

FEDERAL DEPOSIT INSURANCE CORPORATION

Washington, D.C. 20429

FORM 10-Q

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

For the quarterly period ended March 31, 2015

FDIC Insurance Cert. Number: 35095

TOWNE BANK

(Exact name of registrant as specified in its charter)

VIRGINIA

(State or other jurisdiction of
incorporation or organization)

54-1910608

(I.R.S. Employer Identification No.)

5716 High Street, Portsmouth, Virginia
(Address of principal executive offices)

23703
(Zip Code)

(757) 638-7500

(Registrant's telephone number, including area code)

No Change

(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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

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 ☒

The number of shares of the Company's common stock outstanding as of April 30, 2015 was 51,457,945 shares.

TOWNE BANK

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

(In thousands, except share data)

	March 31,		December 31,
	2015	2014	2014
	(unaudited)		(audited)
ASSETS			
Cash and due from banks	\$ 144,215	\$ 235,984	\$ 212,994
Interest-bearing deposits in financial institutions	1,000	1,000	1,011
Total Cash and Cash Equivalents	145,215	236,984	214,005
Securities available for sale, at fair value	771,208	551,797	603,908
Securities held to maturity, at amortized cost	252,173	232,879	252,370
Federal Home Loan Bank stock, at amortized cost	22,366	21,987	22,157
Total Securities	1,045,747	806,663	878,435
Mortgage loans held for sale	102,850	57,745	71,390
Loans, net of unearned income and deferred costs:			
Real estate - residential 1-4 family	915,205	810,145	837,370
Real estate - commercial	1,725,706	1,395,369	1,447,078
Real estate - construction and land development	519,390	469,841	452,481
Real estate - multifamily	146,395	50,014	51,472
Commercial and industrial business	531,831	495,576	533,500
Consumer and other loans	88,747	48,417	75,365
Loans, net of unearned income and deferred costs	3,927,274	3,269,362	3,397,266
Less: Allowance for loan losses	(35,907)	(37,543)	(35,917)
Net Loans	3,891,367	3,231,819	3,361,349
Premises and equipment, net	166,164	152,976	155,774
Goodwill	156,516	104,508	113,159
Other intangible assets, net	23,090	15,084	22,509
Bank-owned life insurance policies	145,401	57,567	58,716
Other assets	152,353	111,888	107,148
TOTAL ASSETS	\$ 5,828,703	\$ 4,775,234	\$ 4,982,485
LIABILITIES AND EQUITY			
Liabilities			
Deposits:			
Noninterest-bearing demand	\$ 1,261,482	\$ 1,090,273	\$ 1,224,466
Interest-bearing:			
Demand and money market accounts	1,643,534	1,303,207	1,365,183
Savings	303,936	197,892	301,033
Certificates of deposit	1,296,666	1,090,337	955,920
Total Deposits	4,505,618	3,681,709	3,846,602
Advances from the Federal Home Loan Bank	397,884	394,855	398,181
Repurchase agreements and other borrowings	37,202	31,571	31,893
Total Borrowings	435,086	426,426	430,074
Other liabilities	96,419	73,693	87,533
TOTAL LIABILITIES	5,037,123	4,181,828	4,364,209
Shareholders' Equity			
Preferred stock: 2,000,000 shares authorized			
0 shares issued at March 31, 2015 and 76,458 shares issued at March 31, 2014 and December 31, 2014	—	76,458	76,458
Common stock, \$1.667 par: 90,000,000 shares authorized			
51,466,606; 35,312,537; and 35,785,679 shares issued at March 31, 2015 and 2014 and December 31, 2014, respectively	85,795	58,866	59,655
Capital surplus	531,483	313,272	317,718
Retained earnings	163,519	135,936	154,655
Common stock issued to deferred compensation trust, at cost			
637,935; 571,101; and 627,730 shares at March 31, 2015 and 2014 and December 31, 2014, respectively	(9,816)	(8,782)	(9,674)
Deferred compensation trust	9,816	8,782	9,674
Accumulated other comprehensive income (loss)	2,359	(112)	458
TOTAL SHAREHOLDERS' EQUITY	783,156	584,420	608,944
Noncontrolling interests	8,424	8,986	9,332
TOTAL EQUITY	791,580	593,406	618,276
TOTAL LIABILITIES AND EQUITY	\$ 5,828,703	\$ 4,775,234	\$ 4,982,485

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED STATEMENTS OF INCOME (unaudited)

(Dollars in thousands, except per share data)

	Three Months Ended March 31,	
	2015	2014
INTEREST INCOME:		
Loans, including fees	\$ 46,145	\$ 38,207
Investment securities	4,533	2,992
Interest-bearing deposits in financial institutions and federal funds sold	125	207
Mortgage loans held for sale	565	428
Total Interest Income	51,368	41,834
INTEREST EXPENSE:		
Deposits	4,424	3,342
Advances from the Federal Home Loan Bank	3,374	3,285
Repurchase agreements and other borrowings	14	15
Total Interest Expense	7,812	6,642
Net Interest Income	43,556	35,192
PROVISION FOR LOAN LOSSES	323	330
Net Interest Income after Provision for Loan Losses	43,233	34,862
NONINTEREST INCOME:		
Residential mortgage banking income, net	8,443	5,062
Real estate brokerage and property management income, net	3,955	3,292
Insurance commissions and other title fees and income, net	11,049	9,061
Service charges on deposit accounts	2,197	2,131
Credit card merchant fees, net	432	773
Other income	2,691	2,408
Net gain on investment securities	49	2
Total Noninterest Income	28,816	22,729
NONINTEREST EXPENSE:		
Salaries and employee benefits	27,679	23,396
Occupancy expense	4,930	4,176
Furniture and equipment	2,369	2,000
Other expenses	15,462	11,509
Total Noninterest Expense	50,440	41,081
Income before income tax expense and noncontrolling interest	21,609	16,510
Provision for income tax expense	6,385	4,905
Net income	15,224	11,605
Net income attributable to noncontrolling interest	(686)	(474)
Net income attributable to TowneBank	\$ 14,538	\$ 11,131
Preferred stock dividends	13	191
Net income available to common shareholders	\$ 14,525	\$ 10,940
Per common share information		
Basic earnings	\$ 0.29	\$ 0.31
Diluted earnings	\$ 0.29	\$ 0.31
Cash dividends declared	\$ 0.11	\$ 0.10

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)

(Dollars in thousands)

	Three Months Ended	
	March 31,	
	2015	2014
Net income	\$ 15,224	\$ 11,605
Other comprehensive income		
Unrealized gains on securities		
Unrealized holding gains arising during the period	2,914	359
Deferred tax expense	(1,020)	(126)
Realized gains reclassified into earnings	(49)	(2)
Deferred tax benefit	17	1
Net unrealized gains	1,862	232
Defined benefit retirement plan		
Amortization	60	—
Deferred tax expense	(21)	—
Change in defined benefit retirement plan, net of tax	39	—
Other comprehensive income, net of tax	1,901	232
Comprehensive income	\$ 17,125	\$ 11,837

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED STATEMENTS OF CASH FLOW (unaudited)

(Dollars in thousands)

	Three Months Ended March 31,	
	2015	2014
OPERATING ACTIVITIES:		
Net income	\$ 15,224	\$ 11,605
Adjustments to reconcile net income to net cash provided by (used for) operating activities:		
Net amortization of securities	780	775
Investment securities gains	(49)	(2)
Depreciation, amortization, and other intangible amortization	4,002	3,288
Provision for loan losses	323	330
Bank-owned life insurance income	(1,140)	(487)
Deferred income tax benefit	(482)	(83)
Share-based compensation expense	724	580
Originations of mortgage loans held for sale	(294,470)	(185,743)
Proceeds from sales of mortgage loans held for sale	273,886	192,961
Gain on sales of mortgage loans held for sale	(10,876)	(6,321)
Loss on sale and write-down of foreclosed assets	672	45
Changes in:		
Interest receivable	(1,757)	362
Other assets	(35,946)	(4,823)
Interest payable	117	(14)
Other liabilities	(2,010)	(3,603)
Net cash from (used for) operating activities	<u>(51,002)</u>	<u>8,870</u>
INVESTING ACTIVITIES:		
Purchase of available-for-sale securities	(118,892)	(226,598)
Purchase of held-to-maturity securities	(3,060)	(31,792)
Sale of available-for-sale securities	133,313	305
Sale of FHLB stock	8,113	1,082
Proceeds from maturities, calls, and prepayments of available-for-sale securities	43,018	217,638
Proceeds from maturities, calls, and prepayments of held-to-maturity securities	3,190	3,225
Net increase in loans	(37,975)	(34,540)
Purchase of premises and equipment	(2,416)	(2,322)
Proceeds from sales of premises and equipment	122	24
Proceeds from sales of foreclosed assets	1,630	2,862
Cash acquired in acquisitions of business, net of cash consideration paid	248,766	—
Net cash from (used for) investing activities	<u>275,809</u>	<u>(70,116)</u>
FINANCING ACTIVITIES:		
Net change in deposit accounts	(23,931)	114,605
Net change in borrowings	(186,467)	(16,757)
Redemption of preferred stock	(76,458)	—
Distribution of interest in joint ventures	(1,594)	(498)
Proceeds from (payments for) issuance of common stock	527	(190)
Cash dividends paid	(5,674)	(3,723)
Net cash from (used for) financing activities	<u>(293,597)</u>	<u>93,437</u>
Change in cash and cash equivalents	(68,790)	32,191
Cash and cash equivalents at beginning of year	214,005	204,793
Cash and cash equivalents at end of period	<u>\$ 145,215</u>	<u>\$ 236,984</u>
Supplemental cash flow information:		
Cash paid for interest	\$ 7,695	\$ 6,656
Cash paid for income taxes	\$ 1	\$ 116
Noncash financing and investing activities:		
Transfer from loans to foreclosed property	\$ 4,020	\$ 5,230
Sales of foreclosed assets financed by the Company	\$ 567	\$ 696
Net unrealized gains (losses) on available-for-sale securities, net of tax	\$ 1,862	\$ 232
Shares issued for business acquisitions	\$ 238,656	\$ —
Common stock issued in connection with conversion of convertible subordinated capital debentures	\$ —	\$ 80

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

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Item 1. Financial Statements

CONSOLIDATED STATEMENT OF EQUITY

(Dollars in thousands)	Common Shares	Preferred Stock	Common Stock	Capital Surplus	Retained Earnings	Deferred Compensation Trust	Common Stock Issued to Deferred Compensation Trust	Accumulated Other Comprehensive Income (Loss)	Non- controlling Interests	Total
Balance, January 1, 2015	35,785,679	\$ 76,458	\$ 59,655	\$ 317,718	\$ 154,655	\$ 9,674	\$ (9,674)	\$ 458	\$ 9,332	\$ 618,276
Net income	—	—	—	—	14,538	—	—	—	686	15,224
Other comprehensive income, net of taxes	—	—	—	—	—	—	—	1,901	—	1,901
Cash dividends declared on common stock	—	—	—	—	(5,661)	—	—	—	—	(5,661)
Cash dividends declared on preferred stock	—	—	—	—	(13)	—	—	—	—	(13)
Director's deferred compensation	—	—	—	—	—	142	(142)	—	—	—
Distribution of interests in joint ventures	—	—	—	—	—	—	—	—	(1,594)	(1,594)
Redemption of preferred stock	—	(76,458)	—	—	—	—	—	—	—	(76,458)
Issuance of common stock - contingent consideration earned on acquisitions	42,141	—	70	553	—	—	—	—	—	623
Issuance of common stock - acquisitions	15,547,462	—	25,916	212,740	—	—	—	—	—	238,656
Issuance of common stock - stock compensation plans	91,324	—	154	472	—	—	—	—	—	626
Balance, March 31, 2015	51,466,606	\$ —	\$ 85,795	\$ 531,483	\$ 163,519	\$ 9,816	\$ (9,816)	\$ 2,359	\$ 8,424	\$ 791,580

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Basis of Presentation

The accompanying unaudited consolidated financial statements of TowneBank (the “Company”) have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all of the disclosures and notes necessary for a complete presentation of financial position, results of operations and cash flow activity required in accordance with accounting principles generally accepted in the United States of America (“GAAP”). In the opinion of management, the financial statements reflect all adjustments, which are of a normal, recurring nature, that are necessary for a fair presentation for the periods presented as required by Regulation S-X, Rule 10-01 of the Securities and Exchange Commission (the “SEC”). These statements should be read in conjunction with the Company’s 2014 audited Consolidated Financial Statements and the 2014 Annual Report on Form 10-K. Results of operations for the period ended March 31, 2015 are not necessarily indicative of the results of operations for the full year or any other interim periods. To maintain consistency and comparability, certain amounts from prior periods have been reclassified to conform to current period presentation.

Recent accounting pronouncements

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

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

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*. The ASU will supersede most of the existing revenue recognition requirements in U.S. GAAP and will require entities to

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Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

recognize revenue at an amount that reflects the consideration to which the Company expects to be entitled in exchange for transferring goods or services to a customer. The new standard also requires significantly expanded disclosures regarding the qualitative and quantitative information of an entity's nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The pronouncement is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period and is to be applied retrospectively, with early application not permitted. The Company is currently evaluating the impact the pronouncement will have on its consolidated financial statements and related disclosures.

In February 2015, the FASB issued ASU No. 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*. The ASU changes the guidance with respect to the analysis that a reporting entity must perform to determine whether it should consolidate certain types of legal entities. The amendments include: (1) modifying the evaluation of limited partnerships and similar legal entities, (2) amending when fees paid to a decision maker should be included in the variable interest entity analysis, (3) amending the related party relationship guidance, and (4) providing a scope exception from the consolidation guidance for reporting entities with interests in certain investment funds. The ASU is effective for interim and annual reporting periods beginning after December 15, 2015, although early adoption is permitted. The Company is currently assessing the impact of adoption of ASU 2015-02.

Note 2. Earnings per Share and Shareholders' Equity

Earnings per share

Earnings per share are computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share are determined by dividing net income available to common shareholders by the weighted average number of common shares outstanding, assuming all securities that could be converted to common stock have been converted or exercised.

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Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes basic and diluted earnings per share calculations for the periods indicated (dollars in thousands, except per share data):

	Three Months Ended	
	March 31,	
	2015	2014
Basic		
Net income, as reported	\$ 14,538	\$ 11,131
Preferred stock dividends	13	191
Net income available to common shareholders	\$ 14,525	\$ 10,940
Weighted-average common shares outstanding	50,652,963	35,050,526
Basic earnings per share amount	<u>\$ 0.29</u>	<u>\$ 0.31</u>
Diluted		
Net income available to common shareholders, for diluted EPS	\$ 14,525	\$ 10,940
Weighted-average common shares outstanding	50,652,963	35,050,526
Add shares if converted:		
Stock compensation plans, net of tax benefit (1)	71,625	73,517
Weighted-average diluted shares outstanding	50,724,588	35,124,043
Diluted earnings per share amount	<u>\$ 0.29</u>	<u>\$ 0.31</u>

(1) Stock options and restricted stock shares totaling 40,231 and 3,523 were excluded from the computation of diluted earnings per share during the first quarter of 2015 and 2014, respectively, because their inclusion would be anti-dilutive.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 3. Investment Securities

Available-for-sale securities

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

March 31, 2015

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency securities	\$ 537,281	\$ 1,382	\$ (37)	\$ 538,626
Municipal securities	21,274	611	(19)	21,866
Trust preferred and other corporate securities	7,706	787	(2)	8,491
Mortgage-backed securities issued by GSE	200,045	2,243	(63)	202,225
Total available-for-sale securities	<u>\$ 766,306</u>	<u>\$ 5,023</u>	<u>\$ (121)</u>	<u>\$ 771,208</u>

December 31, 2014

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Held-to-maturity securities

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

March 31, 2015

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Trust preferred corporate securities	\$ 500	\$ 254	\$ —	\$ 754
Mortgage-backed securities issued by GSE	28,306	390	—	28,696
Municipal securities	54,945	3,893	—	58,838
Industrial revenue bonds	168,422	8,361	(216)	176,567
Total held-to-maturity securities	<u>\$ 252,173</u>	<u>\$ 12,898</u>	<u>\$ (216)</u>	<u>\$ 264,855</u>

December 31, 2014

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

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Maturities of investment securities

Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The amortized cost and estimated fair value of investment securities are shown by contractual maturity (including mortgage-backed securities) as of March 31, 2015 and December 31, 2014 in the following table (in thousands):

March 31, 2015

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 79,747	\$ 79,873	\$ 17,557	\$ 17,907
Due after one year through five years	449,936	451,265	31,128	32,561
Due after five years through 10 years	56,879	57,347	112,592	116,834
Due after 10 years	178,351	181,330	90,896	97,553
	764,913	769,815	252,173	264,855
Other equity securities	1,393	1,393	—	—
	<u>\$ 766,306</u>	<u>\$ 771,208</u>	<u>\$ 252,173</u>	<u>\$ 264,855</u>

December 31, 2014

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

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Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Unrealized losses

The following table shows the Company's gross unrealized losses and fair values, aggregated by investment category and the length of time that individual securities have been in a continuous unrealized loss position as of March 31, 2015 and December 31, 2014 (in thousands):

March 31, 2015	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Description of Securities						
U.S. Treasury obligations and direct obligations of U.S. government agencies	\$ 10,875	\$ (3)	\$ 39,851	\$ (34)	\$ 50,726	\$ (37)
Municipal securities	2,498	(10)	2,043	(9)	4,541	(19)
Industrial revenue bonds	4,855	(215)	950	(1)	5,805	(216)
Mortgage-backed securities issued by GSE	10,812	(63)	—	—	10,812	(63)
Corporate Obligations	1,991	(2)	—	—	1,991	(2)
Total temporarily impaired securities	<u>\$ 31,031</u>	<u>\$ (293)</u>	<u>\$ 42,844</u>	<u>\$ (44)</u>	<u>\$ 73,875</u>	<u>\$ (337)</u>

December 31, 2014	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Description of Securities						
U.S. Treasury obligations and direct obligations of U.S. government agencies	\$ 176,379	\$ (255)	\$ 70,335	\$ (437)	\$ 246,714	\$ (692)
Municipal securities	5,041	(30)	3,765	(13)	8,806	(43)
Industrial revenue bonds	5,270	(292)	946	(5)	6,216	(297)
Mortgage-backed securities issued by GSE	7,330	(17)	—	—	7,330	(17)
Total temporarily impaired securities	<u>\$ 194,020</u>	<u>\$ (594)</u>	<u>\$ 75,046</u>	<u>\$ (455)</u>	<u>\$ 269,066</u>	<u>\$ (1,049)</u>

U.S. government agency securities

The Company's unrealized losses on obligations of U.S. government agencies were caused by interest rate fluctuations. At March 31, 2015, four securities had unrealized losses of \$0.04 million. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on the credit quality of the issuers, and because it is the Company's intent to hold these securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Municipal securities

The Company's unrealized losses on municipal securities were caused by interest rate fluctuations. At March 31, 2015, four securities had unrealized losses of \$0.02 million. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on the credit quality of the issuers, and because it is the Company's intent to hold these securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

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Government-Sponsored Enterprises (“GSE”) mortgage-backed securities

The Company’s unrealized losses on investments in federal agency mortgage-backed securities were caused by interest rate fluctuations. At March 31, 2015, two securities had unrealized losses of \$0.06 million. The severity and duration of the unrealized loss will fluctuate with interest rates in the economy. Because our mortgage-related securities are backed by FNMA and FHLMC, which are GSEs, or are collateralized by securities backed by these agencies, and because it is the Company’s intent to hold these securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the securities before their anticipated recovery, the Company does not consider this investment other than temporarily impaired.

Trust preferred and other corporate securities

The Company’s unrealized losses on corporate securities were caused by interest rate fluctuations. At March 31, 2015, two corporate securities had unrealized losses of \$2,000. Based on the credit quality of the issuers, and because it is the Company’s intent to hold these securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Industrial revenue bonds

The Company’s unrealized losses on industrial revenue bonds were caused by interest rate fluctuations. At March 31, 2015, two bond issuances had total unrealized losses of \$0.22 million. Based on the credit quality of the issuers, and because it is the Company’s intent to hold these bonds until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the bonds before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Other investments, including common stock

The Company had no unrealized losses in other investments or common stocks at March 31, 2015.

Federal Home Loan Bank of Atlanta (“FHLB”) stock

The Company is required to maintain an investment in the capital stock of the FHLB. The FHLB stock is stated at cost, as this is a restricted security without a readily determinable fair value. The Company had \$22.37 million and \$22.16 million of FHLB stock at March 31, 2015, and December 31, 2014, respectively. Based on the Company’s review of the credit quality of the institution, the institution’s ability to repurchase shares, and the Company’s carrying value in the shares, the Company does not consider this investment other than temporarily impaired.

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Note 4. Loans and Allowance for Loan Losses

The Company grants commercial, real estate, and consumer loans to customers throughout our lending area. Although the Company has a diversified loan portfolio, a substantial portion of the Company's debtors' abilities to honor their contracts is dependent upon the economic environment of the lending area.

Allowance for loan losses

The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the balance sheet date. While portions of the allowance are attributed to specific portfolio segments, the entire allowance is available to absorb credit losses inherent in the total loan portfolio. The Company considers the allowance for loan losses of \$35.91 million adequate to cover estimated loan losses inherent in the loan portfolio at March 31, 2015.

The following table presents, by portfolio segment, the changes in the allowance for loan losses for the three-month periods ended March 31, 2015 and 2014 (in thousands):

Three Months Ended	Construction and Land Development	Commercial Real Estate	Multi- Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
March 31, 2015							
Allowance for loan losses:							
Balance, beginning of period	\$ 5,661	\$ 14,226	\$ 667	\$ 9,121	\$ 4,963	\$ 1,279	\$ 35,917
Provision for loan losses	(64)	862	33	(360)	(385)	237	323
Losses charged off	(51)	(174)	—	(347)	(5)	(13)	(590)
Recoveries	1	13	—	129	85	29	257
Balance, end of period	<u>\$ 5,547</u>	<u>\$ 14,927</u>	<u>\$ 700</u>	<u>\$ 8,543</u>	<u>\$ 4,658</u>	<u>\$ 1,532</u>	<u>\$ 35,907</u>
Three Months Ended							
March 31, 2014							
Allowance for loan losses:							
Balance, beginning of year	\$ 7,925	\$ 13,621	\$ 699	\$ 10,730	\$ 4,711	\$ 694	\$ 38,380
Provision for loan losses	47	383	(175)	85	(203)	193	\$ 330
Losses charged off	(226)	(386)	(1)	(707)	(142)	(164)	\$ (1,626)
Recoveries	22	304	1	60	45	27	\$ 459
Balance, end of period	<u>\$ 7,768</u>	<u>\$ 13,922</u>	<u>\$ 524</u>	<u>\$ 10,168</u>	<u>\$ 4,411</u>	<u>\$ 750</u>	<u>\$ 37,543</u>

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The following table presents, by portfolio segment, the allocation of the allowance for loan losses at March 31, 2015 and December 31, 2014 (in thousands):

	Construction and Land Development	Commercial Real Estate	Multi- Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
March 31, 2015							
Period-end balance allocated to:							
Loans individually evaluated for impairment	\$ 436	\$ 1,079	\$ —	\$ 966	\$ 222	\$ 37	\$ 2,740
Loans collectively evaluated for impairment	5,111	13,848	700	7,577	4,436	1,495	33,167
Balance, end of period	<u>\$ 5,547</u>	<u>\$ 14,927</u>	<u>\$ 700</u>	<u>\$ 8,543</u>	<u>\$ 4,658</u>	<u>\$ 1,532</u>	<u>\$ 35,907</u>
December 31, 2014							
Period-end balance allocated to:							
Loans individually evaluated for impairment	\$ 464	\$ 1,177	\$ —	\$ 1,195	\$ 231	\$ —	\$ 3,067
Loans collectively evaluated for impairment	5,197	13,049	667	7,926	4,732	1,279	32,850
Balance, end of year	<u>\$ 5,661</u>	<u>\$ 14,226</u>	<u>\$ 667</u>	<u>\$ 9,121</u>	<u>\$ 4,963</u>	<u>\$ 1,279</u>	<u>\$ 35,917</u>

The following table presents, by portfolio segment, the Company's investment in loans at March 31, 2015 and December 31, 2014 (in thousands):

	Construction and Land Development	Commercial Real Estate	Multi- Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
March 31, 2015							
Ending balance: individually evaluated for impairment	\$ 10,267	\$ 16,288	\$ 756	\$ 12,123	\$ 519	\$ 70	\$ 40,023
Ending balance: collectively evaluated for impairment	500,003	1,666,314	121,870	877,260	531,312	88,677	3,785,436
Ending balance: loans acquired with deteriorated credit quality	9,120	43,104	23,769	25,822	—	—	101,815
Ending Balance	<u>\$ 519,390</u>	<u>\$1,725,706</u>	<u>\$ 146,395</u>	<u>\$ 915,205</u>	<u>\$ 531,831</u>	<u>\$ 88,747</u>	<u>\$3,927,274</u>
December 31, 2014							
Ending balance: individually evaluated for impairment	\$ 10,924	\$ 19,141	—	\$ 14,379	\$ 674	\$ 41	\$ 45,159
Ending balance: collectively evaluated for impairment	440,663	1,425,888	51,472	819,642	531,987	75,324	3,344,976
Ending balance: loans acquired with deteriorated credit quality	894	2,049	—	3,349	839	—	7,131
Ending Balance	<u>\$ 452,481</u>	<u>\$1,447,078</u>	<u>\$ 51,472</u>	<u>\$ 837,370</u>	<u>\$ 533,500</u>	<u>\$ 75,365</u>	<u>\$3,397,266</u>

Loans acquired in a transfer, including business combinations, where there is evidence of credit deterioration since origination and it is probable at the date of acquisition that we will not collect all contractually required principal and interest payments, are accounted for as purchased impaired loans. Purchased impaired loans are

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initially recorded at fair value, which includes estimated future credit losses expected to be incurred over the life of the loan. Accordingly, the historical allowance for credit losses related to these loans is not carried over.

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

The following table presents the changes in the accretable yield for purchased impaired loans for the three months ended March 31, 2015 and 2014 (in thousands):

	Three Months Ended	
	March 31,	
	2015	2014
Balance at beginning of period	\$ 2,107	\$ 2,800
Additions	42,648	—
Accretion	(1,819)	(176)
Reclassifications from nonaccretable balance, net	3,182	—
Other changes, net	292	—
Balance at end of period	<u>\$ 46,410</u>	<u>\$ 2,624</u>

At March 31, 2015, none of the purchased loans were classified as nonperforming assets. Therefore, interest income, through accretion of the difference between the carrying amount of the loans and the expected cash flows, is being recognized on all purchased loans. Any decreases in cash flows expected to be collected (other than due to decreases in interest rate indices and changes in prepayment assumptions), will be charged to the provision for loan losses, resulting in an increase to the allowance for loan losses.

Portfolio quality indicators

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

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The Company's internally assigned grades are as follows:

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

The following table represents credit exposures by internally assigned grades as of March 31, 2015 and December 31, 2014 (in thousands):

	Construction and Land Development	Commercial Real Estate	Multi- Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
March 31, 2015							
Pass	\$ 492,347	\$ 1,684,356	\$ 141,978	\$ 893,548	\$ 524,611	\$ 88,637	\$ 3,825,477
Special Mention	3,551	21,202	1,213	3,655	3,978	2	33,601
Substandard	23,492	20,148	3,204	18,002	3,242	108	68,196
Doubtful	—	—	—	—	—	—	—
Total	\$ 519,390	\$ 1,725,706	\$ 146,395	\$ 915,205	\$ 531,831	\$ 88,747	\$ 3,927,274
	Construction and Land Development	Commercial Real Estate	Multi- Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
December 31, 2014							
Pass	\$ 431,101	\$ 1,411,831	\$ 47,962	\$ 816,659	\$ 528,610	\$ 75,313	\$ 3,311,476
Special Mention	295	14,222	288	3,658	1,506	4	19,973
Substandard	21,085	21,025	3,222	17,053	3,384	48	65,817
Doubtful	—	—	—	—	—	—	—
Total	\$ 452,481	\$ 1,447,078	\$ 51,472	\$ 837,370	\$ 533,500	\$ 75,365	\$ 3,397,266

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Age analysis of past-due financing receivables by class

The following table includes an aging analysis of the recorded investment of past-due financing receivables as of March 31, 2015 and December 31, 2014. Also included are loans that are 90 days or more past due as to interest and principal and still accruing, because they are (1) well-secured and in the process of collection, or (2) real estate loans or loans exempt under regulatory rules from being classified as nonaccrual.

Purchased impaired loans are included in the aging schedule, but are excluded from the disclosure of accruing loans more than 90 days past due as they are considered to be accruing due to the existence of the accretable yield and not based on consideration given to contractual interest payments (in thousands):

	Loans 30 - 59 Days Past Due	Loans 60 - 89 Days Past Due	Loans 90 or More Days Past Due	Nonaccrual Loans	Total Past Due and Nonaccruing	Current Loans	Total Loans Receivable	Accruing Loans More Than 90 Days Past Due
March 31, 2015								
Construction and land development	\$ 5,809	\$ —	\$ 564	\$ 1,202	\$ 7,575	\$ 511,815	\$ 519,390	\$ —
Commercial real estate	3,381	398	—	2,008	5,787	1,719,919	1,725,706	—
Multifamily real estate	—	—	—	756	756	145,639	146,395	—
1-4 family residential real estate	5,879	3,488	595	2,678	12,640	902,565	915,205	—
Commercial and industrial business loans	421	28	—	401	850	530,981	531,831	—
Consumer loans and other	108	25	3	—	136	88,611	88,747	3
Total	\$ 15,598	\$ 3,939	\$ 1,162	\$ 7,045	\$ 27,744	\$ 3,899,530	\$ 3,927,274	\$ 3
	Loans 30 - 59 Days Past Due	Loans 60 - 89 Days Past Due	Loans 90 or More Days Past Due	Nonaccrual Loans	Total Past Due and Nonaccruing	Current Loans	Total Loans Receivable	Accruing Loans More Than 90 Days Past Due
December 31, 2014								
Construction and land development	\$ 1,735	\$ 19	\$ —	\$ 1,680	\$ 3,434	\$ 449,047	\$ 452,481	\$ —
Commercial real estate	1,552	721	—	2,132	4,405	1,442,673	1,447,078	—
Multifamily real estate	762	—	—	—	762	50,710	51,472	—
1-4 family residential real estate	4,800	3,552	12	2,546	10,910	826,460	837,370	12
Commercial and industrial business loans	234	—	—	383	617	532,883	533,500	—
Consumer loans and other	61	—	—	—	61	75,304	75,365	—
Total	\$ 9,144	\$ 4,292	\$ 12	\$ 6,741	\$ 20,189	\$ 3,377,077	\$ 3,397,266	\$ 12

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The following table includes an aging analysis of the recorded investment of purchased impaired loans as of March 31, 2015, included in the table above (in thousands):

	Loans 30-59 Days Past Due	Loans 60-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due	Current Loans	Total Loans Receivable
March 31, 2015						
Construction and land development	\$ 5,318	\$ —	\$ 564	\$ 5,882	\$ 3,238	\$ 9,120
Commercial real estate	65	46	—	111	42,993	43,104
Multifamily real estate	—	—	—	—	23,769	23,769
1-4 family residential real estate	1,321	2,304	595	4,220	21,602	25,822
Commercial and industrial business loans	—	—	—	—	—	—
Consumer loans and other	—	—	—	—	—	—
Total	\$ 6,704	\$ 2,350	\$ 1,159	\$ 10,213	\$ 91,602	\$ 101,815

Impaired loans

Management considers a loan to be impaired when, based on current information and events, it is determined that the Company will not be able to collect all amounts due according to the loan contract, including scheduled interest payments. Determination of impairment is treated the same across all classes of loans. When management identifies a loan as impaired, the impairment is measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, except when the sole (remaining) source of repayment for the loan is the operation or liquidation of the collateral. In these cases, management uses the current fair value of the collateral, less selling costs when foreclosure is probable, instead of discounted cash flows. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs, and unamortized premium or discount), impairment is recognized as a specific component to be provided for in the allowance for loan losses, or the impaired balance on collateral dependent loans is charged off if it is determined that such amount represents a confirmed loss.

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

Unearned loan income was \$2.54 million in excess of deferred loan costs at March 31, 2015, \$2.52 million at March 31, 2014, and \$2.57 million at December 31, 2014. There were \$7.05 million, \$10.98 million, and \$6.74 million in nonaccrual loans at March 31, 2015, March 31, 2014, and December 31, 2014, respectively. The Company would have earned \$0.81 million in the first quarter of 2015 if interest on the loans had been accrued.

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The following tables include the recorded investment and unpaid principal balances for impaired financing receivables, excluding purchased impaired loans, with the associated allowance amount, if applicable, as of March 31, 2015 and December 31, 2014 (in thousands):

	Unpaid			Average	YTD
	Principal	Recorded	Specific	Recorded	Interest
March 31, 2015	Balance	Balance	Allowance	Investment	Income
					Recognized
Loans without a specific valuation allowance					
Construction and land development	\$ 8,685	\$ 8,670	\$ —	\$ 8,812	\$ 105
Commercial real estate	8,373	8,097	—	8,387	87
Multi-family real estate	756	756	—	757	8
1-4 family residential real estate	4,923	4,677	—	4,940	56
Commercial and industrial business loans	427	297	—	415	2
Consumer loans and other	33	33	—	35	1
Total	\$ 23,197	\$ 22,530	\$ —	\$ 23,346	\$ 259
Loans with a specific valuation allowance					
Construction and land development	\$ 1,905	\$ 1,597	\$ 436	\$ 2,047	\$ 6
Commercial real estate	8,195	8,191	1,079	8,202	76
Multi-family real estate	—	—	—	—	—
1-4 family residential real estate	7,676	7,446	966	7,694	82
Commercial and industrial business loans	248	222	222	253	2
Consumer loans and other	37	37	37	43	4
Total	\$ 18,061	\$ 17,493	\$ 2,740	\$ 18,239	\$ 170
Total impaired loans					
Construction and land development	\$ 10,590	\$ 10,267	\$ 436	\$ 10,859	\$ 111
Commercial real estate	16,568	16,288	1,079	16,589	163
Multi-family real estate	756	756	—	757	8
1-4 family residential real estate	12,599	12,123	966	12,634	138
Commercial and industrial business loans	675	519	222	668	4
Consumer loans and other	70	70	37	78	5
Total	\$ 41,258	\$ 40,023	\$ 2,740	\$ 41,585	\$ 429

Note: Included in the table above are accruing TDRs of \$32.90 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled \$2.29 million.

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

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

Troubled debt restructurings

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

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agreement. All restructured loans are considered impaired in the calendar year of restructuring. Effective January 1, 2015, the Company adopted a policy stating that in subsequent years, a restructured loan may cease being classified as impaired if the loan was modified at a market rate and has performed according to the modified terms for at least six months. The adoption of this policy resulted in a reduction of \$4.74 million in loans designated as TDR and impaired.

The following table shows the loans modified in TDRs for the three months ended March 31, 2015 and 2014 (in thousands, except number of loans):

Three Months Ended March 31, 2015			
	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
1-4 family residential real estate	1	\$ 101	\$ 101
Total	1	\$ 101	\$ 101

Three Months Ended March 31, 2014			
	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
Consumer loans and other	1	\$ 32	\$ 32
Total	1	\$ 32	\$ 32

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

The specific reserve portion of the allowance for loan losses on TDRs is determined by discounting the restructured cash flows at the original effective rate of the loan before modification, or is based on the underlying collateral value less costs to sell, if repayment of the loan is collateral-dependent. If the resulting amount is less than the recorded book value, the Company either establishes a valuation allowance as a component of the allowance for loan losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio. At March 31, 2015, all significant impaired loans have been determined to be collateral-dependent.

Nonaccrual loans

The Company generally places loans on nonaccrual status when the full and timely collection of interest or principal becomes uncertain, part of the principal balance has been charged off and no restructuring has occurred, or the loans reach a certain number of days past due. Commercial loans are placed on nonaccrual status when full collection of principal and interest becomes doubtful, or when any portion of principal or interest becomes 90 days past due, whichever occurs first, unless the debt is both well-secured and in the process of collection. Residential mortgage loans and other consumer loans are placed on nonaccrual status when full collection of principal and interest becomes doubtful, or when any portion of principal or interest becomes 120 days past due, whichever occurs first, unless the debt is both well-secured and in the process of collection. When loans are placed on nonaccrual status, interest receivable is reversed against interest income recognized in the current period, and any prior year unpaid interest is charged off against the

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allowance for loan losses. Interest payments received thereafter are applied as a reduction of the remaining principal balance so long as doubt exists as to the ultimate collection of the principal. Loans are removed from nonaccrual status when they become current as to both principal and interest and when the collection of principal or interest is no longer doubtful. Similarly, mortgage loans and other consumer loans are also placed on nonaccrual status when full collection of principal and interest becomes doubtful, or they become delinquent for a specified period of time.

Note 5. Other Real Estate Owned (“OREO”)

The table below presents a summary of the activity related to OREO for the three months ended March 31, 2015 and 2014 (in thousands):

	Three Months Ended March 31,	
	2015	2014
Beginning balance	\$ 35,115	\$ 39,534
Additions	4,497	5,569
Additions from Franklin Merger	14,955	—
Sales	(2,197)	(3,548)
Valuation allowance	(186)	(300)
Gain (loss) on sale and write-downs, net	(486)	255
Ending balance	<u>\$ 51,698</u>	<u>\$ 41,510</u>

As of March 31, 2015, the Company’s recorded investment in OREO collateralized by residential real estate was \$12.11 million. As of March 31, 2015, the Company’s recorded investment in mortgage loans collateralized by residential real estate that are in the process of foreclosure was \$0.33 million.

Note 6. Segment Reporting

The Company has three reportable segments: Banking, Realty, and Insurance. The Banking segment provides loan and deposit services to retail and commercial customers throughout Richmond, Virginia, the Greater Hampton Roads area in southeastern Virginia, and northeastern North Carolina and includes the operations of TowneBank Commercial Mortgage, LLC and Towne Investment Group. The Realty segment combines the operations of Berkshire Hathaway HomeServices Towne Realty with TowneBank Mortgage: Virginia Home Title and Settlements, LLC; SimonTowne Mortgage, LLC; Towne Mortgage of the Carolinas, LLC; NewTowne Mortgage, LLC; Homesale Mortgage, LLC; and GSH NC Resort Management, LLC, d/b/a Corolla Classic Vacations, to provide residential real estate services, resort property management, originations of a variety of mortgage loans, and commercial and residential title insurance. Mortgage loans are originated and sold principally in the secondary market through purchase commitments from investors. The Insurance segment provides full-service commercial and retail insurance and employee benefit services through Towne Insurance and TFA Benefits.

All the segments are service-based. The Banking segment offers a distribution and referral network for the realty and insurance services, and the Realty and Insurance divisions offer a similar network for the Banking segment, due largely to overlapping geographic markets. A major distinction is the source of income. The

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Realty and Insurance businesses are fee-based, while the Banking segment is driven principally by net interest income.

Segment profit and loss is measured by net income after income tax. Inter-segment transactions are recorded at cost and eliminated as part of the consolidation process. Because of the interrelationships of the various segments, the information presented is not indicative of how the segments would perform if they operated as independent entities.

The following tables provide information about reportable segments and reconciliation of such information to the consolidated financial statements for the periods indicated (dollars in thousands):

Three Months Ended March 31, 2015

	Banking	Realty	Insurance	Consolidated Totals
Net interest income	\$ 43,185	\$ 371	\$ —	\$ 43,556
Provision for loan losses	323	—	—	323
Net interest income after provision for loan losses	42,862	371	—	43,233
Residential mortgage banking income, net	(71)	8,514	—	8,443
Real estate brokerage and property management income, net	—	3,955	—	3,955
Insurance commissions and other title fees and income, net	—	301	10,748	11,049
Other noninterest income	4,898	290	181	5,369
Noninterest expense	32,744	10,436	7,260	50,440
Income before income tax, corporate allocation and noncontrolling interest	14,945	2,995	3,669	21,609
Corporate allocation	292	(132)	(160)	—
Income before income tax provision and noncontrolling interest	15,237	2,863	3,509	21,609
Provision for income tax expense	4,129	960	1,296	6,385
Net income	11,108	1,903	2,213	15,224
Noncontrolling interest	—	(256)	(430)	(686)
Net income attributable to TowneBank	\$ 11,108	\$ 1,647	\$ 1,783	\$ 14,538
Net income as percentage of total	76.41%	11.33%	12.26%	100.00%
Total assets	\$ 5,540,554	\$ 178,956	\$ 109,193	\$ 5,828,703

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Three Months Ended March 31, 2014

	Banking	Realty	Insurance	Consolidated Totals
Net interest income	\$ 34,905	\$ 287	\$ —	\$ 35,192
Provision for loan losses	306	24	—	330
Net interest income after provision for loan losses	34,599	263	—	34,862
Residential mortgage banking income, net	(56)	5,118	—	5,062
Real estate brokerage and property management income, net	—	3,292	—	3,292
Insurance commissions and other title fees and income, net	—	345	8,716	9,061
Other noninterest income	4,740	281	293	5,314
Noninterest expense	26,845	8,922	5,314	41,081
Income before income tax, corporate allocation and noncontrolling interest	12,438	377	3,695	16,510
Corporate allocation	253	(148)	(105)	—
Income before income tax provision and noncontrolling interest	12,691	229	3,590	16,510
Provision for income tax expense	3,654	42	1,209	4,905
Net income	9,037	187	2,381	11,605
Noncontrolling interest	—	(212)	(262)	(474)
Net income (loss) attributable to TowneBank	\$ 9,037	\$ (25)	\$ 2,119	\$ 11,131
Net income as percentage of total	81.19%	(0.22)%	19.03%	100.00%
Total assets	\$ 4,573,814	\$ 118,501	\$ 82,919	\$ 4,775,234

Note 7. Commitments and Contingencies

Commitments to extend credit are agreements to lend to customers provided there are no violations of any conditions set forth in the contracts. Commitments are evaluated on a case-by-case basis based on the customer's creditworthiness. They tend to have fixed expiration dates and may expire without being completely utilized. Therefore, total commitment amounts may not necessarily represent future cash requirements. At March 31, 2015, the amounts of off-balance sheet commitments to extend credit were \$1.38 billion.

Standby letters of credit are written conditional commitments issued by us to guarantee the performance of customers to third parties. The credit risk involved is similar to the risk involved in extending loans to customers. At March 31, 2015, standby letters of credit and financial guarantees were \$33.94 million.

Additionally, the Company had \$16.26 million in mortgage loans sold to investors with various recourse and warranty provisions as of March 31, 2015.

Rate lock commitments, which are designed to mitigate the Company's exposure to fluctuations in interest rates associated with rate lock commitments and loans held for sale, are related to the origination of mortgage loans held for sale and the corresponding loan sale commitments and are considered derivative instruments. Outstanding loan balances under these rate lock commitments totaled \$127.93 million at March 31, 2015. The income statement impact associated with these instruments is recorded in net residential mortgage banking income in the amount of \$1.03 million and an increase of \$0.18 million for the three-month periods ended March 31, 2015 and 2014, respectively.

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Note 8. Mergers and Acquisitions

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

In the merger with Franklin, each outstanding share of common stock of Franklin was converted into the right to receive 1.40 shares of TowneBank common stock. TowneBank issued an aggregate of 15.55 million shares of TowneBank common stock to Franklin stockholders and cash of \$9.90 million to holders of equity awards. Based on the closing price of TowneBank’s common stock on January 2, 2015 of \$15.35 per share, the aggregate consideration paid to Franklin common stockholders and holders of equity awards to acquire Franklin common stock was approximately \$248.56 million.

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

The Franklin merger has been accounted for under the acquisition method of accounting in accordance with Accounting Standards Codification Topic (“ASC”) 805, *Business Combinations*. The assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of the January 2, 2015 merger date. Such fair values are preliminary estimates and are subject to adjustment for up to one year after the merger date or when additional information relative to the closing date fair values becomes available and such information is considered final, whichever is earlier. The application of the acquisition method of accounting resulted in goodwill of approximately \$41.52 million. All of the recognized goodwill is expected to be non-deductible for tax purposes.

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The following table presents the estimated fair values of the assets acquired and liabilities assumed for Franklin as of January 2, 2015 (dollars in thousands):

Fair value of assets acquired:	
Cash and cash equivalents	\$ 260,559
Securities available for sale	222,539
Net loans	492,366
Bank premise and equipment	11,254
OREO, net of valuation allowance	14,955
Core deposit intangible	17
Other assets	89,574
Total assets	<u>\$ 1,091,264</u>
Fair value of liabilities assumed:	
Deposits	\$ 682,947
Long-term borrowings	191,478
Other liabilities	9,800
Total liabilities	<u>\$ 884,225</u>
Net identifiable assets acquired	\$ 207,039
Goodwill	41,517
Net assets acquired	<u>\$ 248,556</u>
Purchase Price:	
Company common shares issued	15,547,627
Purchase price per share of Company's common stock	<u>\$ 15.35</u>
Common stock issued and cash exchanged for fractional shares	<u>\$ 238,656</u>
Cash consideration for stock options paid	9,900
Fair value of total consideration transferred	<u>\$ 248,556</u>

The Company assumed long-term borrowings of \$191.48 million in the form of FHLB advances. On January 5, 2015, the Company repaid the advances in full.

The acquired loans were divided into loans with evidence of credit quality deterioration which are accounted for under ASC 310-30 (purchased impaired) and loans that do not meet this criteria, which are accounted for under ASC 310-20 (purchased performing). As of January 2, 2015, the fair value of the Franklin purchased performing loans acquired was \$390.78 million, the related gross contractual amount was \$557.82 million, and the estimated contractual cash flows not expected to be collected were \$15.27 million.

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The following table presents the acquired impaired loans receivable at the acquisition date (dollars in thousands):

Contractual principal and interest at acquisition	\$ 177,615
Nonaccretable difference	(33,439)
Expected cash flows at acquisition	144,176
Accretable yield	(42,648)
Fair value of loans acquired with a deterioration of credit quality	<u>\$ 101,528</u>

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

(in thousands)	Pro Forma for the Three Months Ended			
	March 31,			
	2015		2014	
Revenues (net interest income plus noninterest income)	\$	72,605	\$	69,658
Net income	\$	14,792	\$	16,163

Insurance Agencies: Effective February 1, 2015, the Company acquired two insurance agencies, Lackey-Saunders Co., Inc. and Gloucester-Southside Insurance Agency, Inc., which were merged with the operations of Towne Insurance Agency (“Towne Insurance”), a wholly-owned subsidiary of TowneBank. The acquisitions were accounted for as business combinations under the acquisition method of accounting, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired businesses are included in the Company’s Consolidated Statements of Income commencing February 1, 2015. The total purchase price for the transactions was \$2.89 million in cash and contingent consideration. The allocation of the purchase price resulted in tangible assets of \$0.24 million, goodwill of \$2.04 million, other intangible assets, including customer lists of \$0.78 million, and assumed liabilities of \$0.17 million.

Beach Properties of Hilton Head: Effective October 1, 2014, the Company acquired Beach Properties of Hilton Head, Inc., an independent resort property management company that was merged with the operations of Towne Vacations, a division of TowneBank’s Realty segment. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired business are

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included in the Company's Consolidated Statements of Income commencing October 1, 2014. The purchase price for the transaction was \$8.60 million in cash and common stock. The allocation of the purchase price resulted in tangible assets of \$3.53 million, goodwill of \$1.52 million, other intangible assets including customer lists of \$5.47 million, and assumed liabilities of \$1.88 million.

Southern Insurance Agency: Effective May 1, 2014, the Company acquired Southern Insurance Agency, Inc., which is affiliated with Towne Insurance. The acquisitions were accounted for as business combinations under the acquisition method of accounting, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired businesses are included in the Company's Consolidated Statements of Income commencing May 1, 2014. The total purchase price for the transactions was \$11.81 million in cash and common stock. The allocation of the purchase price resulted in tangible assets of \$1.22 million, goodwill of \$7.14 million, other intangible assets including customer lists of \$3.90 million, and assumed liabilities of \$0.45 million.

Note 9. Goodwill and Other Intangibles

Goodwill and intangible assets with an indefinite life are subject to impairment testing at least annually or more often if events or circumstances suggest potential impairment. Other acquired intangible assets determined to have a finite life are amortized over their estimated useful life in a manner that best reflects the economic benefits of the intangible asset. Intangible assets with a finite life are periodically reviewed for other than temporary impairment. See *Note 1 – Summary of Significant Accounting Policies* and *Note 7 – Goodwill and Intangible Assets* of the 2014 Annual Report to the Stockholders for more information on the Company's goodwill and other intangibles. The following table presents the gross carrying amount and accumulated amortization for the Company's intangible assets as of the dates indicated (in thousands):

	March 31,				December 31, 2014	
	2015		2014		Carrying Amount	Accumulated Amortization
	Carrying Amount	Accumulated Amortization	Carrying Amount	Accumulated Amortization		
Core deposit intangible	\$ 434	\$ 224	\$ 417	\$ 172	\$ 417	\$ 211
Non-compete agreements	1,431	1,121	1,456	1,310	1,706	1,374
Customer lists	31,795	12,572	21,119	9,815	30,386	11,773
Trade name	211	95	211	53	211	84
Total intangible assets subject to amortization	33,871	14,012	23,203	11,350	32,720	13,442
Contractual agreements	3,231	—	3,231	—	3,231	—
Total intangible assets not subject to amortization	3,231	—	3,231	—	3,231	—
Total intangible assets	\$ 37,102	\$ 14,012	\$ 26,434	\$ 11,350	\$ 35,951	\$ 13,442

Amortization expense for intangible assets was \$845,000 and \$530,000 for the three-month periods ended March 31, 2015 and 2014, respectively.

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Changes in the net carrying amount of goodwill related to each of the Company's segments since December 31, 2014, are as follows (in thousands):

	Banking	Realty	Insurance	Consolidated Totals
Balance, December 31, 2014	\$ 58,884	\$ 17,340	\$ 36,935	\$ 113,159
Additions to goodwill	41,517	—	2,076	43,593
Other adjustments	(236)	—	—	(236)
Balance, March 31, 2015	\$ 100,165	\$ 17,340	\$ 39,011	\$ 156,516

Note 10. Bank-Owned Life Insurance Policies

The total carrying amount of bank-owned life insurance policies ("BOLI") as of March 31, 2015, was \$145.40 million. The Company had \$57.57 million and \$58.72 million of BOLI at March 31, 2014 and December 31, 2014, respectively. The Company recognized BOLI income, included in other noninterest income, of \$1.14 million and \$0.49 million for the three-month periods ended March 31, 2015 and 2014, respectively. The Company has a related retirement plan, implemented in the fourth quarter of 2008, which provides retirement benefits to the executives covered under the plan. Although the retirement plan is technically unfunded, the life insurance policies are available to finance future benefits.

Note 11. Postretirement Benefits

The following table sets forth the Company's periodic postretirement benefit cost for the interim period identified (in thousands):

	Three Months Ended March 31, 2015	Three Months Ended March 31, 2014
Service cost	\$ 366	\$ 396
Interest cost	211	196
Amortization of actuarial loss	60	—
Net periodic postretirement benefit cost	\$ 637	\$ 592

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Note 12. Accumulated Other Comprehensive Income (Loss)

The following table summarizes the components of accumulated other comprehensive income (loss) at March 31, 2015 and 2014 (in thousands), and changes in the three months then ended. The amounts reclassified from accumulated other comprehensive income for the securities available for sale are included in gain on investment securities, net on the consolidated statements of income, while the amounts reclassified from accumulated other comprehensive income for the defined benefit retirement plan are a component of salaries and employee benefits expense on the consolidated statements of income.

	Unrealized Gains (Losses) on Securities (1)	Defined Benefit Retirement Plan (2)	Accumulated Other Comprehensive Income (Loss), Net of Tax
Balance, December 31, 2014	\$ 1,325	\$ (867)	\$ 458
Other comprehensive income before reclassifications	1,894	—	1,894
Amounts reclassified from AOCI	(32)	39	7
Net change	1,862	39	1,901
Balance, March 31, 2015	\$ 3,187	\$ (828)	\$ 2,359

	Unrealized Gains on Securities (a)	Defined Benefit Retirement Plan (b)	Accumulated Other Comprehensive Income (Loss), Net of Tax
Balance, December 31, 2013	\$ (244)	\$ (100)	\$ (344)
Other comprehensive income before reclassifications	233	—	233
Amounts reclassified from AOCI	(1)	—	(1)
Net change	232	—	232
Balance, March 31, 2014	\$ (12)	\$ (100)	\$ (112)

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

(2) For additional information about retirement plans, refer to Note 11.

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Note 13. Other Expenses

The following table shows a summary of other expenses for the three months ended March 31, 2015 and 2014 (in thousands):

	Three Months Ended	
	March 31,	
	2015	2014
Advertising and marketing	\$ 1,780	\$ 1,059
Acquisition-related expenses	415	52
Other	1,725	1,936
Charitable contributions	1,413	778
Outside processing	1,422	863
Professional fees	1,464	1,188
Stationery and supplies	666	441
FDIC and other insurance	1,099	899
Foreclosed property expenses	873	804
Software expense	1,293	981
Telephone and postage	1,227	994
Amortization-intangibles	845	530
Bank franchise tax/SCC fees	629	513
Directors fees and expenses	332	221
Travel/meals/entertainment	279	250
Total other expenses	<u>\$ 15,462</u>	<u>\$ 11,509</u>

Note 14. Variable Interest Entities

In the normal course of business, the Company is involved with various entities that are considered to be Variable Interest Entities (“VIE”). A VIE is an entity that has either a total equity investment that is insufficient to permit the entity to finance its activities without additional subordinated financial support, or whose equity investors lack the characteristics of a controlling financial interest. In accordance with existing accounting guidance, the Company is required to consolidate any VIE of which it is determined to be the primary beneficiary. The primary beneficiary is the entity that has (i) the power to direct the activities of a VIE that most significantly impact the entity’s economic performance, and (ii) the obligation to absorb losses of the entity that could potentially be significant to the VIE, or the right to receive benefits from the entity that could potentially be significant to the VIE. The Company reviews all significant interests in the VIEs it is involved with, including the amounts and types of financial and other support, including equity investments, debt financing, and guarantees. The Company also considers the activities of the VIEs that most significantly impact the VIEs’ economic performance and whether it has control over those activities. To provide the necessary disclosures, similar VIEs are aggregated based on the nature and purpose of the entities.

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Low income housing tax credit partnerships

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

For each of the partnerships, the Company acts strictly in a limited partnership capacity. The Company has determined that it is not the primary beneficiary of these partnerships because it does not have the power to direct the activities of the entity that most significantly impact the entity's economic performance. The Company accounts for its limited partner interests in accordance with the accounting guidance for investments in affordable housing projects. Partnership assets of \$61.33 million, \$58.12 million, and \$59.62 million in these partnerships were not included in the Consolidated Balance Sheets at March 31, 2015, March 31, 2014, and December 31, 2014, respectively. These limited partner interests had carrying values of \$14.86 million, \$15.40 million, and \$15.17 million at March 31, 2015, March 31, 2014, and December 31, 2014, respectively, and are recorded in other assets on the Company's Consolidated Balance Sheets. The Company's maximum exposure to loss for these limited partner investments totaled \$14.86 million, \$15.40 million, and \$15.17 million at March 31, 2015, March 31, 2014, and December 31, 2014, respectively. As of March 31, 2015, the Company has \$9.67 million in funding commitments that are dependent on certain contractual milestones. For the quarter ended March 31, 2015, a tax benefit totaling \$0.32 million, net of amortization expense of \$0.60 million, respectively, was recognized as a component of income tax expense.

Note 15. Fair Value Disclosures

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. A three-level valuation hierarchy was established for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

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

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted prices that are traded less frequently than exchange-traded instruments, and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data.

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Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

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

Securities available for sale: Fair values are based on published market prices or dealer quotes. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Interest Rate Lock Commitments: Interest rate lock commitments, related to the origination of mortgage loans held for sale, are recorded at estimated fair value based on the value of the underlying loan, which in turn is based on quoted prices for similar loans in the secondary market. However, this value is adjusted by a factor which considers the likelihood that the loan in a lock position will ultimately close. This factor, the fall-out rate, is derived from the Company's internal data and is adjusted using significant management judgment. The fall-out rate is largely dependent on the loan processing stage that a loan is currently in and the change in prevailing interest rates from the time of the rate lock. As such, interest rate lock commitments are classified as recurring Level 3. For the three-month periods ended March 31, 2015 and 2014, and the year ended December 31, 2014, the Company used a weighted average fall-out rate of 20%. The carrying value of the interest rate lock commitments was \$1.98 million at March 31, 2015 and \$0.95 million at December 31, 2014.

The following table presents the recorded amount of assets and liabilities measured at fair value on a recurring basis as of March 31, 2015 and December 31, 2014 (in thousands):

	March 31, 2015			
	Level 1	Level 2	Level 3	Total
U.S. agency securities	\$ —	\$ 538,626	\$ —	\$ 538,626
Municipal securities	—	21,866	—	21,866
Mortgage-backed securities issued by GSEs	—	202,225	—	202,225
Trust preferred and other corporate securities	—	8,491	—	8,491
Interest rate lock commitments	—	—	1,980	1,980

	December 31, 2014			
	Level 1	Level 2	Level 3	Total
U.S. agency securities	\$ —	\$ 512,441	\$ —	\$ 512,441
U.S. Treasury notes	—	—	—	—
Municipal securities	—	24,719	—	24,719
Mortgage-backed securities issued by GSEs	—	58,292	—	58,292
Trust preferred and other corporate securities	—	8,456	—	8,456
Interest rate lock commitments	—	—	946	946

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The Company may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with GAAP. These adjustments to fair value usually result from application of lower-of-cost-or-market accounting or write-downs of individual assets. For assets measured at fair value on a nonrecurring basis that were still held in the balance sheet at quarter-end, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related assets at March 31, 2015 and December 31, 2014 (in thousands):

March 31, 2015	Level 1	Level 2	Level 3	Fair Value
Impaired loans	\$ —	\$ —	\$ 14,753	\$ 14,753
Other real estate owned	\$ —	\$ 37,422	\$ 14,276	\$ 51,698
December 31, 2014	Level 1	Level 2	Level 3	Fair Value
Impaired loans	\$ —	\$ —	\$ 16,142	\$ 16,142
Other real estate owned	\$ —	\$ 21,409	\$ 13,706	\$ 35,115

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

Loans: Impaired loans for which repayment of the loan is expected to be provided solely by the value of the underlying collateral are considered collateral-dependent and are valued based on the fair value of such collateral. Collateral values are estimated using inputs based on observable market data or inputs based on customized discounting criteria. In cases where such inputs were unobservable, specifically, discounts applied to appraisal values to adjust such values to current market conditions or to reflect net realizable value, the impaired loan balance is reflected within Level 3 of the hierarchy. These discounts ranged from 2% to 89%, with a weighted average of 32.40%.

Loans held for sale: Loans held for sale are carried at the lower of cost or estimated fair value. Fair values of loans held for sale are based on commitments on hand from investors or, if commitments have not yet been obtained, prevailing market rates.

Foreclosed property: The fair value of foreclosed property is estimated using Level 2 inputs based on observable market data, or Level 3 inputs based on assumptions specific to the individual property. Level 3 inputs typically include unobservable inputs such as management-applied discounts used to further reduce values to a net realizable value, or in situations where our appraisal date predates a likely change in market conditions. These deductions ranged from 6% to 17%, with a weighted average of 11.27%.

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

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

Securities held to maturity: Fair values are based on published market prices or dealer quotes. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. Industrial revenue bonds are classified as Level 3 and, as such, use significant estimates to determine the fair

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value of these securities. The Company values these securities using a discounted cash flow approach based on assumptions that are generally not observable in the current markets.

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

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

Deposits: The fair value of noninterest-bearing deposits and deposits with no defined maturity is estimated by discounting anticipated future cash flows using current borrowing rates. The fair value of certificates of deposit is estimated by discounting future cash flows using current rates at which similar deposits would be made.

Advances from the FHLB: The fair value of advances from the FHLB is determined using the discounted cash flow method with the discount rate being equal to the rate currently offered on similar products.

Repurchase agreements: The carrying amount approximates fair value.

Federal funds purchased: The carrying amount approximates fair value.

Commitments to extend and standby letters of credit: These financial instruments are generally not sold or traded. The estimated fair values of off-balance-sheet credit commitments, including standby letters of credit and guarantees written, are not readily available due to the lack of cost-effective and reliable measurement methods for these instruments.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The levels within the fair value hierarchy and the estimated fair values of our financial instruments required to be disclosed under ASC 825, *Financial Instruments*, as of March 31, 2015 and December 31, 2014 are as follows (in thousands):

	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
March 31, 2015					
Cash and due from banks	\$ 144,215	\$ 144,215	\$ 144,215	\$ —	\$ —
Interest-bearing deposits in financial institutions	1,000	1,000	1,000	—	—
Securities available for sale	771,208	771,208	—	771,208	—
Securities held to maturity	252,173	264,855	—	88,288	176,567
Mortgage loans held for sale	102,850	102,953	—	102,953	—
Net loans	3,891,367	3,985,886	—	—	3,985,886
Interest receivable	14,032	14,032	—	14,032	—
Deposits	4,505,618	4,136,371	—	4,136,371	—
Advances from the Federal Home Loan Bank of Atlanta	397,884	417,144	—	417,144	—
Repurchase agreements and other borrowings	37,202	37,204	—	37,204	—
Interest payable	2,527	2,527	—	2,527	—

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

PART I. FINANCIAL INFORMATION

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

Selected Quarterly Information (unaudited) TOWNEBANK

(Dollars in thousands, except per share data)	First Quarter 2015	Fourth Quarter 2014	Third Quarter 2014	Second Quarter 2014	First Quarter 2014
Results of Operations:					
Interest income	\$ 51,368	\$ 43,843	\$ 43,668	\$ 43,165	\$ 41,834
Interest expense	7,812	6,704	6,801	6,627	6,642
Net interest income	43,556	37,139	36,867	36,538	35,192
Provision for loan losses	323	(1)	996	(833)	330
Net interest income after provision for loan losses	43,233	37,140	35,871	37,371	34,862
Noninterest income:					
Residential mortgage banking income, net	8,443	6,523	7,858	7,735	5,062
Real estate brokerage and property management income, net	3,955	2,450	3,645	3,248	3,292
Insurance commissions and other title fees and income, net	11,049	7,743	8,861	8,893	9,061
Service charges on deposit accounts	2,197	2,288	2,406	2,366	2,131
Credit card merchant fees, net	432	911	927	965	773
Other income	2,691	2,486	2,572	2,139	2,408
Gain (loss) on investment securities	49	—	44	(62)	2
Total noninterest income	28,816	22,401	26,313	25,284	22,729
Noninterest expense:					
Salaries and benefits	27,679	25,205	25,080	25,325	23,396
Occupancy expense	4,930	4,676	4,618	4,393	4,176
Furniture and equipment	2,369	2,103	2,040	2,040	2,000
Other expenses	15,462	16,975	12,416	12,910	11,509
Total noninterest expense	50,440	48,959	44,154	44,668	41,081
Income before noncontrolling interest and income tax	21,609	10,582	18,030	17,987	16,510
Provision for income tax expense	6,385	2,798	5,044	5,432	4,905
Net income	15,224	7,784	12,986	12,555	11,605
Net income from noncontrolling interest	(686)	(549)	(860)	(878)	(474)
Net income attributable to TowneBank	\$ 14,538	\$ 7,235	\$ 12,126	\$ 11,677	\$ 11,131
Net income available to common shareholders	\$ 14,525	\$ 7,044	\$ 11,935	\$ 11,486	\$ 10,940
Per Share Data:					
Net income:					
Basic	\$ 0.29	\$ 0.20	\$ 0.34	\$ 0.33	\$ 0.31
Diluted	0.29	0.20	0.34	0.33	0.31
Book value at period end	15.22	14.88	14.85	14.63	14.38
Tangible book value at period end	11.73	11.09	11.21	10.96	11.00
Cash dividends declared	0.11	0.11	0.11	0.11	0.10
Common Stock Closing Price:					
High	16.38	15.83	16.46	16.47	15.97
Low	14.28	13.51	13.58	14.85	14.41
Close	16.08	15.12	13.58	15.71	15.51
Selected Financial Ratios (annualized):					
Return on average assets	1.01%	0.57%	0.97%	0.97%	0.96%
Return on average tangible assets	1.08%	0.63%	1.03%	1.03%	0.99%
Return on average equity	7.54%	4.62%	7.86%	7.79%	7.63%
Return on average tangible equity	10.27%	6.35%	10.32%	10.20%	9.57%
Net interest margin (tax-equivalent basis) (1)	3.52%	3.35%	3.32%	3.43%	3.44%
Daily Averages:					
Total assets	\$ 5,829,533	\$ 5,005,112	\$ 4,961,204	\$ 4,810,582	\$ 4,684,881
Total tangible assets	5,642,883	4,868,868	4,831,294	4,683,697	4,565,004
Loans, net of unearned income, excluding nonaccrual loans	3,898,576	3,362,814	3,314,756	3,290,610	3,225,089
Total earning assets (1)	5,290,562	4,610,309	4,558,857	4,413,137	4,301,821
Total deposits	4,504,857	3,864,688	3,838,834	3,705,188	3,583,412
FHLB advances	408,288	398,326	398,620	394,723	394,962
Total equity	781,833	621,579	612,250	601,203	591,688
Tangible equity	595,183	485,335	482,341	474,319	471,811
Basic weighted average shares outstanding	50,652,963	35,400,548	35,271,506	35,207,989	35,050,526
Diluted weighted average shares outstanding	50,724,588	35,458,804	35,311,332	35,237,872	35,124,043

(1) Includes bank-owned life insurance.

PART I. FINANCIAL INFORMATION

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

Our Management's Discussion and Analysis of Financial Condition and Results of Operations is intended to assist readers in understanding and evaluating our consolidated results of operations and financial condition. The following should be read in conjunction with our 2014 audited Consolidated Financial Statements included in our 2014 Annual Report to Stockholders and our 2014 Annual Report on Form 10-K. The financial statements contained in this Form 10-Q have been subject to a review by Dixon Hughes Goodman LLP, independent certified public accountants, as described in their report included as Exhibit 99.

Forward-Looking Statements. *This quarterly report on Form 10-Q contains certain forward-looking statements with respect to our financial condition, results of operations, and business. These forward-looking statements involve certain risks and uncertainties and are based on the beliefs and assumptions of our management. When used in this quarterly report or future regulatory filings, in press releases or other public shareholder communications, or in oral statements made with the approval of an authorized executive officer, the words or phrases "will likely result," "are expected to," "will continue," "is anticipated," "estimate," "project," "believe," or similar expressions are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. We wish to caution the readers and users of this information not to place undue reliance on any such forward-looking statements, which speak only as of the date made, and to advise readers that various factors, including regional and national economic conditions, changes in the levels of market rates of interest, credit risk and lending activities, mergers and acquisitions, competitive and legislative or regulatory factors, and other factors described in our 2014 Annual Report on Form 10-K could affect our financial performance and could cause actual results for future periods to differ materially from those anticipated or projected.*

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

Overview

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

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

The following is a summary of the Company's financial performance in the quarter ended March 31, 2015:

- Net income for the three months ended March 31, 2015 was \$14.54 million, or \$0.29 per common diluted share, compared with \$11.13 million, or \$0.31 per common diluted share in the same period in 2014. Net income available to common shareholders for the first quarter of 2015 was \$14.53 million after preferred dividend payments, compared with \$10.94 million in the same period of 2014.

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- Net interest income increased \$8.36 million, or 23.77%, in the first quarter of 2015 from the comparable period in 2014. The increase was primarily due to a significant increase in average earning assets as a result of the acquisition of Franklin Financial Corporation ("Franklin") in the first quarter of 2015.
- The provision for loan losses was \$0.32 million, essentially unchanged from the comparative three-month period of 2014, and an increase of \$0.32 million from December 31, 2014. The loan loss reserve was 0.91% of total loans at March 31, 2015, down from 1.06% at December 31, 2014, and down from 1.15% at March 31, 2014. The increase in the provision for loan losses in the current quarter from the fourth quarter of the prior year was largely due to loan growth, while the decrease in the loan loss reserve as a percentage of total loans, excluding purchased loans, is consistent with continued improvements in credit quality.
- Excluding gains on investment securities, noninterest income for the three-month period ended March 31, 2015 increased by \$6.04 million, or 26.58%, over the first quarter of 2014, and increased \$6.37 million, or 28.42%, from December 31, 2014. The increase from the comparable three-month period of the prior year was related to an increase in residential mortgage banking income combined with increases in our Insurance segment related to our acquisition of an insurance agency in the second quarter of 2014 and two insurance agencies on February 1, 2015. The increase from the sequential quarter was primarily due to increases in our Insurance segment related to the insurance agency acquisitions in February 2015 and increased contingency commission income. Also contributing was the seasonal effects of our resort property management business and an increase in residential mortgage banking income.
- For the first quarter of 2015, noninterest expense increased \$9.36 million, or 22.78%, respectively, compared to first quarter 2014, and increased \$1.48 million, or 3.02% from December 31, 2014. The increase from prior year comparative periods was primarily driven by increased operating expenses related to the acquisitions of Franklin, the aforementioned insurance agencies, and a resort property management company in the fourth quarter of 2014. The increase in operating expenses from the sequential quarter was partially offset by a decrease in acquisition-related expenses of \$2.69 million.
- Our effective tax rate was 30.52% for the first quarter of 2015, a slight decrease from 30.58% in the comparative period of 2014 and increased from 27.89% in the fourth quarter of 2014. The variance from first quarter of the prior year was primarily a result of an increase in non-taxable income arising from bank-owned life insurance partially offset by a slight increase in nondeductible merger expenses. The increase from the sequential quarter was due to non-recurring severance and merger expenses in fourth quarter 2014, which resulted in a reduction in taxable income subject to the federal statutory rate of 35%. A decrease in nondeductible merger expenses from the linked quarter partially offset the rate increase.

PART I. FINANCIAL INFORMATION

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

Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make judgments, assumptions, and estimates in certain circumstances that affect amounts reported in the consolidated financial statements and the accompanying footnotes. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from management's current judgments. We consider our policies for the allowance for loan losses, other real estate owned, deferred income taxes, estimates of fair value of financial instruments, and goodwill and other intangibles to be critical accounting policies. Refer to our 2014 Annual Report to the Stockholders for further discussion of these policies.

ANALYSIS OF RESULTS OF OPERATIONS

Consolidated Performance Summary

Profitability as measured by our annualized return on average assets ("ROA") was 1.01% for the first quarter of 2015 compared to 0.96% for the first quarter of 2014, and 0.57% for the fourth quarter of 2014. The annualized return on average tangible assets was 1.08%, 0.99%, and 0.63% for the same respective periods. In comparison to both prior year comparative periods, ROA was positively affected by the increase in net income, which outpaced the growth in average assets.

The annualized return on average equity ("ROE") was 7.54% for the first quarter of 2015, 7.63% for the first quarter of 2014, and 4.62% for the fourth quarter of 2014, while the annualized return on average tangible equity was 10.27%, 9.57%, and 6.35% for the same respective periods.

Operating income, calculated as net interest income and noninterest income less gains on investment securities, was \$72.32 million for the quarter ended March 31, 2015, which increased \$14.40 million, or 24.87%, compared to the quarter ended March 31, 2014. Operating income was \$59.54 million for the quarter ended December 31, 2014.

Basic earnings per share were \$0.29 for the three months ended March 31, 2015 compared to \$0.31 in comparative 2014, and \$0.20 for the quarter ended December 31, 2014. Diluted earnings per share for the first quarter of 2015 were \$0.29, \$0.31 for the first quarter of 2014, and \$0.20 for the linked quarter. Earnings per share were affected, as compared to the comparative prior year periods, by the issuance 15.55 million shares of TowneBank common stock related to the acquisition of Franklin on January 2, 2015 and the reduction of preferred dividends related to the redemption in full of \$76.46 million of outstanding Non-Cumulative Convertible Preferred Stock, Series C issued to the U.S. Treasury under the Small Business Lending Fund on January 7, 2015.

Net Interest Income. Net interest income, the major source of our earnings, is the income generated by interest-earning assets reduced by the total interest cost of the funds incurred to carry them. It is impacted by market interest rates and the mix and volume of earning assets and interest-bearing liabilities. The yields and rates in this discussion and in the following tables have been computed based upon interest income and expense adjusted to a fully taxable equivalent basis using a 35% federal marginal tax rate for all periods shown.

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

TowneBank reported net interest income, on a tax-equivalent basis, of \$45.86 million for the quarter ended March 31, 2015, which was \$9.41 million, or 25.81%, higher than the year-ago amount of \$36.45 million. On a linked quarter basis, tax-equivalent net interest income increased by \$6.96 million, or 17.89%, from the \$38.90 million reported for the fourth quarter of 2014. In comparison to the prior year comparative period, net interest income rose primarily due to increased balances of earning assets related to the Franklin merger. Accretion of purchase accounting marks added \$0.78 million, or 8 basis points, to margin in the current quarter.

Interest income, on a tax-equivalent basis, was \$53.67 million for the quarter ended March 31, 2015, which was \$10.58 million, or 24.55%, higher than the \$43.09 million reported for the period ended March 31, 2014. On a linked quarter basis, tax-equivalent interest income increased \$8.07 million, or 17.69%, from \$45.60 million in the fourth quarter of 2014. Average earning assets grew to \$5.29 billion in the quarter ended March 31, 2015, from \$4.30 billion in the comparative prior year quarter, an increase of \$988.74 million, or 22.98%. In the linked quarter comparison, average earning assets increased by \$680.25 million, or 14.76%, from \$4.61 billion in the fourth quarter of 2014. The yield on earning assets was 4.11% in the quarter ended March 31, 2015, which compared to 4.06% in the comparative prior year and 3.92% in the linked period. Average loan balances, excluding nonaccrual loans, of \$3.90 billion were \$673.49 million, or 20.88%, higher in the first quarter of 2015 than in the same period a year ago, while loan yields declined by one basis point. In the linked quarter, loans grew \$535.76 million, or 15.93%, and loan yields were 14 basis points higher. The increase in interest income from comparative prior periods was driven by higher balances of earning assets largely due to the Franklin merger.

Interest expense for the quarter ended March 31, 2015, was \$7.81 million, which was \$1.17 million, or 17.62%, higher than the \$6.64 million amount in the year-ago quarter. The average balance of interest-bearing liabilities increased to \$3.70 billion in the first quarter of 2015 from \$2.98 billion in the comparative prior year quarter, an increase of 23.98%. On a linked quarter basis, interest expense decreased by \$1.11 million, or 16.53%, from \$6.70 million in the fourth quarter of 2014. In the linked quarter, average interest-bearing liabilities increased by \$648.68 million, or 21.29%, from \$3.05 billion in the quarter ended December 31, 2014. The increase in interest expense as compared to the prior year periods was primarily driven by a significant increase in interest-bearing deposits as a result of the Franklin merger combined with slightly higher rates in certificates of deposits and money market funds.

Net interest margin, which is net interest income expressed as a percentage of average earning assets, was 3.52% in the quarter ended March 31, 2015, which was eight basis points higher than the 3.44% margin of the March 31, 2014 quarter and 17 basis points higher than the 3.35% margin of the December 31, 2014 quarter. The margin improvement in comparison to the prior periods was driven by the rise in earning asset yields as loans and investment securities were a higher percentage of interest-earning assets as a result of the Franklin merger.

PART I. FINANCIAL INFORMATION

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

The following tables depict our interest income on earning assets and related average yields, as well as interest expense on interest-bearing liabilities and related average rates paid for the periods presented. Also presented for the three-month periods are the changes in interest income and expense caused by variations in the volume and mix of these assets and liabilities, as well as changes in interest rates when compared to the previous three-month period (dollars in thousands):

	Three Months Ended March 31, 2015			Three Months Ended December 31, 2014			Three Months Ended March 31, 2014		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
Assets:									
Loans (net of unearned income and deferred costs), excluding nonaccrual loans	\$ 3,898,576	\$ 46,160	4.80%	\$ 3,362,814	\$ 39,508	4.66%	\$ 3,225,089	\$ 38,220	4.81%
Taxable investment securities	803,681	3,145	1.57%	714,991	2,178	1.22%	470,029	1,720	1.46%
Tax-exempt investment securities	180,453	1,922	4.26%	176,887	1,919	4.34%	172,205	1,769	4.11%
Interest-bearing deposits	202,852	125	0.25%	227,773	145	0.25%	334,136	206	0.25%
Loans held for sale	64,512	565	3.50%	69,496	652	3.75%	42,849	428	4.00%
Bank-owned life insurance	140,488	1,753	5.06%	58,348	1,200	8.16%	57,514	749	5.28%
Total earning assets	5,290,562	53,670	4.11%	4,610,309	45,602	3.92%	4,301,822	43,092	4.06%
Less: allowance for loan losses	(36,048)			(36,296)			(38,596)		
Total nonearning assets	575,019			431,099			421,655		
Total assets	<u>\$ 5,829,533</u>			<u>\$ 5,005,112</u>			<u>\$ 4,684,881</u>		
Liabilities and Equity:									
Interest-bearing deposits									
Demand and money market	\$ 1,635,454	\$ 1,111	0.28%	\$ 1,344,262	\$ 772	0.23%	\$ 1,258,335	\$ 740	0.24%
Savings	305,016	683	0.91%	303,623	699	0.91%	319,263	725	0.92%
Certificates of deposit	1,308,364	2,630	0.82%	969,091	1,837	0.75%	967,907	1,877	0.79%
Total interest-bearing deposits	3,248,834	4,424	0.55%	2,616,976	3,308	0.50%	2,545,505	3,342	0.53%
Borrowings	447,198	3,388	3.03%	430,374	3,396	3.09%	435,559	3,300	3.03%
Total interest-bearing liabilities	3,696,032	7,812	0.86%	3,047,350	6,704	0.87%	2,981,064	6,642	0.90%
Demand deposits	1,256,025			1,247,712			1,037,907		
Other noninterest-bearing liabilities	95,643			88,471			74,222		
Total liabilities	5,047,700			4,383,533			4,093,193		
Shareholders' equity	781,833			621,579			591,688		
Total liabilities and equity	<u>\$ 5,829,533</u>			<u>\$ 5,005,112</u>			<u>\$ 4,684,881</u>		
Net interest income (tax-equivalent basis)		\$ 45,858			\$ 38,898			\$ 36,451	
Reconciliation of Non-GAAP Financial Measures									
Bank-owned life insurance		(1,753)			(1,200)			(749)	
Tax-equivalent basis adjustment		(549)			(558)			(510)	
Net interest income (GAAP)		<u>\$ 43,556</u>			<u>\$ 37,140</u>			<u>\$ 35,192</u>	
Interest rate spread (1)			3.26%			3.05%			3.16%
Interest expense as a percent of average earning assets			0.60%			0.58%			0.63%
Net interest margin (tax equivalent basis) (2)			3.52%			3.35%			3.44%
Total cost of deposits			0.40%			0.34%			0.38%

- (1) Interest spread is the average yield earned on earning assets less the average rate paid on interest-bearing liabilities. Fully tax equivalent.
- (2) Net interest margin is net interest income expressed as a percentage of average earning assets. Fully tax equivalent.

PART I. FINANCIAL INFORMATION

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

(Dollars in thousands)

	Increase/(Decrease)			Increase/(Decrease)		
	Three Months Ended			Three Months Ended		
	March 31, 2015			March 31, 2015		
	Compared to Three Months Ended			Compared to Three Months Ended		
	December 31, 2014			March 31, 2014		
	Volume	Rate (1)	Total	Volume	Rate (1)	Total
Assets:						
Loans	\$ 5,592	\$ 1,060	\$ 6,652	\$ 8,005	\$ (65)	\$ 7,940
Taxable investment securities	294	673	967	1,294	131	1,425
Tax-exempt investment securities	38	(35)	3	87	66	153
Interest-bearing deposits	(19)	(1)	(20)	(82)	—	(82)
Loans held for sale	(45)	(42)	(87)	196	(59)	137
Bank-owned life insurance	1,138	(585)	553	1,037	(33)	1,004
Total earning assets	6,998	1,070	8,068	10,537	40	10,577
Liabilities and Equity:						
Interest-bearing deposits						
Demand and money market	172	167	339	223	148	371
Savings	(4)	(12)	(16)	(33)	(9)	(42)
Certificates of deposit	640	153	793	604	149	753
Total interest-bearing deposits	808	308	1,116	794	288	1,082
Borrowings	78	(87)	(9)	88	—	88
Total interest-bearing liabilities	886	221	1,107	882	288	1,170
Net interest income	\$ 6,112	\$ 849	\$ 6,961	\$ 9,655	\$ (248)	\$ 9,407

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

Noninterest Income. Total noninterest income, excluding securities gains or losses, for the quarter ended March 31, 2015 was \$28.77 million, an increase of \$6.04 million, or 26.58%, compared to the same period in 2014 and an increase of \$6.37 million, or 28.42%, compared to the fourth quarter of 2014. As a percentage of total operating income, noninterest income, excluding securities gains or losses, for the first quarter of 2015 was 39.78%, compared with 39.24% for comparative 2014 and 37.62% for the fourth quarter of 2014.

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

Our noninterest income primarily consists of fee income produced by our three reportable segments, less applicable commission expenses. The following table provides an analysis of noninterest income for the periods presented (dollars in thousands):

	Three Months Ended March 31,		Increase/(Decrease) 2015 over 2014	
	2015	2014	Amount	Percent
Residential mortgage banking income, net	\$ 8,443	\$ 5,062	\$ 3,381	66.79 %
Real estate brokerage and property management, net	3,955	3,292	663	20.14 %
Insurance commissions and other title fees and income, net	11,049	9,061	1,988	21.94 %
Service charges on deposit accounts	2,197	2,131	66	3.10 %
Credit card merchant fees, net	432	773	(341)	(44.11)%
Other income	2,691	2,408	283	11.75 %
Subtotal before gain on investment securities	28,767	22,727	6,040	26.58 %
Net gain on investment securities	49	2	47	N/M
Total noninterest income	<u>\$ 28,816</u>	<u>\$ 22,729</u>	<u>\$ 6,087</u>	<u>26.78 %</u>

	Three Months Ended		Increase/(Decrease) First Quarter 2015 over Fourth Quarter 2014	
	March 31, 2015	December 31, 2014	Amount	Percent
Residential mortgage banking income, net	\$ 8,443	\$ 6,523	\$ 1,920	29.43 %
Real estate brokerage and property management, net	3,955	2,450	1,505	61.43 %
Insurance commissions and other title fees and income, net	11,049	7,743	3,306	42.70 %
Service charges on deposit accounts	2,197	2,288	(91)	(3.98)%
Credit card merchant fees, net	432	911	(479)	(52.58)%
Other income	2,691	2,486	205	8.25 %
Subtotal before gain on investment securities	28,767	22,401	6,366	28.42 %
Net gain on investment securities	49	—	49	N/M
Total noninterest income	<u>\$ 28,816</u>	<u>\$ 22,401</u>	<u>\$ 6,415</u>	<u>28.64 %</u>

For the first quarter of 2015, residential mortgage banking income, net of commission expense, was \$8.44 million, reflecting an increase of \$3.38 million, or 66.79%, compared to the first quarter of 2014 and an increase of \$1.92 million, or 29.43%, compared to the fourth quarter of 2014. The increase from the prior year periods was primarily due to higher production volumes and improved pricing and margins. Also factoring in the variance from the prior periods was an increase in mortgage banking income of \$1.03 million associated with an increase in the value of rate lock commitments recorded as of March 31, 2015, as compared to a decrease of \$0.32 million and an increase of \$0.18 million recognized for the quarters ended December 31, 2014 and March 31, 2014, respectively.

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Real estate brokerage and property management income, net of commission expense, for first quarter 2015 was \$3.96 million, which was \$0.66 million, or 20.14%, higher than comparative 2014, and \$1.51 million, or 61.43%, higher than fourth quarter 2014. The increase from the comparative three-month 2014 period was primarily a result of an increase in property management fees associated with our purchase of Beach Properties of Hilton Head, Inc. ("Beach Properties") on October 1, 2014, combined with a slight increase in real estate brokerage income. Our North Carolina-based property management business, which was sold to a third party on April 1, 2015, generated \$1.80 million in management fee revenue in first quarter 2015. The increase from the linked quarter was primarily due to the seasonal increase in our resort property management business, partially offset by a slight decrease in real estate brokerage income.

For the first quarter of 2015, insurance commissions and other title income, net of commission expense, was \$11.05 million, which was \$1.99 million, or 21.94%, higher than comparative 2014, and \$3.31 million, or 42.70%, lower than fourth quarter of 2014. The increase from the comparative prior year period was largely due to the acquisition of two insurance agencies in February 2015 and the acquisition of Southern Insurance Agency, Inc. in May 2014, which contributed additional commission and fee income of \$1.05 million in 2015, while the current year acquisitions accounted for additional commission and fee income of \$0.42 million in the comparison to the fourth quarter of 2014. Additionally, the Company recognized an increase in contingency and bonus revenue income of \$2.46 million from the fourth quarter of 2014 as contingent commissions are mostly received during the first quarter of each year. The Company recognized contingency income of \$2.61 million in the first quarter of 2014.

Service charges on deposit accounts were \$2.20 million for the first quarter of 2015, compared with \$2.13 million for the comparative 2014 period, and \$2.29 million for the fourth quarter of 2014, respectively. Decreases in overdraft checking fees from prior year periods mostly offset the increase in average deposits of 25.71% and 16.56% from the first quarter of 2014 and the fourth quarter of 2014, respectively.

For the first quarter of 2015, credit card merchant fees totaled \$0.43 million, which was \$0.34 million, or 44.11%, lower than comparative 2014, and \$0.48 million, or 52.58%, lower than the fourth quarter of 2014. The variances were primarily related to decreased merchant fees related to structural changes in vendor contractual terms and non-recurring expenses related to a platform change. The Company believes the contractual changes will be beneficial in the long-term.

Other noninterest income for the three months ended March 31, 2015 was \$2.69 million and included income generated by Towne Investment Group, net of commission expense. For the three months ended March 31, 2015, net commission income for Towne Investment Group totaled \$692,000 as compared to \$645,000 for the first quarter of 2014 and \$752,000 for the fourth quarter of 2014.

Noninterest Expense. For the quarter ended March 31, 2015, total noninterest expense was \$50.44 million, which was \$9.36 million, or 22.78%, higher than comparative 2014, and \$1.48 million, or 3.02%, higher than the quarter ended December 31, 2014.

As a percentage of operating income, noninterest expense was 69.74% for the first quarter of 2015, 70.93% for comparative 2014, and 82.23% for the quarter ended December 31, 2014. The primary components of noninterest expense in the first quarter of 2015 were salaries and employee benefits of \$27.68 million, occupancy expenses of \$4.93 million, furniture and equipment expenses of \$2.37 million, advertising and marketing expenses of \$1.78 million, and professional fees of \$1.46 million. In comparison to the prior year comparative quarter, a significant portion of the increase in total noninterest expense is due to operational expenses related to the Franklin acquisition, which resulted in additional expenses of \$2.88 million.

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Additionally, insurance acquisitions in February 2015 and May 2014, which resulted in additional operational expenses of \$1.46 million and the Beach Properties acquisition in October 2014 contributed \$1.10 million of additional expenses. Merger activities related to the acquisitions of Franklin and the insurance agencies resulted in \$0.42 million of acquisition-related expenses in first quarter 2015 as compared to \$0.05 million in first quarter 2014 and \$3.10 million in fourth quarter 2014. Also contributing to the increase from first quarter 2014 was the opening of a new banking office in the Wards Corner area of Norfolk, Virginia, in June 2014, which resulted in additional noninterest expenses of \$0.25 million.

The following table provides an analysis of quarterly total noninterest expense by line item for the periods presented (dollars in thousands):

	Three Months Ended			Increase/(Decrease)			
	March 31,		December 31,	March 31, 2015 over		March 31, 2015 over	
	March 31,		December 31,	March 31, 2014		December 31, 2014	
	2015	2014	2014	Amount	Percent	Amount	Percent
Salaries and benefits	\$ 27,679	\$ 23,396	\$ 25,205	\$ 4,283	18.31 %	\$ 2,474	9.82 %
Occupancy expense	4,930	4,176	4,676	754	18.06 %	254	5.43 %
Furniture and equipment	2,369	2,000	2,103	369	18.45 %	266	12.65 %
Other							
Advertising and marketing	1,780	1,059	1,484	721	68.08 %	296	19.95 %
Acquisition-related expenses	415	52	3,103	363	698.08 %	(2,688)	(86.63)%
Other	1,725	1,936	1,513	(211)	(10.90)%	212	14.01 %
Charitable contributions	1,413	778	1,049	635	81.62 %	364	34.70 %
Outside processing	1,422	863	942	559	64.77 %	480	50.96 %
Professional fees	1,464	1,188	1,965	276	23.23 %	(501)	(25.50)%
Stationery and supplies	666	441	626	225	51.02 %	40	6.39 %
FDIC and other insurance	1,099	899	1,028	200	22.25 %	71	6.91 %
Foreclosed property expenses	873	804	879	69	8.58 %	(6)	(0.68)%
Software expense	1,293	981	1,304	312	31.80 %	(11)	(0.84)%
Telephone and postage	1,227	994	1,080	233	23.44 %	147	13.61 %
Amortization - intangibles	845	530	829	315	59.43 %	16	1.93 %
Bank franchise tax/SCC fees	629	513	572	116	22.61 %	57	9.97 %
Directors fees and expenses	332	221	301	111	50.23 %	31	10.30 %
Travel/meals/entertainment	279	250	301	29	11.60 %	(22)	(7.31)%
Total other expenses	15,462	11,509	16,976	3,953	34.35 %	(1,514)	(8.92)%
Total noninterest expense	\$ 50,440	\$ 41,081	\$ 48,960	\$ 9,359	22.78 %	\$ 1,480	3.02 %

Salary and benefits expense, the largest portion of noninterest expense, was \$27.68 million, representing 54.88% of total noninterest expense for the quarter ended March 31, 2015, and 56.95% for the three months ended March 31, 2014. Salary and benefits expense increased \$4.28 million, or 18.31%, from the comparative period in 2014 and increased \$2.47 million, or 9.82%, over the fourth quarter of 2014. The increase from first quarter 2014 is primarily due to the addition of staff resulting from the Franklin acquisition, which resulted in an increase of \$1.21 million and expansion of our Insurance and Realty segment businesses, which resulted in an increase of \$1.34 million. Also contributing to the increase were higher employee profit sharing and 401(k) plan expense as the Company did not match employee contributions in 2014. The increase from the linked quarter is due to the Franklin and insurance agency acquisitions combined with increased 401(k) matching and payroll tax expenses. Also contributing to the

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increase was a reversal in fourth quarter 2014 of incentive compensation recorded previously in 2014 of \$0.90 million due to a slowing of results in the fourth quarter, primarily in acquisition and severance costs. The linked quarter increase was partially offset by severance-related costs of \$2.53 million in fourth quarter 2014.

In our Banking segment we had a total of 704 full-time equivalent employees ("FTE") at March 31, 2015, which was up from 631 at March 31, 2014, and 622 at December 31, 2014. In our non-Banking segments at March 31, 2015, we had a total of 749 FTEs, excluding real estate sales agents, which was up from 680 at March 31, 2014, and 722 at December 31, 2014. Real estate sales agents are independent contractors and, therefore, not included as our employees. Total operating income per FTE was \$50,000 for the quarter ended March 31, 2015, increased from \$44,000 for the three-month period ended March 31, 2014, and increased from \$44,000 for the three-month period ended December 31, 2014.

Occupancy expense for the first quarter of 2015 experienced a \$0.75 million, or 18.06%, increase from the comparative quarter of 2014, and a \$0.25 million, or 5.43%, increase from the fourth quarter of 2014. The increase from first quarter of the prior year was primarily driven by increases related to the acquisition of Franklin, the Insurance and Realty segment acquisitions, and the opening of a new banking office in Norfolk in June 2014. The increase from the sequential quarter was primarily a result of the Franklin merger.

For the three-month period ended March 31, 2015, furniture and equipment expense increased by \$0.37 million over comparative 2014, and \$0.27 million over the fourth quarter of 2014. Increases from comparative prior year periods were primarily related to facilities acquired in the Franklin acquisition.

Other noninterest expenses for the first quarter of 2015 were \$15.46 million, an increase of \$3.95 million, or 34.35%, while there was a decrease of \$1.51 million, or 8.92%, compared to fourth quarter of 2014. The Franklin merger was the primary driver of increase from first quarter 2014 combined with increased charitable contributions and advertising and marketing expenses. In the linked quarter comparison, the increase in operating expenses related to the Franklin merger was more than offset by the decrease in merger expenses of \$2.69 million.

Provision for Income Taxes. We reported a provision for income tax expense of \$6.39 million, representing an effective tax rate of 30.52%, in the first quarter of 2015. The provision for income tax expense was \$4.91 million for the first quarter of 2014, with an effective rate of 30.58%, and \$2.80 million, with an effective rate of 27.89%, in the fourth quarter of 2014. The variance from first quarter of the prior year was primarily a result of an increase in non-taxable income arising from bank-owned life insurance partially offset by a slight increase in nondeductible merger expenses. The increase from the sequential quarter was due to non-recurring severance and merger expenses in fourth quarter 2014, which resulted in a reduction in taxable income subject to the federal statutory rate of 35%. A decrease in nondeductible merger expenses from the linked quarter partially offset the rate increase.

Segment Performance Summary. Our reportable segments are a traditional full-service community bank, a full-service realty business, and a full-service insurance agency. In this section, we discuss the performance and financial results of our segments. For further financial details, see *Note 6 – Segment Reporting* of the Notes to Consolidated Financial Statements in this report.

Banking Segment. For the three months ended March 31, 2015, the Banking segment represented 76.41%, or \$11.11 million, of our total consolidated net income compared to 81.19%, or \$9.04 million, for comparative 2014.

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Pre-tax earnings for the three months ended March 31, 2015 for the Banking segment were \$15.24 million, increasing \$2.55 million, or 20.06%, from comparative 2014. The increase in earnings from the comparative 2014 quarter was primarily driven by an increase in net interest income of \$8.28 million and other income of \$0.37 million, which was offset by an increase in noninterest expenses of \$5.90 million. The increase in net interest income was primarily a result of additional interest income from earning assets acquired in the Franklin merger, as average loan balances increased \$673.49 million to \$3.90 billion and average investments increased to \$984.13 million from \$642.23 million. An increase in interest expense partially offset this increase as average interest-bearing deposits were higher by \$703.33 million, primarily due to the Franklin merger.

The increase in noninterest expense was due to an increase in salaries and employee benefits of \$2.28 million, an increase in occupancy expense of \$0.57 million, and an increase in other expense of \$2.77 million. The increase is largely due to operational expenses related to the Franklin acquisition, which resulted in additional salary expenses of \$1.21 million, occupancy expenses of \$0.25 million, and other expenses of \$1.19 million. Also contributing to the increase from the first quarter of 2014 were increases in charitable contributions, marketing expenses, and the opening of a new banking office in June 2014.

Pre-tax earnings were up \$5.75 million compared to the linked quarter ended December 31, 2014. The increase in earnings was a result of an overall increase in revenue of \$6.32 million. There was also an increase in the provision for loan losses of \$0.36 million and noninterest expenses of \$0.25 million, which slightly offset the increase. The increase in net interest income of \$6.49 million was primarily due to the increase in earning assets related to the Franklin merger.

The increase in noninterest expense to the linked quarter ended December 31, 2014 was driven by an increase in salaries and employee benefits of \$1.59 million primarily due to the acquired Franklin operations, but was more than offset by a decrease in other expenses of \$1.71 million, as acquisition-related expenses decreased by \$2.83 million.

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The following charts present the revenue and expenses for the Banking segment for the periods presented, as well as changes between periods (dollars in thousands):

	Three Months Ended			Increase/(Decrease)			
	March 31,		December 31, 2014	2015 over 2014		March over December	
	2015	2014		Amount	Percent	Amount	Percent
Net interest income	\$ 43,185	\$ 34,905	\$ 36,700	\$ 8,280	23.72 %	\$ 6,485	17.67 %
Service charges on deposit accounts	2,197	2,131	2,288	66	3.10 %	(91)	(3.98)%
Credit card merchant fees	433	773	911	(340)	(43.98)%	(478)	(52.47)%
Other income	2,148	1,778	1,793	370	20.81 %	355	19.80 %
Net gain on investment securities	49	2	—	47	N/M	49	N/M
Total noninterest income	4,827	4,684	4,992	143	3.05 %	(165)	(3.31)%
Total revenue	48,012	39,589	41,692	8,423	21.28 %	6,320	15.16 %
Provision for loan losses	323	306	(40)	17	5.56 %	363	N/M
Salaries and employee benefits	16,855	14,572	15,268	2,283	15.67 %	1,587	10.39 %
Occupancy expense	3,424	2,856	3,231	568	19.89 %	193	5.97 %
Furniture and equipment	1,842	1,564	1,663	278	17.77 %	179	10.76 %
Other expenses	10,623	7,853	12,336	2,770	35.27 %	(1,713)	(13.89)%
Total noninterest expenses	32,744	26,845	32,498	5,899	21.97 %	246	0.76 %
Income before income tax and corporate allocation	14,945	12,438	9,234	2,507	20.16 %	5,711	61.85 %
Corporate allocation	292	253	257	39	15.42 %	35	13.62 %
Income before income tax provision	15,237	12,691	9,491	2,546	20.06 %	5,746	60.54 %
Provision for income tax expense	4,129	3,654	2,298	475	13.00 %	1,831	79.68 %
Net income	\$ 11,108	\$ 9,037	\$ 7,193	\$ 2,071	22.92 %	\$ 3,915	54.43 %
Efficiency ratio (1)	68.27%	67.81%	77.95%	0.46%	0.68 %	(9.68)%	(12.42)%

(1) Excludes gain on investment securities.

Realty Segment. For the three months ended March 31, 2015, the Realty segment had income before income tax provision and noncontrolling interest of \$2.86 million, as compared to \$0.23 million for the comparative 2014 period, and \$0.20 million for the linked quarter ended December 31, 2014. Total revenue increased to \$13.43 million in the first quarter of 2015 from \$9.30 million in the first quarter of 2014. The \$3.40 million, or 66.35%, increase in residential mortgage banking income was a result of increased production volume and improved pricing combined with an increase in the value of rate lock commitments of \$1.03 million for the quarter ended March 31, 2015, compared to \$0.18 million in the same period of 2014. The increase in property management fees from the first quarter of 2014 was primarily due to our purchase of Beach Properties on October 1, 2014.

Expenses for the Realty segment increased 16.97%, or \$1.51 million, when compared to the same period in 2014, and increased by 5.97%, or \$0.59 million, when compared to the quarter ended December 31, 2014. The increase from first quarter 2014 was primarily due to operating expenses related to Beach Properties operations combined with an expansion of our mortgage processing centers in 2014. The increase in expenses over the linked quarter ended December 31, 2014 was mainly driven by volume and seasonal increases.

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The following charts present the revenue and expenses for the Realty segment for the periods presented (dollars in thousands):

	Three Months Ended			Increase/(Decrease)			
	March 31,		December 31,	March 31, 2015		March 31, 2015	
	March 31,		December 31,	March 31, 2014		December 31, 2014	
	2015	2014	2014	Amount	Percent	Amount	Percent
Residential mortgage banking income, net	\$ 8,514	\$ 5,118	\$ 6,632	\$ 3,396	66.35 %	\$ 1,882	28.38 %
Real estate brokerage income, net	1,266	1,140	1,513	126	11.05 %	(247)	(16.33)%
Title insurance and settlement fees	301	345	314	(44)	(12.75)%	(13)	(4.14)%
Property management fees, net	2,689	2,152	937	537	24.95 %	1,752	186.98 %
Income from unconsolidated subsidiary	125	86	113	39	45.35 %	12	10.62 %
Net interest and other income	536	458	679	78	17.03 %	(143)	(21.06)%
Total revenue	13,431	9,299	10,188	4,132	44.43 %	3,243	31.83 %
Salaries and employee benefits	6,030	5,415	5,505	615	11.36 %	525	9.54 %
Occupancy expense	1,049	942	988	107	11.36 %	61	6.17 %
Furniture and equipment	285	277	266	8	2.89 %	19	7.14 %
Amortization of intangible assets	304	127	303	177	139.37 %	1	0.33 %
Other expenses	2,768	2,161	2,786	607	28.09 %	(18)	(0.65)%
Total expenses	10,436	8,922	9,848	1,514	16.97 %	588	5.97 %
Income before income tax, corporate allocation and noncontrolling interest	2,995	377	340	2,618	694.43 %	2,655	780.88 %
Corporate allocation	(132)	(148)	(140)	16	10.81 %	8	5.71 %
Income before income tax provision and noncontrolling interest	2,863	229	200	2,634	N/M	2,663	N/M
Provision for income tax	960	42	7	918	N/M	953	N/M
Net income	1,903	187	193	1,716	917.65 %	1,710	(886.01)%
Noncontrolling interest	(256)	(212)	(427)	(44)	(20.75)%	171	40.05 %
Net income (loss) attributable to TowneBank	\$ 1,647	\$ (25)	\$ (234)	\$ 1,672	N/M	\$ 1,881	803.85 %
Key data:							
Efficiency ratio	77.70%	95.95%	96.66%	(18.25)%	(19.02)%	(18.96)%	(19.62)%
Number of units sold	736	611	942	125	20.46 %	(206)	(21.87)%
Volume of units sold	\$ 192,861	\$ 165,876	\$ 253,898	\$ 26,985	16.27 %	\$ (61,037)	(24.04)%
Number of real estate agents	381	393	393	(12)	(3.05)%	(12)	(3.05)%
Loans originated, mortgage	\$ 160,872	\$ 82,698	\$ 153,164	\$ 78,174	94.53 %	\$ 7,708	5.03 %
Loans originated, joint venture	157,553	121,069	168,141	36,484	30.13 %	(10,588)	(6.30)%
Total loans originated	\$ 318,425	\$ 203,767	\$ 321,305	\$ 114,658	56.27 %	\$ (2,880)	(0.90)%
Number of loans, mortgage	716	392	631	324	82.65 %	85	13.47 %
Number of loans, joint venture	746	575	798	171	29.74 %	(52)	(6.52)%
Total number of loans	1,462	967	1,429	495	51.19 %	33	2.31 %
Average loan amount, mortgage	\$ 225	\$ 211	\$ 243	\$ 14	6.64 %	\$ (18)	(7.41)%
Average loan amount, joint venture	211	211	211	\$ —	— %	—	— %
Average loan amount	\$ 218	\$ 211	\$ 225	\$ 7	3.32 %	\$ (7)	(3.11)%
Average number of originators, mortgage	68	63	70	5	7.94 %	(2)	(2.86)%
Average number of originators, joint venture	52	60	62	(8)	(13.33)%	(10)	(16.13)%
Average number of originators	120	123	132	(3)	(2.44)%	(12)	(9.09)%

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Mortgage. The loan volume for the combined mortgage operations increased in the quarter ended March 31, 2015 as compared to the same period in 2014. Total loans originated in the first quarter of 2015 were \$318.43 million, a 56.27% increase, or \$114.66 million, from \$203.77 million in the comparative period of 2014. This was a \$2.88 million, or 0.90%, decrease compared to the volume for the quarter ended December 31, 2014. Refinance activity comprised \$76.96 million of loan volume for the quarter ended March 31, 2015, while purchases accounted for the remaining \$241.47 million in loan volume for the quarter. For the quarters ended March 31, 2014 and December 31, 2014, refinance volume was \$28.76 million and \$55.91 million, respectively, while purchase volume was \$175.01 million and \$265.40 million, respectively.

Insurance Segment. The Insurance segment comprises property and casualty and group benefit divisions. The Insurance segment represented 12.26%, or \$1.78 million, of total consolidated net income at March 31, 2015, and 19.03%, or \$2.12 million, at March 31, 2014.

Earnings before income taxes and noncontrolling interests for the three months ended March 31, 2015 were \$3.51 million, decreasing \$0.08 million, or 2.26%, from comparative 2014, and up \$2.62 million or 293.39% from the linked quarter ended December 31, 2014. The primary factors affecting earnings in the aforementioned periods were higher acquisition-related expenses due to the acquisitions of two insurance agencies in first quarter 2015 and one agency in second quarter 2014 and a one-time reclassification of expenses between segments in the prior year.

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The following chart presents the revenue and expenses as well as the changes for the Insurance segment for the periods presented (dollars in thousands):

	Three Months Ended			Increase/(Decrease)			
	March 31,		December 31,	March 31, 2015		March 31, 2015	
	March 31,		December 31,	March 31, 2014		December 31, 2014	
	2015	2014	2014	Amount	Percent	Amount	Percent
Net commission and fee income							
Property and casualty	\$ 6,372	\$ 4,278	\$ 5,548	\$ 2,094	48.95 %	\$ 824	14.85 %
Specialized benefit services	133	133	1,816	—	— %	(1,683)	(92.68)%
Employee benefits	1,853	1,829	136	24	1.31 %	1,717	N/M
Total net commissions and fees	8,358	6,240	7,500	2,118	33.94 %	858	11.44 %
Contingency and bonus revenue	2,523	2,609	66	(86)	(3.30)%	2,457	N/M
Other income	48	160	56	(112)	(70.00)%	(8)	(14.29)%
Total revenues	10,929	9,009	7,622	1,920	21.31 %	3,307	43.39 %
Salaries and employee benefits	4,794	3,409	4,433	1,385	40.63 %	361	8.14 %
Occupancy expense	456	378	456	78	20.63 %	—	— %
Furniture and equipment	242	160	174	82	51.25 %	68	39.08 %
Amortization of intangible assets	526	388	511	138	35.57 %	15	2.94 %
Other expenses	1,242	979	1,039	263	26.86 %	203	19.54 %
Total operating expenses	7,260	5,314	6,613	1,946	36.62 %	647	9.78 %
Income before income tax, corporate allocation and noncontrolling interest	3,669	3,695	1,009	(26)	(0.70)%	2,660	263.63 %
Corporate allocation	(160)	(105)	(117)	(55)	52.38 %	(43)	36.75 %
Income before income tax provision and noncontrolling interest	3,509	3,590	892	(81)	(2.26)%	2,617	293.39 %
Provision for income tax	1,296	1,209	493	87	7.20 %	803	162.88 %
Net income	2,213	2,381	399	(168)	(7.06)%	1,814	454.64 %
Noncontrolling interest	(430)	(262)	(122)	(168)	64.12 %	(308)	252.46 %
Net income attributable to TowneBank	\$ 1,783	\$ 2,119	\$ 277	\$ (336)	(15.86)%	\$ 1,506	543.68 %
Efficiency ratio	66.43%	58.99%	86.76%	7.44%	12.61 %	(20.33)%	(23.43)%

Total revenues for the first quarter of 2015 increased \$1.92 million, or 21.31%, when compared to the same period in 2014, and increased \$3.31 million, or 43.39%, for the three months ended December 31, 2014. The increase from the comparative 2014 period was impacted by the aforementioned insurance agency acquisitions which contributed additional commission and fee income of \$1.47 million for the three-month period. The increase from the acquisitions on a linked quarter basis totaled \$0.42 million. Also contributing to the linked quarter increase was higher contingency and bonus revenue of \$2.46 million. Contingent commissions primarily consist of amounts received from various property and casualty insurance carriers. The carriers use several non-client-specific factors to determine the amount of the contingency payments. Such factors include the aggregate loss performance of insurance policies previously placed and the volume of business, among other things. Such commissions are seasonal in nature and are mostly received during the first quarter of each year.

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Salaries and employee benefits expense increased \$1.39 million, or 40.63%, when comparing the three months ended March 31, 2015 to the same period for 2014. The increase was largely driven by the insurance agency acquisitions, which resulted in additional salaries and employee benefit expenses of \$0.89 million. The increase over the linked quarter of \$0.36 million was primarily due to the most recent acquisitions occurring on February 1, 2015.

Occupancy expense increased \$0.08 million, or 20.63%, when comparing the three months ended March 31, 2015 to the same period for 2014, which was also a result of the acquisitions.

Other expenses also increased as a direct result of the insurance agency acquisitions. The increase for the three months ended March 31, 2015, was \$0.26 million when compared to the same period in 2014, while the increase over the linked quarter was \$0.20 million.

ANALYSIS OF FINANCIAL CONDITION

Overview. At March 31, 2015, total assets were \$5.83 billion, which is \$1.05 billion, or 22.06%, higher than the period-end balance for comparative 2014, and \$846.22 million, or 16.98%, greater than the balance at December 31, 2014. Our loan portfolio, less unearned income and deferred costs, made up 67.38% of our period-end assets and totaled \$3.93 billion at March 31, 2015. Average assets for the quarter ended March 31, 2015 were \$5.83 billion, up \$1.14 billion, or 24.43%, from comparative March 31, 2014, and up \$824.42 million, or 16.47%, from the quarter ended December 31, 2014.

Average earning assets increased \$988.74 million, or 22.98%, from \$4.30 billion for the first quarter of 2014 to \$5.29 billion for the first quarter of 2015. Compared to the fourth quarter of 2014, average earning assets increased \$680.25 million.

Our average total deposits were \$4.50 billion for first quarter 2015, reflecting growth of \$921.45 million, or 25.71%, compared to first quarter 2014. Growth continued in average noninterest-bearing deposits, which increased \$218.12 million, or 21.02%, from March 31, 2014.

Interest-Bearing Deposits in Financial Institutions. Interest-bearing deposits in other banks and federal funds sold are used for daily cash management purposes, management of short-term interest rate opportunities, and liquidity. Interest-bearing deposit balances at March 31, 2015 were \$126.58 million and consisted mainly of overnight deposits with the Federal Reserve Bank of Richmond.

The average balance of interest-bearing deposits in other banks and federal funds sold during the first quarter of 2015 was \$202.85 million, or 3.83%, of average total earning assets compared with \$334.14 million, or 7.77%, of average total earning assets for comparative 2014. For the fourth quarter of 2014, the average balance of interest-bearing deposits in other banks was \$227.77 million, or 4.94%, of average total earning assets.

Securities Available for Sale. Our available-for-sale securities portfolio is reported at fair value, which is determined based on market prices of similar instruments. The available-for-sale securities portfolio was \$771.21 million at March 31, 2015, compared with \$551.80 million at March 31, 2014. The average balance during the first quarter of 2015 was \$693.85 million, compared to the 2014 period average of \$396.68 million, or 13.11% and 9.22% of average earning assets, respectively. During the three months ended March 31, 2015, we had sales, maturities, and calls totaling \$176.28 million in investment securities that were classified as available for sale.

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The securities are held primarily for earnings, liquidity, and asset/liability management purposes and reviewed quarterly for possible other-than-temporary impairments. During this review, we analyze the length of time the fair value has been below cost, the expectation for that security's performance, the creditworthiness of the issuer, and our intent and ability to hold the security to recovery or maturity. These factors are analyzed on an individual basis.

Securities Held to Maturity. Held-to-maturity securities are valued at amortized cost. Securities held to maturity were \$252.17 million at March 31, 2015, and \$232.88 million at March 31, 2014. The average balance during the first quarter of 2015 was \$252.42 million, compared with \$208.84 million in the 2014 period, representing 4.77% and 4.85% of total average earning assets, respectively. These securities are held primarily for yield and pledging purposes. Similar to available-for-sale securities, held-to-maturity securities are reviewed quarterly for possible other-than-temporary impairment.

Loans Held for Sale. At March 31, 2015, we held \$102.85 million in mortgage loans originated and intended for sale in the secondary market, as compared with \$57.75 million at March 31, 2014, and \$71.39 million at December 31, 2014. Average loans held for sale were 1.21% and 1.00% of average earning assets for the quarters ended March 31, 2015 and 2014, respectively. Average loans held for sale were 1.51% of average earning assets for the quarter ended December 31, 2014. The majority of mortgage loans held for sale have been pre-committed to investors, which minimizes our interest rate risk.

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

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

Loan Portfolio. Loans, net of unearned income and deferred costs, were \$3.93 billion at March 31, 2015, which was \$657.91 million, or 20.12%, above the \$3.27 billion reported at March 31, 2014, and \$530.01 million, or 15.60%, above the \$3.40 billion at December 31, 2014. The primary factor that contributed to the increase in loans from the prior year was the Franklin merger, which resulted in \$492.37 million of acquired loans. Also contributing to the increase were the efforts of our loan officers in developing new loan relationships, combined with the support of existing customers and directors. As a percentage of total average earning assets, average loans were 73.69% for the quarter ended March 31, 2015, compared with 74.97% for comparable 2014 and 72.94% for the quarter ended December 31, 2014.

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Allowance for Loan Losses and Asset Quality. The allowance for loan losses is established through a provision for loan losses charged against earnings. The level of the allowance for loan losses is based on management's evaluation of the risk inherent in the loan portfolio at the balance sheet date and changes in the nature and volume of loan activity. This evaluation includes a review of loans for which collection may not be reasonably assured. It considers internal risk grades, the estimated fair value of the underlying collateral, current economic conditions, historical loan loss experience, and other current factors that warrant consideration in determining an adequate allowance.

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

It is our policy to recommend internal risk grades to all loans as a component of the approval process. Based on the size of the loan, senior credit officers, regional credit administrators, and the chief credit officer review the classification to ensure accuracy and consistency of classifications, which are then validated by the internal loan review process. Loan classifications are internally reviewed to determine if any changes in the circumstances of the loan require a different risk grade. To determine the most appropriate risk grade classification for each loan, the credit officers examine the borrower's liquidity level, asset quality, the amount of the borrower's other indebtedness, cash flow, earnings, sources of financing, and existing lending relationships. The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of classified loans.

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

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

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The allowance for loan losses at March 31, 2015, March 31, 2014, and December 31, 2014 was \$35.91 million, \$37.54 million, and \$35.92 million, respectively. The allowance was equal to 0.91% of total loans outstanding at March 31, 2015, compared with 1.15% and 1.06% at March 31, 2014, and December 31, 2014, respectively. Excluding purchased loans, the allowance was equal to 1.05% of loans outstanding at March 31, 2015, compared with 1.16% and 1.07% at March 31, 2014 and December 31, 2014, respectively. We believe the decline in the ratio, excluding purchased loans, is appropriate given continued improvement in the risk profile of our loan portfolio and diversification efforts in the loan portfolio. Reflective of improving credit quality, classified loans, defined as loans in the substandard and doubtful categories, remained low at 1.85% of total loans at March 31, 2015, down from 1.89% at March 31, 2014 and 1.94% at December 31, 2014. Additionally, loans 60 to 89 days past due were \$3.94 million, including purchased impaired loans of \$2.35 million, at March 31, 2015, as compared to \$1.90 million and \$4.29 million at March 31, 2014 and December 31, 2014, respectively, and total past due and nonaccruing loans were to \$27.74 million, including purchased impaired past-due loans of \$10.21 million, at March 31, 2015, from \$24.24 million and \$20.19 million at March 31, 2014, and December 31, 2014, respectively. Also reflecting improvement in our loan portfolio and supporting the adequacy of coverage levels of the allowance for loan losses, the allowance was equal to 5.10x of nonperforming loans at March 31, 2015, compared with 3.42x and 5.33x at March 31, 2014 and December 31, 2015, respectively. Additionally, overall economic conditions and labor market conditions have continued to show improvement. Given the combination of these noted factors, we believe that our allowance for loan losses is adequate to cover loan losses inherent in the loan portfolio at March 31, 2015.

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The following table provides information on activity for the allowance for loan losses and nonperforming assets for the periods presented (dollars in thousands):

	Three Months Ended		
	March 31,		December 31,
	2015	2014	2014
Allowance for loan losses			
Balance beginning of period	\$ 35,917	\$ 38,380	\$ 36,180
Loans charged off:			
Residential 1-4 family	(347)	(707)	(149)
Multifamily	—	(1)	—
Commercial real estate	(174)	(386)	(221)
Construction	(51)	(226)	(147)
Commercial and industrial	(5)	(142)	(181)
Consumer and other	(13)	(164)	(10)
Total	(590)	(1,626)	(708)
Loans recovered:			
Residential 1-4 family	129	60	167
Multifamily	—	1	46
Commercial real estate	13	304	23
Construction	1	22	85
Commercial and industrial	85	45	34
Consumer and other	29	27	91
Total	257	459	446
Net loans charged off	(333)	(1,167)	(262)
Provision for loan losses	323	330	(1)
Balance end of period	<u>\$ 35,907</u>	<u>\$ 37,543</u>	<u>\$ 35,917</u>
Nonperforming assets			
Nonperforming loans	\$ 7,045	\$ 10,977	\$ 6,741
Foreclosed property	51,698	41,511	35,116
Total nonperforming assets	<u>\$ 58,743</u>	<u>\$ 52,488</u>	<u>\$ 41,857</u>
Loans past due 90 days and still accruing interest	<u>\$ 3</u>	<u>\$ 576</u>	<u>\$ 12</u>
Asset Quality Ratios			
Allowance for loan losses to nonperforming loans	5.10x	3.42x	5.33x
Allowance for loan losses to period end loans	0.91%	1.15%	1.06%
Allowance for loan losses to period end loans excluding purchased loans	1.05%	1.16%	1.07%
Nonperforming loans to period end loans	0.18%	0.34%	0.20%
Nonperforming assets to period end assets	1.01%	1.10%	0.84%
Net charge-offs to average loans (annualized)	0.03%	0.15%	0.03%

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Nonperforming assets consist of nonaccrual loans, foreclosed real estate, and other repossessed collateral. It is our policy to place commercial loans on nonaccrual status when full collection of principal and interest becomes doubtful, or when any portion of principal or interest becomes 90 days past due, whichever occurs first, unless the debt is both well-secured and in the process of collection. When loans are placed on nonaccrual status, interest receivable is reversed against interest income recognized in the current period, and any prior year unpaid interest is charged off against the allowance for loan losses. Interest payments received thereafter are applied as a reduction of the remaining principal balance so long as doubt exists as to the ultimate collection of the principal. Loans are removed from nonaccrual status when they become current as to both principal and interest and when the collection of principal or interest is no longer doubtful. Similarly, residential mortgage loans and other consumer loans are also placed on nonaccrual status when full collection of principal and interest becomes doubtful, or when any portion of principal or interest becomes 120 days past due, whichever occurs first, unless the debt is both well-secured and in the process of collection.

At March 31, 2015, we had \$58.74 million in nonperforming assets, which amounted to 1.01% of total assets. Additionally, there were essentially no loans past due 90 days or more that were accruing interest. Nonperforming assets consist of \$7.05 million in nonperforming loans as well as \$51.70 million in foreclosed property. Nonperforming loans increased by \$0.30 million, or 4.5%, from December 31, 2014, as additions to nonaccrual loans during the first quarter of 2015 outpaced transfers to other real estate owned ("OREO"), charge-offs, and payments received. Nonperforming residential loans increased by \$0.13 million, with paydowns of \$0.37 million, transfers to OREO of \$3.0 million, and charge-offs of \$0.34 million. Additionally, new multi-family nonperforming loans increased \$0.76 million. These additions outpaced reductions in nonperforming construction and development loans, which decreased by \$0.48 million, with paydowns of \$0.40 million, charge-offs of \$0.05 million, and transfers to OREO of \$0.02 million. At March 31, 2015, foreclosed property totaled \$51.70 million, an increase from \$35.12 million at December 31, 2014, and an increase from \$41.51 million at March 31, 2014. Included in foreclosed property at March 31, 2015 was OREO of \$14.30 million acquired in the Franklin merger. The five largest foreclosed property developments represented approximately 53% of total foreclosed property at March 31, 2015, with the largest development representing approximately 28%. Foreclosed property consists of 31 residential properties, 40 construction and development properties, and six commercial properties.

At March 31, 2015, loans 60-89 days past due, excluding nonperforming loans, totaled \$3.94 million. Additionally, there are other performing loans, totaling \$26.34 million, that are current but have certain documentation deficiencies or other potential weaknesses that management has determined warrant additional monitoring. All loans in these categories are subject to constant management attention, and their status is reviewed on a regular basis.

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

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At March 31, 2015, nonaccruing TDRs, which are included in nonperforming loans, totaled \$2.29 million, and accruing TDRs totaled \$32.90 million. Nonaccruing loans that are modified can be placed back on accrual status when both principal and interest are current, there is a sustained repayment performance of six months or greater, and it is probable that we will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement. All restructured loans are considered impaired in the calendar year of restructuring. In subsequent years, a restructured loan may cease being classified as impaired if the loan was modified at a market rate and has performed according to the modified terms for at least six months.

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

	March 31, 2015	December 31, 2014
Construction and land development	\$ 1,202	\$ 1,680
Commercial real estate	2,008	2,132
Multi-family real estate	756	—
1-4 family residential real estate	2,678	2,546
Commercial and industrial business loans	401	383
Consumer loans and other	—	—
Total nonperforming loans	<u>\$ 7,045</u>	<u>\$ 6,741</u>

Allocation of the Allowance for Loan Losses. The following table provides a breakdown of the allowance for loan losses among the various loan types as of the dates indicated (in thousands):

	March 31, 2015	March 31, 2014	December 31, 2014
Real estate loans:			
Residential 1-4 family	\$ 8,543	\$ 10,168	\$ 9,121
Commercial	14,927	13,922	14,226
Construction	5,547	7,768	5,661
Multi-family	700	524	667
Total real estate loans	<u>29,717</u>	<u>32,382</u>	<u>29,675</u>
Commercial and industrial loans	<u>4,658</u>	<u>4,411</u>	<u>4,963</u>
Consumer loans and other	<u>1,532</u>	<u>750</u>	<u>1,279</u>
Total	<u>\$ 35,907</u>	<u>\$ 37,543</u>	<u>\$ 35,917</u>

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Deposits. Total deposits at March 31, 2015 were \$4.51 billion, representing an increase of 22.38%, or \$823.91 million, over March 31, 2014, and an increase of \$659.02 million, or 17.13%, compared to December 31, 2014. Overall growth in deposits from the fourth quarter of 2014 is primarily attributed to the Franklin merger, combined with an increase in the Banking segment customer base, and new branch strategies. Total average deposits were \$4.50 billion during the first quarter of 2015, compared to \$3.58 billion during the first quarter of 2014, and \$3.86 billion during the fourth quarter of 2014.

Average noninterest-bearing demand deposits as a percentage of average total deposits were 27.88% during the first quarter of 2015 and 28.96% during the same period in 2014. Average noninterest-bearing demand deposits were 32.28% of average total deposits for the fourth quarter of 2014. The cost of interest-bearing deposits was 0.55% for the first quarter of 2015, compared with 0.53% for the first quarter of 2014, and 0.50% for the fourth quarter of 2014.

The following tables set forth a summary of our various deposit categories and their respective cost rates for the periods presented (dollars in thousands):

		Average Balance/Cost Rate					
		Three Months Ended					
		March 31,				December 31,	
		2015		2014		2014	
Interest-bearing demand and money market accounts	\$	1,635,454	0.28%	\$	1,258,335	0.24%	\$ 1,344,262 0.23%
Regular savings		305,016	0.91%		319,263	0.92%	303,623 0.91%
Certificates of deposit		1,308,364	0.82%		967,907	0.79%	969,091 0.75%
Total interest-bearing		3,248,834	0.55%		2,545,505	0.53%	2,616,976 0.50%
Noninterest-bearing		1,256,025			1,037,907		1,247,712
Total	\$	4,504,859	0.40%	\$	3,583,412	0.38%	\$ 3,864,688 0.34%

The following table provides the average balance and composition of our deposits by major classification for the periods presented (dollars in thousands):

		Average Balance and Composition					
		Three Months Ended					
		March 31,				December 31,	
		2015		2014		2014	
Interest-bearing demand and money market accounts	\$	1,635,454	36.31%	\$	1,258,335	35.12%	\$ 1,344,262 34.78%
Regular savings		305,016	6.77%		319,263	8.91%	303,623 7.86%
Certificates of deposit		1,308,364	29.04%		967,907	27.01%	969,091 25.08%
Total interest bearing		3,248,834	72.12%		2,545,505	71.04%	2,616,976 67.72%
Noninterest-bearing		1,256,025	27.88%		1,037,907	28.96%	1,247,712 32.28%
Total	\$	4,504,859	100.00%	\$	3,583,412	100.00%	\$ 3,864,688 100.00%

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Advances from the Federal Home Loan Bank of Atlanta. Advances from the Federal Home Loan Bank of Atlanta ("FHLB") at March 31, 2015 were \$397.88 million, compared to \$394.85 million at March 31, 2014, and \$398.18 million at December 31, 2014. The average borrowing cost for the first quarter of 2015 was 3.32%, unchanged from the same period in 2014 and the fourth quarter of 2014.

The scheduled maturity dates, call dates, and related fixed interest rates on advances from the FHLB at March 31, 2015, are summarized as follows (dollars in thousands):

Maturity	Interest Rate	Call Date	Outstanding Amount
03/06/2017	4.08%	06/08/2015	\$ 100,000
05/18/2017	4.35%	05/18/2015	80,000
05/18/2017	4.48%	05/18/2015	80,000
01/29/2018	3.05%	—	13,000
01/29/2018	3.05%	—	7,000
09/28/2015	0.55%	—	33,000
09/28/2017	0.95%	—	34,000
09/30/2019	1.44%	—	33,000
06/08/2026	2.38%	—	8,389
11/15/2028	3.43%	—	5,518
12/01/2028	2.83%		3,977
Total FHLB Loans			\$ 397,884

At March 31, 2015, certain residential HELOCS, second mortgages, and commercial mortgages secured by real estate with carrying values of \$707.41 million collateralized the advances from the FHLB. At March 31, 2014, certain loans with carrying values of \$799.88 million collateralized the advances from the FHLB. At December 31, 2014, certain residential HELOCS, second mortgages, and commercial mortgages secured by real estate with carrying values of \$748.86 million collateralized the advances from the FHLB.

In addition to borrowings from the FHLB, we maintain various borrowing arrangements with financial institutions to support liquidity needs. As of March 31, 2015, we had no outstanding balances on these borrowing agreements with other financial institutions. Average total borrowings, including FHLB advances, during the first quarter of 2015 were \$447.20 million, compared with \$435.56 million for the first quarter of 2014, and \$430.37 million for the fourth quarter of 2014, while the average cost of these funds was 3.03%, 3.03%, and 3.09%, respectively.

Common Stock and Dividends. For the high and low prices of our common stock, see *Selected Quarterly Information* on page 40 in this report.

On February 27, 2015, we declared a quarterly shareholder cash dividend of \$0.11 per common share. The dividend was paid on April 10, 2015, to shareholders of record on March 30, 2015.

All dividends paid are limited by the requirement to meet capital guidelines issued by regulatory authorities, and future declarations are subject to financial performance and regulatory requirements.

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

Risk-based capital guidelines for United States banking organizations have been issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (the "FDIC"), and the Office of the Comptroller of the Currency. Per these guidelines, we consider our sources of liquidity to be adequate to meet our estimated needs and have sufficient alternative sources of liquidity to meet our funding commitments and growth plans.

In July 2013, the FDIC and the other federal banking agencies approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (commonly known as Basel III). On January 1, 2015, the Company became subject to the FDIC final rule's revised definitions of regulatory capital, the new minimum regulatory capital ratios, and various regulatory capital adjustments and deductions according to transition provisions and timelines. All banking organizations began calculating standardized total risk-weighted assets on January 1, 2015. A transition period for the capital conservation buffer under Basel III for all banking organizations will begin on January 1, 2016 and end January 1, 2019.

An additional measure of capital adequacy is risk-based capital ratios. Risk-based capital ratios, which include common equity tier I, tier I capital, total capital and leverage capital, are calculated based on Basel III regulatory transitional guidance related to the measurement of capital, risk-weighted assets and average assets. As indicated below, our risk-based capital ratios are 13.09% for common equity tier I, 13.20% for tier I, and 13.96% for total capital, which are well above the required minimums of 4.50%, 6.00%, and 8.00%, respectively. Under the FDIC rules, we are considered "well capitalized" as of March 31, 2015.

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The following table provides information on our risk-based capital position as of the dated indicated (dollars in thousands):

	March 31,		December 31,
	2015	2014	2014
	Basel III	Basel I	Basel I
Tier I Capital:			
Shareholders' equity	\$ 791,580	\$ 593,406	\$ 618,276
Less: goodwill and intangible assets, net of deferred tax	163,454	\$ 117,816	\$ 133,469
AOCI-related adjustments	2,359	\$ (113)	\$ 458
Noncontrolling interests	8,424	N/A	N/A
Total common equity tier I capital	617,343	N/A	N/A
Included noncontrolling interests	5,244	N/A	N/A
Total tier I capital	622,587	475,703	484,349
Tier II Capital:			
Qualifying allowance for loan losses (1)	35,907	37,543	35,917
Total tier II capital	35,907	37,543	35,917
Total Risk-Based Capital	\$ 658,494	\$ 513,246	\$ 520,266
Total assets	\$ 5,828,703	\$ 4,775,234	\$ 4,982,485
Total risk-weighted assets (2)	4,716,018	3,673,660	3,805,569
Average assets for leverage capital purposes	5,666,078	4,567,065	4,871,643
Risk-weighted assets to total assets	80.91%	76.93%	76.38%
Risk-based capital ratios:			
Common equity tier I (4.5% minimum requirement)	13.09%	N/A	N/A
Tier I (6% minimum requirement in 2015, 4% in prior periods)	13.20%	12.95%	12.73%
Total (8% minimum requirement, all periods)	13.96%	13.97%	13.67%
Tier I leverage ratio (4% minimum requirement, all periods)	10.99%	10.42%	9.94%

(1) Limited to 1.25% of risk-weighted assets.

(2) Risk-weighted assets are determined based on the regulatory capital requirements in effect for the periods presented.

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Non-GAAP Reconciliations. The Company presents return on average assets, return on average tangible assets, return on average equity, and return on average tangible equity. Management excludes the balance of average goodwill and other intangible assets from the Company's calculation of return on average tangible assets and return on average tangible equity. This adjustment allows management to review the Company's core operating result and core capital position.

	Three Months Ended March 31,	
	2015	2014
Return on average assets (GAAP basis)	1.01%	0.96%
Impact of excluding average goodwill and other intangibles and amortization	0.07%	0.03%
Return on average tangible assets	1.08%	0.99%

	Three Months Ended March 31,	
	2015	2014
Return on average equity (GAAP basis)	7.54%	7.63%
Impact of excluding average goodwill and other intangibles and amortization	2.73%	1.94%
Return on average tangible equity	10.27%	9.57%

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

	Three Months Ended March 31,	
	2015	2014
Book value (GAAP basis)	\$ 15.22	\$ 14.38
Impact of excluding goodwill and other intangibles and amortization	(3.49)	3.38
Tangible book value	\$ 11.73	\$ 11.00

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Disclosures About Market Risk. Our Asset/Liability Management Committee (“ALCO”) monitors loan, investment, and liability portfolios to ensure comprehensive management of interest rate risk. These portfolios are analyzed for proper fixed-rate and variable-rate mixes under various interest rate scenarios.

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

Market Risk. The effective management of market risk is essential to achieving our strategic objectives. As a financial institution, our most significant market risk exposure is interest rate risk. The primary objective of interest rate risk management is to minimize the effect that changes in interest rates have on net interest income. This is accomplished through active management of asset and liability portfolios with a focus on the strategic pricing of asset and liability accounts and management of appropriate maturity mixes of assets and liabilities. The goal of these activities is the development of appropriate maturity and repricing opportunities in our portfolios of assets and liabilities that will produce consistent net interest income during periods of changing interest rates.

Prudent balance sheet management requires processes that monitor and protect us against unanticipated or significant changes in the level of market interest rates. Net interest income stability should be maintained in changing rate environments by ensuring that interest rate risk is kept to an acceptable level.

The ability to reprice our interest-sensitive assets and liabilities over various time intervals is of critical importance. An asset-sensitive balance sheet structure implies that assets, such as loans and securities, will reprice faster than liabilities; consequently, net interest income should be positively affected in an increasing interest rate environment. Conversely, a liability-sensitive balance sheet structure implies that liabilities, such as deposits, will reprice faster than assets; consequently, net interest income should be positively affected in a decreasing interest rate environment.

Interest Rate Risk. We utilize a variety of measurement techniques to identify and manage our exposure to interest rates. We do not use off-balance sheet financial instruments to manage interest rate sensitivity and net interest income. We do, however, use a variety of traditional and on-balance sheet tools to manage our interest rate risk. Gap analysis, which monitors the “gap” between interest-sensitive assets and liabilities, is one such tool. In addition, we use simulation modeling to forecast future balance sheet and income statement behavior. By studying the effects on net interest income of rising, stable, and falling interest rate scenarios, we can position ourselves to take advantage of anticipated interest rate movement and to protect ourselves from unanticipated rate movements by understanding the dynamic nature of our balance sheet components.

At March 31, 2015, we had \$643.21 million more liabilities than assets subject to repricing within one year and, therefore, were in a liability-sensitive position. This is a one-day position, which is continually

PART I. FINANCIAL INFORMATION

Item 3. Quantitative and Qualitative Disclosures About Market Risk

changing and is not necessarily indicative of our position at any other time. There were no known reported material changes in interest rate risk information from the preceding year-end.

Item 4. Controls and Procedures

Controls and Procedures. As of March 31, 2015, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are adequate and effective.

Management assessed the effectiveness of our internal control over financial reporting as of March 31, 2015. There were no changes that occurred during the period covered by this Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In the ordinary course of operations, we are a party to various legal proceedings. Based upon information currently available, management believes that such legal proceedings, in the aggregate, will not have a material adverse effect on our business, financial condition, or results of operations.

Item 1A. Risk Factors

For information regarding factors that could affect the Company's results of operations, financial condition, or liquidity, see the risk factors discussed in Part I, Item 1A, of TowneBank's 2014 Annual Report on Form 10-K. See also "Forward-Looking Statements," included in Part I, Item 2, of this Quarterly Report on Form 10-Q. There have been no material changes from the risk factors previously disclosed in TowneBank's 2014 Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

Item 6. Exhibits

<u>Exhibit No.</u>	<u>Description</u>
(2.1)	Agreement and Plan of Reorganization, dated as of July 14, 2014, by and among TowneBank, Franklin Financial Corporation and Franklin Federal Savings Bank (incorporated by reference to Exhibit 2.1 to Current Report on Form 8-K filed on July 16, 2014)
(31.1)	Chief Executive Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
(31.2)	Chief Financial Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
(32)	Certification Pursuant to 18 U.S.C. Section 1350 as adopted by Section 906 of the Sarbanes-Oxley Act of 2002
(99)	Independent Accountants' Report by Dixon Hughes Goodman LLP, dated May 11, 2015

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

TOWNEBANK

May 11, 2015

Date

By: /s/ G. Robert Aston, Jr.

G. Robert Aston, Jr.

Chairman of the Board/Chief Executive
Officer

May 11, 2015

Date

By: /s/ Clyde E. McFarland, Jr.

Clyde E. McFarland, Jr.

Senior Executive Vice President/Chief
Financial Officer

CERTIFICATIONS

I, G. Robert Aston, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended March 31, 2015 of TowneBank;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors, and the audit committee of the registrant's board of directors:
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

Exhibit (31.1)

continued

- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

May 11, 2015

Date

/s/ G. Robert Aston, Jr.

G. Robert Aston, Jr.

Chairman of the Board/Chief Executive Officer

A signed original of this written statement required by Section 906 has been provided to TowneBank and will be retained by TowneBank and furnished to the Federal Deposit Insurance Corporation or its staff upon request.

CERTIFICATIONS

I, Clyde E. McFarland, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended March 31, 2015 of TowneBank;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors, and the audit committee of the registrant's board of directors:
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

Exhibit (31.2)

continued

- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

May 11, 2015

Date

/s/ Clyde E. McFarland, Jr.

Clyde E. McFarland, Jr.

Senior Executive Vice President/Chief Financial
Officer

A signed original of this written statement required by Section 906 has been provided to TowneBank and will be retained by TowneBank and furnished to the Federal Deposit Insurance Corporation or its staff upon request.

Exhibit (32)

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED BY
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

Pursuant to 18 U.S.C. §1350, as adopted by §906 of the Sarbanes-Oxley Act of 2002, the undersigned officers of TowneBank do hereby certify, to such officer's knowledge, that:

1. Our Quarterly Report on Form 10-Q for the quarter ended March 31, 2015 (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, our financial condition and result of operations as of and for the period covered by the Report.

May 11, 2015

Date

/s/ G. Robert Aston, Jr.

G. Robert Aston, Jr.

Chairman of the Board/Chief Executive Officer

May 11, 2015

Date

/s/ Clyde E. McFarland, Jr.

Clyde E. McFarland, Jr.

Senior Executive Vice President/Chief Financial
Officer

A signed original of this written statement required by Section 906 has been provided to TowneBank and will be retained by TowneBank and furnished to the Federal Deposit Insurance Corporation or its staff upon request.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and
Shareholders of *TowneBank*

We have reviewed the accompanying consolidated balance sheets of *TowneBank* and subsidiaries (the Company) as of March 31, 2015 and 2014, the related consolidated statement of equity for the three months ended March 31, 2015, and the related consolidated statements of income, comprehensive income and cash flows for the three months ended March 31, 2015 and 2014. This condensed financial information is the responsibility of the Company's management.

We conducted our reviews in accordance with the standards established by the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial information taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying condensed financial information referred to above for it to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) the consolidated balance sheet of *TowneBank* and subsidiaries as of December 31, 2014, and the related consolidated statements of income, comprehensive income, equity, and cash flows for the year then ended (not presented herein); and in our report dated March 13, 2015, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2014, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.



Norfolk, Virginia
May 11, 2015