COMMUNITY FINANCIAL CORP /MD/
Form 10-K
March 07, 2019

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2018

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _________ to ________

Commission File No. **001-36094**

THE COMMUNITY FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Maryland	**52-1652138**
(State of other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3035 Leonardtown Road, Waldorf, Maryland	20601
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: **(301) 645-5601**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $.01 per share	The NASDAQ Stock Market, LLC

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

Large Accelerated Filer ¨ Accelerated Filer x
Non-Accelerated Filer ¨ Smaller Reporting Company x
Emerging Growth Company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.)

Yes ¨ No x

The aggregate market value of voting stock held by non-affiliates of the registrant was approximately $166.80 million based on the closing price $35.36 per share at which the common stock was sold on the last business day of the Company's most recently completed second fiscal quarter. For purposes of this calculation only, the shares held by directors, executive officers and the Company's Employee Stock Ownership Plan of the registrant are deemed to be shares held by affiliates.

Number of shares of common stock outstanding as of March 1, 2019: 5,581,521

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2019 Annual Meeting of Stockholders. (Part III)

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PART I

This report contains certain “forward-looking statements” within the meaning of the federal securities laws. These statements are not historical facts, rather statements based on The Community Financial Corporation’s current expectations regarding its business strategies, intended results and future performance. Forward-looking statements are preceded by terms such as “expects,” “believes,” “anticipates,” “intends” and similar expressions.

Management’s ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors that could affect actual results include interest rate trends, the general economic climate in the market area in which The Community Financial Corporation operates, as well as nationwide, The Community Financial Corporation’s ability to control costs and expenses, competitive products and pricing, changes in accounting principles, loan demand, loan delinquency rates, charge-offs, changes in federal and state legislation and regulation and effectively manage the risks the Company faces, including credit, operational and cyber security risks. These factors should be considered in evaluating the forward-looking statements and undue reliance should not be placed on such statements. The Community Financial Corporation assumes no obligation to update any forward-looking statement after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

Item 1. Business

Business

The Community Financial Corporation (the “Company’) is a bank holding company organized in 1989 under the laws of the State of Maryland. It owns all the outstanding shares of capital stock of Community Bank of the Chesapeake (the “Bank”), a Maryland-chartered commercial bank. The Bank was organized in 1950 as Tri-County Building and Loan Association of Waldorf, a mutual savings and loan association, and in 1986 converted to a federal stock savings bank and adopted the name Tri-County Federal Savings Bank. In 1997, the Bank converted to a Maryland-chartered commercial bank and adopted the name Community Bank of Tri-County. Effective October 18, 2013, Community Bank changed its name to become Community Bank of the Chesapeake.

The Company engages in no significant activity other than holding the stock of the Bank and operating the business of the Bank. Accordingly, the information set forth in this 10-K, including financial statements and related data, relates primarily to the Bank and its subsidiaries.

The Bank maintains its main office and operations center in Waldorf, Maryland, in addition to its branch offices in Lexington Park, Leonardtown, La Plata (two branches), Dunkirk, Bryans Road, Waldorf, Charlotte Hall, Prince Frederick and Lusby, Maryland; and downtown Fredericksburg, Virginia. In addition, the Bank maintains five loan production offices ("LPOs") in La Plata, Prince Frederick, Leonardtown and Annapolis, Maryland and in Fredericksburg, Virginia. The Leonardtown LPO is co-located with the branch. We also serve our customers through our website: www.cbtc.com. In addition to providing our customers with 24-hour access to their accounts, and information regarding our products and services, hours of service, and locations, the website provides extensive information about the Company for the investment community. In addition, our filings with the SEC (including our annual report on Form 10-K; our quarterly reports on Form 10-Q; and our current reports on Form 8-K), and all amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, are available without charge, and are posted to the Investor Relations portion of our website. The website also provides information regarding our Board of Directors and management team, as well as certain Board Committee charters and our corporate governance policies. The content of our website shall not be deemed to be incorporated by reference into this Annual Report.

On January 1, 2018, the Company completed its acquisition of County First Bank ("County First") with and into the Bank, with the Bank as the surviving bank (the "Merger") pursuant to the Agreement and Plan of Merger, dated as of July 31, 2017, by and among the Company, the Bank and County First. As of January 1, 2018, the Company acquired fair valued total assets of $227.7[1] million, total loans of $140.8 million and total deposits of $199.2 million. The acquisition represented 16.2% of the Company's December 31, 2017 total assets of $1.4 billion. County First had five branch offices in La Plata, Waldorf, New Market, Prince Frederick and California, Maryland. The Bank kept the La Plata branch open. In May 2018, the remaining four branches were closed and consolidated with legacy Community Bank of the Chesapeake branch offices. The three bank locations that were held for sale were sold in the first six months of 2018. The remaining closed branch lease expired in December 2018.

As of December 31, 2018, the Bank operated 15 automated teller machines which includes three stand-alone locations. The Bank offers telephone and internet banking services. The Bank is engaged in the commercial and retail banking business as authorized by the banking statutes of the States of Maryland and Virginia and applicable federal regulations, including the acceptance of deposits, and the origination of loans to individuals, associations, partnerships and corporations. The Bank's real estate loan portfolio consists of commercial mortgage loans, residential first and second mortgage loans and home equity lines of credit. Commercial lending consists of both secured and unsecured loans. The Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund administered by the Federal Deposit Insurance Corporation ("FDIC"), the Bank's primary federal regulator.

[1] Total acquired assets do not include goodwill of $10.8 million.

Market Area

The Bank considers its principal lending and deposit market area to consist of the tri-county area in Southern Maryland and the greater Fredericksburg area in Virginia. As a result of the Bank's expansion into the greater Fredericksburg market in 2013, Stafford County has become part of the Bank's principal lending and deposit market area. The Annapolis LPO opening in October 2014 provided additional market expansion opportunities in 2015. Our market area is one of the fastest growing regions in the country and is home to a mix of federal facilities, industrial and high-tech businesses. The Bank's primary market areas boast a strong median household income, low unemployment and projected population growth better than national averages**.**

The presence of several major federal facilities located within the Bank's footprint and in adjoining counties contribute to economic growth. Major federal facilities include the Patuxent River Naval Air Station in St. Mary's County, the Indian Head Division, Naval Surface Warfare Center in Charles County and the Naval Surface Warfare –Naval Support Facility in King George County. In addition, there are several major federal facilities located in adjoining markets including Andrews Air Force Base and Defense Intelligence Agency & Defense Intelligence Analysis Center in Prince Georges County, Maryland and the U.S. Marine Base Quantico, Drug Enforcement Administration Quantico facility and Federal Bureau of Investigation Quantico facility in Prince William County, Virginia. These facilities directly employ thousands of local employees and serve as an important contributor to the region's overall economic health.

The economic health of the region, while stabilized by the influence of the federal government, is not solely dependent on this sector. Calvert County is home to the Dominion Power Cove Point Liquid Natural Gas Terminal, which is one of the nation's largest liquefied natural gas terminals and Dominion Power is currently constructing liquefaction facilities for exporting liquefied natural gas. Based on information from the U.S. Bureau of Labor Statistics, unemployment rates in the Company's footprint have historically remained well below the national average.

The Bank expanded into the greater Fredericksburg, Virginia market in August 2013. According to the Fredericksburg Regional Alliance, the Fredericksburg Region, including the City of Fredericksburg and the counties of Caroline, King George, Spotsylvania, and Stafford, Virginia, has been the fastest growing region in the Commonwealth of Virginia for the last five years.

Competition

The Bank faces strong competition in the attraction of deposits and in the origination of loans. Its most direct competition for deposits and loans comes from other banks and federal and state credit unions located in its primary market area. There are more than 25 FDIC-insured depository institutions as well as several large credit unions operating in the Bank’s footprint including several large regional and national bank holding companies. The Bank also faces additional significant competition for customers’ funds from mutual funds, brokerage firms, online Banks, and other financial service companies. The Bank competes for loans by providing competitive rates and flexibility of terms and service, including customer access to senior decision makers. It competes for deposits by offering depositors a wide variety of account types, convenient office locations and competitive rates. Other services offered include tax deferred retirement programs, brokerage services through an affiliation with Community Wealth Advisors, cash management services and safe deposit boxes. The Bank has used targeted direct mail, print and online advertising and community outreach to increase its market share of deposits, loans and other services in its market area. It provides ongoing training for its staff to provide high-quality service.

Lending Activities

General

The Bank offers a wide variety of real estate and commercial loans. The Bank’s lending activities include commercial real estate loans, loans secured by residential rental property, construction loans, land acquisition and development loans, equipment financing, commercial and consumer loans. The Company exited the origination of owner-occupied residential mortgages in April 2015 and has established third party sources to supply its residential whole loan portfolio. Most of the Bank’s customers are residents of or businesses located in the Bank’s market area. The Bank’s primary targets for commercial loans consist of small and medium-sized businesses with revenues of $5.0 million to $35.0 million as well as not-for-profits in Southern Maryland, the Annapolis area of Maryland and the greater Fredericksburg area of Virginia.

Commercial Real Estate (CRE) and Other Non-Residential Real Estate Loans

The permanent financing of commercial and other improved real estate projects, including office buildings, retail locations, churches, and other special purpose buildings, is the largest component of the Bank's loan portfolio. Commercial real estate loans amounted to $878.0 million or 65.2% of the loan portfolio and $727.3 million or 63.3% of the loan portfolio, respectively at December 31, 2018 and 2017. This portfolio has increased in both absolute size and as a percentage of the loan portfolio in each of the last seven years. The CRE portfolio includes commercial construction balances. At December 31, 2018 and 2017, commercial construction balances were $51.5 million or 5.9% and $44.8 million or 6.2%, respectively, of the CRE portfolio.

The primary securities on a commercial real estate loan are the real property and the leases or businesses that produce income for the real property. The Bank generally limits its exposure to a single borrower to 15% of the Bank's capital and participates with other lenders on larger projects. Loans secured by commercial real estate are generally limited to 80% of the lower of the appraised value or sales price and have an initial contractual loan amortization period ranging from three to 20 years. Interest rates and payments on these loans typically adjust after an initial fixed-rate period, which is generally between three and ten years. Interest rates and payments on adjustable-rate loans are adjusted to a rate based on the United States Treasury Bill Index. Almost all the Bank's commercial real estate loans are secured by real estate located in the Bank's primary market area. At December 31, 2018 and 2017, the largest outstanding commercial real estate loans were $21.5 million and $21.8 million, respectively, which were secured by commercial real estate and performing according to their terms.

Loans secured by commercial real estate are larger and involve greater risks than one- to four-family residential mortgage loans. Because payments on loans secured by such properties are often dependent on the successful operation of the business or management of the properties, repayment of such loans may be subject to a greater extent to adverse conditions in the real estate market or the economy. As a result of the greater emphasis that the Bank places on increasing its portfolio of commercial real estate loans, the Bank is increasingly exposed to the risks posed by this type of lending. To monitor cash flows on income properties, the Bank requires borrowers and loan guarantors, if any, to provide annual financial statements on multi-family or commercial real estate loans. In reaching a decision on whether to make a commercial real estate loan, the Bank considers the net operating income of the property, the borrower's expertise, credit history and profitability, and the value of the underlying property, as well as the borrower's global cash flows.

If a determination is made that there is a potential environmental hazard, the Bank will complete an Environmental Assessment Checklist. If this checklist or the appraisal indicates potential issues, a Phase 1 environmental survey will generally be required.

Residential First Mortgage Loans

Residential first mortgage loans are generally long-term loans, amortized on a monthly or bi-weekly basis, with principal and interest due each payment. These loans are secured by owner-occupied single-family homes. The initial contractual loan payment period for residential loans typically ranges from ten to 30 years. The Bank's experience indicates that residential real estate loans remain outstanding for significantly shorter time periods than their contractual terms. Borrowers may refinance or prepay loans at their option, without penalty.

The Company stopped originating owner-occupied residential first mortgages in April 2015 and established third-party sources to fund its residential whole loan portfolio. It has been the Bank's practice to buy residential first mortgages from only other financial institutions. The third-party sources allow the Company to maintain a well-diversified residential portfolio while addressing the credit needs of the communities in its footprint. The Bank's practice has been to purchase individual residential first mortgage loans as well as the right to service the loans acquired.

Total fixed-rate loans in our residential first mortgage portfolio amounted to $102.5 million and $113.4 million, respectively, as of December 31, 2018 and 2017. Fixed-rate loans may be packaged and sold to investors or retained in the Bank's loan portfolio. The Bank generally retains the right to service loans sold for a payment based upon a percentage (generally 0.25% of the outstanding loan balance). As of December 31, 2018, and 2017, the Bank serviced $38.1 million and $43.7 million, respectively, in residential mortgage loans for others.

Adjustable mortgages are generally adjustable on one-, three- and five-year terms with limitations on upward adjustments per re-pricing period and an upward cap over the life of the loan. As of December 31, 2018, and 2017, the Bank had $54.2 million and $56.9 million, respectively, in adjustable-rate residential mortgage loans.

At December 31, 2018 and 2017, the largest outstanding residential first mortgage loans were $2.1 million and $2.1 million, respectively, which were secured by residences located in the Bank's market area. The loans were performing according to terms.

Residential first mortgage loans with loan-to-value ratios in excess of 80% generally carry private mortgage insurance to lower the Bank's exposure to approximately 80% of the value of the property. The Bank had fewer than 10 loans with private mortgage insurance at December 31, 2018 and 2017.

All improved real estate that serves as security for a loan made by the Bank must be insured, in the amount and by such companies as may be approved by the Bank, against fire, vandalism, malicious mischief and other hazards. Such insurance must be maintained through the entire term of the loan and in an amount not less than that amount necessary to pay the Bank's indebtedness in full.

Longer-term fixed-rate and adjustable-rate residential mortgage loans are subject to greater interest-rate risk due to term and annual and lifetime limitations on interest rate adjustments. There are also credit risks resulting from potential increased costs to the borrower as a result of repricing of adjustable-rate mortgage loans. During periods of rising interest rates, the risk of default on adjustable-rate mortgage loans may increase due to the upward adjustment of interest cost to the borrower.

Residential Rentals

Residential rental mortgage loans are amortizing, with principal and interest due each month. These loans are non-owner occupied and secured by income-producing 1-4 family units and apartments. The Bank originates both fixed-rate and adjustable-rate residential rental first mortgages. Loans secured by residential rental properties are generally limited to 80% of the lower of the appraised value or sales price at origination and have initial contractual loan payments period ranging from three to 20 years. The primary securities on a residential rental loan are the property and the leases that produce income.

Total fixed-rate loans in our residential rental mortgage portfolio amounted to $26.9 million and $16.8 million, respectively, as of December 31, 2018 and 2017. As of December 31, 2018, and 2017, the Bank had $97.4 million and $93.4 million, respectively, in adjustable-rate residential rental mortgage loans. As of December 31, 2018, and 2017, $96.6 million and $85.0 million, respectively, were 1-4 family units and $27.7 million and $25.2 million, respectively, were apartment buildings.

At December 31, 2018 and 2017, the largest outstanding residential rental mortgage loan was $10.0 million and $10.2 million, respectively, which was secured by over 120 single family homes located in the Bank's market area. The loan was performing according to its terms at December 31, 2018 and 2017.

Loans secured by residential rental properties involve greater risks than 1-4 family residential mortgage loans. Although, there are similar risk characteristics shared with commercial real estate loans, the balances for the loans secured by residential rental properties are generally smaller. Because payments on loans secured by residential rental properties are often dependent on the successful operation or management of the properties, repayment of these loans may be subject to a greater extent to adverse conditions in the rental real estate market or the economy than similar owner-occupied properties.

Construction and Land Development Loans

The Bank offers loans to home builders for the construction of one- to four-family dwellings. Construction loans totaled $11.8 million and $8.8 million, respectively, at December 31, 2018 and 2017. Generally, these loans are secured by the real estate under construction as well as by guarantees of the principals involved. Draws are made upon satisfactory completion of predefined stages of construction. The Bank will typically lend up to 80% of the lower of appraised value or the contract purchase price of the homes to be constructed. In addition, the Bank offers loans to acquire and develop land, as well as loans on undeveloped, subdivided lots for home building by individuals. Land acquisition and development loans totaled $17.9 million and $19.1 million, respectively, at December 31, 2018 and 2017. Bank policy requires that zoning and permits must be in place prior to making development loans. The Bank typically lends up to the lower of 75% of the appraised value or cost. At December 31, 2018 and 2017, the largest outstanding construction and land development loans were $2.5 million and $3.5 million, respectively, which were secured by land in the Bank's market area.

The Bank's ability to originate residential construction and development loans is heavily dependent on the continued demand for single-family housing in the Bank's market area. The Bank's investment in these loans has declined in recent years. Construction and land development loans as a percentage of the Bank's portfolio have been decreasing since the 2008 financial crisis. As of December 31, 2018, and 2017 residential construction and development loans as a percentage of the total loans were 2.2% and 2.4%, respectively. If the demand for new houses being built from smaller builders in the Bank's market areas continues to decline, this portion of the loan portfolio may continue to decline. In addition, a decline in demand for new housing might adversely affect the ability of borrowers to repay these loans.

Construction and land development loans are inherently riskier than providing financing on owner-occupied real estate. The Bank's risk of loss is affected by the accuracy of the initial estimate of the market value of the completed project as well as estimates to complete the project. In addition, the volatility of the real estate market makes it increasingly difficult to ensure that the valuation of land associated with these loans is accurate. During the construction phase, a number of factors could result in delays and cost overruns. If the estimate of construction costs proves to be inaccurate, the Bank may be required to advance funds beyond the amount originally committed to permit completion of the development. If the estimate of completed value proves to be inaccurate, the Bank may be confronted, at or before the maturity of the loan, with a project having a value that is insufficient to assure full repayment. As a result of these factors, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the project rather than the ability of the borrower or guarantor to repay principal and interest. If the Bank forecloses on a project, the Bank may not be able to recover all of the unpaid balance of, and accrued interest on, the loan as well as related foreclosure and holding costs.

Home Equity and Second Mortgage Loans

The Bank maintains a portfolio of home equity and second mortgage loans. Home equity loans, which totaled $34.6 million and $20.0 million, respectively at December 31, 2018 and 2017, are generally made in the form of lines of credit and have terms of up to 20 years, variable rates priced at the then current Wall Street Journal prime rate plus a margin, and require an 80% or 90% loan-to-value ratio (including any prior liens), depending on the specific loan program. The $14.6 million increase at December 31, 2018 compared to the prior year end was primarily due to the acquisition of County First Bank in January 2018.

Second mortgage loans, which totaled $920,000 and $1.4 million, respectively at December 31, 2018 and 2017, are fixed or variable-rate loans that have original terms between five and 15 years. These products contain a higher risk of default than residential first mortgages as in the event of foreclosure, the first mortgage must be paid off prior to collection of the second mortgage. This risk is heightened as the market value of residential property has not fully returned to pre-financial crisis levels and interest rates began to increase in 2017.

Commercial Loans

The Bank offers commercial loans to its business customers. The Bank offers a variety of commercial loan products including term loans and lines of credit. The portfolio consists primarily of demand loans and lines of credit. Such loans can be made for terms of up to five years. However, most of the loans are originated for a term of two years or less. The Bank offers both fixed-rate and adjustable-rate loans (typically tied to the then current Wall Street Journal prime rate plus a margin with a floor) under these product lines. Commercial loans remain an important class of the Bank's loan portfolio. At $71.7 million and 5.3% of total loans and $56.4 million and 4.9% of total loans at December 31, 2018 and 2017, respectively, the commercial loan portfolio increased $15.3 million compared to the prior year end balance.

When making commercial business loans, the Bank considers the borrower's financial condition, global cash flows, ability to service the debt, payment history of both corporate and personal debt, the projected cash flows of the business, the viability of the industry in which the borrower operates and the value of the collateral. These loans are primarily secured by equipment, real property, accounts receivable or other security as determined by the Bank. The higher interest rates and shorter loan terms available on commercial lending make these products attractive to the Bank.

Commercial business loans entail greater risk than residential mortgage loans. Unlike residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income and which are secured by real property whose value tends to be more easily ascertainable, commercial loans are made on the basis of the borrower's ability to make repayment from the cash flows of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. In the case of business failure, collateral would need to be liquidated to provide repayment for the loan. In many cases, the highly specialized nature of collateral would make full recovery from the sale of collateral unlikely. The Bank controls these risks by establishing guidelines that provide for loans with low loan-to-value ratios. At December 31, 2018 and 2017, the largest outstanding commercial loans were $4.2 million and $4.4 million, respectively, which were secured by commercial real estate (all of which were located in the Bank's market area), cash and investments. These loans were performing according to terms at December 31, 2018 and 2017.

Consumer Loans

The Bank has consumer loans secured by automobiles, boats, recreational vehicles and trucks. The Bank also makes home improvement loans and offers both secured and unsecured personal lines of credit. Consumer loans totaled $751,000 and $573,000, respectively, at December 31, 2018 and 2017. Consumer loans entail greater risk from other loan types due to being secured by rapidly depreciating assets or the reliance on the borrower's continuing financial stability.

Commercial Equipment Loans

The Bank also maintains an amortizing commercial portfolio consisting primarily of commercial equipment loans. Commercial equipment loans totaled $50.2 million and $35.9 million, or 3.7% and 3.1% of the total loan portfolio, respectively, at December 31, 2018 and 2017. These loans consist primarily of fixed-rate, short-term loans collateralized by customers' equipment including trucks, cars, construction and other more specialized equipment. When making commercial equipment loans, the Bank considers the same factors it considers when underwriting a commercial business loan. The higher interest rates and shorter repayment terms available on commercial equipment lending make these products attractive to the Bank. These loans entail greater risk than loans such as residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income and which are secured by real property whose value tends to be more easily ascertainable. Commercial loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flows of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. In the case of business failure, collateral must be liquidated to provide repayment for the loan. In many cases, the highly specialized nature of collateral equipment would make full recovery from the sale of collateral problematic. The Bank assesses the amount of collateral required for a loan based upon the borrowers' credit worthiness.

Loan Portfolio Analysis

Set forth below is selected data relating to the composition of the Bank's loan portfolio by type of loan on the dates indicated.

	At December 31,								
	2018		2017		2016		2015		2014
(dollars in thousands)	Amount	%	Amount	%	Amount	%	Amount	%	Amour

Commercial real estate	$878,016	65.18 %	$727,314	63.25 %	$667,105	61.25 %	$538,888	58.64 %	$485,6
Residential first mtgs.	156,709	11.63 %	170,374	14.81 %	171,004	15.70 %	131,401	14.30 %	146,5
Residential rentals [1]	124,298	9.23 %	110,228	9.58 %	101,897	9.36 %	93,157	10.14 %	81,77
Construction and land dev.	29,705	2.21 %	27,871	2.42 %	36,934	3.39 %	36,189	3.94 %	36,37
Home equity and second mtgs.	35,561	2.64 %	21,351	1.86 %	21,399	1.97 %	21,716	2.36 %	21,45
Commercial loans	71,680	5.32 %	56,417	4.91 %	50,484	4.64 %	67,246	7.32 %	73,62
Consumer loans	751	0.06 %	573	0.05 %	422	0.04 %	366	0.04 %	613
Commercial equipment	50,202	3.73 %	35,916	3.12 %	39,737	3.65 %	29,931	3.26 %	26,15
Total Loans	1,346,922	100.00 %	1,150,044	100.00 %	1,088,982	100.00 %	918,894	100.00 %	872,1
Deferred loan fees and premiums	(1,183)		(1,086)		(397)		1,154		1,239
Allowance for loan losses	10,976		10,515		9,860		8,540		8,481
Loans receivable, net	$1,337,129		$1,140,615		$1,079,519		$909,200		$862,4

[1] Loans secured by residential rental property were included in the residential first mortgage and commercial real estate loan portfolios prior to a reclassification in 2016. Comparative financial information was reclassified to conform to the classification presented in the Consolidated Financial Statements at and for the years ended December 31, 2016, 2015 and 2014.

The following table sets forth for the periods indicated the average balances outstanding and average interest yields for each major category of loans.

	For the Years Ended December 31,									
	2018		2017		2016		2015		2014	
dollars in thousands	Average Balance	Average Yield	Average Balance	Average Yield	Average Balance	Average Yield	Average Balance	Average Yield	Average Balance	Average Yield
Commercial real estate	$833,355	4.61%	$699,349	4.42%	$602,648	4.50%	$518,329	4.64%	$460,014	4.84%
Residential first mtgs.	162,505	3.69%	176,186	3.77%	151,366	3.99%	134,728	4.35%	148,367	4.43%
Residential rentals (1)	126,491	4.91%	106,000	4.62%	96,611	4.69%	88,251	4.63%	75,104	4.65%
Construction and land dev.	28,489	5.56%	33,798	4.96%	36,938	4.58%	37,665	4.99%	29,921	4.68%
Home equity and second mtgs.	37,862	5.26%	21,515	4.38%	21,781	4.08%	21,332	4.09%	21,426	4.21%
Commercial (2)	103,537	5.30%	86,871	5.21%	87,705	5.27%	81,957	5.61%	92,199	5.21%
Consumer loans	798	6.77%	477	7.76%	397	8.56%	465	8.82%	701	7.99%
Allowance for loan losses	(10,745)	n/a	(10,374)	n/a	(9,157)	n/a	(8,541)	n/a	(8,351)	n/a
Net Average Loans	$1,282,292	4.66%	$1,113,822	4.45%	$988,289	4.55%	$874,186	4.73%	$819,381	4.82%

(1) Loans secured by residential rental property were included in the residential first mortgage and commercial real estate loan portfolios prior to a reclassification in 2016. Comparative financial information was reclassified to conform to the classification presented in the Consolidated Financial Statements at and for the years ended December 31, 2016, 2015 and 2014.

(2) Includes both commercial loans and commercial equipment loans.

Loan Originations, Purchases and Sales

The Bank solicits loan applications through marketing by commercial loan officers, its branch network, and referrals from customers. Loans are processed and approved according to guidelines established by the Bank. Loan requirements such as income verification, collateral appraisal, and credit reports vary by loan type. Additionally, residential mortgages are purchased from third-party providers after reviewing loan documents, underwriting support, and completing other procedures, as necessary. During the years ended December 31, 2018 and 2017, the Bank purchased residential first mortgages of $11.0 million and $25.5 million, respectively.

Loan processing functions are generally centralized except for small consumer loans. Depending on market conditions, residential mortgage loans may be classified with the intent to sell to third parties such as FHLMC. The Company sold no residential mortgage loans for the years ended December 31, 2018, 2017 and 2016. During the year ended December 31, 2017, the Company sold the guaranteed portion of a U.S. Small Business Administration ("SBA") loan for proceeds of $2.8 million and recognized a gain of $294,000.

To comply with internal and regulatory limits on loans to one borrower, the Bank may sell portions of commercial, commercial real estate and commercial construction loans to other lenders. The Bank's sold participated loans with other lenders at December 31, 2018 and 2017 were $24.6 million and $9.6 million, respectively. The Bank may also buy loans, portions of loans, or participation certificates from other lenders to limit overall exposure and to ensure that all participants remain below internal and regulatory limits. The Bank only purchases loans or portions of loans after reviewing loan documents, underwriting support, and completing other procedures, as necessary.

The Bank participates in commercial, commercial real estate and commercial construction loans. The Bank's purchased participation loans from other lenders at December 31, 2018 and 2017 were $11.9 million and $6.3 million, respectively. Purchased participation loans are subject to the same regulatory and internal policy requirements as other loans in the Bank's portfolio as described below.

Loan Approvals, Procedures and Authority

Loan approval authority is established by Board policy. The Officer's Loan Committee (OLC) consists of the following members of the Bank's executive management; the Chief Executive Officer ("CEO"), President and Chief Risk Officer ("CRO"), Chief Operating Officer ("COO") and the Chief Lending Officer ("CLO"). In addition, the OLC includes the Senior Credit Officer ("SCO") and Senior Loan Officers ("SLO's"). The OLC must have three (3) members of Executive Management approve all loans presented above individual loan authorities granted to the SCO and the SLOs. The SCO and SLOs have individual loan authority up to $1.0 million and $750,000, respectively. Loan approval authorities vary by individual. The individual lending authority of the other lenders is set by management and is based on their individual abilities.

All loans and loan relationships that exceed the Bank's in-house lending limit are required to be approved by at least three (3) members of the Bank's Credit Risk Committee ("CRC"). In addition, the Board of Directors or the CRC approve all loans required to be approved by regulation, such as Regulation O loans or commercial loans to employees. The in-house lending guideline is approved by the Board on an annual basis or as needed if more frequently and is less than the Bank's legal lending limit.

Depending on the loan and collateral type, conditions for protecting the Bank's collateral are specified in the loan documents. Typically, these conditions might include requirements to maintain hazard and title insurance and to pay property taxes.

The Credit Risk Committee of the Board, consisting of three or more directors, assists the Board in its oversight responsibilities. The Committee reviews the Bank's credit risk management, including the significant policies, procedures and practices employed to manage credit risk, and provides recommendations to the Board and strategic guidance to management on the assumption, management and mitigation of credit risk.

Loans to One Borrower

Under Maryland law, the maximum amount that the Bank is permitted to lend to any one borrower and his or her related interests may generally not exceed 10% of the Bank's unimpaired capital and surplus, which is defined to include the Bank's capital, surplus, retained earnings and 50% of its reserve for possible loan losses. Under this authority, the Bank would have been permitted to lend up to $19.1 million and $14.4 million, respectively, to any one borrower at December 31, 2018 and 2017. By interpretive ruling of the Maryland Commissioner, Maryland banks have the option of lending up to the amount that would be permissible for a national bank, which is generally 15% of unimpaired capital and surplus (defined to include a bank's total capital for regulatory capital purposes plus any loan loss allowances not included in regulatory capital). Under this formula, the Bank would have been permitted to lend up to $29.4 million and $22.4 million, respectively, to any one borrower at December 31, 2018 and 2017. At December 31, 2018 and 2017, the largest amount outstanding to any one borrower and borrower's related interests was $25.7 million and $21.8 million, respectively.

Loan Commitments

The Bank does not normally negotiate standby commitments for the construction and purchase of real estate. The Bank's outstanding commitments to originate loans at December 31, 2018 and 2017 were approximately $56.8 million and $63.5 million, respectively, excluding undisbursed portions of loans in process. It has been the Bank's experience that few commitments expire unfunded.

Maturity of Loan Portfolio

See Note 7 of the Consolidated Financial Statements for information regarding the dollar amount of loans maturing in the Bank's portfolio based on their contractual terms to maturity as of December 31, 2018. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less.

Asset Classification

Federal regulations and our policies require that we utilize an internal asset classification system as a means of reporting on asset quality. We use an internal asset classification system, substantially consistent with Federal banking regulations, as a part of our credit monitoring system. Federal banking regulations set forth a classification scheme for problem and potential problem assets as "substandard," "doubtful" or "loss" assets. An asset is considered "substandard" if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. "Substandard" assets include those characterized by the "distinct possibility" that the insured institution will sustain "some loss" if the deficiencies are not corrected. Assets classified as "doubtful" have all of the weaknesses inherent in those classified "substandard" with the added characteristic that the weaknesses present make "collection or liquidation in full," on the basis of currently existing facts, conditions, and values, "highly questionable and improbable." Assets classified as "loss" are those considered "uncollectible" and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. Assets that do not currently expose the insured institution to sufficient risk to warrant classification in one of these categories but possess weaknesses are required to be designated "special mention."

When an insured institution classifies assets as “substandard” or “doubtful,” it is required that a specific valuation allowance for loan losses be established in an amount deemed prudent by management. When an insured institution classifies assets as “loss,” it is required either to establish a specific allowance for losses equal to 100% of the amount of the asset so classified or to charge off such amount.

The table below sets forth information on our classified assets and assets designated special mention at the dates indicated. Classified and special mention assets include loans, securities and other real estate owned.

(dollars in thousands)	December 31 2018	December 31, 2017	December 31, 2016	December 31, 2015	December 31, 2014
Classified assets					
Substandard	$ 40,819	$ 50,298	$ 39,109	$ 42,485	$ 54,022
Doubtful	-	-	137	861	-
Loss	-	-	-	-	-
Total classified assets	40,819	50,298	39,246	43,346	54,022
Special mention assets	-	96	-	1,642	5,460
	$ 40,819	$ 50,394	$ 39,246	$ 44,988	$ 59,482

Delinquencies

The Bank’s collection procedures provide that when a loan is 15 days delinquent, the borrower is contacted, and payment is requested. If the delinquency continues, efforts will be made to contact the delinquent borrower and obtain payment. If these efforts prove unsuccessful, the Bank will pursue appropriate legal action including repossession of the collateral. In certain instances, the Bank will attempt to modify the loan or grant a limited moratorium on loan payments to enable the borrower to reorganize borrower’s financial affairs. For an analysis of past due loans as of December 31, 2018 and 2017, respectively, refer to Note 7 in the Consolidated Financial Statements.

Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The Bank evaluates substandard classified loans on an individualized basis to determine whether a loan is impaired. Classified doubtful and loss loans, loans delinquent 90 days or greater, non-accrual loans and troubled debt restructures (“TDRs”) are generally considered impaired (See Notes 1 and 7 of the Consolidated Financial Statements).

Factors considered by management in determining impaired status include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and shortfalls on a case-by-case basis, taking into consideration the circumstances surrounding the loan. These circumstances include the length of the delay, the reasons for the delay, the borrower's payment record and the amount of the shortfall in relation to the principal and interest owed. Loans not impaired are included in the pool of loans evaluated in the general component of the allowance.

If a specific loan is deemed to be impaired, it is evaluated for impairment. Impairment is measured on a loan-by-loan basis for commercial and construction loans using one of three acceptable methods: the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral, if the loan is collateral dependent. For loans that have an impairment, a specific allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than carrying value of that loan.

TDRs are loans that have been modified to provide for a reduction or a delay in the payment of either interest or principal because of deterioration in the financial condition of the borrower. A loan extended or renewed at a stated interest rate equal to the current interest rate for new debt with similar risk is not considered a TDR. Once an obligation has been classified as a TDR it continues to be considered a TDR until paid in full or until the debt is refinanced and considered unimpaired. All TDRs are considered impaired and are evaluated for impairment on a loan-by-loan basis. The Company does not participate in any specific government or Company-sponsored loan modification programs. All restructured loan agreements are individual contracts negotiated with a borrower.

Specific loan loss reserves of $1.2 million and $1.0 million, respectively, related to impaired loans at December 31, 2018 and 2017. The following table sets forth information with respect to the Bank's impaired loans at the dates indicated. The table includes a breakdown between impaired loans with and without an allowance:

	December 31,				
(dollars in thousands)	2018	2017	2016	2015	2014
Recorded investment with no allowance	$32,813	$39,028	$26,436	$35,171	$45,587
Recorded investment with allowance	4,067	4,226	8,924	4,066	4,122
Total impaired loans	$36,880	$43,254	$35,360	$39,237	$49,709
Specific allocations of allowance	$1,180	$1,024	$1,289	$1,608	$451
Interest income recognized	$1,693	$1,829	$1,309	$1,366	$1,841

For additional information regarding impaired loans by class at December 31, 2018 and 2017, respectively, refer to Note 7 in the Consolidated Financial Statements.

Management closely monitors the payment activity of all its loans. Management periodically reviews the adequacy of the allowance for loan losses based on an analysis of the size and composition of the loan portfolio; the Bank's historical loss experience; trends in delinquency, non-performing, classified loans and charge-offs; as well as economic conditions and the regulatory environment. Loan losses are charged off against the allowance when individual loans are deemed uncollectible. Subsequent recoveries, if any, are credited to the allowance. Management believes it has established its existing allowance for loan losses in accordance with accounting principles generally accepted in the United States of America and is in compliance with appropriate regulatory guidelines. However, the establishment of the level of the allowance for loan losses is highly subjective and dependent on incomplete information as to the ultimate disposition of loans. Accordingly, actual losses may vary from the amounts estimated. Additionally, our regulators as an integral part of their examination process, periodically review our allowance for loan losses and may require us to increase or decrease the allowance for loan losses, thereby affecting the Bank's financial condition and earnings. For a more complete discussion of the allowance for loan losses, see the section captioned *"Management's Discussion and Analysis of Financial Condition and Results of Operations-Critical Accounting Policies"* and Notes 1 and 7 of the Consolidated Financial Statements.

The following table allocates the allowance for loan losses by loan category at the dates indicated. The allocation of the allowance to each category is not necessarily indicative of future losses and does not restrict the use of the allowance to absorb losses in any category.

At December 31,

(dollars in thousands)	2018 Amount	% [1]	2017 Amount	% [1]	2016 Amount	% [1]	2015 Amount	% [1]	2014 Amount	% [1]
Commercial real estate	$6,882	65.18 %	$6,451	63.25 %	$5,212	61.25 %	$3,465	58.64 %	$3,528	55.68 %
Residential first mtgs.	755	11.63 %	1,144	14.81 %	1,406	15.70 %	584	14.30 %	1,047	16.80 %
Residential rentals [2]	498	9.23 %	512	9.58 %	362	9.36 %	538	10.14 %	593	9.38 %
Construction and land dev.	310	2.21 %	462	2.42 %	941	3.39 %	1,103	3.94 %	1,071	4.17 %
Home equity and second mtgs.	133	2.64 %	162	1.86 %	138	1.97 %	142	2.36 %	173	2.46 %
Commercial loans	1,482	5.32 %	1,013	4.91 %	794	4.64 %	1,477	7.32 %	1,677	8.44 %
Consumer loans	6	0.06 %	7	0.05 %	3	0.04 %	2	0.04 %	3	0.07 %
Commercial equipment	910	3.73 %	764	3.12 %	1,004	3.65 %	1,229	3.26 %	389	3.00 %
Total allowance for loan losses	$10,976	100.00%	$10,515	100.00%	$9,860	100.00%	$8,540	100.00%	$8,481	100.00%

[1] Percent of loans in each category to total loans

[2] Loans secured by residential rental property were included in the residential first mortgage and commercial real estate loan portfolios prior to a reclassification in 2016. Comparative financial information was reclassified to conform to the classification presented in the Consolidated Financial Statements at and for the years ended December 31, 2016, 2015 and 2014.

The following table sets forth an analysis of activity in the Bank's allowance for loan losses for the periods indicated.

	At December 31,				
(dollars in thousands)	2018	2017	2016	2015	2014
Balance at beginning of period	$10,515	$9,860	$8,540	$8,481	$8,138
Charge-offs:					
Commercial real estate	268	217	-	78	195
Residential first mtgs.	115	-	-	30	94
Residential rentals [1]	84	42	14	-	155
Construction and land dev.	-	26	526	-	992
Home equity and second mtgs.	7	14	-	100	59
Commercial loans	94	13	594	432	1,134
Consumer loans	2	2	1	-	3
Commercial equipment	647	168	34	818	10
Total Charge-offs	1,217	482	1,169	1,458	2,642
Recoveries:					
Commercial real estate	10	63	58	17	11
Residential first mtgs.	-	-	-	1	186
Residential rentals [1]	-	-	-	-	
Construction and land dev.	-	-	1	32	84
Home equity and second mtgs.	18	1	5	-	10
Commercial loans	189	1	18	11	5
Consumer loans	-	-	-	-	11
Commercial equipment	56	62	48	23	25
Total Recoveries	273	127	130	84	332
Net Charge-offs	944	355	1,039	1,374	2,310
Provision for Loan Losses	1,405	1,010	2,359	1,433	2,653
Balance at end of period	$10,976	$10,515	$9,860	$8,540	$8,481
Allowance for loan losses to total loans	0.81 %	0.91 %	0.91 %	0.93 %	0.97 %
Net charge-offs to average loans	0.07 %	0.03 %	0.11 %	0.16 %	0.28 %

[1] Loans secured by residential rental property were included in the residential first mortgage and commercial real estate loan portfolios prior to a reclassification in 2016. Comparative financial information was reclassified to conform to the classification presented in the Consolidated Financial Statements at and for the years ended December 31, 2016, 2015 and 2014.

Non-performing Assets

The Bank's non-performing assets include other real estate owned, non-accrual loans and TDRs. Both non-accrual and TDR loans include loans that are paid current and are performing in accordance with the term of their original or modified contract terms. For a detailed discussion on asset quality see the section captioned *"Management's Discussion and Analysis of Financial Condition and Results of Operations-Asset Quality."*

Other Real Estate Owned ("OREO")

Real estate acquired by the Bank as a result of foreclosure or by deed in lieu of foreclosure is classified as foreclosed real estate until such time as it is sold. When such property is acquired, it is recorded at its estimated fair value. Subsequently, OREO is carried at the lower of carrying value or fair value. Additional write-downs as well as carrying expenses of the foreclosed properties are charged to expenses in the current period. The Bank had foreclosed real estate with a carrying value of approximately $8.1 million and $9.3 million, respectively at December 31, 2018 and 2017. For a discussion of the accounting for foreclosed real estate, see *"Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies - Other Real Estate Owned"* and Notes 1 and 9 in the Consolidated Financial Statements.

Non-accrual Loans

Loans are reviewed on a regular basis and are placed on non-accrual status when the collection of additional interest is doubtful. The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in the process of collection. Consumer loans are typically charged-off no later than 90 days past due. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Non-accrual loans are evaluated for impairment on a loan by loan basis in accordance with the Company's impairment methodology.

All interest accrued but not collected from loans that are placed on non-accrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. Non-accrual loans include certain loans that are current with all loan payments and are placed on non-accrual status due to customer operating results or cash flows. Interest is recognized on non-accrual loans on a cash-basis if there is no impairment. For a discussion of the accounting for non-accrual loans, see *"Management's Discussion and Analysis of Financial Condition and Results of Operations-Asset Quality"* and Notes 1 and 7 in the Consolidated Financial Statements.

The following table sets forth information with respect to the Bank's non-performing assets. There were no loans 90 days or more past due that were still accruing interest at the dates indicated.

	December 31,				
(dollars in thousands)	2018	2017	2016	2015	2014
Non-accrual loans:					
Commercial real estate	$14,632	$1,987	$2,371	$2,875	$3,824
Residential first mtgs.	1,374	985	623	1,948	533
Residential rentals [3]	963	825	577	605	-
Construction and land dev.	-	-	3,048	3,555	3,634
Home equity and second mtgs.	147	257	61	48	399
Commercial loans	866	172	1,044	2,054	1,587
Consumer loans	-	-	-	-	-
Commercial equipment	1,300	467	650	348	286
Total non-accrual loans [1]	19,282	4,693	8,374	11,433	10,263
OREO	8,111	9,341	7,763	9,449	5,883
TDRs: [2]					
Commercial real estate	5,612	9,273	9,587	9,839	10,438
Residential first mtgs.	66	527	545	881	906
Residential rentals [3]	216	221	227	2,058	
Construction and land dev.	729	729	3,777	4,283	4,376
Home equity and second mtgs.	-	-	872	-	-
Commercial loans	53	4	-	1,384	2,262
Commercial equipment	29	36	113	123	154
Total TDRs	6,705	10,790	15,121	18,568	18,136
Total Accrual TDRs	6,676	10,021	10,448	13,133	13,249
Total non-accrual loans, OREO and Accrual TDRs	$34,069	$24,055	$26,585	$34,015	