer banks), and other current factors that warrant consideration in determining an adequate allowance. It is the Company's policy to assign internal risk grades to all loans as a component of the approval process. Based on the size of the loan, senior credit officers and the loan committee may review the classification to ensure accuracy and consistency of classification.

Loan classifications are internally reviewed to determine if any changes in the circumstances of the loan require a different risk grade. To determine the most appropriate risk grade classification for each loan, the credit officers examine the borrower's liquidity level, asset quality, the amount of the borrower's other indebtedness, cash flow, earnings, sources of financing and existing lending relationships.

As of December 31, 2006, all loans 60 days or more delinquent, including nonperforming loans, totaled $1.50 million. Additionally, other performing loans totaling $11.83 million exist that are current, but have certain documentation deficiencies or other potential weaknesses that management considers warrant additional monitoring. All loans in these categories are subject to constant management attention, and their status is reviewed on a regular basis. With the exception of $1.03 million, all of these loans are generally secured with appraised values that exceed the remaining principal balances on such loans.

The Company's objective is to maintain a loan portfolio that is diverse in terms of loan type, industry concentration and borrower concentration in order to reduce overall credit risk by minimizing the adverse impact of any single event or combination of related events.

Commercial lending involves a higher degree of risk as compared to other types of lending because repayment usually depends on the cash flows generated by a borrower's business, and the debt service capacity of a business can deteriorate because of downturns in national and local economic conditions. To control risk, initial and continuing financial analysis of a borrower's financial information is required. While management uses the best information available to establish the allowance for loan losses, future adjustments to the allowance methodology may be necessary if economic conditions differ substantially from the assumptions used in making the valuations, or if required by regulators based upon information at the time of their examinations. Such adjustments to original estimates, as necessary, are made in the period in which these factors and other relevant considerations indicate that loss levels may vary from previous estimates.

Nonperforming Assets: Nonperforming assets include nonaccrual loans, foreclosed real estate and other repossessed collateral. It is the Company's policy to place commercial loans on nonaccrual status when full collection of principal and interest becomes doubtful, or when any portion of principal or interest becomes 90 days past due, whichever occurs first. When loans are placed on nonaccrual status, interest receivable is reversed against interest income recognized in the current period, and any prior year unpaid interest is charged off against the allowance for loan losses. Interest payments received thereafter are applied as a reduction of the remaining principal balance so long as doubt exists as to the ultimate collection of the principal. Loans are removed from nonaccrual status when they become current as to both principal and interest and when the collection of principal or interest is no longer doubtful. Mortgage loans and other consumer loans are also placed on nonaccrual status when full collection of principal and interest becomes doubtful, or they become delinquent for a specified period of time.

Deposits: Deposits are attracted principally from customers within the Company's market area through the offering of a broad selection of deposit instruments including demand deposits, negotiable order of withdrawal accounts, savings accounts, money rate savings, certificates of deposit, and individual retirement accounts. Deposit account terms vary with respect to the minimum balance required, the time period the funds must remain on deposit, and service charge schedules.

Interest rates paid on specific deposit types are set by considering the (i) interest rates offered by competitors, (ii) anticipated amount and timing of funding needs (iii) availability of and cost of alternative sources of funding, and (iv) anticipated future economic conditions and interest rates.

Customer deposits are attractive sources of liquidity because of their stability, cost and the ability to generate fee income through the cross-sale of other services to the depositors.

Deposit accounts held by the Company as of December 31, 2006, totaled $1.70 billion, of which 26.60%, or $453.35 million, was in noninterest bearing deposits. At year-end 2006, the Company had a total of $473.23 million in no-penalty time deposits. Deposit accounts represent the Company's primary source of funds and are provided by individuals, professionals and small-to-medium sized businesses in the Greater Hampton Roads area. The deposits are comprised of demand deposits, interest bearing checking accounts, money market deposit accounts, and time deposits. The Company has no brokered deposits. The following table provides the average balance and cost rate of interest bearing deposits in addition to maturities of Certificates of Deposit of $100,000 and greater. See Note 9 in the Notes to Consolidated Financial Statements for additional information on deposits.

(Dollars in thousands)	Average Balance			Average Cost Rate		
Year ended December 31,	**2006**	**2005**	**2004**	**2006**	**2005**	**2004**
Noninterest bearing demand deposits	$ 434,490	$ 389,658	$ 288,124	-	-	-
Demand and money markets	478,947	438,356	357,907	2.65%	1.61%	0.78%
Savings	23,181	24,967	23,474	1.32%	0.79%	0.48%
Certificates of deposit:						
Less than $100,000	305,603	251,172	208,163	4.20%	3.39%	3.20%
$100,000 or more	340,426	202,323	140,700	4.57%	3.15%	2.37%
Total interest bearing deposits	1,148,157	916,818	730,244	3.60%	2.42%	1.76%
Total deposits	$1,582,647	$1,306,476	$1,018,368	2.61%	1.69%	1.26%

Maturities of CD's $100,000 and Greater at December 31, 2006

(Dollars in thousands)

	Amount	Percent
Three months or less	$ 194,093	46.32%
Over three months through twelve months	203,354	48.53%
Over twelve months through three years	19,884	4.75%
Over three years	1,709	0.41%
Total	$ 419,040	100.00%

Advances from the Federal Home Loan Bank of Atlanta: The Company's ability to borrow funds through nondeposit sources provides additional flexibility in meeting the liquidity needs of customers while enhancing its cost of funds structure. Average funds borrowed were $72.8 million and $45.20 million for the years ended December 31, 2006 and 2005, respectively. Refer to Notes 10, 11, and 12 in the Notes to Consolidated Financial Statements for additional disclosures related to borrowing arrangements.

Convertible Subordinated Capital Notes: Total convertible subordinated capital debentures at December 31, 2006 were $42.47 million and included a convertible debenture premium of $829,000 recorded as part of the Harbor Bank acquisition. At December 31, 2005, the debentures totaled $43.10 million. Average total convertible subordinated capital debentures for the year ended December 31, 2006 were $42.76 million compared with $43.39 million for 2005. The average cost of these debentures was 5.32% and 4.86%, respectively. Refer to Note 11 of the Notes to Consolidated Financial Statements for information on convertible subordinated capital debentures.

Liquidity: Liquidity represents the Company's ability to provide funds to meet customer demand for loan and deposit withdrawals without impairing profitability. To meet such needs, the Company maintains cash reserves and marketable investments to supplement funds provided from deposit growth, loan repayments and maturing securities. Refer to Notes 10, 11, and 12 of the Notes to Consolidated Financial Statements for information on borrowing arrangements. The Company maintained an average of $7.40 million outstanding in overnight interest bearing deposits during 2006 compared with $43.06 million for 2005. The Company intends to maintain sufficient liquidity at all times to meet its funding commitments and growth plans. During 2006, the Company funded its growth in total assets with deposit growth and borrowings. At year end 2006, average loans to average deposits was 90.92%, compared to 90.33% at December 31, 2005.

Capital Resources: On January 30, 2002, the Board of Directors approved an amendment to the Articles of Incorporation of the Company to increase the number of authorized shares of Common Stock from 15,000,000 to 30,000,000 shares, to reduce the par value of each share from $5.00 to $2.50 per share, and effect a two-for-one stock split on February 15, 2002.

On April 29, 2004, the Board of Directors approved an amendment to the Articles of Incorporation of the Company to increase the number of authorized shares of Common Stock from 30,000,000 to 45,000,000 shares, to reduce the par value of each share from $2.50 to $1.667 per share, and effect a three-for-two stock split to be distributed on June 17, 2004 to shareholders of record May 17, 2004.

On July 27, 2005, the Company's Board of Directors announced a special 3% stock dividend payable on September 16, 2005 to shareholders of record on August 26, 2005. All per share amounts included in the accompanying consolidated financial statement and footnotes have been restated for all periods presented to reflect the stock splits and stock dividend.

Federal banking laws set forth certain regulatory capital requirements that apply to the Company. Within the framework established by the law, the Company qualifies for the classification "well-capitalized," which is the highest regulatory classification. Due to growth of the Company, Series I and II Towne Investment Units were offered to existing shareholders and customers in subscription offerings in early March 2002 and August 2004, respectively. The Series I offering closed during April 2002 and increased the Company's capital by $22.3 million, while the Series II offering closed in August 2004 and increased the Company's capital by $48.95 million. Additional information concerning the Company's capital resources is contained in Note 12 of the Notes to Consolidated Financial Statements.

Contractual Obligations, Contingent Liabilities and Commitments: The following table summarizes the Company's significant contractual obligations, contingent liabilities and certain other commitments outstanding as of December 31, 2006:

(Dollars in thousands)	Payments due by period				
Contractual Obligations	**Total**	**Less than 1 year**	**1 - 3 years**	**3 - 5 years**	**More than 5 years**
Operating lease obligations	$ 22,095	$ 3,134	$ 5,513	$ 4,327	$ 9,121
Other long-term liabilities reflected on the registrant's balance sheet under GAAP					
Federal Home Loan Bank Advances	142,363	105,500	2,918	33,945	-
Convertible subordinated capital debenutres	42,469	-	829	-	41,640
Other commitments					
Outstanding commitments for construction	23,980	23,980	-	-	-
Standby letters of credit	25,793	25,793	-	-	-
Commitments to extend credit	1,008,079	1,008,079	-	-	-
Total contractual obligations	$ 1,264,779	$ 1,166,486	$ 9,260	$ 38,272	$ 50,761

Additional information regarding these obligations is contained in Notes 5, 8, 10, and 12 of the Notes to Consolidated Financial Statements.

Impact of Inflation and Changing Prices: The financial statements and related data presented herein have been prepared in accordance with generally accepted accounting principles. These principles dictate that financial position and operating results be measured in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation. A financial institution's assets and liabilities are primarily monetary in nature. As a result, general levels of inflation typically have a less significant effect on financial performance than do changes in interest rates; however, noninterest expenses tend to rise in periods of general inflation.

Return on Equity and Assets: The annualized ratio of the operating income to average total assets and average shareholders' equity and average equity to average assets for the years ended December 31, 2006, 2005, and 2004 are as follows:

Year ended December 31,	**2006**	**2005**	**2004**
Return on average assets	1.10%	1.09%	0.88%
Return on average equity	9.86%	8.72%	7.73%
Average equity to average assets	11.15%	12.45%	11.39%
Dividend payout ratio, as a percentage of previous year's net income	30.64%	25.63%	15.77%

Interest Sensitivity: Prudent balance sheet management requires processes that monitor and protect the Company against unanticipated or significant changes in the level of market interest rates. Net interest income stability should be maintained in changing rate environments by ensuring that interest rate risk is kept to an acceptable level. The ability to reprice its interest-sensitive assets and liabilities over various time intervals is of critical importance.

The Company uses a variety of traditional and on-balance sheet tools to manage its interest rate risk. Gap analysis, which monitors the "gap" between interest-sensitive assets and liabilities, is one such tool. In addition, the Company uses simulation modeling to forecast future balance sheet and income statement behavior. By studying the effects on net interest income of rising, stable and falling interest rate scenarios, the Company can position itself to take advantage of anticipated interest rate movement, and protect itself from unanticipated rate movements, by understanding the dynamic nature of its balance sheet components.

An asset-sensitive balance sheet structure implies that assets, such as loans and securities, will reprice faster than liabilities; consequently, net interest income should be positively affected in an increasing interest rate environment. Conversely, a liability-sensitive balance sheet structure implies that liabilities, such as deposits, will reprice faster than assets; consequently, net interest income should be positively affected in a decreasing interest rate environment.

At December 31, 2006, the Company had $257.68 million more liabilities than assets subject to repricing within one year and therefore, was in an liability-sensitive position. An asset-sensitive institution's net interest margin and net interest income generally will be impacted favorably by increasing interest rates, while that of a liability-sensitive institution generally will be impacted favorably by declining interest rates.

The following table summarizes the Company's interest sensitivity position at December 31, 2006, under a static gap approach based on contractual repricings. In the table, the repricing data represents the earliest date on which the interest rate may be changed, which may occur on or before the maturity date.

	Three months or less	More than three months to one year	More than one year to three years	More than three years to five years	More than five years	Total
Interest Sensitive Assets:						
Loans and leases						
Fixed rate by maturity	$ 51,359	$ 79,005	$ 168,499	$ 161,770	$ 252,729	$ 713,362
Floating rate by repricing interval	880,864	7,249	24,654	2,169	196	915,132
Loans in process	-	-	13,053	279	-	13,332
Securities (at cost):						-
Fixed rate by maturity	27,602	9,922	108,611	32,055	155,343	333,533
Equity securities	-	-	-	-	10,101	10,101
Interest bearing balances	5,324	-	-	-	-	5,324
Federal funds sold and repos	829	-	-	-	-	829
Mortgage loans held for sale	16,717	-	-	-	-	16,717
Total earning assets	982,695	96,176	314,817	196,273	418,369	2,008,330
Non interest sensitive assets	-	-	-	-	-	186,255
Total assets	$ 982,695	$ 96,176	$ 314,817	$ 196,273	$ 418,369	$ 2,194,585
Interest Sensitive Liabilities						
Interest bearing checking accounts	$ 153,910	$ -	$ -	$ -	$ -	$ 153,910
Money market deposit accounts	344,521	-	-	-	-	344,521
Other savings accounts	21,868	-	-	-	-	21,868
No penalty CDs	255,415	214,209	2,393	1,210	-	473,227
Other time deposits - $100M & over	41,241	82,258	19,099	1,709	-	144,307
Other time deposits - Under $100M	23,897	59,054	28,427	2,137	-	113,515
Federal funds sold and repos	34,674	-	-	-	-	34,674
FHLB advances	105,500	-	2,918	33,945	-	142,363
Notes payable	-	-	-	-	-	-
Covertible subordinated capital debentures	-	-	-	829	41,640	42,469
Total interest bearing liabilities	981,026	355,521	52,837	39,830	41,640	1,470,854
Non interest sensitive deposits	-	-	-	-	453,351	453,351
Other liabilities & equity	-	-	-	-	-	270,380
Total Liabilities & Equity	$ 981,026	$ 355,521	$ 52,837	$ 39,830	$ 494,991	$ 2,194,585
Net position of assets (period gap)	$ 1,669	$ (259,345)	$ 261,980	$ 156,443	$ (76,622)	
Net position as a percent of total assets	0.08%	(11.82%)	11.94%	7.13%	(3.49%)	
Cumulative gap	1,669	(257,676)	4,304	160,747	84,125	
Cumulative gap as a % of total assets	0.08%	(11.74%)	0.20%	7.32%	3.83%	
Rate sensitive assets as a percent of rate sensitive liabilities	100.17%	27.05%	595.83%	492.78%	84.52%	

Market Risk Management: The effective management of market risk is essential to achieving the Company's strategic objectives. As a financial institution, the Company's most significant market risk exposure is interest rate risk. The primary objective of interest rate risk management is to minimize the effect that changes in interest rates have on net interest income. This is accomplished through active management of asset and liability portfolios with a focus on the strategic pricing of asset and liability accounts and management of appropriate maturity mixes of assets and liabilities. The goal of these activities is the development of appropriate maturity and repricing opportunities in the Company's portfolios of assets and liabilities that will produce consistent net interest income during periods of changing interest rates. The Company's ALCO monitors loan, investment and liability portfolios to ensure comprehensive management of interest rate risk. These portfolios are analyzed for proper fixed-rate and variable-rate mixes under various interest rate scenarios.

The asset and liability management process is designed to achieve relatively stable net interest margins and assure liquidity by coordinating the volumes, maturities and/or repricing opportunities of earning assets, deposits and borrowed funds. It is the responsibility of the ALCO to determine and achieve the most appropriate volume and mix of earning assets and interest bearing liabilities, as well as ensure an adequate level of liquidity and capital, within the context of corporate performance goals. The ALCO also sets policy guidelines and establishes long-term strategies with respect to interest rate risk exposure and liquidity. The ALCO meets regularly to review the Company's interest rate risk and liquidity positions in relation to present and prospective market and business conditions. In addition, funding and balance sheet management strategies are adopted with the intent to ensure that the potential impact on earnings and liquidity due to fluctuations in interest rates are within acceptable standards.

The Company currently does not use off-balance sheet financial instruments to manage interest rate sensitivity and net interest income.

Earnings Simulation Analysis: Management uses simulation analysis to measure the sensitivity of net interest income to changes in interest rates. The model calculates an earnings estimate based on current and projected balances and rates. This method is subject to the accuracy of the assumptions that underlie the process, but it provides an additional analysis of the sensitivity of earnings to changes in interest rates to static gap analysis. Assumptions used in the model rates are derived from historical trends, peer analysis and management's outlook, and include loans and deposit growth rates and projected yields and rates. All maturities, calls and prepayments in the securities portfolio are assumed to be reinvested in like instruments. Mortgage loans and mortgage backed securities prepayment assumptions are based on industry estimates of prepayment speeds for portfolios with similar coupon ranges and seasoning. Different interest rate scenarios and yield curves are used to measure the sensitivity of earnings to changing interest rates. Interest rates on different asset and liability accounts move differently when the prime rate changes and is reflected in the different rate scenarios. The following table represents the interest rate sensitivity on net interest income for the Company using different rate scenarios:

Change in Prime Rate	% Change in Net Interest Income
+ 200 basis points	3.47%
- 200 basis points	(0.69%)

Market Value Simulation: Market value simulation is used to calculate the estimated fair value of assets and liabilities over different interest rate environments. Market values are calculated based on the discounted cash flow analysis. The net market value is the market value of all assets minus the market value of all liabilities. The change in net market value over different rate environments is an indication of the longer term repricing risk in the balance sheet. The same assumptions are used in the market value simulation as in the earnings simulation.

The following table reflects the change in net market value over different rate environments:

Change in Prime Rate	Change in Net Market Value (Dollars in thousands)
+ 200 basis points	$ 26,344
- 200 basis points	$ (40,314)

Credit Risk Elements: The Company places a loan in nonaccrual status when management believes, after considering economic and business conditions and collections efforts, that the borrower's financial condition is such that full collection of principal and interest is doubtful, or when the loan is past due for 90 days or more, unless the debt is both well-secured and in the process of collection. At December 31, 2006, the Company had $636,000 in nonaccrual loans and $458,000 loans past due 90 days or more and still accruing interest, and no troubled debt restructurings. As of December 31, 2006, all loans 60 days or more delinquent, including nonperforming loans, totaled $1.50 million. Additionally, other performing loans totaling $11.83 million exist that are current, but have certain documentation deficiencies or other potential weaknesses that management considers warranting additional monitoring. All loans in these categories are subject to constant management attention, and their status is reviewed on a regular basis.

Critical accounting policies: The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates in certain circumstances that affect amounts reported in the consolidated financial statements and the accompanying footnotes. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from management's current judgments. The following critical accounting policies are significantly affected by judgments, assumptions and estimates used by the Company's management in the preparation of the consolidated financial statements.

Allowance for Loan Losses: The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. Increases and decreases in the allowance due to changes in the measurement of impaired loans, if applicable, are included in the provision for loan losses. The Company periodically evaluates the adequacy of the allowance for loan losses in order to maintain the allowance at a level that is sufficient to absorb probable credit losses. The amount of allowance is based on management's evaluation of the collectibility of the loan portfolio, including the nature of the loan portfolio, credit concentrations, trends in historical loss experience (based primarily on peer group data due to the age of the Company), specific impaired loans and economic conditions.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance based on their judgments of information available to them at the time of their examination. Although management believes that it uses the best information available to evaluate the adequacy of the allowance, unknown market or borrower circumstances could result in adjustments and net earnings being significantly affected if conditions differ substantially from the assumptions used by management in determining the adequacy of the allowance.

Deferred Income Taxes: Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets, including tax loss and credit carry forwards, and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Deferred income tax expense (benefit) represents the change during the period in the deferred tax assets and deferred tax liabilities.

The Company uses the liability method in accounting for income taxes. This method recognizes the amount of taxes payable or refundable for the current year and recognizes deferred tax liabilities and assets for the expected future tax consequences of events and transactions that have been recognized in the Company's financial statements or tax returns.

Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Realization of the deferred income tax asset is dependent on generating sufficient taxable income in future years, and, as such, material changes could impact the Company's financial condition and results of operations.

Estimates of Fair Value: The estimation of fair value is significant to certain Company assets including, loans held-for-sale, available for sale securities, and on-balance sheet commitments to originate loans held for sale. These assets and liabilities are recorded either at fair value or at the lower of cost or fair value, as applicable. The fair values of loans held-for-sale are based on commitments on hand from investors or, if commitments have not yet been obtained, prevailing market rates. The fair values of available-for-sale securities are based on published market prices or dealer quotes. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. The fair values of commitments to originate loans held for sale are based on fees currently charged to enter into similar agreements and, for fixed-rate commitments, also consider the difference between current levels of interest rates and committed rates.

Fair values can be volatile and may be influenced by a number of factors, including market interest rates, prepayment speeds, discount rates, and market conditions. Since these factors can change significantly and rapidly, fair values are difficult to predict and subject to material changes that could impact the Company's financial condition and results of operations.

Goodwill and Other Intangibles: The Company records all assets and liabilities acquired in purchase acquisitions, including goodwill, intangibles with indefinite lives, and other intangibles, at fair value as required by SFAS 141. The initial recording of goodwill and other intangibles requires subjective decisions concerning estimates of the fair value of the acquired assets.

Goodwill is tested for impairment by reportable segment on an annual basis, or more often if events or circumstances indicate there may be impairment. Testing is conducted in two steps: identifying the potential impairment and then if necessary, identifying the amount of impairment. The first step compares the fair value of the reporting segment to its carrying amount. If the fair value is less than the carrying amount, a second test is conducted by comparing the implied fair value of segment goodwill with the carrying amount of that goodwill. If the carrying amount exceeds the implied fair value, an impairment loss is recognized in an amount equal to that excess

Other identifiable intangible assets are evaluated for impairment if events and circumstances indicate a possible impairment. Such evaluation is based on undiscounted cash flow projections, which may extend far into the future and, by their nature, are difficult to determine over an extended timeframe. Fair value may be influenced by market prices, comparison to similar assets, market multiples, discounted cash flow analysis and other determinants. Factors that may significantly affect the estimates include, among others, competitive forces, customer behaviors and attrition, changes in revenue growth trends, cost structures and technology, and changes in discount rates and specific industry or market sector conditions. Other key judgments in accounting for intangibles include useful life and classification between goodwill and intangibles with indefinite lives or other intangibles that require amortization.

Changes in and Disagreements with Accountants Regarding Accounting and Financial Disclosures: There were no changes in or disagreements with accountants regarding accounting and financial disclosures.

Sarbanes-Oxley Act: Congress enacted the Sarbanes-Oxley Act (the "Act") on July 30, 2002, which pertains to the oversight of the accounting profession and corporate responsibility. All companies subject to the Form 10-K, 10-Q, and 8-K reporting requirements under the Securities Exchange Act of 1934 are subject to the Act. Under the Act, the Securities and Exchange Commission has adopted various rules related to officer certification of quarterly and annual reports, audit firm independence, audit committee responsibilities, officer and director prohibited activities, financial reporting and disclosure, and internal control reporting.

Bank Headquarters
5716 High Street West, Portsmouth, Virginia 23703
(757) 638-7500

Corporate Administration and Member Service Center
6001 Harbour View Boulevard, Suffolk, Virginia 23435
(757) 638-6700

Banking Offices

Chesapeake
- Great Bridge Office, 137 Mount Pleasant Road, Chesapeake, Virginia 23322
  (757) 546-7200
- Greenbrier Office, 1312 Greenbrier Parkway, Chesapeake, Virginia 23320
  (757) 548-720

Hampton
- Hampton Office, 550 Settlers Landing Road, Hampton, Virginia 23669
  (757) 723-0900

Newport News
- Oyster Point Office, 1 Old Oyster Point Road, Suite 100, Newport News, Virginia 23602
  (757) 249-7800
- Warwick Office, 11001 Warwick Boulevard, Newport News, Virginia 23601
  (757) 591-7000
- Port Warwick Office, 1103 William Styron Square South, Newport News, Virginia 23606
  (757) 223-1100

Norfolk
- Norfolk Office, 109 East Main Street, Norfolk, Virginia, 23510
  (757) 628-6340
- 1 Colley Avenue, Ste 100, Norfolk, VA 23510
  (757) 622-7300

Portsmouth
- Churchland Office, 5716 High Street West, Portsmouth, Virginia 23703
  (757) 638-7500
- Olde Towne Office, 200 High Street, Portsmouth, Virginia 23704
  (757) 391-3500
- Portsmouth Boulevard Office, 6201 Portsmouth Boulevard, Portsmouth, Virginia 23701
  (757) 405-5400

Virginia Beach
- First Colonial Office, 984 First Colonial Road, Virginia Beach, Virginia 23454
  (757) 412-2400
- Pavilion Office, 2101 Parks Avenue, Suite 100, Virginia Beach, Virginia 23451
  (757) 417-6200
- Pembroke Office, 297 Constitution Avenue, Virginia Beach, Virginia 23462
  (757) 473-2500

Williamsburg
Patriots Colony Office, 6000 Patriots Colony Drive, Williamsburg, Virginia 23188
(757) 220-9953
Williamsburg Office, 5216 Monticello Avenue, Williamsburg, Virginia 23188
(757) 564-4700
York County
York Office, 6515 George Washington Memorial Highway, Yorktown, Virginia 23669
(757) 877-3500

Commercial Lending Centers
Chesapeake
Greenbrier Office, 1312 Greenbrier Parkway, 2nd Floor, Chesapeake, Virginia 23320
(757) 548-7212
Newport News
Oyster Point Office, 1 Old Oyster Point Road, Suite 100, Newport News, Virginia 23602
(757) 249-7800
Norfolk
Norfolk Office, 109 East Main Street, Norfolk, Virginia, 23510
(757) 628-6340
Portsmouth
Olde Towne Office, 200 High Street, Portsmouth, Virginia 23704
(757) 391-3500
Virginia Beach
First Colonial Office, 984 First Colonial Road, 2nd Floor, Virginia Beach, Virginia 23454
(757) 412-2413
Pavilion Annex, 2101 Parks Avenue, Suite 100, Virginia Beach, Virginia 23451
(757) 417-6211
Pembroke Office, 297 Constitution Avenue, Virginia Beach, Virginia 23462
(757) 473-2500
Williamsburg
Williamsburg Office, 5216 Monticello Avenue, Williamsburg, Virginia 23188
(757) 564-7400

Mortgage Centers
4525 South Boulevard, Suite 100, Virginia Beach, Virginia 23452
(757) 687-5000

Commercial Mortgage Center
109 East Main Street, 8th Floor, Norfolk, Virginia 23510
(757) 628-6360

Insurance Centers

137 Mount Pleasant Road, Chesapeake, Virginia 23322
(757) 436-4600
308 35TH Street, Virginia Beach, Virginia 23451
(757) 428-9161
110 Westover Avenue, Williamsburg, Virginia 23187
(757) 229-5757

Insurance offices in the following banking and mortgage offices:
First Colonial Office, 984 First Colonial Road, Virginia Beach, Virginia 23454
(757) 412-2400
Greenbrier Office, 1312 Greenbrier Parkway, Chesapeake, Virginia 23320
(757) 548-7200
Norfolk Office, 109 East Main Street, Norfolk, Virginia, 23510
(757) 628-6340
Olde Towne Office, 200 High Street, Portsmouth, Virginia 23704
(757) 391-3500
Oyster Point Office, 1 Old Oyster Point Road, Suite 100, Newport News, Virginia 23602
(757) 249-7800
4525 South Boulevard, Virginia Beach, Virginia 23451
(757) 687-5000
Town Center Office, 297 Constitution Avenue, Virginia Beach, Virginia 23462
(757) 473-2500
Williamsburg Office, 5216 Monticello Avenue, Williamsburg, Virginia 23188
(757) 564-4700

Benefit Design Group

5520 Greenwich Road, Suite 106, Virginia Beach, Virginia 23462
(757) 499-9000
Beneflex Management, 5900 E. Virginia Beach Boulevard, Suite 501, Norfolk, Virginia 23502
(757) 455-6600

The Frieden Agency, Inc.

The 3300 Building, Suite 108, 397 Little Neck Road, Virginia Beach, Virginia 23452
(757) 340-3873
(800) 356-0321 Toll-Free

Towne Investment Group

6001 Harbour View Boulevard, Suffolk, Virginia 23435
(757) 638-6850

GSH Residential Real Estate

Corporate Office, 582 Lynnhaven Parkway, Suite 400, Virginia Beach, Virginia 23452
(757) 490-6500
(757) 481-7000 (Lynnhaven Office)
By the Bay Office, 2301 Urchin Road, Suite 101, Virginia Beach, Virginia 23451
(757) 460-3341
(757) 222-0710 (By the Bay Property Management/Rentals Office)
Chesapeake Office, 500 Independence Parkway, Suite 150, Chesapeake, Virginia 23320
(757) 547-3355
Churchland Office, 3328 Western Branch Boulevard, Chesapeake, Virginia 23321
(757) 484-2419
(757) 638-9090 (Churchland Property Management/Rentals Office)
Gloucester Office, 7319 Martin Street, Suite 3, Gloucester, Virginia 23061
(804) 695-1414
Hampton Office, 1919 Commerce Drive, Suite 100, Hampton, Virginia 23666
(757) 826-1930
Kempsville Office, 6056 Providence Road, Virginia Beach, Virginia 23464
(757) 424-6500
(757) 420-0071 (Kempsville Property Management/Rentals Office)
Kitty Hawk Office, 5108 N. Croatan Highway, Kitty Hawk, North Carolina 27949
(866) 819-9436
Newport News Office, 11844 Rock Landing Drive, Newport News, Virginia 23606
(757) 873-6900
(757) 595-7350 (Newport News Property Management/Rentals Office)
Norfolk Office, 4141 Granby Street, Norfolk, Virginia 23504
(757) 627-3561
(757) 227-3891 (Norfolk Property Management/Rentals Office)
Oceanfront Office, 3704 Pacific Avenue, Suite 300, Virginia Beach, Virginia 23451
(757) 422-9700
(757) 428-0201 (Vacation/Resort Rentals Property Management Office)
Smithfield Office, 803 S. Church Street, Smithfield, Virginia 23430
(757) 356-5541
Williamsburg Office, 1312 Jamestown Road, Williamsburg, Virginia 23185
(757) 253-2442
(757) 259-0545 (Williamsburg Property Management/Rentals Office)

Lawyers Escrow & Title

4525 South Boulevard, Virginia Beach, Virginia 23452
(757) 497-2272

Eastern Title

Main Office, 582 Lynnhaven Parkway, Suite 200, Virginia Beach, Virginia 23452
(757) 490-6520
Hampton Office, 1919 Commerce Drive, Suite 110, Hampton, Virginia 23666
(757) 224-2356
Newport News Office, 11844 Rock Landing Drive, Newport News, Virginia 23606
(757) 591-2615

Web Address

www.townebankonline.com

ANNUAL MEETING

The Annual Meeting of Stockholders will be held at 11:30 a.m. on Wednesday, May 23, 2007, at the Virginia Beach Convention Center, 1000 19th Street in Virginia Beach, Virginia.

COMMON STOCK

The Company's Common Stock is listed on the OTC Bulletin Board, under the symbol TOWN. The OTC Bulletin Board is a quotation system for equity securities not listed on the NASDAQ Stock Market or stock exchanges, whose quotations reflect inter-dealer prices, without retail mark-up, markdown, or commission and may not necessarily represent actual transactions.

As of December 31, 2006, the Company had 23,601,356 shares of Common Stock issued and outstanding. These shares were held by approximately 8,534 shareholders of record. The Company's Common Stock was issued on October 7, 1998, at a price of $3.24 per share (as adjusted for the three-for-two stock split and the 3% stock dividend) and began trading on the OTCBB on May 3, 1999. On January 30, 2002, the Board of Directors approved a two-for-one stock split effective February 15, 2002. On April 29, 2004, the Board of Directors approved a three-for-two stock split effective June 17, 2004. On July 27, 2005, the Company's Board of Directors announced a special 3% stock dividend payable on September 16, 2005 to shareholders of record on August 26, 2005. All share and per share amounts included in the accompanying consolidated financial statements and footnotes, and management's discussion and analysis have been restated for all periods to reflect the stock split.

On March 26, 2003, the Company declared its first annual cash dividend of $0.032 per common share payable on May 8, 2003, to shareholders of record on April 25, 2003. The dividend, in the amount of $508,000, represented 9.23% of 2002 net income. On January 28, 2004, the Company declared a special annual cash dividend of $0.065 per common share payable on March 15, 2004 to shareholders of record on February 27, 2004. The dividend represents 15.77% of 2003 net income. On January 26, 2005, the Company declared a special shareholder cash dividend of $0.126 per common share payable on March 14, 2005 to shareholders of record on February 25, 2005. The dividend represents 25.63%, or $2.891 million, of the Company's 2004 earnings. On January 25, 2006, the Company declared a special shareholder cash dividend bonus of $0.23 per common share payable on March 10, 2006 to shareholders of record on February 24, 2006. The dividend represents 30.64% of 2005 net income. On November 22, 2006, the Company declared a special shareholder cash dividend bonus of $0.30 per common share payable on January 16, 2007 to shareholders of record on December 20, 2006. The total dividend paid was $7.13 million.

The Company is subject to certain restrictions imposed by the reserve and capital requirements of federal and Virginia banking statutes and regulations. The future dividend policy of the Company is subject to the discretion of the Board of Directors and will depend upon a number of factors, including future earnings, financial condition, cash requirements, and general business conditions.

Following are the high and low closing stock prices in 2006, 2005 and 2004:

	2006		2005		2004	
Quarter	High	Low	High	Low	High	Low
First	$ 22.50	$ 19.19	$ 24.66	$ 20.00	$ 21.36	$ 16.34
Second	23.00	19.40	24.42	20.78	25.24	18.45
Third	21.00	19.00	23.20	20.87	25.24	21.60
Fourth	20.10	19.19	22.50	19.35	23.98	21.07

INVESTOR RELATIONS

TowneBank's Annual Report, Form 10-K, and other corporate publications are available to shareholders on request, without charge, by writing:

Mr. Clyde E. McFarland, Jr.
Senior Executive Vice President and Chief Financial Officer
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Suffolk, VA 23435
(757) 638-6801
e-mail: Clyde.McFarland@townebank.net

This report is also available on our website at http://www.townebankonline.com/inv_documents.htm.

INDEPENDENT AUDITORS

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TRANSFER AGENT

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CORPORATE COUNSEL

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