EAGLE BANCORP INC
Form 10-Q
May 10, 2016
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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-Q**

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

For the Quarterly Period Ended March 31, 2016

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 Number 0-25923

**Eagle Bancorp, Inc.**

(Exact name of registrant as specified in its charter)

Maryland 52-2061461

| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
|---|---|

| 7830 Old Georgetown Road, Third Floor, Bethesda, Maryland | 20814 |
|---|---|
| (Address of principal executive offices) | (Zip Code) |

(301) 986-1800

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

| Large accelerated filer | Accelerated filer | Non-accelerated filer | Smaller Reporting Company |
|---|---|---|---|

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

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of April 30, 2016, the registrant had 33,591,710 shares of Common Stock outstanding.

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**EAGLE BANCORP, INC.**

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**Item 1 – Financial Statements (Unaudited)**

**EAGLE BANCORP, INC.**

**Consolidated Balance Sheets (Unaudited)**

**(dollars in thousands, except per share data)**

| | March 31, 2016 | December 31, 2015 | March 31, 2015 |
|---|---|---|---|
| **Assets** | | | |
| Cash and due from banks | $11,856 | $10,270 | $9,615 |
| Federal funds sold | 14,905 | 3,791 | 2,700 |
| Interest bearing deposits with banks and other short-term investments | 175,136 | 284,302 | 403,346 |
| Investment securities available-for-sale, at fair value | 487,609 | 487,869 | 333,531 |
| Federal Reserve and Federal Home Loan Bank stock | 17,696 | 16,903 | 16,793 |
| Loans held for sale | 45,679 | 47,492 | 62,758 |
| Loans | 5,155,871 | 4,998,368 | 4,444,893 |
| Less allowance for credit losses | (54,608 ) | (52,687 ) | (47,779 ) |
| Loans, net | 5,101,263 | 4,945,681 | 4,397,114 |
| Premises and equipment, net | 17,939 | 18,254 | 18,185 |
| Deferred income taxes | 41,136 | 40,311 | 32,089 |
| Bank owned life insurance | 58,974 | 58,682 | 56,983 |
| Intangible assets, net | 108,268 | 108,542 | 109,617 |
| Other real estate owned | 3,846 | 5,852 | 12,338 |
| Other assets | 46,915 | 47,628 | 44,106 |
| **Total Assets** | $6,131,222 | $6,075,577 | $5,499,175 |
| | | | |
| **Liabilities and Shareholders' Equity** | | | |
| **Liabilities** | | | |
| Deposits: | | | |
| Noninterest bearing demand | $1,474,102 | $1,405,067 | $1,196,165 |
| Interest bearing transaction | 219,646 | 178,797 | 178,291 |
| Savings and money market | 2,704,249 | 2,835,325 | 2,405,435 |
| Time, $100,000 or more | 409,698 | 406,570 | 412,691 |
| Other time | 381,951 | 332,685 | 391,783 |
| Total deposits | 5,189,646 | 5,158,444 | 4,584,365 |
| Customer repurchase agreements | 66,963 | 72,356 | 58,589 |
| Long-term borrowings | 68,958 | 68,928 | 78,135 |
| Other liabilities | 43,159 | 37,248 | 36,556 |
| **Total Liabilities** | 5,368,726 | 5,336,976 | 4,757,645 |
| | | | |
| **Shareholders' Equity** | | | |

| | | | |
|---|---|---|---|
| Preferred stock, par value $.01 per share, shares authorized 1,000,000, Series B, $1,000 per share liquidation preference, shares issued and outstanding 0 at March 31, 2016 and December 31, 2015, and 56,600 at March 31, 2015; Series C, $1,000 per share liquidation preference, shares issued and outstanding 0 at March 31, 2016, and December 31, 2015, and 15,300 at March 31, 2015 | - | - | 71,900 |
| Common stock, par value $.01 per share; shares authorized 100,000,000, shares issued and outstanding 33,581,599, 33,467,893 and 33,303,467 respectively | 333 | 331 | 329 |
| Warrant | 946 | 946 | 946 |
| Additional paid in capital | 505,338 | 503,529 | 495,784 |
| Retained earnings | 256,926 | 233,604 | 169,291 |
| Accumulated other comprehensive income | (1,047 ) | 191 | 3,280 |
| **Total Shareholders' Equity** | 762,496 | 738,601 | 741,530 |
| **Total Liabilities and Shareholders' Equity** | $6,131,222 | $6,075,577 | $5,499,175 |

See notes to consolidated financial statements.

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**EAGLE BANCORP, INC.**

**Consolidated Statements of Operations (Unaudited)**

**(dollars in thousands, except per share data)**

| | Three Months Ended March 31, | |
|---|---|---|
| | **2016** | **2015** |
| **Interest Income** | | |
| Interest and fees on loans | $64,922 | $57,179 |
| Interest and dividends on investment securities | 2,588 | 2,139 |
| Interest on balances with other banks and short-term investments | 284 | 138 |
| Interest on federal funds sold | 13 | 9 |
| Total interest income | 67,807 | 59,465 |
| **Interest Expense** | | |
| Interest on deposits | 4,143 | 3,242 |
| Interest on customer repurchase agreements | 37 | 27 |
| Interest on short-term borrowings | - | 54 |
| Interest on long-term borrowings | 1,037 | 1,411 |
| Total interest expense | 5,217 | 4,734 |
| **Net Interest Income** | 62,590 | 54,731 |
| **Provision for Credit Losses** | 3,043 | 3,310 |
| **Net Interest Income After Provision For Credit Losses** | 59,547 | 51,421 |
| | | |
| **Noninterest Income** | | |
| Service charges on deposits | 1,448 | 1,333 |
| Gain on sale of loans | 1,463 | 3,587 |
| Gain on sale of investment securities | 624 | 2,164 |
| Loss on early extinguishment of debt | - | (1,130 ) |
| Increase in the cash surrender value of bank owned life insurance | 390 | 390 |
| Other income | 2,365 | 1,460 |
| Total noninterest income | 6,290 | 7,804 |
| **Noninterest Expense** | | |
| Salaries and employee benefits | 16,119 | 15,706 |
| Premises and equipment expenses | 3,826 | 4,010 |
| Marketing and advertising | 774 | 685 |
| Data processing | 2,014 | 1,784 |
| Legal, accounting and professional fees | 1,063 | 982 |
| FDIC insurance | 809 | 771 |
| Merger expenses | - | 111 |
| Other expenses | 3,497 | 4,024 |
| Total noninterest expense | 28,102 | 28,073 |
| **Income Before Income Tax Expense** | 37,735 | 31,152 |
| **Income Tax Expense** | 14,413 | 11,734 |

| | | |
|---|---|---|
| **Net Income** | 23,322 | 19,418 |
| **Preferred Stock Dividends** | - | 180 |
| **Net Income Available to Common Shareholders** | $23,322 | $19,238 |
| | | |
| **Earnings Per Common Share** | | |
| Basic | $0.70 | $0.62 |
| Diluted | $0.68 | $0.61 |

See notes to consolidated financial statements.

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**EAGLE BANCORP, INC.**

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

**(dollars in thousands)**

| | Three Months Ended March 31, | |
|---|---|---|
| | **2016** | **2015** |
| **Net Income** | $23,322 | $19,418 |
| **Other comprehensive (loss) income, net of tax:** | | |
| Unrealized gain on securities available for sale | 3,578 | 1,931 |
| Unrealized loss on derivatives | (4,442 ) | - |
| Reclassification adjustment for net gains included in net income | (374 ) | (1,298 ) |
| Net change other comprehensive (loss) income | (1,238 ) | 633 |
| **Comprehensive Income** | $22,084 | $20,051 |

See notes to consolidated financial statements.

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**EAGLE BANCORP, INC.**

**Consolidated Statements of Changes in Shareholders' Equity (Unaudited)**

**(dollars in thousands except share data)**

| | **Preferred** | | **Common** | | | **Additional Paid in Capital** | **Retained Earnings** | **Accumulated Other Comprehensive Income (Loss)** | **Total Shareholders' Equity** |
|---|---|---|---|---|---|---|---|---|---|
| | **Shares** | **Amount** | **Shares** | **Amount** | **Warrant** | | | | |
| **Balance January 1, 2016** | - | $ - | 33,467,893 | $ 331 | $ 946 | $ 503,529 | $ 233,604 | $ 191 | $ 738,601 |
| Net Income | - | - | - | - | - | - | 23,322 | - | 23,322 |
| Net change in other comprehensive income, net of tax | - | - | - | - | - | - | - | (1,238) | (1,238) |
| Stock-based compensation | - | - | - | - | - | 1,430 | - | - | 1,430 |
| Issuance of common stock related to options exercised, net of shares withheld for payroll taxes | - | - | 15,915 | - | - | 159 | - | - | 159 |
| Tax benefits realized from stock compensation | - | - | - | - | - | 65 | - | - | 65 |
| Vesting of restricted stock awards issued at date of grant, net of shares withheld for payroll taxes | - | - | (10,434) | 2 | - | (2) | - | - | - |
| Restricted stock awards granted | - | - | 104,775 | - | - | - | - | - | - |
| Issuance of common stock related to employee stock purchase plan | - | - | 3,450 | - | - | 157 | - | - | 157 |
| **Balance March 31, 2016** | - | **$ -** | **33,581,599** | **$ 333** | **$ 946** | **$ 505,338** | **$ 256,926** | **$ (1,047)** | **$ 762,496** |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Balance January 1, 2015** | 71,900 | $71,900 | 30,139,396 | $296 | $946 | $394,933 | $150,037 | $2,647 | $620,759 |
| Net Income | - | - | - | - | - | - | 19,418 | - | 19,418 |
| Net change in other comprehensive income, net of tax | - | - | - | - | - | - | - | 633 | 633 |
| Stock-based compensation | - | - | - | - | - | 1,148 | - | - | 1,148 |
| Issuance of common stock related to options exercised, net of shares withheld for payroll taxes | - | - | 279,373 | 3 | - | 3,435 | - | - | 3,438 |
| Tax benefits realized from stock compensation | - | - | - | - | - | 1,450 | - | - | 1,450 |
| Vesting of restricted stock awards issued at date of grant, net of shares withheld for payroll taxes | - | - | (15,039) | 2 | - | (2) | - | - | - |
| Restricted stock awards granted | - | - | 78,070 | - | - | - | - | - | - |
| Shares issued in public offering, net of issuance costs of $5,302 | - | - | 2,816,900 | 28 | - | 94,670 | - | - | 94,698 |
| Issuance of common stock related to employee stock purchase plan | - | - | 4,767 | - | - | 154 | - | - | 154 |
| Cash paid in lieu of fractional shares upon merger with Virginia Heritage | - | - | - | - | - | (4) | - | - | (4) |
| Preferred stock dividends | - | - | - | - | - | - | (164) | - | (164) |
| **Balance March 31, 2015** | **71,900** | **$71,900** | **33,303,467** | **$329** | **$946** | **$495,784** | **$169,291** | **$3,280** | **$741,530** |

See notes to consolidated financial statements.

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**EAGLE BANCORP, INC.**

**Consolidated Statements of Cash Flows (Unaudited)**

**(dollars in thousands)**

| | **Three Months Ended March 31,** | |
|---|---|---|
| | **2016** | **2015** |
| **Cash Flows From Operating Activities:** | | |
| Net Income | $23,322 | $19,418 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for credit losses | 3,043 | 3,310 |
| Depreciation and amortization | 1,596 | 2,915 |
| Gains on sale of loans | (1,463) | (3,587) |
| Securities premium amortization (discount accretion), net | 1,142 | 683 |
| Origination of loans held for sale | (125,644) | (279,612) |
| Proceeds from sale of loans held for sale | 128,920 | 264,758 |
| Net increase in cash surrender value of BOLI | (390) | (390) |
| (Increase) decrease in deferred income taxes | (825) | 422 |
| Decrease in value of other real estate owned | 6 | 750 |
| Net (gain) loss on sale of other real estate owned | (573) | 17 |
| Net gain on sale of investment securities | (624) | (2,164) |
| Loss on early extinguishment of debt | - | 1,130 |
| Stock-based compensation expense | 1,430 | 1,148 |
| Tax benefits realized from stock compensation | (65) | (1,450) |
| Decrease (increase) in other assets | 713 | (296) |
| Increase in other liabilities | 5,911 | 623 |
| **Net cash provided by operating activities** | 36,499 | 7,675 |
| **Cash Flows From Investing Activities:** | | |
| Decrease in interest bearing deposits with other banks and short-term investments | 698 | 295 |
| Purchases of available for sale investment securities | (41,378) | (26,885) |
| Proceeds from maturities of available for sale securities | 24,182 | 12,110 |
| Proceeds from sale/call of available for sale securities | 15,700 | 65,701 |
| Purchases of Federal Reserve and Federal Home Loan Bank stock | (793) | (2,322) |
| Proceeds from redemption of Federal Reserve and Federal Home Loan Bank stock | - | 8,100 |
| Net increase in loans | (159,159) | (134,100) |
| Proceeds from sale of other real estate owned | 2,572 | 153 |
| Purchases of BOLI | - | (389) |
| Purchases of annuities | - | (992) |
| Bank premises and equipment acquired | (977) | (348) |
| **Net cash used in investing activities** | (159,155) | (78,677) |
| **Cash Flows From Financing Activities:** | | |
| Increase in deposits | 31,202 | 273,597 |
| Decrease in customer repurchase agreements | (5,393) | (2,531) |

| | | |
|---|---|---|
| Issuance of common stock | - | 94,698 |
| Decrease in short-term borrowings | - | (100,000) |
| Decrease in long-term borrowings | - | (40,000) |
| Payment of dividends on preferred stock | - | (164) |
| Proceeds from exercise of stock options | 159 | 3,439 |
| Tax benefits realized from stock compensation | 65 | 1,450 |
| Payment in lieu of fractional shares | - | (4) |
| Proceeds from employee stock purchase plan | 157 | 153 |
| **Net cash provided by financing activities** | 26,190 | 230,638 |
| **Net (Decrease) Increase In Cash and Cash Equivalents** | (96,466) | 159,636 |
| **Cash and Cash Equivalents at Beginning of Period** | 298,363 | 256,025 |
| **Cash and Cash Equivalents at End of Period** | $201,897 | $415,661 |
| **Supplemental Cash Flows Information:** | | |
| Interest paid | $6,105 | $6,045 |
| Income taxes paid | $7,100 | $8,350 |
| **Non-Cash Investing Activities** | | |
| Transfers from loans to other real estate owned | $- | $- |
| Transfers from other real estate owned to loans | $- | $- |

See notes to consolidated financial statements.

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**EAGLE BANCORP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

## Note 1. Summary of Significant Accounting Policies

### Basis of Presentation

The Consolidated Financial Statements include the accounts of Eagle Bancorp, Inc. and its subsidiaries (the "Company"), EagleBank (the "Bank"), Eagle Commercial Ventures, LLC ("ECV"), Eagle Insurance Services, LLC, and Bethesda Leasing, LLC, with all significant intercompany transactions eliminated.

The Consolidated Financial Statements of the Company included herein are unaudited. The Consolidated Financial Statements reflect all adjustments, consisting of normal recurring accruals that in the opinion of management, are necessary to present fairly the results for the periods presented. The amounts as of and for the year ended December 31, 2015 were derived from audited Consolidated Financial Statements. Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. There have been no significant changes to the Company's Accounting Policies as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. The Company believes that the disclosures are adequate to make the information presented not misleading. Certain reclassifications have been made to amounts previously reported to conform to the current period presentation.

These statements should be read in conjunction with the audited Consolidated Financial Statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. Operating results for the three months ended March 31, 2016 are not necessarily indicative of the results of operations to be expected for the remainder of the year, or for any other period.

### Nature of Operations

The Company, through the Bank, conducts a full service community banking business, primarily in Northern Virginia, Montgomery County, Maryland, and Washington, D.C. The primary financial services offered by the Bank include real estate, commercial and consumer lending, as well as traditional deposit and repurchase agreement products. The Bank is also active in the origination and sale of residential mortgage loans and the origination of small business loans. The guaranteed portion of small business loans, guaranteed by the Small Business Administration ("SBA"), is typically sold to third party investors in a transaction apart from the loan's origination. As of March 31, 2016, the Bank offers its products and services through twenty-one banking offices, five lending centers and various electronic capabilities, including remote deposit services and mobile banking services. Eagle Insurance Services, LLC, a subsidiary of the Bank, offers access to insurance products and services through a referral program with a third party insurance broker. Eagle Commercial Ventures, LLC, a direct subsidiary of the Company, provides subordinated financing for the acquisition, development and construction of real estate projects; these transactions involve higher levels of risk, together with commensurate higher returns. Refer to Higher Risk Lending – Revenue Recognition below.

**Use of Estimates**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts in the financial statements and accompanying notes. Actual results may differ from those estimates and such differences could be material to the financial statements.

**Cash Flows**

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks, federal funds sold, and interest bearing deposits with other banks which have an original maturity of three months or less.

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**Loans Held for Sale**

The Company regularly engages in sales of residential mortgage loans and the guaranteed portion of SBA loans originated by the Bank. Loans held for sale are carried at fair value. Fair value is derived from secondary market quotations for similar instruments. Gains and losses on sales of these loans are recorded as a component of noninterest income in the Consolidated Statements of Operations.

The Company's current practice is to sell residential mortgage loans on a servicing released basis, and, therefore, it has no intangible asset recorded for the value of such servicing as of March 31, 2016, December 31, 2015 and March 31, 2015. The sale of the guaranteed portion of SBA loans on a servicing retained basis gives rise to an Excess Servicing Asset, which is computed on a loan by loan basis with the unamortized amount being included in intangible assets in the Consolidated Balance Sheets. This excess servicing asset is being amortized on a straight-line basis (with adjustment for prepayments) as an offset to servicing fees collected and is included in other income in the Consolidated Statement of Operations.

The Company enters into commitments to originate residential mortgage loans whereby the interest rate on the loan is determined prior to funding (i.e. interest rate lock commitments). Such interest rate lock commitments on mortgage loans to be sold in the secondary market are considered to be derivatives. To protect against the price risk inherent in residential mortgage loan commitments, the Company utilizes both "best efforts" and "mandatory delivery" forward loan sale commitments to mitigate the risk of potential decreases in the values of loans that would result from the exercise of the derivative loan commitments. Under a "best efforts" contract, the Company commits to deliver an individual mortgage loan of a specified principal amount and quality to an investor and the investor commits to a price that it will purchase the loan from the Company if the loan to the underlying borrower closes. The Company protects itself from changes in interest rates through the use of best efforts forward delivery commitments, whereby the investor commits to purchase a loan at a price representing a premium on the day the borrower commits to an interest rate with the intent that the buyer/investor has assumed the interest rate risk on the loan. As a result, the Bank is not generally exposed to losses on loans sold utilizing best efforts, nor will it realize gains related to rate lock commitments due to changes in interest rates. The market values of interest rate lock commitments and best efforts contracts are not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded. Because of the high correlation between rate lock commitments and best efforts contracts, no gain or loss should occur on the interest rate lock commitments. Under a "mandatory delivery" contract, the Company commits to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If the Company fails to deliver the amount of mortgages necessary to fulfill the commitment by the specified date, it is obligated to pay the investor a "pair-off" fee, based on then-current market prices, to compensate the investor for the shortfall. The Company manages the interest rate risk on interest rate lock commitments by entering into forward sale contracts of mortgage backed securities, whereby the Company obtains the right to deliver securities to investors in the future at a specified price. Such contracts are accounted for as derivatives and are recorded at fair value in derivative assets or liabilities, carried on the Consolidated Balance Sheet within other assets or other liabilities with changes in fair value recorded in other income within the Consolidated Statement of Income. The period of time between issuance of a loan commitment to the customer and closing and sale of the loan to an investor generally ranges from 30 to 90 days under current market conditions. The gross gains on loan sales are recognized based on new loan commitments with

adjustment for price and pair-off activity. Commission expenses on loans held for sale are recognized based on loans closed.

In circumstances where the Company does not deliver the whole loan to an investor, but rather elects to retain the loan in its portfolio, the loan is transferred from held for sale to loans at fair value at date of transfer.

**Investment Securities**

The Company has no securities classified as trading, or as held to maturity. Marketable equity securities and debt securities not classified as held to maturity or trading are classified as available-for-sale. Securities available-for-sale are acquired as part of the Company's asset/liability management strategy and may be sold in response to changes in interest rates, current market conditions, loan demand, changes in prepayment risk and other factors. Securities available-for-sale are carried at fair value, with unrealized gains or losses being reported as accumulated other comprehensive income/(loss), a separate component of shareholders' equity, net of deferred income tax. Realized gains and losses, using the specific identification method, are included as a separate component of noninterest income in the Consolidated Statements of Operations.

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Premiums and discounts on investment securities are amortized/accreted to the earlier of call or maturity based on expected lives, which lives are adjusted based on prepayment assumptions and call optionality if any. Declines in the fair value of individual available-for-sale securities below their cost that are other-than-temporary in nature result in write-downs of the individual securities to their fair value. Factors affecting the determination of whether other-than-temporary impairment has occurred include a downgrading of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or a change in management’s intent and ability to hold a security for a period of time sufficient to allow for any anticipated recovery in fair value. Management systematically evaluates investment securities for other-than-temporary declines in fair value on a quarterly basis. This analysis requires management to consider various factors, which include (1) duration and magnitude of the decline in value, (2) the financial condition of the issuer or issuers and (3) structure of the security.

The entire amount of an impairment loss is recognized in earnings only when (1) the Company intends to sell the security, or (2) it is more likely than not that the Company will have to sell the security before recovery of its amortized cost basis, or (3) the Company does not expect to recover the entire amortized cost basis of the security. In all other situations, only the portion of the impairment loss representing the credit loss must be recognized in earnings, with the remaining portion being recognized in shareholders’ equity as comprehensive income, net of deferred taxes.

**Loans**

Loans are stated at the principal amount outstanding, net of unamortized deferred costs and fees. Interest income on loans is accrued at the contractual rate on the principal amount outstanding. It is the Company’s policy to discontinue the accrual of interest when circumstances indicate that collection is doubtful. Deferred fees and costs are being amortized on the interest method over the term of the loan.

Management considers loans impaired when, based on current information, it is probable that the Company will not collect all principal and interest payments according to contractual terms. Loans are evaluated for impairment in accordance with the Company’s portfolio monitoring and ongoing risk assessment procedures. Management considers the financial condition of the borrower, cash flow of the borrower, payment status of the loan, and the value of the collateral, if any, securing the loan. Generally, impaired loans do not include large groups of smaller balance homogeneous loans such as residential real estate and consumer type loans which are evaluated collectively for impairment and are generally placed on nonaccrual when the loan becomes 90 days past due as to principal or interest. Loans specifically reviewed for impairment are not considered impaired during periods of “minimal delay” in payment (90 days or less) provided eventual collection of all amounts due is expected. The impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan’s effective interest rate, or the fair value of the collateral if repayment is expected to be provided solely by the collateral. In appropriate circumstances, interest income on impaired loans may be recognized on a cash basis.

**Higher Risk Lending – Revenue Recognition**

The Company has occasionally made higher risk acquisition, development, and construction ("ADC") loans that entail higher risks than ADC loans made following normal underwriting practices ("higher risk loan transactions"). These higher risk loan transactions are currently made through the Company's subsidiary, ECV. This activity is limited as to individual transaction amount and total exposure amounts, based on capital levels, and is carefully monitored. The loans are carried on the balance sheet at amounts outstanding and meet the loan classification requirements of the Accounting Standard Executive Committee ("AcSEC") guidance reprinted from the CPA Letter, Special Supplement, dated February 10, 1986 (also referred to as Exhibit 1 to AcSEC Practice Bulletin No. 1). Additional interest earned on these higher risk loan transactions (as defined in the individual loan agreements) is recognized as realized under the provisions contained in AcSEC's guidance reprinted from the CPA Letter, Special Supplement, dated February 10, 1986 (also referred to as Exhibit 1 to AcSEC Practice Bulletin No.1) and Staff Accounting Bulletin No. 101 (Revenue Recognition in Financial Statements). Certain additional interest is included as a component of noninterest income. ECV had four higher risk loan transactions outstanding as of March 31, 2016, as compared to four higher risk loan transactions outstanding as of December 31, 2015, amounting to $9.4 million and $9.2 million, respectively.

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**Allowance for Credit Losses**

The allowance for credit losses represents an amount which, in management's judgment, is adequate to absorb probable losses on loans and other extensions of credit that may become uncollectible. The adequacy of the allowance for credit losses is determined through careful and continuous review and evaluation of the loan portfolio and involves the balancing of a number of factors to establish a prudent level of allowance. Among the factors considered in evaluating the adequacy of the allowance for credit losses are lending risks associated with growth and entry into new markets, loss allocations for specific credits, the level of the allowance to nonperforming loans, historical loss experience, economic conditions, portfolio trends and credit concentrations, changes in the size and character of the loan portfolio, and management's judgment with respect to current and expected economic conditions and their impact on the existing loan portfolio. Allowances for impaired loans are generally determined based on collateral values. Loans or any portion thereof deemed uncollectible are charged against the allowance, while recoveries are credited to the allowance. Management adjusts the level of the allowance through the provision for credit losses, which is recorded as a current period operating expense. The allowance for credit losses consists of allocated and unallocated components.

The components of the allowance for credit losses represent an estimation done pursuant to ASC Topic 450, *"Contingencies,"* or ASC Topic 310, *"Receivables."* Specific allowances are established in cases where management has identified significant conditions or circumstances related to a specific credit that management believes indicate the probability that a loss may be incurred. For potential problem credits for which specific allowance amounts have not been determined, the Company establishes allowances according to the application of credit risk factors. These factors are set by management and approved by the appropriate Board committee to reflect its assessment of the relative level of risk inherent in each risk grade. A third component of the allowance computation, termed a nonspecific or environmental factors allowance, is based upon management's evaluation of various environmental conditions that are not directly measured in the determination of either the specific allowance or formula allowance. Such conditions include general economic and business conditions affecting key lending areas, credit quality trends (including trends in delinquencies and nonperforming loans expected to result from existing conditions), loan volumes and concentrations, specific industry conditions within portfolio categories, recent loss experience in particular loan categories, duration of the current business cycle, bank regulatory examination results, findings of outside review consultants, and management's judgment with respect to various other conditions including credit administration and management and the quality of risk identification systems. Executive management reviews these environmental conditions quarterly, and documents the rationale for all changes.

Management believes that the allowance for credit losses is adequate; however, determination of the allowance is inherently subjective and requires significant estimates. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. Evaluation of the potential effects of these factors on estimated losses involves a high degree of uncertainty, including the strength and timing of economic cycles and concerns over the effects of a prolonged economic downturn in the current cycle. In addition, various banking agencies, as an integral part of their examination process, and independent consultants engaged by the Bank, periodically review the Bank's loan portfolio and allowance for credit losses. Such review may result in recognition of additions to the allowance based on their judgments of information available to

them at the time of their examination.

**Premises and Equipment**

Premises and equipment are stated at cost less accumulated depreciation and amortization computed using the straight-line method for financial reporting purposes. Premises and equipment are depreciated over the useful lives of the assets, which generally range from five to seven years for furniture, fixtures and equipment, to three to five years for computer software and hardware, and to ten to forty years for buildings and building improvements. Leasehold improvements are amortized over the terms of the respective leases, which may include renewal options where management has the positive intent to exercise such options, or the estimated useful lives of the improvements, whichever is shorter. The costs of major renewals and betterments are capitalized, while the costs of ordinary maintenance and repairs are expensed as incurred. These costs are included as a component of premises and equipment expenses on the Consolidated Statements of Operations.

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**Other Real Estate Owned (OREO)**

Assets acquired through loan foreclosure are held for sale and are recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. The new basis is supported by appraisals that are generally no more than twelve months old. Costs after acquisition are generally expensed. If the fair value of the asset declines, a write-down is recorded through noninterest expense. The valuation of foreclosed assets is subjective in nature and may be adjusted in the future because of changes in market conditions or appraised values.

**Goodwill and Other Intangible Assets**

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that lack physical substance but can be distinguished from goodwill because of contractual or other legal rights. Intangible assets that have finite lives, such as core deposit intangibles, are amortized over their estimated useful lives and subject to periodic impairment testing. Intangible assets (other than goodwill) are amortized to expense using accelerated or straight-line methods over their respective estimated useful lives.

Goodwill and other intangibles are subject to impairment testing at the reporting unit level, which must be conducted at least annually. The Company performs impairment testing during the fourth quarter of each year or when events or changes in circumstances indicate the assets might be impaired.

The Company performs a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing updated qualitative factors, the Company determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, it does not have to perform the two-step goodwill impairment test. Determining the fair value of a reporting unit under the first step of the goodwill impairment test and determining the fair value of individual assets and liabilities of a reporting unit under the second step of the goodwill impairment test are judgmental and often involve the use of significant estimates and assumptions. Similarly, estimates and assumptions are used in determining the fair value of other intangible assets. Estimates of fair value are primarily determined using discounted cash flows, market comparisons and recent transactions. These approaches use significant estimates and assumptions including projected future cash flows, discount rates reflecting the market rate of return, projected growth rates and determination and evaluation of appropriate market comparables. Based on the results of quantitative assessments of all reporting units, the Company concluded that no impairment existed at December 31, 2015. However, future events could cause the Company to conclude that goodwill or other intangibles have become impaired, which would result in recording an impairment loss. Any resulting impairment loss could have a material adverse impact on the Company’s financial condition and results of operations.

**Interest Rate Swap Derivatives**

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk, primarily by managing the amount, sources, and duration of its assets and liabilities and through the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. With the exception of forward commitment contracts discussed above under Loans Held for Sale, the Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts and its known or expected cash payments principally related to certain variable rate deposits.

At the inception of a derivative contract, the Company designates the derivative as one of three types based on the Company's intentions and belief as to likely effectiveness as a hedge. These three types are (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment ("fair value hedge"), (2) a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability ("cash flow hedge"), or (3) an instrument with no hedging designation ("stand-alone derivative"). The Company has no fair value hedges or stand-alone derivatives, only cash flow hedges. For a cash flow hedge, the gain or loss on the derivative is reported in other comprehensive income (a Consolidated Balance Sheet component of shareholders' equity) and is reclassified into earnings in the same period(s) during which the hedged transaction affects earnings (i.e. the period when cash flows are exchanged between counterparties). For both fair value and cash flow hedges, changes in the fair value of derivatives that are not highly effective in hedging the changes in fair value or expected cash flows of the hedged item are recognized immediately in current earnings. Changes in the fair value of derivatives that do not qualify for hedge accounting are reported currently in earnings, as noninterest income.

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Net cash settlements on derivatives that qualify for hedge accounting are recorded in interest income or interest expense, based on the item being hedged. Net cash settlements on derivatives that do not qualify for hedge accounting are reported in noninterest income. Cash flows on hedges are classified in the cash flow statement the same as the cash flows of the items being hedged.

The Company formally documents the relationship between derivatives and hedged items, as well as the risk-management objective and the strategy for undertaking hedge transactions at the inception of the hedging relationship. This documentation includes linking fair value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivative instruments that are used are highly effective in offsetting changes in fair values or cash flows of the hedged items. The Company discontinues hedge accounting when it determines that the derivative is no longer effective in offsetting changes in the fair value or cash flows of the hedged item, the derivative is settled or terminates, a hedged forecasted transaction is no longer probable, a hedged firm commitment is no longer firm, or treatment of the derivative as a hedge is no longer appropriate or intended.

When hedge accounting is discontinued, subsequent changes in fair value of the derivative are recorded as noninterest income or expense. When a fair value hedge is discontinued, the hedged asset or liability is no longer adjusted for changes in fair value and the existing basis adjustment is amortized or accreted over the remaining life of the asset or liability. When a cash flow hedge is discontinued but the hedged cash flows or forecasted transactions are still expected to occur, gains or losses that were accumulated in other comprehensive income are amortized into earnings over the same periods which the hedged transactions will affect earnings.

**Customer Repurchase Agreements**

The Company enters into agreements under which it sells securities subject to an obligation to repurchase the same securities. Under these arrangements, the Company may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Company to repurchase the assets. As a result, securities sold under agreements to repurchase are accounted for as collateralized financing arrangements and not as a sale and subsequent repurchase of securities. The agreements are entered into primarily as accommodations for large commercial deposit customers. The obligation to repurchase the securities is reflected as a liability in the Company's Consolidated Balance of Sheets, while the securities underlying the securities sold under agreements to repurchase remain in the respective assets accounts and are delivered to and held as collateral by third party trustees.

**Marketing and Advertising**

Marketing and advertising costs are generally expensed as incurred.

**Income Taxes**

The Company employs the liability method of accounting for income taxes as required by ASC Topic 740, "*Income Taxes*." Under the liability method, deferred tax assets and liabilities are determined based on differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities (i.e., temporary timing differences) and are measured at the enacted rates that will be in effect when these differences reverse. The Company utilizes statutory requirements for its income tax accounting, and avoids risks associated with potentially problematic tax positions that may incur challenge upon audit, where an adverse outcome is more likely than not. Therefore, no provisions are made for either uncertain tax positions nor accompanying potential tax penalties and interest for underpayments of income taxes in the Company's tax reserves. In accordance with ASC Topic 740, the Company may establish a reserve against deferred tax assets in those cases where realization is less than certain, although no such reserves exist at March 31, 2016, December 31, 2015, or March 31, 2015.

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**Transfer of Financial Assets**

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity. In certain cases, the recourse to the Bank to repurchase assets may exist but is deemed immaterial based on the specific facts and circumstances.

**Earnings per Common Share**

Basic net income per common share is derived by dividing net income available to common shareholders by the weighted-average number of common shares outstanding during the period measured. Diluted earnings per common share is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding during the period measured including the potential dilutive effects of common stock equivalents.

**Stock-Based Compensation**

In accordance with ASC Topic 718, *"Compensation,"* the Company records as compensation expense an amount equal to the amortization (over the remaining service period) of the fair value of option and restricted stock awards computed at the date of grant. Compensation expense on variable stock option grants (i.e. performance based grant) is recorded based on the probability of achievement of the goals underlying the performance grant. Refer to Note 10 for a description of stock-based compensation awards, activity and expense.

**New Authoritative Accounting Guidance**

ASU 2014-09, *"Revenue from Contracts with Customers (Topic 606)"*. The amendments in ASU 2014-09 supersede the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific guidance. The general principle of the amendments require an entity to recognize revenue upon the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance sets forth a five step approach to be utilized for revenue recognition. As amended, the new guidance is effective for annual reporting periods beginning after December 15,

2017, including interim periods within that reporting period. The Company is currently evaluating the provisions of ASU 2014-09 and will be closely monitoring developments and additional guidance to determine the potential impact the new standard will have on the Company's Consolidated Financial Statements.

ASU 2015-03, *"Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs."* The update simplifies the presentation of debt issuance costs by requiring that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of debt liability, consistent with debt discounts or premiums. Prior to the issuance of ASU 2015-03, debt issuance costs were required to be presented as deferred charge assets, separate from the related debt liability. ASU 2015-03 does not change the recognition and measurement requirements for debt issuance costs. The Company adopted ASU 2015-03 as of the end of its fiscal year 2015, and applied its provisions retrospectively. The adoption of ASU 2015-03 resulted in the reclassification of approximately $1.0 million of unamortized debt issuance costs related to the Company's Subordinated Notes (see Note 8) from other assets to long-term debt within its Consolidated Balance Sheets as of March 31, 2016, December 31, 2015, and March 31, 2015. Other than this reclassification, the adoption of ASU 2015-03 did not have an impact on the Company's Consolidated Financial Statements.

ASU 2015-16, *"Business Combinations (Topic 805) – Simplifying the Accounting for Measurement-Period Adjustments."* ASU 2015-16 requires that adjustments to provisional amounts that are identified during the measurement period of a business combination be recognized in the reporting period in which the adjustment amounts are determined. Furthermore, the income statement effects of such adjustments, if any, must be calculated as if the accounting had been completed at the acquisition date. The portion of the amount recorded in current-period earnings that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. Under previous guidance, adjustments to provisional amounts identified during the measurement period are to be recognized retrospectively. ASU 2015-16 was effective for the Company on January 1, 2016 and is not expected to have a significant impact on its financial statements.

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ASU 2016-01, "*Financial Instruments—(Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.*" ASU 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments by making targeted improvements to GAAP as follows: (1) require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer; (2) simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value; (3) eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (4) eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (5) require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (6) require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; (7) require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (8) clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity’s other deferred tax assets. ASU No. 2016-01 is effective for interim and annual reporting periods beginning after December 15, 2017. Early application is permitted as of the beginning of the fiscal year of adoption only for provisions (3) and (6) above. Early adoption of the other provisions mentioned above is not permitted. The Company has performed a preliminary evaluation of the provisions of ASU No. 2016-01. Based on this evaluation, the Company has determined that ASU No. 2016-01 is not expected to have a material impact on the Company's Consolidated Financial Statements; however, the Company will continue to closely monitor developments and additional guidance.

ASU 2016-02, *"Leases (Topic 842)."* Under the new guidance, lessees will be required to recognize the following for all leases (with the exception of short-term leases): 1) a lease liability, which is the present value of a lessee's obligation to make lease payments, and 2) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Lessor accounting under the new guidance remains largely unchanged as it is substantially equivalent to existing guidance for sales-type leases, direct financing leases, and operating leases. Leveraged leases have been eliminated, although lessors can continue to account for existing leveraged leases using the current accounting guidance. Other limited changes were made to align lessor accounting with the lessee accounting model and the new revenue recognition standard. All entities will classify leases to determine how to recognize lease-related revenue and expense. Quantitative and qualitative disclosures will be required by lessees and lessors to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. The intention is to require enough information to supplement the amounts recorded in the financial statements so that users can understand more about the nature of an entity’s leasing activities. ASU 2016-02 is effective for interim and annual reporting periods beginning after December 15, 2018; early adoption is permitted. All entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. They have the option to use certain relief; full retrospective application is prohibited. The Company is currently evaluating the

provisions of ASU 2016-02 and will be closely monitoring developments and additional guidance to determine the potential impact the new standard will have on the Company's Consolidated Financial Statements.

ASU 2016-09, *"Improvements to Employee Share-Based Payment Accounting (Topic 718)."* ASU 2016-09 includes provisions intended to simplify various aspects related to how share-based payments are accounted for and presented in the financial statements. Some of the key provisions of this new ASU include: (1) companies will no longer record excess tax benefits and certain tax deficiencies in additional paid-in capital (“APIC”). Instead, they will record all excess tax benefits and tax deficiencies as income tax expense or benefit in the income statement, and APIC pools will be eliminated. The guidance also eliminates the requirement that excess tax benefits be realized before companies can recognize them. In addition, the guidance requires companies to present excess tax benefits as an operating activity on the statement of cash flows rather than as a financing activity; (2) increase the amount an employer can withhold to cover income taxes on awards and still qualify for the exception to liability classification for shares used to satisfy the employer’s statutory income tax withholding obligation. The new guidance will also require an employer to classify the cash paid to a tax authority when shares are withheld to satisfy its statutory income tax withholding obligation as a financing activity on its statement of cash flows (current guidance did not specify how these cash flows should be classified); and (3) permit companies to make an accounting policy election for the impact of forfeitures on the recognition of expense for share-based payment awards. Forfeitures can be estimated, as required today, or recognized when they occur. ASU No. 2016-09 is effective for interim and annual reporting periods beginning after December 15, 2016. Early adoption is permitted, but all of the guidance must be adopted in the same period. The Company is currently evaluating the provisions of ASU No. 2016-09 to determine the potential impact the new standard will have on the Company's Consolidated Financial Statements.

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**Note 2. Cash and Due from Banks**

Regulation D of the Federal Reserve Act requires that banks maintain noninterest reserve balances with the Federal Reserve Bank based principally on the type and amount of their deposits. During 2016, the Bank maintained balances at the Federal Reserve sufficient to meet reserve requirements, as well as significant excess reserves. Late in 2008, the Federal Reserve in connection with the Emergency Economic Stabilization Act of 2008 began paying a nominal amount of interest on balances held, which interest on excess reserves was increased under provisions of the Dodd Frank Wall Street Reform and Consumer Protection Act passed in July 2010.

Additionally, the Bank maintains interest-bearing balances with the Federal Home Loan Bank of Atlanta and noninterest bearing balances with nine domestic correspondent banks as compensation for services they provide to the Bank.

**Note 3. Investment Securities Available-for-Sale**

Amortized cost and estimated fair value of securities available-for-sale are summarized as follows:

| **March 31, 2016**<br>**(dollars in thousands)** | **Amortized Cost** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Estimated Fair Value** |
|---|---|---|---|---|
| U. S. agency securities | $ 54,948 | $ 774 | $ 100 | $ 55,622 |
| Residential mortgage backed securities | 305,351 | 2,073 | 612 | 306,812 |
| Municipal bonds | 104,840 | 5,069 | - | 109,909 |
| Corporate bonds | 15,085 | - | 147 | 14,938 |
| Other equity investments | 310 | 18 | - | 328 |
| | $ 480,534 | $ 7,934 | $ 859 | $ 487,609 |

| **December 31, 2015**<br>**(dollars in thousands)** | **Amortized Cost** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Estimated Fair Value** |
|---|---|---|---|---|
| U. S. agency securities | $ 56,775 | $ 477 | $ 277 | $ 56,975 |
| Residential mortgage backed securities | 299,709 | 692 | 3,160 | 297,241 |

| | | | | |
|---|---|---|---|---|
| Municipal bonds | 114,253 | 4,131 | 3 | 118,381 |
| Corporate bonds | 15,090 | - | 152 | 14,938 |
| Other equity investments | 307 | 27 | - | 334 |
| | $ 486,134 | $ 5,327 | $ 3,592 | $ 487,869 |

In addition, at March 31, 2016, the Company held $17.7 million in equity securities in a combination of Federal Reserve Bank (“FRB”) and Federal Home Loan Bank (“FHLB”) stocks, which are required to be held for regulatory purposes and which are not marketable, and therefore are carried at cost.

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Gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in a continuous unrealized loss position are as follows:

| March 31, 2016 (dollars in thousands) | Less than 12 Months Estimated Fair Value | Less than 12 Months Unrealized Losses | 12 Months or Greater Estimated Fair Value | 12 Months or Greater Unrealized Losses | Total Estimated Fair Value | Total Unrealized Losses |
|---|---|---|---|---|---|---|
| U. S. agency securities | $7,218 | $ 100 | $- | $ - | $7,218 | $ 100 |
| Residential mortgage backed securities | 55,594 | 100 | 53,087 | 512 | 108,681 | 612 |
| Municipal bonds | - | - | - | - | - | - |
| Corporate bonds | 14,937 | 147 | - | - | 14,937 | 147 |
| | $77,749 | $ 347 | $53,087 | $ 512 | $130,836 | $ 859 |

| December 31, 2015 (dollars in thousands) | Less than 12 Months Estimated Fair Value | Less than 12 Months Unrealized Losses | 12 Months or Greater Estimated Fair Value | 12 Months or Greater Unrealized Losses | Total Estimated Fair Value | Total Unrealized Losses |
|---|---|---|---|---|---|---|
| U. S. agency securities | $32,927 | $ 277 | $- | $ - | $32,927 | $ 277 |
| Residential mortgage backed securities | 157,871 | 1,438 | 58,954 | 1,722 | 216,825 | 3,160 |
| Municipal bonds | 1,559 | 3 | - | - | 1,559 | 3 |
| Corporate bonds | 14,938 | 152 | - | - | 14,938 | 152 |
| | $207,295 | $ 1,870 | $58,954 | $ 1,722 | $266,249 | $ 3,592 |

The unrealized losses that exist are generally the result of changes in market interest rates and interest spread relationships since original purchases. The weighted average duration of debt securities, which comprise 99.9% of total investment securities, is relatively short at 3.5 years. If quoted prices are not available, fair value is measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security’s credit rating, prepayment assumptions and other factors such as credit loss assumptions. The Company does not believe that the investment securities that were in an unrealized loss position as of March 31, 2016 represent an other-than-temporary impairment. The Company does not intend to sell the investments and it is more likely than not that the Company will not have to sell the securities before recovery of its amortized cost basis, which may be maturity.

The amortized cost and estimated fair value of investments available-for-sale by contractual maturity are shown in the table below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (dollars in thousands) | March 31, 2016 | | December 31, 2015 | |
|---|---|---|---|---|
| | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| U. S. agency securities maturing: | | | | |
| One year or less | $36,534 | $36,613 | $31,436 | $31,361 |
| After one year through five years | 13,907 | 14,274 | 18,826 | 19,047 |
| Five years through ten years | 4,507 | 4,735 | 6,513 | 6,567 |
| Residential mortgage backed securities | 305,351 | 306,812 | 299,709 | 297,241 |
| Municipal bonds maturing: | | | | |
| One year or less | 4,423 | 4,438 | 4,450 | 4,478 |
| After one year through five years | 41,357 | 43,872 | 41,213 | 43,720 |
| Five years through ten years | 56,870 | 59,114 | 66,001 | 67,398 |
| After ten years | 2,190 | 2,485 | 2,589 | 2,785 |
| Corporate bonds | | | | |
| After one year through five years | 15,085 | 14,938 | 15,090 | 14,938 |
| Other equity investments | 310 | 328 | 307 | 334 |
| | $480,534 | $487,609 | $486,134 | $487,869 |

For the three months ended March 31, 2016, gross realized gains on sales of investments securities were $624 thousand and there were no gross realized losses on sales of investment securities. For the three months ended March 31, 2015, gross realized gains on sales of investment securities were $2.5 million and gross realized losses on sales of investment securities were $294 thousand.

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Proceeds from sales and calls of investment securities for the three months ended March 31, 2016 were $15.7 million, and in 2015 were $65.7 million.

The carrying value of securities pledged as collateral for certain government deposits, securities sold under agreements to repurchase, and certain lines of credit with correspondent banks at March 31, 2016 was $425 million, which is well in excess of required amounts in order to operationally provide significant reserve amounts for new business. As of March 31, 2016 and December 31, 2015, there were no holdings of securities of any one issuer, other than the U.S. Government and U.S. agency securities, which exceeded ten percent of shareholders' equity.

**Note 4. Mortgage Banking Derivative**

As part of its mortgage banking activities, the Bank enters into interest rate lock commitments, which are commitments to originate loans where the interest rate on the loan is determined prior to funding and the customers have locked into that interest rate. The Bank then locks in the loan and interest rate with an investor and commits to deliver the loan if settlement occurs ("best efforts") or commits to deliver the locked loan in a binding ("mandatory") delivery program with an investor. Certain loans under interest rate lock commitments are covered under forward sales contracts of mortgage backed securities ("MBS"). Forward sales contracts of MBS are recorded at fair value with changes in fair value recorded in noninterest income. Interest rate lock commitments and commitments to deliver loans to investors are considered derivatives. The market value of interest rate lock commitments and best efforts contracts are not readily ascertainable with precision because they are not actively traded in stand-alone markets. The Bank determines the fair value of interest rate lock commitments and delivery contracts by measuring the fair value of the underlying asset, which is impacted by current interest rates, taking into consideration the probability that the interest rate lock commitments will close or will be funded.

Certain additional risks arise from these forward delivery contracts in that the counterparties to the contracts may not be able to meet the terms of the contracts. The Bank does not expect any counterparty to any MBS to fail to meet its obligation. Additional risks inherent in mandatory delivery programs include the risk that, if the Bank does not close the loans subject to interest rate risk lock commitments, it will still be obligated to deliver MBS to the counterparty under the forward sales agreement. Should this be required, the Bank could incur significant costs in acquiring replacement loans or MBS and such costs could have an adverse effect on mortgage banking operations.

The fair value of the mortgage banking derivatives is recorded as a freestanding asset or liability with the change in value being recognized in current earnings during the period of change.

At March 31, 2016 the Bank had mortgage banking derivative financial instruments with a notional value of $99.6 million related to its forward contracts. The net fair value of these derivative instruments at March 31, 2016 was $377 thousand, which is included in other assets and $306 thousand included in other liabilities. At March 31, 2015 the Bank had mortgage banking derivative financial instruments with a notional value of $62.4 million related to its forward contracts. The net fair value of these derivative instruments at March 31, 2015 was $219 thousand included in other assets and $140 thousand included in other liabilities.

Included in other noninterest income for the three months ended March 31, 2016 was a net gain of $209 thousand, relating to mortgage banking derivative instruments. The amount included in other noninterest income for the three months ended March 31, 2016 pertaining to its mortgage banking hedging activities was a loss of $168 thousand. Included for the three months ended March 31, 2015 there was a net gain of $30 thousand, relating to mortgage banking derivative instruments. The amount included in other noninterest income for the three months ended March 31, 2015 pertaining to its mortgage banking hedging activities was a net realized gain of $171 thousand.

**Note 5. Loans and Allowance for Credit Losses**

The Bank makes loans to customers primarily in the Washington, DC metropolitan area and surrounding communities. A substantial portion of the Bank’s loan portfolio consists of loans to businesses secured by real estate and other business assets.

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Loans, net of unamortized net deferred fees, at March 31, 2016, December 31, 2015, and March 31, 2015 are summarized by type as follows:

| | March 31, 2016 | | December 31, 2015 | | March 31, 2015 | |
|---|---|---|---|---|---|---|
| **(dollars in thousands)** | **Amount** | **%** | **Amount** | **%** | **Amount** | **%** |
| Commercial | $1,060,047 | 21 % | $1,052,257 | 21 % | $933,715 | 21 % |
| Income producing - commercial real estate | 2,138,091 | 40 % | 2,115,478 | 42 % | 1,739,483 | 40 % |
| Owner occupied - commercial real estate | 569,915 | 11 % | 498,103 | 10 % | 493,003 | 11 % |
| Real estate mortgage - residential | 149,159 | 3 % | 147,365 | 3 % | 147,871 | 3 % |
| Construction - commercial and residential | 1,034,689 | 20 % | 985,607 | 20 % | 862,013 | 19 % |
| Construction - C&I (owner occupied) | 87,324 | 2 % | 79,769 | 2 % | 49,558 | 1 % |
| Home equity | 110,985 | 3 % | 112,885 | 2 % | 120,543 | 3 % |
| Other consumer | 5,661 | - | 6,904 | - | 98,707 | 2 % |
| Total loans | 5,155,871 | 100% | 4,998,368 | 100% | 4,444,893 | 100% |
| Less: Allowance for Credit Losses | (54,608) | | (52,687) | | (47,779) | |
| Net loans | $5,101,263 | | $4,945,681 | | $4,397,114 | |

Unamortized net deferred fees amounted to $18.9 million, $18.4 million, and $15.8 million at March 31, 2016, December 31, 2015, and March 31, 2015, respectively.

As of March 31, 2016 and December 31, 2015, the Bank serviced $77.7 million and $78.8 million, respectively, of SBA loans which are not reflected as loan balances on the Consolidated Balance Sheets.

*Loan Origination / Risk Management*

The Company's goal is to mitigate risks in the event of unforeseen threats to the loan portfolio as a result of economic downturn or other negative influences. Plans for mitigating inherent risks in managing loan assets include: carefully enforcing loan policies and procedures, evaluating each borrower's business plan during the underwriting process and throughout the loan term, identifying and monitoring primary and alternative sources for loan repayment, and obtaining collateral to mitigate economic loss in the event of liquidation. Specific loan reserves are established based upon credit and/or collateral risks on an individual loan basis. A risk rating system is employed to proactively estimate loss exposure and provide a measuring system for setting general and specific reserve allocations.

The composition of the Company's loan portfolio is heavily weighted toward commercial real estate, both owner occupied and income producing real estate. At March 31, 2016, owner occupied commercial real estate and owner

occupied commercial real estate construction represent 13% of the loan portfolio. At March 31, 2016, non-owner occupied commercial real estate and real estate construction represented approximately 60% of the loan portfolio. The combined owner occupied and commercial real estate loans represent 73% of the loan portfolio. These loans are underwritten to mitigate lending risks typical of this type of loan such as declines in real estate values, changes in borrower cash flow and general economic conditions. The Bank typically requires a maximum loan to value of 80% and minimum cash flow debt service coverage of 1.15 to 1.0. Personal guarantees are generally required, but may be limited. In making real estate commercial mortgage loans, the Bank generally requires that interest rates adjust not less frequently than five years.

The Company is also an active traditional commercial lender providing loans for a variety of purposes, including working capital, equipment and account receivable financing. This loan category represents approximately 21% of the loan portfolio at March 31, 2016 and was generally variable or adjustable rate. Commercial loans meet reasonable underwriting standards, including appropriate collateral and cash flow necessary to support debt service. Personal guarantees are generally required, but may be limited. SBA loans represent 2.7% of the commercial loan category of loans. In originating SBA loans, the Company assumes the risk of non-payment on the unguaranteed portion of the credit. The Company generally sells the guaranteed portion of the loan generating noninterest income from the gains on sale, as well as servicing income on the portion participated. SBA loans are subject to the same cash flow analyses as other commercial loans. SBA loans are subject to a maximum loan size established by the SBA.

Approximately 3% of the loan portfolio at March 31, 2016 consists of home equity loans and lines of credit and other consumer loans. These credits, while making up a smaller portion of the loan portfolio, demand the same emphasis on underwriting and credit evaluation as other types of loans advanced by the Bank.

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Approximately 3% of the loan portfolio consists of residential mortgage loans. The repricing duration of these loans was 25 months. These credits represent first liens on residential property loans originated by the Bank. While the Bank's general practice is to originate and sell (servicing released) loans made by its Residential Lending department, from time to time certain loan characteristics do not meet the requirements of third party investors and these loans are instead maintained in the Bank's portfolio until they are resold to another investor at a later date.

Loans are secured primarily by duly recorded first deeds of trust. In some cases, the Bank may accept a recorded junior trust position. In general, borrowers will have a proven ability to build, lease, manage and/or sell a commercial or residential project and demonstrate satisfactory financial condition. Additionally, an equity contribution toward the project is customarily required.

Construction loans require that the financial condition and experience of the general contractor and major subcontractors be satisfactory to the Bank. Guaranteed, fixed price contracts are required whenever appropriate, along with payment and performance bonds or completion bonds for larger scale projects.

Loans intended for residential land acquisition, lot development and construction are made on the premise that the land: 1) is or will be developed for building sites for residential structures, and; 2) will ultimately be utilized for construction or improvement of residential zoned real properties, including the creation of housing. Residential development and construction loans will finance projects such as single family subdivisions, planned unit developments, townhouses, and condominiums. Residential land acquisition, development and construction loans generally are underwritten with a maximum term of 36 months, including extensions approved at origination.

Commercial land acquisition and construction loans are secured by real property where loan funds will be used to acquire land and to construct or improve appropriately zoned real property for the creation of income producing or owner user commercial properties. Borrowers are generally required to put equity into each project at levels determined by the appropriate Loan Committee. Commercial land acquisition and construction loans generally are underwritten with a maximum term of 24 months.

Substantially all construction draw requests must be presented in writing on American Institute of Architects documents and certified either by the contractor, the borrower and/or the borrower's architect. Each draw request shall also include the borrower's soft cost breakdown certified by the borrower or their Chief Financial Officer. Prior to an advance, the Bank or its contractor inspects the project to determine that the work has been completed, to justify the draw requisition.

Commercial permanent loans are secured by improved real property which is generating income in the normal course of operation. Debt service coverage, assuming stabilized occupancy, must be satisfactory to support a permanent loan. The debt service coverage ratio is ordinarily at least 1.15 to 1.00. As part of the underwriting process, debt service coverage ratios are stress tested assuming a 200 basis point increase in interest rates from their current levels.

Commercial permanent loans generally are underwritten with a term not greater than 10 years or the remaining useful life of the property, whichever is lower. The preferred term is between 5 to 7 years, with amortization to a maximum of 25 years.

The Company's loan portfolio includes ADC real estate loans including both investment and owner occupied projects. ADC loans amounted to $1.12 billion at March 31, 2016. A portion of the ADC portfolio, both speculative and non-speculative, includes loan funded interest reserves at origination. ADC loans containing loan funded interest reserves represent approximately 45.4% of the outstanding ADC loan portfolio at March 31, 2016. The decision to establish a loan-funded interest reserve is made upon origination of the ADC loan and is based upon a number of factors considered during underwriting of the credit including: (i) the feasibility of the project; (ii) the experience of the sponsor; (iii) the creditworthiness of the borrower and guarantors; (iv) borrower equity contribution; and (v) the level of collateral protection. When appropriate, an interest reserve provides an effective means of addressing the cash flow characteristics of a properly underwritten ADC loan. The Company does not significantly utilize interest reserves in other loan products. The Company recognizes that one of the risks inherent in the use of interest reserves is the potential masking of underlying problems with the project and/or the borrower's ability to repay the loan. In order to mitigate this inherent risk, the Company employs a series of reporting and monitoring mechanisms on all ADC loans, whether or not an interest reserve is provided, including: (i) construction and development timelines which are monitored on an ongoing basis which track the progress of a given project to the timeline projected at origination; (ii) a construction loan administration department independent of the lending function; (iii) third party independent construction loan inspection reports; (iv) monthly interest reserve monitoring reports detailing the balance of the interest reserves approved at origination and the days of interest carry represented by the reserve balances as compared to the then current anticipated time to completion and/or sale of speculative projects; and (v) quarterly commercial real estate construction meetings among senior Company management, which includes monitoring of current and projected real estate market conditions. If a project has not performed as expected, it is not the customary practice of the Company to increase loan funded interest reserves.

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From time to time the Company may make loans for its own portfolio or through its higher risk loan affiliate, ECV. Such loans, which are made to finance projects (which may also be financed at the Bank level), may have higher risk characteristics than loans made by the Bank, such as lower priority interests and/or higher loan to value ratios. The Company seeks an overall financial return on these transactions commensurate with the risks and structure of each individual loan. Certain transactions may bear current interest at a rate with a significant premium to normal market rates. Other loan transactions may carry a standard rate of current interest, but also earn additional interest based on a percentage of the profits of the underlying project or a fixed accrued rate of interest.

On July 24, 2015, the Company completed the sale of the indirect consumer loan portfolio acquired in the Merger, amounting to approximately $80.3 million as of the time of sale. A fair value adjustment on the sale of $879 thousand was recorded as an adjustment to the intangibles established in the Merger.

The following tables detail activity in the allowance for credit losses by portfolio segment for the three months ended March 31, 2016 and 2015. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

| (dollars in thousands) | Commercial | Income Producing Commercial Real Estate | Owner Occupied Commercial Real Estate | Real Estate Mortgage Residential | Construction Commercial and Residential | Home Equity | Other Consumer | Total |
|---|---|---|---|---|---|---|---|---|
| **Three months ended March 31, 2016** | | | | | | | | |
| Allowance for credit losses: | | | | | | | | |
| Balance at beginning of period | $ 11,563 | $ 14,122 | $ 3,279 | $ 1,268 | $ 21,088 | $ 1,292 | $ 75 | $ 52,687 |
| Loans charged-off | (805) | (590) | - | - | - | (4) | (7) | (1,406) |
| Recoveries of loans previously charged-off | 72 | 4 | 1 | 2 | 196 | 1 | 8 | 284 |
| Net loans (charged-off) recoveries | (733) | (586) | 1 | 2 | 196 | (3) | 1 | (1,122) |
| Provision for credit losses | 2,792 | 2,258 | 651 | (219) | (2,818) | 194 | 185 | 3,043 |
| Ending balance | $ 13,622 | $ 15,794 | $ 3,931 | $ 1,051 | $ 18,466 | $ 1,483 | $ 261 | $ 54,608 |
| **As of March 31, 2016** | | | | | | | | |
| Allowance for credit losses: | | | | | | | | |
| Individually evaluated for impairment | $ 2,922 | $ 868 | $ 360 | $ - | $ 310 | $ 88 | $ - | $ 4,548 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Collectively evaluated for impairment | 10,700 | 14,926 | 3,571 | 1,051 | 18,156 | 1,395 | 261 | 50,060 |
| Ending balance | $ 13,622 | $ 15,794 | $ 3,931 | $ 1,051 | $ 18,466 | $ 1,483 | $ 261 | $ 54,608 |
| **Three months ended March 31, 2015** | | | | | | | | |
| Allowance for credit losses: | | | | | | | | |
| Balance at beginning of period | $ 13,222 | $ 11,442 | $ 2,954 | $ 1,259 | $ 15,625 | $ 1,469 | $ 104 | $ 46,075 |
| Loans charged-off | (998 ) | (318 ) | - | - | - | (419 ) | (71 ) | (1,806 ) |
| Recoveries of loans previously charged-off | 51 | - | 1 | 2 | 95 | 2 | 49 | 200 |
| Net loans (charged-off) recoveries | (947 ) | (318 ) | 1 | 2 | 95 | (417 ) | (22 ) | (1,606 ) |
| Provision for credit losses | 1,502 | 528 | 172 | (206 ) | 663 | 457 | 194 | 3,310 |
| Ending balance | $ 13,777 | $ 11,652 | $ 3,127 | $ 1,055 | $ 16,383 | $ 1,509 | $ 276 | $ 47,779 |
| **As of March 31, 2015** | | | | | | | | |
| Allowance for credit losses: | | | | | | | | |
| Individually evaluated for impairment | $ 5,771 | $ 568 | $ 400 | $ - | $ 550 | $ 289 | $ 5 | $ 7,583 |
| Collectively evaluated for impairment | 8,006 | 11,084 | 2,727 | 1,055 | 15,833 | 1,220 | 271 | 40,196 |
| Ending balance | $ 13,777 | $ 11,652 | $ 3,127 | $ 1,055 | $ 16,383 | $ 1,509 | $ 276 | $ 47,779 |

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The Company’s recorded investments in loans as of March 31, 2016, December 31, 2015 and March 31, 2015 related to each balance in the allowance for loan losses by portfolio segment and disaggregated on the basis of the Company’s impairment methodology was as follows:

| (dollars in thousands) | Commercial | Income Producing Commercial Real Estate | Owner occupied Commercial Real Estate | Real Estate Mortgage Residential | Construction Commercial and Residential | Home Equity | Other Consumer | Total |
|---|---|---|---|---|---|---|---|---|
| **March 31, 2016** | | | | | | | | |
| Recorded investment in loans: | | | | | | | | |
| Individually evaluated for impairment | $ 13,161 | $ 19,905 | $ 1,724 | $ 257 | $ 5,422 | $ 122 | $ - | $ 40,591 |
| Collectively evaluated for impairment | 1,046,886 | 2,118,186 | 568,191 | 148,902 | 1,116,591 | 110,863 | 5,661 | 5,115,280 |
| Ending balance | $ 1,060,047 | $ 2,138,091 | $ 569,915 | $ 149,159 | $ 1,122,013 | $ 110,985 | $ 5,661 | $ 5,155,871 |
| **December 31, 2015** | | | | | | | | |
| Recorded investment in loans: | | | | | | | | |
| Individually evaluated for impairment | $ 13,008 | $ 6,118 | $ 1,753 | $ - | $ 10,454 | $ 161 | $ 22 | $ 31,516 |
| Collectively evaluated for impairment | 1,039,249 | 2,109,360 | 496,350 | 147,365 | 1,054,922 | 112,724 | 6,882 | 4,966,852 |
| Ending balance | $ 1,052,257 | $ 2,115,478 | $ 498,103 | $ 147,365 | $ 1,065,376 | $ 112,885 | $ 6,904 | $ 4,998,368 |
| **March 31, 2015** | | | | | | | | |
| Recorded investment in loans: | | | | | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Individually evaluated for impairment | $ 16,981 | $ 4,601 | $ 6,840 | $ - | $ 14,000 | $ 889 | $ 10 | $ 43,321 |
| Collectively evaluated for impairment | 916,734 | 1,734,882 | 486,163 | 147,871 | 897,571 | 119,654 | 98,697 | 4,401,572 |
| Ending balance | $ 933,715 | $ 1,739,483 | $ 493,003 | $ 147,871 | $ 911,571 | $ 120,543 | $ 98,707 | $ 4,444,893 |

At March 31, 2016, nonperforming loans acquired from Fidelity & Trust Financial Corporation ("Fidelity") and Virginia Heritage have a carrying value of $504 thousand and $1.2 million, and an unpaid principal balance of $561 thousand and $2.3 million, and were evaluated separately in accordance with ASC Topic 310-30, *"Loans and Debt Securities Acquired with Deteriorated Credit Quality*." The various impaired loans were recorded at estimated fair value with any excess being charged-off or treated as a non-accretable discount. Subsequent downward adjustments to the valuation of impaired loans acquired will result in additional loan loss provisions and related allowance for credit losses. Subsequent upward adjustments to the valuation of impaired loans acquired will result in accretable discount. No adjustments have been made to the fair value amounts of impaired loans subsequent to the allowable period of adjustment from the date of acquisition.

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*Credit Quality Indicators*

The Company uses several credit quality indicators to manage credit risk in an ongoing manner. The Company's primary credit quality indicators are to use an internal credit risk rating system that categorizes loans into pass, watch, special mention, or classified categories. Credit risk ratings are applied individually to those classes of loans that have significant or unique credit characteristics that benefit from a case-by-case evaluation. These are typically loans to businesses or individuals in the classes which comprise the commercial portfolio segment. Groups of loans that are underwritten and structured using standardized criteria and characteristics, such as statistical models (e.g., credit scoring or payment performance), are typically risk rated and monitored collectively. These are typically loans to individuals in the classes which comprise the consumer portfolio segment.

The following are the definitions of the Company's credit quality indicators:

| | |
|---|---|
| Pass: | Loans in all classes that comprise the commercial and consumer portfolio segments that are not adversely rated, are contractually current as to principal and interest, and are otherwise in compliance with the contractual terms of the loan agreement. Management believes that there is a low likelihood of loss related to those loans that are considered pass. |
| Watch: | Loan paying as agreed with generally acceptable asset quality; however the obligor’s performance has not met expectations. Balance sheet and/or income statement has shown deterioration to the point that the obligor could not sustain any further setbacks. Credit is expected to be strengthened through improved obligor performance and/or additional collateral within a reasonable period of time. |
| Special Mention: | Loans in the classes that comprise the commercial portfolio segment that have potential weaknesses that deserve management's close attention. If not addressed, these potential weaknesses may result in deterioration of the repayment prospects for the loan. The special mention credit quality indicator is not used for classes of loans that comprise the consumer portfolio segment. Management believes that there is a moderate likelihood of some loss related to those loans that are considered special mention. |
| Classified: | Classified (a) Substandard - Loans inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the company will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard loans, does not have to exist in individual loans classified substandard. |
| | Classified (b) Doubtful - Loans that have all the weaknesses inherent in a loan classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently |

existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the assets, its classification as an estimated loss is deferred until its more exact status may be determined.

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The Company's credit quality indicators are updated generally on a quarterly basis, but no less frequently than annually. The following table presents by class and by credit quality indicator, the recorded investment in the Company's loans and leases as of March 31, 2016, December 31, 2015 and March 31, 2015.

| (dollars in thousands) | Pass | Watch and Special Mention | Substandard | Doubtful | Total Loans |
|---|---|---|---|---|---|
| **March 31, 2016** | | | | | |
| Commercial | $1,031,263 | $16,788 | $ 11,996 | $ - | $1,060,047 |
| Income producing - commercial real estate | 2,110,620 | 12,709 | 14,762 | - | 2,138,091 |
| Owner occupied - commercial real estate | 559,390 | 9,262 | 1,263 | - | 569,915 |
| Real estate mortgage – residential | 146,804 | 2,098 | 257 | - | 149,159 |
| Construction - commercial and residential | 1,115,027 | 1,564 | 5,422 | - | 1,122,013 |
| Home equity | 109,065 | 1,798 | 122 | - | 110,985 |
| Other consumer | 5,657 | 4 | - | - | 5,661 |
| Total | $5,077,826 | $44,223 | $ 33,822 | $ - | $5,155,871 |
| **December 31, 2015** | | | | | |
| Commercial | $1,021,427 | $17,822 | $ 13,008 | $ - | $1,052,257 |
| Income producing - commercial real estate | 2,096,032 | 13,328 | 6,118 | - | 2,115,478 |
| Owner occupied - commercial real estate | 488,496 | 7,854 | 1,753 | - | 498,103 |
| Real estate mortgage – residential | 146,651 | 714 | - | - | 147,365 |
| Construction - commercial and residential | 1,049,926 | 4,996 | 10,454 | - | 1,065,376 |
| Home equity | 110,870 | 1,854 | 161 | - | 112,885 |
| Other consumer | 6,877 | 5 | 22 | - | 6,904 |
| Total | $4,920,279 | $46,573 | $ 31,516 | $ - | $4,998,368 |
| **March 31, 2015** | | | | | |
| Commercial | $891,850 | $24,884 | $ 16,981 | $ - | $933,715 |
| Investment - commercial real estate | 1,719,982 | 14,900 | 4,601 | - | 1,739,483 |
| Owner occupied - commercial real estate | 478,486 | 7,677 | 6,840 | - | 493,003 |
| Real estate mortgage – residential | 147,121 | 750 | - | - | 147,871 |
| Construction - commercial and residential | 889,346 | 8,225 | 14,000 | - | 911,571 |
| Home equity | 117,936 | 1,718 | 889 | - | 120,543 |
| Other consumer | 98,697 | - | 10 | - | 98,707 |
| Total | $4,343,418 | $58,154 | $ 43,321 | $ - | $4,444,893 |

*Nonaccrual and Past Due Loans*

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on nonaccrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on nonaccrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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The following table presents, by class of loan, information related to nonaccrual loans as of the periods ended March 31, 2016, December 31, 2015 and March 31, 2015.

| (dollars in thousands) | March 31, 2016 | December 31, 2015 | March 31, 2015 |
|---|---|---|---|
| Commercial | $4,234 | $ 4,940 | $11,257 |
| Income producing - commercial real estate | 10,305 | 5,961 | 2,152 |
| Owner occupied - commercial real estate | 1,263 | 1,268 | 1,314 |
| Real estate mortgage - residential | 582 | 329 | 342 |
| Construction - commercial and residential | 5,422 | 557 | 3,608 |
| Home equity | 122 | 161 | 889 |
| Other consumer | - | 23 | 10 |
| Total nonaccrual loans (1)(2) | $21,928 | $ 13,239 | $19,572 |

(1) Excludes troubled debt restructurings (“TDRs”) that were performing under their restructured terms totaling $6.8 million at March 31, 2016, $11.8 million at December 31, 2015 and $13.4 million at March 31, 2015.

(2) Gross interest income of $335 thousand would have been recorded for the three months ended March 31, 2016 if nonaccrual loans shown above had been current and in accordance with their original terms, while interest actually recorded on such loans was $74 thousand. See Note 1 to the Consolidated Financial Statements for a description of the Company’s policy for placing loans on nonaccrual status.

The following table presents, by class of loan, an aging analysis and the recorded investments in loans past due as of March 31, 2016 and December 31, 2015.

| (dollars in thousands) | Loans 30-59 Days Past Due | Loans 60-89 Days Past Due | Loans 90 Days or More Past Due | Total Past Due Loans | Current Loans | Total Recorded Investment in Loans |
|---|---|---|---|---|---|---|
| March 31, 2016 | | | | | | |
| Commercial | $2,401 | $995 | $4,234 | $7,630 | $1,052,417 | $1,060,047 |
| Income producing - commercial real estate | 15,041 | - | 10,305 | 25,346 | 2,112,745 | 2,138,091 |
| Owner occupied - commercial real estate | 3,159 | 894 | 1,263 | 5,316 | 564,599 | 569,915 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Real estate mortgage – residential | - | - | 582 | 582 | 148,577 | 149,159 |
| Construction - commercial and residential | 1,174 | - | 5,422 | 6,596 | 1,115,417 | 1,122,013 |
| Home equity | - | - | 122 | 122 | 110,863 | 110,985 |
| Other consumer | 12 | 54 | - | 66 | 5,595 | 5,661 |
| Total | $21,787 | $1,943 | $21,928 | $45,658 | $5,110,213 | $5,155,871 |
| | | | | | | |
| **December 31, 2015** | | | | | | |
| Commercial | $4,130 | $1,364 | $4,940 | $10,434 | $1,041,823 | $1,052,257 |
| Income producing - commercial real estate | 2,841 | - | 5,961 | 8,802 | 2,106,676 | 2,115,478 |
| Owner occupied - commercial real estate | 3,189 | 902 | 1,268 | 5,359 | 492,744 | 498,103 |
| Real estate mortgage – residential | - | - | 329 | 329 | 147,036 | 147,365 |
| Construction - commercial and residential | - | 5,020 | 557 | 5,577 | 1,059,799 | 1,065,376 |
| Home equity | - | 77 | 161 | 238 | 112,647 | 112,885 |
| Other consumer | 56 | 60 | 23 | 139 | 6,765 | 6,904 |
| Total | $10,216 | $7,423 | $13,239 | $30,878 | $4,967,490 | $4,998,368 |

*Impaired Loans*

Loans are considered impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged-off when deemed uncollectible.

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The following table presents, by class of loan, information related to impaired loans for the periods ended March 31, 2016, December 31, 2015 and March 31, 2015.

| (dollars in thousands) | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance | Year To Date Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|---|---|
| **March 31, 2016** | | | | | | | |
| Commercial | $ 17,305 | $ 1,165 | $ 11,996 | $ 13,161 | $ 2,922 | $ 12,920 | $ 16 |
| Income producing - commercial real estate | 19,905 | 5,143 | 14,762 | 19,905 | 868 | 13,012 | 58 |
| Owner occupied - commercial real estate | 1,724 | 461 | 1,263 | 1,724 | 360 | 1,739 | - |
| Real estate mortgage – residential | 257 | 257 | - | 257 | - | 293 | - |
| Construction - commercial and residential | 5,422 | 4,870 | 552 | 5,422 | 310 | 7,938 | - |
| Home equity | 122 | - | 122 | 122 | 88 | 142 | - |
| Other consumer | - | - | - | - | - | 11 | - |
| Total | $ 44,735 | $ 11,896 | $ 28,695 | $ 40,591 | $ 4,548 | $ 36,055 | $ 74 |
| **December 31, 2015** | | | | | | | |
| Commercial | $ 16,123 | $ 2,396 | $ 10,283 | $ 12,679 | $ 3,478 | $ 9,973 | $ 69 |
| Income producing - commercial real estate | 6,811 | 1,190 | 4,928 | 6,118 | 1,033 | 10,294 | 354 |
| Owner occupied - commercial real estate | 1,753 | 946 | 807 | 1,753 | 400 | 1,810 | - |
| Real estate mortgage – residential | 329 | 329 | - | 329 | - | 336 | - |
| Construction - commercial and residential | 10,454 | 4,877 | 5,577 | 10,454 | 950 | 7,594 | 205 |
| Home equity | 161 | 116 | 45 | 161 | 38 | 650 | - |
| Other consumer | 22 | 19 | 3 | 22 | 3 | 31 | 1 |
| Total | $ 35,653 | $ 9,873 | $ 21,643 | $ 31,516 | $ 5,902 | $ 30,688 | $ 629 |
| **March 31, 2015** | | | | | | | |
| Commercial | $ 13,080 | $ 1,464 | $ 9,793 | $ 11,257 | $ 5,771 | $ 12,116 | $ - |
| Income producing - commercial real estate | 10,668 | 8,753 | 1,222 | 9,975 | 568 | 10,235 | 35 |
| Owner occupied - commercial real estate | 1,867 | 1,025 | 842 | 1,867 | 400 | 1,878 | - |
| Real estate mortgage – residential | 342 | 342 | - | 342 | - | 344 | - |
| Construction - commercial and residential | 8,671 | 8,071 | 600 | 8,671 | 550 | 8,728 | 99 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Home equity | 889 | 118 | 771 | 889 | 289 | 1,144 | - |
| Other consumer | 10 | - | 10 | 10 | 5 | 34 | - |
| Total | $ 35,527 | $ 19,773 | $ 13,238 | $ 33,011 | $ 7,583 | $34,479 | $ 134 |

*Modifications*

A modification of a loan constitutes a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company offers various types of concessions when modifying a loan. Commercial and industrial loans modified in a TDR often involve temporary interest-only payments, term extensions, and converting revolving credit lines to term loans. Additional collateral, a co-borrower, or a guarantor is often requested. Commercial mortgage and construction loans modified in a TDR often involve reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, or substituting or adding a new borrower or guarantor. Construction loans modified in a TDR may also involve extending the interest-only payment period.

Loans modified in a TDR for the Company may have the financial effect of increasing the specific allowance associated with the loan. An allowance for impaired consumer and commercial loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the estimated fair value of the collateral, less any selling costs, if the loan is collateral dependent. Management exercises significant judgment in developing these estimates.

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The following table presents by class, the recorded investment of loans modified in TDRs held by the Company during the periods ended March 31, 2016 and December 31, 2015.

| (dollars in thousands) | Number of Contracts | TDRs Performing to Modified Terms | TDRs Not Performing to Modified Terms | Total TDRs |
|---|---|---|---|---|
| **March 31, 2016** | | | | |
| Commercial | 4 | $ 1,165 | $ 207 | $1,372 |
| Income producing - commercial real estate | 2 | 5,143 | - | 5,143 |
| Owner occupied - commercial real estate | 1 | 461 | - | 461 |
| Construction - commercial and residential | 1 | - | 5,013 | 5,013 |
| Total | 8 | $ 6,769 | $ 5,220 | $11,989 |
| **December 31, 2015** | | | | |
| Commercial | 4 | $ 1,171 | $ 211 | $1,382 |
| Income producing - commercial real estate | 2 | 5,160 | - | 5,160 |
| Owner occupied - commercial real estate | 1 | 485 | - | 485 |
| Construction - commercial and residential | 1 | 5,020 | - | 5,020 |
| Total | 8 | $ 11,836 | $ 211 | $12,047 |

During the three months of 2016, there was one default on a $5.0 million restructured loan, as compared to the three months of 2015, which had no defaults on restructured loans. A default is considered to have occurred once the TDR is past due 90 days or more or it has been placed on nonaccrual. There was one nonperforming TDR totaling $5.0 million reclassified to nonperforming loans during the three months ended March 31, 2016. There were no nonperforming TDRs reclassified to nonperforming loans during the three months ended March 31, 2015. Commercial and consumer loans modified in a TDR are closely monitored for delinquency as an early indicator of possible future default. If a loan modified in a TDR subsequently defaults, the Company evaluates the loan for possible further impairment. The allowance may be increased, adjustments may be made in the allocation of the allowance, or partial charge-offs may be taken to further write-down the carrying value of the loan. There were no loans modified in a TDR during the three months ended March 31, 2016 and 2015.

**Note 6. Interest Rate Swap Derivatives**

The Company uses interest rate swap agreements to assist in its interest rate risk management. The Company's objective in using interest rate derivatives is to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company entered into forward starting interest rate swaps in April 2015 as part of its interest rate risk management strategy intended to mitigate the potential risk of rising interest rates

on the Bank’s cost of funds. The notional amounts of the interest rate swaps do not represent amounts exchanged by the counterparties, but rather, the notional amount is used to determine, along with other terms of the derivative, the amounts to be exchanged between the counterparties. The interest rate swaps are designated as cash flow hedges and involve the receipt of variable rate amounts from two counterparties in exchange for the Company making fixed payments beginning in April 2016. The Company is hedging its exposure to the variability in future cash flows for forecasted transactions over a maximum period of ten months (excluding forecasted transactions related to the payment of variable interest on existing financial instruments) and as such existing hedges are deemed forward starting swaps and no net settlements of cash flows is occurring.

As of March 31, 2016, the Company had three forward starting interest rate swap transactions outstanding that had a notional amount of $250 million associated with the Company’s variable rate deposits. The net unrealized loss before income tax on the swaps was $8.8 million at March 31, 2016. The unrealized loss is due to the increase in spread between short and longer term interest rates between the date the forward starting swap was entered into and March 31, 2016. There were no interest rate swap derivative instruments as of March 31, 2015.

For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings), net of tax, and subsequently reclassified to earnings when the hedged transaction affects earnings, and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. The Company assesses the effectiveness of each hedging relationship by comparing the changes in cash flows of the derivative hedging instrument with the changes in cash flows of the designated hedged transactions. The Company did not recognize any hedge ineffectiveness in earnings during the period ended March 31, 2016.

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Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest income/expense as interest payments are made/received on the Company's variable-rate assets/liabilities. During the quarter ended March 31, 2016, the Company did not have any reclassifications to interest expense. During the next twelve months, the Company estimates (based on existing interest rates) that $2.84 million will be reclassified as an increase in interest expense.

The Company is exposed to credit risk in the event of nonperformance by the interest rate swap counterparty. The Company minimizes this risk by entering into derivative contracts with only large, stable financial institutions, and the Company has not experienced, and does not expect, any losses from counterparty nonperformance on the interest rate swaps. The Company monitors counterparty risk in accordance with the provisions of ASC Topic 815, "Derivatives and Hedging." In addition, the interest rate swap agreements contain language outlining collateral-pledging requirements for each counterparty. Collateral must be posted when the market value exceeds certain threshold limits.

The interest rate swap agreements detail: the requirement that collateral be posted when the market value exceeds certain threshold limits associated with the secured party's exposure; that if the Company defaults on any of its indebtedness (including default where repayment of the indebtedness has not been accelerated by the lender), then the Company could also be declared in default on its derivative obligations; and that if the Company fails to maintain its status as a well/adequate capitalized institution then the counterparty could terminate the derivative positions and the Company would be required to settle its obligations under the agreements.

As of March 31, 2016, the aggregate fair value of all derivative contracts with credit risk contingent features (i.e., those containing collateral posting or termination provisions based on our capital status) that were in a net liability position totaled $8.8 million. As of March 31, 2016, the Company has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of $8.2 million against its obligations under these agreements. If the Company had breached any of these provisions at March 31, 2016, it could have been required to settle its obligations under the agreements at the termination value.

The table below identifies the balance sheet category and fair values of the Company's derivative instruments designated as cash flow hedges as of March 31, 2016. There were no derivative instruments as of March 31, 2015.

| **March 31, 2016**<br><br>**(dollars in thousands)** | **Swap**<br><br>**Number** | **Notional**<br><br>**Amount** | **Fair Value** | **Balance Sheet**<br><br>**Category** | **Receive Rate** | **Pay Rate** | **Maturity** |
|---|---|---|---|---|---|---|---|
| | (1 ) | $75,000 | $(2,068 ) | | | 1.71 % | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Interest rate swap | | | | Other Liabilities | 1 month USD-LIBOR-BBA w/ -1 day lookback +10 basis points | | | March 31, 2020 |
| Interest rate swap | (2 | ) | 100,000 | (3,802 ) | Other Liabilities | Federal Funds Effective Rate +10 basis points | 1.74 % | April 15, 2021 |
| Interest rate swap | (3 | ) | 75,000 | (2,950 ) | Other Liabilities | 1 month USD-LIBOR-BBA w/ -1 day lookback +10 basis points | 1.92 % | March 31, 2022 |

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The table below presents the pre-tax net gains (losses) of the Company's cash flow hedges for the three months ended March 31, 2016. Since all transactions are forward starting swaps all amounts are balance sheet related (Accumulated Other Comprehensive Income- "AOCI"), and no amounts were recorded in the income statement.

| | Three Months Ended March 31, 2016 | | | | | |
|---|---|---|---|---|---|---|
| | | Effective Portion | | | Ineffective Portion | |
| | | Amount of Pre-tax gain (loss) | Reclassified from AOCI into income | | Recognized in Income on Derivatives | |
| (dollars in thousands) | Swap Number | Recognized in OCI | Category | Amount of Gain (Loss) | Category | Amount of Gain (Loss) |
| Interest rate swap | (1) | $(2,068) | | $ - | | $ - |
| Interest rate swap | (2) | (3,802) | | - | | - |
| Interest rate swap | (3) | (2,950) | | - | | - |

**Note 7. Other Real Estate Owned**

The activity within Other Real Estate Owned ("OREO") for the three months ended March 31, 2016 and 2015 is presented in the table below. There were no residential real estate loans in the process of foreclosure as of March 31, 2016. For the three months ended March 31, 2016, proceeds on sales of OREO were $2.6 million. The net gain on sales was $573 thousand for the three months ended March 31, 2016.

| | Three Months Ended | |
|---|---|---|
| (dollars in thousands) | March 31, 2016 | March 31, 2015 |
| Balance beginning of period | $5,852 | $13,224 |
| Real estate acquired from borrowers | - | - |
| Valuation allowance | (6) | (750) |
| Properties sold | (2,000) | (136) |

| | | |
|---|---|---|
| Balance end of period | $3,846 | $12,338 |

**Note 8. Borrowings**

ASU 2015-03, *"Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs* simplifies the presentation of debt issuance costs by requiring that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of debt liability, consistent with debt discounts or premiums. The Company adopted ASU 2015-03 as of the end of its fiscal year 2015, and applied its provisions retrospectively.

The following table presents information related to the Company's borrowings for the periods ended March 31, 2016, December 31, 2015 and March 31, 2015.

| (dollars in thousands) | March 31, 2016 | December 31, 2015 | March 31, 2015 |
|---|---|---|---|
| Subordinated Notes, 5.75% | $70,000 | $ 70,000 | $70,000 |
| Subordinated Notes, 8.5% | - | - | 9,300 |
| Less: debt issurance costs | (1,042 ) | (1,072 ) | (1,165 ) |
| Long-term borrowings | $68,958 | $ 68,928 | $78,135 |

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On August 5, 2014, the Company completed the sale of $70.0 million of its 5.75% subordinated notes, due September 1, 2024 (the “Notes”). The Notes were offered to the public at par and qualify as Tier 2 capital for regulatory purposes to the fullest extent permitted under the Basel III Rule capital requirements. The net proceeds were approximately $68.8 million, which includes $1.2 million in deferred financing costs which is being amortized over the life of the Notes.

On August 30, 2010, the Company entered into and consummated a Note Exchange Agreement, pursuant to which the Company issued, on a private placement basis, to eight parties, all of which are current or former directors of the Company or accounts for the benefit of such persons, an aggregate of $9.3 million of a new series of subordinated notes. During 2015, the Company redeemed the remaining balance of $9.3 million of subordinated notes, due 2021.

**Note 9. Net Income per Common Share**

The calculation of net income per common share for the three months ended March 31, 2016 and 2015 was as follows.

| | **Three Months Ended March 31,** | |
|---|---|---|
| **(dollars and shares in thousands, except per share data)** | **2016** | **2015** |
| Basic: | | |
| Net income available to common shareholders | $- | $19,238 |
| Average common shares outstanding | 33,519 | 31,083 |
| Basic net income per common share | $- | $0.62 |
| | | |
| Diluted: | | |
| Net income available to common shareholders | $- | $19,238 |
| Average common shares outstanding | 33,519 | 31,083 |
| Adjustment for common share equivalents | 585 | 693 |
| Average common shares outstanding-diluted | 34,104 | 31,776 |
| Diluted net income per common share | $- | $0.61 |
| | | |
| Anti-dilutive shares | 5 | 13 |

**Note 10. Stock-Based Compensation**

The Company maintains the 2006 Stock Plan (“2006 Plan”) and the 2011 Employee Stock Purchase Plan (“2011 ESPP”).

In connection with the acquisition of Fidelity, the Company assumed the Fidelity 2004 Long Term Incentive Plan and the 2005 Long Term Incentive Plan (the “Fidelity Plans”).

In connection with the acquisition of Virginia Heritage, the Company assumed the Virginia Heritage 2006 Stock Option Plan and the 2010 Long Term Incentive Plan (the “Virginia Heritage Plans”).

No additional options may be granted under the Fidelity Plans or the Virginia Heritage Plans.

The 2006 Plan provides for the issuance of awards of incentive stock options, non-qualifying stock options, restricted stock and stock appreciation rights to selected key employees and members of the Board. As amended, 1,996,500 shares of common stock are subject to issuance pursuant to awards under the 2006 Plan. Stock options and restricted stock awards are made with an exercise price equal to the average of the high and low price of the Company’s shares at the date of grant.

For awards that are service based, compensation expense is being recognized over the service (vesting) period based on fair value, which for stock option grants is computed using the Black-Scholes model, and for restricted stock awards is based on the average of the high and low stock price of the Company’s shares on the date of grant. For awards that are performance-based, compensation expense is recorded based on the probability of achievement of the goals underlying the grant.

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In February 2016, the Company awarded 80,365 shares of time vested restricted stock to senior officers, and certain employees. The shares vest in three substantially equal installments beginning on the first anniversary of the date of grant.

In February 2016 the Company awarded senior officers a targeted number of 34,957 performance vested restricted stock units (PRSU's). PRSU's are subject to the satisfaction of certain performance conditions based on the achievement of pre-established average targets for earnings per share growth, total shareholder return and return on average assets over or at the end of a three-year vesting period (2016-2018).

In March 2016, the Company awarded 24,410 shares of time vested restricted stock to directors. The shares vest in three substantially equal installments beginning on the first anniversary of the date of grant.

Below is a summary of changes in stock option shares pursuant to our equity compensation plans for the three months ended March 31, 2016 and 2015. The information excludes restricted stock units and awards.

| | **Three Months Ended March 31,** | | | |
|---|---|---|---|---|
| | **2016** | | **2015** | |
| | **Shares** | **Weighted-Average Exercise Price** | **Shares** | **Weighted-Average Exercise Price** |
| Beginning balance | 298,740 | $ 9.97 | 759,683 | $ 11.36 |
| Issued | - | - | - | - |
| Exercised | (16,759 ) | 11.80 | (280,425) | 12.40 |
| Forfeited | (1,100 ) | 15.48 | - | - |
| Expired | (6,037 ) | 13.57 | (8,007 ) | 16.90 |
| Ending balance | 274,844 | $ 9.76 | 471,251 | $ 10.65 |

The following summarizes information about stock options outstanding at March 31, 2016. The information excludes restricted stock units and awards.

| **<u>Outstanding:</u>** | **Stock Options** | **Weighted-Average** | **Weighted-Average Remaining** |
|---|---|---|---|

| Range of Exercise Prices | | Outstanding | Exercise Price | | Contractual Life |
|---|---|---|---|---|---|
| $5.76 | $9.21 | 157,495 | $ | 5.76 | 2.78 |
| $9.22 | $15.47 | 96,544 | | 12.61 | 1.41 |
| $15.48 | $22.66 | 11,657 | | 19.05 | 4.68 |
| $22.67 | $49.50 | 9,148 | | 36.61 | 7.40 |
| | | 274,844 | $ | 9.76 | 2.53 |

| Exercisable: | | Stock Options | Weighted-Average | |
|---|---|---|---|---|
| Range of Exercise Prices | | Exercisable | Exercise Price | |
| $5.76 | $9.21 | 105,448 | $ | 5.76 |
| $9.22 | $15.47 | 96,544 | | 12.61 |
| $15.48 | $22.66 | 10,337 | | 18.93 |
| $22.67 | $49.50 | 2,648 | | 24.59 |
| | | 214,977 | $ | 9.70 |

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The fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option pricing model with the assumptions as shown in the table below used for grants during the years ended December 31, 2015 and 2014. There were no grants of stock options during the three months ended March 31, 2016.

| | Three Months Ended March 31, 2016 | Years Ended December 31, | |
|---|---|---|---|
| | | 2015 | 2014 |
| Expected volatility | n/a | 31.21 % | 34.25 % |
| Weighted-Average volatility | n/a | 31.21 % | 34.25 % |
| Expected dividends | 0.0 % | 0.0 % | 0.0 % |
| Expected term (in years) | n/a | 7.0 | 9.4 |
| Risk-free rate | n/a | 1.64 % | 2.26 % |
| Weighted-average fair value (grant date) | n/a | $ 16.73 | $ 13.49 |
| Weighted-average fair value (grant date) for Virginia Heritage Bank ("VHB") options assumed | n/a | n/a | $ 24.89 |

The expected lives are based on the “simplified” method allowed by ASC Topic 718 *“Compensation,”* whereby the expected term is equal to the midpoint between the vesting period and the contractual term of the award.

The total intrinsic value of outstanding stock options was $10.5 million at March 31, 2016. The total intrinsic value of stock options exercised during the three months ended March 31, 2016 and 2015 was $604 thousand and $6.0 million, respectively. The total fair value of stock options vested was $40 thousand and $79 thousand for the three months ended March 31, 2016 and 2015, respectively. Unrecognized stock-based compensation expense related to stock options totaled $121 thousand at March 31, 2016. At such date, the weighted-average period over which this unrecognized stock option expense is expected to be recognized was 3.10 years.

The Company has unvested restricted stock awards and PRSU grants of 312,871 shares under the 2006 Plan at March 31, 2016. Unrecognized stock based compensation expense related to restricted stock awards totaled $10.1 million at March 31, 2016. At such date, the weighted-average period over which this unrecognized expense was expected to be recognized was 2.0 years. The following table summarizes the unvested restricted stock awards at March 31, 2016 and 2015.

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| | 2016 | | 2015 | |
| | Shares | Weighted- | Shares | Weighted- |

| | | Average Grant<br>Date Fair Value | | Average Grant<br>Date Fair Value |
|---|---|---|---|---|
| Unvested at beginning | 369,093 | $ 24.43 | 509,336 | $ 21.58 |
| Issued | 139,732 | 46.17 | 78,070 | 36.06 |
| Forfeited | (766 ) | 37.48 | (339 ) | 28.09 |
| Vested | (195,188) | 22.53 | (193,338) | 20.66 |
| Unvested at end | 312,871 | $ 35.29 | 393,729 | $ 24.90 |

Approved by shareholders in May 2011, the 2011 ESPP reserved 550,000 shares of common stock (as adjusted for stock dividends) for issuance to employees. Whole shares are sold to participants in the plan at 85% of the lower of the stock price at the beginning or end of each quarterly offering period. The 2011 ESPP is available to all eligible employees who have completed at least one year of continuous employment, work at least 20 hours per week and at least five months a year. Participants may contribute a minimum of $10 per pay period to a maximum of $6,250 per offering period or $25,000 annually (not to exceed more than 10% of compensation per pay period). At March 31, 2016, the 2011 ESPP had 429,837 shares remaining for issuance.

Included in salaries and employee benefits the Company recognized $1.4 million and $1.1 million in stock-based compensation expense for the three months ended March 31, 2016 and 2015, respectively. Stock-based compensation expense is recognized ratably over the requisite service period for all awards.

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**Note 11. Other Comprehensive Income**

The following table presents the components of other comprehensive (loss) income for the three months ended March 31, 2016 and 2015.

| (dollars in thousands) | Before Tax | Tax Effect | Net of Tax |
|---|---|---|---|
| **Three Months Ended March 31, 2016** | | | |
| Net unrealized gain on securities available-for-sale | $5,963 | $2,385 | $3,578 |
| Net unrealized loss on derivatives | (7,403) | (2,961) | (4,442) |
| Less: Reclassification adjustment for net gains included in net income | (624) | (250) | (374) |
| Other Comprehensive Loss | $(2,064) | $(826) | $(1,238) |
| **Three Months Ended March 31, 2015** | | | |
| Net unrealized gain on securities available-for-sale | $3,218 | $1,287 | $1,931 |
| Less: Reclassification adjustment for net gains included in net income | (2,164) | (866) | (1,298) |
| Other Comprehensive Income | $1,054 | $421 | $633 |

The following table presents the changes in each component of accumulated other comprehensive income (loss), net of tax, for the three months ended March 31, 2016 and 2015.

| (dollars in thousands) | Securities Available For Sale | Derivatives | Accumulated Other Comprehensive (Loss) Income |
|---|---|---|---|
| **Three Months Ended March 31, 2016** | | | |
| **Balance at Beginning of Period** | $ 1,041 | $ (850) | $ 191 |
| Other comprehensive income (loss) before reclassifications | 3,578 | (4,442) | (864) |
| Amounts reclassified from accumulated other comprehensive income | (374) | - | (374) |
| Net other comprehensive income (loss) during period | 3,204 | (4,442) | (1,238) |
| Balance at End of Period | $ 4,245 | $ (5,292) | $ (1,047) |
| **Three Months Ended March 31, 2015** | | | |
| **Balance at Beginning of Period** | $ 2,647 | $ - | $ 2,647 |
| Other comprehensive income before reclassifications | 1,931 | - | 1,931 |
| Amounts reclassified from accumulated other comprehensive income | (1,298) | - | (1,298) |
| Net other comprehensive income during period | 633 | - | 633 |

| Balance at End of Period | $ 3,280 | $ - | $ 3,280 |
|---|---|---|---|

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the three months ended March 31, 2016 and 2015.

| **Details about Accumulated Other Comprehensive Income Components (dollars in thousands)** | **Amount Reclassified from Accumulated Other Comprehensive (Loss) Income Three Months Ended March 31,** | | **Affected Line Item in the Statement Where Net Income is Presented** |
|---|---|---|---|
| | **2016** | **2015** | |
| Realized gain on sale of investment securities | $ 624 | $ 2,164 | Gain on sale of investment securities |
| | (250 ) | (866 ) | Tax Expense |
| Total Reclassifications for the Period | $ 374 | $ 1,298 | Net of Tax |

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**Note 12. Fair Value Measurements**

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, the Company utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. ASC Topic 820, *"Fair Value Measurements and Disclosures,"* establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

| | |
|---|---|
| Level 1 | Quoted prices in active exchange markets for identical assets or liabilities; also includes certain U.S. Treasury and other U.S. Government and agency securities actively traded in over-the-counter markets. |
| Level 2 | Observable inputs other than Level 1 including quoted prices for similar assets or liabilities, quoted prices in less active markets, or other observable inputs that can be corroborated by observable market data; also includes derivative contracts whose value is determined using a pricing model with observable market inputs or can be derived principally from or corroborated by observable market data. This category generally includes certain U.S. Government and agency securities, corporate debt securities, derivative instruments, and residential mortgage loans held for sale. |
| Level 3 | Unobservable inputs supported by little or no market activity for financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation; also includes observable inputs for single dealer nonbinding quotes not corroborated by observable market data. This category generally includes certain private equity investments, retained interests from securitizations, and certain collateralized debt obligations. |

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Assets and Liabilities Recorded at Fair Value on a Recurring Basis

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis as of March 31, 2016 and December 31, 2015.

| **(dollars in thousands)** | **Quoted Prices (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Other Unobservable Inputs (Level 3)** | **Total (Fair Value)** |
|---|---|---|---|---|
| **March 31, 2016** | | | | |
| **Assets:** | | | | |
| Investment securities available for sale: | | | | |
| U. S. agency securities | $ - | $ 55,622 | $ - | $55,622 |
| Residential mortgage backed securities | - | 306,812 | - | 306,812 |
| Municipal bonds | - | 109,909 | - | 109,909 |
| Corporate bonds | - | 14,938 | - | 14,938 |
| Other equity investments | 109 | - | 219 | 328 |
| Loans held for sale | - | 45,679 | - | 45,679 |
| Mortgage banking derivatives | - | - | 377 | 377 |
| Interest rate swap derivatives | - | - | - | - |
| Total assets measured at fair value on a recurring basis as of March 31, 2016 | $ 109 | $ 532,960 | $ 596 | $533,665 |
| **Liabilities:** | | | | |
| Mortgage banking derivatives | $ - | $ - | $ 306 | $306 |
| Interest rate swap derivatives | - | 8,820 | - | 8,820 |
| Total liabilities measured at fair value on a recurring basis as of March 31, 2016 | $ - | $ 8,820 | $ 306 | $9,126 |
| **December 31, 2015** | | | | |
| **Assets:** | | | | |
| Investment securities available for sale: | | | | |
| U. S. agency securities | $ - | $ 56,975 | $ - | $56,975 |
| Residential mortgage backed securities | - | 297,241 | - | 297,241 |
| Municipal bonds | - | 118,381 | - | 118,381 |
| Corporate bonds | - | 14,938 | - | 14,938 |
| Other equity investments | 115 | - | 219 | 334 |
| Loans held for sale | - | 47,492 | - | 47,492 |
| Mortgage banking derivatives | - | - | 24 | 24 |

| | | | | |
|---|---|---|---|---|
| Total assets measured at fair value on a recurring basis as of December 31, 2015 | $ 115 | $ 535,027 | $ 243 | $535,385 |
| | | | | |
| **Liabilities:** | | | | |
| Mortgage banking derivatives | $ - | $ - | $ 30 | $30 |
| Interest rate swap derivatives | - | 1,417 | - | 1,417 |
| Total liabilities measured at fair value on a recurring basis as of December 31, 2015 | $ - | $ 1,417 | $ 30 | $1,447 |

Investment Securities Available-for-Sale

Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair value is measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security’s credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include U.S. agency debt securities, mortgage backed securities issued by Government Sponsored Entities (“GSEs”) and municipal bonds. Securities classified as Level 3 include securities in less liquid markets, the carrying amount approximate the fair value.

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*Loans held for sale*: Loans held for sale are carried at the fair value. Fair value is derived from secondary market quotations for similar instruments. Gains and losses on sales of these loans are recorded as a component of noninterest income in the Consolidated Statements of Operations. As such, the Company classifies loans subjected to fair value adjustments as Level 2 valuation.

*Interest rate swap derivatives:* These derivative instruments consist of forward starting interest rate swap agreements, which are accounted for as cash flow hedges. The Company's derivative position is classified within Level 2 of the fair value hierarchy and is valued using models generally accepted in the financial services industry and that use actively quoted or observable market input values from external market data providers and/or non-binding broker-dealer quotations. The fair value of the derivatives is determined using discounted cash flow models. These models' key assumptions include the contractual terms of the respective contract along with significant observable inputs, including interest rates, yield curves, nonperformance risk and volatility. Derivative contracts are executed with a Credit Support Annex, which is a bilateral ratings-sensitive agreement that requires collateral postings when the market value exceeds certain threshold limits. These agreements protect the interests of the Company and its counterparties should either party suffer a credit rating deterioration.

The following is a reconciliation of activity for assets and liabilities measured at fair value based on Significant Other Unobservable Inputs (Level 3):

| **(dollars in thousands)** | **Other Equity Investments** | **Mortgage Banking Derivatives** | **Total** |
|---|---|---|---|
| Assets: | | | |
| Beginning balance at January 1, 2016 | $ 219 | $ 24 | $ 243 |
| Realized gain (loss) included in earnings - net mortgage banking derivatives | - | 353 | 353 |
| Principal redemption | - | - | - |
| Ending balance at March 31, 2016 | $ 219 | $ 377 | $ 596 |
| | | | |
| Liabilities: | | | |
| Beginning balance at January 1, 2016 | $ - | $ 30 | $ 30 |
| Realized (gain) loss included in earnings - net mortgage banking derivatives | - | 276 | 276 |
| Principal redemption | - | - | - |
| Ending balance at March 31, 2016 | $ - | $ 306 | $ 306 |

| **(dollars in thousands)** | **Other Equity Investments** | **Mortgage Banking Derivatives** | **Total** |
|---|---|---|---|
| Assets: | | | |

| | | | |
|---|---|---|---|
| Beginning balance at January 1, 2015 | $ 219 | $ 146 | $ 365 |
| Realized gain (loss) included in earnings - net mortgage banking derivatives | - | (122) | (122) |
| Principal redemption | - | - | - |
| Ending balance at December 31, 2015 | $ 219 | $ 24 | $ 243 |
| | | | |
| Liabilities: | | | |
| Beginning balance at January 1, 2015 | $ - | $ 250 | $ 250 |
| Realized (gain) loss included in earnings - net mortgage banking derivatives | - | (220) | (220) |
| Principal redemption | - | - | - |
| Ending balance at December 31, 2015 | $ - | $ 30 | $ 30 |

The other equity securities classified as Level 3 consist of equity investments in the form of common stock of two local banking companies which are not publicly traded, and for which the carrying amount approximates fair value.

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The Company relies on a third-party pricing service to value its mortgage banking derivative financial assets and liabilities, which the Company classifies as a Level 3 valuation. The external valuation model to estimate the fair value of its interest rate lock commitments to originate residential mortgage loans held for sale includes grouping the interest rate lock commitments by interest rate and terms, applying an estimated pull-through rate based on historical experience, and then multiplying by quoted investor prices determined to be reasonably applicable to the loan commitment groups based on interest rate, terms, and rate lock expiration dates of the loan commitment groups. The Company also relies on an external valuation model to estimate the fair value of its forward commitments to sell residential mortgage loans (i.e., an estimate of what the Company would receive or pay to terminate the forward delivery contract based on market prices for similar financial instruments), which includes matching specific terms and maturities of the forward commitments against applicable investor pricing.

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

The Company measures certain assets at fair value on a nonrecurring basis and the following is a general description of the methods used to value such assets.

*Impaired loans*: The Company considers a loan impaired when it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the note agreement, including both principal and interest. Management has determined that nonaccrual loans and loans that have had their terms restructured in a troubled debt restructuring meet this impaired loan definition. For individually evaluated impaired loans, the amount of impairment is based upon the present value of expected future cash flows discounted at the loan’s effective interest rate or the estimated fair value of the underlying collateral for collateral-dependent loans, which the Company classifies as a Level 3 valuation.

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*Other real estate owned*: Other real estate owned is initially recorded at fair value less estimated selling costs. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral, which the Company classifies as a Level 3 valuation. Assets measured at fair value on a nonrecurring basis are included in the table below:

| (dollars in thousands) | Quoted Prices (Level 1) | | Significant Other Observable Inputs (Level 2) | | Significant Other Unobservable Inputs (Level 3) | | Total (Fair Value) | |
|---|---|---|---|---|---|---|---|---|
| **March 31, 2016** | | | | | | | | |
| Impaired loans: | | | | | | | | |
| Commercial | $ | - | $ | 257 | $ | 9,982 | $ | 10,239 |
| Income producing - commercial real estate | | - | | - | | 19,037 | | 19,037 |
| Owner occupied - commercial real estate | | - | | - | | 1,364 | | 1,364 |
| Real estate mortgage - residential | | - | | - | | 257 | | 257 |
| Construction - commercial and residential | | - | | - | | 5,112 | | 5,112 |
| Home equity | | - | | - | | 34 | | 34 |
| Other consumer | | - | | - | | - | | - |
| Other real estate owned | | - | | - | | 3,846 | | 3,846 |
| Total assets measured at fair value on a nonrecurring basis as of March 31, 2016 | $ | - | $ | 257 | $ | 39,632 | $ | 39,889 |

| (dollars in thousands) | Quoted Prices (Level 1) | Significant Other Observable | Significant Other Unobservable | Total (Fair Value) |
|---|---|---|---|---|

| | | Inputs (Level 2) | Inputs (Level 3) | |
|---|---|---|---|---|
| **December 31, 2015** | | | | |
| Impaired loans: | | | | |
| Commercial | $ - | $ 271 | $ 8,930 | $9,201 |
| Income producing - commercial real estate | - | - | 5,085 | 5,085 |
| Owner occupied - commercial real estate | - | 282 | 1,071 | 1,353 |
| Real estate mortgage - residential | - | - | 329 | 329 |
| Construction - commercial and residential | - | - | 9,504 | 9,504 |
| Home equity | - | - | 123 | 123 |
| Other consumer | - | - | 19 | 19 |
| Other real estate owned | - | 5,394 | 458 | 5,852 |
| Total assets measured at fair value on a nonrecurring basis as of December 31, 2015 | $ - | $ 5,947 | $ 25,519 | $31,466 |

Loans

The Company does not record loans at fair value on a recurring basis; however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with ASC Topic 310, *"Receivables."* The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At March 31, 2016, substantially all of the totally impaired loans were evaluated based upon the fair value of the collateral. In accordance with ASC Topic 820, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.

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Fair Value of Financial Instruments

The Company discloses fair value information about financial instruments for which it is practicable to estimate the value, whether or not such financial instruments are recognized on the balance sheet. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation, and is best evidenced by quoted market price, if one exists.

Quoted market prices, if available, are shown as estimates of fair value. Because no quoted market prices exist for a portion of the Company's financial instruments, the fair value of such instruments has been derived based on management's assumptions with respect to future economic conditions, the amount and timing of future cash flows and estimated discount rates. Different assumptions could significantly affect these estimates. Accordingly, the net realizable value could be materially different from the estimates presented below. In addition, the estimates are only indicative of individual financial instrument values and should not be considered an indication of the fair value of the Company taken as a whole.

The following methods and assumptions were used to estimate the fair value of each category of financial instrument for which it is practicable to estimate value:

*Cash due from banks and federal funds sold:* For cash and due from banks and federal funds sold the carrying amount approximates fair value.

*Interest bearing deposits with other banks:* Values are estimated by discounting the future cash flows using the current rates at which similar deposits would be earning.

*Investment securities:* For these instruments, fair values are based upon quoted prices, if available. If quoted prices are not available, fair value is measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions.

*Federal Reserve and Federal Home Loan Bank stock:* The carrying amount approximate the fair values at the reporting date.

*Loans held for sale:* The fair value of loans held for sale is based on commitments outstanding from investors as well as what secondary markets are currently offering for portfolios with similar characteristics for residential mortgage loans held for sale since such loans are typically committed to be sold (servicing released) at a profit.

*Loans:* For variable rate loans that re-price on a scheduled basis, fair values are based on carrying values. The fair value of the remaining loans are estimated by discounting the estimated future cash flows using the current interest rate at which similar loans would be made to borrowers with similar credit ratings and for the same remaining term.

*Bank owned life insurance:* The fair value of bank owned life insurance is the current cash surrender value, which is the carrying value.

*Annuity investment:* The fair value of the annuity investments is the carrying amount at the reporting date.

*Mortgage banking derivatives:* The Company enters into interest rate lock commitments (IRLCs) with prospective residential mortgage borrowers. These commitments are carried at fair value based on the fair value of the underlying mortgage loans which are based on market data. These commitments are classified as Level 3 in the fair value disclosures, as the valuations are based on market unobservable inputs. The Company hedges the risk of the overall change in the fair value of loan commitments to borrowers by selling forward contracts on securities of GSEs. These forward settling contracts are classified as Level 3, as valuations are based on market unobservable inputs. See Note 4 of the Consolidated Financial Statements for additional detail.

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*Interest rate swap derivatives:* These derivative instruments consist of forward starting interest rate swap agreements, which are accounted for as cash flow hedges. The Company's derivative position is classified within Level 2 of the fair value hierarchy and is valued using models generally accepted in the financial services industry and that use actively quoted or observable market input values from external market data providers and/or non-binding broker-dealer quotations. The fair value of the derivatives is determined using discounted cash flow models. These models' key assumptions include the contractual terms of the respective contract along with significant observable inputs, including interest rates, yield curves, nonperformance risk and volatility. Derivative contracts are executed with a Credit Support Annex, which is a bilateral ratings-sensitive agreement that requires collateral postings when the market value exceeds certain threshold limits. These agreements protect the interests of the Company and its counterparties should either party suffer a credit rating deterioration.

*Noninterest bearing deposits:* The fair value of these deposits is the amount payable on demand at the reporting date, since generally accepted accounting standards do not permit an assumption of core deposit value.

*Interest bearing deposits:* The fair value of interest bearing transaction, savings, and money market deposits with no defined maturity is the amount payable on demand at the reporting date, since generally accepted accounting standards do not permit an assumption of core deposit value.

*Certificates of deposit:* The fair value of certificates of deposit is estimated by discounting the future cash flows using the current rates at which similar deposits with remaining maturities would be accepted.

*Customer repurchase agreements:* The carrying amount approximate the fair values at the reporting date.

*Borrowings:* The carrying amount for variable rate borrowings approximate the fair values at the reporting date. The fair value of fixed rate FHLB advances and the subordinated notes are estimated by computing the discounted value of contractual cash flows payable at current interest rates for obligations with similar remaining terms. The fair value of variable rate FHLB advances is estimated to be carrying value since these liabilities are based on a spread to a current pricing index.

*Off-balance sheet items:* Management has reviewed the unfunded portion of commitments to extend credit, as well as standby and other letters of credit, and has determined that the fair value of such instruments is equal to the fee, if any, collected and unamortized for the commitment made.

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The estimated fair values of the Company’s financial instruments at March 31, 2016 and December 31, 2015 are as follows:

| | | | Fair Value Measurements | | |
|---|---|---|---|---|---|
| **(dollars in thousands)** | **Carrying Value** | **Fair Value** | **Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| **March 31, 2016** | | | | | |
| **Assets** | | | | | |
| Cash and due from banks | $11,856 | $11,856 | $- | $11,856 | $ - |
| Federal funds sold | 14,905 | 14,905 | - | 14,905 | - |
| Interest bearing deposits with other banks | 175,136 | 175,136 | - | 175,136 | - |
| Investment securities | 487,609 | 487,609 | 109 | 487,281 | 219 |
| Federal Reserve and Federal Home Loan Bank stock | 17,696 | 17,696 | - | 17,696 | - |
| Loans held for sale | 45,679 | 45,679 | - | 45,679 | - |
| Loans | 5,155,871 | 5,161,705 | - | 257 | 5,161,448 |
| Bank owned life insurance | 58,974 | 58,974 | - | 58,974 | - |
| Annuity investment | 12,007 | 12,007 | - | 12,007 | - |
| Mortgage banking derivatives | 377 | 377 | - | - | 377 |
| Interst rate swap derivatives | - | - | - | - | - |
| | | | | | |
| **Liabilities** | | | | | |
| Noninterest bearing deposits | 1,474,102 | 1,474,102 | - | 1,474,102 | - |
| Interest bearing deposits | 2,923,895 | 2,923,895 | - | 2,923,895 | - |
| Certificates of deposit | 791,649 | 791,366 | - | 791,366 | - |
| Customer repurchase agreements | 66,963 | 66,963 | - | 66,963 | - |
| Borrowings | 68,958 | 68,960 | - | 68,960 | - |
| Mortgage banking derivatives | 306 | 306 | - | - | 306 |
| Interst rate swap derivatives | 8,820 | 8,820 | - | 8,820 | - |
| | | | | | |
| **December 31, 2015** | | | | | |
| **Assets** | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| Cash and due from banks | $11,009 | $11,009 | $- | $11,009 | $ - |
| Federal funds sold | 3,791 | 3,791 | - | 3,791 | - |
| Interest bearing deposits with other banks | 283,563 | 283,563 | - | 283,563 | - |
| Investment securities | 487,869 | 487,869 | 115 | 487,535 | 219 |
| Federal Reserve and Federal Home Loan Bank stock | 16,903 | 16,903 | - | 16,903 | - |
| Loans held for sale | 47,492 | 47,492 | - | 47,492 | - |
| Loans | 4,998,368 | 5,000,717 | - | 553 | 5,000,164 |
| Bank owned life insurance | 58,682 | 58,682 | - | 58,682 | - |
| Annuity investment | 12,136 | 12,136 | - | 12,136 | - |
| Mortgage banking derivatives | 24 | 24 | - | - | 24 |
| Interest rate swap derivatives | - | - | - | - | - |
| **Liabilities** | | | | | |
| Noninterest bearing deposits | 1,405,067 | 1,405,067 | - | 1,405,067 | - |
| Interest bearing deposits | 3,014,122 | 3,014,122 | - | 3,014,122 | - |
| Certificates of deposit | 739,255 | 736,973 | - | 736,973 | - |
| Customer repurchase agreements | 72,356 | 72,356 | - | 72,356 | - |
| Borrowings | 70,000 | 69,992 | - | 69,992 | - |
| Mortgage banking derivatives | 30 | 30 | - | - | 30 |
| Interest rate swap derivatives | 1,417 | 1,417 | - | 1,417 | - |

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**Note 13. Supplemental Executive Retirement Plan**

The Bank has entered into Supplemental Executive Retirement and Death Benefit Agreements (the "SERP Agreements") with certain of the Bank's executive officers other than Mr. Paul, which upon the executive's retirement, will provide for a stated monthly payment for such executive's lifetime, subject to certain death benefits described below. The retirement benefit is computed as a percentage of each executive's projected average base salary over the five years preceding retirement, assuming retirement at age 67. The SERP Agreements provide that (a) the benefits vest ratably over six years of service to the Bank, with the executive receiving credit for years of service prior to entering into the SERP Agreement, (b) death, disability and change-in-control shall result in immediate vesting, and (c) the monthly amount will be reduced if retirement occurs earlier than age 67 for any reason other than death, disability or change-in-control. The SERP Agreements further provide for a death benefit in the event the retired executive dies prior to receiving 180 monthly installments, paid either in a lump sum payment or continued monthly installment payments, such that the executive's beneficiary has received payment(s) sufficient to equate to a cumulative 180 monthly installments.

The SERP Agreements are unfunded arrangements maintained primarily to provide supplemental retirement benefits and comply with Section 409A of the Internal Revenue Code. The Bank financed the retirement benefits by purchasing fixed annuity contracts with four insurance carriers totaling $11.4 million that have been designed to provide a future source of funds for the lifetime retirement benefits of the SERP Agreements. The primary impetus for utilizing fixed annuities is a substantial savings in compensation expenses for the Bank as opposed to a traditional SERP Agreement. The annuity contracts accrued $32 thousand of income for the quarter ended March 31, 2016, which is included in other noninterest income on the Consolidated Statement of Operations. The cash surrender value of the annuity contracts was $12.0 million at March 31, 2016 and is included in other assets on the Consolidated Balance Sheet. For the three months ended March 31, 2016, the Company recorded benefit expense accruals of $253 thousand for this post retirement benefit.

Upon death of an executive, the annuity contract related to such executive terminates. The Bank has purchased additional bank owned life insurance contracts, which would effectively finance payments (up to a 15 year certain amount) to the executives' named beneficiaries.

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

The following discussion provides information about the results of operations, and financial condition, liquidity, and capital resources of the Company and its subsidiaries as of the dates and periods indicated. This discussion and analysis should be read in conjunction with the unaudited Consolidated Financial Statements and Notes thereto,

appearing elsewhere in this report and the Management Discussion and Analysis in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

This report contains forward looking statements within the meaning of the Securities Exchange Act of 1934, as amended, including statements of goals, intentions, and expectations as to future trends, plans, events or results of Company operations and policies and regarding general economic conditions. In some cases, forward- looking statements can be identified by use of such words as "may," "will," "anticipate," "believes," "expects," "plans," "estimates," "potential," "continue," "should," and similar words or phrases. These statements are based upon current and anticipated economic conditions, nationally and in the Company's market, interest rates and interest rate policy, competitive factors and other conditions, which by their nature are not susceptible to accurate forecast, and are subject to significant uncertainty. For details on factors that could affect these expectations, see the risk factors and other cautionary language included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 and in other periodic and current reports filed by the Company with the Securities and Exchange Commission. Because of these uncertainties and the assumptions on which this discussion and the forward-looking statements are based, actual future operations and results in the future may differ materially from those indicated herein. Readers are cautioned against placing undue reliance on any such forward looking statements.

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## GENERAL

The Company is a growth oriented, one-bank holding company headquart