

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, 2017

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)

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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☒

Non-accelerated filer ☐

(Do not check if a smaller reporting company)

Accelerated filer ☐

Smaller reporting company ☐

Emerging growth company ☐

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

☐

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

Yes ☐ No ☒

The number of shares of the Company's common stock outstanding as of April 28, 2017 was 62,572,033 shares.

TOWNE BANK

TABLE OF CONTENTS

Part I. Financial Information

Item 1.	Financial Statements	
	Consolidated Balance Sheets	3
	March 31, 2017 (unaudited)	
	March 31, 2016 (unaudited)	
	December 31, 2016 (audited)	
	Consolidated Statements of Income	4
	Three Months Ended March 31, 2017 (unaudited)	
	Three Months Ended March 31, 2016 (unaudited)	
	Consolidated Statements of Comprehensive Income	5
	Three Months Ended March 31, 2017 (unaudited)	
	Three Months Ended March 31, 2016 (unaudited)	
	Consolidated Statements of Cash Flow	6
	Three Months Ended March 31, 2017 (unaudited)	
	Three Months Ended March 31, 2016 (unaudited)	
	Consolidated Statement of Equity	7
	Three Months Ended March 31, 2017 (unaudited)	
	Notes to Consolidated Financial Statements	8
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	41
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	70
Item 4.	Controls and Procedures	72

Part II. Other Information

Item 1.	Legal Proceedings	73
Item 1A.	Risk Factors	73
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	75
Item 3.	Defaults Upon Senior Securities	75
Item 4.	Mine Safety Disclosures	75
Item 5.	Other Information	75
Item 6.	Exhibits	75

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

(In thousands, except share data)	March 31,		December 31,
	2017	2016	2016
	(unaudited)		(audited)
ASSETS			
Cash and due from banks	\$ 420,192	\$ 195,161	\$ 130,967
Interest-bearing deposits in financial institutions	5,335	1,006	5,581
Total Cash and Cash Equivalents	425,527	196,167	136,548
Securities available for sale, at fair value	720,667	821,551	812,974
Securities held to maturity, at amortized cost	65,117	66,921	66,490
Federal Home Loan Bank stock, at amortized cost	36,402	23,903	35,937
Total Securities	822,186	912,375	915,401
Mortgage loans held for sale	214,047	97,491	314,117
Loans, net of unearned income and deferred costs:			
Real estate - residential 1-4 family	1,215,278	988,432	1,215,823
Real estate - commercial	2,269,233	1,762,312	2,251,312
Real estate - construction and land development	898,540	635,992	826,027
Real estate - multifamily	236,782	160,246	222,791
Commercial and industrial business	1,086,273	852,005	1,089,539
Consumer and other loans	206,974	153,273	201,729
Loans, net of unearned income and deferred costs	5,913,080	4,552,260	5,807,221
Less: Allowance for loan losses	(43,195)	(37,760)	(42,001)
Net Loans	5,869,885	4,514,500	5,765,220
Premises and equipment, net	198,664	178,154	198,568
Goodwill	264,910	157,659	264,910
Other intangible assets, net	37,052	29,286	37,856
Bank-owned life insurance policies	190,917	150,623	189,499
Other assets	151,598	128,914	151,796
TOTAL ASSETS	\$ 8,174,786	\$ 6,365,169	\$ 7,973,915
LIABILITIES AND EQUITY			
Liabilities			
Deposits:			
Noninterest-bearing demand	\$ 2,052,598	\$ 1,449,660	\$ 1,947,312
Interest-bearing:			
Demand and money market accounts	2,270,025	1,769,414	2,263,894
Savings	320,104	302,373	319,611
Certificates of deposit	1,548,045	1,433,679	1,504,380
Total Deposits	6,190,772	4,955,126	6,035,197
Advances from the Federal Home Loan Bank	687,366	428,940	687,511
Repurchase agreements and other borrowings	35,318	40,235	32,540
Total Borrowings	722,684	469,175	720,051
Other liabilities	160,085	104,865	132,109
TOTAL LIABILITIES	7,073,541	5,529,166	6,887,357
Shareholders' Equity			
Preferred stock:			
Authorized and unissued shares - 2,000,000	—	—	—
Common stock, \$1.667 par: 90,000,000 shares authorized			
62,571,739; 51,680,059; and 62,492,168 shares issued at			
March 31, 2017 and 2016 and December 31, 2016, respectively	104,307	86,151	104,174
Capital surplus	746,289	536,294	745,411
Retained earnings	243,337	204,413	229,503
Common stock issued to deferred compensation trust, at cost			
693,654; 651,379; and 692,431 shares at			
March 31, 2017 and 2016 and December 31, 2016, respectively	(11,294)	(10,288)	(11,168)
Deferred compensation trust	11,294	10,288	11,168
Accumulated other comprehensive income (loss)	(4,173)	17	(3,986)
TOTAL SHAREHOLDERS' EQUITY	1,089,760	826,875	1,075,102
Noncontrolling interests	11,485	9,128	11,456
TOTAL EQUITY	1,101,245	836,003	1,086,558
TOTAL LIABILITIES AND EQUITY	\$ 8,174,786	\$ 6,365,169	\$ 7,973,915

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,	
	2017	2016
INTEREST INCOME:		
Loans, including fees	\$ 64,255	\$ 50,247
Investment securities	3,218	3,464
Interest-bearing deposits in financial institutions and federal funds sold	887	330
Mortgage loans held for sale	1,727	693
Total Interest Income	70,087	54,734
INTEREST EXPENSE:		
Deposits	6,003	5,213
Advances from the Federal Home Loan Bank	3,772	3,163
Repurchase agreements and other borrowings	31	22
Total Interest Expense	9,806	8,398
Net Interest Income	60,281	46,336
PROVISION FOR LOAN LOSSES	2,541	(259)
Net Interest Income after Provision for Loan Losses	57,740	46,595
NONINTEREST INCOME:		
Residential mortgage banking income, net	17,632	7,118
Insurance commissions and other title fees and income, net	14,800	14,033
Real estate brokerage and property management income, net	4,993	4,827
Service charges on deposit accounts	2,472	2,176
Credit card merchant fees, net	1,118	895
Bank owned life insurance	1,474	1,172
Other income	2,397	2,194
Total Noninterest Income	44,886	32,415
NONINTEREST EXPENSE:		
Salaries and employee benefits	40,208	30,187
Occupancy expense	6,684	5,017
Furniture and equipment	3,343	2,357
Other expenses	20,013	14,600
Total Noninterest Expense	70,248	52,161
Income before income tax expense and noncontrolling interest	32,378	26,849
Provision for income tax expense	9,386	8,188
Net income	\$ 22,992	\$ 18,661
Net income attributable to noncontrolling interest	(1,024)	(842)
Net income attributable to TowneBank	\$ 21,968	\$ 17,819
Net income available to common shareholders	\$ 21,968	\$ 17,819
Per common share information		
Basic earnings	\$ 0.35	\$ 0.35
Diluted earnings	\$ 0.35	\$ 0.35
Cash dividends declared	\$ 0.13	\$ 0.12

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,	
	2017	2016
Net income	\$ 22,992	\$ 18,661
Other comprehensive income (loss)		
Unrealized gains on securities		
Unrealized holding gains arising during the period	162	4,480
Deferred tax expense	(57)	(1,568)
Net unrealized gains	105	2,912
Pension and postretirement benefit plans		
Actuarial gains (loss)	(538)	109
Deferred tax benefit (expense)	188	(38)
Amortization of prior service costs	51	38
Deferred tax expense	(18)	(13)
Amortization of net actuarial loss	39	4
Deferred tax expense	(14)	(1)
Change in retirement plans, net of tax	(292)	99
Other comprehensive income (loss), net of tax	(187)	3,011
Comprehensive income	\$ 22,805	\$ 21,672

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)

OPERATING ACTIVITIES:

Net income

Adjustments to reconcile net income to net cash from (used for) operating activities:

Net amortization of securities

Depreciation, amortization, and other intangible amortization

Provision for loan losses

Bank-owned life insurance income

Deferred income tax expense (benefit)

Share-based compensation expense

Originations of mortgage loans held for sale

Proceeds from sales of mortgage loans held for sale

Gain on sales of mortgage loans held for sale

(Gain) loss on sale and write-down of foreclosed assets

Changes in:

Interest receivable

Other assets

Interest payable

Other liabilities

Net cash from operating activities

INVESTING ACTIVITIES:

Purchase of available-for-sale securities

Sale of available-for-sale securities

Proceeds from maturities, calls, and prepayments of available-for-sale securities

Proceeds from maturities, calls, and prepayments of held-to-maturity securities

Net increase in loans

Purchase of premises and equipment

Proceeds from sales of premises and equipment

Proceeds from sales of foreclosed assets

Investment from noncontrolling interest in consolidated joint ventures

Cash acquired in acquisitions of business, net of cash consideration paid

Net cash used for investing activities

FINANCING ACTIVITIES:

Net change in deposit accounts

Net change in borrowings

Distribution of interest in joint ventures

Proceeds from issuance of common stock

Cash dividends paid

Net cash from financing activities

Change in cash and cash equivalents

Cash and cash equivalents at beginning of year

Cash and cash equivalents at end of period

Supplemental cash flow information:

Cash paid for interest

Cash paid for income taxes

Noncash financing and investing activities:

Transfer from loans to foreclosed property

Sales of foreclosed assets financed by the Company

Net unrealized gains on available-for-sale securities, net of tax

Common stock issued in connection with business acquisitions

Common stock issued in connection with conversion of convertible subordinated capital debentures

		Three Months Ended March 31,	
		2017	2016
	\$	22,992	\$ 18,661
		716	677
		5,941	4,253
		2,541	(259)
		(1,474)	(1,172)
		1,574	(129)
		593	443
		(655,459)	(270,877)
		773,304	285,187
		(17,775)	(9,455)
		358	(355)
		739	(4,132)
		(3,642)	9,947
		17	782
		27,510	9,195
		<u>157,935</u>	<u>42,766</u>
		(201,986)	(203,254)
		250	—
		293,078	108,836
		1,319	2,074
		(108,198)	(33,206)
		(4,397)	(7,439)
		224	163
		1,258	4,010
		1,029	—
		—	(5,554)
		<u>(17,423)</u>	<u>(134,370)</u>
		155,574	41,100
		2,634	1,868
		(2,024)	(987)
		417	161
		<u>(8,134)</u>	<u>(6,208)</u>
		<u>148,467</u>	<u>35,934</u>
		288,979	(55,670)
		<u>136,548</u>	<u>251,837</u>
	\$	<u>425,527</u>	\$ <u>196,167</u>
	\$	9,788	\$ 2,298
	\$	17	\$ 14
	\$	992	\$ 1,406
	\$	—	\$ 2,918
	\$	105	\$ 2,912
	\$	—	\$ 720
	\$	1	\$ 1

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED STATEMENT OF EQUITY

(Dollars in thousands)	Common Shares	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, 2017	62,492,168	\$ 104,174	\$ 745,411	\$ 229,503	\$ 11,168	\$ (11,168)	\$ (3,986)	\$ 11,456	\$ 1,086,558
Net income	—	—	—	21,968	—	—	—	1,024	22,992
Other comprehensive loss, net of taxes	—	—	—	—	—	—	(187)	—	(187)
Cash dividends declared on common stock	—	—	—	(8,134)	—	—	—	—	(8,134)
Investment of noncontrolling interest in consolidated joint ventures	—	—	—	—	—	—	—	1,029	1,029
Director's deferred compensation	—	—	—	—	126	(126)	—	—	—
Distribution of interests in joint ventures	—	—	—	—	—	—	—	(2,024)	(2,024)
Conversion of convertible debt into common stock	69	—	1	—	—	—	—	—	1
Issuance of common stock - net contingent consideration earned on acquisitions	15,208	26	448	—	—	—	—	—	474
Issuance of common stock - stock compensation plans	64,294	107	429	—	—	—	—	—	536
Balance, March 31, 2017	62,571,739	\$ 104,307	\$ 746,289	\$ 243,337	\$ 11,294	\$ (11,294)	\$ (4,173)	\$ 11,485	\$ 1,101,245

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 2016 audited Consolidated Financial Statements and the 2016 Annual Report on Form 10-K. Results of operations for the three-month period ended March 31, 2017, are not necessarily indicative of the results of operations for the full year or any other interim periods.

Recent accounting pronouncements

In January 2016, the Financial Accounting Standards Board (the “FASB”) issued Accounting Standards Update (“ASU”) No. 2016-01, *Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. The ASU amends the Financial Instruments topic of the ASC to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendments will be effective for interim and annual reporting periods beginning after December 15, 2017. The Company will apply the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values will be applied prospectively to equity investments that exist as of the date of adoption of the amendments. The Company is currently evaluating the impact the pronouncement will have on its Consolidated Financial Statements, but does not expect the adoption of this guidance to have a material impact.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. The ASU was issued in order to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet for those leases classified as operating leases under previous GAAP. The ASU requires that a lessee should recognize a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term on the balance sheet. The ASU is effective for interim and annual periods beginning after December 15, 2018, using a modified retrospective approach, and early adoption is permitted. The Company is currently evaluating the impact the pronouncement will have on its Consolidated Financial Statements.

In March 2016, the FASB issued ASU No. 2016-09, *Improvements to Employee Share-Based Payment Accounting*. The ASU amends Accounting Standards Codification (“ASC”) Topic 718, *Compensation – Stock Compensation*. The ASU simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The ASU is effective for interim and annual periods beginning after December 15, 2016, and early adoption was permitted. The Company adopted the accounting standard during the first quarter of 2017 and recognized a \$0.49 million reduction in income taxes for the excess tax benefits on stock-based compensation.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In June 2016, the FASB issued No. ASU 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The ASU was issued to change the accounting for credit losses and modify the impairment model for certain debt securities. The ASU is effective for the Company for interim and annual periods beginning after December 15, 2019. The Company is currently evaluating the effect that implementation of the new standard will have on its Consolidated Financial Statements.

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The ASU was issued with the intent to simplify goodwill impairment testing by eliminating the second step of the analysis under which the implied fair value of goodwill is determined as if the reporting unit were being acquired in a business combination. The update instead requires entities to compare the fair value of a reporting unit with its carrying amount and recognize an impairment charge for any amount by which the carrying amount exceeds the reporting unit's fair value, to the extent that the loss recognized does not exceed the amount of goodwill allocated to that reporting unit. ASU 2017-04 must be applied prospectively and is effective for the Company on January 1, 2020. Early adoption is permitted. The Company does not expect the new guidance to have a material impact on its Consolidated Financial Statements.

In March 2017, the FASB issued ASU No. 2017-08, *Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities*. The ASU shortens the amortization period for certain callable debt securities held at a premium. Specifically, the update requires the premium to be amortized to the earliest call date. The ASU does not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The ASU should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company is currently evaluating the effect that implementation of the new standard will have on its Consolidated Financial Statements.

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.

TOWNE BANK

PART I. FINANCIAL INFORMATION

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,	
	2017	2016
Basic		
Net income available to common shareholders	\$ 21,968	\$ 17,819
Weighted-average common shares outstanding	62,075,983	51,290,010
Basic earnings per common share	\$ 0.35	\$ 0.35
Diluted		
Net income available to common shareholders, for diluted EPS	\$ 21,968	\$ 17,819
Weighted-average common shares outstanding	62,075,983	51,290,010
Effect of dilutive securities:		
Stock compensation plans, net of tax benefit (1)	186,806	102,847
Weighted-average diluted shares outstanding	62,262,789	51,392,857
Diluted earnings per common share	\$ 0.35	\$ 0.35

(1) Stock options and restricted stock shares totaling 36,960 and 13,154 were excluded from the computation of diluted earnings per share during the first quarter of 2017 and 2016, respectively, because their inclusion would be anti-dilutive.

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, 2017

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency securities	\$ 268,460	\$ 81	\$ (1,328)	\$ 267,213
U.S. Treasury notes	201,985	—	(2)	201,983
Municipal securities	17,378	177	(49)	17,506
Trust preferred and other corporate securities	3,512	627	—	4,139
Mortgage-backed securities issued by GSE	233,953	335	(4,462)	229,826
Total available-for-sale securities	\$ 725,288	\$ 1,220	\$ (5,841)	\$ 720,667

December 31, 2016

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency securities	\$ 293,663	\$ 102	\$ (1,295)	\$ 292,470
U.S. Treasury notes	251,994	9	(2)	252,001
Municipal securities	23,502	184	(134)	23,552
Trust preferred and other corporate securities	3,493	555	—	4,048
Mortgage-backed securities issued by GSE	245,106	352	(4,555)	240,903
Total available-for-sale securities	\$ 817,758	\$ 1,202	\$ (5,986)	\$ 812,974

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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, 2017

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Trust preferred corporate securities	\$ 500	\$ 218	\$ —	\$ 718
Municipal securities	40,895	1,939	—	42,834
Mortgage-backed securities issued by GSE	23,722	116	(481)	23,357
Total held-to-maturity securities	<u>\$ 65,117</u>	<u>\$ 2,273</u>	<u>\$ (481)</u>	<u>\$ 66,909</u>

December 31, 2016

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Trust preferred corporate securities	\$ 500	\$ 204	\$ —	\$ 704
Municipal securities	40,922	1,824	—	42,746
Mortgage-backed securities issued by GSE	25,068	122	(444)	24,746
Total held-to-maturity securities	<u>\$ 66,490</u>	<u>\$ 2,150</u>	<u>\$ (444)</u>	<u>\$ 68,196</u>

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2017, and December 31, 2016, in the following table (in thousands):

March 31, 2017

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 235,191	\$ 235,166	\$ —	\$ —
Due after one year through five years	252,921	251,688	2,871	2,961
Due after five years through 10 years	24,946	24,726	42,472	42,731
Due after 10 years	210,696	207,553	19,774	21,217
	723,754	719,133	65,117	66,909
Other equity securities	1,534	1,534	—	—
	<u>\$ 725,288</u>	<u>\$ 720,667</u>	<u>\$ 65,117</u>	<u>\$ 66,909</u>

December 31, 2016

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 311,908	\$ 311,895	\$ —	\$ —
Due after one year through five years	251,962	250,690	2,881	2,967
Due after five years through 10 years	30,467	30,306	43,638	43,877
Due after 10 years	221,906	218,568	19,971	21,352
	816,243	811,459	66,490	68,196
Other equity securities	1,515	1,515	—	—
	<u>\$ 817,758</u>	<u>\$ 812,974</u>	<u>\$ 66,490</u>	<u>\$ 68,196</u>

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Unrealized losses

The following table shows the Company's gross unrealized losses and fair values of available-for-sale and held-to-maturity securities, aggregated by investment category and the length of time that individual securities have been in a continuous unrealized loss position as of March 31, 2017, and December 31, 2016 (in thousands):

March 31, 2017	Less than 12 months		12 months or more		Total	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury obligations and direct obligations of U.S. government agencies	\$ 241,521	\$ (1,330)	\$ —	\$ —	\$ 241,521	\$ (1,330)
Municipal securities	8,153	(49)	—	—	8,153	(49)
Mortgage-backed securities issued by GSE	223,732	(4,899)	9,981	(44)	233,713	(4,943)
Total temporarily impaired securities	<u>\$ 473,406</u>	<u>\$ (6,278)</u>	<u>\$ 9,981</u>	<u>\$ (44)</u>	<u>\$ 483,387</u>	<u>\$ (6,322)</u>

December 31, 2016	Less than 12 months		12 months or more		Total	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury obligations and direct obligations of U.S. government agencies	\$ 241,582	\$ (1,297)	\$ —	\$ —	\$ 241,582	\$ (1,297)
Municipal securities	12,176	(134)	—	—	12,176	(134)
Mortgage-backed securities issued by GSE	230,504	(4,897)	5,122	(102)	235,626	(4,999)
Total temporarily impaired securities	<u>\$ 484,262</u>	<u>\$ (6,328)</u>	<u>\$ 5,122</u>	<u>\$ (102)</u>	<u>\$ 489,384</u>	<u>\$ (6,430)</u>

U.S. Treasury obligations and direct obligations of U.S. government agencies

The Company's unrealized losses on obligations of U.S. government agencies were caused by interest rate fluctuations. At March 31, 2017, 22 securities had an aggregate unrealized loss of \$1.33 million. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on 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 investments in municipal securities were caused by interest rate fluctuations. At March 31, 2017, 11 securities had an aggregate unrealized loss of \$0.05 million. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on 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.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2017, 36 securities had an aggregate unrealized loss of \$4.94 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 had no unrealized losses on corporate securities at March 31, 2017.

Other investments, including common stock

The Company had no unrealized losses in other investments or common stocks at March 31, 2017.

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, since this is a restricted security without a readily determinable fair value. The Company had \$36.40 million and \$35.94 million of FHLB stock at March 31, 2017, and December 31, 2016, 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.

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 \$43.19 million adequate to cover estimated loan losses inherent in the loan portfolio at March 31, 2017.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents, by portfolio segment, the changes in the allowance for loan losses for the three-month periods ended March 31, 2017, and 2016 (in thousands):

Three Months Ended	Construction and Land	Commercial	Multi- Family	1-4 Family Residential	Commercial and Industrial	Consumer Loans and	
March 31, 2017	Development	Real Estate	Real Estate	Real Estate	Business	Other	Total
Allowance for loan losses:							
Balance, beginning of period	\$ 4,280	\$ 16,248	\$ 1,370	\$ 9,050	\$ 6,410	\$ 4,643	\$ 42,001
Provision for loan losses	924	190	(57)	1,079	217	188	2,541
Losses charged off	—	(67)	—	(1,288)	(36)	(228)	(1,619)
Recoveries	11	10	—	101	—	150	272
Balance, end of period	<u>\$ 5,215</u>	<u>\$ 16,381</u>	<u>\$ 1,313</u>	<u>\$ 8,942</u>	<u>\$ 6,591</u>	<u>\$ 4,753</u>	<u>\$ 43,195</u>

Three Months Ended	Construction and Land	Commercial	Multi- Family	1-4 Family Residential	Commercial and Industrial	Consumer Loans and	
March 31, 2016	Development	Real Estate	Real Estate	Real Estate	Business	Other	Total
Allowance for loan losses:							
Balance, beginning of period	\$ 4,984	\$ 14,687	\$ 945	\$ 8,990	\$ 5,774	\$ 2,979	\$ 38,359
Provision charged to expense	88	196	(23)	(571)	(342)	393	(259)
Losses charged off	(62)	(66)	—	(321)	(72)	(12)	(533)
Recoveries	5	16	—	114	30	28	193
Balance, end of period	<u>\$ 5,015</u>	<u>\$ 14,833</u>	<u>\$ 922</u>	<u>\$ 8,212</u>	<u>\$ 5,390</u>	<u>\$ 3,388</u>	<u>\$ 37,760</u>

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents, by portfolio segment, the allocation of the allowance for loan losses at March 31, 2017, and December 31, 2016 (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, 2017							
Period-end balance allocated to:							
Loans individually evaluated for impairment	\$ 59	\$ 1,049	\$ —	\$ 909	\$ 72	\$ 6	\$ 2,095
Loans collectively evaluated for impairment	5,063	15,332	1,313	7,809	6,519	4,747	40,783
Loans acquired with deteriorated credit quality	93	—	—	224	—	—	317
Balance, end of period	<u>\$ 5,215</u>	<u>\$ 16,381</u>	<u>\$ 1,313</u>	<u>\$ 8,942</u>	<u>\$ 6,591</u>	<u>\$ 4,753</u>	<u>\$ 43,195</u>
December 31, 2016							
Period-end balance allocated to:							
Loans individually evaluated for impairment	\$ 61	\$ 1,078	\$ 13	\$ 1,384	\$ 71	\$ 14	\$ 2,621
Loans collectively evaluated for impairment	4,179	15,102	1,357	7,473	6,339	4,629	39,079
Loans acquired with deteriorated credit quality	40	68	—	193	—	—	301
Balance, end of year	<u>\$ 4,280</u>	<u>\$ 16,248</u>	<u>\$ 1,370</u>	<u>\$ 9,050</u>	<u>\$ 6,410</u>	<u>\$ 4,643</u>	<u>\$ 42,001</u>

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

	Construction and Land Development	Commercial Real Estate	Multi- Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
March 31, 2017							
Ending balance: individually evaluated for impairment	\$ 9,734	\$ 27,270	\$ 1,202	\$ 19,942	\$ 3,232	\$ 238	\$ 61,618
Ending balance: collectively evaluated for impairment	878,360	2,209,196	219,905	1,165,010	1,081,797	206,736	5,761,004
Ending balance: loans acquired with deteriorated credit quality	10,446	32,767	15,675	30,326	1,244	—	90,458
Ending Balance	<u>\$ 898,540</u>	<u>\$2,269,233</u>	<u>\$ 236,782</u>	<u>\$1,215,278</u>	<u>\$ 1,086,273</u>	<u>\$ 206,974</u>	<u>\$5,913,080</u>
December 31, 2016							
Ending balance: individually evaluated for impairment	\$ 18,923	\$ 31,586	\$ 1,507	\$ 21,128	\$ 3,247	\$ 348	\$ 76,739
Ending balance: collectively evaluated for impairment	797,575	2,186,027	205,551	1,163,958	1,084,620	201,381	5,639,112
Ending balance: loans acquired with deteriorated credit quality	9,529	33,699	15,733	30,737	1,672	—	91,370
Ending Balance	<u>\$ 826,027</u>	<u>\$2,251,312</u>	<u>\$ 222,791</u>	<u>\$1,215,823</u>	<u>\$ 1,089,539</u>	<u>\$ 201,729</u>	<u>\$5,807,221</u>

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Accounting for purchased impaired loans involves estimating fair value, at acquisition, using the principal and interest cash flows expected to be collected, discounted at the prevailing market rate of interest. The excess of cash flows expected to be collected over the estimated fair value at acquisition date is referred to as the accretable yield and is recognized in interest income using an effective yield method over the remaining life of the loans. The difference between contractually required payments and the cash flows expected to be collected at acquisition, considering the impact of prepayments, is referred to as the nonaccretable difference. Any decreases in cash flows expected to be collected (other than due to decreases in interest rate indices and changes in prepayment assumptions) will be charged to the provision for loan losses, resulting in an increase to the allowance for loan losses.

The following table presents the changes in the accretable yield for purchased impaired loans for the three months ended March 31, 2017, and 2016 (in thousands):

	March 31,	
	2017	2016
Balance at beginning of period	\$ 40,467	\$ 43,959
Accretion	(1,717)	(1,543)
Reclassifications from nonaccretable balance, net	1,384	2,039
Other changes, net	814	(2,261)
Balance at end of period	<u>\$ 40,948</u>	<u>\$ 42,194</u>

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.

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

deterioration of 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, 2017, and December 31, 2016 (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, 2017							
Pass	\$ 889,484	\$ 2,226,269	\$ 235,314	\$ 1,191,886	\$ 1,080,176	\$ 206,736	\$ 5,829,865
Special Mention	5,321	17,827	266	2,829	2,731	—	28,974
Substandard	3,735	25,137	1,202	20,562	3,366	238	54,240
Doubtful	—	—	—	1	—	—	1
Total	<u>\$ 898,540</u>	<u>\$ 2,269,233</u>	<u>\$ 236,782</u>	<u>\$ 1,215,278</u>	<u>\$ 1,086,273</u>	<u>\$ 206,974</u>	<u>\$ 5,913,080</u>

	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, 2016							
Pass	\$ 802,941	\$ 2,204,051	\$ 221,284	\$ 1,191,410	\$ 1,083,798	\$ 201,406	\$ 5,704,890
Special Mention	5,327	16,944	—	2,405	1,866	—	26,542
Substandard	17,759	30,317	1,507	22,008	3,795	323	75,709
Doubtful	—	—	—	—	80	—	80
Total	<u>\$ 826,027</u>	<u>\$ 2,251,312</u>	<u>\$ 222,791</u>	<u>\$ 1,215,823</u>	<u>\$ 1,089,539</u>	<u>\$ 201,729</u>	<u>\$ 5,807,221</u>

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2017, and December 31, 2016. 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 because 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, 2017								
Construction and land development	\$ 687	\$ —	\$ 40	\$ 307	\$ 1,034	\$ 897,506	\$ 898,540	\$ —
Commercial real estate	636	713	373	5,245	6,967	2,262,266	2,269,233	—
Multifamily real estate	—	—	—	665	665	236,117	236,782	—
1-4 family residential real estate	5,005	2,249	284	4,918	12,456	1,202,822	1,215,278	—
Commercial and industrial business loans	749	416	99	347	1,611	1,084,662	1,086,273	—
Consumer loans and other	767	202	35	56	1,060	205,914	206,974	35
Total	\$ 7,844	\$ 3,580	\$ 831	\$ 11,538	\$ 23,793	\$ 5,889,287	\$ 5,913,080	\$ 35
December 31, 2016								
Construction and land development	\$ 67	\$ —	\$ 396	\$ 696	\$ 1,159	\$ 824,868	\$ 826,027	\$ —
Commercial real estate	2,133	1,354	19	5,110	8,616	2,242,696	2,251,312	—
Multifamily real estate	—	—	—	690	690	222,101	222,791	—
1-4 family residential real estate	5,170	77	1,157	6,113	12,517	1,203,306	1,215,823	—
Commercial and industrial business loans	792	75	4	362	1,233	1,088,306	1,089,539	—
Consumer loans and other	678	113	76	128	995	200,734	201,729	76
Total	\$ 8,840	\$ 1,619	\$ 1,652	\$ 13,099	\$ 25,210	\$ 5,782,011	\$ 5,807,221	\$ 76

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table includes an aging analysis of the recorded investment of purchased impaired loans 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, 2017						
Construction and land development	\$ —	\$ —	\$ 40	\$ 40	\$ 10,406	\$ 10,446
Commercial real estate	—	—	373	373	32,394	32,767
Multifamily real estate	—	—	—	—	15,675	15,675
1-4 family residential real estate	759	462	284	1,505	28,821	30,326
Commercial and industrial business loans	—	—	99	99	1,145	1,244
Consumer loans and other	—	—	—	—	—	—
Total	<u>\$ 759</u>	<u>\$ 462</u>	<u>\$ 796</u>	<u>\$ 2,017</u>	<u>\$ 88,441</u>	<u>\$ 90,458</u>

	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
December 31, 2016						
Construction and land development	\$ —	\$ —	\$ 396	\$ 396	\$ 9,133	\$ 9,529
Commercial real estate	—	346	19	365	33,334	33,699
Multifamily real estate	—	—	—	—	15,733	15,733
1-4 family residential real estate	902	—	1,157	2,059	28,678	30,737
Commercial and industrial business loans	206	75	4	285	1,387	1,672
Consumer loans and other	—	—	—	—	—	—
Total	<u>\$ 1,108</u>	<u>\$ 421</u>	<u>\$ 1,576</u>	<u>\$ 3,105</u>	<u>\$ 88,265</u>	<u>\$ 91,370</u>

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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. Smaller balance loans (under \$500,000) are generally not individually assessed for impairment, but are evaluated collectively.

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 \$4.27 million in excess of deferred loan costs at March 31, 2017, \$3.10 million at March 31, 2016, and \$4.02 million at December 31, 2016. There were \$11.54 million, \$7.94 million, and \$13.10 million in nonaccrual loans at March 31, 2017, March 31, 2016, and December 31, 2016, respectively. The Company would have earned \$0.85 million in first quarter 2017 if interest on the loans had been accrued.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2017, and December 31, 2016 (in thousands):

	Unpaid			Average	YTD
	Principal	Recorded	Specific	Recorded	Interest
March 31, 2017	Balance	Balance	Allowance	Investment	Income
					Recognized
Loans without a specific valuation allowance					
Construction and land development	\$ 6,740	\$ 6,712	\$ —	\$ 6,761	\$ 36
Commercial real estate	16,829	16,423	—	16,894	210
Multifamily real estate	1,268	1,202	—	1,278	27
1-4 family residential real estate	7,784	7,655	—	7,848	77
Commercial and industrial business loans	1,882	1,711	—	1,899	25
Consumer loans and other	—	—	—	—	—
Total	\$ 34,503	\$ 33,703	\$ —	\$ 34,680	\$ 375
Loans with a specific valuation allowance					
Construction and land development	\$ 3,379	\$ 3,022	\$ 59	\$ 3,423	\$ 37
Commercial real estate	10,901	10,847	1,049	10,946	127
Multifamily real estate	—	—	—	—	—
1-4 family residential real estate	13,333	12,287	909	13,482	154
Commercial and industrial business loans	1,606	1,521	72	1,649	22
Consumer loans and other	238	238	6	251	2
Total	\$ 29,457	\$ 27,915	\$ 2,095	\$ 29,751	\$ 342
Total impaired loans					
Construction and land development	\$ 10,119	\$ 9,734	\$ 59	\$ 10,184	\$ 73
Commercial real estate	27,730	27,270	1,049	27,840	337
Multifamily real estate	1,268	1,202	—	1,278	27
1-4 family residential real estate	21,117	19,942	909	21,330	231
Commercial and industrial business loans	3,488	3,232	72	3,548	47
Consumer loans and other	238	238	6	251	2
Total	\$ 63,960	\$ 61,618	\$ 2,095	\$ 64,431	\$ 717

Note: Included in the table above are accruing TDRs of \$26.66 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled \$5.97 million.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Unpaid Principal Balance	Recorded Balance	Specific Allowance	Average Recorded Investment	YTD Interest Income Recognized
December 31, 2016					
Loans without a specific valuation allowance					
Construction and land development	\$ 15,933	\$ 15,842	\$ —	\$ 16,454	\$ 808
Commercial real estate	18,495	18,251	—	20,024	1,006
Multifamily real estate	1,288	1,239	—	1,313	69
1-4 family residential real estate	7,569	7,445	—	7,711	323
Commercial and industrial business loans	1,892	1,749	—	1,904	106
Consumer loans and other	—	—	—	—	—
Total	\$ 45,177	\$ 44,526	\$ —	\$ 47,406	\$ 2,312
Loans with a specific valuation allowance					
Construction and land development	\$ 3,431	\$ 3,082	\$ 61	\$ 3,459	\$ 146
Commercial real estate	13,533	13,336	1,078	13,742	692
Multifamily real estate	268	268	13	274	15
1-4 family residential real estate	14,084	13,682	1,384	14,322	642
Commercial and industrial business loans	1,579	1,497	71	1,867	97
Consumer loans and other	351	348	14	392	16
Total	\$ 33,246	\$ 32,213	\$ 2,621	\$ 34,056	\$ 1,608
Total impaired loans					
Construction and land development	\$ 19,364	\$ 18,924	\$ 61	\$ 19,913	\$ 954
Commercial real estate	32,028	31,587	1,078	33,766	1,698
Multifamily real estate	1,556	1,507	13	1,587	84
1-4 family residential real estate	21,653	21,127	1,384	22,033	965
Commercial and industrial business loans	3,471	3,246	71	3,771	203
Consumer loans and other	351	348	14	392	16
Total	\$ 78,423	\$ 76,739	\$ 2,621	\$ 81,462	\$ 3,920

Note: Included in the table above are accruing TDRs of \$31.35 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled \$6.10 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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 shows the loans modified in TDRs for the three months ended March 31, 2017 and 2016 (in thousands, except number of loans):

Three Months Ended March 31, 2017			
	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
Commercial and industrial	1	\$ 14	\$ 13
Total	1	\$ 14	\$ 13

Three Months Ended March 31, 2016			
	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
Construction and land development	1	\$ 150	\$ 148
Total	1	\$ 150	\$ 148

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. One loan relationship consisting of five commercial loans, which totaled \$1.52 million, was restructured within the last 12 months and subsequently defaulted.

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, 2017, the large majority of 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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2017 and 2016 (in thousands):

	Three Months Ended March 31,	
	2017	2016
Beginning balance	\$ 24,505	\$ 34,420
Additions and capital improvements	1,381	2,127
Franklin merger	—	(234)
Sales	(1,257)	(6,928)
Valuation allowance	—	91
Gain (Loss) on sale and write-downs, net	(358)	264
Ending balance	<u>\$ 24,271</u>	<u>\$ 29,740</u>

As of March 31, 2017, the Company’s recorded investment in OREO collateralized by residential real estate was \$4.08 million. As of March 31, 2017, the Company’s recorded investment in mortgage loans collateralized by residential real estate that are in the process of foreclosure was \$0.43 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; Lawyers Escrow and Title, LLC, d/b/a Virginia Home Title and Settlements; SimonTowne Mortgage, LLC; Towne Mortgage of the Carolinas, LLC; Towne Center Mortgage, LLC; Coastal Home Mortgage, LLC; NewTowne Mortgage, LLC; Homesale Mortgage, LLC; Towne Vacations, LLC, d/b/a Beach Properties of Hilton Head; and Towne Vacations Oak Island, LLC, d/b/a Oak Island Accommodations, 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 Agency, LLC, and Towne Benefits.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

All the segments are service-based. The Banking segment offers a distribution and referral network for the realty and insurance services, and the Realty and Insurance divisions offer a similar network for the Banking segment, due largely to overlapping geographic markets. A major distinction is the source of income. The Realty and Insurance businesses are fee-based, 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, 2017

	Banking	Realty	Insurance	Consolidated Totals
Net interest income	\$ 58,444	\$ 1,837	\$ —	\$ 60,281
Provision for loan losses	2,541	—	—	2,541
Net interest income after provision for loan losses	55,903	1,837	—	57,740
Residential mortgage banking income, net	(143)	17,775	—	17,632
Insurance commissions and other title fees and income, net	120	355	14,325	14,800
Real estate brokerage and property management income, net	—	4,993	—	4,993
Other noninterest income	6,719	490	252	7,461
Noninterest expense	38,349	23,078	8,821	70,248
Income before income tax, corporate allocation and noncontrolling interest	24,250	2,372	5,756	32,378
Corporate allocation	484	(307)	(177)	—
Income before income tax provision and noncontrolling interest	24,734	2,065	5,579	32,378
Provision for income tax expense	6,765	627	1,994	9,386
Net income	17,969	1,438	3,585	22,992
Noncontrolling interest	(2)	(512)	(510)	(1,024)
Net income attributable to TowneBank	\$ 17,967	\$ 926	\$ 3,075	\$ 21,968
Net income as percentage of total	81.79%	4.22%	13.99%	100.00%
Total assets	\$ 7,626,364	\$ 386,107	\$ 162,315	\$ 8,174,786

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Three Months Ended March 31, 2016

	Banking	Realty	Insurance	Consolidated Totals
Net interest income	\$ 45,823	\$ 513	\$ —	\$ 46,336
Provision for loan losses	(259)	—	—	(259)
Net interest income after provision for loan losses	46,082	513	—	46,595
Residential mortgage banking income, net	(192)	7,310	—	7,118
Insurance commissions and other title fees and income, net	—	350	13,683	14,033
Real estate brokerage and property management income, net	—	4,827	—	4,827
Other noninterest income	5,793	414	230	6,437
Noninterest expense	32,181	11,184	8,796	52,161
Income before income tax, corporate allocation and noncontrolling interest	19,502	2,230	5,117	26,849
Corporate allocation	360	(170)	(190)	—
Income before income tax provision and noncontrolling interest	19,862	2,060	4,927	26,849
Provision for income tax expense	5,729	659	1,800	8,188
Net income	14,133	1,401	3,127	18,661
Noncontrolling interest	—	(368)	(474)	(842)
Net income attributable to TowneBank	\$ 14,133	\$ 1,033	\$ 2,653	\$ 17,819
Net income as percentage of total	79.31%	5.80%	14.89%	100.00%
Total assets	\$ 6,046,199	\$ 178,289	\$ 140,681	\$ 6,365,169

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, 2017, the amounts of off-balance sheet commitments to extend credit were \$2.13 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, 2017, standby letters of credit and financial guarantees were \$83.05 million.

Additionally, the Company had \$44.61 million in mortgage loans sold to investors with various recourse and warranty provisions as of March 31, 2017.

Note 8. Mergers and Acquisitions

Monarch Financial Holdings: Effective June 24, 2016, the Company completed its acquisition of Monarch Financial Holdings, Inc. ("Monarch"), and its wholly owned bank subsidiary, Monarch Bank, which were merged with and into TowneBank.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In the merger with Monarch, each outstanding share of common stock of Monarch was converted into 0.8830 shares of TowneBank common stock. TowneBank issued an aggregate of 10.49 million shares of TowneBank common stock to Monarch stockholders. Based on the closing price of TowneBank's common stock on June 24, 2016, of \$21.21 per share, the aggregate consideration paid to Monarch common stockholders to acquire Monarch common stock was approximately \$222.44 million.

Monarch Bank had 12 branches, of which 11 branches were closed and one branch was re-opened on June 27, 2016, as a TowneBank branch. The integration of Monarch Bank's deposit system and the conversion of the re-opened Monarch Bank branch to TowneBank's operating platform were completed over the weekend of June 25-26, 2016.

The Monarch merger has been accounted for under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*. The assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of the June 24, 2016, merger date. Such fair values were preliminary estimates and were subject to adjustment for up to one year after the merger date or when additional information relative to the closing date fair values became available and such information is considered final, whichever is earlier. The application of the acquisition method of accounting resulted in goodwill of approximately \$108.05 million. All of the recognized goodwill is expected to be non-deductible for tax purposes.

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the estimated fair values of the assets acquired and liabilities assumed for Monarch as of June 24, 2016 (dollars in thousands):

Fair value of assets acquired:	
Cash and cash equivalents	\$ 67,457
Securities available for sale	20,818
Loans held for sale	283,528
Loans held for investment	808,137
Bank premise and equipment	23,998
Intangible assets	13,210
Other assets	62,427
Total assets	<u>\$ 1,279,575</u>
Fair value of liabilities assumed:	
Deposits	\$ 1,061,620
Total borrowings	82,046
Other liabilities	21,513
Total liabilities	<u>\$ 1,165,179</u>
Net identifiable assets acquired	114,396
Goodwill	108,048
Net assets acquired	<u>\$ 222,444</u>
Purchase price:	
Company common shares issued	10,487,069
Purchase price per share of Company's common stock	\$ 21.21
Common stock issued	\$ 222,431
Cash exchanged for fractional shares	13
Fair value of total consideration transferred	<u>\$ 222,444</u>

During the year ended December 31, 2016, adjustments were made to the purchase price allocations that resulted in a decrease to the initial fair value estimate of loans of \$9.98 million, an increase in deferred tax assets of \$3.37 million, and a decrease to acquired net assets of \$0.83 million resulting from adjustments to other assets and liabilities. The Company made these measurement period adjustments to reflect facts and circumstances that existed as of the merger date and did not result from intervening events subsequent to such date. The revised fair value estimates resulted in an increase to goodwill of \$7.44 million. As of December 31, 2016, the Company finalized its valuation of all assets and liabilities acquired.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The loans acquired in the Monarch merger 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 June 24, 2016, as revised for measurement period adjustments, the estimated fair value of the Monarch purchased performing loans acquired was \$793.10 million, the related gross contractual amount was \$917.34 million, and the estimated contractual cash flows not expected to be collected were \$7.33 million.

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

Contractual principal and interest at acquisition	\$ 36,510
Nonaccretable difference	<u>(19,264)</u>
Expected cash flows at acquisition	17,246
Accretable yield	<u>(2,207)</u>
Estimated fair value of loans acquired with a deterioration of credit quality	<u><u>\$ 15,039</u></u>

Oak Island Accommodations, Inc.: Effective January 14, 2016, the Company acquired Oak Island Accommodations, Inc., an independent resort property management company that was merged with the operations of Towne Vacations Oak Island, LLC, a division of TowneBank's Realty segment. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired business are included in the Company's Consolidated Statements of Income commencing January 14, 2016. The purchase price for the transaction was \$5.52 million in cash. The allocation of the purchase price resulted in tangible assets of \$0.36 million, goodwill of \$1.58 million, and other intangible assets of \$3.58 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 2016 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):

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	March 31,				December 31, 2016	
	2017		2016			
	Carrying Amount	Accumulated Amortization	Carrying Amount	Accumulated Amortization	Carrying Amount	Accumulated Amortization
Core deposit intangible	\$ 9,818	\$ 2,434	\$ 1,918	\$ 486	\$ 9,818	\$ 1,827
Non-compete agreements	1,898	1,105	1,531	1,216	2,201	1,407
Customer lists	42,415	16,802	38,380	14,146	43,291	17,493
Trade name	211	180	211	137	211	169
Total intangible assets subject to amortization	54,342	20,521	42,040	15,985	55,521	20,896
Contractual agreements	3,231	—	3,231	—	3,231	—
Total intangible assets not subject to amortization	3,231	—	3,231	—	3,231	—
Total intangible assets	\$ 57,573	\$ 20,521	\$ 45,271	\$ 15,985	\$ 58,752	\$ 20,896

Amortization expense for intangible assets was \$1.86 million and \$1.09 million for the three-month periods ended March 31, 2017 and 2016, respectively.

Changes in the net carrying amount of goodwill related to each of the Company's segments since December 31, 2016, are as follows (in thousands):

	Banking	Realty	Insurance	Consolidated Totals
Balance, December 31, 2016	\$ 194,913	\$ 23,495	\$ 46,502	\$ 264,910
Additions to goodwill	—	—	—	—
Other adjustments	—	—	—	—
Balance, March 31, 2017	\$ 194,913	\$ 23,495	\$ 46,502	\$ 264,910

Note 10. Bank-Owned Life Insurance Policies

The total carrying amount of bank-owned life insurance policies ("BOLI") as of March 31, 2017, was \$190.92 million. The Company had \$150.62 million and \$189.50 million of BOLI as of March 31, 2016, and December 31, 2016, respectively. The Company recognized BOLI income, included in other noninterest income, of \$1.47 million and \$1.17 million for the three-month periods ended March 31, 2017 and 2016, respectively. The Company has a related retirement plan, which provides retirement benefits to the executives covered under the plan. Although the retirement plan is technically unfunded, the life insurance policies are available to finance future benefits.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 11. Postretirement Benefits

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

	SERP		Other Postretirement Benefits	
	Three Months Ended		Three Months Ended	
	2017	2016	2017	2016
March 31,				
Service cost	\$ 634	\$ 409	\$ (45)	\$ 15
Interest cost	285	255	15	8
Amortization of prior service costs	51	38	—	—
Amortization of actuarial (gain) loss	39	19	(6)	(15)
Net periodic postretirement benefit cost	<u>\$ 1,009</u>	<u>\$ 721</u>	<u>\$ (36)</u>	<u>\$ 8</u>

Note 12. Accumulated Other Comprehensive Income (Loss)

The following table summarizes the components of accumulated other comprehensive income (loss) at March 31, 2017 and 2016 (in thousands), and changes in the three months then ended. The amounts reclassified from accumulated other comprehensive income ("AOCI") 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 AOCI for the pension and postretirement plans are a component of salaries and employee benefits expense on the consolidated statements of income.

	Unrealized Gains (Losses) on Securities (a)	Pension and Postretirement Plans (b)	Accumulated Other Comprehensive Income (Loss), Net of Tax
Balance, December 31, 2016	\$ (3,109)	\$ (877)	\$ (3,986)
Other comprehensive income before reclassifications	105	(350)	(245)
Amounts reclassified from AOCI	—	58	58
Net change	105	(292)	(187)
Balance, March 31, 2017	<u>\$ (3,004)</u>	<u>\$ (1,169)</u>	<u>\$ (4,173)</u>

	Unrealized Gains (Losses) on Securities (a)	Pension and Postretirement Plans (b)	Accumulated Other Comprehensive Income (Loss), Net of Tax
Balance, December 31, 2015	\$ (1,805)	\$ (1,189)	\$ (2,994)
Other comprehensive income before reclassifications	2,912	71	2,983
Amounts reclassified from AOCI	—	28	28
Net change	2,912	99	3,011
Balance, March 31, 2016	<u>\$ 1,107</u>	<u>\$ (1,090)</u>	<u>\$ 17</u>

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

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 13. Other Expenses

The following table shows a summary of other expenses for the three month periods ended March 31, 2017 and 2016 (in thousands):

	Three Months Ended	
	March 31,	
	2017	2016
Advertising and marketing	\$ 2,642	\$ 1,902
Acquisition-related expenses	(5)	414
Other	2,813	1,174
Charitable contributions	1,398	1,048
Outside processing	1,634	1,397
Professional fees	1,828	1,451
Stationery and supplies	609	594
FDIC and other insurance	937	991
Foreclosed property expenses	131	113
Software expense	2,251	1,622
Telephone and postage	1,671	1,210
Amortization-intangibles	1,864	1,092
Bank franchise tax/SCC fees	1,242	941
Directors fees and expenses	316	271
Travel/meals/entertainment	682	380
Total other expenses	<u>\$ 20,013</u>	<u>\$ 14,600</u>

Note 14. Variable Interest Entities

A Variable Interest Entity (“VIE”) is an entity that either (i) has an insufficient amount of equity to carry out its principal activities without additional subordinated financial support, (ii) has a group of equity owners that are unable to make significant decisions about its activities, or (iii) has a group of equity owners that do not have the obligation to absorb losses or the right to receive returns as generated by its operations. If any of these characteristics are present, the entity is subject to a variable interest consolidation model, and consolidation is based on variable interests, not on ownership of the entity's outstanding voting stock. Variable interests are defined as contractual, ownership, or other monetary interests in an entity that change with fluctuations in the entity's net asset value. The primary beneficiary consolidates the VIE. 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.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 meet the definition of a VIE and are evaluated for the purpose 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 the general partner of each limited partnership has both the power to direct the activities which most significantly affect the performance of each partnership and the obligation to absorb losses or the right to receive benefits that could be significant to the entities. The Company accounts for its limited partner interests in accordance with the accounting guidance for investments in affordable housing projects. Partnership assets of \$91.53 million, \$77.92 million, and \$92.44 million were not included in the Consolidated Balance Sheets at March 31, 2017, March 31, 2016, and December 31, 2016, respectively. These limited partner interests had carrying values of \$13.54 million, \$15.57 million, and \$14.94 million at March 31, 2017, March 31, 2016, and December 31, 2016, 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 \$22.88 million, \$21.49 million, and \$21.02 million at March 31, 2017, March 31, 2016, and December 31, 2016, respectively. The Company's maximum exposure to loss would result from the loss of its limited partner investments, along with \$2.67 million of loans to the entities at March 31, 2017. As of March 31, 2017, the Company had \$19.92 million in funding commitments that are dependent on certain contractual milestones and \$12.0 million in loans, unfunded short-term construction loans, or letters of credit commitments. For the three-month period ended March 31, 2017, tax benefits totaling \$0.54 million, net of amortization expenses of \$1.40 million, respectively, were 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.
- 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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

Derivative Financial Instruments: 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 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, 2017 and 2016, and the year ended December 31, 2016, the Company used weighted average fall-out rates of 17.14%, 17.16%, and 17.99%, respectively.

To mitigate the effect of the interest rate risk inherent in providing rate lock commitments to borrowers, the Company enters into either a forward sales contract to sell loans to investors when using best efforts or a "to be announced" ("TBA") mortgage-backed security under mandatory delivery. The forward sales contracts lock in a price for the sale of loans with similar characteristics to the specific rate lock commitments. The Company has not formally designated these derivatives as a qualifying hedge relationship, accordingly, changes to fair value are recorded to earnings each period. These valuations fall into a Level 2 category.

The following table presents the recorded amount of assets and liabilities measured at fair value on a recurring basis as of March 31, 2017, and December 31, 2016 (in thousands):

	March 31, 2017			
	Level 1	Level 2	Level 3	Total
U.S. agency securities	\$ —	\$ 267,213	\$ —	\$ 267,213
U.S. Treasury notes	—	201,983	—	201,983
Municipal securities	—	17,506	—	17,506
Mortgage-backed securities issued by GSEs	—	229,826	—	229,826
Trust preferred and other corporate securities	—	4,139	—	4,139
Derivative assets	—	—	3,516	3,516
Derivative liabilities	—	—	—	—

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	December 31, 2016			
	Level 1	Level 2	Level 3	Total
U.S. agency securities	\$ —	\$ 292,470	\$ —	\$ 292,470
U.S. Treasury notes	—	252,001	—	252,001
Municipal securities	—	23,552	—	23,552
Mortgage-backed securities issued by GSEs	—	240,903	—	240,903
Trust preferred and other corporate securities	—	4,048	—	4,048
Derivative assets	—	1,547	2,282	3,829
Derivative liabilities	—	647	—	647

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, 2017, and December 31, 2016 (in thousands):

March 31, 2017	Level 1	Level 2	Level 3	Fair Value
Impaired loans	\$ —	\$ —	\$ 7,608	\$ 7,608
Other real estate owned and other nonperforming assets	—	20,310	3,961	24,271

December 31, 2016	Level 1	Level 2	Level 3	Fair Value
Impaired loans	\$ —	\$ —	\$ 12,097	\$ 12,097
Other real estate owned and other nonperforming assets	—	20,355	4,150	24,505

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 3% to 34%, with a weighted average of 14.83%.

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 86%, with a weighted average of 10.28%.

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.

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 approximates the carrying amount payable on demand. 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 fair value of securities sold under agreements to repurchase is calculated using discounted cash flows, applying discount rates based on market yield curve rates for similar maturities.

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, 2017, and December 31, 2016, are as follows (in thousands):

	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
March 31, 2017					
Cash and due from banks	\$ 420,192	\$ 420,192	\$ 420,192	\$ —	\$ —
Interest-bearing deposits in financial institutions	5,335	5,335	5,335	—	—
Securities available for sale	720,667	720,667	—	720,667	—
Securities held to maturity	65,117	66,909	—	66,909	—
Mortgage loans held for sale	214,047	214,224	—	214,224	—
Net loans	5,913,080	5,956,473	—	—	5,956,473
Interest receivable	19,549	19,549	—	19,549	—
Non-maturity deposits	4,565,763	4,565,763	—	4,565,763	—
Time deposits	1,625,009	1,612,973	—	1,612,973	—
Advances from the Federal Home Loan Bank of Atlanta	687,366	684,484	—	684,484	—
Repurchase agreements and other borrowings	35,318	35,323	—	35,323	—
Interest payable	3,571	3,571	—	3,571	—

	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
December 31, 2016					
Cash and due from banks	\$ 130,967	\$ 130,967	\$ 130,967	\$ —	\$ —
Interest-bearing deposits in financial institutions	5,581	5,581	5,581	—	—
Securities available for sale	812,974	812,974	—	812,974	—
Securities held to maturity	66,490	68,196	—	68,196	—
Mortgage loans held for sale	314,117	314,409	—	314,409	—
Net loans	5,807,221	5,828,335	—	—	5,828,335
Interest receivable	20,288	20,288	—	20,288	—
Non-maturity deposits	4,411,835	4,411,835	—	4,411,835	—
Time deposits	1,623,362	1,611,537	—	1,611,537	—
Advances from the Federal Home Loan Bank of Atlanta	687,511	687,100	—	687,100	—
Repurchase agreements and other borrowings	32,540	32,543	—	32,543	—
Interest payable	3,320	3,320	—	3,320	—

Note 16. Derivative Instruments and Hedging Activities

The Company enters into rate lock commitments with its mortgage customers. The Company is also a party to forward mortgage loan sales contracts to sell loans servicing released and sales of TBA mortgage-backed securities. When the interest rate is locked with the borrower, the rate lock commitment, forward sale agreement, and mortgage-backed security position are undesignated derivatives and marked to fair value through earnings. The fair value of the rate lock derivative is based on quoted prices for similar loans in the secondary market adjusted by a factor which considers the likelihood that the loan in a lock position will

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

ultimately close. Both the rate lock commitment and the corresponding forward sales contracts are considered derivatives, but are not accounted for using hedge accounting. As such, changes in the estimated fair value of the derivatives during the commitment period are recorded in current earnings and included in net residential mortgage banking income in the Consolidated Statements of Income.

As a result of the Monarch merger, we participate in a “mandatory” delivery program for mortgage loans. Under the mandatory delivery system, loans with interest rate locks are paired with the sale of a TBA mortgage-backed security bearing similar attributes. Under the mandatory delivery program, we commit to deliver loans to an investor at an agreed upon price prior to the close of such loans. This differs from a “best efforts” delivery, which sets the sale price with the investor on a loan-by-loan basis when each loan is locked.

The following table reflects the amount and market value of mortgage banking derivatives included in the Consolidated Balance Sheets (in thousands):

	March 31, 2017		December 31, 2016	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Included in other assets:				
Forward contracts related to interest rate lock commitments and mortgage loans held for sale	\$ —	\$ —	\$ 14,923	\$ 78
Interest rate lock commitments	379,446	3,516	215,166	2,282
TBA mortgage-backed securities	—	—	73,500	1,469
Total included in other assets		\$ 3,516		\$ 3,829
Included in other liabilities:				
Forward contracts related to interest rate lock commitments and mortgage loans held for sale	\$ —	\$ —	\$ 29,881	\$ 647
Total included in other liabilities		\$ —		\$ 647

The following table indicates the gain or loss recognized in income on derivatives for the periods presented (in thousands):

	Three Months Ended March 31,	
	2017	2016
Interest rate lock commitments	\$ 1,234	\$ 384
Forward sales contracts	(15)	—
	<u>\$ 1,219</u>	<u>384</u>

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 17. Borrowings

The Company has short-term borrowings for terms under one year consisting of retail repurchase agreements (“REPOs”) and FHLB advances. FHLB advances are for various terms and are secured by a blanket lien on residential mortgages and other real estate secured loans. All REPOs are overnight short-term investments and are not insured by the Federal Deposit Insurance Corporation. Securities pledged as collateral under these REPO financing arrangements cannot be sold or repledged by the secured party and are therefore accounted for as a secured borrowing. Mortgage-backed securities and U.S. government agency securities with a total carrying value of \$42.88 million at March 31, 2017, and \$42.01 million at December 31, 2016, were pledged as collateral for these secured transactions. The pledged securities are held in safekeeping at the FHLB. Due to the overnight, short-term nature of REPOs, potential risk due to a decline in the value of the pledged collateral is low. Collateral pledging requirements with REPOs are monitored daily.

Note 18. Subsequent Events

On April 27, 2017, the Company announced the signing of a definitive agreement and plan of reorganization, dated April 26, 2017 (the “Paragon merger agreement”), pursuant to which the Company will acquire Paragon Commercial Corporation (“Paragon”), and its wholly-owned bank subsidiary, Paragon Commercial Bank, a Raleigh, North Carolina-based bank with three banking offices servicing Raleigh, Cary, and Charlotte, North Carolina. The proposed acquisition of Paragon and Paragon Commercial Bank has been approved by the Boards of Directors of TowneBank, Paragon, and Paragon Commercial Bank and is expected to close in the fourth quarter of 2017, subject to customary closing conditions, including the receipt of required regulatory approvals and the approval of Paragon’s shareholders. At December 31, 2016, Paragon had total assets of \$1.50 billion, gross loans of \$1.19 billion, and total deposits of \$1.17 billion.

Under the terms of the Paragon merger agreement, Paragon shareholders will receive 1.725 shares of the Company’s common stock for each share of Paragon common stock held immediately prior to the effective date of the merger. As a result of the merger, unexercised Paragon stock options, whether or not vested, will be converted into replacement option awards of TowneBank on the same terms and conditions applicable to Paragon stock options, as adjusted based on the 1.725 exchange ratio. Similarly, restricted stock awards will be converted into replacement restricted stock awards of TowneBank on the same terms and conditions applicable to the Paragon restricted stock awards, adjusted based on the 1.725 exchange ratio, unless vested at the time of the merger in accordance with the related award agreement and converted into shares of TowneBank common stock.

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 2017	Fourth Quarter 2016	Third Quarter 2016	Second Quarter 2016	First Quarter 2016
Results of Operations:					
Interest income	\$ 70,087	\$ 71,818	\$ 71,823	\$ 56,241	\$ 54,734
Interest expense	9,806	9,667	9,218	8,457	8,398
Net interest income	60,281	62,151	62,605	47,784	46,336
Provision for loan losses	2,541	1,831	1,686	2,099	(259)
Net interest income after provision for loan losses	57,740	60,320	60,919	45,684	46,595
Noninterest income:					
Residential mortgage banking income, net	17,632	18,096	21,430	12,148	7,118
Insurance commissions and other title fees and income, net	14,800	9,823	11,258	11,627	14,033
Real estate brokerage and property management income, net	4,993	2,925	6,647	6,116	4,827
Service charges on deposit accounts	2,472	2,535	2,552	2,284	2,176
Credit card merchant fees, net	1,118	1,135	1,365	1,113	895
Bank owned life insurance	1,474	2,377	1,264	1,181	1,172
Other income	2,397	2,621	2,305	1,999	2,194
Gain on investment securities	—	6	—	—	—
Total noninterest income	44,886	39,518	46,821	36,468	32,415
Noninterest expense:					
Salaries and benefits	40,208	43,071	40,497	30,093	30,187
Occupancy expense	6,684	6,885	6,656	5,157	5,017
Furniture and equipment	3,343	3,378	3,199	2,381	2,357
Other expenses	20,013	19,500	20,581	34,268	14,600
Total noninterest expense	70,248	72,834	70,933	71,899	52,161
Income before noncontrolling interest and income tax	32,378	27,004	36,807	10,254	26,849
Provision for income tax expense	9,386	7,160	10,974	2,375	8,188
Net income	22,992	19,844	25,833	7,879	18,661
Net income attributable to noncontrolling interest	(1,024)	(848)	(1,657)	(1,620)	(842)
Net income attributable to TowneBank	\$ 21,968	\$ 18,996	\$ 24,176	\$ 6,259	\$ 17,819
Net income available to common shareholders	\$ 21,968	\$ 18,996	\$ 24,176	\$ 6,259	\$ 17,819

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 2017	Fourth Quarter 2016	Third Quarter 2016	Second Quarter 2016	First Quarter 2016
Per Share Data:					
Net income:					
Basic	\$ 0.35	\$ 0.31	\$ 0.39	\$ 0.12	\$ 0.35
Diluted	0.35	0.31	0.39	0.12	0.35
Book value at period end	17.42	17.20	17.11	16.84	16.00
Tangible book value at period end	12.59	12.36	12.23	12.05	12.38
Cash dividends declared	0.13	0.13	0.13	0.13	0.12
Common Stock Closing Price:					
High	33.50	34.10	24.03	22.64	20.88
Low	30.60	23.83	21.66	19.10	16.65
Close	32.40	33.25	24.03	21.65	19.19
Selected Financial Ratios (annualized):					
Return on average assets	1.11%	0.95%	1.20%	0.39%	1.14%
Return on average tangible assets	1.22%	1.05%	1.29%	0.44%	1.21%
Return on average equity	8.15%	6.95%	8.95%	2.93%	8.63%
Return on average tangible equity	11.88%	10.27%	12.87%	4.19%	11.56%
Net interest margin (tax-equivalent basis)	3.45%	3.52%	3.55%	3.33%	3.33%
Daily Averages:					
Total assets	\$ 8,000,366	\$ 7,965,438	\$ 7,991,213	\$ 6,534,063	\$ 6,313,238
Total tangible assets	7,698,310	7,661,845	7,689,122	6,339,815	6,126,524
Loans, net of unearned income, excluding nonaccrual loans	5,862,799	5,705,832	5,583,711	4,702,825	4,516,277
Total earning assets	7,177,697	7,297,299	7,093,401	5,873,137	5,815,383
Total deposits	6,059,996	6,099,708	6,178,341	5,082,863	4,915,400
FHLB advances	723,506	628,272	479,660	433,626	429,020
Total equity	1,093,490	1,087,382	1,075,023	859,938	830,178
Tangible equity	791,433	783,789	772,932	665,690	643,464
Basic weighted average shares outstanding	62,075,983	61,963,948	61,908,316	51,994,473	51,290,010
Diluted weighted average shares outstanding	62,262,789	62,175,705	62,067,832	52,116,772	51,392,857

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 2016 audited Consolidated Financial Statements included in our 2016 Annual Report to Stockholders and our 2016 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 (including the pending acquisition of Paragon Commercial Corporation), competitive and legislative or regulatory factors, and other factors described in our 2016 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, 2017:

- Net income for the three months ended March 31, 2017, was \$21.97 million, or \$0.35 per common diluted share, compared with \$17.82 million, or \$0.35 per common diluted share, in the same period in 2016.

PART I. FINANCIAL INFORMATION

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

- Net interest income increased \$13.95 million, or 30.10%, in first quarter 2017 from the comparable period in 2016. The increase was primarily due to an increase in average earning assets as a result of the acquisition of Monarch Financial Holdings, Inc. ("Monarch") in the second quarter of 2016.
- The provision for loan losses was \$2.54 million compared to the negative provision of \$0.26 million in first quarter 2016, and \$1.83 million in fourth quarter 2016. The loan loss reserve was 0.73% of total loans at March 31, 2017, as compared to 0.72% at December 31, 2016, and 0.83% at March 31, 2016. The increase in the provision for loan losses in comparison to prior year and linked quarters was primarily a result of loan growth, partially offset by a reduction in historical loss ratios. Loan loss reserve as a percentage of total loans, excluding purchased loans, remained steady at 0.86% at March 31, 2017, as compared to 0.87% at December 31, 2016, which is consistent with continued stability in credit quality.
- Noninterest income for the three-month period ended March 31, 2017, increased by \$12.47 million, or 38.47%, and \$5.37 million, or 13.58%, from the three-month periods ended March 31, 2016 and December 31, 2016, respectively. The increase from first quarter 2016 was primarily due to an increase in residential mortgage banking income related to the Monarch acquisition, combined with an increase in insurance commissions. The increase from the linked quarter was primarily due to increased insurance contingency commission income combined with a seasonal increase in resort property management income.
- For the first quarter of 2017, noninterest expense increased \$18.09 million, or 34.68%, compared to the first quarter of 2016, and decreased \$2.59 million, or 3.55% from the quarter ended December 31, 2016. The increase from first quarter 2016 was driven by increased operating expenses related to the 2016 acquisition of Monarch. The decrease from the linked quarter was primarily due to lower personnel expenses.
- Our effective tax rate was 29.94% for the first quarter of 2017, a decrease from 31.48% in the comparative period of 2016, and increased from 27.37% in the fourth quarter of 2016. The decrease from the prior year first quarter was primarily a result of an increase in non-taxable income combined with the effect of the adoption of Accounting Standards Update ("ASU") No. 2016-09, *Improvements to Employee Share-Based Payment Accounting*, which resulted in a \$0.49 million reduction in income taxes for the excess tax benefits on stock-based compensation. The increase from the linked quarter was primarily due to an increase in income subject to the federal statutory rate of 35% and a decrease in non-taxable income, partially offset by the reduction in income taxes for the excess tax benefits on stock-based compensation.

Pending Acquisition of Paragon Commercial Corporation

On April 27, 2017, the Company announced the signing of a definitive agreement and plan of reorganization, dated April 26, 2017 (the "Paragon merger agreement"), pursuant to which the Company will acquire Paragon Commercial Corporation ("Paragon") and its wholly-owned bank subsidiary, Paragon Commercial Bank, a Raleigh, North Carolina-based bank with three banking offices servicing Raleigh, Cary, and Charlotte, North Carolina. The proposed acquisition of Paragon and Paragon Commercial Bank is expected to close in the fourth quarter of 2017, subject to customary closing conditions, including the receipt of required regulatory approvals and the approval of Paragon's shareholders. Under terms of the Paragon merger agreement, Paragon shareholders will receive 1.725 shares of the Company's common stock for each

PART I. FINANCIAL INFORMATION

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

share of Paragon common stock held immediately prior to the effective date of the merger. For further information, see *Note 18 - Subsequent Event* of the Notes to Consolidated Financial Statements in this report and the Company's Current Report on Form 8-K filed with the Federal Deposit Insurance Corporation ("FDIC") on April 2, 2017.

We expect to exceed \$10 billion in total consolidated assets at the time of the closing of this transaction. The Dodd-Frank Act and its implementing regulations impose various additional requirements on banks with \$10 billion or more in total assets, including compliance with portions of the Federal Reserve's enhanced prudential oversight requirements and annual stress testing requirements. In addition, once our assets exceed \$10 billion, we will be subject to the Durbin Amendment promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Under the Durbin Amendment, interchange fees for debit card transactions are capped at \$0.21 plus five basis points. This limitation on interchange fees will adversely impact our 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, mergers and acquisitions, and goodwill and other intangibles to be critical accounting policies. Refer to our 2016 Annual Report to 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 was 1.11% for first quarter 2017 compared to 1.14% for first quarter 2016, and 0.95% for fourth quarter 2016. The annualized return on average tangible assets was 1.22%, 1.21%, and 1.05% for the same respective periods.

The annualized return on average equity was 8.15% for first quarter 2017, 8.63% for first quarter 2016, and 6.95% for fourth quarter 2016, while the annualized return on average tangible equity was 11.88%, 11.56%, and 10.27% for the same respective periods.

Operating income, calculated as net interest income and noninterest income less gains on investment securities, was \$103.69 million for the quarter ended March 31, 2017, which increased \$26.11 million, or 33.66%, compared to the quarter ended March 31, 2016. Operating income was \$101.66 million for the quarter ended December 31, 2016.

Basic earnings per share were \$0.35 for the three months ended March 31, 2017, compared to \$0.35 in comparative 2016, and \$0.31 for the quarter ended December 31, 2016. Diluted earnings per share were \$0.35 for the three months ended March 31, 2017, \$0.35 for the first quarter 2016, and \$0.31 for the linked quarter.

PART I. FINANCIAL INFORMATION

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

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 affected 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.

TowneBank reported net interest income, on a tax-equivalent basis, of \$61.01 million for the quarter ended March 31, 2017, which was \$14.13 million, or 30.16%, higher than the year-ago amount of \$46.87 million. On a linked quarter basis, tax-equivalent net interest income decreased by \$2.06 million, or 3.26%, from the \$63.06 million reported for fourth quarter 2016. In comparison to first quarter 2016, net interest income rose primarily due to increased balances of earning assets, while the decrease from the linked quarter was due to a combination of lower balances of loans held for sale and lower yields on loans held for investment. Accretion of purchase accounting marks added \$1.13 million, or nine basis points, to margin in the current quarter, \$0.65 million, or six basis points, in first quarter 2016, and \$2.34 million, or 15 basis points, in the linked quarter.

Interest income, on a tax-equivalent basis, was \$70.81 million for the quarter ended March 31, 2017, which was \$15.54 million, or 28.12%, higher than the \$55.27 million reported for the quarter ended March 31, 2016. On a linked quarter basis, tax-equivalent interest income decreased \$1.92 million, or 2.64%, from \$72.73 million in fourth quarter 2016. Average earning assets grew to \$7.18 billion in the quarter ended March 31, 2017, from \$5.66 billion in the comparative prior year quarter, an increase of \$1.51 billion, or 26.71%. In the linked quarter comparison, average earning assets increased by \$51.96 million, or 0.73%, from \$7.13 billion in fourth quarter 2016. The yield on earning assets was 4.00% in the quarter ended March 31, 2017, which compared to 3.92% in the comparative prior year and 4.06% in the linked period. Average loan balances, excluding nonaccrual loans, of \$5.86 billion were \$1.35 billion, or 29.81%, higher in first quarter 2017 than in the same period a year ago, while loan yields declined by 3 basis points. In the linked quarter, average loans grew \$156.97 million, or 2.75%, and loan yields decreased by 12 basis points. The increase in interest income from the prior year first quarter was primarily driven by growth in loans and loans held for sale resulting from the Monarch acquisition, combined with the increase in yields. The decrease from the linked quarter was primarily due to a seasonal decline in loans held for sale, combined with a decrease in loan yields.

Interest expense for the quarter ended March 31, 2017, was \$9.81 million, which was \$1.41 million, or 16.77%, higher than the \$8.40 million amount in the year-ago quarter. The average balance of interest-bearing liabilities increased to \$4.83 billion in first quarter 2017 from \$3.97 billion in the comparative prior year quarter, an increase of 21.60%. On a linked quarter basis, interest expense increased by 1.44% from \$9.67 million in fourth quarter 2016. In the linked quarter, average interest-bearing liabilities increased by \$59.54 million, or 1.25%, from \$4.77 billion in the quarter ended December 31, 2016. The increase in interest expense as compared to prior periods was primarily due to the increase in interest-bearing liabilities, partially offset by lower rates in borrowings. During fourth quarter 2016, the Company pre-funded \$260 million of Federal Home Loan Bank of Atlanta ("FHLB") advances with maturities in 2017. The existing cost on these funds was an average of 4.28% and was replaced at a cost of 1.26%. The resulting annualized pre-tax savings is expected to be approximately \$7.9 million.

PART I. FINANCIAL INFORMATION

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

Net interest margin, which is net interest income expressed as a percentage of average earning assets, was 3.45% in the quarter ended March 31, 2017, which was 12 basis points higher than the 3.33% margin of the March 31, 2016 quarter, and 7 basis points lower than the 3.52% margin from the December 31, 2016, quarter. The improvement in margin from the prior year first quarter was driven by accretion of purchase accounting marks and rate decreases in borrowings. As the positive effect of the Monarch acquisition on net interest margin diminishes, the Company expects compression in the net interest margin to continue in the coming quarters. The rate of compression will reflect the impacts of the merger, including acquisition accounting impacts. Net interest margin will be impacted by future changes in short-term and long-term interest rate levels, as well as the impact from the competitive environment.

The following table sets forth an estimate of the expected effects of the estimated aggregate acquisition accounting adjustments on the pre-tax net interest income for the periods shown (in thousands):

	Discount Accretion (Premium Amortization)			
	For the three months ended			
	June 30, 2017	September 30, 2017	December 31, 2017	March 31, 2018
Assets:				
Investment Securities	\$ (57)	\$ (51)	\$ (45)	\$ (39)
Loans	\$ 1,150	\$ 1,067	\$ 1,051	\$ 949
Liabilities:				
Deposits	(232)	(71)	136	111
Total estimated effect on net interest income	1,325	1,087	870	799

Note: This information is intended for informational purposes only and is not necessarily indicative of future results. Actual results may differ due to factors such as changes in estimated prepayment speeds or projected credit loss rates.

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, 2017			Three Months Ended December 31, 2016			Three Months Ended March 31, 2016		
	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	\$ 5,862,799	\$ 64,979	4.49%	\$ 5,705,832	\$ 66,061	4.61%	\$ 4,516,277	\$ 50,781	4.52%
Taxable investment securities	627,338	2,843	1.81%	666,936	2,762	1.66%	754,514	3,055	1.62%
Tax-exempt investment securities	50,485	375	2.97%	52,199	390	2.99%	52,979	410	3.09%
Interest-bearing deposits	450,076	887	0.80%	352,418	487	0.55%	265,256	330	0.50%
Loans held for sale	186,999	1,727	3.69%	348,357	3,028	3.48%	75,435	693	3.67%
Total earning assets	7,177,697	70,811	4.00%	7,125,742	72,728	4.06%	5,664,461	55,269	3.92%
Less: allowance for loan losses	(42,610)			(41,188)			(38,555)		
Total nonearning assets	865,279			880,884			687,332		
Total assets	<u>\$ 8,000,366</u>			<u>\$ 7,965,438</u>			<u>\$ 6,313,238</u>		
Liabilities and Equity:									
Interest-bearing deposits									
Demand and money market	\$ 2,272,911	\$ 1,865	0.33%	\$ 2,230,198	\$ 1,742	0.31%	\$ 1,782,908	\$ 1,328	0.30%
Savings	320,319	757	0.96%	316,211	728	0.92%	300,070	700	0.94%
Certificates of deposit	1,508,879	3,381	0.91%	1,591,397	3,458	0.86%	1,416,629	3,185	0.90%
Total interest-bearing deposits	4,102,109	6,003	0.59%	4,137,806	5,928	0.57%	3,499,607	5,213	0.60%
Borrowings	723,506	3,803	2.10%	628,272	3,739	2.33%	468,798	3,185	2.69%
Total interest-bearing liabilities	4,825,615	9,806	0.82%	4,766,078	9,667	0.81%	3,968,405	8,398	0.85%
Demand deposits	1,957,887			1,961,902			1,415,793		
Other noninterest-bearing liabilities	123,374			150,076			98,862		
Total liabilities	6,906,876			6,878,056			5,483,060		
Shareholders' equity	1,093,490			1,087,382			830,178		
Total liabilities and equity	<u>\$ 8,000,366</u>			<u>\$ 7,965,438</u>			<u>\$ 6,313,238</u>		
Net interest income (tax-equivalent basis)		\$ 61,005			\$ 63,061			\$ 46,871	
Reconciliation of Non-GAAP Financial Measures									
Tax-equivalent basis adjustment		(724)			(910)			(535)	
Net interest income (GAAP)		<u>\$ 60,281</u>			<u>\$ 62,151</u>			<u>\$ 46,336</u>	
Interest rate spread (1)			3.18%			3.25%			3.07%
Interest expense as a percent of average earning assets			0.55%			0.54%			0.60%
Net interest margin (tax equivalent basis) (2)			3.45%			3.52%			3.33%
Total cost of deposits			0.40%			0.39%			0.43%

(1) Interest rate 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

	Increase/(Decrease) Three Months Ended March 31, 2017 Compared to Three Months Ended December 31, 2016			Increase/(Decrease) Three Months Ended March 31, 2017 Compared to Three Months Ended March 31, 2016		
	Volume	Rate (1)	Total	Volume	Rate (1)	Total
Assets:						
Loans	\$ 1,121	\$ (2,203)	\$ (1,082)	\$ 14,518	\$ (320)	\$ 14,198
Taxable investment securities	(170)	251	81	(551)	339	(212)
Tax-exempt investment securities	(13)	(2)	(15)	(19)	(16)	(35)
Interest-bearing deposits	151	249	400	300	257	557
Loans held for sale	(1,480)	179	(1,301)	1,030	4	1,034
Total earning assets	(391)	(1,526)	(1,917)	15,278	264	15,542
Liabilities and Equity:						
Interest-bearing deposits						
Demand and money market	26	97	123	383	154	537
Savings	6	23	29	43	14	57
Certificates of deposit	(217)	140	(77)	182	14	196
Total interest-bearing deposits	(185)	260	75	608	182	790
Borrowings	482	(418)	64	1,432	(814)	618
Total interest-bearing liabilities	297	(158)	139	2,040	(632)	1,408
Net interest income	\$ (688)	\$ (1,368)	\$ (2,056)	\$ 13,238	\$ 896	\$ 14,134

(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, 2017, was \$44.89 million, an increase of \$12.47 million, or 38.47%, compared to the same period in 2016 and an increase of \$5.37 million, or 13.60%, compared to fourth quarter 2016. As a percentage of total operating income, noninterest income, excluding securities gains or losses, for first quarter 2017 was 42.68%, compared with 41.16% for comparative 2016 and 38.87% for fourth quarter 2016.

PART I. FINANCIAL INFORMATION

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) 2017 over 2016	
	2017	2016	Amount	Percent
Residential mortgage banking income, net	\$ 17,632	\$ 7,118	\$ 10,514	147.71%
Insurance commissions and other title fees and income, net	14,800	14,033	767	5.47%
Real estate brokerage and property management, net	4,993	4,827	166	3.44%
Service charges on deposit accounts	2,472	2,176	296	13.60%
Credit card merchant fees, net	1,118	895	223	24.92%
Bank owned life insurance	1,474	1,172	302	25.77%
Other income	2,397	2,194	203	9.25%
Subtotal before gain on investment securities	44,886	32,415	12,471	38.47%
Net gain on investment securities	—	—	—	—
Total noninterest income	<u>\$ 44,886</u>	<u>\$ 32,415</u>	<u>\$ 12,471</u>	38.47%

	Three Months Ended		Increase/(Decrease) First Quarter 2017 over Fourth Quarter 2016	
	March 31, 2017	December 31, 2016	Amount	Percent
Residential mortgage banking income, net	\$ 17,632	\$ 18,096	\$ (464)	(2.56)%
Insurance commissions and other title fees and income, net	14,800	9,823	4,977	50.67 %
Real estate brokerage and property management, net	4,993	2,925	2,068	70.70 %
Service charges on deposit accounts	2,472	2,535	(63)	(2.49)%
Credit card merchant fees, net	1,118	1,135	(17)	(1.50)%
Bank owned life insurance	1,474	2,377	(903)	(37.99)%
Other income	2,397	2,621	(224)	(8.55)%
Subtotal before gain on investment securities	44,886	39,512	5,374	13.60 %
Net gain on investment securities	—	6	(6)	(100.00)%
Total noninterest income	<u>\$ 44,886</u>	<u>\$ 39,518</u>	<u>\$ 5,368</u>	13.58 %

For the first quarter of 2017, residential mortgage banking income, net of commission expense, was \$17.63 million, an increase of \$10.51 million, or 147.71%, compared to first quarter 2016, and a decrease of \$0.46 million, or 2.56%, compared to fourth quarter 2016. The increase from first quarter 2016 was primarily due to higher production volumes resulting from the Monarch merger in June 2016, while the decrease from the linked quarter was due to a seasonally driven decrease in production volumes. Also factoring in the variance from the prior periods was a seasonal increase in mortgage banking income of \$1.22 million associated with an increase in the value of rate lock commitments and forward contracts

PART I. FINANCIAL INFORMATION

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

recorded as of March 31, 2017, as compared to a decrease of \$1.43 million and an increase of \$0.38 million recognized for the quarters ended December 31, 2016, and March 31, 2016, respectively.

For the first quarter of 2017, insurance commissions and other title income, net of commission expense, was \$14.80 million, which was \$0.77 million, or 5.47%, higher than comparative 2016, and \$4.98 million, or 50.67%, higher than fourth quarter 2016. The increase from the comparative prior year quarter was largely due to organic growth in property and casualty insurance and employee benefits insurance. Also contributing was an increase in commissions from travel insurance due to organic growth from existing accounts and new business. In comparison to fourth quarter 2016, the Company saw a seasonal increase in travel insurance of \$0.80 million and an increase in contingency and bonus revenue income of \$3.47 million, as contingent commissions are mostly received during the first quarter of each year. The Company recognized contingency income of \$3.41 million in first quarter 2016.

Real estate brokerage and property management income, net of commission expense, for first quarter 2017 was \$4.99 million, which was \$0.17 million, or 3.44%, higher than comparative 2016, and \$2.07 million, or 70.70%, higher than fourth quarter 2016. The slight increase from the prior year comparative period was primarily a result of an increase in residential real estate sales commissions, while the increase from the linked quarter was primarily due to the seasonal increase in resort property management fees.

Service charges on deposit accounts were \$2.47 million for first quarter 2017, compared with \$2.18 million for the comparative 2016 period, and \$2.53 million for fourth quarter 2016. The increase from first quarter 2016 was primarily due to the addition of accounts related to the Monarch merger, while the slight decrease in the linked quarter was related to lower overdraft fees.

For the first quarter of 2017, credit card merchant fees totaled \$1.12 million, which was \$0.22 million, or 24.92%, higher than comparative 2016, and \$0.02 million, or 1.50%, seasonally lower than fourth quarter 2016. The increase from the prior comparative period was primarily related to the effects of the Monarch merger, combined with a decrease in prior year merchant fees related to structural changes in vendor contractual terms and nonrecurring expenses related to a platform change and equipment purchases associated with Europay, MasterCard, and Visa (EMV) compliance.

Income from bank-owned life insurance ("BOLI") was \$1.47 million in first quarter 2017, compared to \$1.17 million in first quarter 2016, and \$2.38 million in fourth quarter 2016. The increase from first quarter 2016 was primarily due to a higher average BOLI balance in the current quarter, while the variance from the linked quarter was due to a death benefit received in fourth quarter 2016.

Other noninterest income for the three months ended March 31, 2017, was \$2.40 million and included income generated by Towne Investment Group, net of commission expense. For the three months ended March 31, 2017, net commission income for Towne Investment Group totaled \$0.94 million as compared to \$0.60 million for first quarter 2016 and \$1.07 million for fourth quarter 2016.

Noninterest Expense. For the quarter ended March 31, 2017, total noninterest expense was \$70.25 million, which was \$18.09 million, or 34.68%, higher than comparative 2016, and \$2.59 million, or 3.55%, lower than the quarter ended December 31, 2016.

As a percentage of operating income, noninterest expense was 66.80% for the first quarter of 2017, 66.24% for comparative 2016, and 71.64% for the quarter ended December 31, 2016. The primary components of noninterest expense in the first quarter of 2017 were salaries and employee benefits of \$40.21 million,

PART I. FINANCIAL INFORMATION

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

occupancy expenses of \$6.68 million, furniture and equipment expenses of \$3.34 million, advertising and marketing expenses of \$2.64 million, professional fees of \$1.83 million, software expenses of \$2.25 million, and amortization expense of \$1.86 million. In comparison to the first quarter of the prior year, the primary driver of the increase in total noninterest expense was due to additional operational expenses related to the Monarch acquisition, while the decrease from the linked quarter was due to a decrease of \$2.86 million in salaries and employee benefits expenses.

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, 2017 over		March 31, 2017 over	
	March 31,		December 31,	March 31, 2016		December 31, 2016	
	2017	2016	2016	Amount	Percent	Amount	Percent
Salaries and benefits	\$ 40,208	\$ 30,187	\$ 43,071	\$ 10,021	33.20 %	\$ (2,863)	(6.65)%
Occupancy expense	6,684	5,017	6,885	1,667	33.23 %	(201)	(2.92)%
Furniture and equipment	3,343	2,357	3,378	986	41.83 %	(35)	(1.04)%
Other							
Advertising and marketing	2,642	1,902	2,235	740	38.91 %	407	18.21 %
Acquisition-related expenses	(5)	414	(707)	(419)	(101.21)%	702	(99.29)%
Other	2,813	1,174	3,158	1,639	139.61 %	(345)	(10.92)%
Charitable contributions	1,398	1,048	1,117	350	33.40 %	281	25.16 %
Outside processing	1,634	1,397	1,697	237	16.96 %	(63)	(3.71)%
Professional fees	1,828	1,451	1,499	377	25.98 %	329	21.95 %
Stationery and supplies	609	594	949	15	2.53 %	(340)	(35.83)%
FDIC and other insurance	937	991	989	(54)	(5.45)%	(52)	(5.26)%
Foreclosed property expenses	131	113	608	18	15.93 %	(477)	(78.45)%
Software expense	2,251	1,622	2,052	629	38.78 %	199	9.70 %
Telephone and postage	1,671	1,210	1,826	461	38.10 %	(155)	(8.49)%
Amortization - intangibles	1,864	1,092	1,897	772	70.70 %	(33)	(1.74)%
Bank franchise tax/SCC fees	1,242	941	1,151	301	31.99 %	91	7.91 %
Directors fees and expenses	316	271	387	45	16.61 %	(71)	(18.35)%
Travel/meals/entertainment	682	380	642	302	79.47 %	40	6.23 %
Total other expenses	20,013	14,600	19,500	5,413	37.08 %	513	2.63 %
Total noninterest expense	<u>\$ 70,248</u>	<u>\$ 52,161</u>	<u>\$ 72,834</u>	<u>\$ 18,087</u>	<u>34.68 %</u>	<u>\$ (2,586)</u>	<u>(3.55)%</u>

Salary and benefits expense, the largest portion of noninterest expense, was \$40.21 million, representing 57.24% of total noninterest expense for the quarter ended March 31, 2017, and \$30.19 million, or 57.87% of total noninterest expense for the three months ended March 31, 2016. Salary and benefits expense increased \$10.02 million, or 33.20%, over the comparative period in 2016, and decreased \$2.86 million, or 6.65%, from fourth quarter 2016. The increase from prior year first quarter was primarily due to the addition of staff resulting from the Monarch acquisition, partially offset by decreases in employee profit-sharing expense. The decrease from the linked quarter was primarily due to decreases in employee profit-sharing and incentive plan expenses.

In our Banking segment, we had a total of 822 full-time equivalent employees ("FTE") at March 31, 2017, as compared to 712 at March 31, 2016, and 848 at December 31, 2016. In our non-Banking segments at

PART I. FINANCIAL INFORMATION

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

March 31, 2017, we had a total of 1,266 FTEs, excluding real estate sales agents, which was up from 739 at March 31, 2016, and 1,272 at December 31, 2016. 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, 2017, decreased from \$54,000 and increased from \$48,000 for the three-month periods ended March 31, 2016, and December 31, 2016, respectively.

Occupancy expense for the first quarter of 2017 experienced a \$1.67 million, or 33.23%, increase from the comparative quarter of 2016, and a \$0.20 million, or 2.92%, decrease from the fourth quarter of 2016. The increase from prior year first quarter was primarily related to facilities acquired in the Monarch acquisition, combined with the opening of a new banking office in Richmond, Virginia, in August 2016. The slight decrease from fourth quarter 2016 was due to a lower level of expenses related to maintenance and cleaning services.

For the three-month period ended March 31, 2017, furniture and equipment expense increased by \$0.99 million over the comparative 2016 period, and decreased \$0.04 million over fourth quarter 2016. The increase from the first quarter of 2016 was primarily related to facilities acquired in the Monarch acquisition.

Other noninterest expenses for the first quarter of 2017 were \$20.01 million, an increase of \$5.41 million, or 37.08%, compared to the same period in 2016, and an increase of \$0.51 million, or 2.63%, compared to fourth quarter 2016. Increases in amortization expenses, loan expenses, and marketing expenses drove the increase from the comparative prior year first quarter, while fourth quarter 2016 expenses were affected by a reversal of previously accrued acquisition-related expenses.

Provision for Income Taxes. We reported a provision for income tax expense of \$9.39 million, representing an effective tax rate of 29.94%, in the first quarter of 2017. The provision for income tax expense was \$8.19 million for the first quarter of 2016, with an effective rate of 31.48%, and \$7.16 million with an effective rate of 27.37%, for the fourth quarter of 2016. The decrease from the prior year first quarter was primarily a result of an increase in non-taxable income combined with the effect of the adoption of ASU No. 2016-09, which resulted in a \$0.49 million reduction in income taxes for the excess tax benefits on stock-based compensation. The increase from the linked quarter was primarily due to an increase in income subject to the federal statutory rate of 35% and a decrease in non-taxable income, partially offset by the reduction in income taxes for the excess tax benefits on stock-based compensation.

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, 2017, the Banking segment represented 81.79%, or \$17.97 million, of our total consolidated net income, compared to 79.31%, or \$14.13 million, for comparative 2016.

Pre-tax earnings for the three months ended March 31, 2017, for the Banking segment were \$24.73 million, increasing \$4.87 million from comparative 2016. The increase in earnings from the comparative 2016 quarter was driven by an increase in net interest income of \$12.62 million, which was primarily a result of additional interest income from earning assets related to the Monarch merger as average loan balances increased \$1.35 billion to \$5.86 billion. Partially offsetting the increase was an increase in the provision for loan losses of \$2.80 million and an increase in noninterest expenses of \$6.17 million, which included

PART I. FINANCIAL INFORMATION

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

increased personnel costs of \$2.83 million, higher occupancy costs of \$0.65 million, and an increase in other expenses of \$1.20 million, which included additional amortization expenses of \$0.55 million.

Pre-tax earnings increased \$0.25 million compared to the linked quarter ended December 31, 2016. The increase in earnings was driven by a decrease in noninterest expenses of \$3.17 million, which included a decrease in personnel costs of \$3.43 million and foreclosed property expenses of \$0.48 million. These factors were partially offset by a decrease in net interest income of \$1.04 million, which was due to a combination of lower loan yields and higher borrowing expenses. Additionally, there was an increase in the provision for loan losses of \$0.74 million.

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,	March 31, 2017		March 31, 2017	
	March 31,		December 31,	March 31, 2016		December 31, 2016	
	2017	2016	2016	Amount	Percent	Amount	Percent
Net interest income	\$ 58,444	\$ 45,823	\$ 59,482	\$ 12,621	27.54 %	\$ (1,038)	(1.75)%
Service charges on deposit accounts	2,472	2,176	2,535	296	13.60 %	(63)	(2.49)%
Credit card merchant fees	1,118	895	1,135	223	24.92 %	(17)	(1.50)%
Other income	3,106	2,530	4,125	576	22.77 %	(1,019)	(24.70)%
Net gain on investment securities	—	—	6	—	— %	(6)	(100.00)%
Total noninterest income	6,696	5,601	7,801	1,095	19.55 %	(1,105)	(14.16)%
Total revenue	65,140	51,424	67,283	13,716	26.67 %	(2,143)	(3.19)%
Provision for loan losses	2,541	(259)	1,801	2,800	N/M	740	41.09 %
Salaries and employee benefits	20,341	17,513	23,770	2,828	16.15 %	(3,429)	(14.43)%
Occupancy expense	4,128	3,475	4,349	653	18.79 %	(221)	(5.08)%
Furniture and equipment	2,274	1,865	2,374	409	21.93 %	(100)	(4.21)%
Advertising and marketing	1,041	874	749	167	19.11 %	292	38.99 %
Charitable contributions	1,313	967	1,011	346	35.78 %	302	29.87 %
Outside processing	1,154	930	1,387	224	24.09 %	(233)	(16.80)%
Foreclosed property expenses	130	112	607	18	16.07 %	(477)	(78.58)%
FDIC and other insurance	987	1,050	848	(63)	(6.00)%	139	16.39 %
Professional fees	1,280	1,049	1,181	231	22.02 %	99	8.38 %
Telephone and postage	904	744	997	160	21.51 %	(93)	(9.33)%
Other expenses	4,797	3,602	4,242	1,195	33.18 %	555	13.08 %
Total noninterest expenses	38,349	32,181	41,515	6,168	19.17 %	(3,166)	(7.63)%
Income before income tax and corporate allocation	24,250	19,502	23,967	4,748	24.35 %	283	1.18 %
Corporate allocation	484	360	519	124	34.44 %	(35)	(6.74)%
Income before income tax provision	24,734	19,862	24,486	4,872	24.53 %	248	1.01 %
Provision for income tax expense	6,765	5,729	6,546	1,036	18.08 %	219	3.35 %
Net income	17,969	14,133	17,940	3,836	27.14 %	29	0.16 %
Noncontrolling interest	(2)	—	(9)	(2)	N/M	7	(77.78)%
Net income attributable to TowneBank	\$ 17,967	\$ 14,133	\$ 17,931	\$ 3,834	27.13 %	\$ 36	0.20 %
Efficiency ratio (1)	58.87%	62.58%	61.71%	(3.71)%	(5.93)%	(2.84)%	(4.60)%

(1) Excludes gain on investment securities.

PART I. FINANCIAL INFORMATION

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

Realty Segment. For the three months ended March 31, 2017, the Realty segment had income before income tax provision and noncontrolling interest of \$2.07 million, as compared to \$2.06 million for the comparative 2016 period, and \$1.70 million for the linked quarter ended December 31, 2016. Total revenue increased to \$25.45 million in first quarter 2017 from \$13.41 million in first quarter 2016. The \$10.47 million, or 143.16%, increase in residential mortgage banking income resulted from higher production volumes related to the Monarch merger. Residential mortgage banking income included an increase in the value of rate lock commitments and forward contracts of \$1.22 million for the quarter ended March 31, 2017, compared to an increase of \$0.38 million in the same period of 2016. The increase in net interest and other income of \$1.44 million was a result of additional net interest income resulting from a higher balance of average mortgage loans held for sale. In the linked quarter comparison, the seasonal increase in resort property management fees was partially offset by the seasonal decrease in mortgage banking.

Expenses for the Realty segment increased 106.35%, or \$11.89 million, when compared to the same period in 2016, and increased by 1.07%, or \$0.24 million, when compared to the quarter ended December 31, 2016. The increase from first quarter 2016 was primarily due to an increase in mortgage operation expenses related to the Monarch merger, while a slight increase in personnel costs drove the linked quarter variance.

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, 2017		March 31, 2017	
	March 31,		December 31,	March 31, 2016		December 31, 2016	
	2017	2016	2016	Amount	Percent	Amount	Percent
Residential mortgage banking income, net	\$ 17,775	\$ 7,310	\$ 18,378	\$ 10,465	143.16 %	\$ (603)	(3.28)%
Real estate brokerage income, net	1,460	1,412	1,761	48	3.40 %	(301)	(17.09)%
Title insurance and settlement fees	355	350	422	5	1.43 %	(67)	(15.88)%
Property management fees, net	3,533	3,415	1,163	118	3.46 %	2,370	203.78 %
Income from unconsolidated subsidiary	124	165	218	(41)	(24.85)%	(94)	(43.12)%
Net interest and other income	2,203	762	2,959	1,441	189.11 %	(756)	(25.55)%
Total revenue	25,450	13,414	24,901	12,036	89.73 %	549	2.20 %
Salaries and employee benefits	13,708	6,706	13,551	7,002	104.41 %	157	1.16 %
Occupancy expense	1,964	1,013	2,002	951	93.88 %	(38)	(1.90)%
Furniture and equipment	869	268	807	601	224.25 %	62	7.68 %
Amortization of intangible assets	559	353	565	206	58.36 %	(6)	(1.06)%
Other expenses	5,978	2,844	5,909	3,134	110.20 %	69	1.17 %
Total expenses	23,078	11,184	22,834	11,894	106.35 %	244	1.07 %
Income before income tax, corporate allocation and noncontrolling interest	2,372	2,230	2,067	142	6.37 %	305	14.76 %
Corporate allocation	(307)	(170)	(364)	(137)	(80.59)%	57	15.66 %
Income before income tax provision and noncontrolling interest	2,065	2,060	1,703	5	0.24 %	362	21.26 %
Provision for income tax	627	659	355	(32)	(4.86)%	272	76.62 %
Net income	1,438	1,401	1,348	37	2.64 %	90	6.68 %
Noncontrolling interest	(512)	(368)	(675)	(144)	(39.13)%	163	(24.15)%
Net income attributable to TowneBank	\$ 926	\$ 1,033	\$ 673	\$ (107)	(10.36)%	\$ 253	37.59 %

PART I. FINANCIAL INFORMATION

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

	Three Months Ended			Increase/(Decrease)			
	March 31,		December 31,	March 31, 2017		March 31, 2017	
	March 31,		December 31,	March 31, 2016		December 31, 2016	
	2017	2016	2016	Amount	Percent	Amount	Percent
Key data:							
Efficiency ratio	90.68%	83.38%	91.70%	7.30%	8.76 %	(1.02)%	(1.11)%
Number of units sold	796	804	1,059	(8)	(1.00)%	(263)	(24.83)%
Volume of units sold	\$ 222,095	\$ 224,701	\$ 310,149	\$ (2,606)	(1.16)%	\$ (88,054)	(28.39)%
Number of real estate agents	411	416	409	(5)	(1.20)%	2	0.49 %
Loans originated, mortgage	\$ 540,958	\$ 162,990	\$ 790,170	\$ 377,968	231.90 %	\$ (249,212)	(31.54)%
Loans originated, joint venture	165,097	150,147	215,812	14,950	9.96 %	(50,715)	(23.50)%
Total loans originated	\$ 706,055	\$ 313,137	\$ 1,005,982	\$ 392,918	125.48 %	\$ (299,927)	(29.81)%
Number of loans, mortgage	2,158	681	2,989	1,477	216.89 %	(831)	(27.80)%
Number of loans, joint venture	781	736	1,029	45	6.11 %	(248)	(24.10)%
Total number of loans	2,939	1,417	4,018	1,522	107.41 %	(1,079)	(26.85)%
Average loan amount, mortgage	\$ 251	\$ 239	\$ 264	\$ 12	5.02 %	\$ (13)	(4.92)%
Average loan amount, joint venture	211	204	210	7	3.43 %	1	0.48 %
Average loan amount	\$ 240	\$ 221	\$ 250	\$ 19	8.60 %	\$ (10)	(4.00)%
Average number of originators, mortgage	251	68	247	183	269.12 %	4	1.62 %
Average number of originators, joint venture	67	53	59	14	26.42 %	8	13.56 %
Average number of originators	318	121	306	197	162.81 %	12	3.92 %

Mortgage. Loan volume for the combined mortgage operations increased in the quarter ended March 31, 2017, as compared to the same period in 2016. Total loans originated in the first quarter of 2017 were \$706.06 million, a 125.48% increase, or \$392.92 million, from \$313.14 million in the comparative period of 2016. This was a \$299.93 million, or 29.81%, seasonal decrease compared to the volume for the quarter ended December 31, 2016. Refinance activity comprised \$129.20 million of loan volume for the quarter ended March 31, 2017, while purchases accounted for the remaining \$576.86 million in loan volume for the quarter. For the quarters ended March 31, 2016, and December 31, 2016, refinance volume was \$49.09 million and \$272.14 million, respectively, while purchase volume was \$264.05 million and \$733.84 million, respectively.

Insurance Segment. The Insurance segment comprises property and casualty and group benefit divisions. The Insurance segment represented 13.99%, or \$3.08 million, of total consolidated net income at March 31, 2017, and 14.89%, or \$2.65 million, at March 31, 2016.

Earnings before income taxes and noncontrolling interests for the three months ended March 31, 2017, were \$5.58 million, increasing \$0.65 million, or 13.23%, from comparative 2016, and \$4.77 million from the linked quarter ended December 31, 2016. The primary factors affecting earnings in comparison to the prior year periods were income related to organic growth in property and casualty and employee benefits lines, an increase in contingency revenue, and growth in our travel insurance business.

PART I. FINANCIAL INFORMATION

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

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, 2017		March 31, 2017	
	March 31,		December 31,	March 31, 2016		December 31, 2016	
	2017	2016	2016	Amount	Percent	Amount	Percent
Net commission and fee income							
Property and casualty	\$ 8,457	\$ 8,086	\$ 7,614	\$ 371	4.59 %	\$ 843	11.07 %
Employee benefits	2,974	2,898	2,930	76	2.62 %	44	1.50 %
Travel insurance	1,627	1,456	828	171	11.74 %	799	96.50 %
Specialized benefit services	165	153	164	12	7.84 %	1	0.61 %
Total net commissions and fees	13,223	12,593	11,536	630	5.00 %	1,687	14.62 %
Contingency and bonus revenue	3,539	3,411	67	128	3.75 %	3,472	N/M
Other income	88	77	71	11	14.29 %	17	23.94 %
Total revenues	16,850	16,081	11,674	769	4.78 %	5,176	44.34 %
Employee commission expense	2,273	2,168	2,221	105	4.84 %	52	2.34 %
Revenue, net of commission expense	14,577	13,913	9,453	664	4.77 %	5,124	54.21 %
Salaries and employee benefits	6,159	5,968	5,749	191	3.20 %	410	7.13 %
Occupancy expense	592	529	535	63	11.91 %	57	10.65 %
Furniture and equipment	200	224	196	(24)	(10.71)%	4	2.04 %
Amortization of intangible assets	697	685	701	12	1.75 %	(4)	(0.57)%
Other expenses	1,173	1,390	1,304	(217)	(15.61)%	(131)	(10.05)%
Total operating expenses	8,821	8,796	8,485	25	0.28 %	336	3.96 %
Income before income tax, corporate allocation and noncontrolling interest	5,756	5,117	968	639	12.49 %	4,788	494.63 %
Corporate allocation	(177)	(190)	(155)	13	(6.84)%	(22)	14.19 %
Income before income tax provision and noncontrolling interest	5,579	4,927	813	652	13.23 %	4,766	586.22 %
Provision for income tax	1,994	1,800	259	194	10.78 %	1,735	669.88 %
Net income	3,585	3,127	554	458	14.65 %	3,031	547.11 %
Noncontrolling interest	(510)	(474)	(162)	(36)	7.59 %	(348)	214.81 %
Net income attributable to TowneBank	\$ 3,075	\$ 2,653	\$ 392	\$ 422	15.91 %	\$ 2,683	684.44 %
Efficiency ratio	60.51%	63.22%	89.76%	(2.71)%	(4.29)%	(29.25)%	(32.59)%

Total revenues for the first quarter of 2017 increased \$0.77 million, or 4.78%, when compared to the same period in 2016, and increased \$5.18 million, or 44.34%, for the three months ended December 31, 2016. The increase from the comparative prior year period was due to organic growth across the lines of business and an increase in contingency and bonus revenue. The increase in revenues of \$5.18 million on a linked quarter basis was a result of a seasonal increase in contingency and bonus revenue of \$3.47 million combined with an increase in travel insurance commissions of \$0.80 million, and an increase in property and casualty commissions of \$0.84 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.

PART I. FINANCIAL INFORMATION

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

Total operating expenses for the first quarter of 2017 increased \$0.03 million, or 0.28%, when compared to the same period in 2016, and increased \$0.34 million, or 3.96%, when compared to the three months ended December 31, 2016. The largest factor in the increase from the comparative prior year period and the linked quarter was salaries and employee benefits expense, which increased \$0.19 million, or 3.20%, and \$0.41 million, and 7.13%, when comparing the first quarter of 2017 to the periods ended March 31, 2016, and December 31, 2016. The linked quarter increase was due to higher health benefit costs and payroll taxes.

ANALYSIS OF FINANCIAL CONDITION

Overview. At March 31, 2017, total assets were \$8.17 billion, which is \$1.81 billion, or 28.43%, higher than the period-end balance for comparative 2016, and \$0.20 billion, or 2.52%, higher than the balance at December 31, 2016. Our loan portfolio, less unearned income and deferred costs, made up 72.33% of our period-end assets and totaled \$5.91 billion at March 31, 2017. Average assets for the quarter ended March 31, 2017, were \$8.0 billion, up \$1.69 billion, or 26.72%, from the comparative March 31, 2016 quarter, and up \$34.93 million, or 0.44%, from the quarter ended December 31, 2016.

Average earning assets increased \$1.51 billion, or 26.71%, from \$5.66 billion for the first quarter of 2016 to \$7.18 billion for the first quarter of 2017. Compared to the fourth quarter of 2016, average earning assets increased \$51.96 million.

Our average total deposits were \$6.06 billion for first quarter 2017, reflecting growth of \$1.14 billion, or 23.29%, compared to first quarter 2016. Growth continued in average noninterest-bearing deposits, which increased \$542.09 million, or 38.29%, from March 31, 2016.

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, 2017, were \$360.97 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 2017 was \$450.08 million, or 6.27%, of average total earning assets compared with \$265.26 million, or 4.68%, of average total earning assets for comparative 2016. For the fourth quarter of 2016, the average balance of interest-bearing deposits in other banks was \$352.42 million, or 4.95%, 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 \$720.67 million at March 31, 2017, compared with \$821.55 million at March 31, 2016. The average balance during the first quarter of 2017 was \$556.20 million, compared to the 2016 period average of \$700.47 million, or 7.75%, and 12.05% of average earning assets, respectively. During the three months ended March 31, 2017, we had sales, maturities, and calls totaling \$293.08 million in investment securities that were classified as available for sale.

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

PART I. FINANCIAL INFORMATION

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

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 \$65.12 million at March 31, 2017, and \$66.92 million at March 31, 2016. The average balance during the first quarter of 2017 was \$65.84 million, compared with \$67.82 million in the 2016 period, representing 0.92% and 1.17% 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, 2017, we held \$214.05 million in mortgage loans originated and intended for sale in the secondary market, as compared with \$97.49 million at March 31, 2016, and \$314.12 million at December 31, 2016. Average loans held for sale were 2.61% and 1.33% of average earning assets for the quarters ended March 31, 2017 and 2016, respectively. Average loans held for sale were 4.89% of average earning assets for the quarter ended December 31, 2016. 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 locked with the customer. The commitments are generally for periods of 60 days and are at market rates. In order to mitigate the effect of the interest rate risk inherent in providing rate lock commitments, we economically hedge our commitments by entering into either a forward loan sales contract under best efforts or a trade of "to be announced" ("TBA") mortgage-backed securities ("notional securities") for mandatory delivery. The changes in fair value related to movements in market rates of the rate lock commitments and the forward loan sales contracts and notional securities generally move in opposite directions, and the net impact of changes in these valuations on net income during the loan commitment period is generally inconsequential. The Company has not formally designated these derivatives as a qualifying hedge relationship and, accordingly, accounts for such forward contracts as freestanding derivatives with changes in fair value recorded to earnings each period.

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 a loan contract and the subject loan is closed.

Loan Portfolio. Loans, net of unearned income and deferred costs, were \$5.91 billion at March 31, 2017, which was \$1.36 billion, or 29.89%, above the \$4.55 billion reported at March 31, 2016, and \$0.11 billion, or 1.82%, above the \$5.81 billion at December 31, 2016. The primary factor that contributed to the increase in loans from the prior year was the Monarch merger, which resulted in \$808.14 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 81.68% for the quarter ended March 31, 2017, compared with 79.73% for comparable 2016 and 80.07% for the quarter ended December 31, 2016.

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

PART I. FINANCIAL INFORMATION

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

not be reasonably assured. It considers internal risk grades, 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.

The allowance for loan losses at March 31, 2017, March 31, 2016, and December 31, 2016, was \$43.19 million, \$37.76 million, and \$42.00 million, respectively. The allowance was equal to 0.73% of total loans outstanding at March 31, 2017, compared with 0.83% and 0.72% at March 31, 2016, and December 31, 2016, respectively. Excluding purchased loans, the allowance was equal to 0.86% of loans outstanding at March 31, 2017, compared with 0.92% and 0.87% at March 31, 2016, and December 31, 2016, respectively. We believe the decline in the ratio from the prior year, excluding purchased loans, is appropriate given continued improvement in the risk profile of our loan portfolio and diversification efforts

PART I. FINANCIAL INFORMATION

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

in the loan portfolio. Reflective of improving credit quality, classified loans, defined as loans in the substandard and doubtful categories, remained low at 0.92% of total loans at March 31, 2017, down from 1.61% at March 31, 2016, and 1.31% at December 31, 2016. Additionally, loans 30 to 89 days past due were \$11.42 million, including purchased impaired loans of \$1.22 million, at March 31, 2017, as compared to \$12.06 million and \$10.46 million at March 31, 2016, and December 31, 2016, respectively, and total past due and nonaccruing loans were \$23.79 million, including purchased impaired past-due loans of \$2.02 million, at March 31, 2017, from \$21.15 million and \$25.21 million at March 31, 2016, and December 31, 2016, 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 3.74x of nonperforming loans at March 31, 2017, compared with 4.75x and 3.21x at March 31, 2016, and December 31, 2016, 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, 2017.

PART I. FINANCIAL INFORMATION

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

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,
	2017	2016	2016
Allowance for loan losses			
Balance beginning of period	\$ 42,001	\$ 38,359	\$ 40,655
Loans charged off:			
Residential 1-4 family	(1,288)	(321)	(308)
Multifamily	—	—	—
Commercial real estate	(67)	(66)	(333)
Construction	—	(62)	(15)
Commercial and industrial	(36)	(72)	(19)
Consumer and other	(228)	(12)	(209)
Total	(1,619)	(533)	(884)
Loans recovered:			
Residential 1-4 family	101	114	307
Multifamily	—	—	1
Commercial real estate	10	16	7
Construction	11	5	4
Commercial and industrial	—	30	41
Consumer and other	150	28	39
Total	272	193	399
Net loans charged off	(1,347)	(340)	(485)
Provision for loan losses	2,541	(259)	1,831
Balance end of period	<u>\$ 43,195</u>	<u>\$ 37,760</u>	<u>\$ 42,001</u>
Nonperforming assets			
Nonperforming loans	\$ 11,538	\$ 7,944	\$ 13,099
Former bank premises	2,798	—	3,494
Foreclosed property	21,473	29,740	21,011
Total nonperforming assets	<u>\$ 35,809</u>	<u>\$ 37,684</u>	<u>\$ 37,604</u>
Loans past due 90 days and still accruing interest	<u>\$ 35</u>	<u>\$ —</u>	<u>\$ 76</u>
Asset Quality Ratios			
Allowance for loan losses to nonperforming loans	3.74x	4.75x	3.21x
Allowance for loan losses to period end loans	0.73%	0.83%	0.72%
Allowance for loan losses to period end loans excluding purchased loans	0.86%	0.92%	0.87%
Nonperforming loans to period end loans	0.20%	0.17%	0.23%
Nonperforming assets to period end assets	0.44%	0.59%	0.47%
Net charge-offs to average loans (annualized)	0.09%	0.03%	0.03%

PART I. FINANCIAL INFORMATION

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

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, 2017, we had \$35.81 million in nonperforming assets, which amounted to 0.44% of total assets. Additionally, there were \$0.04 million loans past due 90 days or more that were accruing interest. Nonperforming assets consist of \$11.54 million in nonperforming loans, \$2.80 million in former bank premises related to the Monarch merger, as well as \$21.47 million in foreclosed property. Nonperforming loans decreased by \$1.56 million from December 31, 2016, as additions to nonaccrual loans during the first quarter of 2017 were outpaced by transfers to other real estate owned ("OREO"), charge-offs, and payments received. Nonperforming residential loans decreased by \$1.19 million as new nonperforming loans of \$0.63 million were outpaced by paydowns of \$0.07 million, transfers to OREO of \$0.44 million, and charge-offs of \$1.31 million. There was also an increase in nonperforming commercial real estate loans, which rose by \$0.33 million, with new nonperforming loans of \$1.13 million and paydowns of \$0.08 million. Additionally, new consumer nonperforming loans decreased \$0.10 million. Foreclosed property increased slightly from \$21.01 million at December 31, 2016, and decreased from \$29.74 million at March 31, 2016. The 10 largest foreclosed property developments represented approximately 88.79% of total foreclosed property at March 31, 2017, with the largest development representing approximately 41%. Foreclosed property consists of 12 residential properties, 20 construction and development properties, and 4 commercial properties.

At March 31, 2017, loans 60-89 days past due, excluding nonperforming loans, totaled \$3.58 million. Additionally, there are other performing loans, totaling \$22.37 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.

PART I. FINANCIAL INFORMATION

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

At March 31, 2017, nonaccruing TDRs, which are included in nonperforming loans, totaled \$5.97 million, and accruing TDRs totaled \$26.66 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 longer, 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, 2017	December 31, 2016
Construction and land development	\$ 307	\$ 696
Commercial real estate	5,245	5,110
Multifamily real estate	665	690
1-4 family residential real estate	4,918	6,113
Commercial and industrial business loans	347	362
Consumer loans and other	56	128
Total nonperforming loans	<u>\$ 11,538</u>	<u>\$ 13,099</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, 2017	March 31, 2016	December 31, 2016
Real estate loans:			
Residential 1-4 family	\$ 8,942	\$ 8,212	\$ 9,050
Commercial	16,381	14,833	16,248
Construction	5,215	5,015	4,280
Multifamily	1,313	922	1,370
Total real estate loans	<u>31,851</u>	<u>28,982</u>	<u>30,948</u>
Commercial and industrial loans	6,591	5,390	6,410
Consumer loans and other	4,753	3,388	4,643
Total	<u>\$ 43,195</u>	<u>\$ 37,760</u>	<u>\$ 42,001</u>

PART I. FINANCIAL INFORMATION

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

Deposits. Total deposits at March 31, 2017, were \$6.19 billion, representing an increase of 24.94%, or \$1.24 billion, over March 31, 2016, and an increase of \$155.57 million, or 2.58%, compared to December 31, 2016. The primary factor that contributed to the increase in deposits from the prior year first quarter was the Monarch merger, which resulted in \$1.06 billion of assumed deposits. Total average deposits were \$6.06 billion during the first quarter of 2017, compared to \$4.92 billion during the first quarter of 2016, and \$6.10 billion during the fourth quarter of 2016.

Average noninterest-bearing demand deposits as a percentage of average total deposits were 32.31% during the first quarter of 2017 and 28.80% during the same period in 2016. Average noninterest-bearing demand deposits were 32.16% of average total deposits for the fourth quarter of 2016. The cost of interest-bearing deposits was 0.59% for the first quarter of 2017, compared with 0.60% for the first quarter of 2016, and 0.57% for the fourth quarter of 2016.

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,	
	2017		2016		2016	
Interest-bearing demand and money market accounts	\$ 2,272,911	0.33%	\$ 1,782,908	0.30%	\$ 2,230,198	0.31%
Regular savings	320,319	0.96%	300,070	0.94%	316,211	0.92%
Certificates of deposit	1,508,879	0.91%	1,416,629	0.90%	1,591,397	0.86%
Total interest bearing	4,102,109	0.59%	3,499,607	0.60%	4,137,806	0.57%
Noninterest bearing	1,957,887		1,415,793		1,961,902	
Total	<u>\$ 6,059,996</u>	0.40%	<u>\$ 4,915,400</u>	0.43%	<u>\$ 6,099,708</u>	0.39%

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,	
	2017		2016		2016	
Interest-bearing demand and money market accounts	\$ 2,272,911	37.50%	\$ 1,782,908	36.27%	\$ 2,230,198	36.56%
Regular savings	320,319	5.29%	300,070	6.11%	316,211	5.19%
Certificates of deposit	1,508,879	24.90%	1,416,629	28.82%	1,591,397	26.09%
Total-interest bearing	4,102,109	67.69%	3,499,607	71.20%	4,137,806	67.84%
Noninterest-bearing	1,957,887	32.31%	1,415,793	28.80%	1,961,902	32.16%
Total	<u>\$ 6,059,996</u>	100.00%	<u>\$ 4,915,400</u>	100.00%	<u>\$ 6,099,708</u>	100.00%

PART I. FINANCIAL INFORMATION

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

Advances from the Federal Home Loan Bank of Atlanta. Advances from the ("FHLB") at March 31, 2017, were \$687.37 million, compared to \$428.94 million at March 31, 2016, and \$687.51 million at December 31, 2016. The average borrowing cost for the first quarter of 2017 was 2.23%, 2.96% in the first quarter of 2016, and 2.75% in the fourth quarter of 2016.

The scheduled maturity dates, call dates, and related fixed interest rates on advances from the FHLB at March 31, 2017, are summarized as follows (dollars in thousands):

Maturity	Interest Rate	Call / Reset Date	Outstanding Amount
05/18/2017	4.35%	—	\$ 80,000
05/18/2017	4.48%	—	80,000
01/29/2018	3.05%	—	13,000
11/15/2028	3.43%	—	4,872
12/01/2028	2.83%	—	3,494
12/07/2020	0.73%	04/07/2017	74,000
08/29/2019	0.92%	04/28/2017	72,000
11/04/2019	1.26%	—	260,000
03/06/2020	0.77%	04/06/2017	100,000
Total FHLB Loans			\$ 687,366

During fourth quarter 2016, the Company pre-funded \$260 million of FHLB advances with maturities in 2017. The existing cost on these funds was an average of 4.28% and was replaced at a cost of 1.26%. The resulting annualized pre-tax savings is expected to be approximately \$7.9 million.

At March 31, 2017, certain residential home equity lines of credit ("HELOCS"), second mortgages, agency securities, and commercial mortgages secured by real estate with carrying values of \$1.18 billion collateralized the advances from the FHLB. At March 31, 2016, certain loans with carrying values of \$737.46 million collateralized the advances from the FHLB. At December 31, 2016, certain residential HELOCS, second mortgages, and commercial mortgages secured by real estate with carrying values of \$1.22 billion 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, 2017, we had no outstanding balances on these borrowing agreements with other financial institutions. Average total borrowings, including FHLB advances, during the first quarter of 2017 were \$723.51 million, compared with \$468.80 million for the first quarter of 2016, and \$628.27 million for the fourth quarter of 2016, while the average cost of these funds was 2.10%, 2.69%, and 2.33%, respectively.

Common Stock and Dividends. For the high and low prices of our common stock, see *Selected Quarterly Information* starting on page 41 in this report.

On February 22, 2017, we declared a quarterly shareholder cash dividend of \$0.13 per common share. The dividend was paid April 12, 2017, to shareholders of record on March 30, 2017.

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.

PART I. FINANCIAL INFORMATION

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

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 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 began on January 1, 2016, and will end January 1, 2019.

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 11.94% for common equity tier I, 11.98% for tier I capital, and 12.62% 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, 2017.

PART I. FINANCIAL INFORMATION

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

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

	March 31,		December 31,
	2017	2016	2016
Tier I Capital:			
Shareholders' equity	\$ 1,101,245	\$ 836,003	\$ 1,086,558
Less: goodwill and disallowed intangible assets, net of deferred tax	287,877	173,563	281,883
AOCI-related adjustments	(4,173)	17	(3,986)
Noncontrolling interests	11,485	9,128	11,456
Total common equity tier I capital	806,056	653,295	797,205
Included noncontrolling interests	2,705	3,847	4,861
Total tier I capital	808,761	657,142	802,066
Tier II Capital:			
Qualifying allowance for loan losses (1)	43,195	37,760	42,001
Total tier II capital	43,195	37,760	42,001
Total Risk-Based Capital	\$ 851,956	\$ 694,902	\$ 844,067
Total assets	\$ 8,174,786	\$ 6,365,169	\$ 7,973,915
Total risk-weighted assets (2)	6,749,487	5,161,961	6,785,586
Average assets for leverage capital purposes	7,712,490	6,139,674	7,683,555
Risk-weighted assets to total assets	82.56%	81.10%	85.10%
Risk-based capital ratios:			
Common equity tier I (4.5% minimum requirement)	11.94%	12.66%	11.75%
Tier I (6% minimum requirement)	11.98%	12.73%	11.82%
Total (8% minimum requirement)	12.62%	13.46%	12.44%
Tier I leverage ratio (4% minimum requirement)	10.49%	10.70%	10.44%

(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.

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,	
	2017	2016
Return on average assets (GAAP basis)	1.11%	1.14%
Impact of excluding average goodwill and other intangibles and amortization	0.11%	0.07%
Return on average tangible assets	1.22%	1.21%

PART I. FINANCIAL INFORMATION

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

	Three Months Ended March 31,	
	2017	2016
Return on average equity (GAAP basis)	8.15%	8.63%
Impact of excluding average goodwill and other intangibles and amortization	3.73%	2.93%
Return on average tangible equity	11.88%	11.56%

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,	
	2017	2016
Book value (GAAP basis)	\$ 17.42	\$ 16.00
Impact of excluding goodwill and other intangibles and amortization	(4.83)	(3.62)
Tangible book value	\$ 12.59	\$ 12.38

PART I. FINANCIAL INFORMATION

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 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.

PART I. FINANCIAL INFORMATION

Item 3. Quantitative and Qualitative Disclosures About Market Risk

At March 31, 2017, we had \$330.38 million more assets than liabilities subject to repricing within one year and, therefore, were in an asset-sensitive position. This is a one-day position, which is continually 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.

Earnings Simulation Analysis: Management uses simulation analysis to measure the sensitivity of net interest income to changes in interest rates. The model calculates an earnings estimate based on current and projected balances and rates. This method is subject to the accuracy of the assumptions that underlie the process, but it provides an additional analysis of the sensitivity of earnings to changes in interest rates to static gap analysis. Assumptions used in the model rates are derived from historical trends, peer analysis, and management's outlook, and include loans and deposit growth rates and projected yields and rates. All maturities, calls, and prepayments in the securities portfolio are assumed to be reinvested in like instruments. Mortgage loans and mortgage-backed securities prepayment assumptions are based on industry estimates of prepayment speeds for portfolios with similar coupon ranges and seasoning. Different interest rate scenarios and yield curves are used to measure the sensitivity of earnings to changing interest rates. Interest rates on different asset and liability accounts move differently when the prime rate changes and is reflected in the different rate scenarios.

The following table represents interest rate sensitivity on our net interest income using different rate scenarios:

<u>Change in Prime Rate</u>	<u>% Change in Net Interest Income</u>
+ 300 basis points	11.05 %
+ 200 basis points	7.60 %
+ 100 basis points	3.88 %
- 100 basis points	(6.89)%

Market Value Simulation: Market value simulation is used to calculate the estimated fair value of assets and liabilities over different interest rate environments. Market values are calculated based on discounted cash flow analysis. The net market value is the market value of all assets minus the market value of all liabilities. The change in net market value over different rate environments is an indication of the longer term repricing risk in the balance sheet. The same assumptions are used in the market value simulation as in the earnings simulation. The following table reflects the change in net market value over different rate environments:

<u>Change in Prime Rate</u>	<u>Change in Net Market Value (dollars in thousands)</u>
+ 300 basis points	\$ (162,483)
+ 200 basis points	\$ (118,171)
+ 100 basis points	\$ (48,699)
- 100 basis points	\$ (90,562)

PART I. FINANCIAL INFORMATION

Item 4. Controls and Procedures

Controls and Procedures. As of March 31, 2017, 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, 2017. There were no changes that occurred during the period covered by this Form 10-Q that have materially affected, or are 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 2016 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. The following risk factors should be considered in addition to the risk factors previously disclosed in TowneBank's 2016 Annual Report on Form 10-K. Such factors relate to the Company's proposed merger with Paragon and Paragon Commercial Bank.

RISK FACTORS RELATING TO THE MERGER WITH PARAGON

Combining the Company and Paragon may be more difficult, costly or time-consuming than we expect.

The success of the merger will depend, in part, on the Company's ability to realize the anticipated benefits and cost savings from combining the businesses of the Company and Paragon. However, to realize these anticipated benefits and cost savings, the Company must successfully combine the businesses of the Company and Paragon. If the Company is not able to achieve these objectives, the anticipated benefits and cost savings of the merger may not be realized fully, or at all, or may take longer to realize than expected.

The Company and Paragon have operated, and, until the completion of the merger, will continue to operate, independently. After the completion of the merger, the Company will integrate Paragon's business into its own. The integration process in the merger could result in the loss of key employees, the disruption of each party's ongoing business, and inconsistencies in standards, controls, procedures and policies that may affect adversely either party's ability to maintain relationships with customers and employees or achieve the anticipated benefits of the merger. The loss of key employees could adversely affect the Company's ability to successfully conduct its business after the merger, which could have an adverse effect on the Company's financial results and the value of its common stock. If the Company experiences difficulties with the integration process, the anticipated benefits of the merger may not be realized, fully or at all, or may take longer to realize than expected. As with any merger of financial institutions, there also may be disruptions that cause the Company and Paragon to lose customers or cause customers to withdraw their deposits from the Company's or Paragon's banking operations, or other unintended consequences that could have a material adverse effect on the Company's results of operations or financial condition after the merger. These integration matters could have an adverse effect on each of the Company and Paragon during this transition period and for an undetermined period after consummation of the merger.

The Company may not realize expected benefits from the merger if it is not able to effectively integrate the operations of Paragon Commercial Bank into the Company.

The future operating performance of the Company will depend, in part, on the success of the merger. The success of the merger will, in turn, depend on a number of factors, including the Company's ability to: (i) integrate the operations of Paragon Commercial Bank and the Company; (ii) retain the deposits and

PART II. OTHER INFORMATION

customers of Paragon Commercial Bank and the Company; (iii) control the incremental increase in noninterest expense arising from the merger in a manner that enables the combined company to improve its overall operating efficiencies; and (iv) retain and integrate the appropriate personnel of Paragon Commercial Bank into the operations of the Company, as well as reducing overlapping bank personnel. The integration of Paragon Commercial Bank and the Company following the merger will require the dedication of the time and resources of the companies' managements and may temporarily distract managements' attention from the day-to-day business of the companies. If the Company is unable to successfully integrate Paragon Commercial Bank, it may not be able to realize expected operating efficiencies and eliminate redundant costs, as well as position itself to achieve growth opportunities after the merger.

Regulatory approvals may not be received, may take longer than expected or may impose conditions that are not presently anticipated or that could have an adverse effect on the Company following the merger.

Before the merger may be completed, the Company and Paragon must obtain approvals from the required bank regulatory agencies. Other approvals, waivers or consents from regulators may also be required. The bank regulators may impose conditions on the completion of the merger or require changes to the terms of the merger. Although the Company and Paragon do not expect that any such conditions or changes would be imposed, there can be no assurance that they will not be, and such conditions or changes could have the effect of delaying or preventing completion of the merger or imposing additional costs on or limiting the revenues of the Company following the merger, any of which might have an adverse effect on the Company following the merger.

Failure to complete the merger could negatively impact the Company.

If the merger is not completed for any reason, the Company's business may be impacted adversely by the failure to pursue other beneficial opportunities due to the focus of management on the merger, without realizing any of the anticipated benefits of completing the merger. Additionally, if the Paragon merger agreement is terminated, the market price of the Company's common stock could decline to the extent that current market prices reflect a market assumption that the merger will be successfully completed. Furthermore, costs relating to the merger, such as legal, accounting and certain financial advisory fees, must be paid even if the merger is not completed.

The merger may distract management of the Company and Paragon from their other responsibilities.

During the pendency of the merger, the respective management groups of the Company and Paragon may need to focus their time and energies on matters related to the transaction that otherwise would be directed to their business and operations. Any such distraction on the part of either company's management could affect its ability to service existing business and develop new business, and adversely affect the business and earnings of the Company or Paragon before the merger, or the business and earnings of the Company after the merger.

If the merger is not completed, the Company will have incurred substantial expenses without realizing the expected benefits of the merger.

The Company has incurred and will incur substantial expenses in connection with the negotiation and completion of the transactions contemplated by the Paragon merger agreement, as well as the costs and

PART II. OTHER INFORMATION

expenses of preparing a proxy statement/prospectus and all filing and other fees paid to the bank regulatory agencies in connection with the merger. If the merger is not completed, the Company would have to incur these expenses without realizing the expected benefits of the merger.

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 April 26, 2017, by and among TowneBank, TB Acquisition, LLC, Paragon Commercial Corporation and Paragon Commercial Bank (incorporated herein by reference to Exhibit 2.1 to our Form 8-K, previously filed on May 2, 2017).
(2.2)	Agreement and Plan of Reorganization, dated as of December 16, 2015, by and among TowneBank, Monarch Financial Holdings, Inc. and Monarch Bank (incorporated herein by reference to Exhibit 2.1 to our Form 8-K, previously filed on December 22, 2015).
(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)	Report of Independent Registered Public Accounting Firm dated May 10, 2017

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 10, 2017

Date

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

G. Robert Aston, Jr.

Chairman of the Board/Chief Executive
Officer

May 10, 2017

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, 2017 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 10, 2017

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, 2017 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 10, 2017

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, 2017 (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 10, 2017

Date

/s/ G. Robert Aston, Jr.

G. Robert Aston, Jr.

Chairman of the Board/Chief Executive Officer

May 10, 2017

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 condensed consolidated balance sheets of TowneBank and subsidiaries (the Company) as of March 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, and cash flows for the three-months ended March 31, 2017 and 2016, and the related consolidated statement of equity for the three months ended March 31, 2017. These financial statements are the responsibility of the Company's management.

We conducted our review 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 statements 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 condensed financial statements referred to above for them 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, 2016, 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 1, 2017, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2016, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Dixon Hughes Goodman LLP

Norfolk, Virginia
May 10, 2017