

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, 2012**

FDIC Insurance Cert. Number: 35095

TOWNE BANK

(Exact name of registrant as specified in its charter)

VIRGINIA

(State or other jurisdiction of
incorporation or organization)

54-1910608

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

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

23703
(Zip Code)

(757) 638-7500

(Registrant's telephone number, including area code)

No Change

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

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

Yes ☒ No ☐

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

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

Large accelerated filer ☐

Accelerated filer ☒

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

Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ☐ No ☒

The number of shares of the Company's common stock outstanding as of April 30, 2012 was 30,243,671 shares.

TOWNE BANK

TABLE of CONTENTS

Part I. Financial Information

Item 1.	Financial Statements	
	Consolidated Balance Sheets	3
	March 31, 2012 (unaudited)	
	March 31, 2011 (unaudited)	
	December 31, 2011 (audited)	
	Consolidated Statements of Income	4
	Quarter Ended March 31, 2012 (unaudited)	
	Quarter Ended March 31, 2011 (unaudited)	
	Consolidated Statements of Comprehensive Income	5
	Quarter Ended March 31, 2012 (unaudited)	
	Quarter Ended March 31, 2011 (unaudited)	
	Consolidated Statements of Cash Flow	6
	Three Months Ended March 31, 2012 (unaudited)	
	Three Months Ended March 31, 2011 (unaudited)	
	Consolidated Statements of Equity	7
	Three Months Ended March 31, 2012 (unaudited)	
	Notes to Consolidated Financial Statements	8
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	36
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	59
Item 4.	Controls and Procedures	60

Part II. Other Information

Item 1.	Legal Proceedings	61
Item 1A.	Risk Factors	61
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	61
Item 3.	Defaults Upon Senior Securities	61
Item 4.	Mine Safety Disclosures	61
Item 5.	Other Information	61
Item 6.	Exhibits	61

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED BALANCE SHEETS (unaudited)

(Dollars in thousands, except share data)

(Dollars in thousands, except share data)

	March 31,		December 31,
	2012	2011	2011
	(unaudited)		(audited)
ASSETS			
Cash and due from banks	\$ 378,759	\$ 231,893	\$ 312,149
Interest bearing deposits in financial institutions	1,693	1,718	1,995
Total Cash and Cash Equivalents	380,452	233,611	314,144
Securities available-for-sale, at fair value	249,330	450,501	330,073
Securities held-to-maturity, at amortized cost	152,295	159,496	153,912
Trading account securities	11,775	10,889	10,854
Federal Home Loan Bank stock, at amortized cost	20,707	23,871	20,445
Total Securities	434,107	644,757	515,284
Mortgage loans held for sale	101,568	34,649	109,453
Loans, net of unearned income and deferred costs:			
Real estate-residential 1-4 family	722,535	707,578	709,129
Real estate-commercial	1,132,407	976,103	1,072,187
Real estate-construction and development	567,445	651,156	557,630
Real estate-multi-family	48,329	41,017	48,321
Commercial	363,508	321,001	362,830
Consumer and other loans	41,487	41,413	43,096
Loans, net of unearned income and deferred costs	2,875,711	2,738,268	2,793,193
Less: Allowance for loan losses	(40,034)	(40,021)	(39,740)
Net Loans	2,835,677	2,698,247	2,753,453
Premises and equipment, net	135,306	117,577	134,047
Goodwill	98,129	96,456	98,127
Other intangible assets, net	16,182	17,677	16,811
Bank-owned life insurance policies	53,763	53,148	53,315
Other assets	89,034	77,232	87,136
TOTAL ASSETS	<u>\$ 4,144,218</u>	<u>\$ 3,973,354</u>	<u>\$ 4,081,770</u>
LIABILITIES AND EQUITY			
Liabilities			
Deposits:			
Noninterest-bearing demand	\$ 881,252	\$ 736,851	\$ 839,211
Interest-bearing:			
Demand and money market accounts	1,049,005	839,155	991,084
Savings	196,062	150,268	192,133
Certificates of deposit	1,125,526	1,329,868	1,168,359
Total Deposits	3,251,845	3,056,142	3,190,787
Advances from the Federal Home Loan Bank	280,000	330,791	280,000
Convertible subordinated capital debentures	-	13,842	13,740
Repurchase agreements and other borrowings	9,500	12,980	11,790
Total Borrowings	289,500	357,613	305,530
Other liabilities	63,136	53,873	64,964
TOTAL LIABILITIES	<u>3,604,481</u>	<u>3,467,628</u>	<u>3,561,281</u>
Shareholders' Equity			
Preferred stock, \$5.00 par: 2,000,000 shares authorized			
659,911 issued and outstanding at March 31, 2012,			
661,365 issued and outstanding at March 31, 2011 and			
659,945 issued and outstanding at December 31, 2011	134,504	132,377	134,507
Common stock, \$1.667 par: 45,000,000 shares authorized			
30,282,744 issued and outstanding at March 31, 2012,			
29,073,191 issued and outstanding at March 31, 2011 and			
29,145,226 issued and outstanding at December 31, 2011	50,481	48,465	48,585
Capital surplus	246,239	231,827	233,895
Retained earnings	99,515	84,615	94,453
Accumulated other comprehensive income	2,710	1,235	2,754
TOTAL SHAREHOLDERS' EQUITY	<u>533,449</u>	<u>498,519</u>	<u>514,194</u>
Noncontrolling interest	6,288	7,207	6,295
TOTAL EQUITY	<u>539,737</u>	<u>505,726</u>	<u>520,489</u>
TOTAL LIABILITIES AND EQUITY	<u>\$ 4,144,218</u>	<u>\$ 3,973,354</u>	<u>\$ 4,081,770</u>

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

TOWNE BANK

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,	
	2012	2011
INTEREST INCOME:		
Loans, including fees	\$ 38,336	\$ 38,557
Investment securities	3,087	4,627
Interest bearing deposits in financial institutions and federal funds sold	199	95
Mortgage loans held for sale	806	466
Total Interest Income	42,428	43,745
INTEREST EXPENSE:		
Deposits	4,387	5,979
Advances from the Federal Home Loan Bank	3,000	3,353
Convertible subordinated capital debentures	237	293
Repurchase agreements and other borrowings	19	24
Total Interest Expense	7,643	9,649
Net Interest Income	34,785	34,096
PROVISION FOR LOAN LOSSES	4,097	3,818
Net Interest Income after Provision for Loan Losses	30,688	30,278
NONINTEREST INCOME:		
Residential mortgage brokerage income, net	5,718	2,153
Real estate brokerage and property management income, net	3,373	3,407
Insurance commissions and other title fees and income, net	6,387	6,364
Service charges on deposit accounts	1,698	1,691
Credit card merchant fees, net	868	609
Other income	1,727	1,542
Net gain on investment securities	778	53
Total Noninterest Income	20,549	15,819
NONINTEREST EXPENSE:		
Salaries and employee benefits	21,491	19,017
Occupancy expense	3,376	3,235
Furniture and equipment	1,580	1,415
Other expenses	11,085	10,638
Total Noninterest Expense	37,532	34,305
Income before income tax expense and noncontrolling interest	13,705	11,792
Provision for income tax expense	4,054	3,398
Net income	9,651	8,394
Net (income) loss attributable to noncontrolling interest	(214)	(90)
Net income attributable to TowneBank	\$ 9,437	\$ 8,304
Preferred stock dividends and accretion	1,916	2,334
Net income available to common shareholders	\$ 7,521	\$ 5,970
Per common share information		
Basic earnings	\$ 0.26	\$ 0.21
Diluted earnings	\$ 0.26	\$ 0.20
Cash dividends declared	\$ 0.08	\$ 0.08

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

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)

(Dollars in thousands)

	Three Months Ended	
	March 31,	
	2012	2011
Net income	\$ 9,651	\$ 8,394
Other comprehensive income (loss)		
Unrealized gains on available-for-sale securities:		
Unrealized holding gains arising during the period	214	1,510
Realized (gains) losses reclassified into earnings	6	(53)
Net unrealized gains (losses)	220	1,457
Defined benefit retirement plan		
Actuarial loss	(288)	-
Other comprehensive income (loss), before tax	(68)	1,457
Income tax expense (benefit) related to items of other comprehensive income	24	(510)
Other comprehensive income (loss), net of tax	(44)	947
Comprehensive income	\$ 9,607	\$ 9,341

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

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED STATEMENTS OF CASH FLOW (unaudited)

(Dollars in thousands)

	Three Months Ended March 31,	
	2012	2011
OPERATING ACTIVITIES:		
Net income	\$ 9,651	\$ 8,394
Adjustments to reconcile net income to net cash from operating activities:		
Net accretion of securities	847	1,467
Investment securities gains	(778)	(53)
Depreciation, amortization, and other intangible amortization	2,845	2,664
Provision for loan losses	4,097	3,818
Bank-owned life insurance income	(448)	(573)
Deferred income tax expense (benefit)	641	(1,411)
Share-based compensation expense	345	301
Purchases of trading account securities	(135)	-
Loss on sale and write-down of foreclosed assets	387	424
Changes in:		
Loans held for sale	7,885	30,379
Interest receivable	581	(34)
Other assets	(6,333)	1,082
Interest payable	(831)	(2,912)
Other liabilities	(867)	(1,495)
Net cash from operating activities	<u>17,887</u>	<u>42,051</u>
INVESTING ACTIVITIES:		
Purchase of available-for-sale securities	(74,214)	(50,144)
Purchase of held-to-maturity securities	-	(12,303)
Proceeds from maturities, calls, and prepayments of available-for-sale securities	154,093	21,834
Proceeds from maturities, calls, and prepayments of held-to-maturity securities	1,585	2,036
Net increase in loans	(86,291)	(9,361)
Purchase of premises and equipment	(3,644)	(4,302)
Proceeds from sales of premises and equipment	140	-
Distribution of interest in joint ventures	(221)	(64)
Proceeds from sales of foreclosed assets	2,559	435
Acquisition of business, net of cash acquired	-	(3,209)
Net cash used for investing activities	<u>(5,993)</u>	<u>(55,078)</u>
FINANCING ACTIVITIES:		
Net increase in deposit accounts	61,058	101,627
Net change in borrowings	(2,283)	(1,081)
Proceeds from issuance of common stock	144	92
Cash dividends paid	(4,505)	(4,476)
Net cash from financing activities	<u>54,414</u>	<u>96,162</u>
Change in cash and cash equivalents	66,308	83,135
Cash and cash equivalents at beginning of year	314,144	150,476
Cash and cash equivalents at end of period	<u>\$ 380,452</u>	<u>\$ 233,611</u>
Supplemental cash flow information:		
Cash paid for interest	\$ 8,474	\$ 10,406
Cash paid for income taxes	\$ 1,500	\$ -
Noncash financing and investing activities:		
Net unrealized gain on available-for-sale securities	\$ 143	\$ 947
Common stock issued in connection with conversion of convertible subordinated capital debentures	\$ 13,747	\$ 26

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

TOWNE BANK

PART 1 FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED STATEMENT OF EQUITY (unaudited)

(Dollars in thousands)

	Common Shares	Preferred Stock	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Noncontrolling Interest	Total
Balance, January 1, 2012	29,145,226	\$ 134,507	\$ 48,585	\$ 233,895	\$ 94,453	\$ 2,754	\$ 6,295	\$ 520,489
Net income	-	-	-	-	9,437	-	214	9,651
Other comprehensive loss, net of taxes	-	-	-	-	-	(44)	-	(44)
Cash dividends declared on common stock	-	-	-	-	(2,459)	-	-	(2,459)
Cash dividends declared on preferred stock	-	-	-	-	(1,916)	-	-	(1,916)
Director's deferred compensation	(2,836)	-	(5)	5	-	-	-	-
Distribution of interests in joint ventures	-	-	-	-	-	-	(221)	(221)
Conversion of preferred stock into common stock	183	(3)	1	3	-	-	-	1
Conversion of convertible debt into common stock	1,027,418	-	1,712	12,035	-	-	-	13,747
Issuance of common stock - stock compensation plans	112,753	-	188	301	-	-	-	489
Balance, March 31, 2012	30,282,744	\$ 134,504	\$ 50,481	\$ 246,239	\$ 99,515	\$ 2,710	\$ 6,288	\$ 539,737

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 required by 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 2011 audited Consolidated Financial Statements and the 2011 Annual Report on Form 10-K. Results of operations for the periods ended March 31, 2012 are not necessarily indicative of the results of operations for the full year or any other interim periods.

Reclassifications and Corrections

During the second quarter of 2011, the Company discovered certain overstatements in income attributable to noncontrolling interests as reported in prior periods, which resulted in a corresponding understatement of net income attributable to TowneBank for those periods. The overstatement of income attributable to noncontrolling interests was \$251,000, \$697,000, and \$34,000 before taxes, for the years ended December 31, 2009 and 2010 and the first quarter of 2011, respectively. The Company recorded the correction to the prior period overstatements in the quarter ended June 30, 2011. The correction of the overstatement of net income attributable to noncontrolling interests has no effect on net income or total equity for the period ended March 31, 2012, or any other previously reported period.

To maintain consistency and comparability, certain amounts from prior periods have been reclassified to conform to current period presentation with no effect on net income or shareholders’ equity as previously reported.

Recent Accounting Pronouncements

In April 2011, the Financial Accounting Standards Board (the “FASB”) issued Accounting Standards Update (“ASU”) No. 2011-02, *A Creditor’s Determination of Whether a Restructuring is a Troubled Debt Restructuring*. The provisions of ASU No. 2011-02 provide additional guidance related to determining whether a creditor has granted a concession, include factors and examples for creditors to consider in evaluating whether a restructuring results in a delay in payment that is insignificant, prohibit creditors from using the borrower’s effective rate test to evaluate whether a concession has been granted to the borrower, and add factors for creditors to use in determining whether a borrower is experiencing financial difficulties. A provision in ASU No. 2011-02 also ends the FASB’s deferral of the additional disclosures about troubled debt restructurings as required by ASU No. 2010-20. The provisions of ASU No. 2011-02 were effective for the Company’s reporting period ending September 30, 2011. The adoption of this ASU did not have a material impact on the Company’s financial statements.

In April 2011, the FASB issued ASU No. 2011-03, *Reconsideration of Effective Control for Repurchase Agreements*. ASU No. 2011-03 modifies the criteria for determining when repurchase agreements would be accounted for as a secured borrowing rather than as a sale. Currently, an entity that maintains effective control over transferred financial assets must account for the transfer as a secured borrowing rather than as a sale. The provisions of ASU No. 2011-03 removes from the assessment of effective control the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee. The FASB believes that contractual rights and

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

obligations determine effective control and that there does not need to be a requirement to assess the ability to exercise those rights. ASU No. 2011-03 does not change the other existing criteria used in the assessment of effective control. The provisions of ASU No. 2011-03 were effective prospectively for transactions, or modifications of existing transactions, that occur on or after January 1, 2012. The adoption of this ASU did not have a material impact on the Company's financial statements.

In May 2011, the FASB issued ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. ASU No. 2011-04 results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between GAAP and International Financial Reporting Standards ("IFRS"). The changes to GAAP as a result of ASU No. 2011-04 are as follows: (1) The concepts of highest and best use and valuation premise are only relevant when measuring the fair value of nonfinancial assets (that is, it does not apply to financial assets or any liabilities); (2) GAAP currently prohibits application of a blockage factor in valuing financial instruments with quoted prices in active markets. ASU No. 2011-04 extends that prohibition to all fair value measurements; (3) An exception is provided to the basic fair value measurement principles for an entity that holds a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk that are managed on the basis of the entity's net exposure to either of those risks. This exception allows the entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position; (4) Aligns the fair value measurement of instruments classified within an entity's shareholders' equity with the guidance for liabilities; and (5) Disclosure requirements have been enhanced for Level 3 fair value measurements to disclose quantitative information about unobservable inputs and assumptions used, to describe the valuation processes used by the entity, and to describe the sensitivity of fair value measurements to changes in unobservable inputs and interrelationships between those inputs. In addition, entities must report the level in the fair value hierarchy of items that are not measured at fair value in the statement of condition but whose fair value must be disclosed. The provisions of ASU No. 2011-04 were effective for the Company's interim reporting period beginning on or after December 15, 2011. The adoption of this ASU resulted in additional disclosures, but did not have a material impact on the Company's financial statements.

In June 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income*. The provisions of ASU No. 2011-05 allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. The statement(s) are required to be presented with equal prominence as the other primary financial statements. ASU No. 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders' equity but does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The provisions of ASU No. 2011-05 were effective for the Company's interim reporting period beginning on or after December 15, 2011, with retrospective application required. The Company adopted the standard beginning with its 2011 year-end reporting, presenting other comprehensive income in a separate statement following the Consolidated Statements of Income.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In September 2011, the FASB issued ASU No. 2011-08, *Intangibles – Goodwill and Other (Topic 350) Testing Goodwill for Impairment*. ASU No. 2011-08 modifies the manner in which the two-step impairment test of goodwill is applied. Under the updated guidance, an entity may assess qualitative factors (such as changes in management, key personnel, strategy, key technology, or customers) that may impact a reporting unit's fair value and lead to the determination that it is more likely than not that the fair value of a reporting unit is less than its carrying value, including goodwill. If an entity determines that it is more likely than not, it must perform step one of the impairment test. The first step of the impairment test involves comparing the estimated fair value of a reporting unit to its carrying value, including goodwill. If the carrying value of a reporting unit exceeds the estimated fair value, a second step must be performed to measure the amount of goodwill impairment, if any. In the second step, the implied fair value of the reporting unit's goodwill is determined in the same manner as goodwill is measured in a business combination (i.e., by measuring the fair value of the reporting unit's assets, liabilities and unrecognized intangible assets and determining the remaining amount ascribed to goodwill) and comparing the amount of the implied goodwill to the carrying amount of the goodwill. If the carrying value of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to the excess. The updated guidance is effective for the quarter ending March 31, 2012. The adoption of this guidance did not have a material impact on the Company's financial statements.

In December 2011, the FASB issued ASU No. 2011-10, *Property, Plant, and Equipment (Topic 360): Derecognition of In-Substance Real Estate*. ASU No. 2011-10 amends Topic 360 to clarify that when a reporting entity ceases to have a controlling financial interest (as described in Accounting Standards Codification Topic ("ASC") 810 "Consolidation") in a subsidiary that is in-substance real estate as a result of default on the subsidiary's nonrecourse debt, the reporting entity should apply the guidance in Subtopic 360-20 to determine whether it should derecognize the in-substance real estate. The clarification is meant to eliminate diversity in practice. The amendments are effective for fiscal years, and interim periods within those years, beginning on or after June 15, 2012. Early adoption is permitted. The adoption of this ASU is not expected to have a material impact on the Company's financial statements.

In December 2011, the FASB issued ASU No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*. ASU No. 2011-11 amends Topic 210 by requiring additional improved information to be disclosed regarding financial instruments and derivatives instruments that are offset in accordance with the conditions under ASC 210-20-45 or ASC 810-10-45 or subject to an enforceable master netting arrangement or similar agreement. The amendments are effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The disclosures required by the amendments should be applied retrospectively for all comparative periods presented. The adoption of this ASU is not expected to have a material impact on the Company's financial statements.

In December 2011, the FASB issued ASU No. 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. ASU No. 2011-12 defers the effective date pertaining to reclassification adjustments out of accumulated other comprehensive income in ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*, until the Board is able to redeliberate the matter. The deferral is not expected to have a material impact on the Company's financial statements.

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO 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 shares outstanding for the period. Diluted earnings per share are determined by dividing net income available to common shareholders by the weighted average shares outstanding, assuming all securities that could be converted to common stock have been converted or exercised. The following table summarizes the basic and diluted earnings per share calculations (dollars in thousands, except share data).

	Three Months Ended March 31,	
	2012	2011
Basic		
Net income, as reported	\$ 9,437	\$ 8,304
Preferred stock dividends and accretion of discount	1,916	2,334
Net income available to common shareholders	\$ 7,521	\$ 5,970
Average common shares outstanding	29,034,036	28,875,294
Basic earnings per share amount	<u>\$ 0.26</u>	<u>\$ 0.21</u>
Diluted		
Net income available to common shareholders	\$ 7,521	\$ 5,970
Add: interest applicable to 8% subordinated debt, net of tax (1)	154	177
Net income available to common shareholders, for diluted EPS	<u>\$ 7,675</u>	<u>\$ 6,147</u>
Average common shares outstanding	29,034,036	28,875,294
Add shares if converted:		
Stock compensation plans, net of tax benefit (2)	76,674	101,298
Convertible subordinated debentures (3)	882,684	1,034,551
Average diluted shares outstanding	<u>29,993,394</u>	<u>30,011,143</u>
Diluted earning per share amount	<u>\$ 0.26</u>	<u>\$ 0.20</u>

(1) Interest on 8% convertible subordinated capital debentures (net of tax) is added to net income since this interest would not be paid subsequent to the conversion of the debentures into common stock.

(2) Stock options and restricted stock shares totaling 100,247 and 59,556 were excluded from the computation of diluted earnings per share during the first quarter of 2012 and 2011, respectively, because their inclusion would be antidilutive.

(3) Shares assumed to have been converted since the beginning of the period through the date of actual conversion.

At March 31, 2012, the terms of the TowneBank 8% Non-Cumulative Convertible Preferred Stock, Series A entitled the holders to convert their shares into 3,143,645 shares of common stock at a conversion price of \$18.56 per share. These shares were not included in the computation of diluted earnings per share as the effect was anti-dilutive for the period.

In conjunction with the Company's issuance of Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series B to the U.S. Treasury, the Company issued a ten-year warrant to purchase 538,184 common shares at an exercise price of \$21.31 per share. These shares were not included in the computation of diluted earnings per share as the effect was anti-dilutive for the period.

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Earnings per share were affected by the March 19, 2012 mandatory conversion of TowneBank's \$13.60 million of outstanding Series III notes into shares of TowneBank common stock. See Note 12 for additional discussion regarding the conversion of the Series III notes.

Note 3. Investment Securities

Available-for-sale securities

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

March 31, 2012

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency securities	\$ 58,210	\$ 1,646	\$ (11)	\$ 59,845
Municipal securities	33,735	1,106	-	34,841
Trust preferred and other corporate securities	7,555	220	-	7,775
Mortgage-backed securities issued by GSE	145,383	1,559	(73)	146,869
Total available-for-sale securities	<u>\$ 244,883</u>	<u>\$ 4,531</u>	<u>\$ (84)</u>	<u>\$ 249,330</u>

December 31, 2011

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency securities	\$ 65,489	\$ 1,646	\$ -	\$ 67,135
U.S. Treasury notes	120,001	-	(1)	120,000
Municipal securities	34,817	1,092	-	35,909
Trust preferred and other corporate securities	7,563	156	-	7,719
Mortgage-backed securities issued by GSE	97,977	1,346	(13)	99,310
Total available-for-sale securities	<u>\$ 325,847</u>	<u>\$ 4,240</u>	<u>\$ (14)</u>	<u>\$ 330,073</u>

Held-to-maturity securities

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

March 31, 2012

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Trust preferred corporate securities	\$ 15,702	\$ 903	\$ -	\$ 16,605
Municipal securities	63,078	3,334	-	66,412
Industrial revenue bonds	73,515	7,141	(12)	80,644
Total held-to-maturity securities	<u>\$ 152,295</u>	<u>\$ 11,378</u>	<u>\$ (12)</u>	<u>\$ 163,661</u>

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2011

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Trust preferred corporate securities	\$ 15,701	\$ 865	\$ (21)	\$ 16,545
Municipal securities	63,272	3,603	-	66,875
Industrial revenue bonds	74,939	1,941	(1,847)	75,033
Total held-to-maturity securities	<u>\$ 153,912</u>	<u>\$ 6,409</u>	<u>\$ (1,868)</u>	<u>\$ 158,453</u>

Trading securities

Trading securities represent mutual fund investments in a self-directed employee deferred compensation plan, which is structured as a rabbi trust. These investments are bought and sold as employees defer compensation, receive distributions, or make changes in the funds underlying their accounts.

Maturities of investment securities

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

March 31, 2012

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ -	\$ -	\$ 4,167	\$ 4,169
Due after one year through five years	62,997	64,665	28,315	30,284
Due after five years through 10 years	29,251	29,727	7,662	8,170
Due after 10 years	152,060	154,363	112,151	121,038
	<u>244,308</u>	<u>248,755</u>	<u>152,295</u>	<u>163,661</u>
Other equity securities	<u>575</u>	<u>575</u>	<u>-</u>	<u>-</u>
	<u>\$ 244,883</u>	<u>\$ 249,330</u>	<u>\$ 152,295</u>	<u>\$ 163,661</u>

December 31, 2011

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 127,001	\$ 127,000	\$ 4,235	\$ 4,237
Due after one year through five years	61,316	62,989	20,459	20,994
Due after five years through 10 years	25,632	26,185	16,186	17,068
Due after 10 years	111,316	113,317	113,032	116,154
	<u>325,265</u>	<u>329,491</u>	<u>153,912</u>	<u>158,453</u>
Other equity securities	<u>582</u>	<u>582</u>	<u>-</u>	<u>-</u>
	<u>\$ 325,847</u>	<u>\$ 330,073</u>	<u>\$ 153,912</u>	<u>\$ 158,453</u>

TOWNE BANK

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, aggregated by investment category and the length of time that individual securities have been in a continuous unrealized loss position (in thousands).

March 31, 2012	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	\$ 14,981	\$ 11	\$ -	\$ -	\$ 14,981	\$ 11
Industrial revenue bonds	188	12	-	-	188	12
Mortgage-backed securities issued by GSE	20,534	73	-	-	20,534	73
Trust preferred corporate securities	-	-	-	-	-	-
Total temporarily impaired securities	<u>\$ 35,703</u>	<u>\$ 96</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 35,703</u>	<u>\$ 96</u>

December 31, 2011	Less than 12 months		12 months or more		Total	
Description of Securities	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
U.S. Treasury obligations and direct obligations of U.S. government agencies	\$ 127,000	\$ 1	\$ -	\$ -	\$ 127,000	\$ 1
Industrial revenue bonds	31,209	1,847	-	-	31,209	1,847
Mortgage-backed securities issued by GSE	6,047	13	-	-	6,047	13
Trust preferred corporate securities	6,559	21	-	-	6,559	21
Total temporarily impaired securities	<u>\$ 170,815</u>	<u>\$ 1,882</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 170,815</u>	<u>\$ 1,882</u>

U.S. Treasury obligations

The Company's unrealized losses on U. S. Treasury obligations were caused by interest rate and spread fluctuations. At March 31, 2012, one security had a total unrealized loss of \$11,000. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Because the securities are obligations of government agencies, and because it is the Company's intent to hold these securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Municipal securities

The Company had no unrealized losses on municipal securities at March 31, 2012.
Government-Sponsored Enterprises ("GSE") mortgage-backed securities

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company's unrealized losses on investments in federal agency mortgage-backed securities were caused by interest rate fluctuations. At March 31, 2012, four securities experienced an unrealized loss of \$73,000. The severity and duration of this 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, they are not considered to be other than temporarily impaired.

Trust preferred corporate securities

The Company's had no unrealized losses on trust preferred corporate securities at March 31, 2012.

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

The Company is required to maintain an investment in the capital stock of the FHLB. The FHLB stock is stated at cost, as this is a restricted security without a readily determinable fair value. The Company had \$20.71 million and \$20.44 million of FHLB stock at March 31, 2012 and December 31, 2011, 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.

Industrial revenue bonds

The Company's unrealized losses on industrial revenue bonds were caused by interest rate fluctuations. At March 31, 2012, two bond issuances had total unrealized losses of \$12,000. Based on the credit quality of the issuers, and because it is the Company's intent to hold these bonds until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the bonds before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Other investments, including common stock

The Company had no unrealized losses in other investments or common stocks at March 31, 2012.

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 \$40.03 million adequate to cover loan losses inherent in the loan portfolio at March 31, 2012.

TOWNE BANK

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, 2012 and 2011 (in thousands):

Three Months Ended March 31, 2012	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	Unallocated	Total
Allowance for loan losses:								
Balance, beginning of year	\$ 13,623	\$ 10,578	\$ 395	\$ 10,837	\$ 3,842	\$ 465	\$ -	\$ 39,740
Provision charged to expense	1,847	532	(68)	1,466	232	88	-	4,097
Losses charged off	(1,756)	(286)	-	(1,803)	(380)	(110)	-	(4,335)
Recoveries	53	3	-	462	10	4	-	532
Balance, end of quarter	<u>\$ 13,767</u>	<u>\$ 10,827</u>	<u>\$ 327</u>	<u>\$ 10,962</u>	<u>\$ 3,704</u>	<u>\$ 447</u>	<u>\$ -</u>	<u>\$ 40,034</u>
March 31, 2011								
Allowance for loan losses:								
Balance, beginning of year	\$ 10,984	\$ 12,827	\$ 557	\$ 9,543	\$ 4,008	\$ 741	\$ -	\$ 38,660
Provision charged to expense	3,435	(1,648)	(255)	2,263	194	(171)	-	3,818
Losses charged off	(645)	(480)	-	(993)	(397)	(40)	-	(2,555)
Recoveries	32	-	-	28	30	8	-	98
Balance, end of quarter	<u>\$ 13,806</u>	<u>\$ 10,699</u>	<u>\$ 302</u>	<u>\$ 10,841</u>	<u>\$ 3,835</u>	<u>\$ 538</u>	<u>\$ -</u>	<u>\$ 40,021</u>

The following table provides a summary of the allowance for loan losses classified by portfolio segment (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	Unallocated	Total
March 31, 2012								
Period-end balance allocated to:								
Loans individually evaluated for impairment	\$ 4,360	\$ 869	\$ -	\$ 1,255	\$ 221	\$ 156	\$ -	\$ 6,861
Loans collectively evaluated for impairment	9,407	9,958	327	9,707	3,483	291	-	33,173
Loans acquired with deteriorated credit quality	-	-	-	-	-	-	-	-
Balance, end of quarter	<u>\$ 13,767</u>	<u>\$ 10,827</u>	<u>\$ 327</u>	<u>\$ 10,962</u>	<u>\$ 3,704</u>	<u>\$ 447</u>	<u>\$ -</u>	<u>\$ 40,034</u>
December 31, 2011								
Period-end balance allocated to:								
Loans individually evaluated for impairment	\$ 4,583	\$ 776	\$ -	\$ 1,302	\$ 282	\$ 165	\$ -	\$ 7,108
Loans collectively evaluated for impairment	9,040	9,802	395	9,535	3,560	300	-	32,632
Loans acquired with deteriorated credit quality	-	-	-	-	-	-	-	-
Balance, end of year	<u>\$ 13,623</u>	<u>\$ 10,578</u>	<u>\$ 395</u>	<u>\$ 10,837</u>	<u>\$ 3,842</u>	<u>\$ 465</u>	<u>\$ -</u>	<u>\$ 39,740</u>

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2012							
Ending balance: individually evaluated for impairment	\$ 45,153	\$ 22,003	\$ 275	\$ 19,895	\$ 2,980	\$ 508	\$ 90,814
Ending balance: collectively evaluated for impairment	520,749	1,105,075	47,872	697,731	360,528	40,979	2,772,934
Ending balance: loans acquired with deteriorated credit quality	1,543	5,329	182	4,909	-	-	11,963
Ending Balance	<u>\$ 567,445</u>	<u>\$ 1,132,407</u>	<u>\$ 48,329</u>	<u>\$ 722,535</u>	<u>\$ 363,508</u>	<u>\$ 41,487</u>	<u>\$ 2,875,711</u>
December 31, 2011							
Ending balance: individually evaluated for impairment	\$ 46,899	\$ 17,500	\$ -	\$ 15,456	\$ 2,864	\$ 518	\$ 83,237
Ending balance: collectively evaluated for impairment	508,982	1,048,549	48,126	688,746	359,966	42,578	2,696,947
Ending balance: loans acquired with deteriorated credit quality	1,749	6,138	195	4,927	-	-	13,009
Ending Balance	<u>\$ 557,630</u>	<u>\$ 1,072,187</u>	<u>\$ 48,321</u>	<u>\$ 709,129</u>	<u>\$ 362,830</u>	<u>\$ 43,096</u>	<u>\$ 2,793,193</u>

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

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

Changes in the carrying amount and accretable yield for purchased impaired and nonimpaired loans were as follows for the three months ended March 31, 2012 and 2011 (in thousands):

	March 31, 2012				March 31, 2011			
	Purchased Impaired		Purchased Nonimpaired		Purchased Impaired		Purchased Nonimpaired	
	Accretable Yield	Carrying Amount of Loans	Accretable Yield	Carrying Amount of Loans	Accretable Yield	Carrying Amount of Loans	Accretable Yield	Carrying Amount of Loans
Balance at beginning of period	\$ 2,134	\$ 13,009	\$ 7,408	\$ 45,440	\$ 1,046	\$ 16,816	\$ 11,756	\$ 58,049
Accretion	(301)	301	(866)	866	(714)	714	(1,229)	1,229
Payments received, net	-	(1,347)	-	(5,173)	-	(1,941)	-	(5,348)
Balance at end of period	<u>\$ 1,833</u>	<u>\$ 11,963</u>	<u>\$ 6,542</u>	<u>\$ 41,133</u>	<u>\$ 332</u>	<u>\$ 15,589</u>	<u>\$ 10,527</u>	<u>\$ 53,930</u>

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

At March 31, 2012, none of the purchased loans were classified as nonperforming assets. Therefore, interest income, through accretion of the difference between the carrying amount of the loans and the expected cash flows, is being recognized on all purchased loans. Any decreases in cash flows expected to be collected (other than due to decreases in interest rate indices and changes in prepayment assumptions), will be charged to the provision for loan losses, resulting in an increase to the allowance for loan losses. The outstanding unpaid principal balance for all purchased impaired loans and purchased nonimpaired loans as of March 31, 2012 was \$16.33 million and \$41.92 million, respectively.

Portfolio Quality Indicators

The Company's portfolio grading analysis estimates the capability of the borrower to repay the contractual obligations of the loan agreements as scheduled or at all. The Company's internal credit risk grading system is based on numerous factors, including management's experiences with similarly graded loans. Credit risk grades 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 close attention. The borrower's ability to repay from the primary (intended) sources is currently adequate, but threatened by potential weaknesses which may, if not corrected, result in the deterioration of the repayment prospects for the asset or in the Company's credit position loss at some future date.
- **Substandard** – Loans in this category are considered to have increased credit risk and servicing needs and generally require that the Company follow their performance very closely. The borrower's ability to repay is threatened by a clearly defined weakness which jeopardizes ultimate repayment of the loan.
- **Doubtful** – Loans in this category are considered to be doubtful or a loss to the Company in terms of principal and interest repayment. The borrower's ability to repay in full, on the basis of currently existing facts, conditions and values, is generally highly questionable and improbable.

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following tables represent consumer credit exposures by internally assigned grades for the periods ended March 31, 2012 and December 31, 2011 (in thousands):

March 31, 2012	Construction and Land Development	Commercial Real Estate	Multi- Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
Pass	\$ 494,491	\$ 1,080,834	\$ 46,727	\$ 697,353	\$ 357,218	\$ 40,259	\$ 2,716,882
Special Mention	16,829	22,680	1,070	5,234	465	12	46,290
Substandard	56,002	28,893	532	19,366	5,825	1,215	111,833
Doubtful	123	-	-	582	-	1	706
Total	\$ 567,445	\$ 1,132,407	\$ 48,329	\$ 722,535	\$ 363,508	\$ 41,487	\$ 2,875,711

December 31, 2011	Construction and Land Development	Commercial Real Estate	Multi- Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
Pass	\$ 473,419	\$ 1,024,259	\$ 46,986	\$ 683,854	\$ 355,885	\$ 41,875	\$ 2,626,278
Special Mention	24,173	22,866	1,072	8,160	771	121	57,163
Substandard	60,038	25,062	263	16,073	6,174	1,077	108,687
Doubtful	-	-	-	1,042	-	23	1,065
Total	\$ 557,630	\$ 1,072,187	\$ 48,321	\$ 709,129	\$ 362,830	\$ 43,096	\$ 2,793,193

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, 2012 and December 31, 2011. Also included are loans that are 90 days or more past due as to interest and principal and still accruing, because they are (1) well-secured and in the process of collection, or (2) real estate loans or loans exempt under regulatory rules from being classified as nonaccrual. Purchased impaired loans are included in the aging schedule, but are excluded from the disclosure of accruing loans more than 90 days past due as they are considered to be accruing due to the existence of the accretable yield and not based on consideration given to contractual interest payments (in thousands).

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	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, 2012								
Construction and land development	\$ 3,466	\$ 102	\$ 755	\$ 32,258	\$ 36,581	\$ 530,864	\$ 567,445	\$ 184
Commercial real estate	1,161	3,437	1,433	7,345	13,376	1,119,031	1,132,407	-
Multifamily real estate	352	-	-	274	626	47,703	48,329	-
1-4 family residential real estate	3,959	628	137	13,152	17,876	704,659	722,535	-
Commercial and industrial business loans	114	-	-	2,741	2,855	360,653	363,508	-
Consumer loans and other	119	27	-	483	629	40,858	41,487	-
Total	\$ 9,171	\$ 4,194	\$ 2,325	\$ 56,253	\$ 71,943	\$ 2,803,768	\$ 2,875,711	\$ 184

	Loans 30 - 59 Days Past Due	Loans 60 - 89 Days Past Due	Loans 90 or More Days Past Due	Nonaccrual Loans	Total Past Due and Nonaccruing	Current Loans	Total Loans Receivable	Accruing Loans More Than 90 Days Past Due
December 31, 2011								
Construction and land development	\$ 718	\$ 94	\$ -	\$ 36,712	\$ 37,524	\$ 520,106	\$ 557,630	\$ -
Commercial real estate	1,486	4,756	705	5,561	12,508	1,059,679	1,072,187	-
Multifamily real estate	-	-	263	-	263	48,058	48,321	-
1-4 family residential real estate	7,954	876	172	10,394	19,396	689,733	709,129	-
Commercial and industrial business loans	362	9	-	2,644	3,015	359,815	362,830	-
Consumer loans and other	148	23	1	490	662	42,434	43,096	1
Total	\$ 10,668	\$ 5,758	\$ 1,141	\$ 55,801	\$ 73,368	\$ 2,719,825	\$ 2,793,193	\$ 1

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 through an allowance estimate or a charge-off to the allowance. When the Company determines an impaired loan is a confirmed loss, the estimated impairment is directly charged-off to the loan rather than creating a specific reserve for inclusion in the allowance for loan losses.

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Unearned loan income was \$2.44 million in excess of deferred loan costs at March 31, 2012, \$1.56 million at March 31, 2011, and \$2.02 million at December 31, 2011. There were \$56.25 million, \$70.94 million, and \$55.80 million in nonaccrual loans at March 31, 2012, March 31, 2011 and December 31 2011. The Company would have earned \$568,000 in the first quarter of 2012 if interest on the loans had been accrued.

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

	Unpaid Principal Balance	Recorded Balance	Specific Allowance	Average Recorded Investment	YTD Interest Income Recognized
March 31, 2012					
Loans without a specific valuation allowance					
Construction and land development	\$ 17,160	\$ 15,098	\$ -	\$ 17,224	\$ 126
Commercial real estate	17,217	16,597	-	17,135	165
Multi-family real estate	275	275	-	275	-
1-4 family residential real estate	16,900	16,349	-	16,916	79
Commercial and industrial business loans	2,789	2,490	-	2,792	3
Consumer loans and other	203	192	-	205	1
Total	\$ 54,544	\$ 51,001	\$ -	\$ 54,547	\$ 374
Loans with a specific valuation allowance					
Construction and land development	\$ 30,919	\$ 30,055	\$ 4,360	\$ 30,552	\$ 23
Commercial real estate	5,610	5,406	869	5,623	41
Multi-family real estate	-	-	-	-	-
1-4 family residential real estate	3,685	3,546	1,255	3,692	9
Commercial and industrial business loans	532	490	221	532	1
Consumer loans and other	354	316	156	354	-
Total	\$ 41,100	\$ 39,813	\$ 6,861	\$ 40,753	\$ 74
Total impaired loans					
Construction and land development	\$ 48,079	\$ 45,153	\$ 4,360	\$ 47,776	\$ 149
Commercial real estate	22,827	22,003	869	22,758	206
Multi-family real estate	275	275	-	275	-
1-4 family residential real estate	20,585	19,895	1,255	20,608	88
Commercial and industrial business loans	3,321	2,980	221	3,324	4
Consumer loans and other	557	508	156	559	1
Total	\$ 95,644	\$ 90,814	\$ 6,861	\$ 95,300	\$ 448

(1) Included in the table above are accruing TDRs of \$32.56 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled \$20.98 million.

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2011	Unpaid Principal Balance	Recorded Balance	Specific Allowance	Average Recorded Investment	YTD Interest Income Recognized
Loans without a specific valuation allowance					
Construction and land development	\$ 27,373	\$ 16,650	\$ -	\$ 30,880	\$ 293
Commercial real estate	14,826	14,033	-	16,846	685
1-4 family residential real estate	16,800	12,418	-	16,772	193
Commercial and industrial business loans	2,823	2,333	-	2,968	2
Consumer loans and other	345	193	-	354	2
Total	\$ 62,167	\$ 45,627	\$ -	\$ 67,820	\$ 1,175
Loans with a specific valuation allowance					
Construction and land development	\$ 31,770	\$ 30,249	\$ 4,583	\$ 32,570	\$ 103
Commercial real estate	3,667	3,467	776	4,305	95
1-4 family residential real estate	3,252	3,038	1,302	3,255	32
Commercial and industrial business loans	534	531	282	554	12
Consumer loans and other	363	325	165	370	1
Total	\$ 39,586	\$ 37,610	\$ 7,108	\$ 41,054	\$ 243
Total impaired loans					
Construction and land development	\$ 59,143	\$ 46,899	\$ 4,583	\$ 63,450	\$ 396
Commercial real estate	18,493	17,500	776	21,151	780
1-4 family residential real estate	20,052	15,456	1,302	20,027	225
Commercial and industrial business loans	3,357	2,864	282	3,522	14
Consumer loans and other	708	518	165	724	3
Total	\$ 101,753	\$ 83,237	\$ 7,108	\$ 108,874	\$ 1,418

(1) Included in the table above are accruing TDRs of \$24.06 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled \$21.39 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 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. The following table shows the loans modified in TDRs for the three months ended March 31, 2012 (in thousands, except number of loans).

Three Months Ended March 31, 2012			
	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
Construction and land development	4	\$ 3,381	\$ 3,319
Commercial real estate	4	3,458	3,458
Multi-family real estate	-	-	-
1-4 family residential real estate	6	1,707	1,629
Commercial and industrial	1	196	196
Consumer loans and other	1	17	17
Total	16	\$ 8,759	\$ 8,619

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In accordance with the Company's adoption of the provisions of ASU No. 2011-02, the Company reassessed all loan modifications occurring since January 1, 2011 for identification as troubled debt restructurings. There were no additional TDRs identified in this reassessment. The restructured loans generally include terms to reduce the interest rate and extend payment terms. We have not forgiven any principal on the above loans. There were three commercial and industrial business loans and three consumer loans that were restructured within the last 12 months that subsequently defaulted. The commercial and industrial business loans had recorded balances of \$883,000 and the consumer loans had a recorded balance of \$787,000.

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, 2012, all significant impaired loans have been determined to be collateral dependent.

Nonaccrual Loans

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

	Three Months Ended March 31,	
	2012	2011
Beginning balance	\$ 29,819	\$ 20,452
Additions	5,338	5,670
Sales	(2,559)	(2,078)
Valuation allowance	(460)	125
Gain (loss) on sale and write-downs	73	(549)
Ending balance	<u>\$ 32,211</u>	<u>\$ 23,620</u>

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 Hampton Roads and northeastern North Carolina and includes the operations of TowneBank Commercial Mortgage and Towne Investment Group. The Realty segment combines the operations of Prudential Towne Realty with TowneBank Mortgage, Virginia Home Title and Settlements, NewTowne Mortgage, LLC, and Corolla Classic Vacations, LLC, to provide residential real estate services, resort property management, originations of a variety of mortgage loans, and commercial and residential title insurance. Mortgage loans are originated and sold principally in the secondary market through purchase commitments from investors. The Insurance segment provides full-service commercial and retail insurance and employee benefit services through Towne Insurance and TFA Benefits.

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

Segment profit and loss is measured by net income after income tax. Inter-segment transactions are recorded at cost and eliminated as part of the consolidation process. Because of the interrelationships of the various segments, the information presented is not indicative of how the segments would perform if they operated as independent entities. The following tables provide information about reportable segments and reconciliation of such information to the consolidated financial statements (dollars in thousands).

Three Months Ended March 31, 2012

	Banking	Realty	Insurance	Consolidated Totals
Net interest income	\$ 34,248	\$ 530	\$ 7	\$ 34,785
Provision for loan losses	4,097	-	-	4,097
Net interest income after provision for loan losses	30,151	530	7	30,688
Residential mortgage brokerage income, net	(129)	5,847	-	5,718
Real estate brokerage and property management income, net	-	3,373	-	3,373
Insurance commissions and other title fees and income, net	-	405	5,982	6,387
Other noninterest income	4,625	266	180	5,071
Noninterest expense	26,335	6,994	4,203	37,532
Income before income tax, corporate allocation and noncontrolling interest	8,312	3,427	1,966	13,705
Corporate allocation	144	(103)	(41)	-
Income before income tax provision and noncontrolling interest	8,456	3,324	1,925	13,705
Provision for income tax expense	2,063	1,272	719	4,054
Net income	6,393	2,052	1,206	9,651
Noncontrolling interest	-	(96)	(118)	(214)
Net income attributable to TowneBank	\$ 6,393	\$ 1,956	\$ 1,088	\$ 9,437
Net income as percentage of total	67.74%	20.73%	11.53%	100.00%

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Three Months Ended March 31, 2011

	Banking	Realty	Insurance	Consolidated Totals
Net interest income	\$ 33,765	\$ 325	\$ 6	\$ 34,096
Provision for loan losses	3,818	-	-	3,818
Net interest income after provision for loan losses	29,947	325	6	30,278
Residential mortgage brokerage income, net	(31)	2,184	-	2,153
Real estate brokerage and property management income, net	-	3,407	-	3,407
Insurance commissions and other title fees and income, net	-	379	5,985	6,364
Other noninterest income	3,421	299	175	3,895
Noninterest expense	24,553	5,644	4,108	34,305
Income before income tax, corporate allocation and noncontrolling interest	8,784	950	2,058	11,792
Corporate allocation	119	(75)	(44)	-
Income before income tax provision and noncontrolling interest	8,903	875	2,014	11,792
Provision for income tax expense	2,239	406	753	3,398
Net income	6,664	469	1,261	8,394
Noncontrolling interest	-	55	(145)	(90)
Net income attributable to TowneBank	\$ 6,664	\$ 524	\$ 1,116	\$ 8,304
Net income as percentage of total	80.25%	6.31%	13.44%	100.00%

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, the total commitment amounts may not necessarily represent future cash requirements. At March 31, 2012, the amounts of off-balance sheet commitments to extend credit were \$886.23 million.

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, 2012, standby letters of credit and financial guarantees were \$39.06 million.

Additionally, the Company had \$349.42 million in mortgage loans sold to investors with various recourse and warranty provisions. The Company provided an allowance for estimated losses from such provisions that management considered adequate at March 31, 2012.

Rate lock commitments, which are designed to mitigate the Company's exposure to fluctuations in interest rates associated with rate lock commitments and loans held for sale, are related to the origination of mortgage loans held for sale and the corresponding loan sale commitments and are considered derivative instruments. Outstanding loan balances under these rate lock commitments totaled \$94.88 million at March 31, 2012. The Company recognized a gain associated with the rate lock commitments on the aforementioned loans of \$960,000, which was recorded as noninterest income in the Company's financials for the three-month period ended March 31, 2012.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8. Mergers and Acquisitions

Stanton Taylor Agency, Inc.: Effective October 3, 2011, the Company acquired the Stanton Taylor Agency, Inc. insurance agency, that is affiliated with Towne Insurance Agency (“Towne Insurance”), a wholly-owned subsidiary of TowneBank. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired business are included in the Company’s Consolidated Statements of Income commencing October 3, 2011. The purchase price was \$2.70 million in cash and common stock. The allocation of the purchase price resulted in tangible assets of \$364,000, goodwill of \$1.50 million, other intangible assets, including customer lists of \$1.13 million, and assumed liabilities of \$293,000.

W. T. Chapin Inc.: Effective January 14, 2011, TowneBank acquired W. T. Chapin Inc. insurance agency, an independent insurance agency that is affiliated with Towne Insurance. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired business are included in the Company’s Consolidated Statements of Income commencing January 14, 2011. The purchase price was \$4.21 million in cash and stock. The allocation of the purchase price resulted in tangible assets of \$25,000, goodwill of \$2.85 million, and other intangible assets, including customer lists of \$1.34 million.

Benchmark Mortgage, Inc.: Effective November 1, 2011, TowneBank acquired Benchmark Mortgage, Inc., an independent mortgage business that was merged with the operations of TowneBank Mortgage, 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 November 1, 2011. The purchase price was \$385,000 in cash. The allocation of the purchase price resulted in tangible assets of \$308,000 and a loan pipeline of \$77,000. There was no goodwill ascribed to the transaction.

The Bank of Currituck: Effective December 3, 2010, TowneBank acquired all the deposit accounts of The Bank of Currituck (“Currituck”) and its six banking offices in northeastern North Carolina, including three banking offices on the Outer Banks. Under the terms of the purchase agreement, TowneBank also purchased a substantial portion of the Moyock-headquartered bank’s loan portfolio and all of its other banking assets. 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. In accordance with the purchase agreement, TowneBank also was required to purchase and sell back certain loans in the amount of \$21.15 million. However, because the transfer of the loans did not meet sale treatment under the accounting provisions of ASC 860, *Transfers and Servicing*, the transfer was treated as a secured borrowing, which was repaid at the time of the business combination. The results of operations of the acquired business are included in the Company’s Consolidated Statements of Income after the acquisition date of December 3, 2010. The purchase price was \$7.84 million in cash. Acquisition-related costs were \$548,000 and were included in noninterest expense in the consolidated statement of income for the year ended December 31, 2010. Following the closing of the transaction, Currituck ceased operation as a commercial

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

bank and is operating as Currituck Resolution Properties, Inc. (the “Resolution Company”) in order to manage the assets it retained in this transaction, including certain loans and other real estate owned. Also in accordance with the purchase agreement, TowneBank entered into a secured credit facility with the Resolution Company, which consists of three components, (i) a revolving line of credit in the principal amount of \$1.0 million to be used for working capital purposes; (ii) a second revolving line of credit in the principal amount of \$1.0 million to be used as an interest reserve to support the interest owed on the loan; and (iii) a term loan, in the amount of \$14.07 million, which was used to fund and support the Resolution Company’s asset base and operations.

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 6 – Goodwill and Intangible Assets* of the 2011 Annual Report to the Stockholders for more information on the Company’s goodwill and other intangibles.

The gross carrying amount and accumulated amortization for the Company’s intangible assets follows (in thousands).

	March 31,				December 31, 2011	
	2012		2011		Carrying Amount	Accumulated Amortization
	Carrying Amount	Accumulated Amortization	Carrying Amount	Accumulated Amortization		
Core deposit intangible	\$ 4,094	\$ 3,649	\$ 4,094	\$ 3,152	\$ 4,094	\$ 3,524
Non-compete agreements	1,456	1,169	1,456	1,023	1,456	1,144
Customer lists	17,920	6,023	16,789	4,181	17,920	5,579
Total intangible assets subject to amortization	23,470	10,841	22,339	8,356	23,470	10,247
 Title plant	-	-	-	-	-	-
Trade name	322	-	463	-	357	-
Contractual agreements	3,231	-	3,231	-	3,231	-
Total intangible assets not subject to amortization	3,553	-	3,694	-	3,588	-
 Total intangible assets	\$ 27,023	\$ 10,841	\$ 26,033	\$ 8,356	\$ 27,058	\$ 10,247

Amortization expense for intangible assets was \$629,000 and \$654,000 for the three month periods ending March 31, 2012 and 2011, respectively.

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Changes in the net carrying amount of goodwill related to each of the Company's segments since December 31, 2011 are as follows (in thousands).

	Banking	Realty	Insurance	Consolidated Totals
Balance, December 31, 2011	\$ 58,885	\$ 15,822	\$ 23,420	\$ 98,127
Additions to goodwill	-	-	-	-
Other adjustments	-	2	-	2
Balance, March 31, 2012	\$ 58,885	\$ 15,824	\$ 23,420	\$ 98,129

Note 10. Bank-Owned Life Insurance Policies

The total carrying amount of bank-owned life insurance policies ("BOLI") as of March 31, 2012 was \$53.76 million. The Company had \$53.32 million and \$53.15 million of BOLI at December 31, 2011 and March 31, 2011, respectively. The Company recognized BOLI income, included in other noninterest income, of \$448,000 and \$573,000 for the quarters ended March 31, 2012 and 2011, respectively. The Company has a related retirement plan, implemented in the fourth quarter of 2008, which provides retirement benefits to the executives covered under the plan.

Note 11. Postretirement Benefits

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

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Service cost	\$ 632	\$ 915
Interest cost	150	97
Net periodic postretirement benefit cost	\$ 782	\$ 1,012

Note 12. Subordinated Capital Notes

During the first quarter of 2012, TowneBank announced the mandatory conversion of its outstanding Series III notes, which totaled \$13.60 million as of that date. At the close of business on March 19, 2012, all outstanding Series III notes were converted into shares of TowneBank common stock at the conversion price of \$13.38 per share (equal to a conversion rate of 149.48 shares per \$2,000 principal amount of notes).

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 (in thousands).

	Three Months Ended March 31,	
	2012	2011
Advertising and marketing	\$ 1,076	\$ 1,019
Other	1,354	1,315
Charitable contributions	884	833
Outside processing	644	650
Professional fees	1,119	810
Stationery and supplies	465	467
FDIC and other insurance	782	1,377
Foreclosed property expenses	1,187	886
Software expense	1,041	775
Telephone and postage	903	795
Amortization exp-intangibles	629	654
Bank franchise tax/SCC fees	468	501
Directors fees and expenses	311	409
Travel/meals/entertainment	222	147
Total other expenses	<u>\$ 11,085</u>	<u>\$ 10,638</u>

Note 14. Variable Interest Entities

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

Low Income Housing Tax Credit Partnerships

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

performance. Accordingly, the Company's limited partner interests are variable interests that the Company evaluates for purposes of determining whether the Company is the primary beneficiary.

For each of the partnerships, the Company acts strictly in a limited partnership capacity. The Company has determined that it is not the primary beneficiary of these partnerships because it does not have the power to direct the activities of the entity that most significantly impact the entity's economic performance. The Company accounts for its limited partner interests in accordance with the accounting guidance for investments in affordable housing projects. Partnership assets of \$45.49 million, \$28.29 million, and \$40.46 million in these partnerships were not included in the Consolidated Balance Sheets at March 31, 2012, March 31, 2011, and December 31, 2011, respectively. These limited partner interests had carrying values of \$13.56 million, \$5.53 million, and \$11.68 million at March 31, 2012, March 31, 2011, and December 31, 2011, 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 \$13.56 million, \$5.53 million, and \$11.68 million at March 31, 2012, March 31, 2011, and December 31, 2011, respectively.

Currituck Resolution Properties, Inc.

Following the Company's acquisition of the banking offices of The Bank of Currituck, the remaining entity ceased operation as a commercial bank and is operating as a North Carolina corporation under the name Currituck Resolution Properties, Inc. The sole purpose of the Resolution Company is to liquidate its remaining assets, pay its remaining liabilities, and wind down its business affairs. The Resolution Company continues to be managed by its existing board of directors and operates with minimal employees. At the closing of the purchase transaction, the Company entered into a secured credit facility with the Resolution Company, consisting of three components: (i) a revolving line of credit in the principal amount of \$1.0 million to be used for working capital purposes; (ii) a second revolving line of credit in the principal amount of \$1.0 million to be used as an interest reserve to support the interest owed on the loan; and (iii) a term loan, of approximately \$14 million, which was to be used to fund and support the Resolution Company's asset base and operations.

The Company concluded that the Resolution Company is a VIE because the equity investors do not have sufficient equity at risk for the entity to independently finance its activities as evidenced by the amount of subordinated support provided by the Company. However, the Company determined that it is not the primary beneficiary of the Resolution Company as it does not have the power to direct the activities of the entity that most significantly impact the entity's economic performance. The Company does not have any contractual obligation to provide additional support to this entity, and its maximum exposure to loss at March 31, 2012, was limited to (i) the current outstanding balance of the term loan, which was \$6.52 million, and (ii) the commitments on the two revolving lines of credit, which were \$428,000 as of March 31, 2012 and \$387,000 as of December 31, 2011. The total unconsolidated assets of the Resolution Company as of March 31, 2012 and December 31, 2011, were \$17.82 million and \$20.71 million, respectively.

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:

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

- Level 1** Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury securities that are highly liquid and are actively traded in over-the-counter markets.
- 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. This category generally includes U.S. Government and agency mortgage-backed debt securities, corporate debt securities, and residential mortgage loans held for sale.
- Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category generally includes certain private equity investments, retained residual interests in securitizations, residential mortgage servicing rights, interest rate lock commitments, asset-backed securities, and highly structured or long-term derivative contracts.

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.

Trading securities: Fair values are based on published market prices or dealer quotes.

Interest Rate Lock Commitments: Interest rate lock commitments, related to the origination of mortgage loans held for sale, are recorded at estimated fair value based on the value of the underlying loan, which in turn is based on quoted prices for similar loans in the secondary market. However, this value is adjusted by a factor which considers the likelihood that the loan in a lock position will ultimately close. This factor, the closing ratio, is derived from the Company's internal data and is adjusted using significant management judgment. The closing ratio is largely dependent on the loan processing stage that a loan is currently in and the change in prevailing interest rates from the time of the rate lock. As such, interest rate lock commitments are classified as recurring Level 3. For the three-month period ending March 31, 2012, the Company used a weighted average closing ratio of 80%. The Company recognized a gain associated with the rate lock commitments of \$960,000 for the three-month period ended March 31, 2012. Because the amounts associated with the rate lock commitments were determined to be immaterial, the Company did not record the value of the rate locks in any period prior to January 1, 2012. The carrying value of the interest rate lock commitments was \$960,000 at March 31, 2012.

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

March 31, 2012				
	Level 1	Level 2	Level 3	Total
U.S. Treasury obligations and direct obligations of U.S. government agencies	\$ -	\$ 59,845	\$ -	\$ 59,845
Municipal securities	-	34,841	-	34,841
Federal agency mortgage-backed securities	-	146,869	-	146,869
Corporate securities and other	4	7,771	-	7,775
Equity securities	11,775	-	-	11,775
Interest rate lock commitments	-	-	960	960

December 31, 2011				
	Level 1	Level 2	Level 3	Total
U.S. Treasury obligations and direct obligations of U.S. government agencies	\$ -	\$ 187,135	\$ -	\$ 187,135
Municipal securities	-	35,909	-	35,909
Federal agency mortgage-backed securities	-	99,310	-	99,310
Corporate securities and other	4	7,715	-	7,719
Equity securities	10,854	-	-	10,854

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, 2012 (in thousands):

March 31, 2012	Level 1	Level 2	Level 3	Fair Value
Impaired loans	\$ -	\$ 26,250	\$ 17,635	\$ 43,885
Other real estate owned	\$ -	\$ 22,750	\$ 9,461	\$ 32,211
December 31, 2011	Level 1	Level 2	Level 3	Fair Value
Impaired loans	\$ -	\$ 26,033	\$ 16,891	\$ 42,924
Other real estate owned	\$ -	\$ 25,959	\$ 3,860	\$ 29,819

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following is a description of valuation methodologies used for assets measured on a non-recurring 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 Level 2 inputs based on observable market data or Level 3 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.

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 upon assumptions specific to the individual property. Level 3 inputs typically include unobservable inputs such as management applied discounts used to further reduce values to a net realizable value or in situations where our appraisal date predates a likely change in market conditions. These deductions ranged from 7% to 15%.

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 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

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

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

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

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

Convertible subordinated capital debentures: The fair values of the convertible subordinated capital debentures are estimated using discounted contractual cash flows based on the Company's incremental rate of borrowing that would be currently available for similar types of borrowing arrangements.

Repurchase agreements: The carrying amount approximates fair value.

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Federal funds purchased: The carrying amount approximates fair value.

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

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

March 31, 2012	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
Cash and due from banks	\$ 378,759	\$ 378,759	\$ 378,759	\$ -	\$ -
Interest-bearing deposits in financial institutions	1,693	1,693	1,693	-	-
Securities available for sale	249,330	249,330	4	249,326	-
Securities held to maturity	152,295	163,661	-	83,017	80,644
Trading securities	11,775	11,775	11,775	-	-
Mortgage loans held for sale	101,568	101,568	-	101,568	-
Net Loans	2,835,677	2,926,681	-	-	2,926,681
Interest receivable	10,904	10,904	-	-	10,904
Interest rate lock commitments	960	960	-	-	960
Deposits	3,251,845	3,051,912	-	3,051,912	-
Advances from the Federal Home Loan Bank of Atlanta	280,000	321,124	-	321,124	-
Repurchase agreements and other borrowings	9,500	9,500	-	9,500	-
Interest payable	2,641	2,641	-	-	2,641

December 31, 2011	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
Cash and due from banks	\$ 312,149	\$ 312,149	\$ 312,149	\$ -	\$ -
Interest-bearing deposits in financial institutions	1,995	1,995	1,995	-	-
Securities available for sale	330,073	330,073	4	330,069	-
Securities held to maturity	153,912	158,453	-	83,420	75,033
Trading securities	10,854	10,854	10,854	-	-
Mortgage loans held for sale	109,453	109,453	-	109,453	-
Net Loans	2,753,453	2,841,709	-	-	2,841,709
Interest receivable	11,485	11,485	-	-	11,485
Deposits	3,190,787	3,012,276	-	3,012,276	-
Advances from the Federal Home Loan Bank of Atlanta	280,000	322,925	-	322,925	-
Convertible subordinated capital debentures	13,740	14,142	-	-	14,142
Repurchase agreements and other borrowings	11,790	11,790	-	11,790	-
Interest payable	3,472	3,472	-	-	3,472

TOWNE BANK

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 17. Subsequent Event

On April 25, 2012, TowneBank's Board of Directors declared a special shareholder stock dividend of 3% per common share. The dividend is payable on June 12, 2012 to shareholders of record on May 25, 2012. Pro forma information reflecting the effect of the stock dividend on basic and diluted earnings per share calculations is shown in following table as if the shares were outstanding at the beginning of each period presented (dollars in thousands, except share data).

	Three Months Ended March 31,	
	2012	2011
Basic		
Net income, as reported	\$ 9,437	\$ 8,304
Preferred stock dividends and accretion of discount	1,916	2,334
Net income available to common shareholders	\$ 7,521	\$ 5,970
Average common shares outstanding	29,905,057	29,741,552
Basic earnings per share amount	\$ 0.25	\$ 0.20
Diluted		
Net income available to common shareholders	\$ 7,521	\$ 5,970
Add: interest applicable to 8% subordinated debt,	154	177
Net income available to common shareholders, for diluted EPS	\$ 7,675	\$ 6,147
Average common shares outstanding	29,905,057	29,741,552
Add shares if converted:		
Stock compensation plans, net of tax benefit (2)	78,975	104,337
Convertible subordinated debentures (3)	909,165	1,065,588
Average diluted shares outstanding	30,893,197	30,911,477
Diluted earning per share amount	\$ 0.25	\$ 0.20

(1) Interest on 8% convertible subordinated capital debentures (net of tax) is added to net income since this interest would not be paid subsequent to the conversion of the debentures into common stock.

(2) Stock options and restricted stock shares totaling 100,247 and 59,556 were excluded from the computation of diluted earnings per share during the first quarter of 2012 and 2011, respectively, because their inclusion would be antidilutive.

(3) Shares assumed to have been converted since the beginning of the period through the date of actual conversion.

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 2012	Fourth Quarter 2011	Third Quarter 2011	Second Quarter 2011	First Quarter 2011
Results of Operations:					
Interest income	\$ 42,428	\$ 42,325	\$ 43,027	\$ 43,376	\$ 43,745
Interest expense	7,643	8,048	8,941	9,613	9,649
Net interest income	34,785	34,277	34,086	33,763	34,096
Provision for loan losses	4,097	1,062	1,400	7,322	3,818
Net interest income after provision for loan losses	30,688	33,215	32,686	26,441	30,278
Noninterest income:					
Residential mortgage brokerage income, net	5,718	4,272	3,396	2,821	2,153
Real estate brokerage and property management income, net	3,373	1,773	3,311	3,005	3,407
Insurance commissions and other title fees and income, net	6,387	5,137	5,619	5,425	6,364
Service charges on deposit accounts	1,698	1,798	1,883	1,840	1,691
Credit card merchant fees, net	868	845	694	680	609
Other income	1,727	2,145	1,920	1,722	1,542
Gain (loss) on investment securities	778	3	(3)	3,629	53
Total noninterest income	20,549	15,973	16,820	19,122	15,819
Noninterest expense:					
Salaries and benefits	21,491	20,100	20,901	19,541	19,017
Occupancy expense	3,376	3,674	3,493	3,477	3,235
Furniture and equipment	1,580	1,490	1,459	1,441	1,415
Other expenses	11,085	11,839	11,236	11,863	10,638
Total noninterest expense	37,532	37,104	37,089	36,322	34,305
Income before noncontrolling interest and income tax	13,705	12,084	12,417	9,241	11,792
Provision for income tax expense	4,054	3,105	3,610	2,613	3,398
Net income	9,651	8,979	8,807	6,628	8,394
Net (income) loss from noncontrolling interest	(214)	8	(282)	877	(90)
Net income attributable to TowneBank	\$ 9,437	\$ 8,987	\$ 8,525	\$ 7,505	\$ 8,304
Net income available to common shareholders	\$ 7,521	\$ 6,846	\$ 4,898	\$ 5,173	\$ 5,970
Per Share Data:					
Net income:					
Basic	\$ 0.26	\$ 0.24	\$ 0.17	\$ 0.18	\$ 0.21
Diluted	0.26	0.23	0.17	0.18	0.20
Book value at period end	13.17	13.03	12.88	12.73	12.59
Tangible book value at period end	9.40	9.08	8.99	8.83	8.67
Cash dividends paid	0.08	0.08	0.08	0.08	0.08
Cash dividends declared	0.08	0.08	0.08	0.08	0.08
Common Stock Closing Price:					
High	\$ 14.52	\$ 13.47	\$ 14.32	\$ 15.73	\$ 16.92
Low	12.34	10.82	10.52	12.46	13.78
Close	13.49	12.24	11.37	13.38	15.66
Selected Financial Ratios:					
Return on average assets	0.93%	0.88%	0.84%	0.75%	0.86%
Return on average tangible assets	0.96%	0.91%	0.87%	0.78%	0.89%
Return on average equity	7.21%	6.87%	6.59%	5.90%	6.68%
Return on average tangible equity	9.21%	8.83%	8.46%	7.60%	8.59%
Net interest margin (tax-equivalent basis) (1)	3.93%	3.94%	3.87%	3.92%	4.08%
Daily Averages:					
Total assets	\$ 4,073,157	\$ 4,049,883	\$ 4,012,377	\$ 3,988,736	\$ 3,910,365
Total tangible assets	3,958,456	3,934,515	3,898,997	3,874,851	3,798,313
Loans, net of unearned income, excluding nonaccrual loans	2,780,762	2,692,055	2,663,562	2,680,353	2,676,028
Total earning assets (1)	3,682,952	3,660,185	3,618,334	3,584,896	3,531,380
Total deposits	3,182,941	3,163,755	3,129,411	3,068,258	2,996,671
FHLB advances	280,000	280,000	287,609	330,770	330,798
Total equity	526,681	519,288	513,257	510,262	503,905
Tangible equity	411,980	403,920	399,877	396,376	391,853
Basic weighted average shares outstanding	29,034,036	28,921,365	28,842,927	28,947,463	28,875,294
Diluted weighted average shares outstanding	29,993,394	30,015,236	29,913,453	30,034,701	30,011,143

(1) Includes bank-owned life insurance.

PART I. FINANCIAL INFORMATION

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

Our Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") 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 2011 audited Consolidated Financial Statements and the 2011 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, competitive and legislative or regulatory factors, and other factors described in our 2011 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 the Greater Hampton Roads area 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, 2012:

- Net income for the three months ended March 31, 2012 was \$9.44 million, or \$0.26 per common diluted share, compared with \$8.30 million, or \$0.20 per diluted share, in the same period in 2011. Net income available to common shareholders for first quarter of 2012 was \$7.52 million after accretion and preferred dividend payments compared with \$5.97 million in the same period of 2011. The increase in earnings was primarily driven by the growth in noninterest income, while net income available to common shareholders was also positively affected by a decrease in preferred stock dividends and accretion from the comparable prior year period.

PART I. FINANCIAL INFORMATION

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

- Net interest income increased \$689,000, or 2.02%, in the first quarter of 2012 from the comparable period in 2011. The increase was primarily due to the growth in earning assets and the positive effect from the repricing of interest-bearing liabilities.
- The provision for loan losses increased \$279,000, or 7.31%, compared to first quarter 2011, and increased \$3.06 million, or 285.78% from December 31, 2011. The increase from first quarter of 2011 was driven by loan growth of \$82.52 million, an increase in nonaccrual loans, and higher levels of net charge-offs. The loan loss reserve decreased to 1.39% of loans at March 31, 2012 from 1.42% at December 31, 2011 and 1.46% at March 31, 2011. The decrease was primarily attributable to slight improvements in credit quality metrics and a large percentage of charge-offs related to loans with specific reserves.
- Excluding gains and losses on securities available for sale, noninterest income increased by \$4.01 million, or 25.40%, over the first quarter of 2011. This increase was driven by improved performance in our Realty segment, primarily due to increases in residential mortgage brokerage income.
- For first quarter 2012, noninterest expense increased \$3.23 million, or 9.41%, compared to first quarter 2011. The increase was driven by acquisitions and expansions during 2011 in our Insurance and Realty segments, which led to higher personnel costs and occupancy expenses.
- Our effective tax rate increased to 30.05% in the first quarter of 2012 from 29.04% in the comparative period of 2011. The increase was primarily a result of higher taxable income, partially offset by increased federal tax credits from community reinvestment activity.

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, deferred income taxes, and estimates of fair value to be critical accounting policies. Refer to our 2011 Annual Report to the Stockholders for further discussion of these policies.

ANALYSIS OF RESULTS OF OPERATIONS

Consolidated Performance Summary

Profitability as measured by our annualized return on average assets ("ROA") was 0.93% for the first quarter of 2012 compared to 0.86% for the first quarter of 2011, and 0.88% for the fourth quarter of 2011. The annualized return on average tangible assets was 0.96%, 0.89%, and 0.91% for the same respective periods. ROA was positively affected by the increase in noninterest income, as the growth in average assets was outpaced by the increase in net income.

The annualized return on average equity was 7.21% for the first quarter of 2012, 6.68% for the first quarter of 2011, and 6.87% for the fourth quarter of 2011, while the annualized return on average tangible equity was 9.21%, 8.59%, and 8.83% for the same respective periods.

PART I. FINANCIAL INFORMATION

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

Operating income, calculated as net interest income and noninterest income less gains on investment securities, was \$54.56 million for the quarter ended March 31, 2012, which increased \$4.70 million, or 9.43%, compared to the quarter ended March 31, 2011. Operating income was \$50.24 million for the quarter ended December 31, 2011.

Basic earnings per share were \$0.26 for the three months ended March 31, 2012 compared to \$0.21 for the first quarter of 2011, and \$0.24 for the fourth quarter of 2011. Diluted earnings per share for the first quarter of 2012 were \$0.26, \$0.20 for the first quarter of 2011, and \$0.23 for the linked quarter. Earnings per share were positively affected, as compared to the prior periods, by the reduction of preferred dividends and accretion due to the Company's participation in the Small Business Lending Fund program. Due to the Company's loan growth, the blended dividend rate for the period from closing through December 31, 2011 was 4.63%, with the rate reduced to 3.92% and 2.28% for the first and second quarters of 2012, respectively.

Net Interest Income. Net interest income, the major source of our earnings, is the income generated by interest earning assets reduced by the total interest cost of the funds incurred to carry them. It is impacted by the 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.

We reported net interest income, on a tax-equivalent basis, of \$35.96 million for the quarter ended March 31, 2012, which was \$511,000 or 1.44% above the year ago amount of \$35.45 million. On a linked quarter basis, tax-equivalent net interest income decreased by \$379,000, or 1.04%, from the \$36.34 million reported for the fourth quarter of 2011. The linked quarter drop was primarily due to a decrease in net interest income related to bank-owned life insurance. Compared to the first quarter of the prior year, net interest income improved primarily due to growth in earning assets and lower funding costs.

Interest income, on a tax-equivalent basis, was \$43.61 million for the quarter ended March 31, 2012, which was \$1.50 million, or 3.31%, less than the \$45.10 million reported for the period ending March 31, 2011. On a linked quarter basis, tax-equivalent interest income declined \$784,000, or 1.77%, from \$44.39 million in the fourth quarter of 2011. Average earning assets grew to \$3.68 billion in the quarter ended March 31, 2012, from \$3.53 billion in the comparative prior year quarter, an increase of \$151.57 million, or 4.29%. In the linked quarter comparison, average earning assets grew by \$22.77 million, or 0.62%, from \$3.66 billion in the quarter ended December 31, 2011. The yield on earning assets was 4.76% in the quarter ended March 31, 2012, which compared to 5.18% in the comparative prior year period and 4.81% in the linked period. Average loan balances, excluding nonaccrual loans, of \$2.78 billion were \$104.73 million, or 3.91%, higher in the first quarter of 2012 than in the same period a year ago, while loan yields declined by 30 basis points. In the linked quarter, loans grew \$88.71 million or 3.30% and loan yields were 9 basis points lower. In both comparative periods, the contraction in interest income was primarily due to lower yields on loans and taxable investments.

Interest expense, for the quarter ended March 31, 2012, was \$7.64 million, which was \$2.01 million or 20.79% below the \$9.65 million amount in the year ago quarter. The average balance of interest-bearing liabilities increased to \$2.66 billion in the first quarter of 2012 from \$2.63 billion in the comparative prior year quarter, an increase of 0.80%. On a linked quarter basis, interest expense declined by \$405,000, or 5.03%, from \$8.05 million in the fourth quarter of 2011. In the linked quarter, average interest bearing liabilities grew by \$28.51 million, or 1.1%, from \$2.63 billion in the quarter ended December 31, 2011. In both cases, the higher balance was offset by a drop in the average rate paid at 1.16% for the March 31, 2012

TOWNE BANK

PART I. FINANCIAL INFORMATION

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

quarter compared with 1.22% for the December 31, 2011 quarter and 1.49% for the March 31, 2011 quarter. The decline was driven by repricing opportunities in certificates of deposit in the year over year comparison and in interest checking, money market and savings costs in the linked quarters.

Net interest margin, which is net interest income expressed as a percentage of average earning assets, was 3.93% in the quarter ended March 31, 2012, which was 14 basis points lower than the 4.07% margin of the March 31, 2011 quarter and 1 basis point lower than the 3.94% margin of the December 31, 2011 quarter. The decrease was driven by the decline in the yields of earning assets.

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, 2012			Three Months Ended December 31, 2011			Three Months Ended March 31, 2011		
	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	\$ 2,780,762	\$ 38,354	5.55%	\$ 2,692,055	\$ 38,254	5.64%	\$ 2,676,028	\$ 38,594	5.85%
Taxable investment securities	293,957	1,759	2.39%	260,271	1,666	2.56%	483,033	3,359	2.78%
Tax-exempt investment securities	147,776	1,786	4.83%	148,332	1,817	4.90%	139,734	1,705	4.88%
Interest bearing deposits	317,009	199	0.25%	421,819	268	0.25%	143,127	95	0.27%
Loans held for sale	89,979	806	3.58%	84,402	801	3.80%	36,562	466	5.10%
Bank-owned life insurance	53,469	689	5.18%	53,305	1,583	11.78%	52,896	881	6.75%
Total earning assets	3,682,952	43,593	4.76%	3,660,185	44,389	4.81%	3,531,380	45,100	5.18%
Less: allowance for loan losses	(39,861)			(40,958)			(38,328)		
Total nonearning assets	430,066			430,656			417,313		
Total Assets	<u>\$ 4,073,157</u>			<u>\$ 4,049,883</u>			<u>\$ 3,910,365</u>		
Liabilities and Equity:									
Interest bearing deposits									
Demand and money market	\$ 1,012,019	\$ 1,125	0.45%	\$ 954,409	\$ 1,315	0.55%	\$ 810,917	\$ 1,086	0.54%
Savings	194,495	277	0.57%	186,140	310	0.66%	142,762	259	0.74%
Certificates of deposit	1,145,801	2,985	1.05%	1,177,541	3,286	1.11%	1,321,852	4,634	1.42%
Total interest bearing deposits	2,352,315	4,387	0.75%	2,318,090	4,911	0.84%	2,275,531	5,979	1.07%
Borrowings	291,462	3,019	4.10%	295,307	2,864	3.80%	345,197	3,377	3.91%
Subordinated debentures	11,865	237	7.99%	13,740	273	7.96%	13,842	293	8.47%
Total interest bearing liabilities	2,655,642	7,643	1.16%	2,627,137	8,048	1.22%	2,634,570	9,649	1.49%
Demand deposits	830,626			845,665			721,139		
Other noninterest bearing liabilities	60,208			57,793			50,751		
Total liabilities	3,546,476			3,530,595			3,406,460		
Shareholders' equity	526,681			519,288			503,905		
Total liabilities and equity	<u>\$ 4,073,157</u>			<u>\$ 4,049,883</u>			<u>\$ 3,910,365</u>		
Net interest income (tax-equivalent basis)		35,950			36,341			35,451	
Reconciliation of Non-GAAP Financial Measures									
Bank-Owned Life Insurance		(689)			(1,583)			(881)	
Tax-equivalent basis adjustment		(476)			(482)			(474)	
Net interest income (GAAP)		<u>\$ 34,785</u>			<u>\$ 34,276</u>			<u>\$ 34,096</u>	
Interest rate spread (1)			3.60%			3.60%			3.69%
Interest expense as a percent of average earning assets			0.83%			0.87%			1.11%
Net interest margin (tax equivalent basis) (2)			3.93%			3.94%			4.07%
Total cost of deposits			0.55%			0.62%			0.81%

(1) Interest spread is the average yield earned on earning assets less the average rate paid on interest bearing liabilities. Fully tax equivalent.

(2) Net interest margin is net interest income expressed as a percentage of average earning assets. Fully tax equivalent.

TOWNE BANK

PART I. FINANCIAL INFORMATION

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

(Dollars in thousands)

	Increase/(Decrease) Three Months Ended March 31, 2012 Compared to Three Months Ended December 31, 2011			Increase/(Decrease) Three Months Ended March 31, 2012 Compared to Three Months Ended March 31, 2011		
	Volume	Rate (1)	Total	Volume	Rate (1)	Total
Assets:						
Loans	\$ 881	\$ (781)	\$ 100	\$ 1,628	\$ (1,868)	\$ (240)
Taxable investment securities	206	(113)	93	(1,180)	(420)	(1,600)
Tax-exempt investment securities	(6)	(25)	(31)	97	(16)	81
Interest bearing deposits	(69)	-	(69)	110	(6)	104
Loans held for sale	51	(46)	5	511	(171)	340
Bank-owned life insurance	4	(898)	(894)	10	(202)	(192)
Total earning assets	1,067	(1,863)	(796)	1,176	(2,683)	(1,507)
Liabilities and Equity:						
Interest bearing deposits						
Demand and money market	70	(260)	(190)	249	(210)	39
Savings	12	(45)	(33)	83	(65)	18
Certificates of deposit	(101)	(200)	(301)	(554)	(1,095)	(1,649)
Total interest bearing deposits	(19)	(505)	(524)	(222)	(1,370)	(1,592)
Borrowings	(41)	196	155	(518)	160	(358)
Subordinated debentures	(37)	1	(36)	(40)	(16)	(56)
Total interest bearing liabilities	(97)	(308)	(405)	(780)	(1,226)	(2,006)
Net interest income	\$ 1,164	\$ (1,555)	\$ (391)	\$ 1,956	\$ (1,457)	\$ 499

(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, 2012 was \$19.77 million, an increase of \$4.01 million, or 25.40%, compared to the same period in 2011 and an increase of \$3.80 million, or 23.80%, compared to the fourth quarter of 2011. As a percentage of total operating income, noninterest income, excluding securities gains or losses, for the first quarter of 2012 was 36.24%, compared with 31.62% for comparative 2011 and 31.78% for the fourth quarter of 2011.

TOWNE BANK

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 tables provide an analysis of noninterest income (dollars in thousands).

	Three Months Ended		Increase/(Decrease)	
	March 31,		2012 over 2011	
	2012	2011	Amount	Percent
Residential mortgage brokerage income, net	\$ 5,718	\$ 2,153	\$ 3,565	165.58%
Real estate brokerage and property management, net	3,373	3,407	(34)	(1.00%)
Insurance commissions and other title fees and income, net	6,387	6,364	23	0.36%
Service charges on deposit accounts	1,698	1,691	7	0.41%
Credit card merchant fees, net	868	609	259	42.53%
Other income	1,727	1,542	185	12.00%
Subtotal before gain on investment securities	19,771	15,766	4,005	25.40%
Net gain on investment securities	778	53	725	N/M
Total noninterest income	<u>\$ 20,549</u>	<u>\$ 15,819</u>	<u>\$ 4,730</u>	<u>29.90%</u>

	Three Months Ended		Increase/(Decrease)	
	March 31, December 31,		First Quarter 2012 over Fourth Quarter 2011	
	2012	2011	Amount	Percent
Residential mortgage brokerage income, net	\$ 5,718	\$ 4,271	\$ 1,447	33.88%
Real estate brokerage and property management, net	3,373	1,773	1,600	90.24%
Insurance commissions and other title fees and income, net	6,387	5,138	1,249	24.31%
Service charges on deposit accounts	1,698	1,798	(100)	(5.56%)
Credit card merchant fees, net	868	845	23	2.72%
Other income	1,727	2,145	(418)	(19.49%)
Subtotal before gain on investment securities	19,771	15,970	3,801	23.80%
Net gain on investment securities	778	3	775	N/M
Total noninterest income	<u>\$ 20,549</u>	<u>\$ 15,973</u>	<u>\$ 4,576</u>	<u>28.65%</u>

For the first quarter of 2012, residential mortgage brokerage income, net of commission expense was \$5.72 million, reflecting an increase of \$3.57 million, or 165.58%, compared to the first quarter of 2011 and an increase of \$1.45 million, or 33.88%, compared to the fourth quarter of 2011. Mortgage brokerage income is highly correlated to the housing market, which saw some improvement in the first quarter of 2012, and mortgage interest rates, which were affected by a general decrease in long-term interest rates during the fourth quarter of 2011 and the first quarter of 2012. These factors contributed to a significantly higher volume in purchase and refinancing transactions and the corresponding increase in net mortgage brokerage income from the comparative prior year period and modest increases from the linked quarter. Additionally, the Company recognized a gain on rate lock commitments of \$960,000 for the quarter ended March 31, 2012. Also, the November 1, 2011, acquisition of Benchmark Mortgage, Inc. ("Benchmark"), a mortgage company affiliated with Townebank Mortgage, and other expansions of our mortgage operations resulted in additional net brokerage income of \$1.91 million as compared to the first quarter of 2011.

PART I. FINANCIAL INFORMATION

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

Real estate brokerage and property management income, net of commission expense, for the first quarter of 2012 was \$3.37 million, which was \$34,000 or 1.00%, less than comparative 2011 and \$1.60 million, or 90.24%, more than the fourth quarter of 2011.

For the first quarter of 2012, insurance commissions and other title income, net of commission expense was \$6.39 million, which was \$23,000, or 0.36%, higher than comparative 2011, and \$1.25 million, or 24.31% more than fourth quarter 2011. The increase in the linked quarter comparison is largely due to contingency income of \$1.17 million. Contingent commissions are mostly received during the first quarter of each year. The increase from the comparative prior year period was largely due to the acquisition of the Stanton Taylor Agency, Inc. ("Stan Taylor") insurance agency in the fourth quarter of 2011, which was mostly offset by a decrease in contingency income of \$395,000.

For the first quarter of 2012, credit card merchant fees totaled \$868,000, which were \$259,000, or 42.53%, higher than comparative 2011 and \$23,000, or 2.72%, more than the fourth quarter of 2011.

Other noninterest income for the three months ended March 31, 2012 was \$1.73 million and included income generated by Towne Investment Group, net of commission expense. For the three months ended March 31, 2012, net commission income totaled \$482,000 as compared to \$343,000 for Towne Investment Group for the first quarter of 2011.

Noninterest Expense. For the quarter ended March 31, 2012, total noninterest expense was \$37.53 million, which was \$3.23 million, or 9.41%, higher than comparative 2011 and \$430,000, or 1.16%, higher than the quarter ended December 31, 2011.

As a percentage of operating income, noninterest expense was 68.80% for the first quarter of 2012, 68.80% for comparative 2011, and 73.85% for the quarter ended December 31, 2011. The primary components of noninterest expense in the first quarter of 2012 were salaries and employee benefits of \$21.49 million, occupancy expenses of \$3.38 million, furniture and equipment expenses of \$1.58 million, foreclosed property expenses of \$1.19 million, and advertising and marketing expenses of \$1.08 million. In comparison to first quarter of 2011, a significant portion of the increase in total noninterest expense is due to the October 3, 2011, acquisition of the Stan Taylor insurance agency, which resulted in additional expenses of \$306,000, primarily in salaries and benefits, and the November 1, 2011, acquisition of Benchmark, and other expansions of our mortgage operations, which resulted in additional expenses of \$1.70 million, primarily in salaries and benefits. Excluding the costs associated with the acquisitions and expansions, noninterest expense increased \$1.23 million, or 3.59%, from the comparative quarter in 2011.

TOWNE BANK

PART I. FINANCIAL INFORMATION

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

The following table provides an analysis of quarterly total noninterest expense by line item (dollars in thousands).

	Three Months Ended			Increase/(Decrease)			
	March 31,		December 31,	March 31, 2012 over		March 31, 2012 over	
	2012	2011	2011	March 31, 2011		December 31, 2011	
	Amount			Amount	Percent	Amount	Percent
Salaries and benefits	\$ 21,491	\$ 19,017	\$ 20,100	\$ 2,474	13.01%	\$ 1,391	6.92%
Occupancy expense	3,376	3,235	3,674	141	4.36%	(298)	(8.11%)
Furniture and equipment	1,580	1,415	1,490	165	11.66%	90	6.04%
Other							
Advertising and marketing	1,076	1,019	646	57	5.59%	430	66.56%
Other	1,354	1,315	2,054	39	2.98%	(700)	(34.07%)
Charitable contributions	884	833	885	51	6.12%	(1)	(0.11%)
Outside processing	644	650	837	(6)	(0.92%)	(193)	(23.06%)
Professional fees	1,119	810	1,304	309	38.15%	(185)	(14.19%)
Stationery and supplies	465	467	596	(2)	(0.43%)	(131)	(21.98%)
FDIC and other insurance	782	1,377	933	(595)	(43.21%)	(151)	(16.18%)
Foreclosed property expenses	1,187	886	1,115	301	33.97%	72	6.46%
Software expense	1,041	775	956	266	34.32%	85	8.89%
Telephone and postage	903	795	806	108	13.58%	97	12.03%
Amortization exp-intangibles	629	654	689	(25)	(3.84%)	(60)	(8.72%)
Bank franchise tax/SCC fees	468	501	487	(33)	(6.59%)	(19)	(3.90%)
Directors fees and expenses	311	409	271	(98)	(23.96%)	40	14.76%
Travel/meals/entertainment	222	147	260	75	51.02%	(38)	(14.62%)
Total other expenses	11,085	10,638	11,839	447	4.20%	(754)	(6.37%)
Total noninterest expense	\$ 37,532	\$ 34,305	\$ 37,103	\$ 3,227	9.41%	\$ 429	1.16%

Salary and benefits expense, the largest portion of noninterest expense, was \$21.49 million, representing 57.26% of total noninterest expense for the quarter ended March 31, 2012. Salary and benefits expense increased \$2.47 million, or 13.01%, over the comparative period in 2011 and \$1.39 million, or 6.92%, over the fourth quarter of 2011. The increase from the comparative period of the prior year is primarily due to the addition of staff resulting from the insurance and mortgage expansion, an increase in profit sharing expenses, and an increase in expense related to management deferred compensation. The increase from the linked quarter is due to the expense related to the management deferred compensation plan and an increase in payroll taxes.

In our Banking segment we had a total of 627 full-time equivalent employees ("FTE") at March 31, 2012, which was up from 596 at March 31, 2011 and 625 at December 31, 2011. In our non-Banking segments at March 31, 2012, we had a total of 510 FTEs, excluding real estate sales agents, which was up from 430 at March 31, 2011 and 506 at December 31, 2011. Real estate sales agents are independent contractors, and therefore, not included as our employees. Total operating income per FTE was \$48,000 for the quarter ended March 31, 2012 a decrease from \$49,000 for the period ended March 31, 2011 and an increase from \$44,000 for the period ended December 31, 2011.

Occupancy expense for the first quarter of 2012 experienced a 4.36% increase from comparative 2011 and an 8.11% decrease from fourth quarter 2011. The increase from the comparative period in the prior year was primarily driven by the expansion of mortgage operations during 2011. The decrease from the sequential quarter was primarily a result of decreases in maintenance, cleaning and other occupancy costs.

PART I. FINANCIAL INFORMATION

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

For the quarter ended March 31, 2012, furniture and equipment expense increased by 11.66% over comparative 2011 and by 6.04% compared with the fourth quarter 2011.

Other noninterest expenses for the first quarter of 2012 saw an increase of \$447,000, or 4.20%, compared to the same period in 2011 and a decrease of \$754,000, or 6.37%, when compared to fourth quarter 2011. The primary drivers of the increase from the comparative prior year period were expenses related to foreclosed properties, increases in professional fees, and higher software expenses. The increases were partially offset by a decrease in FDIC fees, related to a change in assessment methodology. The linked quarter decrease was driven by lower merger and acquisition costs, a decrease in fraud losses, outside processing expenses, and professional fees, partially offset by increased advertising and marketing expenses.

Provision for Income Taxes. We reported a provision for income tax expense of \$4.05 million, representing an effective rate of 30.05% for the first quarter of 2012. The provision for income tax expense was \$3.40 million for the first quarter of 2011, with an effective rate of 29.04%.

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, 2012, the Banking segment represented 67.74%, or \$6.39 million, of our total consolidated net income compared to 80.25%, or \$6.66 million, for comparative 2011.

Pre-tax earnings for the three months ended March 31, 2012 for the Banking segment were \$8.46 million, decreasing \$447,000, or 5.02%, from comparative 2011. The decrease in earnings from comparative 2011 was primarily driven by an increase in noninterest expenses and an increase in the provision for loan losses, which were partially offset by an increase in net interest income of \$483,000, or 1.43%, and an increase in the net gain on investment securities.

Noninterest expenses increased by \$1.78 million, or 7.26%, in the first quarter of 2012 compared to the first quarter of 2011. The primary factor in the increase was an increase in salaries and employee benefits expense of \$1.49 million, or 11.59%, primarily due to increases in profit sharing expense and an increase in the management deferred compensation plan liability. Additional factors in the increase include an increase in furniture and equipment expense of \$174,000, and an increase in occupancy expense of \$128,000.

TOWNE BANK

PART I. FINANCIAL INFORMATION

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

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

	Quarter Ended			Increase/(Decrease)			
	March 31,		December 31,	2012 over 2011		March over December	
	2012	2011	2011	Amount	Percent	Amount	Percent
Net interest income	\$ 34,248	\$ 33,765	\$ 33,752	\$ 483	1.43%	\$ 496	1.47%
Service charges on deposit accounts	1,698	1,691	1,798	7	0.41%	(100)	(5.56%)
Credit card merchant fees	868	609	845	259	42.53%	23	2.72%
Other income	1,152	1,037	1,714	115	11.09%	(562)	(32.79%)
Net gain on investment securities	778	53	3	725	1367.92%	775	25833.33%
Total noninterest income	4,496	3,390	4,360	1,106	32.63%	136	3.12%
Total revenue	38,744	37,155	38,112	1,589	4.28%	632	1.66%
Provision for loan losses	4,097	3,818	\$ 1,062	279	7.31%	3,035	285.78%
Salaries and employee benefits	14,346	12,856	13,503	1,490	11.59%	843	6.24%
Occupancy expense	2,561	2,433	2,770	128	5.26%	(209)	(7.55%)
Furniture and equipment	1,254	1,080	1,149	174	16.11%	105	9.14%
Other expenses	8,174	8,184	8,183	(10)	(0.12%)	(9)	(0.11%)
Total expenses	26,335	24,553	25,605	1,782	7.26%	730	2.85%
Income before income tax and corporate allocation	8,312	8,784	11,445	(472)	(5.37%)	(3,133)	(27.37%)
Corporate allocation	144	119	108	25	21.01%	36	33.33%
Income before income tax provision	8,456	8,903	11,553	(447)	(5.02%)	(3,097)	(26.81%)
Provision for income tax expense	2,063	2,239	2,944	(176)	(7.86%)	(881)	(29.93%)
Net income	\$ 6,393	\$ 6,664	\$ 8,609	\$ (271)	(4.07%)	\$ (2,216)	(25.74%)

Realty Segment. For the three months ended March 31, 2012, the Realty segment had income before income tax provision and noncontrolling interest of \$3.32 million as compared to \$875,000 for the comparative 2011 period. Total revenue increased to \$10.42 million in 2012 from \$6.59 million in the first quarter of 2011. The increase in revenue is largely due to an improvement in net mortgage brokerage income as a result of increased volume in purchase and refinancing transactions. As discussed previously, mortgage volumes were positively affected by a degree of stabilization in the housing market and a decrease in mortgage interest rates. Additionally, the Company recognized a gain on rate lock commitments of \$960,000 for the quarter ended March 31, 2012 and the expansions of our mortgage operations resulted in additional net brokerage income of \$1.91 million as compared to the first quarter of 2011. The linked quarter comparison was also affected by a seasonal increase in resort property management fees for Corolla Classic Vacations.

Expenses for the Realty segment increased 23.92%, or \$1.35 million, when compared to the same period in 2011, and decreased by 1.59% or \$113,000 when compared to the quarter ended December 31, 2011. The increase from the comparative period in 2011 is primarily due to higher noninterest expenses related to the expansion of our mortgage operations.

TOWNE BANK

PART I. FINANCIAL INFORMATION

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

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

	Three Months Ended			Increase/(Decrease)			
	March 31,		December 31,	March 31, 2012		March 31, 2012	
	2012	2011	2011	Amount	Percent	Amount	Percent
Residential mortgage brokerage income, net	\$ 5,847	\$ 2,184	\$ 4,354	\$ 3,663	167.72%	\$ 1,493	34.29%
Real estate brokerage income, net	1,001	1,151	1,251	(150)	(13.03%)	(250)	(19.98%)
Title insurance and settlement fees	405	379	465	26	6.86%	(60)	(12.90%)
Property management fees, net	2,372	2,256	522	116	5.14%	1,850	354.41%
Income (loss) from unconsolidated subsidiary	131	99	(50)	32	32.32%	181	(362.00%)
Net interest and other income	664	525	738	139	26.48%	(74)	(10.03%)
Total revenue	10,420	6,594	7,280	3,826	58.02%	3,140	43.13%
Salaries and employee benefits	4,236	3,277	3,731	959	29.26%	505	13.54%
Occupancy expense	584	588	661	(4)	(0.68%)	(77)	(11.65%)
Furniture and equipment	190	210	194	(20)	(9.52%)	(4)	(2.06%)
Amortization of intangible assets	173	227	227	(54)	(23.79%)	(54)	(23.79%)
Other expenses	1,811	1,342	2,294	469	34.95%	(483)	(21.05%)
Total expenses	6,994	5,644	7,107	1,350	23.92%	(113)	(1.59%)
Income before income tax, corporate allocation and noncontrolling interest	3,426	950	173	2,476	260.63%	3,253	N/M
Corporate allocation	(103)	(75)	(77)	(28)	(37.33%)	(26)	(33.77%)
Income before income tax provision and noncontrolling interest	3,323	875	96	2,448	279.77%	3,227	N/M
Provision for income tax benefit	1,272	406	(14)	866	213.30%	1,286	N/M
Net income	2,051	469	110	1,582	337.31%	1,941	N/M
Noncontrolling interest	(96)	55	4	(151)	(274.55%)	(100)	N/M
Net income attributable to TowneBank	\$ 1,955	\$ 524	\$ 114	\$ 1,431	273.09%	\$ 1,841	N/M
Key data:							
Number of units sold	569	569	788	-	0.00%	(219)	(27.79%)
Volume of units sold	\$ 139,603	\$ 152,614	\$ 213,588	\$ (13,011)	(8.53%)	\$ (73,985)	(34.64%)
Number of real estate agents	381	434	392	(53)	(12.21%)	(11)	(2.81%)
Loans originated, mortgage	\$ 140,554	\$ 64,251	\$ 124,825	\$ 76,303	118.76%	\$ 15,729	12.60%
Loans originated, joint venture	126,675	87,475	127,023	39,200	44.81%	(348)	(0.27%)
Total loans originated	\$ 267,229	\$ 151,726	\$ 251,848	\$ 115,503	76.13%	\$ 15,381	6.11%
Number of loans, mortgage	610	257	569	353	137.35%	41	7.21%
Number of loans, joint venture	587	423	579	164	38.77%	8	1.38%
Total number of loans	1,197	680	1,148	517	76.03%	49	4.27%
Average loan amount, mortgage	\$ 230	\$ 250	\$ 219	\$ (20)	(7.91%)	\$ 11	5.03%
Average loan amount, joint venture	216	207	219	9	4.28%	(4)	(1.63%)
Average loan amount	\$ 223	\$ 223	\$ 219	\$ 0	(0.10%)	\$ 4	1.76%
Average number of originators, mortgage	45	23	40	22	95.65%	5	-
Average number of originators, joint venture	37	35	39	2	5.71%	(2)	(5.13%)
Average number of originators	82	58	79	24	41.38%	3	3.80%

Mortgage. The loan volume for the combined mortgage operations increased in the quarter ended March 31, 2012 as compared to the same period in 2011. Total loans originated in 2012 were \$267.23 million, a 76.13% increase, or \$115.50 million from \$151.73 million in 2011. This was a \$15.38 million, or 6.11%, increase compared to the volume for the quarter ended December 31, 2011. Refinance activity comprised \$106.89 million of loan volume for the quarter ended March 31, 2012, while purchases accounted for the remaining \$160.34 million in loan volume for the quarter. For the quarters ended March 31, 2011 and December 31, 2011, refinance volume was \$45.74 million and \$100.99 million, respectively, while purchase volume was \$105.99 million and \$150.86 million, respectively.

TOWNE BANK

PART I. FINANCIAL INFORMATION

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

Insurance Segment. The Insurance segment is comprised of property and casualty and group benefit divisions. The Insurance segment represented 11.53%, or \$1.09 million, of total consolidated net income at March 31, 2012 and 13.44%, or \$1.12 million, at March 31, 2011.

Earnings before income taxes and noncontrolling interests for the three months ended March 31, 2012 for the Insurance segment were \$1.93 million, decreasing \$87,000, or 4.32%, from comparative 2011. The decrease was primarily attributable to slight increases in salaries and employee benefits and other operating expenses over the comparative quarter in 2011. The increase in expenses was partially offset by the effects of the Stan Taylor acquisition, which resulted in additional commission income of \$296,000 and contingency income of \$46,000. Contingent commissions primarily consist of amounts received from various property and casualty insurance carriers. The carriers use several non-client-specific factors to determine the amount of the contingency payments. Such factors include the aggregate loss performance of insurance policies previously placed and the volume of business, among other things. Such commissions are seasonal in nature and are mostly received during the first quarter of each year.

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

	Three Months Ended			Increase/(Decrease)			
	March 31,		December 31,	March 31, 2012		March 31, 2012	
	2012		2011	March 31, 2011		December 31, 2011	
	2012	2011	2011	Amount	Percent	Amount	Percent
Net commission and fee income							
Property and casualty	\$ 3,350	\$ 3,005	\$ 3,270	\$ 345	11.48%	\$ 80	2.45%
Specialized benefit services	127	110	124	17	15.45%	3	2.42%
Employee benefits	1,460	1,412	1,332	48	3.40%	128	9.61%
Total net commissions and fees	4,937	4,527	4,726	410	9.06%	211	4.46%
Contingency and bonus revenue	1,173	1,568	71	(395)	(25.19%)	1,102	N/M
Other income	61	70	61	(9)	(12.86%)	-	0.00%
Total revenues	\$ 6,171	\$ 6,165	\$ 4,858	\$ 6	0.10%	\$ 1,313	27.03%
Salaries and employee benefits	\$ 2,909	\$ 2,884	\$ 2,866	\$ 25	0.87%	\$ 43	1.50%
Occupancy expense	232	214	242	18	8.41%	(10)	(4.13%)
Furniture and equipment	136	125	147	11	8.80%	(11)	(7.48%)
Amortization of intangible assets	311	282	317	29	10.28%	(6)	(1.89%)
Other expenses	616	603	819	13	2.16%	(203)	(24.79%)
Total operating expenses	4,204	4,108	4,391	96	2.34%	(187)	(4.26%)
Income before income tax, corporate allocation and noncontrolling interest	1,967	2,057	467	(90)	(4.38%)	1,500	321.20%
Corporate allocation	(41)	(44)	(32)	3	(6.82%)	(9)	28.13%
Income before income tax provision and noncontrolling interest	1,926	2,013	435	(87)	(4.32%)	1,491	342.76%
Provision for income tax expense	719	752	175	(33)	(4.39%)	544	310.86%
Net income	1,207	1,261	260	(54)	(4.28%)	947	364.23%
Noncontrolling interest	(118)	(145)	4	27	(18.62%)	(122)	N/M
Net income attributable to TowneBank	\$ 1,089	\$ 1,116	\$ 264	\$ (27)	(2.42%)	\$ 825	312.50%

Salaries and employee benefits expense increased \$25,000, or 0.87%, when comparing the three months ended March 31, 2012 to the same period for 2011. The increase was due to the Stan Taylor business combination.

Occupancy expense increased \$18,000, or 8.41%, when comparing the three months ended March 31, 2012 to the same period for 2011.

PART I. FINANCIAL INFORMATION

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

ANALYSIS OF FINANCIAL CONDITION

Overview. At March 31, 2012, total assets were \$4.14 billion, which is \$170.86 million, or 4.30%, greater than the period end balance for comparative 2011 and \$62.45 million, or 1.53% greater than the balance at December 31, 2011. Our loan portfolio, less unearned income and deferred costs, made up 69.39% of our period end assets and totaled \$2.88 billion at March 31, 2012. Average assets for the quarter ended March 31, 2012 were \$4.07 billion, up \$162.79 million, or 4.16%, from the quarter ended March 31, 2011 and \$23.27 million, or 0.57%, from the quarter ended December 31, 2011.

Average earning assets increased \$151.57 million, or 4.29%, from \$3.53 billion for the first quarter of 2011 to \$3.68 billion for the first quarter of 2012. Compared to the fourth quarter of 2011, average earning assets increased \$22.77 million.

Our average total deposits were \$3.18 billion for first quarter 2012, reflecting growth of \$186.27 million, or 6.22%, compared to first quarter 2011. Average noninterest bearing deposits, which increased \$109.49 million, or 15.18%, grew at a higher rate than interest bearing deposits over comparative 2011.

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, 2012 were \$365.51 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 2012 was \$316.58 million, or 8.61%, of average total earning assets compared with \$143.13 million, or 4.06%, of average total earning assets for comparative 2011. For the fourth quarter of 2011, the average balance of interest bearing deposits in other banks was \$421.65 million, or 11.52%, 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 securities available-for-sale portfolio was \$249.33 million at March 31, 2012 compared with \$450.50 million at March 31, 2011. The average balance for the 2012 period was \$256.57 million compared to the 2011 period average of \$435.76 million, or 6.97% and 12.34% of average earning assets, respectively. During the three months ended March 31, 2012, we had maturities and calls totaling \$154.09 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 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 \$152.30 million at March 31, 2012 and \$159.50 million at March 31, 2011. Our average balance for the 2012 period was \$153.44 million compared with \$158.94 million in the 2011 period, representing 4.17% and 4.50% of total average earning assets. 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.

PART I. FINANCIAL INFORMATION

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

Loans Held for Sale. At March 31, 2012, we held \$101.57 million in mortgage loans originated and intended for sale in the secondary market, as compared with \$34.65 million for comparative 2011 and \$109.45 million for the quarter ended December 31, 2011.

Average loans held for sale were 2.44% and 1.04% of average earning assets for the quarters ended March 31, 2012 and 2011, respectively. Average loans held for sale were 2.31% of average earning assets for the quarter ended December 31, 2011. The majority of mortgage loans held for sale have been pre-committed to investors, which minimizes our interest rate risk.

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

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

Loan Portfolio. Loans, net of unearned income and deferred costs, were \$2.88 billion at March 31, 2012, which was \$137.44 million, or 5.02%, above the \$2.74 billion reported at March 31, 2011 and \$82.52 million, or 2.95%, above the \$2.79 billion at December 31, 2011. Factors that contributed to the increase in our loan demand were the stabilization of our local economy, and the efforts of our experienced 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 75.50% for the quarter ended March 31, 2012 compared with 75.77% for 2011 and 73.55% for the quarter ended December 31, 2011.

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

The allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 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 Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Company.

It is our policy to assign internal risk grades to all loans as a component of the approval process. Based on the size of the loan, senior credit officers and the peer review committees may review the classification to ensure accuracy and consistency of classifications, which are then validated by the chief credit officer. Loan classifications are internally reviewed to determine if any changes in the circumstances of the loan require a

PART I. FINANCIAL INFORMATION

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

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, 2012, March 31, 2011 and December 31, 2011 was \$40.03 million, \$40.02 million, and \$39.74 million, respectively. The allowance was equal to 1.39% of total loans outstanding at March 31, 2012, compared with 1.46% and 1.42% for March 31, 2011 and December 31, 2011. On certain loans when the Company determines a loan is impaired, the estimated impairment is directly charged-off to the loan rather than creating a specific reserve for inclusion in the allowance for loan losses.

TOWNE BANK

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 (dollars in thousands).

	Three Months Ended		
	March 31,		December 31,
	2012	2011	2011
Allowance for loan losses			
Balance beginning of period	\$ 39,740	\$ 38,660	\$ 40,941
Loans charged off:			
Residential 1-4 family	(1,803)	(993)	(928)
Commercial real estate	(286)	(480)	(387)
Construction	(1,756)	(645)	(1,145)
Commercial and industrial	(380)	(397)	-
Consumer and other	(110)	(40)	(21)
Total	(4,335)	(2,555)	(2,481)
Loans recovered:			
Residential 1-4 family	462	28	19
Commercial real estate	3	-	46
Construction	53	32	117
Commercial and industrial	10	30	-
Consumer and other	4	8	36
Total	532	98	218
Net loans charged off	(3,803)	(2,457)	(2,263)
Provision for loan losses	4,097	3,818	1,062
Balance end of period	<u>\$ 40,034</u>	<u>\$ 40,021</u>	<u>\$ 39,740</u>
Nonperforming assets			
Nonperforming loans	\$ 56,253	\$ 70,936	\$ 55,801
Foreclosed property	32,211	23,699	29,819
Total nonperforming assets	<u>\$ 88,464</u>	<u>\$ 94,635</u>	<u>\$ 85,620</u>
Loans past due 90 days and still accruing interest	<u>\$ 184</u>	<u>\$ 175</u>	<u>\$ 1</u>
Asset Quality Ratios			
Allowance for loan losses to nonperforming loans	0.71x	0.56x	.71x
Allowance for loan losses to period end loans	1.39%	1.46%	1.42%
Nonperforming loans to period end loans	1.96%	2.59%	2.00%
Nonperforming assets to period end assets	2.13%	2.38%	2.10%
Net charge-offs to average loans (annualized)	0.54%	0.36%	0.33%

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, 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. At March 31, 2012, we had \$88.46 million in nonperforming assets, which amounted to 2.13% of total assets. Additionally, loans past due 90 days that were accruing interest totaled \$184,000. Nonperforming assets consist of \$56.25 million in nonperforming loans as well as \$32.21 million in foreclosed property. Foreclosed property consists of 41 residential properties, 59 construction and development properties, and nine commercial properties.

At March 31, 2012, loans 60-89 days past due totaled \$4.19 million. Additionally, there are other performing loans, totaling \$55.47 million, that are current but have certain documentation deficiencies or other potential weaknesses that management considers warrant additional monitoring. All loans in these categories are subject to constant management attention, and their status is reviewed on a regular basis. With the exception of \$14.73 million, which represents management's estimate of total potential loss of loans reviewed for impairment, these loans are generally secured with appraised values that exceed the remaining principal balances on such loans.

In order to maximize the collection of loan balances, we evaluate troubled loan accounts on a case-by-case basis to determine if a loan modification would be appropriate. We may pursue loan modifications when there is a reasonable chance that an appropriate modification would allow our clients to continue servicing the debt. Because some troubled debt restructurings ("TDRs") may not ultimately result in the complete collection of principal and interest (as modified by the terms of the restructuring), additional incremental losses could result. These potential incremental losses have been factored into our overall allowance for loan losses estimate. At March 31, 2012, nonaccruing TDRs, which are included in nonperforming loans, totaled \$20.98 million and accruing TDRs totaled \$32.56 million. Nonaccruing loans that are modified can be placed back on accrual status when both principal and interest are current 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.

TOWNE BANK

PART I. FINANCIAL INFORMATION

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

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

	March 31, 2012	December 31, 2011
1-4 family residential real estate	\$ 13,152	\$ 10,394
Commercial real estate	7,345	5,561
Construction and land development	32,258	36,712
Real estate-multi-family	274	-
Commercial and industrial business loans	2,741	2,644
Consumer loans and other	483	490
Total nonperforming loans	<u>\$ 56,253</u>	<u>\$ 55,801</u>

Allocation of the Allowance for Loan Losses. Management anticipates that the specific loan and loan type allocations will increase over time, and the reserves set aside for perceived and anticipated trends known to management will decrease as the loan portfolio ages and other information used in the allocation methodology changes with actual experience of the loan portfolio performance.

The following table provides a breakdown of the allowance for loan losses among the various loan types for the periods indicated (in thousands):

	March 31, 2012	March 31, 2011	December 31, 2011
Real estate loans:			
Residential 1-4 family	\$ 10,962	\$ 10,841	\$ 10,837
Commercial	10,827	10,699	10,578
Construction	13,767	13,806	13,623
Multi-family	327	302	395
Total real estate loans	35,883	35,648	35,433
Commercial and industrial loans	3,704	3,835	3,842
Consumer loans and other	447	538	465
Total	<u>\$ 40,034</u>	<u>\$ 40,021</u>	<u>\$ 39,740</u>

Deposits. Total deposits at March 31, 2012 were \$3.25 billion, representing an increase of 6.40%, or \$195.70 million, over March 31, 2011, and an increase of \$61.06 million, or 1.91%, compared to December 31, 2011. Overall growth in deposits is primarily attributed to an increase in the Banking segment customer base and in the number of accounts. Total average deposits were \$3.18 billion during the first quarter of 2012 compared to \$3.00 billion during the first quarter of 2011 and \$3.16 billion during the fourth quarter of 2011.

Average noninterest bearing demand deposits as a percentage of average total deposits were 26.10% during the first quarter of 2012 and 24.06% during the same period in 2011. Average noninterest bearing demand deposits were 26.73% of average total deposits for the fourth quarter of 2011. The cost of interest bearing

TOWNE BANK

PART I. FINANCIAL INFORMATION

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

deposits was 0.75% for the first quarter of 2012 compared with 1.07% for the first quarter of 2011 and 0.84% for the fourth quarter of 2011.

The following tables set forth a summary of our various deposit categories and their respective cost rates (dollars in thousands).

	Average Balance/Cost Rate Three Months Ended					
	March 31,				December 31,	
	2012		2011		2011	
Interest bearing demand and money market accounts	\$ 1,012,019	0.45%	\$ 810,917	0.54%	\$ 954,409	0.55%
Regular savings	194,495	0.57%	142,762	0.74%	186,140	0.66%
Certificates of deposit	1,145,801	1.05%	1,321,852	1.42%	1,177,541	1.11%
Total interest bearing	2,352,315	0.75%	2,275,531	1.07%	2,318,090	0.84%
Noninterest bearing	830,626		721,139		845,665	
Total	\$ 3,182,941	0.55%	\$ 2,996,670	0.81%	\$ 3,163,755	0.62%

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

	Average Balance and Composition Three Months Ended					
	March 31,				December 31,	
	2012		2011		2011	
Interest bearing demand and money market accounts	\$ 1,012,019	31.80%	\$ 810,917	27.06%	\$ 954,409	30.17%
Regular savings	194,495	6.11%	142,762	4.76%	186,140	5.88%
Certificates of deposit	1,145,801	36.00%	1,321,852	44.11%	1,177,541	37.22%
Total interest bearing	2,352,315	73.90%	2,275,531	75.94%	2,318,090	73.27%
Noninterest bearing	830,626	26.10%	721,139	24.06%	845,665	26.73%
Total	\$ 3,182,941	100.00%	\$ 2,996,670	100.00%	\$ 3,163,755	100.00%

TOWNE BANK

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. Borrowings of advances from the Federal Home Loan Bank of Atlanta ("FHLB") as of March 31, 2012 were \$280.00 million, compared to \$330.79 million at March 31, 2011 and \$280.00 million at December 31, 2011. The average borrowing cost for the first quarter of 2012 was 4.20%, compared to 4.05% for the same period in 2011 and 4.20% at December 31, 2011. The scheduled maturity dates, call dates, and related fixed interest rates on advances from the FHLB at March 31, 2012 are summarized as follows (dollars in thousands).

Maturity	Interest Rate	Call Date	Outstanding Amount
03/06/2017	4.08%	06/06/2012	100,000
05/18/2017	4.35%	05/18/2012	80,000
05/18/2017	4.48%	05/18/2012	80,000
01/29/2018	3.05%	-	13,000
01/29/2018	3.05%	-	7,000
Total FHLB Loans			\$ 280,000

At March 31, 2012, certain residential HELOCs, second mortgages, and commercial mortgages secured by real estate with carrying values of \$588.11 million collateralized the advances from the FHLB. At March 31, 2011, certain loans with carrying values of \$652.09 million collateralized the advances from the FHLB. At December 31, 2011, certain residential HELOCs, second mortgages, and commercial mortgages secured by real estate with carrying values of \$610.70 million collateralized the advances from the FHLB.

In addition to borrowings from the FHLB, we maintain various borrowing arrangements with financial institutions to support liquidity needs. As of March 31, 2012, we had no outstanding balances on these borrowing agreements with other financial institutions. Average total borrowings, including FHLB advances, during the first quarter of 2012 were \$291.46 million compared with \$345.20 million for the first quarter of 2011 and \$295.31 million for the fourth quarter of 2011, while the average cost of these funds was 4.10%, 3.91% and 3.80%, respectively.

Convertible Subordinated Capital Debentures. During the first quarter of 2012, TowneBank announced the mandatory conversion of its outstanding Series III notes. At the close of business on March 19, 2012, all \$13.60 million of outstanding Series III notes were converted into shares of TowneBank common stock at the conversion price of \$13.38 per share (equal to a conversion rate of 149.48 shares per \$2,000 principal amount of notes). There were no convertible subordinated capital debentures at March 31, 2012. At March 31, 2011, the debentures totaled \$13.84 million, and at December 31, 2011, they were \$13.74 million.

Average total convertible subordinated capital debentures during the first quarter of 2012 were \$11.87 million compared with \$13.84 million for the first quarter of 2011 and \$13.74 million for the fourth quarter of 2011 while the average cost of these debentures was 7.99%, 8.47% and 7.96%, respectively.

TOWNE BANK

PART I. FINANCIAL INFORMATION

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

Common Stock and Dividends. For the high and low prices of our common stock, see *Selected Quarterly Information* in *Part I. Financial Information, Item 2. MD&A*, in this report.

On February 23, 2011, we declared a quarterly shareholder cash dividend of \$0.08 per common share. The dividend was paid on April 12, 2011 to shareholders of record on March 31, 2011. 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.

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 Federal Reserve, 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.

An additional measure of capital adequacy is risk-based capital ratios. As indicated below, our risk-based capital ratios are 12.62% for Tier I and 13.81% for total capital, which are both well above the required minimums of 4.00% and 8.00%, respectively. Under the FDIC rules, we are considered "well capitalized" as of March 31, 2012.

The following table provides information on our risk-based capital position (dollars in thousands).

	March 31,		December 31,
	2012	2011	2011
Tier I Capital:			
Shareholders' equity (1)(2)	\$ 537,027	\$ 504,491	\$ 517,735
Less: goodwill and intangible assets	114,311	114,133	114,938
Total Tier I	422,716	390,358	402,797
Tier II Capital:			
Convertible subordinated debentures	-	13,842	13,740
Qualifying allowance for loan losses (3)	40,034	40,021	39,740
Total Tier II	40,034	53,863	53,480
Total Risk Based Capital	\$ 462,750	\$ 444,221	\$ 456,277
Total Assets	\$ 4,144,218	\$ 3,973,354	\$ 4,081,770
Total risk weighted assets	3,350,166	3,257,533	3,219,283
Average assets for leverage capital purposes	3,958,846	3,796,232	3,934,945
Risk Weighted Assets to Total Assets	80.84%	81.98%	78.87%
Risk Based Capital Ratios:			
Tier I (4% minimum requirement)	12.62%	11.98%	12.51%
Total (8% minimum requirement)	13.81%	13.64%	14.17%
Tier I Leverage Ratio (4% minimum requirement)	10.68%	10.28%	10.24%

(1) Excludes unrealized gains/losses on securities available-for-sale.

(2) Includes adjustments per regulatory guidelines.

(3) Limited to 1.25% of risk weighted assets.

PART I. FINANCIAL INFORMATION

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

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,	
	2012	2011
Return on average assets (GAAP basis)	0.93%	0.86%
Impact of excluding average goodwill and other intangibles and amortization	0.03%	0.03%
Return on average tangible assets	0.96%	0.89%

	Three Months Ended March 31,	
	2012	2011
Return on average equity (GAAP basis)	7.21%	6.68%
Impact of excluding average goodwill and other intangibles and amortization	2.00%	1.91%
Return on average tangible equity	9.21%	8.59%

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,	
	2012	2011
Book value (GAAP basis)	\$ 13.17	\$ 12.59
Impact of excluding goodwill and other intangibles and amortization	(3.77)	(3.92)
Tangible book value	\$ 9.40	\$ 8.67

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

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

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

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

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

At March 31, 2012, we had \$87.32 million more liabilities than assets subject to repricing within one year, and therefore, were in a liability-sensitive position. This is a one-day position, which is continually 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.

PART I. FINANCIAL INFORMATION

Item 4. Controls and Procedures

Controls and Procedures. As of March 31, 2012, 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, 2012. There were no changes that occurred during the period covered by this Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

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

Item 1A. Risk Factors.

For information regarding factors that could affect the Company's results of operations, financial condition or liquidity, see the risk factors discussed under "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 of TowneBank's 2011 Annual Report on Form 10-K. See also "Forward-Looking Statements," included in Part I, Item 2 of this Quarterly Report on Form 10-Q. There have been no material changes from the risk factors previously disclosed in TowneBank's 2011 Annual Report on Form 10-K.

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

None

Item 3. Defaults Upon Senior Securities.

None

Item 4. Mine Safety Disclosures.

Not applicable

Item 5. Other Information.

None

Item 6. Exhibits.

<u>Exhibit No.</u>	<u>Description</u>
(31.1)	CEO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
(31.2)	CFO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
(32)	Certification Pursuant to 18 U.S.C. Section 1350 as adopted by Section 906 of the Sarbanes-Oxley Act of 2002
(99)	Independent Accountants' Report by Dixon Hughes Goodman LLP, dated May 7, 2012

TOWNE BANK

PART II. OTHER INFORMATION

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 7, 2012

Date

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

G. Robert Aston, Jr.
Chairman/Chief Executive Officer

May 7, 2012

Date

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

Clyde E. McFarland, Jr.
Senior Executive Vice President/CFO

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, 2012 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 Rule 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rule 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 our 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 the 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

- (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 7, 2012

Date

/s/ G. Robert Aston, Jr.

G. Robert Aston, Jr.

Chairman/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, 2012 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 Rule 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rule 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 our 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 the 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

- (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 7, 2012

Date

/s/ Clyde E. McFarland, Jr.

Clyde E. McFarland, Jr.

Senior Executive Vice President/CFO

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.

**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, 2012 (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 7, 2012

Date

/s/ G. Robert Aston, Jr.

G. Robert Aston, Jr.

Chairman/Chief Executive Officer

May 7, 2012

Date

/s/ Clyde E. McFarland, Jr.

Clyde E. McFarland, Jr.

Senior Executive Vice President/CFO

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.



DIXON HUGHES GOODMAN LLP
Certified Public Accountants and Advisors

Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Shareholders of *TowneBank*

We have reviewed the accompanying consolidated balance sheets of *TowneBank* and subsidiaries (the Company) as of March 31, 2012 and 2011, the related consolidated statements of income, comprehensive income, equity and cash flows for the three-month periods then ended. This condensed financial information is the responsibility of the Company's management.

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

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) the consolidated balance sheet of *TowneBank* and subsidiaries as of December 31, 2011, and the related consolidated statements of income, comprehensive income, equity, and cash flows for the year then ended (not presented herein); and in our report dated March 13, 2012, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2011, 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 7, 2012