TowneBank

2008 Annual Report

TowneBank
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BUSINESS PROFILE

TowneBank was organized in 1998 under the laws of the Commonwealth of Virginia to engage in a general retail and commercial banking business and began operations on April 8, 1999. We place special emphasis on serving the financial needs of small- and medium-size businesses, professionals, and individuals in the Greater Hampton Roads region in Southeastern Virginia. We offer a full range of banking and related financial services through our controlled divisions and subsidiaries that include TowneBank Investment Corporation; Towne Investments, LLC; Towne Insurance Agency, Inc. ("Towne Insurance"), which includes Lawyers Escrow and Title, LLC ("LET"); TowneBank Commercial Mortgage, LLC; TFA Benefits, which encompasses Benefit Design Group and The Frieden Agency, Inc.; Out of Town, LLC, d/b/a Red Sky Travel Insurance, LLC; Towne Mortgage, LLC; NewTowne Mortgage, LLC; Corolla Classic Vacations, LLC; Corolla Real Estate, LLC; Towne 1031 Exchange, LLC; GSH Residential Real Estate Corporation ("GSH"); Towne Investment Group, which provides investment and asset management services; and TowneBank Mortgage, which originates mortgage loans and sells them to investors on the national secondary market. Effective January 19, 2009, we contributed GSH and $5.74 million in cash into a joint venture with Virginia Beach based Prudential Decker Realty and Prudential McCardle Realty of Williamsburg. We own 65% of the resulting new company, Prudential Towne Realty.

Since our inception, we have expanded our financial services to include banking, real estate, mortgage, title-related services, insurance, employee benefit services, and investments. We have three reportable segments: Banking, Realty, and Insurance. Our Banking segment provides loan and deposit services to retail and commercial customers. The Realty segment offers residential real estate services, mortgage loans, and residential and commercial title insurance. Commercial and retail insurance and employee benefit services are provided through our Insurance segment.

CORPORATE MISSION STATEMENT

TowneBank will be a relationship and friendship driven local bank focused on 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,	2008	2007	2008/2007 Increase/(Decrease)	
(Dollars in thousands, except per share data)				
Results of Operations:				
Net interest income	$ 87,127	$ 85,499	$ 1,628	1.90%
Noninterest income (1)	40,907	36,752	4,155	11.31%
Noninterest expenses	91,257	85,507	5,750	6.72%
Provision for loan losses	7,022	2,743	4,279	156.00%
Net income	23,894	23,259	635	2.73%
Net income per common share - basic	0.93	0.98	(0.05)	(5.10%)
Net income per common share - diluted	0.89	0.92	(0.03)	(3.26%)
Period End Data:				
Total assets	$ 3,133,578	$ 2,501,078	$ 632,500	25.29%
Total assets - tangible	3,061,545	2,433,009	628,536	25.83%
Earning assets	2,860,820	2,267,763	593,057	26.15%
Loans (net of unearned income and deferred costs)	2,350,186	1,829,456	520,730	28.46%
Allowance for loan losses	27,503	21,323	6,180	28.98%
Goodwill and other intangibles	72,033	68,069	3,964	5.82%
Noninterest-bearing deposits	475,290	439,122	36,168	8.24%
Interest-bearing deposits	1,763,378	1,395,224	368,154	26.39%
Total deposits	2,238,668	1,834,346	404,322	22.04%
Shareholders' equity	419,671	256,856	162,815	63.39%
Shareholders' equity - tangible	347,637	188,787	158,850	84.14%
Book value per share	11.58	10.66	0.92	8.63%
Book value per share - tangible	8.64	7.83	0.81	10.34%
Cash dividends declared per share	0.32	0.32	-	-
Daily Average Balances:				
Total assets	$ 2,778,722	$ 2,387,258	$ 391,464	16.40%
Total assets - tangible	2,706,140	2,321,193	384,947	16.58%
Earning assets	2,491,049	2,171,352	319,697	14.72%
Loans (net of unearned income)	2,059,351	1,741,441	317,910	18.26%
Allowance for loan losses	23,745	20,401	3,344	16.39%
Goodwill and other intangibles	72,582	66,064	6,518	9.87%
Noninterest-bearing deposits	484,735	453,799	30,936	6.82%
Interest-bearing deposits	1,537,759	1,325,619	212,140	16.00%
Total deposits	2,022,494	1,779,418	243,076	13.66%
Shareholders' equity	296,749	242,186	54,563	22.53%
Shareholders' equity - tangible	224,167	176,122	48,045	27.28%
Key Ratios:				
Return on average assets	0.86%	0.97%	(0.11%)	(11.34%)
Return on average tangible assets	0.88%	1.00%	(0.12%)	(12.00%)
Return on average equity	8.05%	9.60%	(1.55%)	(16.15%)
Return on average tangible equity	10.66%	13.21%	(2.55%)	(19.30%)
Net interest margin	3.50%	3.94%	(0.44%)	(11.17%)
Efficiency ratio (1)	71.28%	69.94%	1.34%	1.92%
Average earning assets/total average assets	89.65%	90.96%	(1.31%)	(1.44%)
Average loans/average deposits	101.82%	97.87%	3.95%	4.04%
Average noninterest deposits/total average deposits	23.97%	25.50%	(1.53%)	(6.00%)
Allowance for loan losses/period end loans	1.17%	1.17%	-	-
Period end shareholders' equity/period end total assets	13.39%	10.27%	3.12%	30.38%

Notes:

(1) Excludes investment securities gains and losses.

TOWNEBANK
SELECTED FINANCIAL HIGHLIGHTS

Period Ended December 31,	**2006**	**2005**	**2004**
(Dollars in thousands, except per share data)			
Results of Operations:			
Net interest income	$ 77,042	$ 62,443	$ 44,443
Noninterest income (1)	35,561	34,076	19,260
Noninterest expenses	76,043	66,948	43,617
Provision for loan losses	2,572	2,364	2,604
Net income	21,786	17,680	11,280
Net income per common share - basic	0.93	0.79	0.56
Net income per common share - diluted	0.86	0.74	0.53
Period End Data:			
Total assets	$ 2,194,585	$ 1,803,182	$ 1,448,359
Total assets - tangible	2,137,537	1,747,320	1,398,031
Earning assets	2,009,270	1,625,125	1,302,157
Loans (net of unearned income and deferred costs)	1,641,826	1,264,492	1,111,001
Allowance for loan losses	19,670	17,071	14,999
Goodwill and other intangibles	57,048	55,862	50,328
Noninterest-bearing deposits	453,451	417,061	325,161
Interest-bearing deposits	1,251,248	1,050,664	801,058
Total deposits	1,704,699	1,467,725	1,126,219
Shareholders' equity	230,017	211,986	188,521
Shareholders' equity - tangible	172,969	156,124	138,193
Book value per share	9.75	9.21	8.40
Book value per share - tangible	7.33	6.78	6.16
Cash dividends declared per share, as restated for 3% stock dividend distributed September 2005	0.53	0.126	0.065
Daily Average Balances:			
Total assets	$ 1,981,403	$ 1,629,425	$ 1,281,919
Total assets - tangible	1,923,968	1,573,697	1,241,472
Earning assets	1,784,736	1,457,050	1,152,830
Loans (net of unearned income)	1,438,927	1,180,150	954,535
Allowance for loan losses	18,191	15,873	13,148
Goodwill and other intangibles	57,435	55,728	40,447
Noninterest-bearing deposits	434,490	389,658	288,124
Interest-bearing deposits	1,148,157	916,818	730,244
Total deposits	1,582,647	1,306,476	1,018,368
Shareholders' equity	220,932	202,811	145,998
Shareholders' equity - tangible	163,497	147,083	105,551
Key Ratios:			
Return on average assets	1.10%	1.09%	0.88%
Return on average tangible assets	1.13%	1.12%	0.91%
Return on average equity	9.86%	8.72%	7.73%
Return on average tangible equity	13.33%	12.02%	10.69%
Net interest margin	4.32%	4.29%	3.86%
Efficiency ratio (1)	67.53%	69.36%	68.47%
Average earning assets/total average assets	90.07%	89.42%	89.93%
Average loans/average deposits	90.92%	90.33%	93.73%
Average noninterest deposits/total average deposits	27.45%	29.83%	28.29%
Allowance for loan losses/period end loans	1.20%	1.35%	1.35%
Period end shareholders' equity/period end total assets	10.48%	11.76%	13.02%

Notes:

The above data is retroactively restated to reflect 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.

OVERVIEW

TowneBank ("Company," "we," "us") is headquartered in Portsmouth, Virginia, and operates primarily within the Greater Hampton Roads area. Within this geographic footprint, we operate under three business segments. These business segments are: Banking, Realty, and Insurance.

With a challenging operating environment in 2008, which included a downturn in the national and local real estate industry, we were able to grow our earnings by $635,000 over 2007. Additionally, loans, deposits, and our overall customer base continued to grow in 2008, reflecting our commitment to customer service. Because of our conservative credit culture, our company has had minimal risk associated with the sub-prime issues currently affecting the financial services industry. Furthermore, we have no exposure to collateralized debt obligations backed by sub-prime residential mortgages.

The following is a summary of the Company's 2008 financial performance:

- Net income increased to $23.89 million, or $0.89 per common diluted share, compared with $23.26 million, or $0.92 per common diluted share, in 2007.

- Net interest income increased $1.63 million, or 1.90%, primarily due to the growth in loans and other earning assets. Net interest margin decreased 44 basis points in 2008 to 3.50% as a result of decreases in the Federal Funds rate and the Prime lending rate, both of which fell 400 basis points during the year. This was partially offset by a positive effect from the repricing of interest-bearing liabilities, which lagged the series of rate cuts.

- The provision for loan losses increased $4.28 million, or 156.00%, compared to 2007. The increase was driven by loan growth of $520.73 million during 2008. The bank's loan loss reserve remained unchanged at 1.17% of loans at December 31, 2008 and 2007.

- Noninterest income improved $7.04 million, or 19.13%, compared to 2007. Excluding gains and losses on securities available for sale, noninterest income increased by $4.16 million, or 11.31%, over 2007. This increase was driven by strong growth in our Realty segment, primarily due to the acquisition of the Corolla companies, as described below. Also contributing to the increase were earnings on our investments in bank-owned life insurance policies. The increase was partially offset by a decline in real estate and residential mortgage brokerage.

- Noninterest expense increased $5.75 million, or 6.72%, compared to 2007. The increase was primarily driven by increased occupancy expenses and higher personnel costs. Excluding the effects of 2008 acquisitions, noninterest expense increased $2.90 million, or 3.39%, reflecting management's focus on controlling expenses.

2008 ACQUISITIONS: Effective January 3, 2008, TowneBank acquired both Corolla Classic Vacations, LLC, a resort property management company, and Corolla Real Estate, LLC, a realty company. The purchase price was $7.2 million, including transaction costs.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America ("GAAP") 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. We consider our policies for the allowance for loan losses, deferred income taxes, estimates of fair value, and goodwill and intangibles to be critical accounting policies.

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. We periodically evaluate 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 collectability of the loan portfolio, including the nature of the loan portfolio, credit concentrations, trends in historical loss experience, specific impaired loans, and external influences such as changes in economic conditions.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses. Such agencies may require us 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 we use 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 deferred tax 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.

We use the asset and 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 our 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 our financial condition and results of operations.

Estimates of Fair Value of Financial Instruments: The estimation of fair value is significant to certain 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 our financial condition and results of operations.

Goodwill and Other Intangibles: We record all assets and liabilities acquired in purchase acquisitions, including goodwill, intangibles with indefinite lives, and other intangibles, at fair value as required by Statement of Financial Accounting Standards No. 141, *Business Acquisitions*. The initial recording of goodwill and other intangibles requires subjective decisions concerning estimates of the fair value of the acquired assets and liabilities.

Goodwill is reviewed for potential impairment at the reporting unit level (one level below the business segments identified on page 14) 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 unit 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 reporting unit 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 or changes in 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, 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.

ANALYSIS OF RESULTS OF OPERATIONS

Consolidated Performance Summary

Results of Operations: We reported net income for the years ended December 31, 2008, 2007, and 2006 of $23.89 million, $23.26 million, and $21.79 million, respectively. Diluted earnings per share were $0.89, $0.92, and $0.86 for the years ended December 31, 2008, 2007, and 2006, respectively.

Profitability, as measured by our return on average assets ("ROA") was 0.86%, 0.97%, and 1.10% for the years ended December 31, 2008, 2007, and 2006, respectively. Return on average tangible assets was 0.88%, 1.00%, and 1.13% for the same respective periods. ROA was impacted by the 16.40%, or $391.47 million, increase in average assets from the prior year and our decision to increase liquidity in response to the current financial environment.

Return on average equity ("ROE") was 8.05%, 9.60%, and 9.86% for years ended December 31, 2008, 2007, and 2006, respectively; while return on average tangible equity was 10.66%, 13.21%, and 13.33% for the same respective years. ROE was impacted by the 1.90% increase in net income from 2007 as compared to an increase in average equity of 22.53%, or $54.56 million, from the year ended December 31, 2007. The increase in average equity was related to the issuance of $135.53 million of preferred stock during 2008.

Our operating margin, calculated by dividing income before taxes by operating revenue (net interest income plus noninterest income, excluding securities gains/losses), was 25.50% for the year ended December 31, 2008, while it was 27.88% and 28.64% for 2007 and 2006, respectively.

Net Interest Income: Net interest income, a major component of our earnings, is the income generated by interest-earning assets reduced by the total interest cost of the funds incurred to carry them. It is impacted by the market interest rates and the mix and volume of earning assets and interest-bearing liabilities. Our management team strives to maximize net interest income through prudent balance sheet administration, maintaining appropriate risk levels as determined by our 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.

Net interest income was $87.13 million for the year ended December 31, 2008, an increase of 1.90% over 2007. In the year earlier comparison, net interest income was 10.98% higher for the year ended December 31, 2007 over comparative 2006. The increase in net interest income was driven by balance sheet growth. Average loans were up 18.26% in 2008 compared to 2007, which saw an increase of $302.51 million, or 21.02%, over 2006.

Net interest margin on a tax-equivalent basis, defined as net interest income as a percentage of average earning assets, decreased 43 basis points in 2008 to 3.55% from 3.98% for the year ended December 31, 2007. The decrease in 2008 was primarily the result of decreases in the Federal Funds rate and the Prime lending rate, both of which fell 400 basis points during the year. Additionally, competition for deposits limited our ability to lower deposit rates as quickly as the Federal Reserve cut other short-term rates.

Total average earning assets for the year ended December 31, 2008 were $2.49 billion, which was an increase of $319.70 million over 2007. Loan growth was virtually all of that growth with an increase of $317.91 million. The yield on average earning assets fell to 6.11% in 2008 from 7.22% in 2007. In the prior year comparison, the balance of average earning assets grew $386.62 million and the yield increased 12 basis points.

Total average interest-bearing liabilities for the year ended December 31, 2008 were $1.96 billion, which was an increase of $306.95 million over the prior year. The cost of interest-bearing liabilities was 3.24%, compared with a cost of 4.25% in 2007. The increase in interest-bearing liabilities was largely driven by growth in certificates of deposit, up $174.21 million, and Federal Home Loan Bank of Atlanta (the "FHLB") advances and repurchase agreements, up $95.63 million.

(continued on next page)

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,								
	2008			2007			2006		
	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	$ 2,059,351	$ 130,742	6.35%	$ 1,741,441	$ 132,993	7.64%	$ 1,438,927	$ 111,032	7.72%
Taxable investment securities	257,666	13,649	5.30%	280,557	15,889	5.66%	280,647	12,145	4.33%
Tax-exempt investment securities	101,265	5,369	5.30%	80,995	4,176	5.16%	40,097	1,958	4.88%
Interest-bearing deposits	51,723	1,221	2.36%	48,854	2,429	4.97%	7,397	368	4.97%
Mortgage loans held for sale	21,044	1,196	5.68%	19,506	1,312	6.73%	17,668	1,217	6.89%
Total earning assets	2,491,049	152,177	6.11%	2,171,353	156,799	7.22%	1,784,736	126,720	7.10%
Less: allowance for loan losses	(23,745)			(20,401)			(18,191)		
Total nonearning assets	311,418			236,306			214,858		
Total assets	$ 2,778,722			$ 2,387,258			$ 1,981,403		
Liabilities and Equity:									
Interest-bearing deposits									
Demand and money market	$ 500,273	$ 6,161	1.23%	$ 483,207	$ 13,444	2.78%	$ 478,947	$ 12,680	2.65%
Savings	45,108	757	1.68%	24,246	400	1.65%	23,181	307	1.32%
Certificates of deposit	992,378	38,901	3.92%	818,166	40,497	4.95%	646,029	28,395	4.40%
Total interest-bearing deposits	1,537,759	45,819	2.98%	1,325,619	54,341	4.10%	1,148,157	41,382	3.60%
FHLB advances and repurchase agreements	384,845	15,737	4.09%	289,217	13,831	4.78%	100,757	5,642	5.60%
Convertible subordinated capital debentures	41,301	2,168	5.25%	42,119	2,253	5.35%	42,760	2,274	5.32% (4)
Total interest-bearing liabilities	1,963,905	63,724	3.24%	1,656,955	70,425	4.25%	1,291,674	49,298	3.82%
Noninterest-bearing liabilities									
Demand deposits	484,735			453,799			434,490		
Other noninterest-bearing liabilities	33,333			34,318			34,307		
Total liabilities	2,481,973			2,145,072			1,760,471		
Shareholders' equity	296,749			242,186			220,932		
Total liabilities and equity	$ 2,778,722			$ 2,387,258			$ 1,981,403		
Net interest income (tax-equivalent basis)		$ 88,453			$ 86,374			$ 77,422	
Tax-equivalent basis adjustment		(1,326)			(875)			(380)	
Net interest income		$ 87,127			$ 85,499			$ 77,042	
Interest rate spread (2)			2.87%			2.97%			3.28%
Interest expense as a percent of average earning assets			2.56%			3.24%			2.76%
Net interest margin (tax-equivalent basis) (3)			3.55%			3.98%			4.34%
Total cost of deposits			2.27%			3.05%			2.61%

(1) Yields and interest income are presented on a taxable-equivalent basis using the federal statutory tax rate of 35%.
(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%.

(in thousands)	2008 vs 2007 Increase (Decrease) Due to Changes In			2007 vs 2006 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	$ 22,184	$ (24,435)	$ (2,251)	$ 23,114	$ (1,153)	$ 21,961
Taxable investment securities	(1,254)	(985)	(2,240)	(4)	3,748	3,744
Tax-exempt investment securities	1,075	118	1,193	2,103	115	2,218
Interest-bearing deposits	135	(1,343)	(1,208)	2,061	-	2,061
Loans held for sale	98	(215)	(116)	124	(29)	95
Total earning assets	22,238	(26,860)	(4,622)	27,398	2,681	30,079
Liabilities and Equity:						
Interest-bearing deposits:						
Demand and money market accounts	458	(7,741)	(7,283)	113	651	764
Savings	350	7	357	15	78	93
Certificates of deposit	7,717	(9,313)	(1,596)	8,214	3,888	12,102
Total interest-bearing deposits	8,525	(17,047)	(8,522)	8,342	4,617	12,959
FHLB advances and repurchase agreements	4,107	(2,201)	1,906	9,124	(935)	8,189
Convertible subordinated capital debentures	(43)	(42)	(85)	(34)	13	(21)
Total interest-bearing liabilities	12,589	(19,290)	(6,701)	17,432	3,695	21,127
Net interest income (tax equivalent basis)	$ 9,649	$ (7,570)	$ 2,079	$ 9,966	$ (1,014)	$ 8,952

(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. Management considers 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 in 2008, 2007, and 2006 were $7.02 million, $2.74 million, and $2.57 million, respectively. Net charge-offs were $842,000 and $1.01 million for 2008 and 2007, respectively. In 2006, there were net recoveries of $27,000. The increase in the provision for loan losses in 2008 was due to loan growth of $520.73 million, or 28.46%, over 2007. The allowance for loan losses as a percentage of period-end loans was 1.17% at December 31, 2008 and 2007.

Noninterest Income: Total noninterest income for the year ended December 31, 2008 was $43.87 million, or $7.04 million and 19.13% higher than 2007. Excluding gains and losses on available-for-sale securities, total noninterest income increased by $4.16 million, or 11.31%, over 2007. Total noninterest income for the year ended December 31, 2007 was $36.82 million, representing a $3.00 million, or 8.87%, increase from 2006. Excluding gains and losses on available-for-sale securities, total noninterest income increased by $1.19 million, or 3.35%, over 2006. Included in noninterest income were gains on securities available-for-sale of $2.96 million in 2008 and $70,000 in 2007. There was a loss of $1.74 million on available for sale securities in 2006. Noninterest income, excluding securities gains or losses, for the year ended December 31, 2008 was 31.95% of total operating income compared with 30.06% for 2007 and 31.58% for 2006.

The following table provides an analysis of noninterest income (dollars in thousands).

For the Year Ended December 31,	2008	2007	2006	2008/2007 Increase/(Decrease) Amount	2008/2007 Increase/(Decrease) %	2007/2006 Increase/(Decrease) Amount	2007/2006 Increase/(Decrease) %
Residential mortgage brokerage income, net	$ 5,319	$ 6,164	$ 8,846	$ (845)	(13.69%)	$ (2,682)	(30.32%)
Real estate brokerage and property management income, net	7,778	5,462	6,333	2,316	42.40%	(871)	(13.75%)
Insurance commissions and other title fees and income, net	13,154	13,101	10,004	53	0.40%	3,097	30.96%
Service charges on deposit accounts	5,845	5,554	5,479	291	5.24%	75	1.37%
Credit card merchant fees	1,824	1,710	1,417	114	6.67%	293	20.68%
Other income							
Other	1,901	1,287	810	614	47.72%	477	58.89%
Towne Investment income, net	1,217	1,056	877	161	15.25%	179	20.41%
Bank-owned life insurance income	2,008	709	312	1,299	183.22%	397	127.24%
Service fees on loans	780	687	870	93	13.54%	(183)	(21.03%)
Towne Mortgage income, net	658	432	-	226	52.31%	432	N/M
Commerical mortgage brokerage fees, net	295	379	392	(84)	(22.16%)	(13)	(3.32%)
Other real estate income	128	211	221	(83)	(39.34%)	(10)	(4.52%)
Total other income	6,987	4,761	3,482	2,226	46.75%	1,279	36.73%
Noninterest income before securities gain/(loss)	40,907	36,752	35,561	4,155	11.31%	1,191	3.35%
Gain/(loss) on securities available for sale	2,960	70	(1,740)	2,890	N/M	1,810	N/M
Total noninterest income	$ 43,867	$ 36,822	$ 33,821	$ 7,045	19.13%	$ 3,001	8.87%

N/M = not meaningful

For the year ended December 31, 2008, residential mortgage brokerage income, net of commission expense, was $5.32 million, reflecting a decrease of $845,000, or 13.69%, compared to 2007, which was $2.68 million, or 30.32%, lower than 2006. The majority of the decrease in net mortgage brokerage income in 2008 is attributable to the downturn in the real estate market that resulted in a decrease in the volume of loan originations. For further information, refer to our discussion of the Realty segment on page 16 of this Annual Report, which provides a comparative schedule of operations.

Real estate brokerage and property management income, net of commission expense, for the year ended December 31, 2008 was $7.78 million, an increase of $2.32 million, or 42.40%, from 2007, which was $871,000, or 13.75%, less than 2006. The increase is attributable to property management revenue of $3.44 million from Corolla Classic Vacations, which was acquired in January 2008. The increase was partially offset by a decline in real estate mortgage brokerage revenue.

For the year ended December 31, 2008, insurance commissions and other title income, net of commission expense, was $13.15 million, which was $53,000, or 0.40%, higher than comparative 2007. The year ended December 31, 2008 included contingency income from property and casualty insurance of $936,000 compared to $576,000 and $432,000 for 2007 and 2006. When compared to 2006, insurance commissions for the year ended December 31, 2007 were $3.10 million, or 30.96%, higher.

Service charges on deposit accounts were $5.85 million for 2008, compared with $5.55 million and $5.48 million for 2007 and 2006, respectively.

The growth in credit card merchant fees reflected continued development of this service prior to the sale of our credit card portfolio in the fourth quarter of 2008. For the year ended December 31, 2008, fees totaled $1.82 million, which was $114,000, or 6.67%, above comparative 2007, which was $293,000, or 20.68%, more than 2006.

Other noninterest income for the year ended December 31, 2008 was $6.99 million and included proceeds from the sale of our credit card portfolio, which resulted in a gain of $598,000. Additionally, the amount includes income generated by TowneBank Commercial Mortgage and Towne Investment Group, net of commission expense. For the year ended December 31, 2008, net commission income totaled $296,000 and $1.22 million for TowneBank Commercial Mortgage and Towne Investment Group, respectively. In comparison, net commission income for years ended December 31, 2007 and 2006 were $379,000 and $392,000 for TowneBank Commercial Mortgage and $1.06 million and $877,000 for Towne Investment Group.

Noninterest Expense: Total noninterest expense for 2008 was $91.26 million, which was $5.75 million and 6.72% higher than 2007. Excluding the effects of January 2008 acquisitions, as discussed below, noninterest expense increased $2.90 million, or 3.39%, from 2007. The primary components of 2008 noninterest expense were salaries and employee benefits of $54.62 million, occupancy expenses of $8.51 million, furniture and equipment expenses of $5.15 million, and advertising and marketing expenses of $2.91 million. In comparison to 2007, a portion of the increase in total noninterest expense is due to the May 31, 2007 acquisition of the assets and operations of B. Martin Weber Inc. ("Weber"), a group benefits agency. The acquisition contributed additional expenses compared to 2007, primarily in salaries and benefits and occupancy. The acquisition of Corolla Classic Vacations and Corolla Real Estate in January 2008 also contributed to the increase in noninterest expenses, primarily in salaries and benefits, and advertising expenses. Advertising and marketing expenses decreased as new advertising campaigns were implemented and completed in 2007. Total noninterest expense for the year ended December 31, 2007 was $85.51 million compared with $76.04 million for the year ended December 31, 2006, representing a 12.45% increase. Total noninterest expense to total operating revenue, excluding securities gains and losses, was 71.28% for the year ended December 31, 2008 compared with 69.94% for 2007 and 67.53% for 2006.

(continued on next page)

The following table provides an analysis of noninterest expense (dollars in thousands).

For the year ended December 31,	2008	2007	2006	2008/2007 Increase/(Decrease) Amount	2008/2007 Increase/(Decrease) %	2007/2006 Increase/(Decrease) Amount	2007/2006 Increase/(Decrease) %
Salaries and benefits	$ 54,615	$ 50,083	$ 46,285	$ 4,532	9.05%	$ 3,798	8.21%
Occupancy	8,506	7,694	6,837	812	10.55%	857	12.53%
Furniture and equipment	5,152	4,872	4,538	280	5.75%	334	7.36%
Other expenses							
Advertising and marketing	2,908	4,621	3,316	(1,713)	(37.07%)	1,305	39.35%
Charitable contributions	2,012	1,726	1,289	286	16.57%	437	33.90%
Telephone and postage	2,254	1,910	1,777	344	18.01%	133	7.48%
Outside processing	2,093	1,860	1,601	233	12.53%	259	16.18%
Professional fees	1,617	1,792	1,421	(175)	(9.77%)	371	26.11%
Other	1,345	1,741	1,166	(396)	(22.75%)	575	49.31%
Stationery and office supplies	1,458	1,707	1,712	(249)	(14.59%)	(5)	(0.29%)
Amortization expense of intangibles	2,488	1,591	1,169	897	56.38%	422	36.10%
FDIC and other insurance	1,622	1,536	623	86	5.60%	913	146.55%
Software expense	2,028	1,363	1,057	665	48.79%	306	28.95%
Travel/Meals/Entertainment	549	1,107	963	(558)	(50.41%)	144	14.95%
Directors' expense	1,436	1,056	1,326	380	35.98%	(270)	(20.36%)
Bank franchise tax/SCC fees	1,174	848	963	326	38.44%	(115)	(11.94%)
Total other expenses	22,984	22,858	18,383	126	0.55%	4,475	24.34%
Total noninterest expense	$ 91,257	$ 85,507	$ 76,043	$ 5,750	6.72%	$ 9,464	12.45%

A portion of the increase in total noninterest expense in 2008 is due to the acquisition of Corolla, which resulted in additional expenses, primarily in salaries and benefits and occupancy (refer to the Realty segment discussion and the table on page 16 for additional information regarding the financial impact of these acquisitions). Advertising and marketing expenses decreased in the Banking and Realty segments as advertising campaigns were completed in 2007. Also Federal Deposit Insurance Corporation (the "FDIC") insurance expense increased as the FDIC increased assessments to replenish the Deposit Insurance Fund.

Salaries and employee benefits, the largest portion of noninterest expense, were $54.62 million, representing 59.85% of total noninterest expense for the year ended December 31, 2008. This was a 9.05% increase over 2007 due to annual merit increases, the addition of employees to create and service customer growth, the implementation of a Supplemental Executive Retirement Plan, and the addition of staff resulting from the business acquisitions in 2007 and 2008. The acquisition of Corolla Classic Vacations and Corolla Real Estate resulted in additional salary and benefit expense of $1.75 million in 2008, while TFA Benefits had an increase in salary and benefits expense of $460,000 in 2008 over 2007, which was primarily due to the Weber acquisition. Salaries and benefits expense for the year ended December 31, 2007 was $50.08 million, up 8.21%, or $3.80 million, over 2006.

The number of full-time equivalent employees, excluding real estate sales agents, was 773 at December 31, 2008, as compared to 704 and 655 at December 31, 2007 and 2006, respectively. Real estate sales agents are independent contractors and, therefore, not included as the Company's employees. There were 291 real estate sales agents at December 31, 2008. Total operating revenue, excluding securities gains and losses per full-time equivalent employee, was approximately $166,000, $174,000, and $172,000 for the years ended December 31, 2008, 2007, and 2006, respectively.

For the year ended December 31, 2008, occupancy expense totaled $8.51 million, representing an increase of $812,000, or 10.54%, over comparative 2007. Occupancy expense for 2007 was $857,000, or 12.53%, over the 2006 amount of $6.84 million. The primary driver of the increase in occupancy expense was an increase in amortization of leasehold improvements of $551,000, while the acquisition of businesses in 2008, as previously discussed, was responsible for $143,000 of the increase.

Furniture and equipment expense was $5.15 million for 2008, or $280,000 and 5.75%, higher than 2007. Furniture and equipment expense was $4.87 million for 2007, or $334,000 and 7.36%, higher than comparative 2006. Furniture depreciation, vehicle depreciation, and fuel expense were the largest sources of the increase from the prior year. Computer equipment depreciation also increased as we replaced our older computers and servers to support newer versions of our core processing software.

Other expenses for 2008 were $22.98 million, which was $126,000, or 0.55%, higher than the 2007 amount of $22.86 million. The increase was primarily due to acceleration of amortization expense of intangible assets in our Realty segment and increases in software expense and other expenses that reflect the growth in customer base and the resulting expenses incurred to support customer service. The increases were partially offset by reductions in advertising and marketing spending and decreases in travel meals and entertainment expense, which reflected management's focus on containing costs. Other expenses for 2007 were $4.48 million, or 24.34%, higher than the 2006 amount of $18.38 million.

Income Taxes: Income taxes for the year ended December 31, 2008 were $8.75 million. This was $2.07 million lower than the 2007 amount of $10.82 million, which was $362,000 higher than the 2006 amount of $10.46 million. The effective tax rate for 2008 was 26.81% versus 31.76% for 2007 and 32.44% for 2006. The decrease in the rate was attributable to several factors, including the acquisition of bank-owned life insurance, additional tax-exempt interest income, and a decrease in disallowed expenses. Refer to Note 18 in the Notes to Consolidated Financial Statements for a discussion regarding the components of the statutory rate and the deferred tax composition.

SEGMENT PERFORMANCE SUMMARY

Our reportable segments are a traditional full-service community bank, a full-service realty business, and a full-service insurance agency. In this section, we discuss the performance and financial results of our segments. For further financial details, see Note 22 in the Notes to Consolidated Financial Statements.

Banking Segment. For the year ended December 31, 2008, the Banking segment represented 88.22%, or $21.08 million, of our total consolidated net income, compared to 89.54% and 88.19% for comparative 2007 and 2006.

Pre-tax earnings for the year ended December 31, 2008 for the Banking segment were $28.77 million, decreasing $1.56 million, or 5.13%, from comparative 2007. The decrease was primarily due to a $4.28 million, or 156.00%, increase in the provision for loan losses from 2007 to 2008. Pre-tax earnings include a net loss of $1.57 million related to Towne Financial Services Group – Other, which includes administration costs related to our non-banking segments. Additionally, pre-tax earnings include corporate administration expenses incurred on behalf of the Realty and Insurance segments of $644,000 and $430,000, respectively. Excluding the results of those non-banking activities, pre-tax earnings for the Banking segment were $31.41 million. Comparatively, pre-tax earnings for the year ended December 31, 2007 for the Banking segment were $30.32 million, increasing $2.06 million, or 7.27%, over comparative 2006.

The increase in the provision for loan losses and noninterest expenses was partially offset by increases in net interest income as we continued to grow and increase our earnings assets. Additionally, other income increased by $903,000 driven by return on our investments in bank-owned life insurance and a gain of $598,000 from the sale of our credit card portfolio. The largest component of the increase in expenses was a $3.14 million, or 8.62%, increase in salaries and benefits due to the hiring of seasoned banking professionals in order to attract additional business, implementation of a Supplemental Executive Retirement Plan, and annual merit increases. The Banking segment also recorded a $263,000 increase in charitable contributions and a $784,000 increase in occupancy expense. Partially offsetting the increase in expenses was a $1.76 million decrease in advertising and marketing expenses.

The following chart presents the revenue and expenses for the Banking segment (dollars in thousands).

	Year Ended December 31,			Increase/(Decrease)			
				2008 over 2007		2007 over 2006	
	2008	2007	2006	Amount	Percent	Amount	Percent
Revenue							
Net interest income	$ 86,337	$ 84,715	$ 76,440	$ 1,622	1.91%	$ 8,275	10.83%
Service charges on deposit accounts	5,845	5,554	5,479	291	5.24%	75	1.37%
Credit card merchant fees	1,824	1,710	1,417	114	6.67%	293	20.68%
Other income	4,944	4,041	3,480	903	22.35%	561	16.12%
Subtotal	12,613	11,305	10,376	1,308	11.57%	929	8.95%
Gain (loss) on available for sale	2,960	70	(1,740)	2,890	N/M	1,810	(104.02%)
Total noninterest income	15,573	11,375	8,636	4,198	36.91%	2,739	31.72%
Total revenue	101,910	96,090	85,076	5,820	6.06%	11,014	12.95%
Provision for loan losses	7,022	2,743	2,572	4,279	156.00%	171	6.65%
Expenses							
Salaries and employee benefits	39,521	36,386	32,798	3,135	8.62%	3,588	10.94%
Occupancy expense	5,999	5,215	4,664	784	15.03%	551	11.81%
Furniture and equipment	4,112	3,986	3,676	126	3.16%	310	8.43%
Advertising and marketing	1,537	3,299	2,067	(1,762)	(53.41%)	1,232	59.60%
Charitable contributions	1,955	1,692	1,268	263	15.54%	424	33.44%
Outside processing	1,746	1,602	1,473	144	8.99%	129	8.76%
FDIC and other insurance	1,523	1,426	471	97	6.80%	955	202.76%
Professional fees	1,157	1,326	974	(169)	(12.75%)	352	36.14%
Telephone and postage	1,497	1,284	1,105	213	16.59%	179	16.20%
Other expenses	7,074	6,807	5,740	267	3.92%	1,067	18.59%
Total expenses	66,121	63,023	54,236	3,098	4.92%	8,787	16.20%
Income before income tax expense	28,767	30,324	28,268	(1,557)	(5.13%)	2,056	7.27%
Provision for income tax expense	7,688	9,499	9,055	(1,811)	(19.07%)	444	4.90%
Net income	$ 21,079	$ 20,825	$ 19,213	$ 254	1.22%	$ 1,612	8.39%

Realty Segment. For the year ended December 31, 2008, the Realty segment represented 2.65%, or $634,000, of total consolidated net income, compared to 3.97%, or $924,000, for 2007 and 9.20%, or $2.01 million, for 2006. Real estate brokerage and property management income for the years ended December 31, 2008, 2007, and 2006 was reported net of commission expense totaling $8.22 million, $10.83 million, and $12.01 million, respectively, while residential mortgage brokerage income was reported net of commission expense of $2.87 million, $3.29 million, and $7.26 million for the same respective periods.

Pre-tax earnings for the year ended December 31, 2008 for the Realty segment were $579,000, decreasing $673,000, or 53.75%, from comparative 2007, which decreased $1.79 million, or 58.79%, from comparative 2006. The decrease in earnings for the Realty segment was due to the continued overall softening of the residential real estate market in our market area and the acceleration of amortization of certain intangible assets, which was partially offset by the acquisition of Corolla Classic Vacations and Corolla Real Estate in January 2008.

The following chart presents the revenue and expenses for the Realty segment (dollars in thousands).

	Year Ended December 31,			Increase/(Decrease)			
				2008 over 2007		2007 over 2006	
	2008	2007	2006	Amount	Percent	Amount	Percent
Revenue							
Residential mortgage brokerage income, net	$ 5,985	$ 5,855	$ 8,495	$ 130	2.22%	$ (2,640)	(31.08%)
Real estate brokerage income, net	3,357	4,530	5,529	(1,173)	(25.89%)	(999)	(18.07%)
Title insurance and settlement fees	2,117	2,695	3,517	(578)	(21.45%)	(822)	(23.37%)
Property management fees, net	4,421	932	804	3,489	374.36%	128	15.92%
Income from Towne Mortgage, net	658	432	-	226	52.31%	432	N/M
Net interest and other income	1,004	937	1,071	67	7.15%	(134)	(12.51%)
Total revenue	17,542	15,381	19,416	2,161	14.05%	(4,035)	(20.78%)
Expenses							
Salaries and employee benefits	9,198	7,638	9,286	1,560	20.42%	(1,648)	(17.75%)
Occupancy expense	2,010	2,030	1,977	(20)	(0.99%)	53	2.68%
Furniture and equipment	764	626	666	138	22.04%	(40)	(6.01%)
Amortization of intangible assets	1,175	377	404	798	211.67%	(27)	(6.68%)
Other expenses	3,750	3,470	4,045	280	8.07%	(575)	(14.22%)
Total expenses	16,897	14,141	16,378	2,756	19.49%	(2,237)	(13.66%)
Income before income tax expense and minority interest	645	1,240	3,038	(595)	(47.98%)	(1,798)	(59.18%)
Minority interest	66	(12)	-	78	(650.00%)	(12)	N/M
Income before income tax expense	579	1,252	3,038	(673)	(53.75%)	(1,786)	(58.79%)
Provision for income tax expense	(55)	328	1,033	(383)	(116.77%)	(705)	(68.25%)
Net income	$ 634	$ 924	$ 2,005	$ (290)	(31.39%)	$ (1,081)	(53.92%)

The following chart shows the key data for the Realty segment (dollars in thousands).

	Year Ended December 31,			Increase/(Decrease)			
				2008 over 2007		2007 over 2006	
	2008	2007	2006	Amount	Percent	Amount	Percent
Key data							
Number of homes sold	1,531	2,161	2,630	(630)	(29.15%)	(469)	(17.83%)
Volume of homes sold	$ 246,253	$ 216,168	$ 248,255	$ 30,085	13.92%	$ (32,087)	(12.93%)
Number of real estate agents	291	323	313	(32)	(9.91%)	10	3.19%
Loans originated, mortgage	$ 324,045	$ 383,731	$ 625,732	$ (59,686)	(15.55%)	$ (242,001)	(38.67%)
Loans originated, joint venture	227,919	196,415	-	31,504	16.04%	196,415	N/M
Total loans originated	$ 551,964	$ 580,146	$ 625,732	$ (28,182)	(4.86%)	$ (45,586)	(7.29%)
Number of loans, mortgage	1,285	1,596	2,887	(311)	(19.49%)	(1,291)	(44.72%)
Number of loans, joint venture	1,435	877	-	558	63.63%	877	N/M
Total number of loans	2,720	2,473	2,887	247	9.99%	(414)	(14.34%)
Average loan amount, mortgage	$ 252	$ 240	$ 217	$ 12	5.00%	$ 23	10.60%
Average loan amount, joint venture	159	224	-	(65)	(29.02%)	224	N/M
Average loan amount	$ 203	$ 235	$ 217	$ (32)	(13.62%)	$ 18	8.29%
Average number of originators, mortgage	31	26	41	5	19.23%	(15)	(36.59%)
Average number of originators, joint venture	19	17	-	2	11.76%	17	N/M
Average number of originators	50	43	41	7	16.28%	2	4.88%

Mortgage. The loan volume for the combined mortgage operations decreased for the year ended December 31, 2008 compared 2007 as a result of the continual softening of the residential real estate market compared to record-setting levels experienced in prior years. Total loans originated in 2008 were $551.96 million, a 4.86%, or $28.18 million, decrease from $580.15 million in 2007. This was a $45.59 million, or 7.29%, decrease compared to the 2006 volume of $625.73 million.

Real Estate. As a result of home sales slowing in our market area, net real estate brokerage income decreased $1.17 million, or 25.89%, for the year ended December 31, 2008 compared to 2007. The number of home sales decreased 29.15% and the dollar volume of these home sales increased 13.92%. This slowing resulted in an increase in rentals which, along with the acquisition of Corolla Classic Vacations, had a positive impact on property management, as net property management income increased $3.49 million, or 374.36%, for the year ended December 31, 2008 compared to 2007. The decrease in the number of home sales also resulted in a $578,000, or 21.45%, decrease in title insurance and settlement fees.

Insurance Segment. The Insurance segment comprises property and casualty and group benefits divisions. Several group benefit agencies were acquired in 2007 that resulted in substantial growth for the division.

The Insurance segment represented 9.13%, or $2.18 million, of total consolidated net income in 2008; 6.49%, or $1.51 million, in 2007; and 2.61%, or $568,000, in 2006. Insurance commissions for the years ended December 31, 2008, 2007, and 2006 are reported net of commission expense of $2.68 million, $1.91 million, and $1.34 million, respectively.

Pre-tax earnings for the Insurance segment were $3.30 million in 2008, increasing $793,000, or 31.63%, over 2007. The increase in pre-tax earnings for the Insurance segment was attributable to organic growth in continuing operations and a full year of earnings related to the acquisitions made in 2007.

Net commissions for our property and casualty division decreased $465,000 for the year ended December 31, 2008 compared to 2007. For our group benefits division, the increase was $733,000, mainly due to the 2007 acquisitions.

The following chart presents the revenue and expenses for the Insurance segment (dollars in thousands).

	Year Ended December 31,			Increase/(Decrease) 2008 over 2007		2007 over 2006	
	2008	2007	2006	Amount	Percent	Amount	Percent
Revenue							
Net commission and fee income							
Property and casualty	$ 4,985	$ 5,450	$ 5,048	$ (465)	(8.53%)	$ 402	7.96%
Group benefits	5,068	4,335	730	733	16.91%	3,605	493.84%
Specialized benefit services	227	131	-	96	73.28%	131	N/M
Total net commissions and fees	10,280	9,916	5,778	364	3.67%	4,138	71.62%
Contingency and bonus revenue	984	621	487	363	58.45%	134	27.52%
Other income	279	313	106	(34)	(10.86%)	207	195.28%
Total revenue	11,543	10,850	6,371	693	6.39%	4,479	70.30%
Expenses							
Salaries and employee benefits	5,895	6,058	4,201	(163)	(2.69%)	1,857	44.20%
Occupancy expense	497	449	196	48	10.69%	253	129.08%
Furniture and equipment	276	260	196	16	6.15%	64	32.65%
Amortization of intangible assets	469	376	114	93	24.73%	262	229.82%
Other expenses	1,102	1,200	722	(98)	(8.17%)	478	66.20%
Total expenses	8,239	8,343	5,429	(104)	(1.25%)	2,914	53.67%
Income before income tax expense and minority interest	3,304	2,507	942	797	31.79%	1,565	166.14%
Minority interest	4	-	-	4	N/M	-	0.00%
Income before income tax expense	3,300	2,507	942	793	31.63%	1,565	166.14%
Provision for income tax expense	1,118	997	374	121	12.14%	623	166.58%
Net income	$ 2,182	$ 1,510	$ 568	$ 672	44.50%	$ 942	165.85%

Salaries and employee benefits expense decreased $163,000, or 2.69%, when comparing 2008 to 2007, which increased $1.86 million, or 44.20%, compared to 2006. This decrease is due mainly to the reclassification of compensation for certain employees to commission expense.

Occupancy expense increased $48,000, or 10.69%, when comparing 2008 to 2007, which increased $253,000, or 129.08%, over 2006.

Other expenses decreased $98,000, or 8.17%, during the year ended December 31, 2008 compared to 2007, which increased $478,000, or 66.20%, over 2006.

ANALYSIS OF FINANCIAL CONDITION

Overview: Our total assets increased $632.50 million, or 25.29%, to $3.13 billion at December 31, 2008 from $2.50 billion at December 31, 2007. The increase was supported by growth in the loan portfolio, which increased $520.73 million, or 28.46%, to $2.35 billion at December 31, 2008 from $1.83 billion at December 31, 2007.

Our total average assets were $2.78 billion for 2008, reflecting an increase of $391.46 million, or 16.40%, compared to the 2007 average of $2.39 billion. Total average assets for 2007 increased $405.86 million, or 20.48%, compared to the 2006 average of $1.98 billion. Major balance sheet categories with increases in average balances include loans, up $317.91 million, or 18.26%, and FHLB advances, which increased $102.84 million, or 39.40%, over 2007. Additionally, average earning assets were $2.49 billion in 2008, reflecting an increase of $319.70 million, or 14.72%, compared to 2007.

Our average total deposits were $2.02 billion in 2008, reflecting growth of $243.08 million, or 13.66%, compared to 2007. Interest-bearing deposits, which increased $212.14 million, or 16.00%, grew at a higher rate than noninterest-bearing deposits in 2008.

Securities: Our securities consist of available-for-sale securities and held-to-maturity securities. Our available-for-sale securities portfolio, which is held primarily for earnings, liquidity, and asset/liability management purposes, is reported at fair value based on market prices for similar instruments. Our held-to-maturity securities portfolio, which is held primarily for yield and pledging purposes, is valued at amortized cost. Our investment portfolio totaled $465.10 million as of December 31, 2008, with a balance of $347.74 million in available-for-sale and $117.36 million in held-to-maturity. Average yield on available-for-sale securities was 3.77% at December 31, 2008, compared with 5.62% at December 31, 2007 and 5.52% at December 31, 2006. Average yield on held-to-maturity securities was 4.72% at December 31, 2008, compared to 4.45% at December 31, 2007 and 4.72% at December 31, 2006.

Our available-for-sale securities portfolio consists of Treasuries, agencies, municipal bonds, mortgage-backed debt, and trust preferred corporate debt. Our held-to-maturity portfolio consists of municipal debt, trust preferred corporate debt, and industrial revenue bonds. Our investment activities are governed internally by a written and Board-approved investment policy, which is administered by our ALCO. The ALCO meets regularly to review the economic environment, to assess current activities for appropriateness, and to 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 our overall interest rate sensitivity. 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 table provides information regarding the composition of our securities portfolio showing selected maturities and yields (dollars in thousands). For more information, refer to Note 3 of the Notes to Consolidated Financial Statements.

Year Ended December 31,	**2008**			**2007**			**2006**		
	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	$ 70,002	$ 71,532	4.53%	$ 125,760	$ 126,974	5.49%	$ 127,865	$ 128,343	5.31%
U.S. Treasury notes	77,000	77,000	(0.07%)	-	-	-	-	-	-
Municipal securities	12,341	11,836	5.74%	2,740	2,859	5.23%	3,749	3,850	6.90%
Corporate obligations	-	-	-	-	-	-	605	605	9.63%
Trust preferred	6,995	6,305	7.84%	-	-	-	-	-	-
Other investments	131	57	-	161	86	-	126	88	-
FHLB stock[1]	20,877	20,877	0.50%	17,305	17,305	6.00%	10,013	10,013	5.90%
Mortgage-backed securities	153,746	160,133	5.46%	131,274	133,204	5.71%	111,905	112,775	5.66%
Total securities available for sale	341,092	347,740	3.77%	277,240	280,428	5.62%	254,263	255,674	5.52%
Securities Held to Maturity:									
U.S. Treasury securities	-	-	-	2,001	2,026	4.78%	3,993	3,984	4.17%
Trust preferred	9,357	8,688	8.20%	5,524	5,998	8.99%	5,520	6,213	8.96%
Municipal bonds	20,970	20,904	4.74%	16,863	16,867	3.53%	16,694	16,517	3.36%
Industrial revenue bonds	87,033	87,219	4.34%	75,328	73,376	4.32%	63,329	63,329	4.26%
Total securities held to maturity	117,360	116,811	4.72%	99,716	98,267	4.45%	89,536	90,043	4.72%
Total Portfolio	$ 458,452	$ 464,551	4.01%	$ 376,956	$ 378,695	5.31%	$ 343,799	$ 345,717	5.22%

[1]This stock is stated at cost, as this is a restricted security without a readily determinable fair value.

The following table indicates the maturities of securities at December 31, 2008 (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	$ 77,000	$ 77,000	(0.07%)	$ -	$ -	-
After one year through five years	49,989	51,018	4.17%	-	-	-
After five years through ten years	5,000	5,153	5.80%	-	-	-
After ten years	15,013	15,361	5.30%	-	-	-
Municipal securities						
Due in one year or less	-	-	-	2,370	2,372	3.10%
After one year through five years	-	-	-	8,025	7,967	3.63%
After five years through ten years	2,149	2,136	4.87%	1,285	1,226	4.13%
After ten years	10,192	9,700	5.92%	9,290	9,339	6.19%
Mortgage-backed securities						
Due in one year or less	237	236	3.93%	-	-	-
After one year through five years	798	802	3.91%	-	-	-
After five years through ten years	4,602	4,728	4.99%	-	-	-
After ten years	148,109	154,367	5.48%	-	-	-
Trust preferred						
After ten years	6,995	6,305	7.84%	9,357	8,688	8.20%
Industrial revenue bonds						
Due in one year or less	-	-	-	4,758	4,739	4.29%
After one year through five years	-	-	-	9,873	9,837	4.12%
After five years through ten years	-	-	-	11,418	11,418	4.40%
After ten years	-	-	-	60,984	61,225	4.35%
Other securities						
No stated maturity	21,008	20,934	0.50%	-	-	-
Total Portfolio	$ 341,092	$ 347,740	3.77%	$ 117,360	$ 116,811	4.72%

Loans Held for Sale: At December 31, 2008, we held $25.88 million in mortgage loans originated and intended for sale in the secondary market, compared with $22.95 million at December 31, 2007. Average loans held for sale were 0.84% and 0.90% of average earning assets for the years ended December 31, 2008 and 2007, respectively. The majority of loans held for sale have been pre-committed to investors, minimizing our interest rate risk.

Our mortgage banking activities include two types of commitments: rate lock commitments and forward loan commitments. Rate lock commitments are loans in our pipeline that have an interest rate lock with the customer. The commitments are generally for periods of 60 days and are at market rates. In order to mitigate the risk from interest rate fluctuations, we enter into forward loan sale commitments on a "best efforts" basis while the loan is in the pipeline.

Rate lock commitments related to the origination of mortgage loans held for sale and the corresponding forward loan sale commitments are considered derivative instruments. All of the gain on sale generated from mortgage banking activities is recorded in the financials at the time the loan is closed.

Loan Portfolio: Our loan portfolio, net of the allowance for loan losses, totaled $2.32 billion on December 31, 2008. As a percentage of total average earning assets, average loans were 82.67% in 2008 compared with 80.20% in 2007 and 80.62% in 2006. Lending activities represent our primary source of income. Factors that contributed to the increase in our loan demand were our local economy and the efforts of our experienced loan officers in developing new loan relationships combined with the support of existing customers. The following tables provide the balance and composition of the loan portfolio by major classification for the periods indicated (dollars in thousands).

Year Ended December 31,	2008	2007	2006	2005	2004
Real estate loans					
Residential 1-4 family	$ 589,075	$ 439,676	$ 362,034	$ 297,452	$ 278,660
Commercial	737,244	561,341	364,657	275,027	253,597
Construction	617,390	522,780	529,933	377,246	279,591
Multifamily	30,079	27,515	17,919	8,247	11,716
Total real estate loans	1,973,788	1,551,312	1,274,543	957,972	823,564
Commercial loans	329,716	218,082	306,437	256,776	237,504
Consumer installment loans					
Personal	27,752	42,702	41,784	30,160	33,045
Credit lines	18,890	17,360	18,885	19,382	16,659
Total consumer installment loans	46,642	60,062	60,669	49,542	49,704
Agriculture loans	40	-	177	202	229
Loans, net of unearned income and deferred costs	$ 2,350,186	$ 1,829,456	$ 1,641,826	$ 1,264,492	$ 1,111,001

Year Ended December 31,	2008	2007	2006	2005	2004
Real estate loans					
Residential 1-4 family	25.06%	24.03%	22.05%	23.52%	25.08%
Commercial	31.37%	30.68%	22.21%	21.75%	22.83%
Construction	26.27%	28.59%	32.28%	29.83%	25.17%
Multifamily	1.28%	1.50%	1.09%	0.65%	1.05%
Total real estate loans	83.98%	84.80%	77.63%	75.75%	74.13%
Commercial loans	14.03%	11.92%	18.66%	20.31%	21.38%
Consumer installment loans					
Personal	1.18%	2.33%	2.55%	2.39%	2.97%
Credit lines	0.80%	0.95%	1.16%	1.53%	1.50%
Total consumer installment loans	1.98%	3.28%	3.71%	3.92%	4.47%
Agriculture loans	0.01%	-	-	0.02%	0.02%
Loans, net of unearned income and deferred costs	100.00%	100.00%	100.00%	100.00%	100.00%

The table below provides the maturity and sensitivity of the loan portfolio at December 31, 2008 (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	Due after one year Adjustable Rates
Real estate loans						
Residential 1-4 family	$ 71,354	$ 45,460	$ 472,261	$ 589,075	$ 253,177	$ 264,544
Commercial	100,940	58,147	578,157	737,244	576,151	60,153
Construction	468,750	125,169	23,471	617,390	51,035	97,605
Multifamily	6,823	1,371	21,885	30,079	22,569	687
Total real estate loans	647,867	230,147	1,095,774	1,973,788	902,932	422,989
Commercial loans	152,539	108,598	68,579	329,716	133,819	43,358
Consumer installment loans						
Personal	11,578	10,495	5,679	27,752	14,798	1,376
Credit lines	18,246	547	97	18,890	22	622
Total consumer installment loans	29,824	11,042	5,776	46,642	14,820	1,998
Agriculture loans	40	-	-	40	-	
Loans, net of unearned income and deferred costs	$ 830,270	$ 349,787	$ 1,170,129	$ 2,350,186	$ 1,051,571	$ 468,345

Allowance for Loan Losses: 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 our 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.

The allowance for loan losses at December 31, 2008, 2007, and 2006 was $27.50 million, $21.32 million, and $19.67 million, respectively. The allowance was equal to 1.17% of total loans outstanding at December 31, 2008, compared with 1.17% and 1.20% for 2007 and 2006, respectively.

The following table provides a summary of the activity in the allowance for loan losses for the periods indicated (dollars in thousands).

Year Ended December 31,	2008	2007	2006	2005	2004
Balance beginning of period	$ 21,323	$ 19,670	$ 17,071	$ 14,999	$ 8,976
Loans charged off:					
Residential 1-4 family	(385)	(474)	(7)	(5)	(59)
Construction	(22)	-	(6)	(3)	(120)
Commercial	(279)	(409)	(153)	(483)	(933)
Consumer	(284)	(285)	(48)	(65)	(104)
Total	(970)	(1,168)	(214)	(556)	(1,216)
Loans recovered:					
Residential 1-4 family	7	2	32	60	4
Construction	-	-	-	16	28
Commercial	89	50	176	117	581
Consumer	32	26	33	71	113
Total	128	78	241	264	726
Net loans (charged off)/recovered	(842)	(1,090)	27	(292)	(490)
Provision for loan losses	7,022	2,743	2,572	2,364	2,604
Balance end of period	$ 27,503	$ 21,323	$ 19,670	$ 17,071	$ 14,999
Nonperforming assets:					
Nonperforming loans	$ 2,817	$ 726	$ 636	$ 213	$ 309
Foreclosed property	980	1,570	400	400	400
Total nonperforming assets	$ 3,797	$ 2,296	$ 1,036	$ 613	$ 709
Loans past due 90 days accruing interest	$ 847	$ 32	$ 459	$ 145	$ 14
Asset Quality Ratios					
Allowance for loan losses to nonperforming loans	9.76x	29.37x	30.93x	80.15x	48.54x
Allowance for loan losses to period end loans	1.17%	1.17%	1.20%	1.35%	1.35%
Nonperforming loans to period end loans	0.12%	0.04%	0.04%	0.02%	0.03%
Nonperforming assets to period end assets	0.12%	0.07%	0.05%	0.03%	0.05%
Net charge-offs to average loans	(0.04%)	(0.06%)	-	(0.02%)	(0.05%)

Nonperforming assets include nonaccrual loans, foreclosed real estate, and other repossessed collateral. It is our 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 120 days past due, whichever occurs first, unless the debt is both well-secured and in the process of collection. 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. Similarly, 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.

Nonperforming assets consist of $2.82 million in nonperforming loans, as well as $980,000 in foreclosed property at December 31, 2008. Foreclosed property consists of four different residential properties. Additionally, loans past due 90 days or more that are accruing interest totaled $847,000. As of December 31, 2008, all loans 60 to 89 days delinquent, including nonperforming loans, totaled $2.32 million. Additionally, there are other performing loans, totaling $51.66 million, 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 $3.64 million, which represents management's estimate of total potential loss of these loans, these loans are generally secured with appraised values that exceed the remaining principal balances on such loans.

Allocation of the Allowance for Loan Losses: In addition to internal and other factors, we also review peer data in determining the adequacy of the allowance. Management anticipates that the specific loan 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.

At December 31, 2008, all of the allowance for loan loss was allocated to specific loan categories. The following table provides a breakdown of the allowance for loan losses among the various loan types for the periods indicated (in thousands).

Year Ended December 31,	**2008**	**2007**	**2006**	**2005**	**2004**
Real estate loans:					
Residential 1-4 family	$ 5,457	$ 3,846	$ 3,242	$ 3,055	$ 2,814
Commercial	7,104	5,129	3,520	3,018	2,738
Construction	6,423	5,810	5,116	4,139	3,019
Multifamily	248	228	155	82	115
Total real estate loans	19,232	15,013	12,033	10,294	8,686
Commercial loans	7,187	4,895	6,207	5,539	5,082
Consumer installment loans:					
Personal	630	1,007	972	741	806
Credit lines	450	408	455	493	420
Total consumer installment loans	1,080	1,415	1,427	1,234	1,226
Agriculture loans	4	-	3	4	5
Total	$ 27,503	$ 21,323	$ 19,670	$ 17,071	$ 14,999

In the opinion of management, the allowance was adequate at December 31, 2008, 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: Our 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.

Deposits: 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. Deposits are attracted principally from customers within our 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.

Deposit accounts held as of December 31, 2008 totaled $2.24 billion. This represented an increase of $404.32 million, or 22.04%, over 2007, which was $129.65 million, or 7.61%, over 2006. Overall growth in deposits is primarily attributed to an increase in the Banking segment customer base and in the number of accounts. Deposit accounts represent our primary source of funds and are predominantly provided by individuals, professionals, and small- to medium-sized businesses in the Greater Hampton Roads area. The deposits consist of demand deposits, interest-bearing checking accounts, money market deposit accounts, and time deposits. We also had $120.00 million of brokered time deposits at December 31, 2008.

The following tables provide the average balance and cost rate of interest-bearing deposits in addition to maturities of certificates of deposit of $100,000 and greater for the periods indicated (dollars in thousands). See Note 8 in the Notes to Consolidated Financial Statements for additional information on deposits.

	Average Balance			Average Cost Rate		
For the Year Ended December 31,	**2008**	**2007**	**2006**	**2008**	**2007**	**2006**
Noninterest-bearing demand deposits	$ 484,735	$ 453,799	$ 434,490	-	-	-
Demand and money markets	500,273	483,207	478,947	1.23%	2.78%	2.65%
Savings	45,108	24,246	23,181	1.68%	1.65%	1.32%
Certificates of deposit:						
Less than $100,000	434,354	336,729	305,603	3.81%	4.74%	4.20%
$100,000 or more	558,024	481,437	340,426	4.01%	4.91%	4.57%
Total interest-bearing deposits	1,537,759	1,325,619	1,148,157	2.98%	4.10%	3.60%
Total deposits	$2,022,494	$1,779,418	$1,582,647	2.27%	3.05%	2.61%

Maturities of CDs $100,000 and Greater at December 31, 2008

	Amount	Percent
Three months or less	$ 169,560	25.37%
Over three months through twelve months	298,777	44.71%
Over twelve months through three years	195,078	29.19%
Over three years	4,844	0.72%
Total	$ 668,259	100.00%

Average noninterest-bearing demand deposits as a percentage of average total deposits were 23.97% during the year ended December 31, 2008 and 25.50% and 27.45% during the same period in 2007 and 2006, respectively. This change is attributed to more competition for funds within the community and has led to an increased cost of funds due to a change in funding mix towards a higher proportion of certificates of deposit. The average cost of interest-bearing deposits was 2.98% for the year ended December 31, 2008, compared with 4.10% for 2007 and 3.60% for 2006.

Advances from the FHLB: Our ability to borrow funds through nondeposit sources provides additional flexibility in meeting the liquidity needs of customers while enhancing our cost of funds structure. Average funds borrowed were $363.88 million and $261.04 million for the years ended December 31, 2008 and 2007, respectively. The increase in borrowed funds was primarily due to the need to fund loan growth, which outpaced deposit growth during 2008. Refer to Note 9 in the Notes to Consolidated Financial Statements for additional disclosures related to borrowing arrangements.

Convertible Subordinated Capital Notes: Convertible subordinated capital debentures are unsecured debt that has a lesser priority than that of other debt claims and are not insured by the FDIC or any other governmental agency. Our notes are convertible to common stock at the option of the note holder. Total convertible subordinated capital debentures at December 31, 2008 were $40.88 million and included a convertible debenture premium of $198,000 recorded as part of our acquisition of Harbor Bank in 2004. At December 31, 2007, the debentures totaled $41.67 million and included a convertible debenture premium of $542,000. Average total convertible subordinated capital debentures for the year ended December 31, 2008 were $41.30 million, compared with $42.12 million for 2007. The average cost of these debentures was 5.25% and 5.35%, respectively. Refer to Note 9 of the Notes to Consolidated Financial Statements for information on convertible subordinated capital debentures.

Liquidity: Liquidity represents our ability to provide funds to meet customer demand for loan and deposit withdrawals without impairing profitability. Our liquid assets consist of cash, interest-bearing deposits in financial institutions, federal funds sold, and investments and loans maturing within one year. Asset liquidity is also provided by managing both loan and security maturities.

We maintained an average of $51.72 million outstanding in overnight interest-bearing deposits during 2008, compared with $48.85 million for 2007. We intend to maintain sufficient liquidity at all times to meet our funding commitments and growth plans. During 2008, we funded our growth in total assets with deposit growth, increased borrowings, and preferred stock offerings.

Capital Resources: Federal banking laws set forth certain regulatory capital requirements that apply to us. Within the framework established by the law, we qualify for the classification "well-capitalized," which is the highest regulatory classification. Due to our growth, 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.

In August 2008, the Company issued 598,542 shares of 8% Non-Cumulative Convertible Preferred Stock, Series A (the "Series A Preferred Stock"), at a purchase price of $100 per share. The Series A Preferred Stock will pay a non-cumulative dividend of 8% per year. Each share of the Series A Preferred Stock may be converted at any time, at the option of the holder, into shares of common stock equal to the purchase price divided by $18.56.

In December 2008, under the U.S. Treasury's TARP Capital Purchase Program, we issued to the U.S. Treasury 76,458 shares of Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Stock"), and a ten-year warrant to purchase 538,184 common shares at an exercise price of $21.31 per share, for aggregate proceeds of $76.46 million. Non-cumulative dividends on the Series B Preferred Stock are payable at a rate of 5% annually through February 14, 2013 and at a rate of 9% annually thereafter.

Additional information concerning our capital resources is contained in Note 15 of the Notes to Consolidated Financial Statements.

Contractual Obligations, Contingent Liabilities, and Commitments: The following table summarizes our significant contractual obligations, contingent liabilities, and certain other commitments outstanding as of December 31, 2008 (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	$ 38,255	$ 4,498	$ 8,611	$ 8,244	$ 16,902
Other long-term liabilities reflected on the registrant's balance sheet under GAAP					
FHLB advances	363,877	-	83,877	-	280,000
Convertible subordinated capital debentures	40,878	198	-	-	40,680
Other commitments					
Standby letters of credit	30,677	30,677	-	-	-
Commitments to extend credit	914,624	914,624	-	-	-
Total contractual obligations	$ 1,388,311	$ 949,997	$ 92,488	$ 8,244	$ 337,582

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 operating income to average total assets and average shareholders' equity and average equity to average assets for the periods indicated are as follows.

Year Ended December 31,	**2008**	**2007**	**2006**
Return on average assets	0.86%	0.97%	1.10%
Return on average equity	8.05%	9.60%	9.86%
Average equity to average assets	13.39%	10.14%	11.15%
Dividend payout ratio, as a percentage of previous year's net income	33.94%	35.65%	70.96%

Interest Sensitivity: Prudent balance sheet management requires processes that monitor and protect us 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 our interest-sensitive assets and liabilities over various time intervals is of critical importance.

We use a variety of traditional and on-balance-sheet tools to manage our interest rate risk. Gap analysis, which monitors the "gap" between interest-sensitive assets and liabilities, is one such tool. In addition, we use 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, we can position ourselves to take advantage of anticipated interest rate movement, and protect ourselves from unanticipated rate movements, by understanding the dynamic nature of our 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, 2008, we had $283.19 million more assets than liabilities subject to repricing within one year and, therefore, were in an asset-sensitive position.

Market Risk Management: The effective management of market risk is essential to achieving our strategic objectives. As a financial institution, our most significant market risk exposure is interest rate risk. The primary objective of the management of interest rate risk 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 our portfolios of assets and liabilities that will produce consistent net interest income during periods of changing interest rates. Our 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 our 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.

We currently do 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 our net interest income using different rate scenarios.

Change in Prime Rate	% Change in Net Interest Income
+ 200 basis points	11.71%
- 200 basis points	(14.31%)

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	$ (27,211)
- 200 basis points	$ (42,193)

Credit Risk Elements: We place 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 120 days or more, unless the debt is both well-secured and in the process of collection.

FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements with respect to our plans, objectives, future performance, and business, which are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Words such as "expects," "anticipates," "believes," "estimates," and other similar expressions or future or conditional verbs such as "will," "should," "would," and "could" are intended to identify such forward-looking statements. These forward-looking statements are no guarantees of future performance and involve certain risks and uncertainties and are based on the beliefs and assumptions of our management.

Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include, among others, the following:

- competitive pressures in the banking industry may increase significantly;
- 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;
- 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;
- changes in the legislative or regulatory environment, including changes in accounting standards, may adversely affect our businesses;
- costs or difficulties related to the integration of the business and the businesses we have acquired may be greater than expected;

- expected cost savings associated with pending or recently completed acquisitions may not be fully realized or realized within the expected time frame;
- our competitors may have greater financial resources and develop products that enable them to compete more successfully;
- changes in business conditions could adversely affect our financial condition and results of operations;
- adverse changes may occur in the securities market; and
- changes in our local economy with regard to our market area and its heavy concentration of U.S. military bases and related personnel could adversely affect our businesses.

We do not undertake and specifically disclaim any obligation to publicly update or revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

(continued on next page)

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 average goodwill and other intangible assets from our calculation of return on average tangible assets and return on average tangible equity. This adjustment allows management to review the Company's core operating result and core capital position.

Year Ended December 31,	2008	2007
Return on average assets (GAAP basis)	0.86%	0.97%
Impact of excluding average goodwill and other intangibles and amortization	0.02%	0.03%
Return on average tangible assets	0.88%	1.00%
Return on average equity (GAAP basis)	8.05%	9.60%
Impact of excluding average goodwill and other intangibles and amortization	2.61%	3.61%
Return on average tangible equity	10.66%	13.21%

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 its core capital position.

	Per share	
Year Ended December 31,	2008	2007
Book value (GAAP basis)	$ 11.58	$ 10.66
Impact of excluding average goodwill and other intangibles and amortization	(2.94)	(2.83)
Tangible book value	$ 8.64	$ 7.83

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.

Year Ended December 31,	2008	2007
Efficiency ratio (GAAP basis)	69.90%	69.90%
Impact of excluding securities gains/(losses)	1.38%	0.04%
Efficiency ratio, as reported	71.28%	69.94%

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
TowneBank

We have audited the accompanying consolidated balance sheets of ***TowneBank*** and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income, shareholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2008. We also have audited ***TowneBank's*** internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). ***TowneBank's*** management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

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

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

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ***TowneBank*** and subsidiaries as of December 31, 2008 and 2007, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, ***TowneBank*** and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

/s/ Goodman and Company, LLP

Norfolk, Virginia
March 10, 2009

INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of TowneBank 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 judgments by management. Management also prepared other information in the Annual Report and is responsible for its accuracy and consistency with the consolidated financial statements. Our management is responsible for establishing and maintaining adequate internal control over financial reporting and for our compliance with laws and regulations relating to safety and soundness designated by the Federal Deposit Insurance Corporation ("FDIC"). Our internal control system was designed to provide reasonable assurance to our 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.

We maintain systems of controls that we believe are reasonably designed to provide our management with timely and accurate information about our 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 independent directors who meet regularly with management, the internal auditor, and the independent auditors to review the scope of their work and findings.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2008. 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, 2008, our internal control over financial reporting is effective based on those criteria and that we complied with the FDIC's safety and soundness laws and regulations over the course of the year ended December 31, 2008.

Financial Statements

Our management is responsible for the preparation, integrity, and fair presentation of our published consolidated financial statements as of December 31, 2008 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 management's judgments and estimates.

Compliance with Laws and Regulations

Our 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 our compliance with the designated laws and regulations. Based on this assessment, our management believes that we complied, in all significant respects, with the designated laws and regulations relating to safety and soundness for the year ended December 31, 2008.

Goodman & Company, LLP, the registered public accounting firm that performed our financial statement audit, has issued an attestation report on our assessment of our 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.

March 10, 2009

/s/ G. Robert Aston, Jr.

G. Robert Aston, Jr.
Chairman and Chief Executive Officer

/s/ Clyde E. McFarland, Jr.

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

TOWNEBANK
CONSOLIDATED BALANCE SHEETS
(dollars in thousands, except share data)
December 31, 2008 and 2007

ASSETS

	2008	2007
Cash and due from banks	$ 67,280	$ 33,400
Interest-bearing deposits in financial institutions	2,467	35,935
Federal funds sold	20,000	-
Total Cash and Cash Equivalents	89,747	69,335
Securities available for sale, at fair value	347,740	280,428
Securities held to maturity, at amortized cost	117,360	99,716
Total Securities	465,100	380,144
Mortgage loans held for sale	25,884	22,953
Loans, net of unearned income	2,350,186	1,829,456
Less: allowance for loan losses	(27,503)	(21,323)
Net Loans	2,322,683	1,808,133
Premises and equipment, net	78,991	74,931
Goodwill	60,198	56,334
Other intangibles	11,835	11,735
Bank-owned life insurance policies	44,529	42,521
Other assets	34,611	34,992
TOTAL ASSETS	$ 3,133,578	$ 2,501,078

LIABILITIES AND SHAREHOLDERS' EQUITY

	2008	2007
Deposits:		
Noninterest-bearing demand	$ 475,290	$ 439,122
Interest-bearing:		
Demand and money market accounts	489,485	508,028
Savings	60,071	24,361
Certificates of deposit:		
Less than $100,000	545,563	342,529
$100,000 and more	668,259	520,306
Total Deposits	2,238,668	1,834,346
Advances from the Federal Home Loan Bank	363,877	296,665
Convertible subordinated capital debentures	40,878	41,669
Repurchase agreements and other borrowings	36,248	36,660
Total Borrowings	441,003	374,994
Other liabilities	34,236	34,882
TOTAL LIABILITIES	2,713,907	2,244,222
Preferred stock, $5.00 par value		
Authorized shares - 2,000,000		
Issued and outstanding shares 669,650 in 2008	3,348	-
Common stock, $1.667 par value		
Authorized shares - 45,000,000		
Issued and outstanding shares 24,549,150 in 2008		
and 24,104,418 in 2007	40,923	40,182
Capital surplus	310,237	168,364
Retained earnings	60,832	46,227
Accumulated other comprehensive income	4,331	2,083
TOTAL SHAREHOLDERS' EQUITY	419,671	256,856
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 3,133,578	$ 2,501,078

See accompanying Notes to Consolidated Financial Statements.

TOWNEBANK
CONSOLIDATED STATEMENTS OF INCOME
(dollars in thousands, except per share data)
For the Years Ended December 31, 2008, 2007, and 2006

	2008	2007	2006
INTEREST INCOME:			
Loans, including fees	$ 130,633	$ 132,993	$ 111,032
Investment securities	17,801	19,190	13,723
Interest-bearing deposits in financial institutions and federal funds sold	1,221	2,429	368
Mortgage loans held for sale	1,195	1,312	1,217
Total interest income	150,850	155,924	126,340
INTEREST EXPENSE:			
Deposits	45,818	54,341	41,382
Advances from the Federal Home Loan Bank	14,840	12,391	4,688
Convertible subordinated capital debentures	2,168	2,253	2,274
Repurchase agreements and other borrowings	897	1,440	954
Total interest expense	63,723	70,425	49,298
Net interest income	87,127	85,499	77,042
PROVISION FOR LOAN LOSSES	7,022	2,743	2,572
Net interest income after provision for loan losses	80,105	82,756	74,470
NONINTEREST INCOME:			
Residential mortgage brokerage income, net	5,319	6,164	8,846
Real estate brokerage and property management income, net	7,778	5,462	6,333
Insurance commissions and other title fees and income, net	13,154	13,101	10,004
Service charges on deposit accounts	5,845	5,554	5,479
Credit card merchant fees, net	1,824	1,710	1,417
Other income	6,987	4,761	3,482
Gain/(loss) on securities available for sale	2,960	70	(1,740)
Total noninterest income	43,867	36,822	33,821
NONINTEREST EXPENSE:			
Salaries and employee benefits	54,615	50,083	46,285
Occupancy	8,506	7,694	6,837
Furniture and equipment	5,152	4,872	4,538
Other expenses	22,984	22,858	18,383
Total noninterest expense	91,257	85,507	76,043
Income before income tax expense & minority interest	32,715	34,071	32,248
Minority interest in net income of unconsolidated subsidiaries	(70)	12	-
Income before income tax expense	32,645	34,083	32,248
Provision for income tax expense	8,751	10,824	10,462
Net income	$ 23,894	$ 23,259	$ 21,786
Net income applicable to common shareholders	$ 22,498	$ 23,259	$ 21,786
Per common share information			
Basic earnings	$ 0.93	$ 0.98	$ 0.93
Diluted earnings	$ 0.89	$ 0.92	$ 0.86
Cash dividends declared	$ 0.32	$ 0.32	$ 0.53

See accompanying Notes to Consolidated Financial Statements.

TOWNEBANK

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(dollars in thousands, except share data)

For the Years Ended December 31, 2008, 2007, and 2006

	Common Shares	Preferred Stock	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
Balance, December 31, 2005	**23,011,526**	**$ -**	**$ 38,360**	**$ 154,573**	**$ 21,433**	**$ (2,380)**	**$ 16,206**	**$ 211,986**
Net Income	-	-	-	-	21,786	-	21,786	21,786
Unrealized gain on securities, net of tax expense of $1,775	-	-	-	-	-	3,297	3,297	3,297
Cash dividends declared	-	-	-	-	(12,545)	-	-	(12,545)
Directors' deferred compensation	(32,749)	-	(55)	(618)	-	-	-	(673)
Issuance of common stock - stock compensation plans	478,878	-	797	2,325	-	-	-	3,122
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**	**25,083**	**230,017**
Net Income	-	-	-	-	23,259	-	23,259	23,259
Unrealized gain on securities, net of tax expense of $627	-	-	-	-	-	1,166	1,166	1,166
Cash dividends declared	-	-	-	-	(7,766)	-	-	(7,766)
Directors' deferred compensation	(42,178)	-	(70)	(739)	-	-	-	(809)
Issuance of common stock - stock compensation plans	143,867	-	241	3,351	-	-	-	3,592
Issuance of common stock - business acquisition	65,480	-	115	1,144	-	-	-	1,259
Issuance of common stock	335,893	-	553	5,585	-	-	-	6,138
Balance, December 31, 2007	**24,104,418**	**-**	**40,182**	**168,364**	**46,227**	**2,083**	**24,425**	**256,856**
Net Income	-	-	-	-	23,894	-	23,894	23,894
Unrealized gain on securities, net of tax expense of $1,211	-	-	-	-	-	2,248	2,248	2,248
Cash dividends declared on common stock	-	-	-	-	(7,893)	-	-	(7,893)
Cash dividends declared on preferred stock	-	-	-	-	(1,396)	-	-	(1,396)
Directors' deferred compensation	(50,079)	-	(85)	3,595	-	-	-	3,510
Conversion of preferred stock into common stock	28,824	(27)	47	487	-	-	-	507
Issuance of preferred stock	-	3,375	-	132,159	-	-	-	135,534
Issuance of common stock - stock compensation plans	150,735	-	254	778	-	-	-	1,032
Issuance of common stock	315,252	-	525	4,854	-	-	-	5,379
Balance, December 31, 2008	**24,549,150**	**$ 3,348**	**$ 40,923**	**$ 310,237**	**$ 60,832**	**$ 4,331**	**$ 26,142**	**$ 419,671**

See accompanying Notes to Consolidated Financial Statements.

TOWNEBANK
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
For the Years Ended December 31, 2008, 2007, and 2006

OPERATING ACTIVITIES:	2008	2007	2006
Net income	$ 23,894	$ 23,259	$ 21,786
Adjustments to reconcile net income to net cash from operating activities:			
Net accretion of securities	(287)	(243)	(553)
Investment securities (gains)/losses	(2,960)	21	1,804
Depreciation, amortization, and other intangible amortization	9,174	7,160	6,366
Provision for loan losses	7,022	2,743	2,572
Share-based compensation expense	1,741	2,359	2,098
Net (increase) decrease in loans held for sale	(2,931)	(6,236)	11,056
Changes in:			
Interest receivable	314	(481)	(1,912)
Other assets	(3,694)	(8,004)	(5,174)
Interest payable	2,396	1,171	(2,142)
Other liabilities	319	(2,290)	5,865
Net cash from operating activities	34,988	19,459	41,766
INVESTING ACTIVITIES:			
Purchase of available-for-sale securities	(236,504)	(59,930)	(249,606)
Purchase of held-to-maturity securities	(30,057)	(16,650)	(53,729)
Sale of available-for-sale securities	148,157	3,639	201,371
Proceeds from maturities, calls, and prepayments of securities	40,155	39,911	70,276
Net increase in loans	(521,599)	(188,973)	(377,560)
Net purchase of premises and equipment	(9,061)	(13,043)	(7,953)
Net purchase of bank-owned life insurance	-	(36,000)	-
Acquisition of business, net of cash acquired	(7,225)	(10,058)	-
Cash acquired in business acquisition	-	-	348
Net cash used for investing activities	(616,134)	(281,104)	(416,853)
FINANCING ACTIVITIES:			
Net increase in deposit accounts	404,322	129,647	236,974
Net change in borrowings	66,217	155,710	124,205
Proceeds from share-based compensation activity	157	1,983	1,127
Proceeds from issuance of common stock	4,583	4,978	242
Proceeds from issuance of preferred stock	135,534	-	-
Cash dividends paid	(9,255)	(12,939)	(5,418)
Net cash from financing activities	601,558	279,379	357,130
Change in cash and cash equivalents	20,412	17,734	(17,957)
Cash and cash equivalents at beginning of year	69,335	51,601	69,558
Cash and cash equivalents at end of year	$ 89,747	$ 69,335	$ 51,601
Supplemental cash flow information:			
Cash paid for interest	$ 61,327	$ 69,254	$ 47,156
Cash paid for income taxes	$ 11,582	$ 11,584	$ 10,357
Noncash financing and investing activities:			
Net unrealized gain on available-for-sale securities	$ 2,248	$ 1,166	$ 3,297
Common stock issued in connection with business acquisition	$ -	$ 1,259	$ 2,351
Common stock issued in connection with conversion of convertible subordinated capital debentures	$ 437	$ 510	$ 349

See accompanying Notes to Consolidated Financial Statements.

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business: TowneBank (the "Company") was organized and incorporated under the laws of the Commonwealth of Virginia on September 1, 1998 and commenced operations on April 8, 1999. The Company, through its banking and non-banking subsidiaries, provides a diverse range of financial services and products throughout the Hampton Roads region.

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; TFA Benefits; Benefit Design Group, Inc.; and GSH Residential Real Estate Corporation ("GSH"). The accompanying consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP") 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.

Use of estimates: The preparation of consolidated financial statements in conformity with GAAP 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 of Richmond; required reserves were $864,000 at December 31, 2008 and 2007.

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's policy restricts the use of trading securities.

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. 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 our 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.

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 accelerated 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.

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. ("SFAS") 142, *Goodwill and Other Intangible Assets*. Additionally, under SFAS 142, acquired intangible assets are separately recognized if the benefit of the assets can be sold, transferred, licensed, rented, or exchanged, and amortized over their useful life.

Goodwill is tested for impairment at the reporting unit level 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.

Intangible assets are amortized or tested for impairment based on whether they have finite or indefinite lives. Intangibles that have finite lives are amortized on a straight-line basis over their useful life and tested for impairment whenever events or circumstances indicate the carrying amount of the assets may not be recoverable. Intangibles with indefinite lives are tested annually for impairment. Note 6 provides additional information related to goodwill and other intangibles.

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) an agreement to repurchase the transferred asset before its maturity does not exist.

Bank-Owned Life Insurance: The Company has purchased life insurance policies on the lives of certain officers. The policies are recorded as an asset at the cash surrender value of the policies. Increases or decreases in the cash surrender value, other than proceeds from death benefits, are recorded as noninterest income. Proceeds from death benefits first reduce the cash surrender value attributable to the individual policy and then any additional proceeds are recorded as noninterest income.

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: The Company enters into commitments to originate loans whereby the interest rate on the loan is determined prior to funding (rate lock commitments). As required by SFAS 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, 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.

Revenue recognition: Revenue earned on interest-earning assets is recognized based on the effective yield of the financial instrument.

Service charges on deposit accounts are recognized as charged. Credit-related fees, including letter of credit fees, are recognized in noninterest income when earned.

Insurance commission income is recorded as of the effective date of insurance coverage or the billing date, whichever is later. Contingent commissions are recognized when determinable, which is generally when such commissions are received or when the Company receives data from the insurance companies that allows the reasonable estimation of these amounts. The income effects of subsequent premium and fee adjustments are recorded when the adjustments become known.

Real estate commissions are earned by the Company's real estate brokerage business upon the closing of a real estate transaction (i.e., purchase or sale of a home). The real estate commissions are recorded net of commissions paid to real estate agents, which are recognized concurrently with the associated revenues.

The Company provides title and closing services, which include title search procedures for title insurance policies, home sale escrow, and other closing services. Title revenues, which are recorded net of amounts remitted to third-party insurance underwriters, and title and closing service fees are recorded at the time a home sale transaction or refinancing closes.

Fund servicing fees are primarily based on a percentage of the fair value of the fund assets serviced.

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 120 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 120 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.

Segment information: Operating segments as defined by SFAS 131, *Disclosures about Segments of an Enterprise and Related Information*, are components of an enterprise for which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. The accounting policies of operating segments are the same as those described elsewhere in this footnote. Revenue for all segments is derived from external sources. See Note 22 for further discussion of the Company's operating segments.

Mergers and acquisitions: Mergers and acquisitions are accounted for using the purchase method, as required by SFAS 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. See Note 2 for further discussion on the Company's mergers and acquisitions.

Income taxes: Income taxes are accounted for under the asset and liability method. 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. Note 18 provides additional information on the Company's income taxes.

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.

Share-based compensation: The Company has a share-based employee compensation plan, which is described in more detail in Note 12. The Company accounts for the plan using the fair value method, according to SFAS 123R, *Share-Based Payment*, 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 is measured based on the fair value of the instruments issued.

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. See Note 23 for further discussion on the Company's earnings per share.

Recent accounting pronouncements

On October 10, 2008, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position ("FSP") FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active.* The FSP clarifies the application of SFAS 157, *Fair Value Measurements*, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The FSP is effective upon issuance, including prior periods for which financial statements have not been issued. The provisions of FSP FAS 157-3 did not have an impact on the Company's consolidated financial position or results of operations.

In May 2008, the FASB issued SFAS 162, *The Hierarchy of Generally Accepted Accounting Principles*. SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles in the United States. This Statement is effective 60 days following the approval by the Securities and Exchange Commission of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles." The adoption of SFAS 162 is not expected to have a material impact on the Company's consolidated financial position and results of operation.

In March 2008, the FASB issued SFAS 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of SFAS 133*. The standard requires enhanced disclosures about derivative instruments and hedged items that are accounted for under SFAS 133 and related interpretations. The standard will be effective for periods beginning after November 15, 2008, with early adoption permitted. The standard expands the disclosure requirements for derivatives and hedged items and is not expected to have a material impact on the Company's consolidated financial position and results of operations.

In December 2007, the FASB issued SFAS 141(R), *Business Combinations*, which replaces SFAS 141, *Business Combinations*. This statement establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree as well as the goodwill acquired in the business combination or a gain from a bargain purchase. SFAS 141(R) also establishes disclosure requirements which will enable users to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact of the adoption of SFAS 141(R) on the Company's consolidated financial position and results of operations.

In December 2007, the FASB issued SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements – an Amendment of ARB No. 51*, which establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS 160 also establishes expanded disclosure requirements that clearly identify and distinguish between the interest of the parent's owners and the interests of the noncontrolling owners of a subsidiary. SFAS 160 is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 160 on the Company's consolidated financial position and results of operations.

Effective January 1, 2008, the Company adopted SFAS 157, *Fair Value Measurements* and SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 157 defines fair value, establishes a framework for measuring fair value under GAAP, and enhances disclosures about fair value measurements. Fair value is defined under SFAS 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 159 allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. The adoption of SFAS 157 and SFAS 159 did not have a material impact on the Company's consolidated results of operations and financial position. For additional information on the fair value of certain financial assets and liabilities, see Note 17 to the Consolidated Financial Statements.

NOTE 2: MERGERS AND ACQUISITIONS

Corolla Companies: Effective January 3, 2008, TowneBank acquired both Corolla Classic Vacations, a resort property management company, and Corolla Real Estate, a realty company (the "Corolla companies"). The acquisition was accounted for as a business combination under the purchase method of accounting and, as such, the assets and liabilities of the Corolla companies were recorded at their respective fair values as of the acquisition date. The results of operations of the Corolla companies were included in the Company's Consolidated Statements of Income commencing January 3, 2008. The purchase price was $7.2 million in cash, including transaction costs. The allocation of the purchase price resulted in tangible assets of $1.6 million, goodwill of $3.3 million, and other intangible assets, including customer lists and non-compete agreements of $2.3 million.

B. Martin Weber, Inc.: On May 31, 2007, Towne Insurance acquired most of the assets and operations of B. Martin Weber, Inc. ("Weber"), a group benefits agency. The acquisition was accounted for as a business combination under the purchase method of accounting and, as such, the assets and liabilities of Weber were recorded at their respective fair values as of the acquisition date. The results of operations of Weber were included in the Company's Consolidated Statements of Income commencing May 31, 2007. The purchase price for Weber was $2.53 million in cash and common stock, including transaction costs. The major components of the purchase price are intangible assets, including customer lists and non-competes of $1.79 million, and goodwill of $706,000. The remaining $30,000 includes tangible assets acquired.

The Frieden Agency, Inc.: Towne Insurance acquired The Frieden Agency, Inc. ("Frieden"), an employee benefits provider, on January 1, 2007. The acquisition was accounted for as a business combination under the purchase method of accounting and, as such, the assets and liabilities of Frieden were recorded at their respective fair values as of the acquisition date. The results of operations of Frieden were included in the Company's Consolidated Statements of Income commencing January 1, 2007. The purchase price was $8 million in cash, including transaction costs. The allocation of the purchase price resulted in the recording of $3.13 million in goodwill and $5.14 million in intangible assets.

Brooks Agency, Inc.: On January 9, 2006, TowneBank announced the addition of the Brooks Agency, Inc. ("Brooks"), as a division of Towne Insurance. The acquisition was accounted for as a business combination under the purchase method of accounting and, as such, the assets and liabilities of Brooks were recorded at their respective fair values as of the acquisition date. The results of operations of Brooks were included in the Company's Consolidated Statements of Income commencing January 9, 2006. Brooks was an independent insurance agency operating in Williamsburg, Virginia and serving customers throughout Hampton Roads. Through this acquisition, the Company added to its existing insurance and bond services. The aggregate purchase price of $2.35 million 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 our common shares. Including other capitalized merger costs and $189,000 in net assets acquired, the Company recorded $1.54 million in goodwill and $678,000 in intangible assets.

These acquisitions, when considered individually or in aggregate under relevant disclosure guidance, do not require the presentation of separate pro forma financial information.

NOTE 3: INVESTMENT SECURITIES

Available-for-sale securities

The following chart indicates the amortized cost and fair values of available-for-sale securities for the periods indicated (in thousands).

December 31, 2008	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
U.S. agency securities	$ 70,002	$ 1,530	$ -	$ 71,532
U.S. Treasury notes	77,000			77,000
Municipal securities	12,341	93	(598)	11,836
Total debt securities	159,343	1,623	(598)	160,368
Other investments	7,126	-	(764)	6,362
Federal Home Loan Bank stock	20,877	-	-	20,877
Collateralized mortage-backed obligations				-
Mortgage-backed securities	153,746	6,389	(2)	160,133
Total equity securities	181,749	6,389	(766)	187,372
Total available-for-sale securities	$ 341,092	$ 8,012	$ (1,364)	$ 347,740

December 31, 2007	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
U.S. agency securities	$ 125,760	$ 1,227	$ (13)	$ 126,974
Municipal securities	2,740	119	-	2,859
Corporate obligations	-	-	-	-
Total debt securities	128,500	1,346	(13)	129,833
Other investments	161	-	(75)	86
Federal Home Loan Bank stock	17,305	-	-	17,305
Mortgage-backed securities	131,274	1,950	(20)	133,204
Total equity securities	148,740	1,950	(95)	150,595
Total available-for-sale securities	$ 277,240	$ 3,296	$ (108)	$ 280,428

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, 2008, proceeds from securities available for sale were $159.14 million and resulted in realized gains of $2.96 million. For the years ended December 31, 2007 and 2006, proceeds from securities available for sale amounted to $0, excluding prepayments related to mortgage-backed securities, and $168.93 million, and resulted in gains of $70,000 and losses of $1.74 million, respectively.

Held-to-maturity securities

The amortized cost and fair values of held-to-maturity investment securities for the periods indicated (in thousands).

December 31, 2008	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	$ -	$ -	$ -	$ -
Trust Preferred	9,357	709	(1,378)	8,688
Municipal bonds	20,970	368	(434)	20,904
Industrial revenue bonds	87,033	186	-	87,219
Total held-to-maturity securities	$ 117,360	$ 1,263	$ (1,812)	$ 116,811

December 31, 2007	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	$ 2,001	$ 25	$ -	$ 2,026
Trust Preferred	5,524	474	-	5,998
Municipal bonds	16,863	60	(56)	16,867
Industrial revenue bonds	75,328	-	(1,952)	73,376
Total held-to-maturity securities	$ 99,716	$ 559	$ (2,008)	$ 98,267

Maturities of investment securities

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. The amortized cost and estimated fair value of investment securities are shown by contractual maturity (including mortgage-backed securities) in the following tables (in thousands).

December 31, 2008	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 77,237	$ 77,236	$ 7,128	$ 7,111
Due after one year through five years	50,787	51,820	17,898	17,804
Due after five years through 10 years	11,751	12,018	12,703	12,644
Due after 10 years	180,310	185,733	79,631	79,252
	320,085	326,807	117,360	116,811
Federal Home Loan Bank stock	20,877	20,877	-	-
Other equity securities	130	56	-	-
	$ 341,092	$ 347,740	$ 117,360	$ 116,811

December 31, 2007	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 272	$ 271	$ 9,913	$ 9,929
Due after one year through five years	63,309	63,486	19,679	19,390
Due after five years through 10 years	51,317	51,941	11,592	11,285
Due after 10 years	144,876	147,339	58,532	57,663
	259,774	263,037	99,716	98,267
Federal Home Loan Bank stock	17,305	17,305	-	-
Other equity securities	161	86	-	-
	$ 277,240	$ 280,428	$ 99,716	$ 98,267

Pledged securities

At December 31, 2008 and 2007, the Company had investment securities with carrying values of $84.72 million and $76.19 million, respectively, pledged to secure federal, state, and municipal deposits. Additionally, the Company had no investment securities pledged to secure borrowings from the Federal Reserve Bank of Richmond ("FRB") at December 31, 2008. Comparatively, the Company had $10.07 million in investment securities pledged to secure borrowings from the FRB at December 31, 2007. The Company also had $49.90 million in investment securities pledged against repurchase agreements with commercial customers at December 31, 2008, compared to $55.47 million at December 31, 2007.

Reconciliation to net unrealized gains

The following table reconciles the reclassification adjustment and the tax effect component of other comprehensive income to net unrealized gains for the years ended December 31 (in thousands):

	2008	2007	2006
Unrealized gains on securities:			
Unrealized holding gains arising during the period	$ 6,396	$ 1,843	$ 3,332
Other than temporary impairment of available-for-sale securities	23	20	-
Reclassification adjustment for (gains) losses on available-for-sale securities included in income	(2,960)	(70)	1,740
Total other comprehensive income before income tax expense	3,459	1,793	5,072
Income tax expense	(1,211)	(627)	(1,775)
Net unrealized gains	$ 2,248	$ 1,166	$ 3,297

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 for the periods indicated (in thousands).

December 31, 2008	**Less than 12 months**		**12 months or more**		**Total**	
Description of Securities	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
Municipal securities	$ 17,567	$ 1,006	$ 976	$ 26	$ 18,543	$ 1,032
Federal agency mortgage-backed securities	235	1	54	1	289	2
Corporate obligations	9,712	2,068	-	-	9,712	2,068
Total temporarily impaired securities	$ 27,514	$ 3,075	$ 1,030	$ 27	$ 28,544	$ 3,102

December 31, 2007	**Less than 12 months**		**12 months or more**		**Total**	
Description of Securities	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
U.S. Treasury obligations and direct obligations of U.S. government agencies	$ 24,987	$ 13	$ -	$ -	$ 24,987	$ 13
Municipal securities	-	-	11,558	56	11,558	56
Federal agency mortgage-backed securities	-	-	1,530	20	1,530	20
Subtotal, debt securities	24,987	13	13,088	76	38,075	89
Other investments, including common stock	-	-	29	75	29	75
Total temporarily impaired securities	$ 24,987	$ 13	$ 13,117	$ 151	$ 38,104	$ 164

U.S. Treasury obligations

The Company did not have any unrealized losses on investments in U.S. Treasury obligations and direct obligations of U.S. government agencies at December 31, 2008.

Municipal securities

The Company's unrealized losses on municipal securities were caused by interest rate fluctuations. At December 31, 2008, 27 securities experienced total unrealized losses of $1.03 million. 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, 2008, two securities experienced total unrealized losses of $2,000. 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's unrealized losses on corporate obligations were caused by interest rate fluctuations. At December 31, 2008, six securities experienced total unrealized losses of $2.07 million. 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.

Other investments, including common stock

At December 31, 2008, one equity security experienced a total unrealized loss of $74,000. This loss was the result of fluctuating market conditions in the local economy. The Company monitors this security and has the ability and intent to hold the investment to allow for an anticipated recovery.

NOTE 4: LOANS AND ALLOWANCE FOR LOAN LOSSES

The Company grants commercial, real estate, and consumer loans to customers throughout our lending area. Although the Company has a diversified loan portfolio, a substantial portion of the Company's debtors' abilities to honor their contracts is dependent upon the economic environment of the lending area. Of total loans, $642.75 million were pledged as collateral to secure overnight borrowings with the FHLB, and $164.02 million were pledged to secure borrowings from the discount window at the FRB at December 31, 2008.

A summary of loan balances by major classification (in thousands).

December 31,	2008	2007
Real estate loans		
Residential 1-4 family	$ 589,075	$ 439,676
Commercial	737,244	561,341
Construction	617,390	522,780
Multifamily	30,079	27,515
Total real estate loans	1,973,788	1,551,312
Commercial loans	329,716	218,082
Consumer installment loans		
Personal installment	27,752	42,702
Credit cards and revolving credit	18,890	17,360
Total consumer installment loans	46,642	60,062
Agriculture loans	40	-
Loans, net of unearned income and deferred costs	$ 2,350,186	$ 1,829,456

Unearned loan income was $939,000 in excess of deferred loan costs at December 31, 2008 and $727,000 at December 31, 2007. There were $2.82 million and $726,000 in nonaccrual loans at December 31, 2008 and 2007. The Company would have earned $38,000 in 2008 and $124,000 in 2007 if interest on the loans had been accrued.

(continued on next page)

Transactions affecting the allowance for loan losses (in thousands).

Years Ended December 31,	2008	2007	2006
Balance, beginning of year	$ 21,323	$ 19,670	$ 17,071
Loans charged off			
Residential 1-4 family	(385)	(474)	(7)
Construction	(22)	-	(6)
Commercial	(279)	(409)	(153)
Consumer	(284)	(285)	(48)
Total	(970)	(1,168)	(214)
Loans recovered			
Residential 1-4 family	7	2	32
Construction	-	-	-
Commercial	89	50	176
Consumer	32	26	33
Total	128	78	241
Net loans recovered (charged off)	(842)	(1,090)	27
Provision for loan losses	7,022	2,743	2,572
Balance, end of year	$ 27,503	$ 21,323	$ 19,670

It is the opinion of management that the allowance was adequate at December 31, 2008 based on conditions reasonably known to them; 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.

NOTE 5: PREMISES, EQUIPMENT, AND LEASES

A summary of the cost and accumulated depreciation of premises and equipment is as follows (in thousands).

December 31,	2008	2007
Land and improvements	$ 16,539	$ 13,304
Buildings and improvements	32,451	31,544
Autos	2,947	2,820
Computer and communication equipment	7,035	6,219
Equipment	8,041	8,460
Furniture and fixtures	19,448	17,881
Leasehold improvements	14,553	13,266
Construction in progress	2,496	738
	103,510	94,232
Less accumulated depreciation	(24,519)	(19,301)
Net premises and equipment	$ 78,991	$ 74,931

Depreciation and leasehold amortization expense for the years ended December 31, 2008, 2007, and 2006 was $5.97 million, $4.94 million, and $4.38 million, respectively.

Various facilities and equipment are leased under noncancellable operating leases with initial remaining terms in excess of one year and an option for renewal. 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 $4.20 million for 2008, compared to $4.00 million for 2007, and $3.75 million for 2006. Future minimum lease payments, by year and in the aggregate, under noncancellable operating facilities leases at December 31, 2008 are listed in the following chart (in thousands).

2009	$	4,498
2010	$	4,398
2011	$	4,213
2012	$	4,216
2013	$	4,028
Thereafter	$	16,902
	$	38,255

Rental income for the year ended December 31, 2008 was $338,000, compared to $282,000 for 2007 and $260,000 for 2006. Future minimum rental income, by year and in the aggregate, under noncancellable operating leases, was as follows at December 31, 2008 (in thousands).

2009	$	139
2010	$	119
2011	$	97
2012	$	42
2013	$	42
Thereafter	$	2,213
	$	2,652

(continued on next page)

NOTE 6: GOODWILL AND INTANGIBLE ASSETS

The gross carrying amount and accumulated amortization for the Company's intangible assets (in thousands).

	December 31,			
	2008		2007	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Intangible assets subject to amortization				
Core deposit intangible	$ 3,677	$ 2,134	$ 3,677	$ 1,689
Non-compete agreements	1,651	803	1,376	464
Property management contracts	620	620	620	492
Customer lists	6,811	1,360	4,814	643
Total intangible assets subject to amortization	12,759	4,917	10,487	3,288
Intangible assets not subject to amortization				
Title plant	428	-	805	-
Trade names	334	-	500	-
Contractual agreements	3,231	-	3,231	-
Total intangible assets not subject to amortization	3,993	-	4,536	-
Total intangible assets	$ 16,752	$ 4,917	$ 15,023	$ 3,288

The aggregate amortization expense for intangible assets with finite lives for the year ended December 31, 2008 was $1.53 million, compared to $1.14 million for 2007 and $902,000 for 2006. The estimated aggregate annual amortization expense for each of the five years subsequent to December 31, 2008 are as follows: 2009, $1.34 million; 2010, $1.11 million; 2011, $906,000; 2012, $837,000; and 2013, $775,000.

During 2008, the Company recorded $3.86 million in goodwill and $2.27 million in intangible assets. This represents acquisitions of the Corolla companies in 2008 and certain other adjustments to goodwill. The intangible assets acquired are finite-lived assets consisting of non-compete agreements and customer lists, which are amortized over four- and eight-year periods, respectively. The majority of these assets are included in the Company's Realty segment.

During 2008 and 2007, the Company recorded $376,000 and $134,000, respectively, of impairment charges for the title plant due to obsolescence. Also during 2007, the Company recorded $5.09 million in goodwill and $7.21 million in intangible assets primarily for the acquisition of benefit agencies. The intangible assets included contracts with an indefinite life and other intangibles with defined lives. These finite-lived assets include customer lists and non-compete agreements, which are both amortized over eight years. These assets are included in the Insurance segment.

Impairment testing indicated that goodwill was not impaired in 2008 or 2007. Changes in the carrying amount of goodwill related to each of the Company's segments are as follows (in thousands).

	Bank	Realty	Insurance	Consolidated Totals
Balance, December 31, 2006	$ 44,363	$ 4,833	$ 2,049	$ 51,245
Additions to goodwill	1,157	-	3,932	5,089
Balance, December 31, 2007	45,520	4,833	5,981	56,334
Additions to goodwill	-	3,362	502	3,864
Balance, December 31, 2008	$ 45,520	$ 8,195	$ 6,483	$ 60,198

NOTE 7: BANK-OWNED LIFE INSURANCE POLICIES

During the fourth quarter of 2007, the Company invested $36 million in bank-owned life insurance policies with the intent to fund a newly created Supplemental Executive Retirement Plan ("SERP") for certain executives. The SERP, which was implemented in the fourth quarter of 2008, as discussed in Note 11, provides retirement benefits and postretirement health benefits to the executives covered under the plan.

NOTE 8: DEPOSITS

A summary of time deposits by maturity at December 31, 2008 is shown in the following chart (dollars in thousands).

Maturity	Total
2009	$ 823,265
2010	234,616
2011	105,119
2012	23,128
2013 and thereafter	27,694
	$ 1,213,822

At year-end 2008, TowneBank had a total of $396.41 million in no-penalty time deposits as compared to $685.76 million for 2007. Some of the Company's officers and directors and the respective companies in which the officers and directors have a financial interest have deposit relationships with the Company. Related party deposits amounted to approximately $34.68 million and $33.62 million at December 31, 2008 and 2007, respectively.

NOTE 9: BORROWINGS

TowneBank is a member of the FHLB 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. The borrowing arrangements available from the FHLB could be either short- or long-term, depending on our related cost and needs.

Advances from the FHLB for the years ended December 31 are summarized as follows (dollars in thousands).

	2008	2007
Balance outstanding at end of year	$ 363,877	$ 296,665
Average balance outstanding	$ 337,548	$ 261,044
Maximum outstanding at any month-end	$ 363,892	$ 296,782
Average interest rate during the year	4.40%	4.66%
Average interest rate at end of year	4.25%	4.49%

The scheduled maturity dates, call dates, and related fixed interest rates on advances from the FHLB at December 31, 2008 are summarized as follows (dollars in thousands).

Maturity Date	Interest Rate	Call Date	Outstanding Amount
02/09/2010	6.45%	02/09/2009	$ 25,000
11/10/2010	5.43%	02/10/2009	8,000
06/29/2011	5.17%	-	877
07/15/2011	3.25%	7/15/2010	50,000
03/16/2017	4.08%	03/06/2009	100,000
05/18/2017	4.35%	05/18/2009	80,000
05/18/2017	4.48%	05/18/2010	80,000
01/29/2018	3.05%	01/30/2012	13,000
01/29/2018	3.05%	01/30/2012	7,000
			$ 363,877

Total interest expense on FHLB advances for the years ended December 31, 2008, 2007, and 2006 was $14.84 million, $12.39 million, and $4.69 million, respectively.

Information concerning securities sold under agreements to repurchase and federal funds purchased is summarized as follows (dollars in thousands).

	2008	2007
Balance outstanding at end of year	$ 36,248	$ 36,660
Average balance outstanding	$ 47,509	$ 28,173
Maximum outstanding at any month-end	$ 69,268	$ 37,046
Average interest rate during the year	1.82%	5.01%
Average interest rate at end of year	0.53%	3.80%

Repurchase agreements totaled $36.25 million at December 31, 2008. They 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. In addition, federal funds lines with other financial institutions were available at December 31, 2008 for short-term funding needs. Federal funds purchased are overnight, unsecured borrowings.

At December 31, 2008 and 2007, the Company had $576.40 million and $453.67 million, respectively, unused line of credit with the FHLB. The FHLB advances are secured by a blanket floating lien on certain 1-

4 family residential, multifamily, HELOCS, second mortgages, and commercial mortgages with carrying values of $642.75 million at December 31, 2008.

Further, the Company had loan participation lines and reverse repurchase agreements with various financial institutions available at December 31, 2008, which provide potential additional funding.

The Company has three different convertible subordinated capital debentures: (1) Series I Towne Investment Note, (2) assumed obligation of the Harbor Bank Bonds, and (3) Series II Towne Investment Note. At year-end 2008, all three debentures accrued and paid interest. Collectively, interest expense on the debentures for the year ended December 31, 2008 was $2.17 million. Total convertible subordinated capital debentures at December 31, 2008 were $40.88 million and included a convertible debenture premium of $198,000 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 2008, the Company had $21.15 million in Series I convertible subordinated notes. The Company may redeem the notes in whole or in part after May 15, 2009 at its 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, Harbor Bank, which was acquired by the Company in 2004, 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 and $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.

In connection with the acquisition of Harbor Bank in 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 2008, the Company had $3.48 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 (“6.25% Note”) in the principal amount of $1,000.

The 6.25% 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 2008, the Company had $16.04 million in Series II convertible subordinated notes. The Company may redeem the notes in whole or in part after November 15, 2009 at its option and with the approval of the FDIC at 100% of the principal amount, together with accrued interest to the date of redemption.

NOTE 10: COMMITMENTS

TowneBank 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."

Our 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.

Our contractual amounts are as follows (in thousands).

December 31,	**2008**	**2007**
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	$ 914,624	$ 992,061
Standby letters of credit	30,677	21,700
	$ 945,301	$ 1,013,761

Commitments to extend credit are agreements to lend to a customer as long as there is not a 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 to guarantee performance of a customer to a third party. The letters of credit are primarily issued to support public and private borrowing arrangements. 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. The Company provides an allowance for estimated losses from such provisions that management considered adequate at December 31, 2008. Management does not anticipate any material losses will arise from additional disbursements of the aforementioned lines or standby letters of credit.

NOTE 11: RETIREMENT PLANS

Defined Contribution Plan

The Company has a defined contribution 401(k) plan. All employees who are at least 18 years of age and have completed one quarter of a year of service are eligible to participate. Under the plan, employees may contribute a percentage of their annual salary, subject to statutory limitations, and the Company will match 100% of the employees' contributions up to 6% of their salary. The Company may also make an additional discretionary contribution; there were no discretionary contributions for the years ended December 31, 2008, 2007, and 2006.

The Company made matching contributions of $2.11 million, $2.22 million, and $2.05 million for the years ended December 31, 2008, 2007, and 2006, respectively. The Company's matching contribution is in the form of the Company's stock, which the Company purchases on the open market at the prevailing rates.

Supplemental Executive Retirement Plan

On December 1, 2008, the Company implemented a noncontributory, unfunded Supplemental Executive Retirement Plan ("SERP") for certain officers and key employees. The SERP is intended to provide retirement benefits and postretirement health benefits to the individuals covered under the plan. The Company recorded net periodic pension cost of the SERP of $245,000 for the year ending December 31, 2008, all of which consisted of service cost. The benefit obligation and the accumulated benefit obligation were $245,000 and $203,000, respectively, at December 31, 2008.

The Company used certain weighted average assumptions to determine benefit obligations and net benefit costs, including discount rate and rate of increase in future compensation levels. The discount rate used to determine net periodic benefit cost and benefit obligation was 5.75% in 2008. The rate of increase in future compensation levels used for 2008 was 4.00%. The discount rate assumption used was a blended rate based on the Moody's Aa rate and the Citigroup Liability Pension Curve.

The following table sets forth expected future benefit payments, which reflect expected future service, for the periods indicated (in thousands).

Year	SERP
2009	$ -
2010	-
2011	-
2012	651
2013	651
2014 - 2018	6,019

NOTE 12: SHARE-BASED COMPENSATION

The Company maintains a share-based compensation plan ("Plan") that provides for the granting of incentive and non-statutory stock options and restricted common stock. The Plan is administered by the Compensation and Benefits Committee of the Board of Directors (the "Compensation Committee"). The maximum number of shares reserved under the Plan is equal to 20% of the fully diluted number of shares of the Company's common stock outstanding or such lesser number of shares as the Compensation Committee shall define. The Company has a policy of using authorized and unissued common shares to satisfy share option exercises and vesting of restricted stock awards. At December 31, 2008, approximately 2.44 million common shares were available for issuance under the Plan.

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 contractual 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 tables summarize our stock option activity and related information.

For the Year Ended December 31,	2008		2007		2006	
	Number	Weighted-Average Exercise Price	Number	Weighted-Average Exercise Price	Number	Weighted-Average Exercise Price
Options outstanding, beginning balance	1,301,678	$10.44	1,394,626	$ 10.44	1,885,359	$ 8.29
Granted	104,500	17.86	110,950	19.17	72,472	21.01
Exercised	(159,111)	3.71	(160,808)	3.72	(466,170)	3.45
Forfeited	(57,404)	20.46	(43,090)	17.49	(97,035)	10.15
Options outstanding, ending balance	1,189,663	$12.97	1,301,678	$11.78	1,394,626	$10.44
Options exercisable at December 31,	727,126	$ 9.99	816,191	$ 8.20	877,311	$ 6.33

	Number	Weighted-Average Exercise Price
Unvested stock options, December 31, 2007	485,487	$17.80
Granted	104,500	17.86
Vested	(89,137)	17.26
Forfeited	(38,313)	20.69
Unvested stock options, December 31, 2008	462,537	$17.67

For the years ended December 31, 2008, 2007, and 2006, the weighted-average fair value of stock options granted was $5.19, $8.48, and $9.13, respectively. For the same periods, the total intrinsic value of options exercised was $2.49 million, $2.41 million, and $7.75 million, respectively. Additional information pertaining to options outstanding at December 31, 2008 is as follows.

	Number	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted-Average Remaining Contractual Life
Options outstanding	1,189,663	$ 12.97	$ 14,056,716	4.28 years
Options vested or expected to vest	1,163,528	$ 12.86	$ 13,879,527	4.21 years
Options exercisable	727,126	$ 9.99	$ 10,764,431	2.81 years

The grant-date fair value of each option grant is estimated using the Black-Scholes option pricing model. Use of a valuation model requires management to make certain assumptions with respect to selected model inputs. Expected volatility was calculated based on the historical volatility of the Company's stock over the most recent period of time equal to the expected term of the option. The average expected life was based on the contractual term of the option and expected employee exercise and post-vesting employment termination behavior based on historical patterns. The risk-free interest rate is based on U.S. Treasury zero-coupon issues with a remaining term equal to the expected life assumed at the date of grant. Forfeitures are estimated based on historical voluntary termination behavior.

The following table summarizes the assumptions used for the following years.

Years Ended December 31,	2008	2007	2006
Dividend yield	1.69%	0.60%	0.60%
Expected life	7.0 years	8.6 years	8.6 years
Expected volatility	27.0%	26.9%	28.2%
Risk-free interest rate	3.27%	4.12%	4.07%

Cash received from exercises of stock options for the year ended December 31, 2008 was $533,000. The tax benefit realized for the tax deductions from stock option exercises for the year ended December 31, 2008 was $414,000 compared to $172,000 for 2007 and $1.30 million for 2006. Compensation expense related to stock options for the years ended December 31, 2008, 2007, and 2006 was $165,000, $766,000, and $740,000, respectively. As of December 31, 2008, there was $2.17 million of total unrecognized compensation cost related to unvested stock option awards; that cost is expected to be recognized over a period of 5.56 years.

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 generally 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. The following chart shows a summary of the restricted stock award activity and related information, assuming the weighted-average price being the weighted-average fair value at the date of grant for the year ended December 31, 2008.

	Number	Weighted-Average Price
Unvested RSAs, beginning balance	162,711	$ 12.73
Granted	19,617	17.67
Vested	(66,494)	11.73
Forfeited	(7,360)	21.70
Unvested RSAs, ending balance	108,474	$ 13.63

Compensation expense related to the awards for the years ended December 31, 2008, 2007, and 2006 was $683,000, $763,000, and $762,000, respectively. The total fair value of awards vested during 2008, 2007, and 2006 was $780,000, $768,000, and $780,000, respectively. As of December 31, 2008, there was $1.05 million of total unrecognized compensation cost related to unvested restricted stock awards; that cost is expected to be recognized over a period of 3.33 years.

NOTE 13: STOCK PURCHASE PLAN, DIVIDEND REINVESTMENT PLAN, AND DIVIDEND RESTRICTIONS

The Board of Directors approved and adopted the Member Stock Purchase and Dividend Reinvestment Plan to raise additional capital by providing a convenient and cost-effective way for shareholders, customers, and employees to purchase shares of TowneBank common stock. For the year ended December 31, 2008, the Company did not issue any shares in connection with the monthly stock purchase plan. Instead the Company entered the open market and acquired 195,587 shares at an average price of $18.09 per share. For the year ended December 31, 2008, the Company issued 255,572 shares in connection with the dividend reinvestment plan at an average price of $17.49 per share.

TowneBank, as a Virginia banking corporation, may pay cash dividends only out of retained earnings. In January 2006, the Company declared a special shareholder cash dividend bonus of $0.23 per common share. In November 2006, the Company declared a special shareholder cash dividend bonus of $0.30 per common share paid in January 2007. The total dividend paid was $7.13 million. In 2008 and 2007, the Company declared quarterly cash dividends of $0.08 per common share. The quarterly dividends were paid on April 16, 2007; July 16, 2007; October 11, 2007; January 10, 2008; April 10, 2008; July 10, 2008; October 10, 2008; and January 9, 2009.

Declaration of future cash dividends will depend on our earnings, our capital position, and other factors. All dividends paid are limited by the requirement to meet capital guidelines issued by regulatory authorities, and future declarations are subject to financial performance and regulatory requirements.

NOTE 14: OTHER EXPENSES

The following chart shows a summary of other expenses (in thousands).

Year Ended December 31,	2008	2007	2006
Advertising and marketing	$ 2,908	$ 4,621	$ 3,316
Charitable contributions	2,012	1,726	1,289
Telephone and postage	2,254	1,910	1,777
Outside processing	2,093	1,860	1,601
Professional fees	1,617	1,792	1,421
Other	1,345	1,741	1,166
Stationery and office supplies	1,458	1,707	1,712
Amortization of intangible assets	2,488	1,591	1,169
FDIC and other insurance	1,622	1,536	623
Software expense	2,028	1,363	1,057
Travel/meals/entertainment	549	1,107	963
Directors' expense	1,436	1,056	1,326
Bank franchise tax/SCC fees	1,174	848	963
	$ 22,984	$ 22,858	$ 18,383

NOTE 15: 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 the Company's 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 of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. Management believes, as of December 31, 2008, that the Company meets all capital adequacy requirements to which it is subject.

As of December 31, 2008, the most recent notification from the FDIC 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 our category.

A summary of our required and actual capital components follows (dollars in thousands).

As of December 31, 2008	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)	$ 411,971	15.43%	$ 213,632	8.00%	$ 267,040	10.00%
Tier 1 capital (to risk-weighted assets)	$ 343,590	12.87%	$ 106,816	4.00%	$ 160,224	6.00%
Tier 1 leverage ratios (to average assets)	$ 343,590	11.59%	$ 118,618	4.00%	$ 148,272	5.00%

As of December 31, 2007	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)	$ 249,621	11.34%	$ 176,079	8.00%	$ 220,099	10.00%
Tier 1 capital (to risk-weighted assets)	$ 186,629	8.48%	$ 88,040	4.00%	$ 132,060	6.00%
Tier 1 leverage ratios (to average assets)	$ 186,629	7.68%	$ 97,196	4.00%	$ 121,495	5.00%

Preferred Stock

In August 2008, the Company issued 598,542 shares of 8% Non-Cumulative Convertible Preferred Stock, Series A (the "Series A Preferred Stock"), at a price of $100 per share. The Series A Preferred Stock will pay a non-cumulative dividend of 8% per year. Dividends are payable quarterly in cash when as, and if, declared by the Board of Directors, on the first days of March, June, September and December, commencing on December 1, 2008. Dividends on the Series A Preferred Stock began accruing August 15, 2008.

Each share of the Series A Preferred Stock may be converted at any time, at the option of the holder, into shares of common stock equal to the purchase price divided by $18.56 ("conversion price"). On or after September 11, 2011, the Company may cause some or all of the outstanding shares of the Series A Preferred Stock, at its option, at any time or from time to time, to be converted into shares of common stock if, for 20 trading days during any period of 30 consecutive trading days, the closing price of common stock exceeds 120% of the then-applicable conversion price. On September 1, 2013, all of the then outstanding shares of the Series A Preferred Stock will automatically convert into common shares without regard to the then market price of the common stock.

In December 2008, under the U.S. Treasury's TARP Capital Purchase Program, the Company issued to the U.S. Treasury 76,458 shares of Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Stock"), and a ten-year warrant to purchase 538,184 common shares at an exercise price of $21.31 per share, for aggregate proceeds of $76.46 million. The value of the warrants was recorded as $4.14 million and is included on the balance sheet in capital surplus. Non-cumulative dividends on the Series B Preferred Stock are payable at a rate of 5% annually through February 14, 2013 and at a rate of 9% annually thereafter.

NOTE 16: DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

SFAS No. 107, *Disclosures About Fair Value of Financial Instruments*, 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 our underlying value.

The following methods and assumptions were used in estimating fair value for our 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 is 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 FHLB: The fair value of advances from the FHLB is determined using the discounted cash flow method with the discount rate being 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: The carrying amount approximates fair value.

Federal funds purchased: The carrying amount approximates fair value.

Commitments to extend and standby letters of credit: These financial instruments are generally not sold or traded. The estimated fair values of off-balance-sheet credit commitments, including standby letters of credit and guarantees written, are not readily available 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 our financial instruments required to be disclosed under SFAS 107 are as follows (in thousands).

Year Ended December 31,	2008		2007	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Cash and due from banks	$ 67,279	$ 67,279	$ 33,400	$ 33,400
Interest-bearing deposits in financial institutions	2,467	2,467	35,935	35,935
Federal funds sold	20,000	20,000	-	-
Securities available for sale	347,740	347,740	280,428	280,428
Securities held to maturity	117,360	116,811	99,716	98,267
Mortgage loans held for sale	25,884	25,884	22,953	22,953
Loans, net	2,322,683	2,357,416	1,808,133	1,796,136
Interest receivable	10,748	10,748	11,062	11,062
Deposits	2,238,668	2,161,120	1,834,346	1,835,280
Advances from the Federal Home Loan Bank of Atlanta	363,877	386,748	296,665	309,545
Convertible subordinated capital debentures	40,878	37,681	41,669	38,745
Repurchase agreements and other borrowings	36,248	36,248	36,660	36,660
Interest payable	8,896	8,896	6,500	6,500

NOTE 17: FAIR VALUE

Effective January 1, 2008, the Company adopted SFAS 157, which provides a framework for measuring fair value under GAAP. As described more fully below, SFAS 157 also eliminated the deferral of gains and losses at inception of certain derivative contracts whose fair value was not evidenced by market observable data. SFAS 157 requires that the impact of this change in accounting for derivative contracts be recorded as an adjustment to beginning retained earnings in the period of adoption.

The Company also adopted SFAS 159 on January 1, 2008. SFAS 159 allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. SFAS 159 requires that the difference between the carrying value before election of the fair value option and the fair value of these instruments be recorded as an adjustment to beginning retained earnings in the period of adoption. The Company has not elected to adopt the fair value option for any financial instruments.

FAIR VALUE MEASUREMENT

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted prices that are traded less frequently than exchange-traded instruments and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. This category generally includes U.S. Government and agency mortgage-backed debt securities, corporate debt securities, derivative contracts and residential mortgage loans held for sale.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category generally includes certain private equity investments, retained residual interests in securitizations, residential mortgage servicing rights, asset-backed securities, and highly structured or long-term derivative contracts.

Assets and liabilities measured at fair value on a recurring basis, including financial instruments for which the Company has elected the fair value option, are summarized below (in thousands).

	Fair Value Measurements Using			Assets/Liabilities at Fair Value
	Level 1	Level 2	Level 3	
Available-for-sale securities	$8	$347,732	-	$347,740

Certain assets and liabilities are measured at fair value on a non-recurring basis and, therefore, are not included in the tables above. These include assets such as loans held for sale that are measured at the lower of cost or market, goodwill, and other intangible assets. There were no fair value adjustments to assets and liabilities measured at fair value on a non-recurring basis during the year ended December 31, 2008.

NOTE 18: INCOME TAXES

The provision for income taxes charged to operations is listed in the following chart (in thousands).

For the Year Ended December 31,	2008	2007	2006
Current income tax expense	$ (11,607)	$ (12,226)	$ (11,314)
Deferred income tax benefit	2,856	1,402	852
Income tax expense	$ (8,751)	$ (10,824)	$ (10,462)

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

	2008		2007		2006	
For the Year Ended December 31,	$	Rate	$	Rate	$	Rate
Federal income tax expense at statutory rate	$ (11,426)	(35.00%)	$ (11,929)	(35.00%)	$ (11,287)	(35.00%)
State income tax expense, net of federal benefit	(31)	(0.09%)	(36)	(0.11%)	(75)	(0.23%)
Tax advantaged income	1,985	6.08%	1,139	3.34%	498	1.54%
Tax credits	542	1.66%	542	1.59%	663	2.06%
Other	179	0.54%	(540)	(1.58%)	(261)	(0.81%)
Income tax expense	$ (8,751)	(26.81%)	$ (10,824)	(31.76%)	$ (10,462)	(32.44%)

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. Management believes it is more likely than not that the Company will realize the benefits of the Company's deferred tax assets. Significant components of deferred tax assets and deferred tax liabilities follow (in thousands).

Year Ended December 31,	2008	2007
Deferred tax assets:		
Allowance for loan losses	$ 9,232	$ 7,069
Stock-based compensation	816	849
Other	508	496
Accrued expenses	414	463
Deferred compensation	4,335	3,174
Total deferred tax assets	15,305	12,051
Deferred tax liabilities:		
Loan costs	1,351	1,181
Depreciation	4,713	4,659
Noncompete and intangibles	908	1,186
Basis differences due to tax credits and partnerships	487	369
Unrealized gain on securities available for sale	2,324	1,114
Total deferred tax liabilities	9,783	8,509
Net deferred tax assets	$ 5,522	$ 3,542

The Company adopted the provisions of FASB Interpretation No. ("FIN") 48, *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. The adoption of FIN 48 did not have a material impact on the financial statements of the Company.

The Company recognizes interest and penalties related to unrecognized tax benefits as "Interest Expense" and "Other Expense," respectively, and not as part of the tax provision. The Company did not recognize any interest expense or penalties for the year ended December 31, 2008. Additionally, there were no interest or penalties accrued at December 31, 2008.

The Company is subject to examination for federal and state purposes for the tax years 2005 through 2008.

NOTE 19: LEGAL CONTINGENCIES

Various legal actions arise from time to time in the normal course of our business. There were no significant asserted claims or assessments at December 31, 2008. Management was not aware of any unasserted claims or assessments that may be probable of assertion at December 31, 2008.

NOTE 20: 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 $110.41 million, $76.92 million, and $67.28 million as of December 31, 2008, 2007, and 2006, respectively. During 2008, new advances on all commitments to such parties totaled $232.23 million, and repayments amounted to $211.87 million. In addition at December 31, 2008, we had $34.43 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 $910,000, $747,000, and $640,000 for the years ended December 31, 2008, 2007, and 2006, respectively.

In October 2000, in connection with the acquisition of Hampton Roads Funding Corporation, TowneBank entered into consulting and non-competition agreements with four individuals, including one of the Company's directors and a member of one of the Company's regional boards of directors. Total amounts expensed under this arrangement with directors were $1.48 million for the year ended December 31, 2006. The agreement with the Company Director was modified for January and February 2007 until Towne Mortgage, LLC began operations in March 2007. The terms of the agreement were the same as the prior agreement, except payments were to be made to the Bank's partner in Towne Mortgage, LLC instead of the individuals previously referenced. The amount expensed in 2007 under this modified agreement was $148,000.

In the ordinary course of business, the Company acquired certain goods and services from companies associated with its directors. Amounts paid to these companies during the years ended December 31, 2008, 2007, and 2006 approximated $1.11 million, $1.64 million, and $1.23 million, respectively.

(continued on next page)

NOTE 21: QUARTERLY FINANCIAL DATA (UNAUDITED)

Summarized unaudited quarterly financial data for the years ended December 31, 2008 and 2007 is as follows (in thousands, except per share data).

2008	Fourth	Third	Second	First
Interest income	$ 38,791	$ 38,510	$ 36,416	$ 37,133
Interest expense	16,478	15,583	14,754	16,908
Provision for loan losses	2,491	1,568	2,068	895
Noninterest income	9,196	10,921	10,508	10,282
Gain on securities available for sale	-	804	678	1,478
Noninterest expense	22,315	24,040	22,350	22,552
Income before income tax expense minority interest	6,703	9,044	8,430	8,538
Minority interest	(17)	(15)	(29)	(9)
Income before income tax expense	6,686	9,029	8,401	8,529
Income tax expense	1,241	2,614	2,360	2,536
Net income	$ 5,445	$ 6,415	$ 6,041	$ 5,993
Net income per common share				
Basic	$ 0.17	$ 0.26	$ 0.25	$ 0.25
Diluted	$ 0.16	$ 0.25	$ 0.24	$ 0.24
Comprehensive income	$ 10,944	$ 6,097	$ 168	$ 8,933
Dividends	$ 0.08	$ 0.08	$ 0.08	$ 0.08

2007	Fourth	Third	Second	First
Interest income	$ 39,493	$ 40,503	$ 39,055	$ 36,873
Interest expense	18,409	18,547	17,188	16,281
Provision for loan losses	831	266	1,042	604
Noninterest income	9,013	9,243	9,590	8,906
Gain (loss) on securities available for sale	80	-	-	(10)
Noninterest expense	20,937	22,114	21,684	20,772
Income before income tax expense minority interest	8,409	8,819	8,731	8,112
Minority interest	12	-	-	-
Income before income tax expense	8,421	8,819	8,731	8,112
Income tax expense	2,554	2,830	2,825	2,615
Net income	$ 5,867	$ 5,989	$ 5,906	$ 5,497
Net income per common share				
Basic	$ 0.25	$ 0.25	$ 0.25	$ 0.23
Diluted	$ 0.23	$ 0.24	$ 0.23	$ 0.22
Comprehensive income	$ 8,218	$ 8,477	$ 2,268	$ 5,462
Dividends	$ 0.08	$ 0.08	$ 0.08	$ 0.08

NOTE 22: SEGMENT REPORTING

The Company has three reportable segments: Banking, Realty, and Insurance. The Banking segment provides loan and deposit services to retail and commercial customers throughout 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, LET, NewTowne Mortgage, LLC, the Corolla companies, and Eastern Title Company to provide residential real estate services, resort property management, 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. The Insurance segment provides full-service commercial and retail insurance and employee benefit services through Towne Insurance and TFA Benefits.

All the segments are service-based. The Banking 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 Banking 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 Banking segment is driven principally by net interest income.

Segment profit and loss is measured by net income after income tax. 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. Refer to the discussion of the Banking segment in the section entitled "Management's Discussion and Analysis" on page 14 of this Annual Report for information on the results of non-banking activities included in the Banking segment.

Information about reportable segments and reconciliation of such information to the consolidated financial statements follows (dollars in thousands).

(continued on next page)

For the Year Ended December 31, 2008	Bank	Realty	Insurance	Consolidated Totals
Net interest income	$ 86,337	$ 774	$ 17	$ 87,128
Provision for loan losses	7,022	-	-	7,022
Net interest income after provision for loan losses	79,315	774	17	80,106
Residential mortgage brokerage income, net	(666)	5,985	-	5,319
Real estate brokerage and property management income, net	-	7,778	-	7,778
Insurance commissions and other title fees and income, net	-	2,117	11,264	13,381
Other noninterest income	16,239	888	262	17,389
Noninterest expense	60,282	14,997	7,522	82,801
Depreciation and amortization	5,839	1,900	718	8,457
Income before income tax and minority interest	28,767	645	3,303	32,715
Minority interest	-	(66)	(4)	(70)
Income before income tax	28,767	579	3,299	32,645
Income tax expense	7,688	(55)	1,118	8,751
Net income	$ 21,079	$ 634	$ 2,181	$ 23,894
Net income as percentage of total	88.22%	2.65%	9.13%	100.00%
Assets	$ 3,046,757	$ 55,280	$ 31,541	$ 3,133,578
Efficiency ratio	64.88%	96.32%	71.39%	69.67%

For the Year Ended December 31, 2007	Bank	Realty	Insurance	Consolidated Totals
Net interest income	$ 84,715	$ 710	$ 74	$ 85,499
Provision for loan losses	2,743	-	-	2,743
Net interest income after provision for loan losses	81,972	710	74	82,756
Residential mortgage brokerage income, net	309	5,855	-	6,164
Real estate brokerage and property	-	5,462	-	5,462
Insurance commissions and other title	-	2,695	10,406	13,101
Other noninterest income	11,066	659	370	12,095
Noninterest expense	57,649	13,166	7,834	78,649
Depreciation and amortization	5,374	975	509	6,858
Income before income tax and minority interest	30,324	1,240	2,507	34,071
Minority interest	-	12	-	12
Income before income tax	30,324	1,252	2,507	34,083
Income tax expense	9,499	328	997	10,824
Net income	$ 20,825	$ 924	$ 1,510	$ 23,259
Net income as percentage of total	89.54%	3.97%	6.49%	100.00%
Assets	$ 2,426,995	$ 44,474	$ 29,609	$ 2,501,078
Efficiency ratio	65.59%	91.94%	76.89%	69.90%

For the Year Ended December 31, 2006	Bank	Realty	Insurance	Consolidated Totals
Net interest income	$ 76,440	$ 602	$ -	$ 77,042
Provision for loan losses	2,572	-	-	2,572
Net interest income after provision for loan losses	73,868	602	-	74,470
Residential mortgage brokerage income, net	351	8,495	-	8,846
Real estate brokerage and property	-	6,333	-	6,333
Insurance commissions and other title	-	3,517	6,265	9,782
Other noninterest income	8,285	469	106	8,860
Noninterest expense	49,508	15,377	4,803	69,688
Depreciation and amortization	4,728	1,001	626	6,355
Income before income tax	28,268	3,038	942	32,248
Income tax expense	9,055	1,033	374	10,462
Net income	$ 19,213	$ 2,005	$ 568	$ 21,786
Net income as percentage of total	88.19%	9.20%	2.61%	100%
Assets	$ 2,134,857	$ 41,072	$ 18,656	$ 2,194,585
Efficiency ratio	63.75%	84.35%	85.21%	68.59%

The following table provides the change in net income and total assets for each segment comparing December 31, 2008 and 2007 (dollars in thousands).

	Banking	Realty	Insurance	Consolidated
Net Income ($)	$ 254	$ (290)	$ 671	$ 635
Net Income (%)	1.22%	(31.39%)	44.44%	2.73%
Total Assets ($)	$ 619,762	$ 10,806	$ 1,932	$ 632,500
Total Assets (%)	25.54%	24.30%	6.53%	25.29%

NOTE 23: EARNINGS PER SHARE

The following chart summarizes information related to the computation of basic and diluted earnings per share (in thousands, except per share data).

Year Ended December 31,	2008	2007	2006
Basic			
Net income, as reported	$ 23,894	$ 23,259	$ 21,786
Preferred stock dividends	(1,396)	-	-
Net income available to common shareholders	$ 22,498	$ 23,259	$ 21,786
Average common shares outstanding	24,174,069	23,712,692	23,356,687
Basic earnings per common share	$ 0.93	$ 0.98	$ 0.93
Diluted			
Net income available to common shareholders	$ 22,498	$ 23,259	$ 21,786
Interest applicable to 6% subordinated debt, net of tax (1)	961	975	990
Net income available to common shareholders, for diluted EPS	23,459	24,234	22,776
Average common shares outstanding	24,174,069	23,712,692	23,356,687
Effect of dilutive securities			
stock compensation plans, net of tax benefit	423,837	670,446	1,147,196
6% convertible subordinated debentures (2)	1,880,315	1,908,606	1,938,188
Average diluted shares outstanding	26,478,221	26,291,744	26,442,071
Diluted earnings per common share	$ 0.89	$ 0.92	$ 0.86

(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 are assumed to have been converted since the beginning of the period.

The Series II convertible subordinated capital notes entitle the holders to convert their notes into 545,336 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.

The TowneBank 8% Non-Cumulative Convertible Preferred Stock, Series A entitled the holders to convert their shares into 3,196,118 shares of common stock. These shares were not included in the computation of diluted earnings per share as the effect was anti-dilutive for the period.

NOTE 24: SUBSEQUENT EVENTS

On January 19, 2009, TowneBank contributed its wholly-owned subsidiary GSH and $5.74 million in cash into a joint venture with Virginia Beach based Prudential Decker Realty and Prudential McCardle Realty of Williamsburg. TowneBank owns 65% of the resulting new company, Prudential Towne Realty. The former owners of Prudential Decker and Prudential McCardle collectively own the balance of the shares of Prudential Towne Realty.

TOWNEBANK
SHAREHOLDER INFORMATION

ANNUAL MEETING

TowneBank's Annual Meeting of Stockholders will be held at 11:30 a.m. on Wednesday, May 20, 2009, at the Virginia Beach Convention Center, 1000 19th Street, Virginia Beach, Virginia 23451.

COMMON STOCK

Effective October 9, 2007, the Company's common stock is listed on the NASDAQ Global Select Market under the symbol TOWN. Prior to that date, it was listed on the OTC Bulletin Board, which is a quotation system for equity securities not listed on the NASDAQ Stock Market or stock exchanges. The following are the Company's quarterly high and low closing stock prices for the periods indicated.

	2008		2007	
Quarter	High	Low	High	Low
First	$18.19	$14.49	$20.80	$18.85
Second	19.80	14.83	19.25	16.25
Third	26.68	12.86	19.75	16.50
Fourth	24.79	16.74	21.30	15.50

INVESTOR RELATIONS

Our 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
6001 Harbour View Boulevard
Suffolk, VA 23435
757-638-6801
e-mail: Clyde.McFarland@townebank.net

These reports are also available on our Web site at http://www.townebank.com/inv_documents.asp.

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TOWNEBANK
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This document has not been reviewed for accuracy or relevance by the Federal Deposit Insurance Corporation.