
TOWNE BANK

2014 Annual Report

TowneBank
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TOWNEBANK

BUSINESS PROFILE AND CORPORATE MISSION STATEMENT

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 Richmond, Virginia and the Greater Hampton Roads region in southeastern Virginia, and northeastern North Carolina. 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, LLC (“Towne Insurance”); TowneBank Commercial Mortgage, LLC; TFA Benefits; Out of Town, LLC, d/b/a Red Sky Travel Insurance; Towne Mortgage, LLC; NewTowne Mortgage, LLC; Towne Mortgage of the Carolinas, LLC; SimonTowne Mortgage, LLC; GSH NC Resort Management, LLC, d/b/a Corolla Classic Vacations; Towne 1031 Exchange, LLC; Towne New Markets CDE, Inc.; and Towne Realty, LLC, d/b/a Berkshire Hathaway HomeServices Towne Realty, which includes Lawyers Escrow and Title, LLC, d/b/a Virginia Home Title and Settlements, 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. Unless indicated otherwise, the terms “Company,” “we,” “us,” and “our” refer to TowneBank and our consolidated subsidiaries.

Since our inception, we have expanded our financial services to include banking, real estate, mortgage, title, 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 the communities we serve.

TOWNEBANK
SELECTED FINANCIAL HIGHLIGHTS

Period Ended December 31,	2014/2013			
2014	2013	Increase/(Decrease)		
<i>(Dollars in thousands, except per share data)</i>				
Results of Operations:				
Net interest income	\$ 145,736	\$ 143,895	\$ 1,841	1.28 %
Noninterest income (1)	96,744	89,916	6,828	7.59 %
Total revenue	242,465	234,423	8,042	3.43 %
Noninterest expenses	178,864	168,792	10,072	5.97 %
Provision for loan losses	492	4,248	(3,756)	(88.42)%
Net income attributable to TowneBank	42,169	41,762	407	0.97 %
Net income per common share - basic	1.18	1.14	0.04	3.51 %
Net income per common share - diluted	1.18	1.14	0.04	3.51 %
Period End Data:				
Total assets	\$ 4,982,485	\$ 4,672,997	\$ 309,488	6.62 %
Total assets - tangible	4,846,816	4,552,935	293,881	6.45 %
Earning assets (2)	4,610,142	4,296,486	313,656	7.30 %
Loans (net of unearned income and deferred costs)	3,397,266	3,235,989	161,277	4.98 %
Allowance for loan losses	35,917	38,380	(2,463)	(6.42)%
Goodwill and other intangibles	135,668	120,061	15,607	13.00 %
Noninterest-bearing deposits	1,224,466	1,037,028	187,438	18.07 %
Interest-bearing deposits	2,622,136	2,530,076	92,060	3.64 %
Total deposits	3,846,602	3,567,104	279,498	7.84 %
Equity	618,276	585,318	32,958	5.63 %
Equity - tangible	482,608	465,257	17,351	3.73 %
Book value per share	14.88	14.16	0.72	5.08 %
Book value per share - tangible	11.09	10.76	0.33	3.07 %
Cash dividends declared per share	0.43	0.38	0.05	13.16 %
Daily Average Balances:				
Total assets	\$ 4,866,584	\$ 4,507,233	\$ 359,351	7.97 %
Total assets - tangible	4,738,306	4,387,578	350,728	7.99 %
Earning assets (2)	4,472,117	4,123,527	348,590	8.45 %
Loans (net of unearned income)	3,298,740	3,158,448	140,292	4.44 %
Allowance for loan losses	37,168	39,698	(2,530)	(6.37)%
Goodwill and other intangibles	128,278	119,655	8,623	7.21 %
Noninterest-bearing deposits	1,158,888	1,022,168	136,720	13.38 %
Interest-bearing deposits	2,590,162	2,415,178	174,984	7.25 %
Total deposits	3,749,050	3,437,346	311,704	9.07 %
Total equity	606,777	574,558	32,219	5.61 %
Total equity - tangible	478,499	454,903	23,596	5.19 %
Key Ratios:				
Return on average assets	0.87%	0.93%	(0.06)%	(6.45)%
Return on average tangible assets	0.93%	0.95%	(0.02)%	(2.11)%
Return on average equity	6.95%	7.27%	(0.32)%	(4.40)%
Return on average tangible equity	9.16%	9.18%	(0.02)%	(0.22)%
Net interest margin (2)(3)	3.38%	3.61%	(0.23)%	(6.37)%
Efficiency ratio (1)	73.76%	72.19%	1.57 %	2.17 %
Average earning assets/total average assets	91.89%	91.49%	0.40 %	0.44 %
Average loans/average deposits	87.99%	91.89%	(3.90)%	(4.24)%
Average noninterest deposits/total average deposits	30.91%	29.74%	1.17 %	3.93 %
Allowance for loan losses/period end loans	1.06%	1.19%	(0.13)%	(10.92)%
Period end equity/period end total assets	12.41%	12.53%	(0.12)%	(0.96)%

Notes:

(1) Excludes investment securities losses of \$15,000 in 2014 and securities gains \$0.61 million in 2013.

(2) Includes bank-owned life insurance.

(3) Presented on a tax-equivalent basis.

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SELECTED FINANCIAL HIGHLIGHTS

Period Ended December 31,	2012	2011	2010
<i>(Dollars in thousands, except per share data)</i>			
Results of Operations:			
Net interest income	\$ 144,284	\$ 136,222	\$ 122,635
Noninterest income (1)	81,184	64,052	60,089
Total revenue	228,473	203,955	188,685
Noninterest expenses	158,749	144,820	122,745
Provision for loan losses	16,155	13,602	22,565
Net income attributable to TowneBank	37,931	33,321	30,276
Net income per common share - basic (2)	1.03	0.77	0.72
Net income per common share - diluted (2)	1.03	0.76	0.71
Period End Data:			
Total assets	\$ 4,405,923	\$ 4,081,770	\$ 3,871,018
Total assets - tangible	4,286,921	3,966,832	3,762,072
Earning assets (3)	4,033,813	3,712,187	3,537,322
Loans (net of unearned income and deferred costs)	3,133,507	2,793,193	2,731,352
Allowance for loan losses	40,427	39,740	38,660
Goodwill and other intangibles	119,002	114,938	108,946
Noninterest-bearing deposits	978,818	839,211	706,040
Interest-bearing deposits	2,401,234	2,351,576	2,248,474
Total deposits	3,380,052	3,190,787	2,954,514
Shareholders' equity	559,879	520,489	499,512
Shareholders' equity - tangible	440,877	405,551	390,566
Book value per share (2)	13.30	12.65	12.10
Book value per share - tangible (2)	9.52	8.82	8.44
Cash dividends declared per share (2)	0.33	0.31	0.31
Daily Average Balances:			
Total assets	\$ 4,201,452	\$ 3,990,783	\$ 3,721,155
Total assets - tangible	4,087,602	3,877,103	3,622,944
Earning assets (3)	3,811,846	3,604,641	3,392,093
Loans (net of unearned income)	2,910,406	2,678,004	2,587,287
Allowance for loan losses	40,100	40,928	35,158
Goodwill and other intangibles	113,850	113,680	98,211
Noninterest-bearing deposits	904,512	781,992	649,840
Interest-bearing deposits	2,370,003	2,308,099	2,101,692
Total deposits	3,274,515	3,090,091	2,751,532
Shareholders' equity	545,566	511,724	490,572
Shareholders' equity - tangible	431,716	398,045	392,361
Key Ratios:			
Return on average assets	0.90%	0.83%	0.81%
Return on average tangible assets	0.93%	0.86%	0.84%
Return on average equity	6.95%	6.51%	6.17%
Return on average tangible equity	8.79%	8.37%	7.72%
Net interest margin (3)(4)	3.92%	3.94%	3.76%
Efficiency ratio (1)	70.41%	72.31%	67.18%
Average earning assets/total average assets	90.73%	90.32%	91.16%
Average loans/average deposits	88.88%	86.66%	94.03%
Average noninterest deposits/total average deposits	27.62%	25.31%	23.62%
Allowance for loan losses/period end loans	1.29%	1.42%	1.42%
Period end equity/period end total assets	12.71%	12.75%	12.90%

Notes:

- (1) Excludes investment securities gains of \$3.01 million, \$3.68 million, and \$5.96 million in 2012, 2011, and 2010, respectively.
- (2) Prior period was restated to reflect 3% common stock dividend paid June 12, 2012.
- (3) Includes bank-owned life insurance.
- (4) Presented on a tax-equivalent basis.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

OVERVIEW

TowneBank is a retail and commercial banking business serving Richmond, Virginia and the Greater Hampton Roads area in southeastern Virginia, and northeastern North Carolina. We place special emphasis on serving the financial needs of small- and medium-size businesses, professionals, and individuals in our geographic footprint. We offer a full range of banking and related financial services through our controlled divisions and subsidiaries.

Since our inception, we have expanded our financial services to include banking, real estate, mortgage, title, 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.

The following is a summary of the Company's 2014 financial performance:

- Net income increased to \$42.17 million compared with \$41.76 million in 2013. Net income available to common shareholders for 2014 was \$41.40 million after preferred stock dividend payments of \$0.76 million. Fully diluted earnings rose to \$1.18 per common share as compared to \$1.14 per common share in 2013.
- Net interest income increased \$1.84 million or 1.28%, primarily due to an increase in average earning assets and was partially offset by a decline in yields on earning assets.
- The provision for loan losses decreased \$3.76 million, or 88.42%, from 2013. The loan loss reserve was 1.06% of loans at December 31, 2014, down from 1.19% at year-end 2013. The decrease in the provision for loan losses in the current year period from the comparative prior year was primarily a result of the reduction in historical loss ratios combined with continued improvements in credit quality.
- Excluding gains and losses on investment securities, noninterest income increased by \$6.83 million, or 7.59%, over 2013. The primary driver of the increase was an increase in our Insurance segment related to our acquisition of Southern Insurance Agency, Inc. ("Southern") in the second quarter of 2014 and the acquisition of two insurance agencies in the third quarter of 2013. The increase was partially offset by a decrease in residential mortgage banking income.
- Noninterest expense increased \$10.07 million, or 5.97%, compared to 2013. The increase was driven by merger expenses of \$4.28 million related to the acquisition of Franklin Financial Corporation ("Franklin"), which was completed on January 2, 2015, and the acquisition of Southern in the second quarter of 2014. Also contributing to the increase were severance-related expenses of \$3.55 million.
- The effective tax rate increased to 30.12% in 2014 compared to 29.09% in 2013. The effective rate increased primarily as a result of the Company's adoption of change in accounting for affordable housing projects that qualify for the low-income housing tax credit. Amortization of the initial investment cost of qualifying projects is now recorded in the provision for income taxes together with the tax credits and benefits received. Previously, the net losses on the investments were recorded in other noninterest income.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

MERGER ACTIVITY

On January 2, 2015, TowneBank completed the acquisition of Franklin and its wholly-owned subsidiary, Franklin Federal Savings Bank, based in Richmond, Virginia. The Company acquired eight office locations, approximately \$491.96 million in loans, and assumed approximately \$682.95 million in deposits.

Effective October 1, 2014, TowneBank acquired Beach Properties of Hilton Head, Inc. ("Beach Properties"), a resort property management company offering vacation rentals in Hilton Head, South Carolina. The purchase price was \$8.60 million in cash and stock.

Effective May 1, 2014, TowneBank acquired an insurance agency, Southern, which is affiliated with Towne Insurance. The total purchase price for the transaction was \$11.81 million in cash and common stock.

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, other real estate owned, deferred income taxes, estimates of fair value of financial instruments, and goodwill and other 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.

Other Real Estate Owned: Other real estate owned ("OREO"), which is included in other assets on the balance sheet, consists primarily of commercial and residential real estate that has been obtained in partial or full satisfaction of loan obligations. OREO is carried at the fair value of the property, less estimated selling costs, with any difference between the fair value of the property, less estimated selling costs, and the carrying value of the loan recorded through a charge to the allowance for loan losses upon transfer to OREO. Subsequent write-downs required for declines in value are recorded through a valuation allowance, or taken directly to the asset, charged to other noninterest expense.

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

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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 Accounting Standards Codification Topic ("ASC") 805, *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 pages 15-21) 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, changes in discount rates, and specific industry or market sector conditions. Other key judgments in accounting for

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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, 2014, 2013, and 2012, of \$42.17 million, \$41.76 million, and \$37.93 million, respectively. Diluted earnings per share were \$1.18, \$1.14, and \$1.03 for the years ended December 31, 2014, 2013, and 2012, respectively. Earnings in 2014 included costs of \$5.49 million on an after-tax basis related to severance and acquisition-related expenses recorded during the year. Earnings per share were positively affected in 2014 by the mandatory conversion of the remaining shares of TowneBank 8% Non-Cumulative Convertible Preferred Stock, Series A ("Series A Preferred Stock") on September 1, 2013, as preferred dividends decreased by \$3.46 million from 2013.

Profitability, as measured by our return on average assets ("ROA"), was 0.87%, 0.93%, and 0.90% for the years ended December 31, 2014, 2013, and 2012, respectively. Return on average tangible assets was 0.93%, 0.95%, and 0.93% for the same respective periods. Return on average equity ("ROE") was 6.95%, 7.27%, and 6.95% for years ended December 31, 2014, 2013, and 2012, respectively; while return on average tangible equity was 9.16%, 9.18%, and 8.79% for the same respective years. The decline in ROA and ROE was primarily due to the above-mentioned severance and acquisition-related noninterest expenses incurred in 2014.

Our operating income, calculated as net interest income and noninterest income less gains on investment securities, was \$242.48 million for the year ended December 31, 2014, compared to \$233.81 million and \$225.47 million for 2013 and 2012, respectively.

Net Interest Income: Net interest income, the major source 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 market interest rates and the mix and volume of earning assets and interest-bearing liabilities. The yields and rates in this discussion and in the following tables include income from bank-owned life insurance ("BOLI"), a non-GAAP measure, and 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.

Our balance sheet is currently in a liability-sensitive balance sheet position, meaning that interest-bearing liabilities generally reprice more quickly than earning assets. If we were in an asset-sensitive balance sheet position, assets such as securities would generally reprice more quickly than liabilities. We are primarily funded by core deposits, with noninterest-bearing demand deposits historically being a significant source of funds. This lower-cost funding base is expected to have a positive impact on the Company's net interest income and net interest margin in a rising interest rate environment.

Net interest income, on a tax-equivalent basis, was \$151.16 million for the year ended December 31, 2014, which was \$2.35 million, or 1.58%, more than the \$148.81 million reported in the previous year. In comparison to the prior year, net interest income rose primarily due to higher balances of earning assets.

Interest income, on a tax-equivalent basis, was \$177.94 million for the year ended December 31, 2014, which was \$2.74 million, or 1.56%, greater than the \$175.20 million for the year ended December 31, 2013. Average earning assets grew to \$4.47 billion in 2014 from \$4.12 billion in 2013, an increase of \$348.59 million, or 8.45%. The yield on earning assets was 3.98% in the year ended December 31, 2014, which compared to 4.25% in the prior year. The increase in interest income was due to increased balances in earning assets, primarily in average loans

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MANAGEMENT'S DISCUSSION AND ANALYSIS

held for investment and taxable investment securities. The increase was partially offset by the effects of lower yields, which was driven by the drop in loan yields as other categories of earning assets had modest yield increases.

Interest expense, for the year ended December 31, 2014, increased by \$0.38 million, or 1.44%, to \$26.78 million compared to \$26.40 million for the year ended December 31, 2013. The balance of average interest-bearing liabilities increased to \$3.02 billion in 2014 from \$2.84 billion in 2013, an increase of \$179.01 million, or 6.30%. The higher balance was partially offset by a drop in the average rate paid, from 0.93% in 2013 to 0.89% in 2014. The rate decline was primarily driven by modest rate improvements in savings accounts and demand and money market accounts.

Net interest margin, which is net interest income expressed as a percentage of average earning assets, was 3.38% in the year ended December 31, 2014, which was 23 basis points lower than the 3.61% a year ago. The compression in the margin was driven by the fall in asset yields and growth in earning assets. Net interest margin will be impacted by future changes in short-term and long-term interest rate levels, as well as the impact from the competitive environment.

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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,								
	2014			2013			2012		
	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)	\$ 3,298,740	\$ 155,980	4.73%	\$ 3,158,448	\$ 156,652	4.96%	\$ 2,910,406	\$ 157,053	5.40%
Taxable investment securities	622,479	8,028	1.29%	341,279	4,263	1.25%	260,630	6,163	2.36%
Tax-exempt investment securities	173,894	7,414	4.26%	169,376	6,993	4.13%	159,322	7,248	4.55%
Interest-bearing deposits	253,416	637	0.25%	300,977	759	0.25%	309,098	783	0.25%
Mortgage loans held for sale	65,746	2,586	3.93%	97,235	3,469	3.57%	118,206	4,173	3.53%
Bank-owned life insurance	57,842	3,290	5.69%	56,212	3,066	5.45%	54,184	3,175	5.86%
Total earning assets	4,472,117	177,935	3.98%	4,123,527	175,202	4.25%	3,811,846	178,595	4.69%
Less: allowance for loan losses	(37,168)			(39,698)			(40,100)		
Total nonearning assets	431,635			423,404			429,706		
Total assets	\$ 4,866,584			\$ 4,507,233			\$ 4,201,452		
Liabilities and Equity:									
Interest-bearing deposits									
Demand and money market	\$ 1,306,738	\$ 3,036	0.23%	\$ 1,166,510	\$ 3,146	0.27%	\$ 1,064,840	\$ 4,242	0.40%
Savings	310,722	2,855	0.92%	323,011	3,117	0.96%	300,235	3,202	1.07%
Certificates of deposit	972,702	7,461	0.77%	925,657	7,090	0.77%	1,004,928	9,305	0.93%
Total interest-bearing deposits	2,590,162	13,352	0.52%	2,415,178	13,353	0.55%	2,370,003	16,749	0.71%
FHLB advances and repurchase agreements	429,249	13,424	3.13%	425,225	13,042	3.07%	318,494	12,236	3.84%
Convertible subordinated capital debentures	—	—	—	—	—	—	2,950	237	8.03%
Total interest-bearing liabilities	3,019,411	26,776	0.89%	2,840,403	26,395	0.93%	2,691,447	29,222	1.09%
Noninterest-bearing liabilities									
Demand deposits	1,158,888			1,022,168			904,512		
Other noninterest-bearing liabilities	81,508			70,104			59,927		
Total liabilities	4,259,807			3,932,675			3,655,886		
Shareholders' equity	606,777			574,558			545,566		
Total liabilities and equity	\$ 4,866,584			\$ 4,507,233			\$ 4,201,452		
Net interest income (tax-equivalent basis)		\$ 151,159			\$ 148,807			\$ 149,373	
Reconciliation of Non-GAAP Financial Measures									
Bank-owned life insurance		(3,290)			(3,066)			(3,175)	
Tax-equivalent basis adjustment		(2,133)			(1,846)			(1,914)	
Net interest income (GAAP)		\$ 145,736			\$ 143,895			\$ 144,284	
Interest rate spread (3)			3.09%			3.32%			3.60%
Interest expense as a percent of average earning assets			0.60%			0.64%			0.77%
Net interest margin (tax-equivalent basis) (4)			3.38%			3.61%			3.92%
Total cost of deposits			0.36%			0.39%			0.51%

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

(2) Excludes average nonaccrual loans of \$9.27 million in 2014, \$20.23 million in 2013, and \$54.44 million in 2012.

(3) Interest rate spread is the average yield earned on earning assets less the average rate paid on interest-bearing liabilities.

(4) Net interest margin is net interest income expressed as a percentage of average earning assets.

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(in thousands)	2014 vs 2013 Increase (Decrease)			2013 vs 2012 Increase (Decrease)		
	Due to Changes In			Due to Changes In		
	Volume	Rate (1)	Total	Volume	Rate (1)	Total
Assets:						
Loans (net of unearned income and deferred costs), excluding nonaccrual loans	\$ 6,800	\$ (7,472)	\$ (672)	\$ 12,829	\$ (13,230)	\$ (401)
Taxable investment securities	3,622	143	3,765	1,551	(3,451)	(1,900)
Tax-exempt investment securities	189	231	420	440	(695)	(255)
Interest-bearing deposits	(120)	(2)	(122)	(21)	(3)	(24)
Loans held for sale	(1,211)	328	(883)	(748)	44	(704)
Bank-owned life insurance	91	134	225	116	(225)	(109)
Total earning assets	<u>9,371</u>	<u>(6,638)</u>	<u>2,733</u>	<u>14,167</u>	<u>(17,560)</u>	<u>(3,393)</u>
Liabilities and Equity:						
Interest-bearing deposits:						
Demand and money market accounts	354	(464)	(110)	375	(1,470)	(1,095)
Savings	(116)	(146)	(262)	233	(318)	(85)
Certificates of deposit	361	10	371	(694)	(1,521)	(2,215)
Total interest-bearing deposits	<u>599</u>	<u>(600)</u>	<u>(1)</u>	<u>(86)</u>	<u>(3,309)</u>	<u>(3,395)</u>
FHLB advances and repurchase agreements	124	258	382	3,584	(2,778)	806
Convertible subordinated capital debentures	—	—	—	(118)	(119)	(237)
Total interest-bearing liabilities	<u>723</u>	<u>(342)</u>	<u>381</u>	<u>3,380</u>	<u>(6,206)</u>	<u>(2,826)</u>
Net interest income (tax equivalent basis)	<u>\$ 8,648</u>	<u>\$ (6,296)</u>	<u>\$ 2,352</u>	<u>\$ 10,787</u>	<u>\$ (11,354)</u>	<u>\$ (567)</u>

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

Provision for Loan Losses: The 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 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 provisions for loan losses recorded in 2014, 2013, and 2012 were \$0.49 million, \$4.25 million, and \$16.16 million, respectively. Net charge-offs were \$2.96 million, \$6.30 million, and \$15.47 million for 2014, 2013, and 2012, respectively. The decrease in the provision for loan losses in the current year periods from the comparative prior periods was primarily a result of the reduction in historical loss ratios combined with continued improvements in credit quality. The allowance for loan losses as a percentage of period-end loans was 1.06% and 1.19% at December 31, 2014 and 2013, respectively. For further discussion and analysis of the loan portfolio and the allowance for loan losses, see the "Analysis of Financial Condition" section found later in this report. Also, see Note 4, "Loans and Allowance for Loan Losses," in the Notes to Consolidated Financial Statements.

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Noninterest Income: Total noninterest income for the year ended December 31, 2014 was \$96.73 million, or \$6.20 million, and 6.85% higher than 2013. Excluding gains and losses on investment securities, total noninterest income increased by \$6.83 million, or 7.59%, over 2013. Total noninterest income for the year ended December 31, 2013, was \$90.53 million, representing a \$6.34 million, or 7.53%, increase from 2012. Excluding gains and losses on investment securities, total noninterest income increased by \$8.73 million, or 10.76%, over 2012. Included in noninterest income were losses on investment securities of \$0.02 million in 2014, and gains of \$0.61 million in 2013, and \$3.01 million in 2012. Noninterest income, excluding securities gains or losses, for the year ended December 31, 2014, was 39.90% of total operating income, compared with 38.46% for 2013 and 36.01% for 2012.

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

For the Year Ended December 31,	2014	2013	2012	2014/2013		2013/2012	
				Increase/(Decrease)		Increase/(Decrease)	
				Amount	%	Amount	%
Residential mortgage banking income, net	\$ 27,179	\$ 28,977	\$ 26,998	\$ (1,798)	(6.20)%	\$ 1,979	7.33 %
Real estate brokerage and property management income, net	12,634	12,316	11,515	318	2.58 %	801	6.96 %
Insurance commissions and other title fees and income, net	34,558	28,322	23,458	6,236	22.02 %	4,864	20.73 %
Service charges on deposit accounts	9,192	8,682	7,798	510	5.87 %	884	11.34 %
Credit card merchant fees	3,576	3,471	3,578	105	3.03 %	(107)	(2.99)%
Other income							
Other	3,539	1,662	1,885	1,877	112.94 %	(223)	(11.83)%
Towne Investment income, net	2,703	2,102	1,954	601	28.59 %	148	7.57 %
Bank-owned life insurance income	2,139	1,993	2,064	146	7.33 %	(71)	(3.44)%
Service fees on loans	282	1,214	1,026	(932)	(76.77)%	188	18.32 %
Towne Mortgage LLC income, net	415	562	527	(147)	(26.16)%	35	6.64 %
Commercial mortgage brokerage fees, net	527	616	381	(89)	(14.45)%	235	61.68 %
Total other income	9,605	8,149	7,837	1,456	17.87 %	312	3.98 %
Noninterest income before securities gain/(loss)	96,744	89,917	81,184	6,827	7.59 %	8,733	10.76 %
Gain/(loss) on securities available for sale	(15)	611	3,005	(626)	(102.45)%	(2,394)	(79.67)%
Total noninterest income	\$ 96,729	\$ 90,528	\$ 84,189	\$ 6,201	6.85 %	\$ 6,339	7.53 %

For the year ended December 31, 2014, residential mortgage banking income, net of commission expense, was \$27.18 million, reflecting a decrease of \$1.80 million, or 6.20%, compared to 2013, which was \$1.98 million, or 7.33%, higher than 2012. The decrease from the prior year was primarily due to a decrease in production volumes related to the slowdown in the mortgage market that started in late 2013. The decrease was partially offset by additional expansion of our mortgage operations into North Carolina and Georgia markets, which resulted in an additional \$1.07 million in revenue over 2013 and an increase in mortgage banking income of \$0.36 million in 2014 as compared to a decrease of \$0.66 million in 2013 associated with the change in the value of rate lock commitments recorded as of December 31, 2014. The increase in net mortgage banking income in 2013 from 2012 was primarily due to the continued expansion of our mortgage operations, as the Company expanded into Pennsylvania in December 2012 and previously added enterprises became fully operational. Also contributing to the increase were continued improvements in the housing market, which led to a higher volume in purchase transactions in the first half of 2013. The increase in 2013 was partially offset by slowing production volumes in the second half of the year related to rising rates and lower revenue margins. Also factoring in the variance from the prior year was a reduction in mortgage banking income of \$0.66 million associated with a decrease in the value of rate lock commitments recorded as of December 31, 2014. For further information, refer to our

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discussion of the Realty segment on page 17 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, 2014, was \$12.63 million, an increase of \$0.32 million, or 2.58%, from 2013, which was \$0.80 million, or 6.96%, higher than 2012. The increase from the prior year is primarily attributable to a slight increase in real estate brokerage income related to strengthening in the housing market. The total dollar volume of units sold increased by \$15.80 million, or 1.59%, while the number of units sold was 3,627, a decrease of 104 units, or 2.79%, from 2013. Also contributing were increased net property management fees associated with our purchase of Beach Properties on October 1, 2014. The increase in 2013 from 2012 was primarily attributable to an increase in real estate brokerage income, partially offset by a slight decrease in net property management fees.

For the year ended December 31, 2014, insurance commissions and other title income, net of commission expense, was \$34.56 million, which was \$6.24 million, or 22.02%, higher than comparative 2013. The increase from the prior year was largely due to an increase in property and casualty insurance commissions related to the acquisition of Southern in May 2014 and a full year of operations for two insurance agencies acquired in July 2013, which contributed additional commission and fee income of \$3.80 million. The year ended December 31, 2013, included contingency income from property and casualty insurance of \$2.91 million, compared to \$1.70 million and \$1.32 million for 2012 and 2011, respectively. When compared to 2012, insurance commissions for the year ended December 31, 2013 were \$4.86 million, or 20.73%, higher, largely due to the acquisition of an insurance agency in December 2012 and two agencies in July 2013, which contributed additional commission and fee income of \$3.37 million.

Service charges on deposit accounts were \$9.19 million for 2014, compared with \$8.68 million and \$7.80 million for 2013 and 2012, respectively. The increases reflect the 9.07% and 4.97% increase in average deposits over the years ended December 31, 2014 and 2013, respectively.

For the year ended December 31, 2014, credit card merchant fees totaled \$3.58 million, which was \$0.11 million, or 3.03%, more than comparative 2013, which was \$0.11 million, or 2.99%, less than 2012. For both prior year comparative periods, variances were primarily related to changes in transaction volume.

Other noninterest income for the year ended December 31, 2014 was \$9.60 million, compared with \$8.15 million for the year ended December 31, 2013, and \$7.84 million for the year ended December 31, 2012. Other noninterest income includes income generated by Towne Investment Group, net of commission expense of \$2.70 million, \$2.10 million, and \$1.95 million for the years ended December 31, 2014, 2013, and 2012, respectively. Also contributing to the increase in 2014 was the Company's adoption of change in accounting for affordable housing projects that qualify for the low-income housing tax credit. Amortization of the initial investment cost of qualifying projects is now recorded in the provision for income taxes together with the tax credits and benefits received. Previously, the net losses on the investments were recorded in other noninterest income.

Noninterest Expense: Total noninterest expense for 2014 was \$178.86 million, which was \$10.07 million, or 5.97%, higher than 2013. The primary components of 2014 noninterest expense were salaries and employee benefits of \$99.01 million, occupancy expenses of \$17.86 million, furniture and equipment expenses of \$8.18 million, advertising and marketing expenses of \$5.18 million, acquisition-related expenses of \$4.28 million, charitable contributions of \$3.43 million, and professional fees of \$5.18 million. In comparison to 2013, a significant portion of the increase in total noninterest expense is due to \$4.28 million of nonrecurring merger expense related to the acquisitions of Franklin, completed January 2, 2015, and Southern in the second quarter of 2014. These merger expenses were included in the other noninterest expense category. Additionally, employee

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severance-related costs resulted in pre-tax salaries and benefits expenses of \$2.87 million and legal fees of \$0.68 million. Also contributing to the increase were operational expenses related to the Southern acquisition and a full year of operations for two insurance agencies acquired in July 2013, which resulted in additional expenses of \$3.38 million, primarily in salaries and benefits. Additionally, our Realty segment had increases related to the expansion of our mortgage operations in North Carolina and our purchase of Beach Properties, which resulted in additional expenses of \$2.20 million. Excluding the costs associated with the acquisitions and expansions, noninterest expense decreased \$3.34 million, or 1.98%, from 2013. Noninterest expense was affected in the fourth quarter of 2014 by a reversal of incentive compensation recorded previously in 2014 of \$0.90 million due to a slowing of results in the fourth quarter, primarily in acquisition and severance costs, which reduced the availability of funds for profit-sharing. A significant portion of the increase in total noninterest expense from 2012 to 2013 was due to the insurance agency acquisitions in December 2012 and July 2013, which resulted in additional expenses of \$3.38 million, primarily in salaries and benefits. Also contributing to the increase from 2012 was the expansion of our mortgage operations into Pennsylvania, which resulted in additional expenses of \$2.17 million. Excluding the costs associated with the acquisitions and expansions, noninterest expense increased \$12.77 million, or 8.49%, from 2012. Noninterest expense was affected in the fourth quarter of 2013 by a reversal of incentive compensation recorded previously in 2013 of \$1.20 million due to a slowing of results in the fourth quarter, primarily in mortgage-related activity.

Total noninterest expense to total operating revenue, excluding securities gains and losses, was 73.76% for the year ended December 31, 2014, compared with 72.19% for 2013 and 70.41% for 2012. The following table provides an analysis of noninterest expense (dollars in thousands):

For the year ended December 31,	2014	2013	2012	2014/2013		2013/2012	
				Increase/(Decrease)		Increase/(Decrease)	
				Amount	%	Amount	%
Salaries and benefits	\$ 99,007	\$ 97,108	\$ 89,669	\$ 1,899	1.96 %	\$ 7,439	8.30 %
Occupancy	17,863	16,298	14,384	1,565	9.60 %	1,914	13.31 %
Furniture and equipment	8,183	7,458	6,467	725	9.72 %	991	15.32 %
Other expenses							
Advertising and marketing	5,178	5,374	4,818	(196)	(3.65)%	556	11.54 %
Acquisition-related expenses	4,280	(19)	768	4,299	N/M	(787)	N/M
Charitable contributions	3,430	4,209	3,574	(779)	(18.51)%	635	17.77 %
Telephone and postage	4,184	3,937	3,527	247	6.27 %	410	11.62 %
Outside processing	3,631	3,425	3,019	206	6.01 %	406	13.45 %
Professional fees	5,178	4,325	4,606	853	19.72 %	(281)	(6.10)%
Other	6,855	7,514	7,019	(659)	(8.77)%	495	7.05 %
Stationery and office supplies	2,132	2,291	2,048	(159)	(6.94)%	243	11.87 %
Amortization expense of intangibles	2,623	2,145	2,251	478	22.28 %	(106)	(4.71)%
Foreclosed property expenses	3,397	2,020	4,612	1,377	68.17 %	(2,592)	(56.20)%
FDIC and other insurance	3,885	3,974	3,729	(89)	(2.24)%	245	6.57 %
Software expense	4,615	4,217	4,227	398	9.44 %	(10)	(0.24)%
Travel/Meals/Entertainment	1,133	1,424	981	(291)	(20.44)%	443	45.16 %
Directors' expense	1,099	1,187	1,179	(88)	(7.41)%	8	0.68 %
Bank franchise tax/SCC fees	2,191	1,905	1,871	286	15.01 %	34	1.82 %
Total other expenses	53,811	47,928	48,229	5,883	12.27 %	(301)	(0.62)%
Total noninterest expense	\$ 178,864	\$ 168,792	\$ 158,749	\$ 10,072	5.97 %	\$ 10,043	6.33 %

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Salaries and employee benefits, the largest portion of noninterest expense, were \$99.01 million, representing 55.35% of total noninterest expense for the year ended December 31, 2014. This was a \$1.90 million, or 1.96%, increase over comparative 2013. The increase from prior year is primarily due to the addition of staff resulting from the expansion of our Insurance and Realty segment businesses, which resulted in an increase of \$3.65 million, combined with salaries and benefits expenses of \$2.87 million related to the above-mentioned severance costs. The increase was partially offset by a decrease of \$2.46 million in employee profit-sharing, incentive compensation, and matching contributions to employee retirement plans. Salaries and benefits expense for the year ended December 31, 2013 was \$97.11 million, up 8.30%, or \$7.44 million, over 2012. The increase was due to the addition of staff resulting from the expansion of our insurance and mortgage businesses, increased operational support staffing, and an increase in payroll taxes. The increase was partially offset by a decrease in profit-sharing and incentive compensation for employees and a reduction in matching contributions made by the Company to employee retirement plans.

In our Banking segment, we had a total of 622 full-time equivalent employees ("FTE") at December 31, 2014, which was down from 660 and 637 at December 31, 2013 and 2012, respectively. In our non-Banking segments at December 31, 2014, we had a total of 722 FTEs, excluding real estate sales agents, which was up from 691 and 584 at December 31, 2013 and 2012, respectively. Real estate agents are independent contractors and, therefore, not included as the Company's employees. There were 393 real estate agents at December 31, 2014. Total operating revenue, excluding securities gains, per FTE was approximately \$180,000, \$173,000, and \$185,000 for the years ended December 31, 2014, 2013, and 2012, respectively.

For the year ended December 31, 2014, occupancy expense totaled \$17.86 million, representing an increase of \$1.57 million, or 9.60%, over comparative 2013. Occupancy expense for 2013 was \$1.91 million, or 13.31%, over the 2012 amount of \$14.38 million. The increase from 2013 was primarily driven by increases related to the opening of a new banking office in Norfolk, a full year of operations for banking offices opened in 2013 in Virginia Beach and Southern Shores, expenses related to the relocation of a banking office from Kill Devil Hills, North Carolina, to Nags Head, North Carolina, and expansions in our Realty and Insurance segments. The increases in occupancy expense in 2013 were related to our mortgage operations, the opening of new banking offices in Virginia Beach and Southern Shores, higher maintenance and repair expenses, and increased depreciation expense.

Furniture and equipment expense was \$8.18 million for 2014, or \$0.73 million and 9.72% higher than 2013. Furniture and equipment expense was \$7.46 million for 2013, or \$0.99 million and 15.32% higher than comparative 2012. Increases in both comparative periods were related to furnishing new facilities and the associated depreciation expense on the capitalized furnishings utilized in those facilities.

Other expenses for 2014 were \$53.81 million, which was \$5.88 million, or 12.27%, higher than the 2013 amount of \$47.93 million. The primary drivers of the increase were acquisition-related expenses, which increased by \$4.30 million, and expenses related to foreclosed properties, which increased by \$1.38 million. The increase was partially offset by a decrease in expenses related to advertising and marketing, which declined by \$0.20 million, a decrease in charitable contributions of \$0.78 million, and a decrease in travel, meals, and entertainment of \$0.29 million. Other expenses for 2013 were \$47.93 million, or 0.62%, less than the 2012 amount of \$48.23 million due to decreases in expenses related to foreclosed properties, which declined by \$2.59 million. The decrease was mostly offset by increases in expenses related to advertising and marketing, which were higher by \$0.56 million, an increase in charitable contributions of \$0.64 million, and an increase in travel, meals, and entertainment of \$0.44 million.

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Income Taxes: Income taxes for the year ended December 31, 2014 were \$18.18 million. This was \$1.05 million higher than the 2013 amount of \$17.13 million, which was \$3.17 million higher than the 2012 amount of \$13.96 million. The effective tax rate for 2014 was 30.12% versus 29.09% for 2013 and 26.91% for 2012. The rate increase in 2014 was primarily a result of the Company's adoption of change in accounting for affordable housing projects that qualify for the low-income housing tax credit. Amortization of the initial investment cost of qualifying projects is now recorded in the provision for income taxes together with the tax credits and benefits received. Previously, the net losses on the investments were recorded in other noninterest income. The rate increase in 2013 was primarily due to higher taxable income, which more than offset the increase in federal tax credits from community reinvestment activity. Refer to Note 19 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 24 in the Notes to Consolidated Financial Statements.

Banking Segment: For the year ended December 31, 2014, the Banking segment represented 82.33%, or \$34.72 million, of our total consolidated net income, compared to 82.36% and 76.29% for 2013 and 2012.

Pre-tax earnings for the year ended December 31, 2014 for the Banking segment were \$47.82 million, increasing \$0.74 million, or 1.57%, from comparative 2013. The increase in earnings was driven by a \$4.19 million, or 2.62%, increase in total revenues coupled with a \$3.85 million, or 90.68%, decrease in the provision for loan losses, which was offset by a \$7.41 million, or 6.79%, increase in expenses.

The increase in net interest income for the year ended December 31, 2014 of \$2.46 million, or 1.74%, was due to a combination of lower interest income on loans, higher interest income on investments, and higher interest expense. Although average loans increased to \$3.30 billion for the year ended December 31, 2014, from \$3.16 billion in 2013, total interest income was down \$0.70 million due to historically low interest rates. The increase in investment interest income of \$3.92 million was driven by average investment balances increasing to \$796.37 million, or 55.95%, over the comparative period in 2013. Interest expense was up slightly for the year ended December 31, 2014 by \$0.67 million mainly due to an increase in our Federal Home Loan Bank of Atlanta ("FHLB") borrowings resulting in an additional \$0.38 million of interest expense.

The increase in other income of \$1.74 million, or 33.17%, was due to a combination of lower service charges on loans of \$0.93 million, offset with increases in investment commission income of \$0.60 million, BOLI income of \$0.14 million, gains on the sale of foreclosed properties of \$0.58 million, and a change in accounting policy related to low income housing tax credit investments whereby current year losses of \$1.87 million are included in the tax expense provision under the proportional amortization method as compared to prior year losses of \$1.39 million, which were included in other noninterest income.

Noninterest expense for the year ended December 31, 2014 increased \$7.41 million, or 6.79%, over 2013. Primary factors resulting in the increase were additional salaries and employee benefits of \$0.77 million, or 1.28%, occupancy expense of \$0.90 million, or 7.83%, furniture and equipment expense of \$0.51 million, or 8.70%, foreclosed property expense of \$0.94 million, or 31.00%, professional fees of \$0.71 million, or 23.96%, other expenses of \$4.64 million, or 47.70%, which were partially offset by a decrease in advertising and marketing of \$0.31 million, or 10.09% and charitable contributions of \$0.87 million, or 21.02%.

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The increase in salaries and employee benefits was primarily due to nonrecurring employee severance costs of approximately \$2.87 million, which was partially offset by a decrease in employee expenses related to employee profit-sharing, incentive compensation, and matching contributions to employee retirement plans totaling approximately \$1.67 million.

The total increase in occupancy and furniture and equipment expense was primarily related to the addition of two new branches, one relocation of a branch, and one full year of expenses related to a branch that was opened in the fall of 2013. The total increase in relation to additional branch costs was approximately \$0.86 million.

The decrease in advertising and marketing, as well as charitable contributions, was also a result of the aforementioned cost-control initiatives.

The increase in foreclosed property expense was due to a \$1.08 million increase in the valuation allowance and was partially offset by a reduction in expenses from a lower foreclosed property balance.

Total costs relating to mergers and acquisitions, including increases in legal and professional fees, totaled \$4.28 million, which were the most significant factors in the overall increases in professional fees and other expenses.

Pre-tax earnings for the year ended December 31, 2013, for the Banking segment were \$47.08 million, increasing \$9.67 million, or 25.85%, over 2012. The increase was primarily due to a \$0.03 million, or 0.02%, increase in net interest income and an increase in service charges on deposit accounts and credit card merchant fees.

For the year ended December 31, 2013, noninterest expenses increased \$0.94 million, or 0.87%, over 2012. The primary factors in the increase were increases in salaries and benefits of \$1.57 million and an increase in charitable contributions of \$0.67 million, which were partially offset by a decrease in foreclosed property expenses of \$1.57 million.

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

	Year Ended			Increase/(Decrease)			
	December 31,			2014 over 2013		2013 over 2012	
	2014	2013	2012	Amount	Percent	Amount	Percent
Revenue							
Net interest income	\$ 143,999	\$ 141,543	\$ 141,517	\$ 2,456	1.74 %	\$ 26	0.02 %
Noninterest income							
Service charges on deposit accounts	9,192	8,682	7,798	510	5.87 %	884	11.34 %
Credit card merchant fees	3,576	3,471	3,578	105	3.03 %	(107)	(2.99)%
Other income	6,993	5,251	5,297	1,742	33.17 %	(46)	(0.87)%
Subtotal	19,761	17,404	16,673	2,357	13.54 %	731	4.38 %
Gain on investment securities	(15)	611	3,005	(626)	(102.45)%	(2,394)	(79.67)%
Total noninterest income	19,746	18,015	19,678	1,731	9.61 %	(1,663)	(8.45)%
Total revenue	163,745	159,558	161,195	4,187	2.62 %	(1,637)	(1.02)%
Provision for loan losses	396	4,248	16,155	(3,852)	(90.68)%	(11,907)	(73.70)%
Expenses							
Salaries and employee benefits	61,031	60,259	58,685	772	1.28 %	1,574	2.68 %
Occupancy expense	12,369	11,471	10,891	898	7.83 %	580	5.33 %
Furniture and equipment	6,358	5,849	5,194	509	8.70 %	655	12.61 %
Advertising and marketing	2,737	3,044	3,099	(307)	(10.09)%	(55)	(1.77)%
Charitable contributions	3,257	4,124	3,452	(867)	(21.02)%	672	19.47 %
Outside processing	2,523	2,443	2,193	80	3.27 %	250	11.40 %
Foreclosed property expenses	3,981	3,039	4,612	942	31.00 %	(1,573)	(34.11)%
FDIC and other insurance	3,660	3,784	3,757	(124)	(3.28)%	27	0.72 %
Professional fees	3,678	2,967	2,911	711	23.96 %	56	1.92 %
Telephone and postage	2,583	2,428	2,259	155	6.38 %	169	7.48 %
Other expenses	14,371	9,730	11,146	4,641	47.70 %	(1,416)	(12.70)%
Total expenses	116,548	109,138	108,199	7,410	6.79 %	939	0.87 %
Income before income tax expense and corporate allocation	46,801	46,172	36,841	629	1.36 %	9,331	25.33 %
Corporate allocation	1,014	904	565	110	12.17 %	339	60.00 %
Income before income tax provision	47,815	47,076	37,406	739	1.57 %	9,670	25.85 %
Provision for income tax expense	(13,098)	(12,680)	(8,468)	(418)	3.30 %	(4,212)	49.74 %
Net income	\$ 34,717	\$ 34,396	\$ 28,938	\$ 321	0.93 %	\$ 5,458	18.86 %

Realty Segment: For the year ended December 31, 2014, the Realty segment represented 6.42%, or \$2.71 million, of our total consolidated net income, compared to 9.73%, or \$4.06 million, for 2013, and 17.78%, or \$6.74 million, for 2012.

Earnings before income tax provision and noncontrolling interest for the year ended December 31, 2014, for the Realty segment were \$6.64 million, decreasing 22.33% from 2013. Total revenue decreased to \$44.70 million in 2014 from \$47.43 million in 2013.

Net residential mortgage banking income decreased by \$1.93 million to \$27.49 million from 2013. Approximately \$4.03 million of the decrease was due to significant decreases in volume, which was partially offset by a \$1.07 million increase from expanded operations and a \$1.03 million change in the rate lock commitment. The decrease in title insurance and settlement fees and net interest and other income were also a

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result of lower volume from 2013. The modest increase in net property management fees was a direct result of the Beach Properties acquisition that occurred during the fourth quarter of 2014.

Expenses for the Realty segment decreased 2.17%, or \$0.83 million, when compared to 2013. For the year ended December 31, 2014, the expansion of our mortgage operations has resulted in additional expenses of \$2.20 million. The increase in expenses relating to expanding our market footprint and processing centers were more than offset by the effects of company-wide cost-control initiatives.

Earnings before income tax provision and noncontrolling interest for the year ended December 31, 2013, for the Realty segment were \$8.55 million, decreasing 30.04% from 2012. Total revenue increased to \$47.43 million in 2013 from \$44.92 million in 2012. The expansion of our mortgage operations resulted in an increase in net mortgage banking income of \$3.14 million in 2013 and \$10.37 million in 2012. Additionally, there was a decrease in income associated with a decline in value of rate lock commitments of \$0.66 million in 2013 compared to an increase of \$1.24 million in 2012. Strengthening in the housing market resulted in an increase in net real estate brokerage income of \$0.96 million, compared to a relatively flat year in 2012.

Expenses for the Realty segment increased 18.60%, or \$6.01 million, when compared to 2012, which increased 29.53%, or \$7.37 million. For the year ended December 31, 2013, the expansion of our mortgage operations has resulted in additional expenses of \$4.01 million.

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

	Year Ended			Increase/(Decrease)			
	December 31,			2014 over 2013		2013 over 2012	
	2014	2013	2012	Amount	Percent	Amount	Percent
Revenue							
Residential mortgage banking income, net	\$ 27,492	\$ 29,425	\$ 27,546	\$ (1,933)	(6.57)%	\$ 1,879	6.82 %
Real estate brokerage income, net	6,439	6,330	5,367	109	1.72 %	963	17.94 %
Title insurance and settlement fees	1,516	1,921	1,830	(405)	(21.08)%	91	4.97 %
Property management fees, net	6,195	5,986	6,148	209	3.49 %	(162)	(2.64)%
Income from unconsolidated subsidiary	516	562	578	(46)	(8.19)%	(16)	(2.77)%
Net interest and other income	2,538	3,206	3,455	(668)	(20.84)%	(249)	(7.21)%
Total revenue	44,696	47,430	44,924	(2,734)	(5.76)%	2,506	5.58 %
Expenses							
Salaries and employee benefits	21,903	22,603	18,973	(700)	(3.10)%	3,630	19.13 %
Occupancy expense	3,806	3,557	2,547	249	7.00 %	1,010	39.65 %
Furniture and equipment	1,088	1,010	778	78	7.72 %	232	29.82 %
Amortization of intangible assets	685	515	663	170	33.01 %	(148)	(22.32)%
Other expenses	10,001	10,631	9,346	(630)	(5.93)%	1,285	13.75 %
Total expenses	37,483	38,316	32,307	(833)	(2.17)%	6,009	18.60 %
Income before income tax, corporate allocation, and noncontrolling interest	7,213	9,114	12,617	(1,901)	(20.86)%	(3,503)	(27.76)%
Corporate allocation	(575)	(568)	(402)	(7)	1.23 %	(166)	41.29 %
Income before income tax provision and noncontrolling interest	6,638	8,546	12,215	(1,908)	(22.33)%	(3,669)	(30.04)%
Provision for income tax	(1,874)	(2,384)	(3,995)	510	(21.39)%	1,611	(40.33)%
Net income	4,764	6,162	8,220	(1,398)	(22.69)%	(2,058)	(25.04)%
Noncontrolling interest	(2,056)	(2,099)	(1,475)	43	(2.05)%	(624)	42.31 %
Net income attributable to TowneBank	\$ 2,708	\$ 4,063	\$ 6,745	\$ (1,355)	(33.35)%	\$ (2,682)	(39.76)%

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

Key data	Year Ended			Increase/(Decrease)			
	December 31,			2014 over 2013		2013 over 2012	
	2014	2013	2012	Amount	Percent	Amount	Percent
Number of units sold	3,627	3,731	3,224	(104)	(2.79)%	507	15.73 %
Volume of units sold	\$ 1,009,539	\$ 993,739	\$ 849,986	\$ 15,800	1.59 %	\$ 143,753	16.91 %
Number of real estate agents	376	373	378	3	0.80 %	(5)	(1.32)%
Loans originated, mortgage	\$ 540,470	\$ 673,148	\$ 655,386	\$(132,678)	(19.71)%	\$ 17,762	2.71 %
Loans originated, joint ventures	682,023	760,426	671,664	(78,403)	(10.31)%	88,762	13.22 %
Total loans originated	\$ 1,222,493	\$ 1,433,574	\$ 1,327,050	\$(211,081)	(14.72)%	\$ 106,524	8.03 %
Number of loans, mortgage	2,405	3,162	2,931	(757)	(23.94)%	231	7.88 %
Number of loans, joint ventures	3,248	3,654	3,125	(406)	(11.11)%	529	16.93 %
Total number of loans	5,653	6,816	6,056	(1,163)	(17.06)%	760	12.55 %
Average loan amount, mortgage	\$ 225	\$ 213	\$ 224	\$ 12	5.63 %	\$ (11)	(4.91)%
Average loan amount, joint ventures	210	208	215	2	0.96 %	(7)	(3.26)%
Average loan amount	\$ 216	\$ 210	\$ 219	\$ 6	2.86 %	\$ (9)	(4.11)%
Average number of originators, mortgage	67	62	52	5	8.06 %	10	19.23 %
Average number of originators, joint ventures	61	52	37	9	17.31 %	15	40.54 %
Average number of originators	128	114	89	14	12.28 %	25	28.09 %

Mortgage. The loan volume for combined mortgage operations showed decreases during the year ended December 31, 2014, as compared to 2013. Total loans originated in 2014 were \$1.22 billion, a 14.72%, or \$211.08 million, decrease from \$1.43 billion in 2013, which was a \$106.52 million, or 8.03%, increase compared to the 2012 volume of \$1.33 billion. Refinance activity comprised \$164.44 million of loan volume for the year ended December 31, 2014, while purchases accounted for the remaining \$1.06 billion in loan volume for the year. For the years ended December 31, 2013 and 2012, refinance volume was \$368.54 million and \$466.11 million, respectively, while purchase volume was \$1.06 billion and \$860.94 million, respectively.

Insurance Segment: The Insurance segment comprises property and casualty and group benefits divisions. The Insurance segment represented 11.25%, or \$4.74 million, of our total consolidated net income in 2014, up from 7.91%, or \$3.30 million, in 2013.

Earnings before taxes and noncontrolling interest for the Insurance segment were \$8.66 million in 2014, increasing \$2.90 million, or 50.25%, from 2013. The primary factors affecting earnings were the acquisitions of two insurance agencies in July 2013 and one agency in May 2014. Net commission and fee income for the year ended December 31, 2014 increased \$4.61 million, or 19.68%. The increase from the prior period was positively impacted by the recent acquisitions, which resulted in an additional \$3.80 million in commission and fee income. Also contributing to the increase was higher contingency and bonus revenue and other income of \$1.20 million and \$0.69 million, respectively. Contingent commissions primarily consist of amounts received from various property and casualty insurance carriers. The carriers use several non-client-specific factors to determine the amount of the contingency payments. Such factors include the aggregate loss performance of insurance policies previously placed and the volume of business, among other things. Such commissions are seasonal in nature and are mostly received during the first quarter of each year. The increase in other income was primarily due to additional revenue from our travel insurance product lines, which was \$0.85 million above 2013.

Earnings before taxes and noncontrolling interest for the Insurance segment were \$5.76 million in 2013, increasing \$1.81 million, or 45.92%, from 2012. The primary factors affecting earnings were the acquisitions of

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two insurance agencies in July 2013 and one agency in December 2012. Net commission and fee income for the year ended December 31, 2013 increased \$3.80 million, or 19.41%. The increase from the prior period was positively impacted by the acquisitions, which resulted in an additional \$3.37 million in commission and fee income. Also contributing to the increase was higher contingency and bonus revenue and other income of \$0.39 million and \$0.89 million, respectively. The increase in other income was primarily due to additional revenue from our travel insurance product lines. Factors contributing to the decrease included an increase in noninterest expenses of \$0.35 million at our travel insurance company due to salaries for new employees and increased professional fees, and a one-time \$0.50 million charge related to the final settlement of the 2009 W. Taylor Johnson Insurance Inc. purchase agreement. Also contributing to the variance from the prior year were the effects of the Stan Taylor Agency, Inc. acquisition, which resulted in additional net commission income of \$0.90 million and additional noninterest expense of \$0.88 million.

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

	Year Ended			Increase/(Decrease)			
	December 31,			2014 over 2013		2013 over 2012	
	2014	2013	2012	Amount	Percent	Amount	Percent
Revenue							
Net commission and fee income							
Property and casualty	\$ 20,076	\$ 16,060	\$ 13,548	\$ 4,016	25.01%	\$ 2,512	18.54%
Group benefits	7,382	6,807	5,533	575	8.45%	1,274	23.03%
Specialized benefit services	543	529	512	14	2.65%	17	3.32%
Total net commissions and fees	28,001	23,396	19,593	4,605	19.68%	3,803	19.41%
Contingency and bonus revenue	3,231	2,031	1,639	1,200	59.08%	392	23.92%
Other income	2,696	2,009	1,122	687	34.20%	887	79.06%
Total revenue	33,928	27,436	22,354	6,492	23.66%	5,082	22.73%
Expenses							
Salaries and employee benefits	16,073	14,246	12,010	1,827	12.82%	2,236	18.62%
Occupancy expense	1,688	1,270	946	418	32.91%	324	34.25%
Furniture and equipment	737	599	495	138	23.04%	104	21.01%
Amortization of intangible assets	1,879	1,558	1,245	321	20.60%	313	25.14%
Other expenses	4,456	3,666	3,547	790	21.55%	119	3.35%
Total expenses	24,833	21,339	18,243	3,494	16.37%	3,096	16.97%
Income before income tax, corporate allocation, and noncontrolling interest	9,095	6,097	4,111	2,998	49.17%	1,986	48.31%
Corporate allocation	(439)	(336)	(163)	(103)	30.65%	(173)	106.13%
Income before income tax provision and noncontrolling interest	8,656	5,761	3,948	2,895	50.25%	1,813	45.92%
Provision for income tax expense	(3,207)	(2,071)	(1,501)	(1,136)	54.85%	(570)	37.97%
Net income	5,449	3,690	2,447	1,759	47.67%	1,243	50.80%
Noncontrolling interest	(705)	(387)	(199)	(318)	82.17%	(188)	94.47%
Net income attributable to TowneBank	\$ 4,744	\$ 3,303	\$ 2,248	\$ 1,441	43.63%	\$ 1,055	46.93%

Salaries and employee benefits expense increased \$1.83 million, or 12.82%, when comparing 2014 to 2013, and increased \$2.24 million, or 18.62%, when comparing 2013 to 2012. The increases were mainly driven by the insurance agency acquisitions, which resulted in additional salaries and employee benefit expenses of \$2.08 million and \$2.05 million for 2014 and 2013, respectively.

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Occupancy expense increased \$0.42 million, or 32.91%, when comparing 2014 to 2013, and increased \$0.32 million, or 34.25%, when comparing 2013 to 2012 as a result of the insurance agency acquisitions.

Amortization of intangible assets increased \$0.32 million, or 20.60%, during the year ended December 31, 2014, compared to 2013, and increased \$0.31 million, or 25.14%, comparing 2013 to 2012, which was also a result of the acquisitions.

ANALYSIS OF FINANCIAL CONDITION

Overview: Our total assets increased \$309.49 million, or 6.62%, to \$4.98 billion at December 31, 2014, from \$4.67 billion at December 31, 2013. Our loan portfolio grew by a rate of 4.98%, or \$161.28 million, to \$3.40 billion at December 31, 2014, from \$3.24 billion at December 31, 2013.

Our total average assets were \$4.87 billion for 2014, reflecting an increase of \$359.35 million, or 7.97%, compared to the 2013 average of \$4.51 billion. Total average assets for 2013 increased \$305.78 million, or 7.28%, compared to the 2012 average of \$4.20 billion. Average earning assets were \$4.47 billion, including BOLI assets, in 2014, reflecting an increase of \$348.59 million, or 8.45%, compared to 2013.

Our average total deposits were \$3.75 billion in 2014, reflecting growth of \$311.70 million, or 9.07%, compared to 2013. Average noninterest-bearing deposits, which increased \$136.72 million, or 13.38%, grew at a significantly higher rate than interest-bearing deposits in 2014, which grew \$174.98 million, or 7.25%.

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 \$878.43 million as of December 31, 2014, with a balance of \$603.91 million in available-for-sale, \$252.37 million in held-to-maturity, and \$22.16 million in Federal Home Loan Bank stock. Average yield on available-for-sale securities was 1.10% at December 31, 2014, compared with 0.87% at December 31, 2013, and 0.88% at December 31, 2012. Average yield on held-to-maturity securities was 2.97% at December 31, 2014, compared to 3.13% at December 31, 2013, and 3.46% at December 31, 2012.

Our available-for-sale securities portfolio consists of U.S. agency securities, municipal securities, mortgage-backed securities, and trust preferred corporate obligations. Our held-to-maturity portfolio consists of municipal securities, trust preferred corporate obligations, and industrial revenue bonds. Our investment activities are governed internally by a written and Board-approved investment policy, which is administered by our Asset-Liability Committee ("ALCO"). The ALCO generally meets quarterly 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).

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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,								
	2014			2013			2012		
	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	\$ 512,762	\$ 512,441	0.81%	\$ 235,143	\$ 233,330	0.75%	\$ 3,219	\$ 3,306	2.83%
U.S. Treasury notes	—	—	—	200,000	200,000	—	300,000	300,000	—
Municipal securities	24,148	24,719	3.12%	36,845	37,079	2.70%	38,854	40,084	3.10%
Trust preferred corporate securities	6,327	7,063	3.47%	6,396	6,848	3.45%	4,480	4,889	4.61%
Other corporate securities	1,393	1,393	1.30%	1,409	1,409	2.61%	488	488	0.67%
Mortgage-backed securities	57,240	58,292	2.52%	64,103	64,855	2.70%	100,490	101,377	2.42%
Total securities available for sale	601,870	603,908	1.10%	543,896	543,521	0.87%	447,531	450,144	0.88%
Securities Held to Maturity:									
Trust preferred corporate securities	500	722	8.75%	500	641	8.75%	500	688	8.75%
Municipal securities	56,923	60,888	3.92%	58,644	59,821	3.91%	62,062	67,409	3.92%
Mortgage-backed securities	27,823	27,942	1.58%	—	—	—	—	—	—
Industrial revenue bonds	167,124	178,712	2.86%	145,204	147,824	2.80%	92,919	97,587	3.12%
Total securities held to maturity	252,370	268,264	2.97%	204,348	208,286	3.13%	155,481	165,684	3.46%
Total Portfolio	\$ 854,240	\$ 872,172	1.65%	\$ 748,244	\$ 751,807	1.49%	\$ 603,012	\$ 615,828	1.54%

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The following table indicates the maturities of securities at December 31, 2014 (dollars in thousands):

	Available for Sale			Held to Maturity		
	Amortized Cost	Fair Market Value	Weighted Average Yield	Amortized Cost	Fair Market Value	Weighted Average Yield
U.S. Treasury & U.S. agency securities						
Due in one year or less	\$ 30,275	\$ 30,295	0.41%	\$ —	\$ —	—
After one year through five years	481,003	480,586	0.83%	—	—	—
After five years through ten years	1,484	1,560	3.77%	—	—	—
After ten years	—	—	—	—	—	—
Municipal securities						
Due in one year or less	1,996	2,005	2.08%	—	—	—
After one year through five years	7,968	8,048	2.26%	2,100	2,273	4.54%
After five years through ten years	6,611	6,651	3.01%	20,591	21,523	3.36%
After ten years	7,574	8,016	4.38%	34,232	37,092	4.23%
Mortgage-backed securities						
Due in one year or less	—	—	—	—	—	—
After one year through five years	—	—	—	—	—	—
After five years through ten years	30,027	30,360	2.25%	27,823	27,942	1.58%
After ten years	27,213	27,932	2.81%	—	—	—
Trust preferred corporate securities						
Due in one year or less	2,358	2,376	1.87%	—	—	—
After one year through five years	1,992	1,993	0.79%	—	—	—
After five years through ten years	—	—	—	—	—	—
After ten years	1,976	2,693	8.09%	500	722	8.75%
Industrial revenue bonds						
Due in one year or less	—	—	—	—	—	—
After one year through five years	—	—	—	1,233	1,333	4.55%
After five years through ten years	—	—	—	16,252	16,853	2.88%
After ten years	—	—	—	149,639	160,526	2.84%
Other securities						
Due in one year or less	993	993	—	—	—	—
After one year through five years	250	250	1.30%	—	—	—
After five years through ten years	150	150	—	—	—	—
After ten years	—	—	—	—	—	—
No stated maturity	—	—	—	—	—	—
Total Portfolio	\$ 601,870	\$ 603,908	1.10%	\$ 252,370	\$ 268,264	2.97%

Loans Held for Sale: At December 31, 2014, we held \$71.39 million in mortgage loans originated and intended for sale in the secondary market, compared with \$58.64 million at December 31, 2013. Average loans held for sale were 1.47% and 2.36% of average earning assets for the years ended December 31, 2014 and 2013, 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.

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Rate lock commitments related to the origination of mortgage loans held for sale and the corresponding forward loan sale commitments are considered derivative instruments, which are carried at fair value. These derivative instruments do not qualify for hedge accounting. The fair value of interest rate lock commitments is based on current secondary market pricing and recognized on the income statement at the time of commitment. Gains on the sales of mortgages are recognized when the Company, the borrower, and the investor enter into the loan contract.

Loan Portfolio: Our loan portfolio, net of the allowance for loan losses, totaled \$3.36 billion on December 31, 2014. As a percentage of total average earning assets, average loans were 73.76% in 2014, compared with 76.60% in 2013 and 76.35% in 2012. Lending activities represent our primary source of income. Factors that contributed to the increase in our loan demand were continued improvements in our local economy and the efforts of our loan officers in developing new loan relationships, combined with the support of existing customers and directors. 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,	2014	2013	2012	2011	2010
Real estate loans					
1-4 family residential	\$ 837,370	\$ 797,723	\$ 754,593	\$ 709,129	\$ 714,122
Commercial	1,447,078	1,365,572	1,231,819	1,072,187	952,727
Construction and land development	452,481	469,679	618,562	557,630	657,341
Multifamily	51,472	53,562	57,831	48,321	41,441
Total real estate loans	2,788,401	2,686,536	2,662,805	2,387,267	2,365,631
Commercial and industrial loans	533,500	500,755	427,994	362,830	322,027
Consumer loans and other	75,365	48,698	42,708	43,096	43,694
Loans, net of unearned income and deferred costs	\$ 3,397,266	\$ 3,235,989	\$ 3,133,507	\$ 2,793,193	\$ 2,731,352

Year Ended December 31,	2014	2013	2012	2011	2010
Real estate loans					
1-4 family residential	24.65%	24.65%	24.08%	25.39%	26.14%
Commercial	42.60%	42.20%	39.31%	38.39%	34.88%
Construction and land development	13.32%	14.51%	19.74%	19.96%	24.07%
Multifamily	1.51%	1.66%	1.85%	1.73%	1.52%
Total real estate loans	82.08%	83.02%	84.98%	85.47%	86.61%
Commercial and industrial loans	15.70%	15.47%	13.66%	12.99%	11.79%
Consumer loans and other	2.22%	1.51%	1.36%	1.54%	1.60%
Loans, net of unearned income and deferred costs	100.00%	100.00%	100.00%	100.00%	100.00%

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The table below provides the maturity and sensitivity of the loan portfolio at December 31, 2014 (in thousands):

	Due in One Year or Less	Due After One Year Through Five Years	Due After Five Years	Totals	Due After One Year	
					Fixed Rates	Adjustable Rates
Real estate loans						
1-4 family residential	\$ 72,743	\$ 79,000	\$ 685,627	\$ 837,370	\$ 308,135	\$ 456,492
Commercial	111,065	117,093	1,218,920	1,447,078	1,137,370	198,643
Construction and land development	278,278	105,541	68,662	452,481	79,123	95,080
Multifamily	2,332	4,104	45,036	51,472	45,013	4,127
Total real estate loans	464,418	305,738	2,018,245	2,788,401	1,569,641	754,342
Commercial and industrial loans	276,505	130,433	126,562	533,500	184,218	72,777
Consumer loans and other	23,386	19,680	32,299	75,365	50,309	1,670
Loans, net of unearned income and deferred costs	\$ 764,309	\$ 455,851	\$ 2,177,106	\$ 3,397,266	\$ 1,804,168	\$ 828,789

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. 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, and other current factors that warrant consideration in determining an adequate allowance.

The allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC 310, *Receivables*, based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC 450, *Contingencies*, based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; and (iii) general valuation allowances determined in accordance with ASC 450 based on general economic conditions and other qualitative risk factors both internal and external to the Company.

It is our policy to recommend internal risk grades to all loans as a component of the approval process. Based on the size of the loan, senior credit officers, regional credit administrators, and the chief credit officer review the classification to ensure accuracy and consistency of classifications, which are then validated by the internal loan review process. 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 allowances established for probable losses on specific loans are based on a regular analysis and evaluation of classified loans.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans. We calculate historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical loss ratios are updated quarterly based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool. Our pools of similar loans include groups of construction and land development loans, commercial real estate loans, commercial and industrial business loans, 1-4 family residential real estate loans, multifamily real estate loans, and consumer and other loans.

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General valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to TowneBank. In general, such valuation allowances are determined by evaluating, among other things: (i) the experience, ability, and effectiveness of the Company's lending management and staff; (ii) the effectiveness of the Company's loan policies, procedures, and internal controls; (iii) changes in asset quality; (iv) changes in loan portfolio volume; (v) the composition and concentrations of credit; (vi) the effectiveness of the internal loan review function; (vii) the impact of national economic trends on portfolio risks; and (viii) the impact of local economic trends on portfolio risk. Management evaluates the degree of risk that each one of these components has on the quality of the loan portfolio on a quarterly basis to determine an appropriate general valuation allowance.

The allowance for loan losses at December 31, 2014, 2013, and 2012 was \$35.92 million, \$38.38 million, and \$40.43 million, respectively. The allowance was equal to 1.06% of total loans outstanding at December 31, 2014, compared with 1.19% at December 31, 2013, and 1.29% at December 31, 2012. We believe the decline in the ratio is appropriate given the continued improvement in the risk profile of our loan portfolio and diversification efforts in the loan portfolio. Reflective of improving metrics, classified loans, defined as loans in the substandard and doubtful categories, remained low at 1.93% of total loans at December 31, 2014, up slightly from 1.90% at December 31, 2013. Additionally, while loans 60 to 89 days past due increased to \$4.29 million at December 31, 2014, from \$0.56 million at December 31, 2013, total past due and nonaccruing loans decreased to \$20.19 million at December 31, 2014, from \$26.66 million at December 31, 2013. Also reflecting improvement in our loan portfolio and supporting the adequacy of coverage levels of the allowance for loan losses, the allowance was equal to 533% of nonperforming loans at December 31, 2014, compared with 301% at December 31, 2013. Additionally, overall economic conditions and labor market conditions have continued to show improvement. Given the combination of these noted factors, we believe our allowance for loan losses is adequate to cover loan losses inherent in the loan portfolio at December 31, 2014.

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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,	2014	2013	2012	2011	2010
Balance beginning of period	\$ 38,380	\$ 40,427	\$ 39,740	\$ 38,660	\$ 33,793
Loans charged off:					
1-4 family residential real estate	(1,473)	(4,402)	(4,640)	(4,837)	(5,932)
Multifamily	(493)	(14)	(345)	—	(95)
Commercial real estate	(1,165)	(396)	(3,295)	(1,093)	(1,933)
Construction and land development	(561)	(1,734)	(5,989)	(7,562)	(7,294)
Commercial and industrial	(432)	(1,040)	(1,791)	(374)	(1,274)
Consumer and other	(415)	(397)	(504)	(318)	(1,867)
Total	(4,539)	(7,983)	(16,564)	(14,184)	(18,395)
Loans recovered:					
Residential 1-4 family	661	465	860	346	123
Multifamily	47	—	—	15	64
Commercial real estate	452	335	60	3	—
Construction and land development	134	367	54	851	332
Commercial and industrial	130	466	66	120	157
Consumer and other	160	55	56	327	21
Total	1,584	1,688	1,096	1,662	697
Net loans charged off	(2,955)	(6,295)	(15,468)	(12,522)	(17,698)
Provision for loan losses	492	4,248	16,155	13,602	22,565
Balance end of period	\$ 35,917	\$ 38,380	\$ 40,427	\$ 39,740	\$ 38,660
Nonperforming assets:					
Nonperforming loans	\$ 6,741	\$ 12,753	\$ 40,691	\$ 55,801	\$ 57,167
Foreclosed property	35,116	39,534	30,297	29,819	20,452
Total nonperforming assets	\$ 41,857	\$ 52,287	\$ 70,988	\$ 85,620	\$ 77,619
Loans past due 90 days accruing interest	\$ 12	\$ —	\$ 222	\$ 1	\$ 1,229
Asset Quality Ratios					
Allowance for loan losses to nonperforming loans	533%	301%	99%	71%	68%
Allowance to nonperforming assets	.86x	.73x	.57x	.46x	.50x
Allowance for loan losses to period end loans	1.06%	1.19%	1.29%	1.42%	1.42%
Nonperforming loans to period end loans	0.20%	0.39%	1.30%	2.00%	2.09%
Nonperforming assets to period end assets	0.84%	1.12%	1.61%	2.10%	2.01%
Net charge-offs to average loans	0.09%	0.20%	0.52%	0.46%	0.67%

Nonperforming assets consist of 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 90 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

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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, residential mortgage loans and other consumer loans are also placed 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.

At December 31, 2014, we had \$41.86 million in nonperforming assets, which amounted to 0.84% of total assets. Nonperforming assets consist of \$6.74 million in nonperforming loans, as well as \$35.12 million in foreclosed property. Nonperforming loans decreased by \$6.01 million, or 47.14%, from December 31, 2013, as additions to nonaccrual loans during 2014 were more than offset by transfers to OREO, charge-offs, and payments received. The majority of the decrease was in construction and land development, which decreased by \$4.01 million, as paydowns of \$1.92 million, charge-offs of \$0.56 million, and transfers to OREO of \$1.97 million outpaced new nonperforming loans. Additionally, nonperforming 1-4 family residential real estate loans decreased by \$1.65 million as paydowns of \$2.10 million, charge-offs of \$1.47 million, and transfers to OREO of \$2.52 million outpaced new nonperforming loans. At December 31, 2014, foreclosed property totaled \$35.12 million, a decrease from \$39.53 million at December 31, 2013. The five largest foreclosed property developments represented 67.17% of total foreclosed property at December 31, 2014. Foreclosed property consists of 26 residential properties, 27 construction and development properties, and six commercial properties.

At December 31, 2014, loans 60 to 89 days delinquent, excluding nonperforming loans, totaled \$4.29 million. Additionally, there are other performing loans, totaling \$55.76 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.

In order to maximize the collection of loan balances, we evaluate troubled loan accounts on a case-by-case basis to determine if a loan modification would be appropriate. We may pursue loan modifications when there is a reasonable chance that an appropriate modification would allow our clients to continue servicing the debt. Because some troubled debt restructurings ("TDRs") may not ultimately result in the complete collection of principal and interest (as modified by the terms of the restructuring), additional incremental losses could result. These potential incremental losses have been factored into our overall allowance for loan losses estimate.

At December 31, 2014, nonaccruing TDRs, which are included in nonperforming loans, totaled \$2.50 million, and accruing TDRs totaled \$38.42 million. Nonaccruing loans that are modified can be placed back on accrual status when both principal and interest are current, there is a sustained repayment performance of six months or greater, and it is probable that we will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

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The following table provides information on the composition of nonperforming loans by loan type (in thousands):

	December 31, 2014	December 31, 2013
Construction and land development	\$ 1,680	\$ 5,687
Commercial real estate	2,132	1,422
Multifamily real estate	—	606
1-4 family residential real estate	2,546	4,194
Commercial and industrial loans	383	687
Consumer loans and other	—	157
Total nonperforming loans	<u>\$ 6,741</u>	<u>\$ 12,753</u>

Allocation of the Allowance for Loan Losses: At December 31, 2014, all of the allowance for loan losses was allocated to specific loan categories. Management monitors whether or not the allowance for loan loss allocation model, as a whole, calculates an appropriate level of allowance for loan losses that moves in direct correlation to the general macroeconomic and loan portfolio conditions the Company experiences over time. This allocation of the allowance for loan losses is calculated on an approximate basis and is not intended as an indication of the specific amounts, by loan classification, to be charged to the allowance. The entire amount of the allowance is available to absorb losses occurring in any category of loans. 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,	2014	2013	2012	2011	2010
Real estate loans:					
1-4 family residential	\$ 9,121	\$ 10,730	\$ 10,722	\$ 10,837	\$ 9,543
Commercial	14,226	13,621	12,521	10,578	12,827
Construction	5,661	7,925	11,691	13,623	10,984
Multifamily	667	699	589	395	557
Total real estate loans	<u>29,675</u>	<u>32,975</u>	<u>35,523</u>	<u>35,433</u>	<u>33,911</u>
Commercial and industrial loans	4,963	4,711	4,378	3,842	4,008
Consumer loans and other	1,279	694	526	465	741
Total	<u>\$ 35,917</u>	<u>\$ 38,380</u>	<u>\$ 40,427</u>	<u>\$ 39,740</u>	<u>\$ 38,660</u>

In the opinion of management, the allowance was adequate at December 31, 2014, 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, changes in the value of collateral, and changes in general economic conditions and other risk factors.

Allowance for Loan Losses Policy and Methodology: Our allowance for loan loss methodology is based on guidance provided by various regulatory agencies and includes allowance allocations calculated in accordance with ASC 310, *Receivables*, and allowance allocations calculated in accordance with ASC 450, *Contingencies*. Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools, and specific loss allocations, with adjustments for current events and conditions. The Company's process for determining the appropriate level of the allowance for possible loan losses is designed to account for credit deterioration as it occurs. 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.

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Commercial lending may involve 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. Additionally, construction and development lending involves an elevated degree of risk because loans are generally made to builders for specific construction projects, and successful repayment of these types of loans is generally dependent upon the sale of the constructed property. 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, low average cost, and the ability to generate fee income through the cross-sale of other services to 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, 2014, totaled \$3.85 billion. This represented an increase of \$279.50 million, or 7.84%, over 2013, which was \$187.05 million, or 5.53%, over 2012. Deposit accounts represent our primary source of funds and are provided by individuals, professionals, and small- to medium-sized businesses in the Greater Hampton Roads area and northeastern North Carolina. The deposits consist of demand deposits, interest-bearing checking accounts, money market deposit accounts, and time deposits. Some of our interest-bearing deposits were obtained through brokered transactions and our participation in CDARS. We had brokered time deposits of \$163.49 million and CDARS deposits of \$50.21 million at December 31, 2014.

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). The aggregate amount of time deposits of \$250,000 or more was \$194.47 million and \$198.22 million at December 31, 2014 and 2013, respectively. See Note 9 in the Notes to Consolidated Financial Statements for additional information on deposits.

For the Year Ended December 31,	Average Balance			Average Cost Rate		
	2014	2013	2012	2014	2013	2012
Noninterest-bearing demand deposits	\$ 1,158,888	\$ 1,022,168	\$ 904,513	—	—	—
Demand and money markets	1,306,738	1,166,510	1,064,840	0.23%	0.27%	0.40%
Savings	310,722	323,011	300,235	0.92%	0.96%	1.07%
Certificates of deposit:						
Less than \$100,000	280,522	351,135	326,076	1.33%	0.90%	1.30%
\$100,000 or more	692,180	574,522	678,852	0.54%	0.69%	0.75%
Total interest-bearing deposits	2,590,162	2,415,178	2,370,003	0.52%	0.55%	0.71%
Total deposits	\$ 3,749,050	\$ 3,437,346	\$ 3,274,516	0.36%	0.39%	0.51%

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Average noninterest-bearing demand deposits were 30.91% of average total deposits during the year ended December 31, 2014, and 29.74% and 27.62% during 2013 and 2012, respectively. This change is attributable to historically low rates and is consistent with the decrease in the Company's cost of funds. The average cost of interest-bearing deposits was 0.52% for the year ended December 31, 2014, compared with 0.55% for 2013, and 0.71% for 2012.

Advances from the Federal Home Loan Bank: 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 \$396.67 million and \$386.09 million for the years ended December 31, 2014 and 2013, respectively. The balance at December 31, 2014, of \$398.18 million, increased \$3.09 million from the balance at December 31, 2013, of \$395.09 million. Refer to Note 10 in the Notes to Consolidated Financial Statements for additional disclosures related to borrowing arrangements.

Convertible Subordinated Capital Notes: The Company had no convertible subordinated capital debentures at December 31, 2014, or December 31, 2013. During the first quarter of 2012, the Company announced the mandatory conversion of its outstanding Series III notes. At the close of business on March 19, 2012, all \$13.60 million of outstanding Series III notes were converted into shares of the Company's common stock. Average total convertible subordinated capital debentures for the years ended December 31, 2014 and 2013, were \$0, compared with \$2.95 million for 2012. Refer to Note 10 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 \$253.42 million outstanding in overnight interest-bearing deposits during 2014, compared with \$300.98 million for 2013. We intend to maintain sufficient liquidity at all times to meet our funding commitments and growth plans. During 2014, we primarily funded our growth in total assets with deposit growth.

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.

On September 22, 2011, the Company entered into a Securities Purchase Agreement with the Secretary of the U.S. Department of the Treasury (the "U.S. Treasury"), pursuant to which the Company sold and issued 76,458 shares of the Company's Series C Preferred Stock, liquidation value of \$1,000 per share (the "Series C Preferred Stock"), for a total purchase price of \$76.46 million. The issuance was pursuant to the Small Business Lending Fund program, a \$30 billion fund established under the Small Business Jobs Act of 2010 that was created to encourage lending to small businesses by providing capital to qualified community banks with assets of less than \$10 billion.

The holder of the Series C Preferred Stock was entitled to receive non-cumulative dividends, payable quarterly, on January 1, April 1, July 1, and October 1 of each year. The dividend rate could fluctuate on a quarterly basis during the first 10 quarters during which the Series C Preferred Stock is outstanding, based upon changes in the level of "Qualified Small Business Lending" ("QSBL") by the Company as compared to the Company's baseline QSBL level, which was established at the closing of the securities issuance. The dividend rate for the initial dividend period was at 5%. For the second through 10th calendar quarters, the dividend rate could be adjusted to

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between 1% and 5% per annum based upon the increase in QSBL as compared to the initial baseline. For the 11th calendar quarter through four and one-half years after issuance, the dividend rate was fixed at between 1% and 7% based upon the level of QSBL compared to the baseline. Due to the Company's loan growth, the blended rate for the period from closing through December 31, 2011 was 4.63%, with the rate reduced to 3.92% for the first quarter of 2012, and 2.28% for the second quarter of 2012. Beginning with the third quarter of 2012, the rate decreased to 1.0% and remained fixed at that rate through the date of repayment (January 7, 2015). The Series C Preferred Stock was redeemable at any time at the Company's option, at a redemption price of 100% of the liquidation amount plus accrued but unpaid dividends to the date of redemption for the current period, subject to the approval of the Federal Deposit Insurance Corporation ("FDIC").

On September 22, 2011, the Company used the proceeds from the sale and issuance of the Series C Preferred Stock to repurchase all 76,458 outstanding shares of its preferred stock issued to the U.S. Treasury in connection with the Capital Purchase Program (the "CPP"), under the Troubled Asset Relief Program, for a redemption price of \$76.46 million, plus accrued but unpaid dividends.

On January 7, 2015, the Company used internally available funds to repurchase all 76,458 outstanding shares of its Series C Preferred Stock for a redemption price of \$76.46 million, plus accrued but unpaid dividends.

In connection with the issuance to the U.S. Treasury under the CPP of its Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series B, liquidation amount \$1,000 per share, which the Company redeemed in 2011, the Company issued a 10-year warrant to purchase 554,330 common shares at an exercise price of \$20.69 per share. On May 15, 2013, the Company repurchased the warrant from the U.S. Treasury for \$1.5 million. The transaction reduced additional paid-in capital within stockholders' equity by \$1.5 million. The warrant repurchase did not impact results of operations.

In August 2008, the Company issued 598,542 shares of Series A Preferred Stock, at a purchase price of \$100 per share. The Series A Preferred Stock paid a non-cumulative dividend of 8% per year. Each share of the Series A Preferred Stock could be converted at any time, at the option of the holder, into shares of common stock equal to the purchase price divided by \$18.02.

On September 1, 2013, all outstanding shares of the Series A Preferred Stock were mandatorily converted into 3.19 million shares of TowneBank common stock reflecting a conversion price of \$18.02 per share of common stock, plus cash in lieu of any fractional shares.

Additional information concerning our capital resources is contained in Note 16 of the Notes to Consolidated Financial Statements.

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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, 2014 (in thousands):

Contractual Obligations	Payments Due by Period				
	Total	Less Than 1 Year	1 - 3 years	3 - 5 years	More Than 5 Years
Operating lease obligations	\$ 35,725	\$ 7,578	\$ 11,942	\$ 7,592	\$ 8,613
Other long-term liabilities reflected on the registrant's balance sheet under GAAP					
FHLB advances	398,181	—	327,000	53,000	18,181
Other commitments					
Standby letters of credit	28,755	28,755	—	—	—
Commitments to extend credit	1,189,546	1,189,546	—	—	—
Total contractual obligations	\$ 1,652,207	\$ 1,225,879	\$ 338,942	\$ 60,592	\$ 26,794

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,	2014	2013	2012
Return on average assets	0.87%	0.93%	0.90%
Return on average equity	6.95%	7.27%	6.95%
Average equity to average assets	12.75%	12.75%	12.99%

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

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rate environment. At December 31, 2014, we had \$371.94 million more liabilities than assets subject to repricing within one year and, therefore, were in a liability-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 interest rate sensitivity on our net interest income using different rate scenarios:

<u>Change in Prime Rate</u>	<u>% Change in Net Interest Income</u>
+ 300 basis points	4.59%
+ 200 basis points	2.46%
+ 100 basis points	1.05%
- 100 basis points	(4.94)%

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 discounted cash flow analysis. The net market value is the market value of all assets minus the market value of all liabilities. The

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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:

<u>Change in Prime Rate</u>	<u>Change in Net Market Value (dollars in thousands)</u>
+ 300 basis points	\$(265.38)
+ 200 basis points	\$(183.36)
+ 100 basis points	\$(80.74)
- 100 basis points	\$(29.92)

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 90 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 not 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;
- changes in the creditworthiness of customers and the possible impairment of the collectability of loans;
- 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;

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- changes 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.

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.

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 results and core capital position and facilitates comparisons with other banks.

Year Ended December 31,	2014	2013
Return on average assets (GAAP basis)	0.87%	0.93%
Impact of excluding average goodwill and other intangibles	0.06%	0.02%
Return on average tangible assets	<u>0.93%</u>	<u>0.95%</u>
Return on average equity (GAAP basis)	6.95%	7.27%
Impact of excluding average goodwill and other intangibles	2.21%	1.91%
Return on average tangible equity	<u>9.16%</u>	<u>9.18%</u>

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.

Year Ended December 31,	Per share	
	2014	2013
Book value (GAAP basis)	\$ 14.88	\$ 14.16
Impact of excluding average goodwill and other intangibles	3.79	3.40
Tangible book value	<u>\$ 11.09</u>	<u>\$ 10.76</u>

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 gains and losses on securities because of the uncertainty of the amount of gain or loss recognized.

Year Ended December 31,	2014	2013
Efficiency ratio (GAAP basis)	73.77 %	72.00%
Impact of excluding securities gains/(losses)	(0.01)%	0.19%
Efficiency ratio, as reported	<u>73.76 %</u>	<u>72.19%</u>

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders

TowneBank

Suffolk, Virginia

We have audited the accompanying consolidated balance sheets of *TowneBank* and subsidiaries as of December 31, 2014 and 2013, and the related consolidated statements of income, comprehensive income, equity, and cash flows for each of the years in the three-year period ended December 31, 2014. We also have audited *TowneBank's* internal control over financial reporting as of December 31, 2014, including controls over the preparation of regulatory financial statements in accordance with the instructions for Consolidated Reports of Condition and Income (Call Report) of the Federal Financial Institutions Examination Council, based on criteria established in *Internal Control—Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). *TowneBank's* management is responsible for these consolidated 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 consolidated 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 consolidated 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 consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 consolidated financial statements for external purposes in accordance with generally accepted accounting principles. Because management's assessment and our audit were conducted to also meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), management's assessment and our audit of the Company's internal control over financial reporting included controls over the preparation of consolidated financial statements in accordance with the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income (call report). 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 consolidated financial statements in accordance with generally accepted accounting principles and call report instructions, 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 consolidated 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, 2014 and 2013, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2014 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, *TowneBank* maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on criteria established in *Internal Control—Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We do not express an opinion or any other form of assurance on management's statements in the accompanying Management's Report on Internal Control in the section Compliance with Designated Laws and Regulations.

/s/ Dixon Hughes Goodman LLP

Norfolk, Virginia
March 13, 2015

TOWNEBANK

MANAGEMENT'S REPORT ON INTERNAL CONTROL

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 and Risk Management Committee of the Board of Directors participates in the adequacy of the system of internal controls and financial reporting. The Audit and Risk Management Committee consists of independent directors who meet regularly with management, the internal auditor, the Chief Risk Officer, 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, 2014, including controls over regulatory financial statements in accordance with the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income ("Call Report"). 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 (2013). Based on our assessment we believe that, as of December 31, 2014, our internal control over financial reporting is effective based on those criteria.

Financial Statements

Our management is responsible for the preparation, integrity, and fair presentation of our published consolidated financial statements as of December 31, 2014, 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.

TOWNEBANK
MANAGEMENT'S REPORT ON INTERNAL CONTROL

Compliance with Designated Laws and Regulations

Our management is also responsible for compliance with 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, 2014.

Dixon Hughes Goodman LLP, the independent registered public accounting firm that performed our consolidated 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 13, 2015

/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 per share data)

December 31, 2014 and 2013

	2014	2013
ASSETS		
Cash and due from banks	\$ 212,994	\$ 203,782
Interest-bearing deposits in financial institutions	1,011	1,011
Total Cash and Cash Equivalents	214,005	204,793
Securities available for sale, at fair value	603,908	543,521
Securities held to maturity, at amortized cost	252,370	204,348
Federal Home Loan Bank stock, at amortized cost	22,157	23,069
Total Securities	878,435	770,938
Mortgage loans held for sale	71,390	58,642
Loans, net of unearned income and deferred costs:	3,397,266	3,235,989
Less: allowance for loan losses	(35,917)	(38,380)
Net Loans	3,361,349	3,197,609
Premises and equipment, net	155,774	153,436
Goodwill	113,159	104,446
Other intangible assets, net	22,509	15,615
Bank-owned life insurance policies	58,716	57,372
Other assets	107,148	110,146
TOTAL ASSETS	\$ 4,982,485	\$ 4,672,997
LIABILITIES AND EQUITY		
Deposits:		
Noninterest-bearing demand	\$ 1,224,466	\$ 1,037,028
Interest-bearing:		
Demand and money market accounts	1,365,183	1,240,949
Savings	301,033	321,103
Certificates of deposit	955,920	968,024
Total Deposits	3,846,602	3,567,104
Advances from the Federal Home Loan Bank	398,181	395,087
Repurchase agreements and other borrowings	31,893	47,659
Total Borrowings	430,074	442,746
Other liabilities	87,533	77,829
TOTAL LIABILITIES	4,364,209	4,087,679
Preferred stock		
Authorized shares - 2,000,000		
Issued and outstanding shares 76,458 in 2014 and 2013	76,458	76,458
Common stock, \$1.667 par value		
Authorized shares - 90,000,000		
Issued and outstanding shares 35,785,679 in 2014 and 35,306,281 in 2013	59,655	58,856
Capital surplus	317,718	312,811
Retained earnings	154,655	128,527
Common stock issued to deferred compensation trust, at cost		
627,730 shares in 2014 and 558,638 shares in 2013	(9,674)	(8,595)
Deferred compensation trust	9,674	8,595
Accumulated other comprehensive income (loss)	458	(344)
TOTAL SHAREHOLDERS' EQUITY	608,944	576,308
Noncontrolling interest	9,332	9,010
TOTAL EQUITY	618,276	585,318
TOTAL LIABILITIES AND EQUITY	\$ 4,982,485	\$ 4,672,997

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, 2014, 2013, and 2012

	2014	2013	2012
INTEREST INCOME:			
Loans, including fees	\$ 155,894	\$ 156,592	\$ 156,979
Investment securities	13,395	9,470	11,571
Interest-bearing deposits in financial institutions and federal funds sold	637	759	783
Mortgage loans held for sale	2,586	3,469	4,173
Total interest income	172,512	170,290	173,506
INTEREST EXPENSE:			
Deposits	13,352	13,353	16,749
Advances from the Federal Home Loan Bank	13,373	13,057	12,233
Convertible subordinated capital debentures	—	—	237
Repurchase agreements and other borrowings, net of capitalized interest	51	(15)	3
Total interest expense	26,776	26,395	29,222
Net interest income	145,736	143,895	144,284
PROVISION FOR LOAN LOSSES	492	4,248	16,155
Net interest income after provision for loan losses	145,244	139,647	128,129
NONINTEREST INCOME:			
Residential mortgage banking income, net	27,179	28,977	26,998
Real estate brokerage and property management income, net	12,634	12,316	11,515
Insurance commissions and other title fees and income, net	34,558	28,322	23,458
Service charges on deposit accounts	9,192	8,682	7,798
Credit card merchant fees, net	3,576	3,471	3,578
Other income	9,605	8,149	7,837
Gain (loss) on investment securities	(15)	611	3,005
Total noninterest income	96,729	90,528	84,189
NONINTEREST EXPENSE:			
Salaries and employee benefits	99,007	97,108	89,669
Occupancy	17,863	16,298	14,384
Furniture and equipment	8,183	7,458	6,467
Other expenses	53,811	47,928	48,229
Total noninterest expense	178,864	168,792	158,749
Income before income tax expense & noncontrolling interest	63,109	61,383	53,569
Provision for income tax expense	18,179	17,135	13,964
Net income	\$ 44,930	\$ 44,248	\$ 39,605
Net income attributable to noncontrolling interest	(2,761)	(2,486)	(1,674)
Net income attributable to TowneBank	\$ 42,169	\$ 41,762	\$ 37,931
Preferred stock dividends and accretion	765	4,227	6,226
Net income available to common shareholders	\$ 41,404	\$ 37,535	\$ 31,705
Per common share information			
Basic earnings	\$ 1.18	\$ 1.14	\$ 1.03
Diluted earnings	\$ 1.18	\$ 1.14	\$ 1.03
Cash dividends declared	\$ 0.43	\$ 0.38	\$ 0.33

See accompanying Notes to Consolidated Financial Statements.

TOWNEBANK**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(in thousands)

For the Years Ended December 31, 2014, 2013, and 2012

	<u>2014</u>	<u>2013</u>	<u>2012</u>
Net income	\$ 44,930	\$ 44,248	\$ 39,605
Other comprehensive income (loss)			
Unrealized gains (losses) on securities:			
Unrealized holding gains (losses) arising during the period	2,404	(2,905)	259
Deferred tax benefit (expense)	(844)	1,017	(91)
Realized (gains) losses reclassified into earnings	15	(84)	(1,881)
Deferred tax benefit (expense)	(6)	29	658
Net unrealized gains (losses)	<u>1,569</u>	<u>(1,943)</u>	<u>(1,055)</u>
Defined benefit retirement plan			
Actuarial gain (loss)	(1,196)	962	(1,359)
Deferred tax benefit (expense)	418	(336)	476
Amortization	17	242	—
Deferred tax expense	(6)	(85)	—
Change in defined benefit retirement plan, net of tax	<u>(767)</u>	<u>783</u>	<u>(883)</u>
Other comprehensive income (loss), net of tax	<u>802</u>	<u>(1,160)</u>	<u>(1,938)</u>
Comprehensive income	<u>\$ 45,732</u>	<u>\$ 43,088</u>	<u>\$ 37,667</u>

See accompanying Notes to Consolidated Financial Statements.

TOWNEBANK

CONSOLIDATED STATEMENTS OF EQUITY

(dollars in thousands, except share data)

For the Years Ended December 31, 2014, 2013, and 2012

	Common Shares	Preferred Stock	Common Stock	Capital Surplus	Retained Earnings	Deferred Compensation Trust	Common Stock Issued to Deferred Compensation Trust	Accumulated Other Comprehensive Income (Loss)	Non-controlling Interests	Total
Balance, December 31, 2011	29,564,991	\$ 134,507	\$ 49,287	\$ 233,193	\$ 94,453	\$ 6,835	\$ (6,835)	\$ 2,754	\$ 6,295	\$ 520,489
Net income	—	—	—	—	37,931	—	—	—	1,674	\$ 39,605
Other comprehensive loss, net of taxes	—	—	—	—	—	—	—	(1,938)	—	\$ (1,938)
Cash dividends declared on common stock	—	—	—	—	(10,419)	—	—	—	—	(10,419)
Cash dividends declared on preferred stock	—	—	—	—	(6,226)	—	—	—	—	(6,226)
Stock dividend on common stock	919,923	—	1,536	10,351	(11,905)	—	—	—	—	(18)
Directors' deferred compensation	—	—	—	—	—	1,009	(1,009)	—	—	—
Distribution of interests in joint ventures, net	—	—	—	—	—	—	—	—	(1,000)	(1,000)
Issuance of common stock - acquisitions	100,000	—	167	1,382	—	—	—	—	—	1,549
Conversion of preferred stock into common stock	11,037	(203)	27	185	—	—	—	—	—	9
Conversion of convertible debt into common stock	1,028,058	—	1,718	12,042	—	—	—	—	—	13,760
Issuance of common stock - stock compensation plans	341,962	—	554	3,514	—	—	—	—	—	4,068
Balance, December 31, 2012	31,965,971	\$ 134,304	\$ 53,289	\$ 260,667	\$ 103,834	\$ 7,844	\$ (7,844)	\$ 816	\$ 6,969	\$ 559,879
Net income	—	—	—	—	41,762	—	—	—	2,486	44,248
Other comprehensive loss, net of taxes	—	—	—	—	—	—	—	(1,160)	—	(1,160)
Cash dividends declared on common stock	—	—	—	—	(12,842)	—	—	—	—	(12,842)
Cash dividends declared on preferred stock	—	—	—	—	(4,227)	—	—	—	—	(4,227)
Stock dividend on common stock	—	—	—	—	—	—	—	—	—	—
Directors' deferred compensation	—	—	—	—	—	751	(751)	—	—	—
Stock Warrant Repurchase	—	—	—	(1,500)	—	—	—	—	—	(1,500)
Distribution of interests in joint ventures, net	—	—	—	—	—	—	—	—	(445)	(445)
Issuance of common stock - acquisitions	10,180	—	17	135	—	—	—	—	—	152
Conversion of preferred stock into common stock	3,226,744	(57,846)	5,378	52,469	—	—	—	—	—	1
Conversion of convertible debt into common stock	1,530	—	3	11	—	—	—	—	—	14
Issuance of common stock - stock compensation plans	117,934	—	196	1,274	—	—	—	—	—	1,470
Common stock - cancellation of shares issued as contingent consideration	(16,078)	—	(27)	(245)	—	—	—	—	—	(272)
Balance, December 31, 2013	35,306,281	\$ 76,458	\$ 58,856	\$ 312,811	\$ 128,527	\$ 8,595	\$ (8,595)	\$ (344)	\$ 9,010	\$ 585,318
Net income	—	—	—	—	42,169	—	—	—	2,761	44,930
Other comprehensive income, net of taxes	—	—	—	—	—	—	—	802	—	802
Cash dividends declared on common stock	—	—	—	—	(15,276)	—	—	—	—	(15,276)
Cash dividends declared on preferred stock	—	—	—	—	(765)	—	—	—	—	(765)
Directors' deferred compensation	—	—	—	—	—	1,079	(1,079)	—	—	—
Distribution of interests in joint ventures, net	—	—	—	—	—	—	—	—	(2,439)	(2,439)
Issuance of common stock - acquisitions	312,891	—	521	4,042	—	—	—	—	—	4,563
Conversion of convertible debt into common stock	6,526	—	12	82	—	—	—	—	—	94
Issuance of common stock - stock compensation plans	159,981	—	266	783	—	—	—	—	—	1,049
Balance, December 31, 2014	35,785,679	\$ 76,458	\$ 59,655	\$ 317,718	\$ 154,655	\$ 9,674	\$ (9,674)	\$ 458	\$ 9,332	\$ 618,276

See accompanying Notes to Consolidated Financial Statements.

TOWNEBANK
CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

For the Years Ended December 31, 2014, 2013, and 2012

	2014	2013	2012
OPERATING ACTIVITIES:			
Net income	\$ 44,930	\$ 44,248	\$ 39,605
Adjustments to reconcile net income to net cash from operating activities:			
Net amortization of securities	3,173	3,959	2,448
Investment securities loss (gains)	15	(611)	(3,005)
Depreciation, amortization, and other intangible amortization	13,900	12,502	11,576
Provision for loan losses	492	4,248	16,155
Bank-owned life insurance income	(2,139)	(1,993)	(2,064)
Deferred income tax expense (benefit)	(1,146)	(2,641)	1,404
Share-based compensation expense	1,391	1,695	1,542
Purchases of trading account securities	—	(483)	(560)
Loss on sale and write-down of foreclosed assets	1,784	693	2,308
Originations of mortgage loans held for sale	(1,130,200)	(1,362,746)	(1,226,287)
Proceeds from sales of mortgage loans held for sale	1,155,261	1,481,347	1,242,103
Gain on sales of mortgage loans held for sale	(37,809)	(42,871)	(38,914)
Changes in:			
Interest receivable	(1,089)	106	193
Other assets	(10,013)	(21,648)	(14,895)
Interest payable	(238)	(71)	(753)
Other liabilities	6,209	(193)	9,480
Net cash from operating activities	<u>44,521</u>	<u>115,541</u>	<u>40,336</u>
INVESTING ACTIVITIES:			
Purchase of available-for-sale securities	(325,395)	(839,055)	(688,988)
Purchase of held-to-maturity securities	(60,443)	(62,342)	(21,879)
Sale of available-for-sale securities	1,861	—	44,939
Sale of Federal Home Loan Bank Stock	1,082	—	—
Proceeds from maturities, calls, and prepayments of available-for-sale securities	262,438	739,107	518,527
Proceeds from maturities, calls, and prepayments of held-to-maturity securities	12,185	13,337	20,758
Net increase in loans	(164,231)	(108,777)	(355,782)
Purchases of premises and equipment	(11,926)	(19,170)	(20,609)
Proceeds from sales of premises and equipment	152	317	416
Proceeds from sales of foreclosed assets	14,185	15,591	9,401
Acquisition of business, net of cash acquired	(12,798)	(1,351)	(3,239)
Net cash used for investing activities	<u>(282,890)</u>	<u>(262,343)</u>	<u>(496,456)</u>
FINANCING ACTIVITIES:			
Net increase in deposit accounts	279,497	187,052	189,265
Net change in borrowings	(13,094)	51,228	100,279
Proceeds (payments) from share-based compensation activity	(342)	(224)	2,526
Payments from issuance of common stock	—	(273)	(9)
Repurchase of warrants	—	(1,500)	—
Distribution of interest in joint ventures, net	(2,439)	(445)	(1,000)
Cash dividends paid	(16,041)	(13,536)	(19,792)
Net cash from financing activities	<u>247,581</u>	<u>222,302</u>	<u>271,269</u>
Change in cash and cash equivalents	9,212	75,500	(184,851)
Cash and cash equivalents at beginning of year	204,793	129,293	314,144
Cash and cash equivalents at end of year	<u>\$ 214,005</u>	<u>\$ 204,793</u>	<u>\$ 129,293</u>
Supplemental cash flow information:			
Cash paid for interest	\$ 27,014	\$ 26,467	\$ 29,974
Cash paid for income taxes	\$ 18,271	\$ 20,373	\$ 11,399
Noncash financing and investing activities:			
Transfer from loans to foreclosed property	\$ 10,684	\$ 18,703	\$ 30,652
Sales of foreclosed assets financed by the Company	\$ 3,138	\$ 8,237	\$ 9,554
Transfers from foreclosed property to premises and equipment	\$ (549)	\$ 511	\$ —
Net unrealized gain (loss) on available-for-sale securities	\$ 1,569	\$ (1,943)	\$ (1,055)
Common stock issued in connection with business acquisitions	\$ 4,563	\$ 152	\$ 1,549
Common stock issued in conversion of convertible subordinated capital debentures	\$ 94	\$ 14	\$ 13,760

See accompanying Notes to Consolidated Financial Statements.

TOWNEBANK

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 greater Hampton Roads region and northeastern North Carolina.

Basis of presentation: The consolidated financial statements include the accounts of the Company and all other entities in which the Company has a controlling financial interest. 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.

Reclassifications and corrections: To maintain consistency and comparability, certain amounts from prior periods have been reclassified to conform to current period presentation with no effect on net income or shareholders’ equity as previously reported. The Company has a directors’ deferred compensation plan whereby all deferred compensation is invested in the Company’s common stock and is held in a rabbi trust. The stock is held in nominee name of the trustee, and the principal and earnings of the trust are held separate and apart from other funds of the Company, and are used exclusively for the uses and purposes of the deferred compensation agreement. The accounts of the trust have been consolidated in the financial statements of the Company with common stock reported separately in a manner similar to treasury stock (that is, changes in fair value are not recognized) and a corresponding deferred compensation obligation shown as a separate component of shareholders’ equity. In the periods ended on December 31, 2013 and prior, the cumulative deferred compensation obligation and corresponding common stock were netted within the common stock and additional paid-in capital line items. This reclassification had no effect on total shareholders’ equity.

The Company determined that a note disclosure to its previously issued consolidated financial statements for the year ended December 31, 2013, included in its Annual Report on Form 10-K for the year ended December 31, 2013, contained an immaterial error. The Company previously disclosed its estimated fair value for its industrial revenue bonds in its investment portfolio in the held-to-maturity category as \$135.25 million, with gross unrealized gains of \$2.79 million and gross unrealized losses of \$12.75 million. Due to corrections to certain cash flow attributes, the Company revised the estimated fair value of the industrial revenue bonds to \$147.82 million, with gross unrealized gains of \$4.29 million and gross unrealized losses of \$1.67 million. The revision had the effect of changing the total held-to-maturity investment portfolio estimated fair value from \$195.71 million to \$208.29 million. This revision had no effect on the Company’s consolidated balance sheets, consolidated statements of income, consolidated statements of comprehensive income, consolidated statements of equity, or consolidated statements of cash flows as of or for the year ended December 31, 2013.

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, valuation of other real estate owned (“OREO”), deferred income taxes, fair value estimates, and goodwill and other intangibles.

TOWNEBANK

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 \$14.98 million and \$9.82 million at December 31, 2014 and 2013, respectively.

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

- a) Debt securities that the Company has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.
- b) Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings.
- 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 determined on a trade date basis using 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.

The Company evaluates its investment securities portfolio on a quarterly basis for indicators of other-than-temporary impairment ("OTTI"). Management assesses whether OTTI has occurred when the fair value of a debt security is less than the amortized cost basis at the balance sheet date. Management reviews the amount of unrealized loss, the length of time the security has been in an unrealized loss position, the credit rating history, market trends of similar security classes, time remaining to maturity, and the source of both interest and principal payments to identify securities which could potentially be impaired. OTTI is considered to have occurred (1) if management intends to sell the security; (2) if it is more likely than not management will be required to sell the security before recovery of its amortized cost basis; or (3) the present value of expected cash flows is not sufficient to recover all contractually required principal and interest payments. For securities that management does not expect to sell, or it is not more likely than not to be required to sell, the OTTI is separated into credit and noncredit components. A discounted cash flow analysis, which includes evaluating the timing of expected cash flows, is completed for all debt securities subject to credit impairment. The measurement of the credit loss component is equal to the difference between the debt security's cost basis and the present value of its expected future cash flows discounted at the security's effective yield. The credit-related OTTI, represented by the expected loss in principal, is recognized in noninterest income. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit-related and, therefore, are recognized in other comprehensive income ("OCI"). Management believes that it will fully collect the carrying value of securities on which noncredit-related impairment has been recognized in OCI. Noncredit-related OTTI results from other factors, including increased liquidity spreads, and extension of the security. For securities that management does expect to sell, or if it is more likely than not the Company will be required to sell the security before recovery of its amortized cost basis, any OTTI is recognized in earnings. Once an OTTI is recorded, when future cash flows can be reasonably estimated, future cash flows are re-allocated between interest and principal cash flows to provide for a level-yield on the security.

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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 outstanding principal less unamortized 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: 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. 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 and anticipated economic conditions, historical loan loss experience, and other current factors that warrant consideration in determining an adequate allowance.

The allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with Accounting Standards Codification Topic ("ASC") 310, *Receivables*, based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC 450, *Contingencies*, based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; and (iii) general valuation allowances determined in accordance with ASC 450 based on general economic conditions and other qualitative risk factors both internal and external to the Company.

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, regional credit administrators, and the chief credit officer review the classification to ensure accuracy and consistency of classifications, which are then validated by the internal loan review process. 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 allowances established for probable losses on specific loans are based on a regular analysis and evaluation of classified loans.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans. We calculate historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical loss ratios are updated quarterly based on actual charge-off experience. An historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool. Our pools of similar loans include groups of construction and land development loans, commercial real estate loans, commercial and industrial business loans, 1-4 family residential real estate loans, multifamily real estate loans, and consumer and other loans.

General valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to the Company. In general, such valuation allowances are determined by evaluating, among other things: (i) the experience, ability, and effectiveness of the Company's lending management and staff; (ii) the effectiveness of the Company's loan policies, procedures, and internal controls; (iii) changes in asset quality; (iv) changes in loan portfolio volume; (v) the composition and concentrations of credit; (vi) the effectiveness of the internal loan review function; (vii) the impact of national economic trends on portfolio risks; and (viii) the impact of local economic trends on portfolio risk. Management evaluates the degree of risk that each one of these

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components has on the quality of the loan portfolio on a quarterly basis to determine an appropriate general valuation allowance. Management considers the current level of allowance for loan losses adequate to absorb losses inherent in the loan portfolio. Management's determination of the adequacy of the allowance for loan losses, which is based on the factors and risk identification procedures previously discussed, requires the use of judgments and estimations that may change in the future. Changes in the factors used by management to determine the adequacy of the allowance or the availability of new information could cause the allowance for loan losses to be adjusted in future periods.

Loans acquired: Loans acquired through the completion of a transfer, including loans acquired in a business combination, that have evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments receivable, are initially recorded at fair value (as determined by the present value of expected future cash flows) with no valuation allowance. Loans are evaluated individually to determine if there is evidence of deterioration of credit quality since origination. Loans where there is evidence of deterioration of credit quality since origination may be aggregated and accounted for as a pool of loans, if the loans being aggregated have common risk characteristics. The difference between the undiscounted cash flows expected at acquisition and the investment in the loan, or the "accretable yield," is recognized as interest income on a level-yield method over the life of the loan. Contractually required payments for interest and principal that exceed the undiscounted cash flows expected at acquisition, or the "nonaccretable difference," are not recognized as a yield adjustment or as a loss accrual or a valuation allowance. Significant increases in expected cash flows subsequent to the initial investment are recognized prospectively through adjustment of the yield on the loan over its remaining life. Decreases in expected cash flows are recognized immediately as impairment. If the Company does not have the information necessary to reasonably estimate expected cash flows, it may use the cost recovery method or cash basis method of income recognition. Valuation allowances on these impaired loans reflect only losses incurred after the acquisition (meaning the present value of all cash flows expected at acquisition that ultimately are not to be received).

For purchased loans that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value. Loans may be aggregated and accounted for as a pool of loans if the loans being aggregated have common risk characteristics. Subsequent to the purchase date, the methods utilized to estimate the required allowance for credit losses for these loans is similar to originated loans; however, the Company records a provision for loan losses only when the required allowance exceeds any remaining credit discounts. The difference between the initial fair value at acquisition and the undiscounted expected cash flows is recorded in interest income over the life of the loans using a method that approximates the effective interest method.

Mortgage 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. 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.

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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 the Financial Accounting Standards Board (the "FASB") ASC 350, *Goodwill and Other Intangible Assets*. Additionally, under ASC 350, 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 as of August 31, 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 (step 1) 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 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. For our annual impairment testing conducted during 2014, we identified five reporting units with goodwill: Berkshire Hathaway HomeServices Towne Realty; property and casualty insurance division; benefits insurance division; Corolla Classic Vacations, LLC; and Banking. For purposes of performing step 1 of the goodwill impairment test, the Company primarily uses the income approach to value its reporting units. The income approach consists of discounting projected long-term future cash flows, which are derived from internal forecasts and economic expectations for the respective reporting units. The significant inputs to the income approach include expected future cash flows, the long-term target tangible equity to tangible assets ratio, and the discount rate. Discount rates are unique to each reporting unit and are based upon the cost of capital specific to the industry in which the reporting unit operates. Management evaluated the sensitivity of the significant assumptions in its impairment analysis, including consideration of the effect of changes in estimated future cash flows or the discount rate for each reporting unit. Based on our analysis, we determined there is no goodwill impairment, since the fair value for all reporting units was in excess of the respective reporting unit's carrying value as of August 31, 2014. The fair value of each of the Company's reporting units exceeded its respective carrying value by at least the 6.3% margin as calculated for our property and casualty insurance division.

The second step (step 2) of impairment testing is necessary only if the reporting unit does not pass step 1. Step 2 compares the implied fair value of the reporting unit goodwill with the carrying amount of the goodwill for the reporting unit. The implied fair value of goodwill is determined in the same manner as goodwill that is recognized in a business combination. Significant judgment and estimates are involved in estimating the fair value of the assets and liabilities of the reporting unit. Since none of the reporting units failed step 1, step 2 was not applicable during 2014 testing. The Company monitored events and circumstances during the fourth quarter of 2014, and it determined that there were no triggering events requiring an updated impairment test as of December 31, 2014.

Significant judgment is applied when goodwill is assessed for impairment. This judgment includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparables, incorporating general economic and market conditions, and selecting an appropriate control premium. Selection and weighting of the various fair value techniques may result in a higher or lower fair value. Judgment is applied in determining the weightings most representative of fair value.

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

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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 7 provides additional information related to goodwill and other intangibles.

Other Real Estate Owned: Other Real Estate Owned (“OREO”), which is included in other assets on the balance sheet, consists primarily of commercial and residential real estate that has been obtained in partial or full satisfaction of loan obligations. OREO is carried at the fair value of the property, less estimated selling costs, with any difference between the fair value of the property, less estimated selling costs, and the carrying value of the loan recorded through a charge to the allowance for loan losses. Subsequent write-downs required for declines in value are recorded through a valuation allowance, or taken directly to the asset, charged to other noninterest expense.

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 (i) the asset has been isolated from the Company, (ii) 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 (iii) an agreement to repurchase the transferred asset before its maturity does not exist.

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). The commitments are generally for periods of 60 days and are at market rates. In order to mitigate 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.

Rate lock commitments on mortgage loans that are intended to be sold are considered to be derivatives. Loans in the pipeline that have an interest rate lock with the customer are termed rate lock commitments, whereby, the interest rate on the loan is determined prior to funding. Under these interest rate lock commitments, expected income less direct origination costs is recorded upon the locking of the interest rate with the borrower. The commitments are generally for periods of 60 days and are at market rates. Changes in the rate lock commitments subjected to recurring fair value adjustments are affected by the changes in the balances of locked mortgage loan commitments, changes in the fall out rates and changes in the prevailing secondary market prices for like-kind mortgage loans. The fall out rate measures the likelihood that an interest rate lock commitment will ultimately not become a closed loan held for sale. The income statement impact associated with these instruments is recorded in net residential mortgage banking income and amounted to an increase in income of \$0.36 million, a reduction in income of \$0.66 million, and an increase in income of \$1.24 million for the years ended December 31, 2014, 2013, and 2012, respectively.

Loans are sold service-released on a non-recourse basis, except for normal representations and warranties, which is consistent with industry practices.

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.

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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.

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

While a loan is classified as nonaccrual and the probability of collecting the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to principal outstanding. When the probability of collecting the recorded loan balance is expected, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate. Cash interest receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

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

Advertising costs: Advertising costs are expensed as incurred.

Segment information: Operating segments as defined by ASC 280, *Segment Reporting*, 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 24 for further discussion of the Company's operating segments.

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Mergers and acquisitions: Mergers and acquisitions are accounted for using the purchase method, as required by ASC 805, *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 19 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. Other comprehensive income or loss includes unrealized gains and losses on available-for-sale securities and actuarial gains and losses on our Supplemental Executive Retirement Plan ("SERP").

Share-based compensation: The Company has a share-based employee compensation plan, which is described in more detail in Note 13. The Company accounts for the plan using the fair value method, which requires that compensation cost relating to stock-based payment transactions be recognized in the financial statements over the vesting period. 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 25 for further discussion on the Company's earnings per share.

Recent accounting pronouncements

In February 2013, the FASB issued Accounting Standards Update ("ASU") No. 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. Under ASU No. 2013-02, an entity is required to provide information about the amounts reclassified out of Accumulated Other Comprehensive Income ("AOCI") by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of AOCI by the respective line items of net income, but only if the amount reclassified is required to be reclassified in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional details about those amounts. ASU No. 2013-02 does not change the current requirements for reporting net income or other comprehensive income in the financial statements. ASU No. 2013-02 was effective for the Company on January 1, 2013 and resulted in additional disclosures.

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In July 2013, the FASB issued ASU No. 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*. The amendments in ASU No. 2013-11 to Topic 740, *Income Taxes*, provide guidance on the financial statement presentation of unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The adoption of this ASU did not have a material impact on the Company's financial statements.

In January 2014, the FASB issued ASU No. 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects*. The amendments in ASU No. 2014-01 to Topic 323, *Equity Investments and Joint Ventures*, permit an accounting policy election to account for investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense. The decision to apply the proportional amortization method of accounting is an accounting policy election that should be applied consistently to all qualifying affordable housing project investments. This guidance is effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2014. This guidance should be applied retrospectively to all periods presented. Early adoption is permitted. The Company early adopted this ASU as of January 1, 2014. Previously, investments in qualified affordable housing projects were accounted for under the equity method; however, the Company believes the proportional amortization method better represents the nature and economics of the investments. It is being adopted prospectively, as the retrospective adjustments were not material.

In January 2014, the FASB issued guidance within ASU No. 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. The objective of the amendments in ASU No. 2014-04 to Topic 310, *Receivables - Troubled Debt Restructurings by Creditors*, is to reduce diversity by clarifying when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 31, 2014. An entity can elect to adopt the amendments using either a modified retrospective transition method or a prospective transition method. Early adoption is permitted. The adoption of this guidance is not expected to have a material impact on the Company's Consolidated Financial Statements.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*. The ASU will supersede most of the existing revenue recognition requirements in GAAP and will require entities to recognize revenue at an amount that reflects the consideration to which the Company expects to be entitled in exchange for transferring goods or services to a customer. The new standard also requires significantly expanded disclosures regarding the qualitative and quantitative information of an entity's nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The pronouncement is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period and is to be applied retrospectively, with early application not permitted. We are currently evaluating the impact the pronouncement will have on our consolidated financial statements and related disclosures.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2: MERGERS AND ACQUISITIONS

Beach Properties of Hilton Head: Effective October 1, 2014, the Company acquired Beach Properties of Hilton Head, Inc., an independent resort property management company that was merged with the operations of Towne Vacations, a division of TowneBank's Realty segment. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired business are included in the Company's Consolidated Statements of Income commencing October 1, 2014. The purchase price for the transaction was \$8.60 million in cash and common stock. The allocation of the purchase price resulted in tangible assets of \$3.53 million, goodwill of \$1.52 million, other intangible assets including customer lists of \$5.47 million, and assumed liabilities of \$1.88 million.

Southern Insurance Agency: Effective May 1, 2014, the Company acquired Southern Insurance Agency, Inc., which is affiliated with Towne Insurance Agency ("Towne Insurance"), a wholly-owned subsidiary of TowneBank. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired business are included in the Company's Consolidated Statements of Income commencing May 1, 2014. The purchase price for the transaction was \$11.81 million in cash and common stock. The allocation of the purchase price resulted in tangible assets of \$1.22 million, goodwill of \$7.14 million, other intangible assets including customer lists of \$3.90 million, and assumed liabilities of \$0.45 million.

Insurance Agencies: Effective July 1, 2013, the Company acquired two insurance agencies, Hooker and Buchanon Incorporated and Yervey Insurance Agency, Inc., that are affiliated with Towne Insurance Agency ("Towne Insurance"), a wholly-owned subsidiary of TowneBank. The acquisitions were accounted for as business combinations under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired businesses are included in the Company's Consolidated Statements of Income commencing July 1, 2013. The total purchase price for the transactions was \$2.73 million in cash and common stock. The allocation of the purchase price resulted in tangible assets of \$0.19 million, goodwill of \$1.53 million, other intangible assets, including customer lists of \$1.16 million, and assumed liabilities of \$1.30 million.

The Clement Companies: Effective December 31, 2012, the Company acquired The Clement Companies insurance agency that is affiliated with Towne Insurance. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired business are included in the Company's Consolidated Statements of Income commencing January 1, 2013. The purchase price was \$6.30 million in cash and common stock. The allocation of the purchase price resulted in tangible assets of \$0.62 million, goodwill of \$4.76 million, other intangible assets, including customer lists of \$1.53 million, and assumed liabilities of \$0.61 million.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2014

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency securities	\$ 512,762	\$ 371	\$ (692)	\$ 512,441
Municipal securities	24,148	614	(43)	24,719
Trust preferred and other corporate securities	7,720	736	—	8,456
Mortgage-backed securities issued by GSE	57,240	1,054	(2)	58,292
Total available-for-sale securities	<u>\$ 601,870</u>	<u>\$ 2,775</u>	<u>\$ (737)</u>	<u>\$ 603,908</u>

December 31, 2013

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency securities	\$ 235,143	\$ 126	\$ (1,939)	\$ 233,330
U.S. Treasury notes	200,000	—	—	200,000
Municipal securities	36,845	515	(281)	37,079
Trust preferred and other corporate securities	7,805	454	(2)	8,257
Mortgage-backed securities issued by GSE	64,103	834	(82)	64,855
Total available-for-sale securities	<u>\$ 543,896</u>	<u>\$ 1,929</u>	<u>\$ (2,304)</u>	<u>\$ 543,521</u>

For the year ended December 31, 2014, proceeds from securities available for sale amounted to \$1.86 million and resulted in gross realized gains of \$45,000 and gross realized losses of \$60,000. For the year ended December 31, 2013, the Company had no proceeds from sales of securities available for sale or related gross realized gains or losses. For the year ended December 31, 2012, proceeds from securities available for sale amounted to \$44.94 million, excluding prepayments related to mortgage-backed securities, and resulted in gross realized gains of \$1.88 million. The Company had no gross realized losses in 2012.

Held-to-maturity securities

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

December 31, 2014

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Trust preferred corporate securities	\$ 500	\$ 222	\$ —	\$ 722
Municipal securities	56,923	3,965	—	60,888
Industrial revenue bonds	167,124	11,885	(297)	178,712
Mortgage-backed securities issued by GSE	27,823	134	(15)	27,942
Total held-to-maturity securities	<u>\$ 252,370</u>	<u>\$ 16,206</u>	<u>\$ (312)</u>	<u>\$ 268,264</u>

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December 31, 2013

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Trust preferred corporate securities	\$ 500	\$ 141	\$ —	\$ 641
Municipal securities	58,644	1,327	(150)	59,821
Industrial revenue bonds	145,204	4,288	(1,668)	147,824
Total held-to-maturity securities	\$ 204,348	\$ 5,756	\$ (1,818)	\$ 208,286

Trading securities

Prior to 2013, the Company had mutual fund investments in a self-directed employee deferred compensation plan, structured as a rabbi trust and classified as trading securities. During 2013, the Company amended its plan and, due to the amendment, the funds held in the plan are no longer accounted for as trading securities. Prior to the plan amendment, employees were permitted to invest in mutual fund investments that were classified as trading securities. These investments were bought and sold as employees deferred compensation, received distributions, or made changes in the funds underlying their accounts. Realized and unrealized gains or losses were recorded in noninterest income. The Company had no gains or losses in 2014 and gains of \$0.53 million and \$1.08 million in 2013 and 2012, respectively. See Note 12 for additional discussion of the deferred compensation plan.

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, 2014

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 34,629	\$ 34,676	\$ —	\$ —
Due after one year through five years	490,964	490,628	3,333	3,605
Due after five years through 10 years	38,121	38,570	64,666	66,318
Due after 10 years	36,763	38,641	184,371	198,341
	600,477	602,515	252,370	268,264
Other equity securities	1,393	1,393	—	—
	\$ 601,870	\$ 603,908	\$ 252,370	\$ 268,264

December 31, 2013

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 211,960	\$ 212,018	\$ —	\$ —
Due after one year through five years	247,903	246,039	3,398	3,624
Due after five years through 10 years	17,968	18,194	28,505	28,491
Due after 10 years	65,994	67,199	172,445	176,171
	543,825	543,450	204,348	208,286
Other equity securities	71	71	—	—
	\$ 543,896	\$ 543,521	\$ 204,348	\$ 208,286

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Pledged securities

At December 31, 2014 and 2013, the Company had investment securities with market values of \$192.53 million and \$148.96 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, 2014 or 2013. The Company also had \$44.72 million in investment securities pledged against repurchase agreements with commercial customers at December 31, 2014, compared to \$59.21 million at December 31, 2013.

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, 2014	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury obligations and direct obligations of U.S. government agencies	\$ 176,379	\$ (255)	\$ 70,335	\$ (437)	\$ 246,714	\$ (692)
Municipal securities	5,041	(30)	3,765	(13)	8,806	(43)
Industrial revenue bonds	5,270	(292)	946	(5)	6,216	(297)
Mortgage-backed securities issued by GSE	7,330	(17)	—	—	7,330	(17)
Total temporarily impaired securities	\$ 194,020	\$ (594)	\$ 75,046	\$ (455)	\$ 269,066	\$ (1,049)

December 31, 2013	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury obligations and direct obligations of U.S. government agencies	\$ 221,212	\$ 1,939	\$ —	\$ —	\$ 221,212	\$ 1,939
Municipal securities	17,566	340	2,425	91	19,991	431
Industrial revenue bonds	47,147	1,563	1,404	105	48,551	1,668
Mortgage-backed securities issued by GSE	11,758	82	—	—	11,758	82
Trust preferred and other corporate securities	1,985	2	—	—	1,985	2
Total temporarily impaired securities	\$ 299,668	\$ 3,926	\$ 3,829	\$ 196	\$ 303,497	\$ 4,122

U.S. government agency securities

At December 31, 2014, 12 securities had unrealized losses of \$0.69 million. The Company’s unrealized losses on U.S. government agency securities were caused by interest rate fluctuations. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on the credit quality of the issuers, and because it is the Company’s intent to hold these securities until a market price recovery or maturity, and it is more

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likely than not that the Company will not be required to sell the securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Municipal securities

At December 31, 2014, eight securities had unrealized losses of \$0.04 million. The Company's unrealized losses on municipal securities were caused by interest rate fluctuations. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on the credit quality of the issuers, and because it is the Company's intent to hold these securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Government-Sponsored Enterprises ("GSE") mortgage-backed securities

At December 31, 2014, two securities experienced a total unrealized loss of \$0.02 million. The Company's unrealized losses on investments in federal agency mortgage-backed securities were caused by interest rate fluctuations. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Because our mortgage-related securities are backed by FNMA and FHLMC, which are GSEs, or are collateralized by securities backed by these agencies, and because it is the Company's intent to hold these securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Trust preferred and other corporate securities

At December 31, 2014, the Company had no unrealized losses in trust preferred corporate securities.

Industrial revenue bonds

At December 31, 2014, three bond issuances had total unrealized losses of \$0.30 million. The Company's unrealized losses on industrial revenue bonds were caused by interest rate fluctuations. Based on the credit quality of the issuers, and because it is the Company's intent to hold these bonds until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the bonds before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Other investments, including common stock

The Company had no unrealized losses in other investments or common stocks at December 31, 2014.

Federal Home Loan Bank of Atlanta ("FHLB") stock

The Company is required to maintain an investment in the capital stock of the FHLB. The FHLB stock is stated at cost, as this is a restricted security without a readily determinable fair value. The Company had \$22.16 million and \$23.07 million of FHLB stock at December 31, 2014 and 2013, respectively. Based on the Company's review of the credit quality of the institution, the institution's ability to repurchase shares, and the Company's carrying value in the shares, the Company does not consider this investment other than temporarily impaired.

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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.

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

December 31,	2014	2013
Real estate loans		
1-4 family residential	\$ 837,370	\$ 797,723
Commercial	1,447,078	1,365,572
Construction and land development	452,481	469,679
Multifamily	51,472	53,562
Total real estate loans	<u>2,788,401</u>	<u>2,686,536</u>
Commercial and industrial business	533,500	500,755
Consumer loans and other	75,365	48,698
Loans, net of unearned income and deferred costs	<u>\$ 3,397,266</u>	<u>\$ 3,235,989</u>

Unearned loan income was \$2.57 million in excess of deferred loan costs at December 31, 2014, \$2.39 million at December 31, 2013, and \$2.47 million at December 31, 2012. There were \$6.74 million, \$12.75 million, and \$40.69 million in nonaccrual loans at December 31, 2014, 2013, and 2012, respectively. The Company would have earned \$0.17 million in 2014, \$0.22 million in 2013, and \$1.07 million in 2012 if interest on the loans had been accrued. Of total loans, \$748.86 million was pledged as collateral to secure overnight borrowings with the FHLB, and \$58.02 million was pledged to secure borrowings from the discount window at the FRB at December 31, 2014.

Allowance for Loan Losses

The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the balance sheet date. While portions of the allowance are attributed to specific portfolio segments, the entire allowance is available to absorb credit losses inherent in the total loan portfolio. The Company considers the allowance for loan losses of \$35.92 million adequate to cover loan losses inherent in the loan portfolio at December 31, 2014.

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The following table presents, by portfolio segment, the changes in the allowance for loan losses for the years ended December 31, 2014, 2013, and 2012 (in thousands):

December 31, 2014	Construction and Land Development	Commercial Real Estate	Multi-Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
Allowance for loan losses:							
Balance, beginning of year	\$ 7,925	\$ 13,621	\$ 699	\$ 10,730	\$ 4,711	\$ 694	\$ 38,380
Provision charged to expense	(1,837)	1,318	414	(797)	554	840	492
Losses charged off	(561)	(1,165)	(493)	(1,473)	(432)	(415)	(4,539)
Recoveries	134	452	47	661	130	160	1,584
Balance, end of year	<u>\$ 5,661</u>	<u>\$ 14,226</u>	<u>\$ 667</u>	<u>\$ 9,121</u>	<u>\$ 4,963</u>	<u>\$ 1,279</u>	<u>\$ 35,917</u>
December 31, 2013							
Allowance for loan losses:							
Balance, beginning of year	\$ 11,691	\$ 12,521	\$ 589	\$ 10,722	\$ 4,378	\$ 526	\$ 40,427
Provision charged to expense	(2,399)	1,161	124	3,945	907	510	4,248
Losses charged off	(1,734)	(396)	(14)	(4,402)	(1,040)	(397)	(7,983)
Recoveries	367	335	—	465	466	55	1,688
Balance, end of year	<u>\$ 7,925</u>	<u>\$ 13,621</u>	<u>\$ 699</u>	<u>\$ 10,730</u>	<u>\$ 4,711</u>	<u>\$ 694</u>	<u>\$ 38,380</u>
December 31, 2012							
Allowance for loan losses:							
Balance, beginning of year	\$ 13,623	\$ 10,578	\$ 395	\$ 10,837	\$ 3,842	\$ 465	\$ 39,740
Provision charged to expense	4,003	5,178	539	3,665	2,261	509	16,155
Losses charged off	(5,989)	(3,295)	(345)	(4,640)	(1,791)	(504)	(16,564)
Recoveries	54	60	—	860	66	56	1,096
Balance, end of year	<u>\$ 11,691</u>	<u>\$ 12,521</u>	<u>\$ 589</u>	<u>\$ 10,722</u>	<u>\$ 4,378</u>	<u>\$ 526</u>	<u>\$ 40,427</u>

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The following table presents, by portfolio segment, the allocation of the allowance for loan losses at December 31, 2014 and 2013 (in thousands):

	Construction and Land Development	Commercial Real Estate	Multi-Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
December 31, 2014							
Period-end balance allocated to:							
Loans individually evaluated for impairment	\$ 464	\$ 1,177	\$ —	\$ 1,195	\$ 231	\$ —	\$ 3,067
Loans collectively evaluated for impairment	5,197	13,049	667	7,926	4,732	1,279	32,850
Balance, end of year	<u>\$ 5,661</u>	<u>\$ 14,226</u>	<u>\$ 667</u>	<u>\$ 9,121</u>	<u>\$ 4,963</u>	<u>\$ 1,279</u>	<u>\$ 35,917</u>
December 31, 2013							
Period-end balance allocated to:							
Loans individually evaluated for impairment	\$ 915	\$ 1,440	\$ 77	\$ 1,994	\$ 352	\$ 29	\$ 4,807
Loans collectively evaluated for impairment	7,010	12,181	622	8,736	4,359	665	33,573
Balance, end of year	<u>\$ 7,925</u>	<u>\$ 13,621</u>	<u>\$ 699</u>	<u>\$ 10,730</u>	<u>\$ 4,711</u>	<u>\$ 694</u>	<u>\$ 38,380</u>

The following table presents, by portfolio segment, the Company's investment in loans (in thousands):

	Construction and Land Development	Commercial Real Estate	Multi-Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
December 31, 2014							
Ending balance: individually evaluated for impairment	\$ 10,924	\$ 19,141	\$ —	\$ 14,379	\$ 674	\$ 41	\$ 45,159
Ending balance: collectively evaluated for impairment	440,663	1,425,888	51,472	819,642	531,987	75,324	3,344,976
Ending balance: loans acquired with deteriorated credit quality	894	2,049	—	3,349	839	—	7,131
Ending Balance	<u>\$ 452,481</u>	<u>\$ 1,447,078</u>	<u>\$ 51,472</u>	<u>\$ 837,370</u>	<u>\$ 533,500</u>	<u>\$ 75,365</u>	<u>\$ 3,397,266</u>
December 31, 2013							
Ending balance: individually evaluated for impairment	\$ 15,820	\$ 22,069	\$ 965	\$ 19,251	\$ 873	\$ 189	\$ 59,167
Ending balance: collectively evaluated for impairment	452,868	1,341,043	52,597	774,890	498,985	48,509	3,168,892
Ending balance: loans acquired with deteriorated credit quality	991	2,460	—	3,582	897	—	7,930
Ending Balance	<u>\$ 469,679</u>	<u>\$ 1,365,572</u>	<u>\$ 53,562</u>	<u>\$ 797,723</u>	<u>\$ 500,755</u>	<u>\$ 48,698</u>	<u>\$ 3,235,989</u>

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Loans acquired in a transfer, including business combinations, where there is evidence of credit deterioration since origination and it is probable at the date of acquisition that we will not collect all contractually required principal and interest payments, are accounted for as purchased impaired loans. Purchased impaired loans are initially recorded at fair value, which includes estimated future credit losses expected to be incurred over the life of the loan. Accordingly, the historical allowance for credit losses related to these loans is not carried over.

Accounting for purchased impaired loans involves estimating fair value, at acquisition, using the principal and interest cash flows expected to be collected discounted at the prevailing market rate of interest. The excess of cash flows expected to be collected over the estimated fair value at acquisition date is referred to as the accretable yield and is recognized in interest income using an effective yield method over the remaining life of the loans. The difference between contractually required payments and the cash flows expected to be collected at acquisition, considering the impact of prepayments, is referred to as the nonaccretable difference.

Changes in the carrying amount and accretable yield for purchased impaired and nonimpaired loans were as follows for the years ended December 31, 2014 and 2013 (in thousands):

	December 31, 2014				December 31, 2013			
	Purchased Impaired		Purchased Nonimpaired		Purchased Impaired		Purchased Nonimpaired	
	Accretable Yield	Carrying Amount of Loans	Accretable Yield	Carrying Amount of Loans	Accretable Yield	Carrying Amount of Loans	Accretable Yield	Carrying Amount of Loans
Balance at beginning of period	\$ 2,800	\$ 7,930	\$ 4,433	\$ 28,165	\$ 992	\$ 9,613	\$ 4,241	\$ 33,757
Accretion	(693)	693	(1,673)	1,673	(737)	737	(2,210)	2,210
Reclassifications from nonaccretable balance, net	—	—	—	—	2,545	—	2,402	—
Payments received, net	—	(1,492)	—	(4,866)	—	(2,420)	—	(7,802)
Balance at end of period	\$ 2,107	\$ 7,131	\$ 2,760	\$ 24,972	\$ 2,800	\$ 7,930	\$ 4,433	\$ 28,165

At December 31, 2014, none of the purchased loans were classified as nonperforming assets. Therefore, interest income, through accretion of the difference between the carrying amount of the loans and the expected cash flows, is being recognized on all purchased loans. Any decreases in cash flows expected to be collected (other than due to decreases in interest rate indices and changes in prepayment assumptions), will be charged to the provision for loan losses, resulting in an increase to the allowance for loan losses. The outstanding unpaid principal balance for all purchased impaired loans and purchased nonimpaired loans as of December 31, 2014, was \$9.77 million and \$26.04 million, respectively.

Portfolio Quality Indicators

The Company's portfolio grading analysis estimates the capability of the borrower to repay the contractual obligations of the loan agreements as scheduled or at all. The Company's internal credit risk grading system is based on numerous factors, including management's experiences with similarly graded loans. Credit risk grades on impaired credits are refreshed each quarter as they become available, at which time management analyzes the resulting scores, as well as other external statistics and factors, to track loan performance.

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The Company's internally assigned grades are as follows:

- Pass – Several pass credit grades comprise loans in this category, which are assigned based on varying levels of risk, ranging from credits that are secured by cash or marketable securities, to management attention credits which have all the characteristics of an acceptable credit risk but warrant more than the normal level of monitoring.
- Special Mention – Loans in this category are considered to have potential weaknesses that deserve management's attention. The borrower's ability to repay from the primary (intended) sources is currently adequate, but threatened by potential weaknesses which may, if not corrected, result in the deterioration of the repayment prospects for the asset or in the Company's credit position loss at some future date.
- Substandard – Loans in this category are considered to have increased credit risk and servicing needs and generally require that the Company follow their performance very closely. The borrower's ability to repay is threatened by a clearly defined weakness which jeopardizes ultimate repayment of the loan.
- Doubtful – Loans in this category are considered to be doubtful or a loss to the Company in terms of principal and interest repayment. The borrower's ability to repay in full, on the basis of currently existing facts, conditions, and values, is generally highly questionable and improbable.

The following tables represent consumer credit exposures by internally assigned grades for the years ended December 31, 2014 and 2013 (in thousands):

December 31, 2014	Construction and Land Development	Commercial Real Estate	Multi-Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
Pass	\$ 431,101	\$ 1,411,831	\$ 47,962	\$ 816,659	\$ 528,610	\$ 75,313	\$ 3,311,476
Special Mention	295	14,222	288	3,658	1,506	4	19,973
Substandard	21,085	21,025	3,222	17,053	3,384	48	65,817
Doubtful	—	—	—	—	—	—	—
Total	\$ 452,481	\$ 1,447,078	\$ 51,472	\$ 837,370	\$ 533,500	\$ 75,365	\$ 3,397,266

December 31, 2013	Construction and Land Development	Commercial Real Estate	Multi-Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
Pass	\$ 439,403	\$ 1,334,228	\$ 49,456	\$ 774,466	\$ 496,578	\$ 48,175	\$ 3,142,306
Special Mention	16,194	11,276	—	3,676	1,210	5	32,361
Substandard	14,082	20,068	4,106	19,581	2,967	518	61,322
Doubtful	—	—	—	—	—	—	—
Total	\$ 469,679	\$ 1,365,572	\$ 53,562	\$ 797,723	\$ 500,755	\$ 48,698	\$ 3,235,989

Age Analysis of Past-Due Financing Receivables by Class

The following table includes an aging analysis of the recorded investment of past-due financing receivables as of December 31, 2014. Also included are loans that are 90 days or more past due as to interest and principal

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and still accruing, because they are (1) well-secured and in the process of collection, or (2) real estate loans or loans exempt under regulatory rules from being classified as nonaccrual. Purchased impaired loans are included in the aging schedule, but are excluded from the disclosure of accruing loans more than 90 days past due as they are considered to be accruing due to the existence of the accretable yield and not based on consideration given to contractual interest payments (in thousands).

	<u>Loans 30 - 59 Days Past Due</u>	<u>Loans 60 - 89 Days Past Due</u>	<u>Loans 90 or More Days Past Due</u>	<u>Nonaccrual Loans</u>	<u>Total Past Due and Nonaccruing</u>	<u>Current Loans</u>	<u>Total Loans Receivable</u>	<u>Accruing Loans More Than 90 Days Past Due</u>
December 31, 2014								
Construction and land development	\$ 1,735	\$ 19	\$ —	\$ 1,680	\$ 3,434	\$ 449,047	\$ 452,481	\$ —
Commercial real estate	1,552	721	—	2,132	4,405	1,442,673	1,447,078	—
Multifamily real estate	762	—	—	—	762	50,710	51,472	—
1-4 family residential real estate	4,800	3,552	12	2,546	10,910	826,460	837,370	12
Commercial and industrial business loans	234	—	—	383	617	532,883	533,500	—
Consumer loans and other	61	—	—	—	61	75,304	75,365	—
Total	\$ 9,144	\$ 4,292	\$ 12	\$ 6,741	\$ 20,189	\$ 3,377,077	\$ 3,397,266	\$ 12

	<u>Loans 30 - 59 Days Past Due</u>	<u>Loans 60 - 89 Days Past Due</u>	<u>Loans 90 or More Days Past Due</u>	<u>Nonaccrual Loans</u>	<u>Total Past Due and Nonaccruing</u>	<u>Current Loans</u>	<u>Total Loans Receivable</u>	<u>Accruing Loans More Than 90 Days Past Due</u>
December 31, 2013								
Construction and land development	\$ 113	\$ —	\$ 28	\$ 5,687	\$ 5,828	\$ 463,851	\$ 469,679	\$ —
Commercial real estate	4,745	190	—	1,422	6,357	1,359,215	1,365,572	—
Multifamily real estate	3,611	—	—	606	4,217	49,345	53,562	—
1-4 family residential real estate	4,723	339	30	4,194	9,286	788,437	797,723	—
Commercial and industrial business loans	19	31	—	687	737	500,018	500,755	—
Consumer loans and other	77	3	—	157	237	48,461	48,698	—
Total	\$ 13,288	\$ 563	\$ 58	\$ 12,753	\$ 26,662	\$ 3,209,327	\$ 3,235,989	\$ —

Impaired Loans

Management considers a loan to be impaired when, based on current information and events, it is determined that the Company will not be able to collect all amounts due according to the loan contract, including scheduled interest payments. Determination of impairment is treated the same across all classes of loans. When management identifies a loan as impaired, the impairment is measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, except when the sole (remaining)

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source of repayment for the loan is the operation or liquidation of the collateral. In these cases, management uses the current fair value of the collateral, less selling costs when foreclosure is probable, instead of discounted cash flows. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs, and unamortized premium or discount), impairment is recognized as a specific component to be provided for in the allowance for loan losses, or the impaired balance on collateral dependent loans is charged-off if it is determined that such amount represents a confirmed loss.

When the ultimate collectability of the total principal of an impaired loan is in doubt and the loan is on nonaccrual status, all payments are applied to principal, under the cost-recovery method. When the ultimate collectability of the total principal of an impaired loan is not in doubt and the loan is on nonaccrual status, contractual interest is credited to interest income when received, under the cash-basis method.

The following table includes the recorded investment, excluding interest receivable, and unpaid principal balances for impaired financing receivables, excluding purchased impaired loans, with the associated allowance amount, if applicable (in thousands):

December 31, 2014	Unpaid Principal Balance	Recorded Investment	Specific Allowance	Average Recorded Investment	Interest Income Recognized
Loans without a specific valuation allowance					
Construction and land development	\$ 9,288	\$ 9,043	\$ —	\$ 9,602	\$ 451
Commercial real estate	10,232	9,964	—	10,342	486
1-4 family residential real estate	6,686	6,459	—	6,730	288
Commercial and industrial business loans	572	443	—	578	23
Consumer loans and other	41	41	—	53	4
Total	\$ 26,819	\$ 25,950	\$ —	\$ 27,305	\$ 1,252
Loans with a specific valuation allowance					
Construction and land development	\$ 2,076	\$ 1,881	\$ 464	\$ 2,452	\$ 36
Commercial real estate	9,350	9,177	1,177	9,474	377
1-4 family residential real estate	8,077	7,920	1,195	8,141	391
Commercial and industrial business loans	255	231	231	282	13
Consumer loans and other	—	—	—	—	—
Total	\$ 19,758	\$ 19,209	\$ 3,067	\$ 20,349	\$ 817
Total impaired loans					
Construction and land development	\$ 11,364	\$ 10,924	\$ 464	\$ 12,054	\$ 487
Commercial real estate	19,582	19,141	1,177	19,816	863
1-4 family residential real estate	14,763	14,379	1,195	14,871	679
Commercial and industrial business loans	827	674	231	860	36
Consumer loans and other	41	41	—	53	4
Total	\$ 46,577	\$ 45,159	\$ 3,067	\$ 47,654	\$ 2,069

(1) Included in the table above are accruing TDRs of \$38.42 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled \$2.50 million.

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December 31, 2013	Unpaid Principal Balance	Recorded Investment	Specific Allowance	Average Recorded Investment	Interest Income Recognized
Loans without a specific valuation allowance					
Construction and land development	\$ 9,819	\$ 9,730	\$ —	\$ 10,445	\$ 527
Commercial real estate	16,100	15,864	—	16,166	885
1-4 family residential real estate	9,307	8,864	—	9,418	422
Commercial and industrial business loans	997	521	—	1,043	49
Consumer loans and other	47	43	—	56	4
Total	\$ 36,270	\$ 35,022	\$ —	\$ 37,128	\$ 1,887
Loans with a specific valuation allowance					
Construction and land development	\$ 6,199	\$ 6,090	\$ 915	\$ 6,820	\$ 162
Commercial real estate	6,286	6,205	1,440	6,357	292
Multifamily real estate	965	965	77	976	59
1-4 family residential real estate	11,059	10,387	1,994	10,780	495
Commercial and industrial business loans	367	352	352	374	21
Consumer loans and other	202	146	29	204	9
Total	\$ 25,078	\$ 24,145	\$ 4,807	\$ 25,511	\$ 1,038
Total impaired loans					
Construction and land development	\$ 16,018	\$ 15,820	\$ 915	\$ 17,265	\$ 689
Commercial real estate	22,386	22,069	1,440	22,523	1,177
Multifamily real estate	965	965	77	976	59
1-4 family residential real estate	20,366	19,251	1,994	20,198	917
Commercial and industrial business loans	1,364	873	352	1,417	70
Consumer loans and other	249	189	29	260	13
Total	\$ 61,348	\$ 59,167	\$ 4,807	\$ 62,639	\$ 2,925

(1) Included in the table above are accruing TDRs of \$46.41 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled \$3.99 million.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012	Unpaid Principal Balance	Recorded Investment	Specific Allowance	Average Recorded Investment	Interest Income Recognized
Loans without a specific valuation allowance					
Construction and land development	\$ 23,374	\$ 20,315	\$ —	\$ 25,497	\$ 667
Commercial real estate	18,290	17,923	—	18,246	1,031
1-4 family residential real estate	11,410	10,867	—	11,534	464
Commercial and industrial business loans	947	626	—	924	53
Consumer loans and other	107	102	—	118	8
Total	\$ 54,128	\$ 49,833	\$ —	\$ 56,319	\$ 2,223
Loans with a specific valuation allowance					
Construction and land development	\$ 22,216	\$ 20,928	\$ 1,544	\$ 22,177	\$ 67
Commercial real estate	6,516	6,278	978	6,571	274
1-4 family residential real estate	5,875	5,357	1,246	5,901	269
Commercial and industrial business loans	—	—	—	—	—
Consumer loans and other	393	348	185	398	9
Total	\$ 35,000	\$ 32,911	\$ 3,953	\$ 35,047	\$ 619
Total impaired loans					
Construction and land development	\$ 45,590	\$ 41,243	\$ 1,544	\$ 47,674	\$ 734
Commercial real estate	24,806	24,201	978	24,817	1,305
1-4 family residential real estate	17,285	16,224	1,246	17,435	733
Commercial and industrial business loans	947	626	—	924	53
Consumer loans and other	500	450	185	516	17
Total	\$ 89,128	\$ 82,744	\$ 3,953	\$ 91,366	\$ 2,842

(1) Included in the table above are accruing TDRs of \$38.91 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled \$25.30 million.

Troubled Debt Restructurings

In order to maximize the collection of loan balances, the Company evaluates troubled loan accounts on a case-by-case basis to determine if a loan modification would be appropriate. Loan modifications may be utilized when there is a reasonable chance that an appropriate modification would allow our clients to continue servicing the debt. A loan is a troubled debt restructuring (“TDR”) if both of the following exist: (1) a creditor has granted a concession to the debtor, and (2) the debtor is experiencing financial difficulties. Nonaccruing loans that are modified can be placed back on accrual status when both principal and interest are current, there is a sustained repayment performance of six months or greater, and it is probable that we will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

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The following table shows the loans modified in TDRs for the years ended December 31, 2014 and 2013 (in thousands, except number of loans):

	Year Ended December 31, 2014		
	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
Construction and land development	—	\$ —	\$ —
Commercial real estate	1	134	134
Multifamily real estate	—	—	—
1-4 family residential real estate	1	549	379
Commercial and industrial	3	293	269
Consumer loans and other	3	69	69
Total	8	\$ 1,045	\$ 851

	Year Ended December 31, 2013		
	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
Construction and land development	2	\$ 2,550	\$ 2,530
Commercial real estate	5	4,819	4,819
Multifamily real estate	1	365	365
1-4 family residential real estate	8	5,914	5,629
Commercial and industrial	1	2,000	2,000
Consumer loans and other	1	4	4
Total	18	\$ 15,652	\$ 15,347

The restructured loans generally include terms to reduce the interest rate and extend payment terms. We have not forgiven any principal on the above loans. There was one consumer loan that was restructured within the last 12 months that subsequently defaulted. The loan had a recorded balances of \$0.03 million.

The specific reserve portion of the allowance for loan losses on TDRs is determined by discounting the restructured cash flows at the original effective rate of the loan before modification, or is based on the underlying collateral value less costs to sell, if repayment of the loan is collateral-dependent. If the resulting amount is less than the recorded book value, the Company either establishes a valuation allowance as a component of the allowance for loan losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio. At December 31, 2014, all significant impaired loans have been determined to be collateral-dependent.

Nonaccrual Loans

The Company generally places loans on nonaccrual status when the full and timely collection of interest or principal becomes uncertain, part of the principal balance has been charged off and no restructuring has occurred, or the loans reach a certain number of days past due. Commercial loans are placed on nonaccrual status when full collection of principal and interest becomes doubtful, or when any portion of principal or interest becomes 90 days past due, whichever occurs first, unless the debt is both well-secured and in the process of collection. Residential mortgage loans and other consumer loans are placed 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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

NOTE 5: OTHER REAL ESTATE OWNED

The table below presents a summary of the activity related to OREO (in thousands):

	Year Ended December 31,	
	2014	2013
Beginning balance	\$ 39,534	\$ 30,297
Additions	14,688	34,269
Sales	(17,323)	(23,828)
Valuation allowance	(1,271)	(414)
Loss on sale and write-downs	(513)	(279)
Transfers to premises and equipment	—	(511)
Ending balance	<u>\$ 35,115</u>	<u>\$ 39,534</u>

NOTE 6: PREMISES, EQUIPMENT, AND LEASES

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

	Useful Life	December 31,	
		2014	2013
Land and improvements	—	\$ 27,898	\$ 26,012
Buildings and improvements	10 to 45 years	95,221	91,656
Autos	3 to 5 years	3,937	3,947
Computer equipment	2 to 5 years	11,780	11,227
Equipment	5 to 10 years	14,371	13,390
Furniture and fixtures	5 to 20 years	39,387	38,340
Leasehold improvements	Lesser of lease term or 15 years	22,399	21,414
Construction in progress	—	2,883	1,516
		<u>217,876</u>	<u>207,502</u>
Less accumulated depreciation		(62,102)	(54,066)
Net premises and equipment		<u>\$ 155,774</u>	<u>\$ 153,436</u>

Depreciation and leasehold amortization expense for the years ended December 31, 2014, 2013, and 2012 was \$10.46 million, \$9.57 million, and \$8.36 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

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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 \$7.64 million for 2014, compared to \$6.98 million for 2013, and \$6.31 million for 2012.

Future minimum lease payments, by year and in the aggregate, under noncancellable operating facilities leases at December 31, 2014, are listed in the following chart (in thousands):

2015	\$	7,578
2016		6,278
2017		5,664
2018		5,276
2019		2,316
Thereafter		8,613
		<u>35,725</u>
	\$	<u>35,725</u>

Rental income for the year ended December 31, 2014 was \$0.33 million, compared to \$0.37 million for 2013, and \$0.43 million for 2012. Future minimum rental income, by year and in the aggregate, under noncancellable operating leases, was as follows at December 31, 2014 (in thousands):

2015	\$	386
2016		247
2017		192
2018		171
2019		57
Thereafter		52
		<u>1,105</u>
	\$	<u>1,105</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7: GOODWILL AND INTANGIBLE ASSETS

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

	December 31,			
	2014		2013	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Intangible assets subject to amortization				
Core deposit intangible	\$ 417	\$ 211	\$ 417	\$ 159
Non-compete agreements	1,706	1,374	1,456	1,292
Customer lists	30,386	11,773	21,119	9,332
Trade names	211	84	211	42
Total intangible assets subject to amortization	32,720	13,442	23,203	10,825
Intangible assets not subject to amortization				
Contractual agreements	3,231	—	3,231	—
Total intangible assets not subject to amortization	3,231	—	3,231	—
Total intangible assets	\$ 35,951	\$ 13,442	\$ 26,434	\$ 10,825

The aggregate amortization expense for intangible assets with finite lives for the year ended December 31, 2014 was \$2.62 million, compared to \$2.14 million for 2013, and \$2.25 million for 2012. The estimated aggregate annual amortization expense for each of the five years subsequent to December 31, 2014, is as follows: 2015, \$2.95 million; 2016, \$2.65 million; 2017, \$2.48 million; 2018, \$2.31 million; and 2019, \$2.07 million.

During 2014, the Company recorded \$8.65 million in net increases to goodwill and \$9.52 million in intangible assets. This represents the acquisitions of an insurance agency, an insurance-related book of business, and a property resort management company. During 2013, the Company recorded \$1.53 million in net increases to goodwill and \$1.67 million in intangible assets. This represented the acquisition of two insurance agencies and several insurance-related books of business. The book-of-business purchases resulted in an increase to intangible assets of \$0.51 million. The intangible assets acquired are finite-lived, consisting primarily of book-of-business purchases. These assets are included in the Company's Insurance segment.

No impairment charges were recorded in any year reported. Impairment testing indicated that goodwill was not impaired in 2014, 2013, or 2012. 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, 2012	\$ 58,884	\$ 15,825	\$ 28,203	\$ 102,912
Additions to goodwill	—	—	1,534	1,534
Balance, December 31, 2013	\$ 58,884	\$ 15,825	\$ 29,737	\$ 104,446
Additions to goodwill	—	1,515	7,139	8,654
Other adjustments	—	—	59	59
Balance, December 31, 2014	\$ 58,884	\$ 17,340	\$ 36,935	\$ 113,159

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8: BANK-OWNED LIFE INSURANCE POLICIES

The total carrying amount of bank-owned life insurance policies (“BOLI”) as of December 31, 2014 was \$58.72 million. The Company had \$57.37 million of BOLI at December 31, 2013, and \$55.38 million at December 31, 2012. The Company recognized BOLI income, included in other noninterest income, of \$2.14 million, \$1.99 million, and \$2.06 million for the years ended December 31, 2014, 2013, and 2012, respectively. The Company has a related retirement plan, which provides retirement benefits to the executives covered under the plan. Although the retirement plan is technically unfunded, the life insurance policies are available to finance future benefits. Refer to Note 12 for additional discussions regarding retirement plans.

NOTE 9: DEPOSITS

A summary of time deposits by maturity at December 31, 2014, is shown in the following chart (dollars in thousands):

<u>Maturity</u>	<u>Total</u>
2015	\$ 585,030
2016	220,927
2017	20,725
2018	13,978
2019 and thereafter	115,260
	<u>\$ 955,920</u>

At year-end 2014, TowneBank had a total of \$380.22 million in no-penalty time deposits as compared to \$364.48 million at December 31, 2013. The aggregate amount of time deposits of \$250,000 or more was \$194.47 million and \$198.22 million at December 31, 2014 and 2013, respectively.

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 \$52.52 million and \$46.35 million at December 31, 2014 and 2013, respectively.

NOTE 10: 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):

	<u>2014</u>	<u>2013</u>
Balance outstanding at end of year	\$ 398,181	\$ 395,087
Average balance outstanding	\$ 396,672	\$ 386,089
Maximum outstanding at any month-end	\$ 398,717	\$ 395,140
Average interest rate during the year	3.37%	3.38%
Average interest rate at end of year	3.32%	3.33%

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The scheduled maturity dates, call dates, and related fixed interest rates on advances from the FHLB at December 31, 2014, are summarized as follows (dollars in thousands):

<u>Maturity Date</u>	<u>Interest Rate</u>	<u>Call Date</u>	<u>Outstanding Amount</u>
03/06/2017	4.08%	03/06/2015	\$ 100,000
05/18/2017	4.35%	02/18/2015	80,000
05/18/2017	4.48%	02/18/2015	80,000
01/29/2018	3.05%	—	13,000
01/29/2018	3.05%	—	7,000
09/28/2015	0.55%	—	33,000
09/28/2017	0.95%	—	34,000
09/30/2019	1.44%	—	33,000
06/08/2026	2.38%	—	8,550
11/15/2028	3.43%	—	5,596
12/01/2028	2.83%	—	4,035
			<u>\$ 398,181</u>

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

	<u>2014</u>	<u>2013</u>
Balance outstanding at end of year	\$ 31,893	\$ 47,659
Average balance outstanding	\$ 32,574	\$ 39,126
Maximum outstanding at any month-end	\$ 42,531	\$ 51,473
Average interest rate during the year	0.16%	0.17%
Average interest rate at end of year	0.16%	0.14%

Repurchase agreements totaled \$31.89 million at December 31, 2014. They are classified as secured borrowings and generally mature within one business day from the transaction date. They are reflected as the amount of cash received in connection with the transaction. In addition, federal funds lines with other financial institutions were available at December 31, 2014, for short-term funding needs. Federal funds purchased are overnight, unsecured borrowings.

At December 31, 2014 and 2013, the Company had an unused line of credit with the FHLB totaling \$996.56 million and \$906.81 million, respectively. 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 \$748.86 million at December 31, 2014.

Further, the Company had loan participation lines and reverse repurchase agreements with various financial institutions available at December 31, 2014, which provide potential additional funding.

At January 1, 2012, the Company had outstanding convertible subordinated capital debentures of \$13.74 million in the form of Series III Towne Investment Notes. During 2012, the debentures were called and there were no convertible subordinated capital debentures outstanding at December 31, 2014 or 2013. Interest expense on debentures was \$0 for the years ended December 31, 2014 and 2013, and \$0.24 million for 2012.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11: 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,	2014	2013
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$ 1,189,546	\$ 859,076
Standby letters of credit	28,755	27,889
	<u>\$ 1,218,301</u>	<u>\$ 886,965</u>

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, 2014. Management does not anticipate any material losses will arise from additional disbursements of the aforementioned lines or standby letters of credit.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12: RETIREMENT PLANS

Defined Contribution Plans

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 make a discretionary match of the employees' contributions up to 6% of their salary. The Company did not match employee contributions in 2014 and matched employee contributions up to 3.0%, and 4.50% in the years ended December 31, 2013, and 2012, respectively. The Company may also make an additional discretionary contribution; there were no discretionary contributions for the years ended December 31, 2014, 2013, or 2012. The Company made matching contributions of \$0, \$2.20 million, and \$2.66 million for the years ended December 31, 2014, 2013, and 2012, respectively.

The Company has a non-qualified deferred compensation plan that allows certain executives, senior officers, and other employees to defer payment of up to 100% of their base salary and annual bonus. The Company has the option to match an employee's combined nonqualified deferred compensation and 401(k) deferrals up to a maximum of 6% of his or her salary. The Company does not match contributions made by employees who are participants in the SERP.

During the third quarter of 2013, the Company amended the deferred compensation plan, which is structured as a rabbi trust, from a self-directed, diversified plan to a plan that does not permit diversification. Due to the change in the plan's structure, the funds previously held in the plan were sold, with proceeds invested in certificates of deposit, which are included in other assets on the balance sheet. Changes in the obligation are now recorded in compensation expense, which resulted in an increase in expenses of \$0.42 million for the year ended December 31, 2014. The Company did not make matching contributions to the plan for the years ended December 31, 2014, 2013, or 2012.

Supplemental Executive Retirement Plan

On December 1, 2008, the Company implemented a noncontributory, unfunded SERP for certain officers and key employees. The SERP is intended to provide retirement benefits and post-retirement health benefits to individuals covered under the plan. The SERP agreements with the officers provide that upon attainment of retirement age, generally at age 65, the participating officer will be entitled to receive a retirement benefit equal to either (i) a designated percentage, ranging from 30% to 50% of their base salary depending on their level of seniority, with an annual 4% increase until retirement, or (ii) a fixed targeted benefit amount. The retirement benefit is payable over a 15-year period, beginning at attainment of contractual retirement age. The SERP agreements provide for an annual vesting schedule until the participating officer reaches retirement age. In the case of a participating officer's voluntary termination of employment, disability, or termination for cause, the annual amount payable under the SERP is equal to the amount of the vested benefit earned as of the date of termination of employment. In the case of involuntary termination without cause or termination of employment for good reason by the participating officer, the participating officer becomes fully vested in the full retirement benefit. Upon termination of employment, payment of the retirement benefit does not begin until the participating officer reaches the designated retirement age set forth in the SERP agreement. In the event of death, the full amount of the retirement benefit is payable.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table sets forth changes in benefit obligations and financial data relative to the SERP. The accrued liability is recorded on the Consolidated Balance Sheets as a component of other liabilities (in thousands):

December 31,	2014	2013
<i>Change in benefit obligation</i>		
Benefit obligation, beginning of year	\$ 16,610	\$ 15,152
Service cost	3,026	1,937
Interest cost	755	666
Net amortization	17	242
Benefits paid	(408)	(183)
Net actuarial (gain) loss	1,179	(1,204)
Benefit obligation, end of year	<u>\$ 21,179</u>	<u>\$ 16,610</u>
<i>Change in plan assets</i>		
Fair value of plan assets, beginning of year	—	—
Employer contributions	408	183
Benefits paid	(408)	(183)
Fair value of plan assets, end of year	<u>\$ —</u>	<u>\$ —</u>
Funded status, end of year	<u>\$ (21,179)</u>	<u>\$ (16,610)</u>
Accumulated benefit obligation, end of year	<u>\$ 19,708</u>	<u>\$ 15,374</u>
<i>Amounts recognized in other comprehensive income, pretax</i>		
Net actuarial (gain) loss	<u>\$ 1,179</u>	<u>\$ (1,204)</u>

The components of the net periodic benefit cost for the SERP are as follows (in thousands):

	2014	2013	2012
Service cost	\$ 3,026	\$ 1,937	\$ 2,515
Interest cost	755	666	476
Net amortization	17	242	—
Net periodic benefit cost	<u>\$ 3,798</u>	<u>\$ 2,845</u>	<u>\$ 2,991</u>

Amounts recognized as a component of accumulated other comprehensive income that have not yet been recognized as a component of net periodic benefit cost consist of the following:

December 31,	2014	2013
Net actuarial loss	\$ 1,333	\$ 154
Deferred tax expense	(466)	(54)
Amounts included in accumulated other comprehensive income, net of tax	<u>\$ 867</u>	<u>\$ 100</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Pre-tax amounts recorded in accumulated other comprehensive income as of December 31, 2014 that are expected to be recognized as a component of our net periodic benefit cost in 2015 consist of the following:

December 31,	Expected Amortization in 2015
Net actuarial loss	<u>\$ 156</u>

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 4.08% in 2014, 4.92% in 2013, and 3.91% 2012. The rate of increase in future compensation levels used was 4.0% in 2014, 2013, and 2012. When estimating the discount rate, we review yields available on high-quality, fixed-income debt instruments and use a yield curve model from which the discount rate is derived by applying the projected benefit payments under the plan to points on a published yield curve.

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

<u>Year</u>	<u>SERP</u>
2015	\$ 533
2016	1,475
2017	1,475
2018	1,518
2019	1,877
2020-2023	10,433

NOTE 13: 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 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 determine. 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, 2014, approximately 3.73 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 10 years from the date of grant. Options and awards granted under the Plan are subject to vesting requirements ranging from two to 10 years.

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The following tables summarize our stock option activity and related information:

For the Year Ended December 31,	2014		2013		2012	
	Number of Shares	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
Options outstanding, beginning balance	514,086	\$ 18.43	574,465	\$ 18.38	862,457	\$ 16.22
Granted	—	—	—	—	—	—
Exercised	—	—	(3,090)	12.77	(254,462)	11.31
Expired	(96,270)	18.50	—	—	—	—
Forfeited	(3,811)	16.05	(57,289)	18.22	(33,530)	16.66
Options outstanding, ending balance	414,005	\$ 18.44	514,086	\$ 18.43	574,465	\$ 18.38
Options exercisable at December 31,	338,781	\$ 18.88	406,678	\$ 18.85	421,228	\$ 18.81

	Number of Shares	Weighted-Average Exercise Price
Unvested stock options, December 31, 2013	107,408	\$ 16.87
Granted	—	—
Vested	(30,742)	17.89
Forfeited	(1,442)	16.72
Unvested stock options, December 31, 2014	75,224	\$ 16.46

For the years ended December 31, 2014, 2013, and 2012, there were no stock options granted. There were no stock options exercised in 2014. For the years ended December 31, 2013 and 2012, the total intrinsic value of options exercised was \$0.01 million and \$0.59 million, respectively. Additional information pertaining to options outstanding at December 31, 2014, is as follows:

	Number of Shares	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted-Average Remaining Contractual Life
Options outstanding	414,005	\$ 18.44	\$ 57,526	2.29
Options vested or expected to vest	410,541	\$ 18.47	\$ 56,327	2.27
Options exercisable	338,781	\$ 18.88	\$ 33,608	1.94

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 the U.S. Department of the Treasury (the "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.

There were no exercises of stock options for the year ended December 31, 2014 for which cash was received and, therefore, no tax benefit realized. For the years ended December 31, 2013 and 2012, the tax benefit on cash paid for stock options exercised was \$3,000 and \$0.20 million. Compensation expense related to stock options for the

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years ended December 31, 2014, 2013, and 2012 was \$0.16 million, \$0.22 million, and \$0.28 million, respectively. As of December 31, 2014, there was \$0.30 million of total unrecognized compensation cost related to unvested stock option awards; that cost is expected to be recognized over a period of 3.52 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 and stock dividends. RSAs granted under the Plan are generally subject to vesting requirements ranging from three to 10 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, 2014:

	Number of Shares	Weighted- Average Price
Unvested RSAs, beginning balance	304,294	\$ 14.52
Granted	174,561	14.81
Vested	(110,363)	14.25
Forfeited	(6,773)	14.80
Unvested RSAs, ending balance	<u>361,719</u>	<u>\$ 14.74</u>

Compensation expense related to awards for the years ended December 31, 2014, 2013, and 2012 was \$1.49 million, \$1.47 million, and \$1.26 million, respectively. The total fair value of awards vested during 2014, 2013, and 2012 was \$1.57 million, \$1.21 million, and \$0.87 million, respectively. As of December 31, 2014, there was \$4.46 million of total unrecognized compensation cost related to unvested restricted stock awards; that cost is expected to be recognized over a period of 4.0 years.

The Company has a directors’ deferred compensation plan whereby the directors may elect to defer up to 100% of their directors’ fees. All deferred compensation is invested in the Company’s common stock and is held in a rabbi trust. The stock is held in nominee name of the trustee, and the principal and earnings of the trust are held separate and apart from other funds of the Company, and are used exclusively for the uses and purposes of the deferred compensation agreement. The accounts of the trust have been consolidated in the financial statements of the Company with common stock reported separately in a manner similar to treasury stock (that is, changes in fair value are not recognized) and a corresponding deferred compensation obligation reflected in additional paid-in capital of \$9.67 million and \$8.59 million at December 31, 2014 and 2013, respectively.

NOTE 14: 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. In connection with the member stock purchase component of the plan for the year ended December 31, 2014, the Company entered the open market and acquired 156,692 shares at an average price of \$15.19 per share. In connection with the dividend reinvestment component of the plan for the year ended December 31, 2014, the Company entered the open market and acquired 279,077 shares at an average price of \$15.28 per share.

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In connection with the member stock purchase component of the plan for the year ended December 31, 2013, the Company entered the open market and acquired 157,626 shares at an average price of \$15.06 per share. In connection with the dividend reinvestment component of the plan for the year ended December 31, 2013, the Company entered the open market and acquired 256,470 shares at an average price of \$15.25 per share.

TowneBank, as a Virginia banking corporation, may pay cash dividends only out of retained earnings. In February 2014, the Company declared a quarterly cash dividend of \$0.10 per common share. In May, August, and November of 2014, the Company declared quarterly cash dividends of \$0.11 per common share. In February 2013 and May 2013, the Company declared quarterly cash dividends of \$0.09 per common share. In August 2013 and November 2013, the Company declared quarterly cash dividends of \$0.10 per common share. In February 2012, the Company declared a quarterly cash dividend of \$0.078 per common share. In May 2012 and August 2012, the Company declared quarterly cash dividends of \$0.08 per common share. In December 2012, the Company declared a quarterly cash dividend of \$0.09 per common share. In 2011, the Company declared quarterly cash dividends of \$0.078 per common share. The quarterly dividends were paid on January 12, 2012; April 12, 2012; July 12, 2012; October 12, 2012; December 28, 2012; April 12, 2013; July 12, 2013; October 11, 2013; January 12, 2014; April 11, 2014; July 11, 2014; October 10, 2014; and January 12, 2015.

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.

Preferred Stock

On September 22, 2011, the Company entered into a Securities Purchase Agreement with the Secretary of the U.S. Treasury, pursuant to which the Company sold and issued 76,458 shares of the Company's Senior Non-Cumulative Perpetual Preferred Stock, Series C ("Series C Preferred Stock"), liquidation value of \$1,000 per share, for a total purchase price of \$76.46 million. The issuance was pursuant to the Small Business Lending Fund program, a \$30 billion fund established under the Small Business Jobs Act of 2010 that was created to encourage lending to small businesses by providing capital to qualified community banks with assets of less than \$10 billion.

The holder of the Series C Preferred Stock is entitled to receive non-cumulative dividends, payable quarterly, on January 1, April 1, July 1, and October 1 of each year. The dividend rate can fluctuate on a quarterly basis during the first 10 quarters during which the Series C Preferred Stock is outstanding, based upon changes in the level of "Qualified Small Business Lending" ("QSBL") by the Company as compared to the Company's baseline QSBL level, which was established at the closing of the issuance. The dividend rate for the initial dividend period has been set at 5%. For the second through 10th calendar quarters, the dividend rate may be adjusted to between 1% and 5% per annum based upon the increase in QSBL as compared to the initial baseline. For the 11th calendar quarter through four and one-half years after issuance, the dividend rate will be fixed at between 1% and 7% based upon the level of QSBL compared to the baseline. After four and one-half years from issuance, the dividend rate will increase to 9%. Due to the Company's loan growth, the blended rate for the period from closing through December 31, 2011 was 4.63%, with the rate reduced to 3.92% for the first quarter of 2012, and 2.28% for the second quarter of 2012. Beginning with the third quarter of 2012, the rate decreased to 1.0% and will remain fixed at that rate through the end of 2015.

If the Company has not declared and paid an aggregate of six dividend payments on the Series C Preferred Stock, whether or not consecutive, the holder of the Series C Preferred Stock will have the right to elect two directors to the Company's Board of Directors. The Series C Preferred Stock may be redeemed at any time at the Company's

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option, at a redemption price of 100% of the liquidation amount plus accrued but unpaid dividends to the date of redemption for the current period, subject to the approval of the FDIC.

On September 22, 2011, the Company used the proceeds from the sale and issuance of the Series C Preferred Stock to repurchase all 76,458 outstanding shares of its Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series B, liquidation amount \$1,000 per share (“Series B Preferred Stock”), for a redemption price of \$76.46 million, plus accrued but unpaid dividends. The Series B Preferred Stock was issued in the fourth quarter of 2008 to the U.S. Treasury under the Capital Purchase Program. With the repurchase of all shares of the Series B Preferred Stock, the remaining accretion of the discount of \$1.86 million was accelerated into the third quarter of 2011 and reduced income available to common shareholders.

In connection with the issuance of the Series B Preferred Stock, the Company was required to issue to the U.S. Treasury immediately exercisable 10-year warrants to purchase 554,330 common shares at an exercise price of \$20.69 per share. On May 15, 2013, the Company repurchased the warrants from the U.S. Treasury for \$1.5 million. The transaction reduced additional paid-in capital within stockholders’ equity by \$1.5 million.

Non-cumulative dividends on the Series B Preferred Stock were payable at a rate of 5% while outstanding. The Company subsequently paid quarterly cash dividends of \$12.50 per share of Series B Preferred Stock on November 15, 2010; February 15, 2011; May 16, 2011; and August 15, 2011.

In August 2008, the Company issued 598,542 shares of 8% Non-Cumulative Convertible Preferred Stock, Series A (the “Series A Preferred Stock”), liquidation value of \$100 per share. The Series A Preferred Stock paid a non-cumulative dividend of 8% per year. Dividends were payable quarterly in cash, when, as, and if declared by the Board of Directors, on the first day of March, June, September, and December, commencing on December 1, 2008. Dividends on the Series A Preferred Stock began accruing August 15, 2008.

In 2012 and 2011, the Company declared quarterly cash dividends of \$2.00 per share of Series A Preferred Stock. The Company also declared quarterly cash dividends of \$2.00 per share of Series A Preferred Stock on January 23, 2013; April 24, 2013; and July 24, 2013. The quarterly dividends were paid on March 2, 2011; June 1, 2011; September 1, 2011; December 1, 2011; March 2, 2012; June 1, 2012; September 1, 2012; December 1, 2012; March 1, 2013; June 3, 2013; and September 3, 2013.

On September 1, 2013, all outstanding shares of the Series A Preferred Stock were mandatorily converted into 3.19 million shares of TowneBank common stock reflecting a conversion price of \$18.02 per share of common stock, plus cash in lieu of any fractional shares. During 2013, prior to the mandatory conversion, certain holders of Series A Preferred Stock voluntarily converted certain shares of Series A Preferred Stock into 37,839 shares of TowneBank common stock at a conversion price of \$18.02 per share of common stock.

The following table presents the changes in the number of preferred shares for the years ended December 31, 2014 and 2013:

	Series A Preferred Shares	Series C Preferred Shares
Balance, December 31, 2012	581,453	76,458
Conversion of preferred stock into common stock	(581,453)	—
Balance, December 31, 2013	—	76,458
Conversion of preferred stock into common stock	—	—
Balance, December 31, 2014	—	76,458

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NOTE 15: OTHER EXPENSES

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

Year Ended December 31,	2014	2013	2012
Advertising and marketing	\$ 5,178	\$ 5,374	\$ 4,818
Acquisition-related expenses	4,280	(19)	768
Charitable contributions	3,430	4,209	3,574
Telephone and postage	4,184	3,937	3,527
Outside processing	3,631	3,425	3,019
Professional fees	5,178	4,325	4,606
Other	6,855	7,514	7,019
Stationery and office supplies	2,132	2,291	2,048
Amortization of intangible assets	2,623	2,145	2,251
Foreclosed property expenses	3,397	2,020	4,612
FDIC and other insurance	3,885	3,974	3,729
Software expense	4,615	4,217	4,227
Travel/Meals/Entertainment	1,133	1,424	981
Directors' expense	1,099	1,187	1,179
Bank franchise tax/SCC fees	2,191	1,905	1,871
	<u>\$ 53,811</u>	<u>\$ 47,928</u>	<u>\$ 48,229</u>

NOTE 16: 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.

Quantitative measures established by 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, 2014, that the Company meets all capital adequacy requirements to which it is subject.

As of December 31, 2014, the Company was categorized 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 which management believes have changed our category.

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A summary of our required and actual capital components follow (dollars in thousands):

As of December 31, 2014	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)	\$ 520,266	13.67%	\$ 304,446	8.00%	\$ 380,557
Tier 1 capital (to risk-weighted assets)	\$ 484,349	12.73%	\$ 152,223	4.00%	\$ 228,334	6.00%
Tier 1 leverage ratios (to average assets)	\$ 484,349	9.94%	\$ 194,866	4.00%	\$ 243,582	5.00%

As of December 31, 2013	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)	\$ 505,643	14.00%	\$ 289,026	8.00%	\$ 361,282
Tier 1 capital (to risk-weighted assets)	\$ 467,263	12.93%	\$ 144,513	4.00%	\$ 216,769	6.00%
Tier 1 leverage ratios (to average assets)	\$ 467,263	10.29%	\$ 181,701	4.00%	\$ 227,127	5.00%

NOTE 17: FAIR VALUE DISCLOSURES

Fair value is defined 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. A three-level valuation hierarchy was established for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

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

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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.

The following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis.

Securities available for sale: Fair values 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.

Interest Rate Lock Commitments: Interest rate lock commitments, related to the origination of mortgage loans held for sale, are recorded at estimated fair value based on the value of the underlying loan, which in turn is based on quoted prices for similar loans in the secondary market. However, this value is adjusted by a factor which considers the likelihood that the loan in a lock position will ultimately close. This factor, the fall-out rate, is derived from the Company's internal data and is adjusted using significant management judgment. The fall-out rate is largely dependent on the loan processing stage that a loan is currently in and the change in prevailing interest rates from the time of the rate lock. As such, interest rate lock commitments are classified as recurring Level 3. The Company used a weighted average fall-out rate ratio of 20%. The carrying value of interest rate lock commitments was \$0.95 million at December 31, 2014, and \$0.58 million at December 31, 2013.

Assets and liabilities measured at fair value on a recurring basis are summarized below (in thousands):

	December 31, 2014			
	Level 1	Level 2	Level 3	Total
U.S. agency securities	\$ —	\$ 512,441	\$ —	\$ 512,441
U.S. Treasury notes	—	—	—	—
Municipal securities	—	24,719	—	24,719
Mortgage-backed securities issued by GSE	—	58,292	—	58,292
Trust preferred and other corporate securities	—	8,456	—	8,456
Interest rate lock commitments	—	—	946	946
	December 31, 2013			
	Level 1	Level 2	Level 3	Total
U.S. agency securities	\$ —	\$ 233,330	\$ —	\$ 233,330
U.S. Treasury notes	—	200,000	—	200,000
Municipal securities	—	37,079	—	37,079
Mortgage-backed securities issued by GSE	—	64,855	—	64,855
Trust preferred and other corporate securities	—	8,257	—	8,257
Equity securities	—	—	—	—
Interest rate lock commitments	—	—	583	583

The Company may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with GAAP. These adjustments to fair value usually result from application of lower-of-cost-or-market accounting or write-downs of individual assets. For assets measured at fair value on a nonrecurring basis that were still held in the balance sheet at quarter-end, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related assets (in thousands):

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December 31, 2014	Level 1	Level 2	Level 3	Total
Impaired loans	\$ —	\$ —	\$ 16,142	\$ 16,142
Foreclosed property	\$ —	\$ 21,409	\$ 13,706	\$ 35,115
December 31, 2013	Level 1	Level 2	Level 3	Total
Impaired loans	\$ —	\$ —	\$ 19,338	\$ 19,338
Foreclosed property	\$ —	\$ 21,437	\$ 18,097	\$ 39,534

The following is a description of valuation methodologies used for assets measured on a nonrecurring basis.

Loans: Impaired loans for which repayment of the loan is expected to be provided solely by the value of the underlying collateral are considered collateral dependent and are valued based on the fair value of such collateral. Collateral values are estimated using inputs based on observable market data, where available, or inputs based on customized discounting criteria. In cases where such inputs were unobservable, specifically discounts applied to appraisal values to adjust such values to current market conditions or to reflect net realizable value, the impaired loan balance is reflected within Level 3 of the hierarchy. These discounts ranged from 1.83% to 84.42%, with a weighted average of 28.40%.

Loans held for sale: Loans held for sale are carried at the lower of cost or estimated fair value. 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.

Foreclosed Property: The fair value of foreclosed property is estimated using Level 2 inputs based on observable market data or Level 3 inputs based on assumptions specific to the individual property. Level 3 inputs typically include unobservable inputs such as management-applied discounts used to further reduce values to a net realizable value or in situations where our appraisal date predates a likely change in market conditions. These deductions ranged from 5% to 12%.

The following methods and assumptions were used in estimating fair value for the remaining classes of our financial instruments.

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

Securities held to maturity: Fair values 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. Industrial revenue bonds are classified as Level 3 and, as such, use significant estimates to determine the fair value of these securities. The Company values these securities using a discounted cash flow approach based on assumptions that are generally not observable in the current markets.

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.

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Deposits: The fair value of noninterest-bearing deposits and deposits with no defined maturity is estimated by discounting anticipated future cash flows using current borrowing rates. 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.

Repurchase agreements: 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.

The estimated fair values of our financial instruments required to be disclosed under ASC 825, *Financial Instruments*, and the level within the fair value hierarchy at which such assets and liabilities are measured on a recurring basis are as follows (in thousands):

December 31, 2014	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
Cash and due from banks	\$ 212,994	\$ 212,994	\$ 212,994	\$ —	\$ —
Interest-bearing deposits in financial institutions	1,011	1,011	1,011	—	—
Securities available for sale	603,908	603,908	—	603,908	—
Securities held to maturity	252,370	268,264	—	89,552	178,712
Mortgage loans held for sale	71,390	71,390	—	71,390	—
Loans, net	3,361,349	3,442,719	—	—	3,442,719
Interest receivable	12,275	12,275	—	12,275	—
Deposits	3,846,602	3,460,829	—	3,460,829	—
Advances from the Federal Home Loan Bank of Atlanta	398,181	417,949	—	417,949	—
Repurchase agreements and other borrowings	31,893	31,895	—	31,895	—
Interest payable	2,410	2,410	—	2,410	—

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December 31, 2013	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
Cash and due from banks	\$ 203,782	\$ 203,782	\$ 203,782	\$ —	\$ —
Interest-bearing deposits in financial institutions	1,011	1,011	1,011	—	—
Securities available for sale	543,521	543,521	—	543,521	—
Securities held to maturity	204,348	195,708	—	60,462	135,246
Mortgage loans held for sale	56,821	56,821	—	56,821	—
Loans, net	3,235,989	3,333,682	—	—	3,333,682
Interest receivable	11,186	11,186	—	11,186	—
Deposits	3,567,104	3,149,022	—	3,149,022	—
Advances from the Federal Home Loan Bank of Atlanta	395,087	421,754	—	421,754	—
Repurchase agreements and other borrowings	47,659	47,661	—	47,661	—
Interest payable	2,648	2,648	—	2,648	—

NOTE 18: VARIABLE INTEREST ENTITIES

In the normal course of business, the Company is involved with various entities that are considered to be Variable Interest Entities (“VIE”). A VIE is an entity that has either a total equity investment that is insufficient to permit the entity to finance its activities without additional subordinated financial support, or whose equity investors lack the characteristics of a controlling financial interest. In accordance with existing accounting guidance, we are required to consolidate any VIE of which we are determined to be the primary beneficiary. The primary beneficiary is the entity that has (i) the power to direct the activities of a VIE that most significantly impact the entity’s economic performance; and (ii) the obligation to absorb losses of the entity that could potentially be significant to the VIE, or the right to receive benefits from the entity that could potentially be significant to the VIE. We review all significant interests in the VIEs we are involved with, including the amounts and types of financial and other support, including equity investments, debt financing, and guarantees. We also consider the activities of the VIEs that most significantly impact the VIEs’ economic performance and whether we have control over those activities. We assess whether or not we are the primary beneficiary of a VIE on an ongoing basis. To provide the necessary disclosures, we aggregate similar VIEs based on the nature and purpose of the entities.

Low Income Housing Tax Credit Partnerships

As part of its community reinvestment initiatives, the Company invests within its footprint in multifamily affordable housing developments as a limited partner. The Company receives tax credits for its partnership investments. The Company has determined that these partnerships are VIEs when it does not own 100% of the entity, because the holders of the equity investment at risk do not have the power through voting rights or similar rights to direct the activities of the entity that most significantly impact the entity’s economic performance. Accordingly, the Company’s limited partner interests are variable interests that the Company evaluates for purposes of determining whether the Company is the primary beneficiary.

For each of the partnerships, the Company acts strictly in a limited partnership capacity. The Company has determined that it is not the primary beneficiary of these partnerships because it does not have the power to direct the activities of the entity that most significantly impact the entity’s economic performance. The Company accounts for its limited partner interests in accordance with the accounting guidance for investments in affordable housing projects. Partnership assets of \$59.62 million and \$57.71 million in these partnerships were not included in the Consolidated Balance Sheets at December 31, 2014 and 2013, respectively. These limited partner interests

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had carrying values of \$15.17 million and \$16.45 million at December 31, 2014 and 2013, respectively, and are recorded in other assets on the Company's Consolidated Balance Sheets. The Company's maximum exposure to loss for these limited partner investments totaled \$15.17 million and \$16.45 million at December 31, 2014 and 2013, respectively. As of December 31, 2014, the Company has \$4.67 million in funding commitments that are dependent on certain contractual milestones. For the 12-month period ended December 31, 2014, a tax benefit totaling \$1.15 million, net of amortization of \$2.08 million, was recognized as a component of income tax expense.

NOTE 19: INCOME TAXES

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

For the Year Ended December 31,	2014	2013	2012
Current income tax expense			
Federal	\$ (18,778)	\$ (19,332)	\$ (12,094)
State	(547)	(444)	(466)
Total current tax expense	<u>(19,325)</u>	<u>(19,776)</u>	<u>(12,560)</u>
Deferred income tax (expense) benefit			
Federal	1,146	2,641	(1,404)
State	—	—	—
Total deferred income tax (expense) benefit	<u>1,146</u>	<u>2,641</u>	<u>(1,404)</u>
Income tax expense	<u>\$ (18,179)</u>	<u>\$ (17,135)</u>	<u>\$ (13,964)</u>

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):

For the Year Ended December 31,	2014		2013		2012	
	\$	Rate	\$	Rate	\$	Rate
Federal income tax expense at statutory rate	\$ (21,122)	(35.00)%	\$ (20,614)	(35.00)%	\$ (18,163)	(35.00)%
State income tax expense, net of federal benefit	(332)	(0.55)%	(289)	(0.49)%	(301)	(0.58)%
Tax advantaged income	2,760	4.57 %	2,443	4.15 %	2,768	5.33 %
Tax credits	222	0.37 %	2,140	3.63 %	2,229	4.30 %
LIHTC, net of amortization	1,152	1.91 %	—	—	—	—
Section 162(m) disallowance	(171)	(0.28)%	(349)	(0.59)%	(598)	(1.15)%
Merger and acquisition expense	(534)	(0.88)%	—	—	—	—
Other	(154)	(0.26)%	(466)	(0.79)%	101	0.19 %
Income tax expense	<u>\$ (18,179)</u>	<u>(30.12)%</u>	<u>\$ (17,135)</u>	<u>(29.09)%</u>	<u>\$ (13,964)</u>	<u>(26.91)%</u>

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.

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Significant components of deferred tax assets and deferred tax liabilities follow (in thousands):

Year Ended December 31,	2014	2013
Deferred tax assets:		
Allowance for loan losses	\$ 12,571	\$ 13,433
Stock-based compensation	1,147	1,386
Basis differences due to tax credits and partnerships	332	—
Other	3,706	3,818
Accrued expenses	1,248	1,769
Retirement plan	7,609	5,937
Unrealized loss on securities available for sale	—	131
Deferred compensation	5,765	5,567
Total deferred tax assets	32,378	32,041
Deferred tax liabilities:		
Depreciation	12,887	12,823
Noncompete and intangibles	1,895	1,321
Basis differences due to tax credits and partnerships	—	457
Unrealized gain on securities available for sale	713	—
Other	553	484
Total deferred tax liabilities	16,048	15,085
Net deferred tax assets	\$ 16,330	\$ 16,956

As of December 31, 2014 and December 31, 2013, the Company did not have any unrecognized tax benefits. The Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next 12 months. 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 years ended December 31, 2014, 2013, and 2012. Additionally, there were no interest or penalties accrued at December 31, 2014 or 2013. The Company is no longer subject to examination for federal and state purposes for tax years prior to 2011.

NOTE 20: ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table summarizes the components of accumulated other comprehensive income (loss) at December 31, 2014, 2013, and 2012, and changes during the years then ended. The amounts reclassified from accumulated other comprehensive income for the securities available for sale are included in gain on investment securities, net on the consolidated statements of income, while the amounts reclassified from accumulated other comprehensive income for the defined benefit retirement plan are a component of salaries and employee benefits expense on the consolidated statements of income.

TOWNEBANK
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Unrealized Gains on Securities (a)	Defined Benefit Retirement Plan (b)	Accumulated Other Comprehensive Income (Loss), Net of Tax
Balance, December 31, 2011	\$ 2,754	\$ —	\$ 2,754
Net change	(1,055)	(883)	(1,938)
Balance, December 31, 2012	1,699	(883)	816
Other comprehensive income (loss) before reclassifications, net of tax	(1,888)	626	(1,262)
Amounts reclassified from AOCI, net of tax	(55)	157	102
Net change	(1,943)	783	(1,160)
Balance, December 31, 2013	(244)	(100)	(344)
Other comprehensive income (loss) before reclassifications, net of tax	1,560	(778)	782
Amounts reclassified from AOCI, net of tax	9	11	20
Net change	1,569	(767)	802
Balance, December 31, 2014	\$ 1,325	\$ (867)	\$ 458

(a) For additional information about securities, refer to Note 3.

(b) For additional information about retirement plans, refer to Note 12.

NOTE 21: 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, 2014. Management was not aware of any unasserted claims or assessments that may be probable of assertion at December 31, 2014.

NOTE 22: 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 \$218.21 million, \$215.65 million, and \$218.95 million as of December 31, 2014, 2013, and 2012, respectively. During 2014, new advances on all commitments to such parties totaled \$138.97 million, adjustments to loans associated with related parties totaled \$2.66 million, and repayments amounted to \$138.41 million. Included in the loans to related parties, at December 31, 2014, we had \$40.65 million in unfunded commitments to extend credit to such related parties.

The Company rents space for various financial centers from companies associated with its directors. Rent expense related to these leases was \$2.38 million, \$2.26 million, and \$2.07 million for the years ended December 31, 2014, 2013, and 2012, respectively.

In the ordinary course of business, the Company acquired certain goods and services from companies associated with its directors, including purchases of automobiles, construction of Company-owned facilities, and maintenance and furnishing of Company facilities. Amounts paid to these companies during the years ended December 31, 2014, 2013, and 2012 approximated \$0.77 million, \$5.29 million, and \$7.54 million, respectively.

TOWNEBANK
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 23: QUARTERLY FINANCIAL DATA (UNAUDITED)

Summarized unaudited quarterly financial data for the years ended December 31, 2014 and 2013, is as follows (in thousands, except per share data):

2014	Fourth	Third	Second	First
Interest income	\$ 43,843	\$ 43,668	\$ 43,165	\$ 41,834
Interest expense	6,704	6,801	6,627	6,642
Provision for loan losses	(1)	996	(833)	330
Noninterest income	22,401	26,269	25,346	22,727
Net gain (loss) on investment securities	—	44	(62)	2
Noninterest expense	48,959	44,154	44,668	41,081
Income before income tax expense and noncontrolling interest	10,582	18,030	17,987	16,510
Income tax expense	2,798	5,044	5,432	4,905
Net income	7,784	12,986	12,555	11,605
Noncontrolling interest	(549)	(860)	(878)	(474)
Net income attributable to TowneBank	\$ 7,235	\$ 12,126	\$ 11,677	\$ 11,131
Net income per common share				
Basic	\$ 0.20	\$ 0.34	\$ 0.33	\$ 0.31
Diluted	\$ 0.20	\$ 0.34	\$ 0.33	\$ 0.31
Comprehensive income	\$ 7,544	\$ 12,818	\$ 13,534	\$ 11,837
Dividends	\$ 0.11	\$ 0.11	\$ 0.11	\$ 0.10

2013	Fourth	Third	Second	First
Interest income	\$ 43,101	\$ 42,695	\$ 42,591	\$ 41,903
Interest expense	6,645	6,543	6,514	6,693
Provision for loan losses	551	328	(202)	3,571
Noninterest income	18,711	22,988	24,463	23,755
Net gain (loss) on investment securities	66	150	(208)	604
Noninterest expense	41,000	43,379	43,817	40,596
Income before income tax expense and noncontrolling interest	13,682	15,583	16,717	15,402
Income tax expense	3,655	4,407	4,707	4,366
Net income	10,027	11,176	12,010	11,036
Noncontrolling interest	(353)	(758)	(811)	(564)
Net income attributable to TowneBank	\$ 9,674	\$ 10,418	\$ 11,199	\$ 10,472
Net income per common share				
Basic	\$ 0.27	\$ 0.28	\$ 0.31	\$ 0.29
Diluted	\$ 0.27	\$ 0.28	\$ 0.31	\$ 0.29
Comprehensive income	\$ 10,267	\$ 11,559	\$ 10,180	\$ 11,082
Dividends	\$ 0.10	\$ 0.10	\$ 0.09	\$ 0.09

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 24: 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 and northeastern North Carolina and includes the operations of TowneBank Commercial Mortgage and Towne Investment Group. The Realty segment combines the operations of Berkshire Hathaway HomeServices Towne Realty with TowneBank Mortgage, Lawyers Escrow and Title, LLC, d/b/a Virginia Home Title and Settlements, SimonTowne Mortgage, LLC, Towne Mortgage of the Carolinas, LLC, NewTowne Mortgage, LLC, and Corolla Classic Vacations, LLC, 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. Inter-segment 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

For the Year Ended December 31, 2014

	Bank	Realty	Insurance	Consolidated Totals
Net interest income	\$ 143,999	\$ 1,737	\$ —	\$ 145,736
Provision for loan losses	396	96	—	492
Net interest income after provision for loan losses	143,603	1,641	—	145,244
Residential mortgage banking income, net	(313)	27,492	—	27,179
Real estate brokerage and property management income, net	—	12,634	—	12,634
Insurance commissions and other title fees and income, net	—	1,516	33,042	34,558
Other noninterest income	20,059	1,413	886	22,358
Noninterest expense	107,162	35,546	22,255	164,963
Depreciation and amortization	9,386	1,937	2,578	13,901
Income before income tax, corporate allocation, and noncontrolling interest	46,801	7,213	9,095	63,109
Corporate allocation	(1,014)	575	439	—
Income before income tax provision and noncontrolling interest	47,815	6,638	8,656	63,109
Income tax provision	13,098	1,874	3,207	18,179
Net income	34,717	4,764	5,449	44,930
Noncontrolling interest	—	(2,056)	(705)	(2,761)
Net income attributable to TowneBank	\$ 34,717	\$ 2,708	\$ 4,744	\$ 42,169
Net income as percentage of total	82.33%	6.42%	11.25%	100.00%
Assets	\$ 4,730,447	\$ 145,274	\$ 106,764	\$ 4,982,485
Efficiency ratio	71.18%	83.68%	73.19%	73.77%

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the Year Ended December 31, 2013

	Bank	Realty	Insurance	Consolidated Totals
Net interest income	\$ 141,543	\$ 2,352	\$ —	\$ 143,895
Provision for loan losses	4,248	—	—	4,248
Net interest income after provision for loan losses	137,295	2,352	—	139,647
Residential mortgage banking income, net	(448)	29,425	—	28,977
Real estate brokerage and property management income, net	—	12,316	—	12,316
Insurance commissions and other title fees and income, net	—	1,921	26,401	28,322
Other noninterest income	18,463	1,416	1,034	20,913
Noninterest expense	100,411	36,651	19,228	156,290
Depreciation and amortization	8,727	1,665	2,110	12,502
Income before income tax, corporate allocation, and noncontrolling interest	46,172	9,114	6,097	61,383
Corporate allocation	(904)	568	336	—
Income before income tax provision and noncontrolling interest	47,076	8,546	5,761	61,383
Income tax provision	12,680	2,384	2,071	17,135
Net income	34,396	6,162	3,690	44,248
Noncontrolling interest	—	(2,099)	(387)	(2,486)
Net income attributable to TowneBank	\$ 34,396	\$ 4,063	\$ 3,303	\$ 41,762
Net income as percentage of total	82.36%	9.73%	7.91%	100.00%
Assets	\$ 4,473,782	\$ 118,150	\$ 81,065	\$ 4,672,997
Efficiency ratio	68.40%	80.78%	77.78%	72.00%

For the Year Ended December 31, 2012

	Bank	Realty	Insurance	Consolidated Totals
Net interest income	\$ 141,517	\$ 2,754	\$ 13	\$ 144,284
Provision for loan losses	16,155	—	—	16,155
Net interest income after provision for loan losses	125,362	2,754	13	128,129
Residential mortgage banking income, net	(548)	27,546	—	26,998
Real estate brokerage and property management income, net	—	11,515	—	11,515
Insurance commissions and other title fees and income, net	—	1,830	21,628	23,458
Other noninterest income	20,226	1,279	713	22,218
Noninterest expense	99,927	30,690	16,556	147,173
Depreciation and amortization	8,272	1,617	1,687	11,576
Income before income tax, corporate allocation, and noncontrolling interest	36,841	12,617	4,111	53,569
Corporate allocation	(565)	402	163	—
Income before income tax provision and noncontrolling interest	37,406	12,215	3,948	53,569
Income tax provision	8,468	3,995	1,501	13,964
Net income	28,938	8,220	2,447	39,605
Noncontrolling interest	—	(1,475)	(199)	(1,674)
Net income attributable to TowneBank	\$ 28,938	\$ 6,745	\$ 2,248	\$ 37,931
Net income as percentage of total	76.29%	17.78%	5.93%	100.00%
Assets	\$ 4,140,727	\$ 192,248	\$ 72,948	\$ 4,405,923
Efficiency ratio	67.12%	71.91%	81.61%	69.48%

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table provides the change in net income and total assets for each segment, comparing the years ended December 31, 2014 and 2013 (dollars in thousands):

	<u>Banking</u>	<u>Realty</u>	<u>Insurance</u>	<u>Consolidated</u>
Net Income (\$)	\$ 321	\$ (1,355)	\$ 1,441	\$ 407
Net Income (%)	0.93%	(33.34)%	43.64%	0.98%
Total Assets (\$)	\$ 256,665	\$ 27,124	\$ 25,699	\$ 309,488
Total Assets (%)	5.74%	22.96 %	31.70%	6.62%

NOTE 25: EARNINGS PER SHARE

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

Year Ended December 31,	<u>2014</u>	<u>2013</u>	<u>2012</u>
Basic			
Net income, as reported	\$ 42,169	\$ 41,762	\$ 37,931
Preferred stock dividends and accretion of discount	(765)	(4,227)	(6,226)
Net income available to common shareholders	\$ 41,404	\$ 37,535	\$ 31,705
Average common shares outstanding	35,160,747	32,863,962	30,772,130
Basic earnings per common share	<u>\$ 1.18</u>	<u>\$ 1.14</u>	<u>\$ 1.03</u>
Diluted			
Net income available to common shareholders	\$ 41,404	\$ 37,535	\$ 31,705
Interest applicable to subordinated debt, net of tax (1)	—	—	154
Net income available to common shareholders, for diluted EPS	41,404	37,535	31,859
Average common shares outstanding	35,160,747	32,863,962	30,772,130
Effect of dilutive securities:			
Stock compensation plans, net of tax benefit (2)	48,333	56,326	52,025
Convertible subordinated debentures (3)	—	—	219,465
Average diluted shares outstanding	<u>35,209,080</u>	<u>32,920,288</u>	<u>31,043,620</u>
Diluted earnings per common share	<u>\$ 1.18</u>	<u>\$ 1.14</u>	<u>\$ 1.03</u>

(1) Annualized interest on 8% convertible subordinated capital debentures (net of tax) is added to net income, since this interest would not be paid if the debentures were converted to common stock.

(2) Stock options and restricted stock shares totaling 140,172; 996; and 24,092 were excluded from the computation of diluted earnings per share during 2014, 2013, and 2012, respectively, because their inclusion would be antidilutive.

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

On September 1, 2013, all outstanding shares of Series A Preferred Stock were mandatorily converted into 3.19 million shares of TowneBank common stock reflecting a conversion price of \$18.02 per share of common stock, plus cash in lieu of any fractional shares. These shares of Series A preferred stock were not included in the computation of diluted earnings per share because the effect was anti-dilutive for all periods presented in the table above.

In conjunction with the Company's issuance of Series B Preferred Stock to the U.S. Treasury, the Company issued a 10-year warrant to purchase 554,330 common shares at an exercise price of \$20.69 per share. These

TOWNEBANK
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

shares were not included in the computation of diluted earnings per share because the effect was anti-dilutive for the periods presented in the table above. On May 15, 2013, the Company repurchased the warrant from the U.S. Treasury for \$1.5 million. The transaction reduced additional paid-in capital within stockholders' equity by \$1.5 million. The warrant repurchase did not impact results of operations.

On March 19, 2012, there was a mandatory conversion of TowneBank's \$13.60 million of outstanding Series III notes into shares of TowneBank common stock.

TOWNEBANK
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 26: SUBSEQUENT EVENTS

Franklin Merger

On January 2, 2015, TowneBank completed its acquisition of Franklin Financial Corporation (“Franklin”) in an all-stock transaction. As part of the merger, Franklin and Franklin Federal Savings Bank (“Franklin Bank”), a wholly-owned subsidiary of Franklin, merged with and into TowneBank.

In the merger with Franklin, each outstanding share of common stock of Franklin was converted into the right to receive 1.40 shares of TowneBank common stock. TowneBank issued an aggregate of 16.38 million shares of TowneBank common stock to Franklin stockholders. Based on the closing price of TowneBank's common stock on January 2, 2015 of \$15.35 per share, the aggregate consideration paid to Franklin common stockholders and holders of equity awards to acquire Franklin common stock was approximately \$261.32 million.

The integration of Franklin Bank's deposit system and the conversion of Franklin Bank's branches to TowneBank's operating platform were completed over the weekend of January 3-4, 2015. Franklin Bank had eight branches, which all re-opened on Monday January 5, 2015 as TowneBank branches.

The Franklin merger has been accounted for under the acquisition method of accounting. The assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of the January 2, 2015 merger date. Such fair values are preliminary estimates and are subject to adjustment for up to one year after the merger date or when additional information relative to the closing date fair values becomes available and such information is considered final, whichever is earlier. The application of the acquisition method of accounting resulted in goodwill of approximately \$64.18 million. All of the recognized goodwill is expected to be non-deductible for tax purposes.

The following table presents our pro forma results of operations for the periods presented as if the Franklin acquisition had been completed on January 1, 2013. The pro forma results of operations include the historical accounts of the Company and Franklin, and pro forma adjustments as may be required, including the amortization of intangibles with definite lives and the amortization or accretion of any premiums or discounts arising from fair value adjustments for assets acquired and liabilities assumed. The pro forma information is intended for informational purposes only and is not necessarily indicative of our future operating results or operating results that would have occurred had the Franklin acquisition been completed at the beginning of 2013. No assumptions have been applied to the pro forma results of operations regarding possible revenue enhancements, expense efficiencies or asset dispositions.

	Pro Forma for the Year Ended	
	December 31,	
(in thousands)	2014	2013
Revenues (net interest income plus noninterest income)	\$ 291,826	\$ 270,672
Net income	\$ 55,095	\$ 53,852

Redemption of SBLF Preferred Stock

On January 7, 2015, the Company redeemed in full its \$76.46 million of outstanding Series C Preferred Stock issued to the U.S. Treasury under the Small Business Lending Fund. The redemption price was \$76.46 million plus accrued but unpaid dividends to the date of redemption.

TOWNEBANK

SHAREHOLDER INFORMATION

ANNUAL MEETING

TowneBank's Annual Meeting of Stockholders will be held at 11:30 a.m. on Wednesday, May 20, 2015, at the Virginia Beach Convention Center, 1000 19th Street, Virginia Beach, Virginia 23451.

COMMON STOCK

The Company's Common Stock is listed on the NASDAQ Global Select Market under the symbol TOWN. The following are the quarterly high and low closing sale prices of the Company's common stock for the periods indicated.

<u>Quarter</u>	<u>2014</u>		<u>2013</u>	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>
First	\$ 15.97	\$ 14.41	\$ 16.00	\$ 14.40
Second	16.47	14.85	15.50	13.43
Third	16.46	13.58	17.13	14.05
Fourth	15.83	13.51	15.57	13.68

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
TowneBank
6001 Harbour View Boulevard
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757-638-6801
email: Clyde.McFarland@townebank.net

These reports are also available on our website at http://www.townebank.com/investor_relations.

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