# FEDERAL DEPOSIT INSURANCE CORPORATION

**Washington, D. C. 20429**

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# FORM 10-Q

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

For the quarterly period ended **June 30, 2012**

FDIC Insurance Cert. Number: 35095

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TOWNEBANK
(Exact name of registrant as specified in its charter)

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| | |
|---|---|
| VIRGINIA | 54-1910608 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 5716 High Street, Portsmouth, Virginia | 23703 |
| (Address of principal executive offices) | (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 [X] 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 [X]

The number of shares of the Company's common stock outstanding as of July 31, 2012 was 31,381,765 shares.

TOWNEBANK

# TABLE *of* CONTENTS

## Part I. Financial Information



## Part II. Other Information

# PART I. FINANCIAL INFORMATION
## Item 1. Financial Statements
## CONSOLIDATED BALANCE SHEETS (unaudited)

| (Dollars in thousands, except share data) | June 30, 2012 | June 30, 2011 | December 31, 2011 |
|---|---|---|---|
| | (unaudited) | (unaudited) | (audited) |
| **ASSETS** | | | |
| Cash and due from banks | $ 172,633 | $ 112,309 | $ 312,149 |
| Interest bearing deposits in financial institutions | 1,521 | 1,865 | 1,995 |
| **Total Cash and Cash Equivalents** | 174,154 | 114,174 | 314,144 |
| Securities available-for-sale, at fair value | 348,188 | 226,224 | 330,073 |
| Securities held-to-maturity, at amortized cost | 161,641 | 510,663 | 153,912 |
| Trading account securities | 11,648 | 11,094 | 10,854 |
| Federal Home Loan Bank stock, at amortized cost | 19,164 | 22,781 | 20,445 |
| **Total Securities** | 540,641 | 770,762 | 515,284 |
| Mortgage loans held for sale | 152,332 | 43,549 | 109,453 |
| Loans, net of unearned income and deferred costs: | | | |
| Real estate-residential 1-4 family | 744,663 | 700,813 | 709,129 |
| Real estate-commercial | 1,217,200 | 993,916 | 1,072,187 |
| Real estate-construction and development | 570,339 | 655,288 | 557,630 |
| Real estate-multi-family | 58,717 | 40,525 | 48,321 |
| Commercial | 372,269 | 324,989 | 362,830 |
| Consumer and other loans | 39,325 | 45,795 | 43,096 |
| Loans, net of unearned income and deferred costs | 3,002,513 | 2,761,326 | 2,793,193 |
| Less: Allowance for loan losses | (40,370) | (41,787) | (39,740) |
| **Net Loans** | 2,962,143 | 2,719,539 | 2,753,453 |
| Premises and equipment, net | 138,380 | 121,590 | 134,047 |
| Goodwill | 98,129 | 96,388 | 98,127 |
| Other intangible assets, net | 15,575 | 17,023 | 16,811 |
| Bank-owned life insurance policies | 54,212 | 53,089 | 53,315 |
| Other assets | 95,427 | 81,605 | 87,136 |
| **TOTAL ASSETS** | $ 4,230,993 | $ 4,017,719 | $ 4,081,770 |
| **LIABILITIES AND EQUITY** | | | |
| **Liabilities** | | | |
| Deposits: | | | |
| Noninterest-bearing demand | $ 922,294 | $ 779,262 | $ 839,211 |
| Interest-bearing: | | | |
| Demand and money market accounts | 1,084,477 | 870,535 | 991,084 |
| Savings | 192,066 | 162,609 | 192,133 |
| Certificates of deposit | 1,130,802 | 1,286,277 | 1,168,359 |
| **Total Deposits** | 3,329,639 | 3,098,683 | 3,190,787 |
| Advances from the Federal Home Loan Bank | 280,000 | 330,000 | 280,000 |
| Convertible subordinated capital debentures | - | 13,798 | 13,740 |
| Repurchase agreements and other borrowings | 10,562 | 12,585 | 11,790 |
| **Total Borrowings** | 290,562 | 356,383 | 305,530 |
| Other liabilities | 63,797 | 53,934 | 64,964 |
| **TOTAL LIABILITIES** | 3,683,998 | 3,509,000 | 3,561,281 |
| **Shareholders' Equity** | | | |
| Preferred stock, $5.00 par: 2,000,000 shares authorized 658,411 issued and outstanding at June 30, 2012, 660,605 issued and outstanding at June 30, 2011 and 659,945 issued and outstanding at December 31, 2011 | 134,354 | 132,508 | 134,507 |
| Common stock, $1.667 par: 45,000,000 shares authorized 31,367,247 issued and outstanding at June 30, 2012, 29,061,507 issued and outstanding at June 30, 2011 and 29,145,226 issued and outstanding at December 31, 2011 | 52,289 | 48,446 | 48,585 |
| Capital surplus | 259,150 | 232,237 | 233,895 |
| Retained earnings | 92,993 | 87,431 | 94,453 |
| Accumulated other comprehensive income | 1,292 | 1,912 | 2,754 |
| **TOTAL SHAREHOLDERS' EQUITY** | 540,078 | 502,534 | 514,194 |
| Noncontrolling interest | 6,917 | 6,185 | 6,295 |
| **TOTAL EQUITY** | 546,995 | 508,719 | 520,489 |
| **TOTAL LIABILITIES AND EQUITY** | $ 4,230,993 | $ 4,017,719 | $ 4,081,770 |

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

# PART I. FINANCIAL INFORMATION
## Item 1. Financial Statements
## CONSOLIDATED STATEMENTS OF INCOME (unaudited)

| (Dollars in thousands, except per share data) | Three Months Ended June 30, 2012 | Three Months Ended June 30, 2011 | Six Months Ended June 30, 2012 | Six Months Ended June 30, 2011 |
|---|---|---|---|---|
| **INTEREST INCOME:** | | | | |
| Loans, including fees | $ 38,948 | $ 38,314 | $ 77,283 | $ 76,871 |
| Investment securities | 2,896 | 4,403 | 5,983 | 9,030 |
| Interest bearing deposits in financial institutions and federal funds sold | 155 | 164 | 354 | 260 |
| Mortgage loans held for sale | 1,211 | 495 | 2,018 | 961 |
| **Total Interest Income** | 43,210 | 43,376 | 85,638 | 87,122 |
| **INTEREST EXPENSE:** | | | | |
| Deposits | 4,318 | 5,907 | 8,705 | 11,886 |
| Advances from the Federal Home Loan Bank | 2,970 | 3,390 | 5,970 | 6,744 |
| Convertible subordinated capital debentures | - | 293 | 237 | 587 |
| Repurchase agreements and other borrowings | 18 | 23 | 37 | 46 |
| **Total Interest Expense** | 7,306 | 9,613 | 14,949 | 19,263 |
| **Net Interest Income** | 35,904 | 33,763 | 70,689 | 67,859 |
| **PROVISION FOR LOAN LOSSES** | 4,122 | 7,322 | 8,220 | 11,140 |
| **Net Interest Income after Provision for Loan Losses** | 31,782 | 26,441 | 62,469 | 56,719 |
| **NONINTEREST INCOME:** | | | | |
| Residential mortgage brokerage income, net | 6,527 | 2,821 | 12,245 | 4,975 |
| Real estate brokerage and property management income, net | 3,293 | 3,005 | 6,666 | 6,412 |
| Insurance commissions and other title fees and income, net | 6,019 | 5,425 | 12,406 | 11,790 |
| Service charges on deposit accounts | 2,010 | 1,840 | 3,708 | 3,531 |
| Credit card merchant fees, net | 1,035 | 680 | 1,903 | 1,289 |
| Other income | 1,859 | 1,722 | 3,587 | 3,263 |
| Net gain on investment securities | 1,753 | 3,629 | 2,531 | 3,681 |
| **Total Noninterest Income** | 22,496 | 19,122 | 43,046 | 34,941 |
| **NONINTEREST EXPENSE:** | | | | |
| Salaries and employee benefits | 22,194 | 19,541 | 43,685 | 38,558 |
| Occupancy expense | 3,540 | 3,477 | 6,917 | 6,712 |
| Furniture and equipment | 1,577 | 1,441 | 3,157 | 2,856 |
| Other expenses | 13,329 | 11,862 | 24,414 | 22,501 |
| **Total Noninterest Expense** | 40,640 | 36,321 | 78,173 | 70,627 |
| **Income before income tax expense and noncontrolling interest** | 13,638 | 9,242 | 27,342 | 21,033 |
| **Provision for income tax expense** | 3,401 | 2,613 | 7,454 | 6,011 |
| **Net income** | 10,237 | 6,629 | 19,888 | 15,022 |
| **Net (income) loss attributable to noncontrolling interest** | (709) | 877 | (923) | 787 |
| **Net income attributable to TowneBank** | $ 9,528 | $ 7,506 | $ 18,965 | $ 15,809 |
| **Preferred stock dividends and accretion** | 1,600 | 2,333 | 3,517 | 4,667 |
| **Net income applicable to common shareholders** | $ 7,928 | $ 5,173 | $ 15,448 | $ 11,142 |
| **Per common share information** | | | | |
| Basic earnings | $ 0.26 | $ 0.17 | $ 0.51 | $ 0.37 |
| Diluted earnings | $ 0.26 | $ 0.17 | $ 0.50 | $ 0.37 |
| Cash dividends declared | $ 0.08 | $ 0.08 | $ 0.16 | $ 0.16 |

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

# PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)

| (Dollars in thousands) | Three Months Ended June 30, 2012 | Three Months Ended June 30, 2011 | Six Months Ended June 30, 2012 | Six Months Ended June 30, 2011 |
|---|---|---|---|---|
| **Net income** | $ 10,237 | $ 6,629 | $ 19,888 | $ 15,022 |
| **Other comprehensive income (loss)** | | | | |
| **Unrealized gains on available-for-sale securities:** | | | | |
| Unrealized holding gains (losses) arising during the period | (169) | 4,670 | 45 | 6,179 |
| Realized gains reclassified into earnings | (2,012) | (3,629) | (2,006) | (3,681) |
| Net unrealized gains (losses) | (2,181) | 1,041 | (1,961) | 2,498 |
| **Defined benefit retirement plan** | | | | |
| Actuarial loss | - | - | (288) | - |
| **Other comprehensive income (loss), before tax** | (2,181) | 1,041 | (2,249) | 2,498 |
| **Income tax expense (benefit) related to items of other comprehensive income** | 763 | (364) | 787 | (874) |
| **Other comprehensive income (loss), net of tax** | (1,418) | 677 | (1,462) | 1,624 |
| **Comprehensive income** | $ 8,819 | $ 7,306 | $ 18,426 | $ 16,646 |

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

# PART I. FINANCIAL INFORMATION
## Item 1. Financial Statements
## CONSOLIDATED STATEMENTS OF CASH FLOW (unaudited)

| (Dollars in thousands) | Six Months Ended June 30, 2012 | Six Months Ended June 30, 2011 |
|---|---|---|
| **OPERATING ACTIVITIES:** | | |
| Net income | $ 19,888 | $ 15,022 |
| Adjustments to reconcile net income to net cash from (used for) operating activities: | | |
| Net accretion of securities | 1,924 | 2,515 |
| Investment securities gains | (2,531) | (3,681) |
| Depreciation, amortization, and other intangible amortization | 5,755 | 5,381 |
| Provision for loan losses | 8,220 | 11,140 |
| Bank-owned life insurance income | (897) | (1,060) |
| Deferred income tax expense (benefit) | 1,130 | (1,411) |
| Share-based compensation expense | 760 | 649 |
| Purchases of trading account securities | (267) | - |
| Loss on sale and write-down of foreclosed assets | 482 | 1,930 |
| Changes in: | | |
| Loans held for sale | (42,879) | 21,479 |
| Interest receivable | (341) | 699 |
| Other assets | (13,161) | (6,797) |
| Interest payable | (320) | (320) |
| Other liabilities | (492) | (4,036) |
| Net cash from (used for) operating activities | (22,729) | 41,510 |
| **INVESTING ACTIVITIES:** | | |
| Purchase of available-for-sale securities | (231,550) | (86,125) |
| Purchase of held-to-maturity securities | (12,145) | (364,449) |
| Sale of available-for-sale securities | 44,520 | 230,536 |
| Proceeds from maturities, calls, and prepayments of available-for-sale securities | 168,393 | 56,254 |
| Proceeds from maturities, calls, and prepayments of held-to-maturity securities | 4,346 | 3,025 |
| Net increase in loans | (216,910) | (37,960) |
| Purchase of premises and equipment | (9,156) | (10,393) |
| Proceeds from sales of premises and equipment | 304 | - |
| Distribution of interest in joint ventures | (301) | (209) |
| Proceeds from sales of foreclosed assets | 4,089 | 1,746 |
| Acquisition of business, net of cash acquired | - | (3,209) |
| Net cash used for investing activities | (248,410) | (210,784) |
| **FINANCING ACTIVITIES:** | | |
| Net increase in deposit accounts | 138,852 | 144,168 |
| Net change in borrowings | (1,215) | (2,249) |
| Proceeds from issuance of common stock | 2,387 | - |
| Cash dividends paid | (8,875) | (8,947) |
| Net cash from financing activities | 131,149 | 132,972 |
| Change in cash and cash equivalents | (139,990) | (36,302) |
| Cash and cash equivalents at beginning of year | 314,144 | 150,476 |
| Cash and cash equivalents at end of period | $ 174,154 | $ 114,174 |
| Supplemental cash flow information: | | |
| Cash paid for interest | $ 15,269 | $ 19,582 |
| Cash paid for income taxes | $ 8,684 | $ 10,200 |
| Noncash financing and investing activities: | | |
| Net unrealized gain (loss) on available-for-sale securities | $ (1,275) | $ 1,624 |
| Common stock issued in connection with conversion of convertible subordinated capital debentures | $ 13,754 | $ 88 |

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

# PART I. FINANCIAL INFORMATION
## Item 1. Financial Statements
## CONSOLIDATED STATEMENTS OF EQUITY

| (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 | - | - | - | - | 18,965 | - | 923 | 19,888 |
| Other comprehensive loss, net of taxes | - | - | - | - | - | (1,462) | - | (1,462) |
| Cash dividends declared on common stock | - | - | - | - | (5,003) | - | - | (5,003) |
| Cash dividends declared on preferred stock | - | - | - | - | (3,517) | - | - | (3,517) |
| Stock dividend on common stock | 919,923 | - | 1,536 | 10,351 | (11,905) | - | - | (18) |
| Director's deferred compensation | (46,620) | - | (78) | 78 | - | - | - | - |
| Distribution of interests in joint ventures | - | - | - | - | - | - | (301) | (301) |
| Conversion of preferred stock into common stock | 8,264 | (153) | 14 | 139 | - | - | - | - |
| Conversion of convertible debt into common stock | 1,027,823 | - | 1,715 | 12,039 | - | - | - | 13,754 |
| Issuance of common stock - stock compensation plans | 312,631 | - | 517 | 2,648 | - | - | - | 3,165 |
| **Balance, June 30, 2012** | **31,367,247** | **$ 134,354** | **$ 52,289** | **$ 259,150** | **$ 92,993** | **$ 1,292** | **$ 6,917** | **$ 546,995** |

*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 June 30, 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 June 30, 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. On April 25, 2012, TowneBank's Board of Directors declared a special shareholder stock dividend of 3% per common share payable on June 12, 2012 to shareholders of record on May 25, 2012. All share and per share amounts included in the accompanying consolidated financial statements and footnotes have been restated for all periods presented to reflect the stock split.

***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 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.

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.

# 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 June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| **Basic** | | | | |
| Net income, as reported | $ 9,528 | $ 7,506 | $ 18,965 | $ 15,809 |
| Preferred stock dividends and accretion of discount | 1,600 | 2,333 | 3,517 | 4,667 |
| Net income available to common shareholders | $ 7,928 | $ 5,173 | $ 15,448 | $ 11,142 |
| Average common shares outstanding | 30,916,123 | 29,815,887 | 30,418,960 | 29,775,745 |
| Basic earnings per share amount | $ 0.26 | $ 0.17 | $ 0.51 | $ 0.37 |
| **Diluted** | | | | |
| Net income available to common shareholders | $ 7,928 | $ 5,173 | $ 15,448 | $ 11,142 |
| Add: interest applicable to 8% subordinated debt, net of tax (1) | - | 179 | 154 | 356 |
| Net income available to common shareholders, for diluted EPS | $ 7,928 | $ 5,352 | $ 15,602 | $ 11,498 |
| Average common shares outstanding | 30,916,123 | 29,815,887 | 30,418,960 | 29,775,745 |
| Add shares if converted: | | | | |
| Stock compensation plans, net of tax benefit (2) | 55,794 | 57,654 | 68,408 | 75,948 |
| Convertible subordinated debentures (3) | - | 1,062,201 | 441,342 | 1,062,201 |
| Average diluted shares outstanding | 30,971,917 | 30,935,742 | 30,928,710 | 30,913,894 |
| Diluted earning per share amount | $ 0.26 | $ 0.17 | $ 0.50 | $ 0.37 |

(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 3,174 and 7,695 were excluded from the computation of diluted earnings per share during the second quarter of 2012 and 2011, respectively, and 48,362 and 40,223 were excluded from the computation of diluted earnings per share during the six months ended June 30, 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 June 30, 2012, the terms of the TowneBank 8% Non-Cumulative Convertible Preferred Stock, Series A entitled the holders to convert their shares into 3,229,839 shares of common stock at a conversion price of $18.02 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 554,330 common shares at an exercise price of $20.69 per share. These shares were not included in the computation of diluted earnings per share as the effect was anti-dilutive for the period.

On March 19, 2012, there was a 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).

| June 30, 2012 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| U.S. agency securities | $ 26,952 | $ 147 | $ - | $ 27,099 |
| U.S. Treasury notes | 149,999 | - | - | 149,999 |
| Municipal securities | 38,960 | 1,259 | (108) | 40,111 |
| Trust preferred and other corporate securities | 10,094 | 172 | (32) | 10,234 |
| Mortgage-backed securities issued by GSE | 119,909 | 978 | (142) | 120,745 |
| Total available-for-sale securities | $ 345,914 | $ 2,556 | $ (282) | $ 348,188 |

| 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 | $ 325,847 | $ 4,240 | $ (14) | $ 330,073 |

*Held-to-maturity securities*

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

| June 30, 2012 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Trust preferred corporate securities | $ 12,661 | $ 893 | $ (42) | $ 13,512 |
| Municipal securities | 62,893 | 4,604 | - | 67,497 |
| Industrial revenue bonds | 86,087 | 9,561 | (1) | 95,647 |
| Total held-to-maturity securities | $ 161,641 | $ 15,058 | $ (43) | $ 176,656 |

| 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 | $ 153,912 | $ 6,409 | $ (1,868) | $ 158,453 |

*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).

| June 30, 2012 | Available for Sale | | Held to Maturity | |
|---|---|---|---|---|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due in one year or less | $ 149,999 | $ 149,999 | $ 4,110 | $ 4,110 |
| Due after one year through five years | 35,838 | 36,129 | 28,184 | 29,741 |
| Due after five years through 10 years | 28,625 | 29,126 | 17,593 | 18,681 |
| Due after 10 years | 130,877 | 132,359 | 111,754 | 124,124 |
| | 345,339 | 347,613 | 161,641 | 176,656 |
| Other equity securities | 575 | 575 | - | - |
| | $ 345,914 | $ 348,188 | $ 161,641 | $ 176,656 |

| 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 |
| | 325,265 | 329,491 | 153,912 | 158,453 |
| Other equity securities | 582 | 582 | - | - |
| | $ 325,847 | $ 330,073 | $ 153,912 | $ 158,453 |

*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).

| June 30, 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 |
| Municipal securities | $ 5,300 | $ 108 | $ - | $ - | $ 5,300 | $ 108 |
| Industrial revenue bonds | 4,009 | 1 | - | - | 4,009 | 1 |
| Mortgage-backed securities issued by GSE | 50,185 | 142 | - | - | 50,185 | 142 |
| Trust preferred corporate securities | 11,012 | 74 | - | - | 11,012 | 74 |
| Total temporarily impaired securities | $ 70,506 | $ 325 | $ - | $ - | $ 70,506 | $ 325 |

| 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 | $ 170,815 | $ 1,882 | $ - | $ - | $ 170,815 | $ 1,882 |

*U.S. Treasury obligations*

The Company had no unrealized losses on U. S. Treasury obligations at June 30, 2012.

*Municipal securities*

The Company's unrealized losses on municipal securities were caused by interest rate fluctuations. At June 30, 2012, four securities had unrealized losses of $108,000. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on the credit quality of the issuers, and because it is the Company's intent to hold these securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

*Government-Sponsored Enterprises ("GSE") mortgage-backed securities*

The Company's unrealized losses on investments in federal agency mortgage-backed securities were caused by interest rate and prepayment fluctuations. At June 30, 2012, seven securities experienced unrealized losses of $142,000. 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 unrealized losses on trust preferred corporate securities were caused by interest rate fluctuations and calls. At June 30, 2012, three securities had unrealized losses of $74,000. The severity and duration of these unrealized losses fluctuates with interest rates in the economy. Based on the credit quality of the issuers and because it was the Company's intent to hold these securities until a market price recovery or maturity, the Company did not consider these investments other than temporarily impaired at June 30, 2012. Subsequent to June 30, 2012, several of the Company's trust preferred corporate securities were called by their various issuers, resulting in a total gain on the transactions of approximately $627,000, which will be recognized in the third quarter of 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 $19.16 million and $20.44 million of FHLB stock at June 30, 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 June 30, 2012, one bond issuance had a total unrealized loss of $1,000. Based on the credit quality of the issuer, and because it is the Company's intent to hold this bond until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the bond before its anticipated recovery, the Company does not consider this investment other than temporarily impaired.

*Other investments, including common stock*

The Company had no unrealized losses in other investments or common stocks at June 30, 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 $40.37 million adequate to cover loan losses inherent in the loan portfolio at June 30, 2012.

The following table presents, by portfolio segment, the changes in the allowance for loan losses for the three and six-month periods ended June 30, 2012 (in thousands):

| Three Months Ended June 30, 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 |
|---|---|---|---|---|---|---|---|
| Allowance for loan losses: | | | | | | | |
| Balance, beginning of period | $ 13,767 | $ 10,827 | $ 327 | $ 10,962 | $ 3,704 | $ 447 | $ 40,034 |
| Provision charged to expense | 694 | 3,115 | 77 | (250) | 465 | 21 | 4,122 |
| Losses charged off | (1,371) | (1,826) | - | (470) | (328) | (99) | (4,094) |
| Recoveries | 1 | 36 | - | 213 | 13 | 45 | 308 |
| Balance, end of quarter | $ 13,091 | $ 12,152 | $ 404 | $ 10,455 | $ 3,854 | $ 414 | $ 40,370 |
| **Six Months Ended June 30, 2012** | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Balance, beginning of year | $ 13,623 | $ 10,578 | $ 395 | $ 10,837 | $ 3,842 | $ 465 | $ 39,740 |
| Provision charged to expense | 2,541 | 3,647 | 9 | 1,216 | 697 | 110 | 8,220 |
| Losses charged off | (3,127) | (2,112) | - | (2,273) | (708) | (209) | (8,429) |
| Recoveries | 54 | 39 | - | 675 | 23 | 48 | 839 |
| Balance, end of quarter | $ 13,091 | $ 12,152 | $ 404 | $ 10,455 | $ 3,854 | $ 414 | $ 40,370 |

The following table presents, by portfolio segment, the changes in the allowance for loan losses for the three and six-month periods ended June 30, 2011 (in thousands):

| Three Months Ended June 30, 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 |
|---|---|---|---|---|---|---|---|
| Allowance for loan losses: | | | | | | | |
| Balance, beginning of period | $ 13,806 | $ 10,699 | $ 302 | $ 10,841 | $ 3,835 | $ 538 | $ 40,021 |
| Provision charged to expense | 6,106 | (510) | (21) | 1,812 | 124 | (189) | 7,322 |
| Losses charged off | (4,512) | (50) | - | (1,723) | (34) | (139) | (6,458) |
| Recoveries | 365 | 12 | 1 | 211 | 35 | 278 | 902 |
| Balance, end of quarter | $ 15,765 | $ 10,151 | $ 282 | $ 11,141 | $ 3,960 | $ 488 | $ 41,787 |
| **Six Months Ended June 30, 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 | 9,540 | (2,157) | (276) | 4,076 | 318 | (361) | 11,140 |
| Losses charged off | (5,156) | (531) | - | (2,717) | (431) | (179) | (9,014) |
| Recoveries | 397 | 12 | 1 | 239 | 65 | 287 | 1,001 |
| Balance, end of quarter | $ 15,765 | $ 10,151 | $ 282 | $ 11,141 | $ 3,960 | $ 488 | $ 41,787 |

# PART I. FINANCIAL INFORMATION
## Item 1. Financial Statements
## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table provides a summary of the allowance for loan losses classified by portfolio segment (in thousands):

| June 30, 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 |
|---|---|---|---|---|---|---|---|
| Period-end balance allocated to: | | | | | | | |
| Loans individually evaluated for impairment | $ 3,718 | $ 859 | $ - | $ 1,426 | $ 219 | $ 156 | $ 6,378 |
| Loans collectively evaluated for impairment | 9,373 | 11,293 | 404 | 9,029 | 3,635 | 258 | 33,992 |
| Loans acquired with deteriorated credit quality | - | - | - | - | - | - | - |
| Balance, end of quarter | $ 13,091 | $ 12,152 | $ 404 | $ 10,455 | $ 3,854 | $ 414 | $ 40,370 |
| **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 | $ 13,623 | $ 10,578 | $ 395 | $ 10,837 | $ 3,842 | $ 465 | $ 39,740 |

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

| June 30, 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 |
|---|---|---|---|---|---|---|---|
| Ending balance: individually evaluated for impairment | $ 44,152 | $ 20,501 | $ 345 | $ 20,151 | $ 2,793 | $ 502 | $ 88,444 |
| Ending balance: collectively evaluated for impairment | 524,664 | 1,192,093 | 58,192 | 719,880 | 369,476 | 38,823 | 2,903,128 |
| Ending balance: loans acquired with deteriorated credit quality | 1,523 | 4,606 | 180 | 4,632 | - | - | 10,941 |
| Ending Balance | $ 570,339 | $ 1,217,200 | $ 58,717 | $ 744,663 | $ 372,269 | $ 39,325 | $ 3,002,513 |

| 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 |
|---|---|---|---|---|---|---|---|
| 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 | $ 557,630 | $ 1,072,187 | $ 48,321 | $ 709,129 | $ 362,830 | $ 43,096 | $ 2,793,193 |

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 six months ended June 30, 2012 and 2011 (in thousands):

| | June 30, 2012 | | | | June 30, 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 | $ 1,121 | $ 17,264 | $ 12,082 | $ 59,967 |
| Additions | - | - | - | - | - | - | - | - |
| Accretion | (639) | 639 | (1,684) | 1,684 | (560) | 560 | (2,231) | 2,231 |
| Reclassifications from nonaccretable balance, net | - | - | - | - | - | - | - | - |
| Payments received, net | - | (2,707) | - | (7,673) | - | (3,086) | - | (8,277) |
| Balance at end of period | $ 1,495 | $ 10,941 | $ 5,724 | $ 39,451 | $ 561 | $ 14,738 | $ 9,851 | $ 53,921 |

At June 30, 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 June 30, 2012 was $14.48 million and $40.27 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.

## PART I. FINANCIAL INFORMATION
### Item 1. Financial Statements
### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

- 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.

The following tables represent consumer credit exposures by internally assigned grades for the periods ended June 30, 2012 and December 31, 2011 (in thousands):

| June 30, 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 | $ 507,876 | $ 1,163,688 | $ 53,894 | $ 720,306 | $ 365,944 | $ 38,292 | $ 2,850,000 |
| Special Mention | 10,648 | 24,260 | 4,568 | 3,925 | 607 | - | 44,008 |
| Substandard | 51,815 | 29,252 | 255 | 19,992 | 5,718 | 1,031 | 108,063 |
| Doubtful | - | - | - | 440 | - | 2 | 442 |
| **Total** | $ 570,339 | $ 1,217,200 | $ 58,717 | $ 744,663 | $ 372,269 | $ 39,325 | $ 3,002,513 |

| 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 June 30, 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).

| | 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 |
|---|---|---|---|---|---|---|---|---|
| **June 30, 2012** | | | | | | | | |
| Construction and land development | $ 3,804 | $ - | $ 571 | $ 30,041 | $ 34,416 | $ 535,923 | $ 570,339 | $ - |
| Commercial real estate | 3,491 | 4,424 | - | 5,854 | 13,769 | 1,203,431 | 1,217,200 | - |
| Multifamily real estate | 605 | - | - | - | 605 | 58,112 | 58,717 | - |
| 1-4 family residential real estate | 2,682 | 1,183 | 250 | 12,188 | 16,303 | 728,360 | 744,663 | 112 |
| Commercial and industrial business loans | 239 | - | 1 | 2,556 | 2,796 | 369,473 | 372,269 | - |
| Consumer loans and other | 36 | 40 | - | 478 | 554 | 38,771 | 39,325 | - |
| **Total** | $ 10,857 | $ 5,647 | $ 822 | $ 51,117 | $ 68,443 | $ 2,934,070 | $ 3,002,513 | $ 112 |

| | 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.

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 $3.16 million in excess of deferred loan costs at June 30, 2012, $1.60 million at June 30, 2011, and $2.02 million at December 31, 2011. There were $51.12 million, $65.27 million, and $55.80 million in nonaccrual loans at June 30, 2012, June 30, 2011, and December 31, 2011. The Company would have earned $461,000 in the second 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).

| June 30, 2012 | Unpaid Principal Balance | Recorded Balance | Specific Allowance | Average Recorded Investment | QTD Interest Income Recognized | YTD Interest Income Recognized |
|---|---|---|---|---|---|---|
| **Loans without a specific valuation allowance** | | | | | | |
| Construction and land development | $ 15,542 | $ 15,134 | $ - | $ 15,622 | $ 160 | $ 286 |
| Commercial real estate | 15,797 | 15,219 | - | 15,692 | 237 | 402 |
| Multi-family real estate | 345 | 345 | - | 345 | 7 | 7 |
| 1-4 family residential real estate | 17,358 | 16,829 | - | 17,685 | 238 | 317 |
| Commercial and industrial business loans | 2,600 | 2,305 | - | 2,611 | 16 | 19 |
| Consumer loans and other | 198 | 186 | - | 201 | 5 | 6 |
| **Total** | $ 51,840 | $ 50,018 | $ - | $ 52,156 | $ 663 | $ 1,037 |
| **Loans with a specific valuation allowance** | | | | | | |
| Construction and land development | $ 31,142 | $ 29,018 | $ 3,718 | $ 31,149 | $ 5 | $ 28 |
| Commercial real estate | 6,648 | 5,282 | 859 | 6,679 | 97 | 138 |
| Multi-family real estate | - | - | - | - | - | - |
| 1-4 family residential real estate | 3,509 | 3,322 | 1,426 | 3,526 | 54 | 63 |
| Commercial and industrial business loans | 529 | 488 | 219 | 532 | 4 | 5 |
| Consumer loans and other | 354 | 316 | 156 | 354 | - | - |
| **Total** | $ 42,182 | $ 38,426 | $ 6,378 | $ 42,240 | $ 160 | $ 234 |
| **Total impaired loans** | | | | | | |
| Construction and land development | $ 46,684 | $ 44,152 | $ 3,718 | $ 46,771 | $ 165 | $ 314 |
| Commercial real estate | 22,445 | 20,501 | 859 | 22,371 | 334 | 540 |
| Multi-family real estate | 345 | 345 | - | 345 | 7 | 7 |
| 1-4 family residential real estate | 20,867 | 20,151 | 1,426 | 21,211 | 292 | 380 |
| Commercial and industrial business loans | 3,129 | 2,793 | 219 | 3,143 | 20 | 24 |
| Consumer loans and other | 552 | 502 | 156 | 555 | 5 | 6 |
| **Total** | $ 94,022 | $ 88,444 | $ 6,378 | $ 94,396 | $ 823 | $ 1,271 |

(1) Included in the table above are accruing TDRs of $35.59 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled $20.15 million.

| 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 and six months ended June 30, 2012 (in thousands, except number of loans).

| | Three Months Ended June 30, 2012 | | | Six Months Ended June 30, 2012 | | |
|---|---|---|---|---|---|---|
| | Number of Loans | Pre-Modification Recorded Balance | Post-Modification Recorded Balance | Number of Loans | Pre-Modification Recorded Balance | Post-Modification Recorded Balance |
| Construction and land development | 10 | $ 2,368 | $ 2,368 | 13 | $ 5,661 | $ 5,661 |
| Commercial real estate | 5 | 1,531 | 1,524 | 9 | 4,970 | 4,962 |
| Multi-family real estate | 1 | 345 | 345 | 1 | 345 | 345 |
| 1-4 family residential real estate | 7 | 2,188 | 2,161 | 13 | 3,893 | 3,787 |
| Commercial and industrial | 1 | 48 | 48 | 2 | 243 | 243 |
| Consumer loans and other | - | - | - | 1 | 17 | 17 |
| Total | 24 | $ 6,480 | $ 6,446 | 39 | $ 15,129 | $ 15,015 |

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 five 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 $1.41 million.

The specific reserve portion of the allowance for loan losses on TDRs is determined by discounting the restructured cash flows at the original effective rate of the loan before modification or is based on the underlying collateral value less costs to sell, if repayment of the loan is collateral-dependent. If the resulting amount is less than the recorded book value, the Company either establishes a valuation allowance as a component of the allowance for loan losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio. At June 30, 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 June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Beginning balance | $ 32,211 | $ 23,620 | $ 29,819 | $ 20,452 |
| Additions | 5,282 | 5,068 | 10,620 | 10,738 |
| Sales | (7,623) | (1,005) | (10,182) | (3,083) |
| Valuation allowance | 460 | - | - | 125 |
| Gain (loss) on sale and write-downs | (555) | (1,506) | (482) | (2,055) |
| Ending balance | $ 29,775 | $ 26,177 | $ 29,775 | $ 26,177 |

**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 Towne 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 June 30, 2012 | Banking | Realty | Insurance | Consolidated Totals |
|---|---|---|---|---|
| Net interest income | $ 35,067 | $ 832 | $ 5 | $ 35,904 |
| Provision for loan losses | 4,122 | - | - | 4,122 |
| Net interest income after provision for loan losses | 30,945 | 832 | 5 | 31,782 |
| Residential mortgage brokerage income, net | (205) | 6,732 | - | 6,527 |
| Real estate brokerage and property management income, net | - | 3,293 | - | 3,293 |
| Insurance commissions and other title fees and income, net | - | 482 | 5,537 | 6,019 |
| Other noninterest income | 6,164 | 329 | 164 | 6,657 |
| Noninterest expense | 28,019 | 8,018 | 4,603 | 40,640 |
| Income before income tax, corporate allocation and noncontrolling interest | 8,885 | 3,650 | 1,103 | 13,638 |
| Corporate allocation | 133 | (95) | (38) | - |
| Income before income tax provision and noncontrolling interest | 9,018 | 3,555 | 1,065 | 13,638 |
| Provision for income tax expense | 1,920 | 1,098 | 383 | 3,401 |
| Net income | 7,098 | 2,457 | 682 | 10,237 |
| Noncontrolling interest | - | (566) | (143) | (709) |
| Net income attributable to TowneBank | $ 7,098 | $ 1,891 | $ 539 | $ 9,528 |
| Net income as percentage of total | 74.50% | 19.85% | 5.66% | 100.00% |

| Three Months Ended June 30, 2011 | Banking | Realty | Insurance | Consolidated Totals |
|---|---|---|---|---|
| Net interest income | $ 33,442 | $ 314 | $ 7 | $ 33,763 |
| Provision for loan losses | 7,322 | - | - | 7,322 |
| Net interest income after provision for loan losses | 26,120 | 314 | 7 | 26,441 |
| Residential mortgage brokerage income, net | (28) | 2,849 | - | 2,821 |
| Real estate brokerage and property management income, net | - | 3,005 | - | 3,005 |
| Insurance commissions and other title fees and income, net | - | 420 | 5,005 | 5,425 |
| Other noninterest income | 7,345 | 368 | 158 | 7,871 |
| Noninterest expense | 26,180 | 6,076 | 4,065 | 36,321 |
| Income before income tax, corporate allocation and noncontrolling interest | 7,257 | 880 | 1,105 | 9,242 |
| Corporate allocation | 123 | (60) | (63) | - |
| Income before income tax provision and noncontrolling interest | 7,380 | 820 | 1,042 | 9,242 |
| Provision for income tax expense | 1,569 | 660 | 384 | 2,613 |
| Net income | 5,811 | 160 | 658 | 6,629 |
| Noncontrolling interest | - | 972 | (95) | 877 |
| Net income attributable to TowneBank | $ 5,811 | $ 1,132 | $ 563 | $ 7,506 |
| Net income as percentage of total | 77.42% | 15.08% | 7.50% | 100.00% |

# PART I. FINANCIAL INFORMATION
## Item 1. Financial Statements
## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

| Six Months Ended June 30, 2012 | Banking | Realty | Insurance | Consolidated Totals |
|---|---|---|---|---|
| Net interest income | $ 69,315 | $ 1,362 | $ 12 | $ 70,689 |
| Provision for loan losses | 8,220 | - | - | 8,220 |
| Net interest income after provision for loan losses | 61,095 | 1,362 | 12 | 62,469 |
| Residential mortgage brokerage income, net | (334) | 12,579 | - | 12,245 |
| Real estate brokerage and property management income, net | - | 6,666 | - | 6,666 |
| Insurance commissions and other title fees and income, net | - | 887 | 11,519 | 12,406 |
| Other noninterest income | 10,790 | 595 | 344 | 11,729 |
| Noninterest expense | 54,355 | 15,012 | 8,806 | 78,173 |
| Income before income tax, corporate allocation and noncontrolling interest | 17,196 | 7,077 | 3,069 | 27,342 |
| Corporate allocation | 277 | (198) | (79) | - |
| Income before income tax provision and noncontrolling interest | 17,473 | 6,879 | 2,990 | 27,342 |
| Provision for income tax expense | 3,982 | 2,370 | 1,102 | 7,454 |
| Net income | 13,491 | 4,509 | 1,888 | 19,888 |
| Noncontrolling interest | - | (662) | (261) | (923) |
| Net income attributable to TowneBank | $ 13,491 | $ 3,847 | $ 1,627 | $ 18,965 |
| Net income as percentage of total | 71.14% | 20.28% | 8.58% | 100.00% |

| Six Months Ended June 30, 2011 | Banking | Realty | Insurance | Consolidated Totals |
|---|---|---|---|---|
| Net interest income | $ 67,207 | $ 639 | $ 13 | $ 67,859 |
| Provision for loan losses | 11,140 | - | - | 11,140 |
| Net interest income after provision for loan losses | 56,067 | 639 | 13 | 56,719 |
| Residential mortgage brokerage income, net | (59) | 5,034 | - | 4,975 |
| Real estate brokerage and property management income, net | - | 6,412 | - | 6,412 |
| Insurance commissions and other title fees and income, net | - | 799 | 10,991 | 11,790 |
| Other noninterest income | 10,766 | 666 | 332 | 11,764 |
| Noninterest expense | 50,734 | 11,720 | 8,173 | 70,627 |
| Income before income tax, corporate allocation and noncontrolling interest | 16,040 | 1,830 | 3,163 | 21,033 |
| Corporate allocation | 242 | (135) | (107) | - |
| Income before income tax provision and noncontrolling interest | 16,282 | 1,695 | 3,056 | 21,033 |
| Provision for income tax expense | 3,808 | 1,066 | 1,137 | 6,011 |
| Net income | 12,474 | 629 | 1,919 | 15,022 |
| Noncontrolling interest | - | 1,027 | (240) | 787 |
| Net income attributable to TowneBank | $ 12,474 | $ 1,656 | $ 1,679 | $ 15,809 |
| Net income as percentage of total | 78.90% | 10.48% | 10.62% | 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 June 30, 2012, the amounts of off-balance sheet commitments to extend credit were $878.69 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 June 30, 2012, standby letters of credit and financial guarantees were $33.72 million.

Additionally, the Company had $384.42 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 June 30, 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 $110.08 million at June 30, 2012. The Company recognized gains associated with the rate lock commitments on the aforementioned loans of $223,000 and $1.18 million, which were recorded as noninterest income in the Company's financials for the three- and six-month periods ended June 30, 2012, respectively.

## 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 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).

| | June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2012 | | 2011 | | December 31, 2011 | |
| | Carrying Amount | Accumulated Amortization | Carrying Amount | Accumulated Amortization | Carrying Amount | Accumulated Amortization |
| Core deposit intangible | $ 4,094 | $ 3,758 | $ 4,094 | $ 3,276 | $ 4,094 | $ 3,524 |
| Non-compete agreements | 1,456 | 1,187 | 1,456 | 986 | 1,456 | 1,144 |
| Customer lists | 17,920 | 6,468 | 16,789 | 4,712 | 17,920 | 5,579 |
| Total intangible assets subject to amortization | 23,470 | 11,413 | 22,339 | 8,974 | 23,470 | 10,247 |
| Title plant | - | - | - | - | - | - |
| Trade name | 287 | - | 427 | - | 357 | - |
| Contractual agreements | 3,231 | - | 3,231 | - | 3,231 | - |
| Total intangible assets not subject to amortization | 3,518 | - | 3,658 | - | 3,588 | - |
| **Total intangible assets** | $ 26,988 | $ 11,413 | $ 25,997 | $ 8,974 | $ 27,058 | $ 10,247 |

Amortization expense for intangible assets was $607,000 and $654,000 for the three-month periods and $1.24 million and $1.31 million for the six-month periods ended June 30, 2012 and 2011, respectively.

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, June 30, 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 June 30, 2012 was $54.21 million. The Company had $53.32 million and $53.09 million of BOLI at December 31, 2011 and June 30, 2011, respectively. The Company recognized BOLI income, included in other noninterest income, of $449,000 and $486,000 for the three-month periods and $897,000 and $1.06 million for the six-month periods ended June 30, 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.

# PART I. FINANCIAL INFORMATION
## Item 1. Financial Statements
## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Note 11. Postretirement Benefits

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

| | Three Months Ended June 30, 2012 | Three Months Ended June 30, 2011 |
|---|---|---|
| Service cost | $ 477 | $ 915 |
| Interest cost | 128 | 97 |
| Net periodic postretirement benefit cost | $ 605 | $ 1,012 |

| | Six Months Ended June 30, 2012 | Six Months Ended June 30, 2011 |
|---|---|---|
| Service cost | $ 1,109 | $ 1,830 |
| Interest cost | 278 | 194 |
| Net periodic postretirement benefit cost | $ 1,387 | $ 2,024 |

### 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).

## Note 13. Other Expenses

The following table shows a summary of other expenses (in thousands).

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Advertising and marketing | $ 1,332 | $ 1,053 | $ 2,409 | $ 2,073 |
| Other | 2,013 | 1,332 | 3,365 | 2,650 |
| Charitable contributions | 1,163 | 717 | 2,047 | 1,551 |
| Outside processing | 775 | 767 | 1,419 | 1,416 |
| Professional fees | 1,290 | 1,123 | 2,409 | 1,932 |
| Stationery and supplies | 630 | 454 | 1,096 | 921 |
| FDIC and other insurance | 1,019 | 1,118 | 1,801 | 2,495 |
| Foreclosed property expenses | 1,512 | 1,917 | 2,700 | 2,803 |
| Software expense | 1,117 | 855 | 2,157 | 1,629 |
| Telephone and postage | 871 | 717 | 1,774 | 1,511 |
| Amortization exp-intangibles | 607 | 654 | 1,236 | 1,308 |
| Bank franchise tax/SCC fees | 453 | 481 | 921 | 982 |
| Directors fees and expenses | 293 | 441 | 604 | 850 |
| Travel/meals/entertainment | 254 | 233 | 476 | 380 |
| Total other expenses | $ 13,329 | $ 11,862 | $ 24,414 | $ 22,501 |

## 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 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 $46.70 million, $28.96 million, and $40.46 million in these partnerships were not included in the Consolidated Balance Sheets at June 30, 2012, June 30, 2011, and December 31, 2011, respectively. These limited partner interests had carrying values of $14.84 million, $6.29 million, and $11.68 million at June 30, 2012, June 30, 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 $14.84 million, $6.29 million, and $11.68 million at June 30, 2012, June 30, 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 June 30, 2012, was limited to (i) the current outstanding balance of the term loan, which was $5.69 million, and (ii) the commitments on the two revolving lines of credit, which were $501,000 as of June 30, 2012 and $387,000 as of December 31, 2011. The total unconsolidated assets of the Resolution Company as of June 30, 2012 and December 31, 2011, were $16.38 million and $20.71 million, respectively.

## PART I. FINANCIAL INFORMATION
### Item 1. Financial Statements
### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Note 15. Fair Value Disclosures

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

**Level 1** 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- and six-month periods ending June 30, 2012, the Company used a weighted average closing ratio of 80%. The Company recognized a gain associated with the rate lock commitments of $223,000 and $1.18 million for the three- and six-month periods ended June 30, 2012, respectively. 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 $1.18 million at June 30, 2012.

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

| | June 30, 2012 | | | |
|---|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** | **Total** |
| U.S. Treasury obligations and direct obligations of U.S. government agencies | $ - | $ 177,098 | $ - | $ 177,098 |
| Municipal securities | - | 40,111 | - | 40,111 |
| Federal agency mortgage-backed securities | - | 120,745 | - | 120,745 |
| Corporate securities and other | 3 | 10,231 | - | 10,234 |
| Equity securities | 11,648 | - | - | 11,648 |
| Interest rate lock commitments | - | - | 1,183 | 1,183 |

| | 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 June 30, 2012 (in thousands):

| June 30, 2012 | Level 1 | Level 2 | Level 3 | Fair Value |
|---|---|---|---|---|
| Impaired loans | $ - | $ 23,877 | $ 17,598 | $ 41,475 |
| Other real estate owned | $ - | $ 23,614 | $ 6,161 | $ 29,775 |
| **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 |

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

**Loans:** Impaired loans for which repayment of the loan is expected to be provided solely by the value of the underlying collateral are considered collateral dependent and are valued based on the fair value of such collateral. Collateral values are estimated using 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 14%.

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.

**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):

| June 30, 2012 | Carrying Value | Estimated Fair Value | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|---|
| Cash and due from banks | $ 172,633 | $ 172,633 | $ 172,633 | $ - | $ - |
| Interest-bearing deposits in financial institutions | 1,521 | 1,521 | 1,521 | - | - |
| Securities available for sale | 348,188 | 348,188 | 3 | 348,185 | - |
| Securities held to maturity | 161,641 | 176,656 | - | 96,012 | 80,644 |
| Trading securities | 11,648 | 11,648 | 11,648 | - | - |
| Mortgage loans held for sale | 152,332 | 152,332 | - | 152,332 | - |
| Net Loans | 2,962,143 | 3,041,346 | - | - | 3,041,346 |
| Interest receivable | 11,826 | 11,826 | - | 11,826 | - |
| Interest rate lock commitments | 1,183 | 1,183 | - | - | 1,183 |
| Deposits | 3,329,639 | 3,133,822 | - | 3,133,822 | - |
| Advances from the Federal Home Loan Bank of Atlanta | 280,000 | 321,124 | - | 321,124 | - |
| Repurchase agreements and other borrowings | 10,562 | 10,562 | - | 10,562 | - |
| Interest payable | 3,152 | 3,152 | - | 3,152 | - |

# PART I. FINANCIAL INFORMATION
## Item 1. Financial Statements
## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

| 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 | - |

# 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) | Second Quarter 2012 | First Quarter 2012 | Fourth Quarter 2011 | Third Quarter 2011 | Second Quarter 2011 |
|---|---|---|---|---|---|
| ***Results of Operations:*** | | | | | |
| Interest income | $ 43,210 | $ 42,428 | $ 42,325 | $ 43,027 | $ 43,376 |
| Interest expense | 7,306 | 7,643 | 8,048 | 8,941 | 9,613 |
| Net interest income | 35,904 | 34,785 | 34,277 | 34,086 | 33,763 |
| Provision for loan losses | 4,122 | 4,097 | 1,062 | 1,400 | 7,322 |
| Net interest income after provision for loan losses | 31,782 | 30,688 | 33,215 | 32,686 | 26,441 |
| Noninterest income: | | | | | |
| Residential mortgage brokerage income, net | 6,527 | 5,718 | 4,272 | 3,396 | 2,821 |
| Real estate brokerage and property management income, net | 3,293 | 3,373 | 1,773 | 3,311 | 3,005 |
| Insurance commissions and other title fees and income, net | 6,019 | 6,387 | 5,137 | 5,619 | 5,425 |
| Service charges on deposit accounts | 2,010 | 1,698 | 1,798 | 1,883 | 1,840 |
| Credit card merchant fees, net | 1,035 | 868 | 845 | 694 | 680 |
| Other income | 1,859 | 1,727 | 2,145 | 1,920 | 1,722 |
| Gain (loss) on investment securities | 1,753 | 778 | 3 | (3) | 3,629 |
| Total noninterest income | 22,496 | 20,549 | 15,973 | 16,820 | 19,122 |
| Noninterest expense: | | | | | |
| Salaries and benefits | 22,194 | 21,491 | 20,100 | 20,901 | 19,541 |
| Occupancy expense | 3,540 | 3,376 | 3,674 | 3,493 | 3,477 |
| Furniture and equipment | 1,577 | 1,580 | 1,490 | 1,459 | 1,441 |
| Other expenses | 13,329 | 11,085 | 11,840 | 11,236 | 11,863 |
| Total noninterest expense | 40,640 | 37,532 | 37,104 | 37,089 | 36,322 |
| Income before noncontrolling interest and income tax | 13,638 | 13,705 | 12,084 | 12,417 | 9,241 |
| Provision for income tax expense | 3,401 | 4,054 | 3,105 | 3,610 | 2,613 |
| Net income | 10,237 | 9,651 | 8,979 | 8,807 | 6,628 |
| Net (income) loss from noncontrolling interest | (709) | (214) | 8 | (282) | 877 |
| Net income attributable to TowneBank | $ 9,528 | $ 9,437 | $ 8,987 | $ 8,525 | $ 7,505 |
| Net income available to common shareholders | $ 7,928 | $ 7,521 | $ 6,846 | $ 4,898 | $ 5,173 |
| ***Per Share Data:*** | | | | | |
| Net income: | | | | | |
| Basic (1) | $ 0.26 | $ 0.25 | $ 0.23 | $ 0.16 | $ 0.17 |
| Diluted (1) | 0.26 | 0.25 | 0.23 | 0.16 | 0.17 |
| Book value at period end (1) | 12.93 | 12.79 | 12.65 | 12.51 | 12.36 |
| Tangible book value at period end (1) | 9.31 | 9.13 | 8.82 | 8.73 | 8.57 |
| 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 | $ 14.04 | $ 14.52 | $ 13.47 | $ 14.32 | $ 15.73 |
| Low | 11.83 | 12.34 | 10.82 | 10.52 | 12.46 |
| Close | 14.00 | 13.49 | 12.24 | 11.37 | 13.38 |
| ***Selected Financial Ratios:*** | | | | | |
| Return on average assets | 0.93% | 0.93% | 0.88% | 0.84% | 0.75% |
| Return on average tangible assets | 0.95% | 0.96% | 0.91% | 0.87% | 0.78% |
| Return on average equity | 7.04% | 7.21% | 6.87% | 6.59% | 5.90% |
| Return on average tangible equity | 8.90% | 9.21% | 8.83% | 8.46% | 7.60% |
| Net interest margin (tax-equivalent basis) (2) | 3.99% | 3.93% | 3.94% | 3.87% | 3.91% |
| ***Daily Averages:*** | | | | | |
| Total assets | $ 4,128,116 | $ 4,073,157 | $ 4,049,883 | $ 4,012,377 | $ 3,988,736 |
| Total tangible assets | 4,014,039 | 3,958,456 | 3,934,515 | 3,898,997 | 3,874,851 |
| Loans, net of unearned income, excluding nonaccrual loans | 2,879,798 | 2,780,762 | 2,692,055 | 2,663,562 | 2,680,353 |
| Total earning assets (2) | 3,735,432 | 3,682,952 | 3,660,185 | 3,618,334 | 3,584,896 |
| Total deposits | 3,235,597 | 3,182,941 | 3,163,755 | 3,129,411 | 3,068,258 |
| FHLB advances | 280,000 | 280,000 | 280,000 | 287,609 | 330,770 |
| Total equity | 544,561 | 526,681 | 519,288 | 513,257 | 510,262 |
| Tangible equity | 430,484 | 411,980 | 403,920 | 399,877 | 396,376 |
| Basic weighted average shares outstanding (1) | 30,916,123 | 29,905,057 | 29,789,006 | 29,708,215 | 29,815,887 |
| Diluted weighted average shares outstanding (1) | 30,971,917 | 30,893,197 | 30,915,694 | 30,810,857 | 30,935,742 |

(1) Prior periods were restated to reflect 3% common stock dividend paid June 12, 2012

(2) Includes bank-owned life insurance.

# PART I. FINANCIAL INFORMATION
## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

*Our Management's Discussion and Analysis of Financial Condition and Results of Operations is intended to assist readers in understanding and evaluating our consolidated results of operations and financial condition. The following should be read in conjunction with our 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 June 30, 2012:

- Net income for the three months ended June 30, 2012 was $9.53 million, or $0.26 per common diluted share, compared with $7.51 million, or $0.17 per diluted share, in the same period in 2011. Net income for the six months ended June 30, 2012 was $18.97 million, or $0.50 per common diluted share, compared with $15.81 million, $0.37 per diluted share, in the six months ended June 30, 2011. Net income available to common shareholders for the second quarter of 2012 was $7.93 million after accretion and preferred dividend payments compared with $5.17 million in the same period of 2011. The increase in earnings was primarily driven by the growth in noninterest income combined with an increase in net interest income related to the growth in earning assets. Net income available to common shareholders was positively affected by a decrease in preferred stock dividends and accretion from the comparable prior year period.

- Net interest income increased $2.14 million, or 6.34%, in the second 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 decreased $3.20 million, or 43.70%, from the comparative three-month period of 2011, and decreased $2.92 million, or 26.21% from the comparative six-month period of 2011. The loan loss reserve decreased to 1.34% of loans at June 30, 2012 from 1.39% at March 31, 2012 and 1.51% at June 30, 2011. The decreases were primarily attributable to improvements in credit quality metrics, a decrease in nonaccrual loans, and a large percentage of charge-offs related to loans with specific reserves. These factors were partially offset by loan growth.

- Excluding gains on investment securities, noninterest income for the three- and six-month periods ended June 30, 2012 increased by $5.25, million, or 33.89%, and $9.26 million, or 29.61%, respectively, compared to the comparative periods in 2011. The increases in both comparative periods were driven by improved performance in our Realty segment, primarily due to increases in residential mortgage brokerage income.

- For the three- and six-month periods ended June 30, 2012, noninterest expense increased $4.32 million, or 11.89%, and $7.55 million, or 10.68%, respectively, compared to the same periods in 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 26.33% for the second quarter of 2012 from 25.85% in the comparative period of 2011. For the first six months of 2012, the effective tax rate increased to 28.22% compared to 27.57% for the same period in 2011. The increases were 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 second quarter of 2012 compared to 0.75% for the second quarter of 2011, and 0.93% for the first quarter of 2012.

The annualized return on average tangible assets was 0.95%, 0.78%, and 0.96% for the same respective periods. ROA for the six months ended June 30, 2012 was 0.93% compared to 0.81% for the six months ended June 30, 2011. 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 7.04% for the second quarter of 2012, 5.90% for the second quarter of 2011, and 7.21% for the first quarter of 2012, while the annualized return on average tangible equity was 8.90%, 7.60%, and 9.21% for the same respective periods. ROE for the six months ended June 30, 2012 was 7.12%, compared to 6.29% for the six months ended June 30, 2011.

Operating income, calculated as net interest income and noninterest income less gains on investment securities, was $56.65 million for the quarter ended June 30, 2012, which increased $7.39 million, or 15.01%, compared to the quarter ended June 30, 2011. Operating income was $54.56 million for the quarter ended March 31, 2012. For the six months ended June 30, 2012, operating income was $111.20 million, reflecting an increase of $12.08 million, or 12.19% over comparative 2011.

Basic earnings per share were $0.26 for the three months ended June 30, 2012 from $0.17 in comparative 2011, while basic earnings per share for the six months ended June 30, 2012 also increased to $0.51 from $0.37 in comparative 2011. Diluted earnings per share increased to $0.26 for the three months ended June 30, 2012 from $0.17 in comparative 2011, while diluted earnings per share for the six months ended June 30, 2012 increased to $0.50 from $0.37 in comparative 2011. 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 $37.07 million for the quarter ended June 30, 2012, which was $2.05 million, or 5.85%, above the year ago amount of $35.02 million. On a linked quarter basis, tax-equivalent net interest income increased by $1.12 million, or 3.10%, from the $35.95 million reported for the first quarter of 2012. The growth in earning assets drove the improvement from both prior periods, while lower funding costs contributed to a wider margin as compared to the second quarter of the prior year.

Interest income, on a tax-equivalent basis, was $44.37 million for the quarter ended June 30, 2012, which was $260,000, or 0.58%, less than the $44.63 million reported for the period ending June 30, 2011. On a linked quarter basis, tax-equivalent interest income increased $779,000, or 1.79%, from $43.59 million in the first quarter of 2012. Average earning assets grew to $3.74 billion in the quarter ended June 30, 2012, from $3.60 billion in the comparative prior year quarter, an increase of $139.43 million, or 3.88%. In the linked quarter comparison, average earning assets grew by $52.48 million, or 1.42%, from $3.68 billion in the quarter ended March 31, 2012. The yield on earning assets was 4.78% in the quarter ended June 30, 2012, which compared to 4.98% in the comparative prior year period and 4.76% in the linked period. Average loan balances, excluding nonaccrual loans, of $2.88 billion were $199.45 million, or 7.44%, higher in the second 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 $99.04 million or 3.56% and loan yields were 11 basis points lower. The increase in interest income from the linked quarter was driven by higher balances and yields on loans held for sale, which was partially offset by yields on taxable investments. In the comparative prior year period, the contraction in interest income was primarily due to lower balances and yields on taxable investments, which offset the increased income form loans held for sale. Subsequent to June 30, 2012, several of the Company's trust preferred corporate securities, with total recorded balances of $17.17 million, were called by their various issuers. The called securities had yields ranging from 6.90% to 9.75%. Trust preferred corporate securities generally have a higher yield than other security types, which may put downward pressure on net interest income and the net interest margin if lower yielding assets are acquired in the place of the called securities.

Interest expense, for the quarter ended June 30, 2012, was $7.31 million, which was $2.31 million or 24.0% below the $9.61 million amount in the year ago quarter. The average balance of interest-bearing liabilities decreased to $2.65 billion in the second quarter of 2012 from $2.67 billion in the comparative prior year quarter, a decrease of 0.85%. On a linked quarter basis, interest expense declined by $337,000, or 4.41%, from $7.64 million in the first quarter of 2012. In the linked quarter, average interest bearing liabilities decreased by $6.40 million, or 0.24%, from $2.66 billion in the quarter ended March 31, 2012. The decline in interest expense was driven by repricing opportunities in certificates of deposit in the year over year comparison and the redemption of the subordinated debentures in the linked quarters.

Net interest margin, which is net interest income expressed as a percentage of average earning assets, was 3.99% in the quarter ended June 30, 2012, which was 8 basis points higher than the 3.91% margin of the June 30, 2011 quarter and 6 basis point higher than the 3.93% margin of the March 31, 2012 quarter. The improvement was primarily driven by loan growth and the redemption of the subordinated notes.

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).

# PART I. FINANCIAL INFORMATION
## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

| | Three Months Ended June 30, 2012 | | | Three Months Ended March 31, 2012 | | | Three Months Ended June 30, 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 | $ 2,879,798 | $ 38,966 | 5.44% | $ 2,780,762 | $ 38,354 | 5.55% | $ 2,680,353 | $ 38,351 | 5.74% |
| Taxable investment securities | 277,980 | 1,555 | 2.24% | 293,957 | 1,759 | 2.39% | 412,089 | 3,028 | 2.94% |
| Tax-exempt investment securities | 151,773 | 1,794 | 4.73% | 147,776 | 1,786 | 4.83% | 149,239 | 1,845 | 4.95% |
| Interest bearing deposits | 244,816 | 155 | 0.25% | 317,009 | 199 | 0.25% | 258,089 | 165 | 0.26% |
| Loans held for sale | 127,148 | 1,211 | 3.81% | 89,979 | 806 | 3.58% | 42,935 | 495 | 4.61% |
| Bank-owned life insurance | 53,917 | 691 | 5.16% | 53,469 | 689 | 5.18% | 53,298 | 748 | 5.63% |
| Total earning assets | 3,735,432 | 44,372 | 4.78% | 3,682,952 | 43,593 | 4.76% | 3,596,003 | 44,632 | 4.98% |
| Less: allowance for loan losses | (40,428) | | | (39,861) | | | (41,053) | | |
| Total nonearning assets | 433,112 | | | 430,066 | | | 433,786 | | |
| Total Assets | $ 4,128,116 | | | $ 4,073,157 | | | $ 3,988,736 | | |
| **Liabilities and Equity:** | | | | | | | | | |
| Interest bearing deposits | | | | | | | | | |
| Demand and money market | $ 1,060,116 | $ 1,083 | 0.41% | $ 1,012,019 | $ 1,125 | 0.45% | $ 842,810 | $ 1,200 | 0.57% |
| Savings | 194,517 | 244 | 0.51% | 194,495 | 277 | 0.57% | 156,263 | 293 | 0.75% |
| Certificates of deposit | 1,102,850 | 2,991 | 1.09% | 1,145,801 | 2,985 | 1.05% | 1,314,439 | 4,414 | 1.35% |
| Total interest bearing deposits | 2,357,483 | 4,318 | 0.74% | 2,352,315 | 4,387 | 0.75% | 2,313,512 | 5,907 | 1.02% |
| Borrowings | 291,763 | 2,988 | 4.05% | 291,462 | 3,019 | 4.10% | 344,671 | 3,413 | 3.92% |
| Subordinated debentures | - | - | - | 11,865 | 237 | 7.99% | 13,829 | 293 | 8.47% |
| Total interest bearing liabilities | 2,649,246 | 7,306 | 1.11% | 2,655,642 | 7,643 | 1.16% | 2,672,012 | 9,613 | 1.44% |
| Demand deposits | 878,114 | | | 830,626 | | | 754,746 | | |
| Other noninterest bearing liabilities | 56,195 | | | 60,208 | | | 51,716 | | |
| Total liabilities | 3,583,555 | | | 3,546,476 | | | 3,478,474 | | |
| Shareholders' equity | 544,561 | | | 526,681 | | | 510,262 | | |
| Total liabilities and equity | $ 4,128,116 | | | $ 4,073,157 | | | $ 3,988,736 | | |
| Net interest income (tax-equivalent basis) | | $ 37,066 | | | $ 35,950 | | | $ 35,019 | |
| Reconcilement of Non-GAAP Financial Measures | | | | | | | | | |
| Bank-Owned Life Insurance | | (691) | | | (689) | | | (748) | |
| Tax-equivalent basis adjustment | | (471) | | | (476) | | | (508) | |
| Net interest income (GAAP) | | $ 35,904 | | | $ 34,785 | | | $ 33,763 | |
| Interest rate spread (1) | | | 3.67% | | | 3.60% | | | 3.54% |
| Interest expense as a percent of average earning assets | | | 0.79% | | | 0.83% | | | 1.07% |
| Net interest margin (tax equivalent basis) (2) | | | 3.99% | | | 3.93% | | | 3.91% |
| Total cost of deposits | | | 0.54% | | | 0.55% | | | 0.77% |

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

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

# PART I. FINANCIAL INFORMATION
## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

| (Dollars in thousands) | Increase/(Decrease) Three Months Ended June 30, 2012 Compared to Three Months Ended March 31, 2012 | | | Increase/(Decrease) Three Months Ended June 30, 2012 Compared to Three Months Ended June 30, 2011 | | |
|---|---|---|---|---|---|---|
| | Volume | Rate (1) | Total | Volume | Rate (1) | Total |
| **Assets:** | | | | | | |
| Loans | $ 1,350 | $ (738) | $ 612 | $ 2,697 | $ (2,082) | $ 615 |
| Taxable investment securities | (93) | (111) | (204) | (850) | (623) | (1,473) |
| Tax-exempt investment securities | 48 | (40) | 8 | 31 | (82) | (51) |
| Interest bearing deposits | (45) | 1 | (44) | (8) | (2) | (10) |
| Loans held for sale | 351 | 54 | 405 | 815 | (99) | 716 |
| Bank-owned life insurance | 5 | (3) | 2 | 8 | (65) | (57) |
| Total earning assets | 1,616 | (837) | 779 | 2,693 | (2,953) | (260) |
| **Liabilities and Equity:** | | | | | | |
| Interest bearing deposits | | | | | | |
| Demand and money market | 52 | (94) | (42) | 266 | (383) | (117) |
| Savings | - | (33) | (33) | 61 | (110) | (49) |
| Certificates of deposit | (114) | 120 | 6 | (652) | (771) | (1,423) |
| Total interest bearing deposits | (62) | (7) | (69) | (325) | (1,264) | (1,589) |
| Borrowings | 3 | (34) | (31) | (539) | 114 | (425) |
| Subordinated debentures | (237) | - | (237) | (293) | - | (293) |
| Total interest bearing liabilities | (296) | (41) | (337) | (1,157) | (1,150) | (2,307) |
| Net interest income | $ 1,912 | $ (796) | $ 1,116 | $ 3,850 | $ (1,803) | $ 2,047 |

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

# PART I. FINANCIAL INFORMATION
## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

| | Six Months Ended June 30, 2012 | | | Six Months Ended June 30, 2011 | | | Six Months Ended June 30, 2012 Compared with June 30, 2011 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Average Balance | Interest Income/ Expense | Average Yield/ Rate | Average Balance | Interest Income/ Expense | Average Yield/ Rate | Increase (Decrease) | Change due to Rate | Change due to Volume |
| Assets: | | | | | | | | | |
| Loans (net of unearned income and deferred costs), excluding | $ 2,830,280 | $ 77,320 | 5.49% | $ 2,678,202 | $ 76,945 | 5.79% | $ 375 | $ (4,000) | $ 4,375 |
| Taxable investment securities | 285,969 | 3,314 | 2.32% | 447,365 | 6,387 | 2.86% | (3,073) | (1,054) | (2,019) |
| Tax-exempt investment securities | 149,775 | 3,580 | 4.78% | 144,513 | 3,550 | 4.91% | 30 | (97) | 127 |
| Interest bearing deposits | 280,912 | 354 | 0.25% | 200,926 | 260 | 0.26% | 94 | (8) | 102 |
| Loans held for sale | 108,563 | 2,017 | 3.72% | 39,766 | 961 | 4.83% | 1,056 | (265) | 1,321 |
| Bank-owned life insurance | 53,693 | 1,380 | 5.17% | 53,098 | 1,629 | 6.19% | (249) | (267) | 18 |
| Total earning assets | 3,709,192 | 87,965 | 4.77% | 3,563,870 | 89,732 | 5.08% | (1,767) | (5,691) | 3,924 |
| Less: allowance for loan losses | (40,144) | | | (39,698) | | | | | |
| Total nonearning assets | 431,589 | | | 425,595 | | | | | |
| Total Assets | $ 4,100,637 | | | $ 3,949,767 | | | | | |
| Liabilities and Equity: | | | | | | | | | |
| Interest bearing deposits | | | | | | | | | |
| Demand and money market | $ 1,036,068 | $ 2,208 | 0.43% | $ 826,952 | $ 2,286 | 0.56% | $ (78) | $ (591) | $ 513 |
| Savings | 194,506 | 521 | 0.54% | 149,550 | 552 | 0.74% | (31) | (174) | 143 |
| Certificates of deposit | 1,124,325 | 5,976 | 1.07% | 1,318,124 | 9,048 | 1.38% | (3,072) | (1,867) | (1,205) |
| Total interest bearing deposits | 2,354,899 | 8,705 | 0.74% | 2,294,626 | 11,886 | 1.04% | (3,181) | (2,632) | (549) |
| Borrowings | 291,612 | 6,007 | 4.07% | 344,933 | 6,790 | 3.92% | (783) | 277 | (1,060) |
| Subordinated debentures | 5,933 | 237 | 7.99% | 13,836 | 587 | 8.49% | (350) | (32) | (318) |
| Total interest bearing liabilities | 2,652,444 | 14,949 | 1.13% | 2,653,395 | 19,263 | 1.46% | (4,314) | (2,387) | (1,927) |
| Demand deposits | 854,370 | | | 738,036 | | | | | |
| Other noninterest bearing liabilities | 58,202 | | | 51,235 | | | | | |
| Total liabilities | 3,565,016 | | | 3,442,666 | | | | | |
| Shareholders' equity | 535,621 | | | 507,101 | | | | | |
| Total liabilities and equity | $ 4,100,637 | | | $ 3,949,767 | | | | | |
| Net interest income (tax-equivalent basis) | | $ 73,016 | | | $ 70,469 | | $ 2,547 | $ (3,304) | $ 5,851 |
| Reconcilement of Non-GAAP Financial Measures | | | | | | | | | |
| Bank-Owned Life Insurance | | (1,380) | | | (1,629) | | 249 | | |
| Tax-equivalent basis adjustment | | (947) | | | (981) | | 34 | | |
| Net interest income (GAAP) | | $ 70,689 | | | $ 67,859 | | $ 2,830 | | |
| Interest rate spread (1) | | | 3.64% | | | 3.61% | | | |
| Interest expense as a percent of average earning assets | | | 0.81% | | | 1.09% | | | |
| Net interest margin (tax equivalent basis) (2) | | | 3.96% | | | 3.99% | | | |
| Total cost of deposits | | | 0.55% | | | 0.79% | | | |

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

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

# PART I. FINANCIAL INFORMATION
## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

***Noninterest Income.*** Total noninterest income, excluding securities gains or losses, for the quarter ended June 30, 2012 was $20.74 million, an increase of $5.25 million, or 33.89%, compared to the same period in 2011 and an increase of $972,000, or 4.92%, compared to the first quarter of 2012. As a percentage of total operating income, noninterest income, excluding securities gains or losses, for the second quarter of 2012 was 36.62%, compared with 31.45% for comparative 2011 and 36.24% for the first quarter of 2012.

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 June 30, | | Increase/(Decrease) 2012 over 2011 | |
|---|---|---|---|---|
| | 2012 | 2011 | Amount | Percent |
| Residential mortgage brokerage income, net | $ 6,527 | $ 2,821 | $ 3,706 | 131.37% |
| Real estate brokerage and property management, net | 3,293 | 3,005 | 288 | 9.58% |
| Insurance commissions and other title fees and income, net | 6,019 | 5,425 | 594 | 10.95% |
| Service charges on deposit accounts | 2,010 | 1,840 | 170 | 9.24% |
| Credit card merchant fees, net | 1,035 | 680 | 355 | 52.21% |
| Other income | 1,859 | 1,722 | 137 | 7.96% |
| Subtotal before gain on investment securities | 20,743 | 15,493 | 5,250 | 33.89% |
| Net gain on investment securities | 1,753 | 3,629 | (1,876) | (51.69%) |
| Total noninterest income | $ 22,496 | $ 19,122 | $ 3,374 | 17.64% |

| | Three Months Ended | | Increase/(Decrease) Second Quarter 2012 over First Quarter 2012 | |
|---|---|---|---|---|
| | June 30, 2012 | March 31, 2012 | Amount | Percent |
| Residential mortgage brokerage income, net | $ 6,527 | $ 5,718 | $ 809 | 14.15% |
| Real estate brokerage and property management, net | 3,293 | 3,373 | (80) | (2.37%) |
| Insurance commissions and other title fees and income, net | 6,019 | 6,387 | (368) | (5.76%) |
| Service charges on deposit accounts | 2,010 | 1,698 | 312 | 18.37% |
| Credit card merchant fees, net | 1,035 | 868 | 167 | 19.24% |
| Other income | 1,859 | 1,727 | 132 | 7.64% |
| Subtotal before gain on investment securities | 20,743 | 19,771 | 972 | 4.92% |
| Net gain on investment securities | 1,753 | 778 | 975 | 125.32% |
| Total noninterest income | $ 22,496 | $ 20,549 | $ 1,947 | 9.47% |

| | Six Months Ended June 30, | | Increase/(Decrease) 2012 over 2011 | |
|---|---|---|---|---|
| | 2012 | 2011 | Amount | Percent |
| Residential mortgage brokerage income, net | $ 12,245 | $ 4,975 | $ 7,270 | 146.13% |
| Real estate brokerage and property management, net | 6,666 | 6,412 | 254 | 3.96% |
| Insurance commissions and other title fees and income, net | 12,406 | 11,790 | 616 | 5.22% |
| Service charges on deposit accounts | 3,708 | 3,531 | 177 | 5.01% |
| Credit card merchant fees, net | 1,903 | 1,289 | 614 | 47.63% |
| Other income | 3,587 | 3,263 | 324 | 9.93% |
| Subtotal before gain on sale of investment securities | 40,515 | 31,260 | 9,255 | 29.61% |
| Net gain on investment securities | 2,531 | 3,681 | (1,150) | (31.24%) |
| Total noninterest income | $ 43,046 | $ 34,941 | $ 8,105 | 23.20% |

For the second quarter of 2012, residential mortgage brokerage income, net of commission expense was $6.53 million, reflecting an increase of $3.71 million, or 131.37%, compared to the second quarter of 2011 and an increase of $809,000, or 14.15%, compared to the first quarter of 2012. For the six-month period ended June 30, 2012, residential mortgage brokerage income, net of commission expense was $12.25 million, reflecting an increase of $7.27 million, or 146.13%, compared to the same period in 2011. Mortgage brokerage income is highly correlated to the housing market, which saw some improvement in the first half of 2012, and mortgage interest rates, which were affected by a general decrease in long-term interest rates during the period. 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 gains on rate lock commitments of $223,000 and $960,000 for the quarters ended June 30, and March 31, 2012, respectively. 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 $2.80 million and $4.71 million in the three- and six-month periods ended June 30, 2012 as compared to the same periods of 2011.

Real estate brokerage and property management income, net of commission expense, for the second quarter of 2012 was $3.29 million, which was $288,000 or 9.58%, higher than comparative 2011 and $80,000, or 2.37%, less than the first quarter of 2012. The increase for the six-month period was $254,000, or 3.96%, from the comparative prior year period. The change from both the comparative prior year quarter and the linked quarter was positively affected by an increase in real estate brokerage income resulting from a rise in total volume of units sold of $47.42 million, or 20.66%, from the prior year quarter, and $137.31 million, or 98.36%, from the linked quarter. The increase in real estate brokerage income in the linked quarter was offset by a decrease in property management fees of $813,000. The increase in the six-month period was primarily due to an increase in net property management fee income.

For the second quarter of 2012, insurance commissions and other title income, net of commission expense was $6.02 million, which was $594,000, or 10.95%, higher than comparative 2011, and $368,000, or 5.76%, less than first quarter 2012. For the six-month period, insurance commissions and other title income, net of commission expense was $616,000, or 5.22%, higher than comparative 2011. The increase from both of the comparative prior year periods was largely due to the acquisition of the Stanton Taylor Agency, Inc. ("Stan Taylor") insurance agency in the fourth quarter of 2011. The decrease in the linked quarter comparison is largely due to contingency income of $1.17 million in the first quarter. Contingent commissions are mostly received during the first quarter of each year.

For the second quarter of 2012, credit card merchant fees totaled $1.04 million, which was $355,000, or 52.21%, higher than comparative 2011 and $167,000, or 19.24%, more than the first quarter of 2012. For the six months ended June 30, 2012, credit card merchant fees totaled $1.90 million, which was $614,000, or 47.63%, higher than comparative 2011. For both periods, the increase was due to a higher volume of transactions.

Other noninterest income for the three and six months ended June 30, 2012 was $1.86 million and $3.59 million, respectively, and included income generated by Towne Investment Group, net of commission expense. For the three months ended June 30, 2012, net commission income totaled $453,000 as compared to $419,000 for the comparative period of 2011 and $482,000 for Towne Investment Group for the first quarter of 2012.

During the second quarter of 2012, we had sales, maturities, prepayments, and calls totaling $58.82 million of investment securities from our available-for-sale securities portfolio. The securities were comprised of callable agencies securities and mortgage-backed securities. As a result of the sales, we recognized security gains of $1.97 million during the period.

***Noninterest Expense.*** For the quarter ended June 30, 2012, total noninterest expense was $40.64 million, which was $4.32 million, or 11.89%, higher than comparative 2011 and $3.11 million, or 8.28%, higher than the quarter ended March 31, 2012. For the six months ended June 30, 2012, total noninterest expense increased $7.54 million, or 10.68%, from comparative 2011 to $78.17 million.

As a percentage of operating income, noninterest expense was 71.74% for the second quarter of 2012, 73.74% for comparative 2011, and 68.80% for the quarter ended March 31, 2012. The primary components of noninterest expense in the second quarter of 2012 were salaries and employee benefits of $22.19 million, occupancy expenses of $3.54 million, furniture and equipment expenses of $1.58 million, foreclosed property expenses of $1.51 million, and advertising and marketing expenses of $1.33 million. In comparison to the second 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 $280,000, 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 $2.08 million, primarily in salaries and benefits. Excluding the costs associated with the acquisitions and expansions, noninterest expense increased $1.96 million, or 5.40%, from the comparative quarter in 2011.

# 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) | | | |
|---|---|---|---|---|---|---|---|
| | June 30, | | March 31, | June 30, 2012 over June 30, 2011 | | June 30, 2012 over March 31, 2012 | |
| | 2012 | 2011 | 2012 | Amount | Percent | Amount | Percent |
| Salaries and benefits | $ 22,194 | $ 19,541 | $ 21,491 | $ 2,653 | 13.58% | $ 703 | 3.27% |
| Occupancy expense | 3,540 | 3,477 | 3,376 | 63 | 1.81% | 164 | 4.86% |
| Furniture and equipment | 1,577 | 1,441 | 1,580 | 136 | 9.44% | (3) | (0.19%) |
| Other | | | | | | | |
| Advertising and marketing | 1,332 | 1,053 | 1,076 | 279 | 26.50% | 256 | 23.79% |
| Other | 2,013 | 1,332 | 1,354 | 681 | 51.14% | 659 | 48.69% |
| Charitable contributions | 1,163 | 717 | 884 | 446 | 62.20% | 279 | 31.56% |
| Outside processing | 775 | 767 | 644 | 8 | 1.04% | 131 | 20.34% |
| Professional fees | 1,290 | 1,123 | 1,119 | 167 | 14.87% | 171 | 15.28% |
| Stationery and supplies | 630 | 454 | 465 | 176 | 38.77% | 165 | 35.48% |
| FDIC and other insurance | 1,019 | 1,118 | 782 | (99) | (8.86%) | 237 | 30.31% |
| Foreclosed property expenses | 1,512 | 1,917 | 1,187 | (405) | (21.13%) | 325 | 27.38% |
| Software expense | 1,117 | 855 | 1,041 | 262 | 30.64% | 76 | 7.30% |
| Telephone and postage | 871 | 717 | 903 | 154 | 21.48% | (32) | (3.54%) |
| Amortization exp-intangibles | 607 | 654 | 629 | (47) | (7.20%) | (22) | (3.51%) |
| Bank franchise tax/SCC fees | 453 | 481 | 468 | (28) | (5.82%) | (15) | (3.21%) |
| Directors fees and expenses | 293 | 441 | 311 | (148) | (33.56%) | (18) | (5.79%) |
| Travel/meals/entertainment | 254 | 233 | 222 | 21 | 9.01% | 32 | 14.41% |
| Total other expenses | 13,329 | 11,862 | 11,085 | 1,467 | 12.37% | 2,244 | 20.24% |
| Total noninterest expense | $ 40,640 | $ 36,321 | $ 37,532 | $ 4,319 | 11.89% | $ 3,108 | 8.28% |

| | Six Months Ended June 30, | | Increase/(Decrease) 2012 over 2011 | |
|---|---|---|---|---|
| | 2012 | 2011 | Amount | Percent |
| Salaries and benefits | $ 43,685 | $ 38,558 | $ 5,127 | 13.30% |
| Occupancy expense | 6,917 | 6,712 | 205 | 3.05% |
| Furniture and equipment | 3,157 | 2,856 | 301 | 10.54% |
| Other | | | | |
| Advertising and marketing | 2,409 | 2,073 | 336 | 16.21% |
| Other | 3,365 | 2,650 | 715 | 26.99% |
| Charitable contributions | 2,047 | 1,551 | 496 | 31.98% |
| Outside processing | 1,419 | 1,416 | 3 | 0.21% |
| Professional fees | 2,409 | 1,932 | 477 | 24.69% |
| Stationery and supplies | 1,096 | 921 | 175 | 19.00% |
| FDIC and other insurance | 1,801 | 2,495 | (694) | (27.82%) |
| Foreclosed property expenses | 2,700 | 2,803 | (103) | (3.67%) |
| Software expense | 2,157 | 1,629 | 528 | 32.41% |
| Telephone and postage | 1,774 | 1,511 | 263 | 17.41% |
| Amortization exp-intangibles | 1,236 | 1,308 | (72) | (5.47%) |
| Bank franchise tax/SCC fees | 921 | 982 | (61) | (6.21%) |
| Directors fees and expenses | 604 | 850 | (246) | (28.94%) |
| Travel/meals/entertainment | 476 | 380 | 96 | 25.26% |
| Total other expenses | 24,414 | 22,501 | 1,913 | 8.50% |
| Total noninterest expense | $ 78,173 | $ 70,627 | $ 7,547 | 10.69% |

Salary and benefits expense, the largest portion of noninterest expense, was $22.19 million, representing 54.61% of total noninterest expense for the quarter ended June 30, 2012 and 55.88% for the six months ended June 30, 2012. Salary and benefits expense increased $2.65 million, or 13.58%, and $5.13 million, or 13.30%, over the comparative three- and six-month periods in 2011 and $703,000, or 3.27%, over the first quarter of 2012. The increase from both comparative periods of the prior year is primarily due to the addition of staff resulting from the insurance and mortgage expansion and an increase in profit sharing and incentive expenses. The increase from the linked quarter is primarily due to increases in profit sharing and incentive expenses, partially offset by a decrease in expense related to the management deferred compensation plan.

In our Banking segment we had a total of 656 full-time equivalent employees ("FTE") at June 30, 2012, which was up from 621 at June 30, 2011 and 627 at March 31, 2012. In our non-Banking segments at June 30, 2012, we had a total of 616 FTEs, excluding real estate sales agents, which was up from 458 at June 30, 2011 and 510 at March 31, 2012. Real estate sales agents are independent contractors, and therefore, not included as our employees. Total operating income per FTE was $45,000 for the quarter ended June 30, 2012 a decrease from $49,000 for the three-month period ended June 30, 2011 and an increase from $48,000 for the three-month period ended March 31, 2012.

Occupancy expense for the second quarter of 2012 experienced a 1.81% increase from comparative 2011 and a 4.86% increase from first quarter 2012. Occupancy expense for the first six months of 2012 increased $205,000, or 3.05%, from comparative 2011. The increase from the comparative periods in the prior year was primarily driven by the expansion of mortgage operations during 2011. The increase from the sequential quarter was primarily a result of increases in rent, real estate taxes, cleaning and other occupancy costs.

For the three- and six-month periods ended June 30, 2012, furniture and equipment expense increased by $136,000 and $301,000, respectively, over 2011 and decreased by $3,000 compared with the first quarter of 2012.

Other noninterest expenses for the second quarter of 2012 saw an increase of $1.47 million , or 12.37%, compared to the same period in 2011, an increase for the first six months of 2012 of $1.91 million, or 8.50%, compared to the same period in 2011, and an increase of $2.24 million, or 20.24%, when compared to first quarter 2012. The primary drivers of the increase from the comparative prior year periods were, increases in merger and acquisition costs, professional fees, charitable contributions, and higher software expenses. The increases were partially offset by a decrease in expenses related to foreclosed properties, and FDIC fees, which was related to a change in assessment methodology, effective April 1, 2011. The linked quarter increase was driven by higher expenses related to foreclosed properties, merger and acquisition costs, advertising and marketing expenses, and charitable contributions.

***Provision for Income Taxes.*** Our effective tax rate increased to 26.30% in the second quarter of 2012 from 25.85% in the comparative period of 2011. For the first six months 2012, the effective tax rate increased to 28.22% compared to 27.57% for the same period in 2011.

**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.

# PART I. FINANCIAL INFORMATION
## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

***Banking Segment.*** For the three months ended June 30, 2012, the Banking segment represented 74.50%, or $7.10 million, of our total consolidated net income compared to 77.42%, or $5.81 million, for comparative 2011. For the six months ended June 30, 2012, the Banking segment represented 71.14%, or $13.49 million, of our total consolidated net income compared to 78.90%, or $12.47 million, for comparative 2011.

Pre-tax earnings for the three months ended June 30, 2012 for the Banking segment were $9.02 million, increasing $1.64 million, or 22.20%, from comparative 2011. The increase in earnings from comparative 2011 was primarily driven by an increase in net interest income of $1.63 million, or 4.86%, and a decrease in the provision for loan losses, which were partially offset by an increase in noninterest expenses and a decrease in the net gain on investment securities.

Noninterest expenses increased by $1.84 million, or 7.02%, in the second quarter of 2012 compared to the second quarter of 2011. The primary factor in the increase was an increase in salaries and employee benefits expense of $1.30 million, or 9.52%, primarily due to increases in profit sharing expense and partially offset by a decrease in management deferred compensation expense. Additional factors in the increase include an increase in furniture and equipment expense of $144,000, and an increase in community support expense of $445,000.

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) | | | |
|---|---|---|---|---|---|---|---|
| | June 30, | | March 31, | 2012 over 2011 | | June over March | |
| | 2012 | 2011 | 2012 | Amount | Percent | Amount | Percent |
| Net interest income | $ 35,067 | $ 33,442 | $ 34,248 | $ 1,625 | 4.86% | $ 819 | 2.39% |
| Service charges on deposit accounts | 2,010 | 1,840 | 1,698 | 170 | 9.24% | 312 | 18.37% |
| Credit card merchant fees | 1,035 | 680 | 868 | 355 | 52.21% | 167 | 19.24% |
| Other income | 1,161 | 1,168 | 1,152 | (7) | (0.60%) | 9 | 0.78% |
| Net gain on investment securities | 1,753 | 3,629 | 778 | (1,876) | (51.69%) | 975 | 125.32% |
| Total noninterest income | 5,959 | 7,317 | 4,496 | (1,358) | (18.56%) | 1,463 | 32.54% |
| Total revenue | 41,026 | 40,759 | 38,744 | 267 | 0.66% | 2,282 | 5.89% |
| Provision for loan losses | 4,122 | 7,322 | 4,097 | (3,200) | (43.70%) | 25 | 0.61% |
| Salaries and employee benefits | 14,928 | 13,631 | 14,346 | 1,297 | 9.52% | 582 | 4.06% |
| Occupancy expense | 2,688 | 2,660 | 2,561 | 28 | 1.05% | 127 | 4.96% |
| Furniture and equipment | 1,251 | 1,107 | 1,254 | 144 | 13.01% | (3) | (0.24%) |
| Other expenses | 9,152 | 8,782 | 8,174 | 370 | 4.21% | 978 | 11.96% |
| Total noninterest expenses | 28,019 | 26,180 | 26,335 | 1,839 | 7.02% | 1,684 | 6.39% |
| Income before income tax and corporate allocation | 8,885 | 7,257 | 8,312 | 1,628 | 22.43% | 573 | 6.89% |
| Corporate allocation | 133 | 123 | 144 | 10 | 8.13% | (11) | (7.64%) |
| Income before income tax provision | 9,018 | 7,380 | 8,456 | 1,638 | 22.20% | 562 | 6.65% |
| Provision for income tax expense | 1,920 | 1,569 | 2,063 | 351 | 22.37% | (143) | (6.93%) |
| Net income | $ 7,098 | $ 5,811 | $ 6,393 | $ 1,287 | 22.15% | $ 705 | 11.03% |

| | Six Months Ended June 30, | | Increase/(Decrease) 2012 over 2011 | |
|---|---|---|---|---|
| | 2012 | 2011 | Amount | Percent |
| Net interest income | $ 69,315 | $ 67,207 | $ 2,108 | 3.14% |
| Service charges on deposit accounts | 3,708 | 3,531 | 177 | 5.01% |
| Credit card merchant fees | 1,903 | 1,289 | 614 | 47.63% |
| Other income | 2,314 | 2,206 | 108 | 4.90% |
| Gain on available-for-sale | 2,531 | 3,681 | (1,150) | (31.24%) |
| Total noninterest income | 10,456 | 10,707 | (251) | (2.34%) |
| Total revenue | 79,771 | 77,914 | 1,857 | 2.38% |
| Provision for loan losses | 8,220 | 11,140 | (2,920) | (26.21%) |
| Salaries and employee benefits | 29,274 | 26,487 | 2,787 | 10.52% |
| Occupancy expense | 5,249 | 5,093 | 156 | 3.06% |
| Furniture and equipment | 2,505 | 2,187 | 318 | 14.54% |
| Other expenses | 17,327 | 16,967 | 360 | 2.12% |
| Total expenses | 54,355 | 50,734 | 3,621 | 7.14% |
| corporate allocation | 17,196 | 16,040 | 1,156 | 7.21% |
| Corporate allocation | 277 | 242 | 35 | 14.46% |
| Income before income tax provision | 17,473 | 16,282 | 1,191 | 7.31% |
| Provision for income tax expense | 3,982 | 3,808 | 174 | 4.57% |
| Net income | $ 13,491 | $ 12,474 | $ 1,017 | 8.15% |

***Realty Segment.*** For the three months ended June 30, 2012, the Realty segment had income before income tax provision and noncontrolling interest of $3.56 million as compared to $820,000 for the comparative 2011 period. Total revenue increased to $11.67 million in 2012 from $6.96 million in the second 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 $223,000 for the quarter ended June 30, 2012 and the expansions of our mortgage operations resulted in additional net brokerage income of $2.80 million as compared to the second quarter of 2011. The linked quarter comparison was affected by a seasonal decrease in resort property management fees for Corolla Classic Vacations.

Expenses for the Realty segment increased 31.96%, or $1.94 million, when compared to the same period in 2011, and increased by 14.64%, or $1.02 million, when compared to the quarter ended March 31, 2012. The increase from the comparative period in 2011 is primarily due to higher noninterest expenses related to the expansion of our mortgage operations, while the increase from the linked quarter was primarily due to increases in other noninterest expenses, including professional fees and loan expenses.

# 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) | | | |
|---|---|---|---|---|---|---|---|
| | June 30, | | March 31, | June 30, 2012 June 30, 2011 | | June 30, 2012 March 31, 2012 | |
| | 2012 | 2011 | 2012 | Amount | Percent | Amount | Percent |
| Residential mortgage brokerage income, net | $ 6,732 | $ 2,849 | $ 5,847 | $ 3,883 | 136.29% | $ 885 | 15.14% |
| Real estate brokerage income, net | 1,734 | 1,541 | 1,001 | 193 | 12.52% | 733 | 73.23% |
| Title insurance and settlement fees | 482 | 420 | 405 | 62 | 14.76% | 77 | 19.01% |
| Property management fees, net | 1,559 | 1,464 | 2,372 | 95 | 6.49% | (813) | (34.27%) |
| Income from unconsolidated subsidiary | 123 | 174 | 131 | (51) | (29.31%) | (8) | (6.11%) |
| Net interest and other income | 1,038 | 508 | 664 | 530 | 104.33% | 374 | 56.33% |
| Total revenue | 11,668 | 6,956 | 10,420 | 4,712 | 67.74% | 1,248 | 11.98% |
| Salaries and employee benefits | 4,450 | 3,128 | 4,236 | 1,322 | 42.26% | 214 | 5.05% |
| Occupancy expense | 619 | 603 | 584 | 16 | 2.65% | 35 | 5.99% |
| Furniture and equipment | 201 | 196 | 190 | 5 | 2.55% | 11 | 5.79% |
| Amortization of intangible assets | 165 | 227 | 173 | (62) | (27.31%) | (8) | (4.62%) |
| Other expenses | 2,583 | 1,922 | 1,811 | 661 | 34.39% | 772 | 42.63% |
| Total expenses | 8,018 | 6,076 | 6,994 | 1,942 | 31.96% | 1,024 | 14.64% |
| Income before income tax, corporate allocation and noncontrolling interest | 3,650 | 880 | 3,426 | 2,770 | 314.77% | 224 | 6.54% |
| Corporate allocation | (95) | (60) | (103) | (35) | (58.33%) | 8 | 7.77% |
| Income before income tax provision and noncontrolling interest | 3,555 | 820 | 3,323 | 2,735 | 333.54% | 232 | 6.98% |
| Provision for income tax benefit | 1,098 | 660 | 1,272 | 438 | 66.36% | (174) | (13.68%) |
| Net income | 2,457 | 160 | 2,051 | 2,297 | 1,435.63% | 406 | 19.80% |
| Noncontolling interest | (566) | 972 | (96) | (1,538) | (158.23%) | (470) | 489.58% |
| Net income attributable to TowneBank | $ 1,891 | $ 1,132 | $ 1,955 | $ 759 | 67.05% | $ (64) | (3.27%) |
| Key data: | | | | | | | |
| Number of units sold | 959 | 884 | 569 | 75 | 8.48% | 390 | 68.54% |
| Volume of units sold | $ 276,913 | $ 229,497 | $ 139,603 | $ 47,416 | 20.66% | $ 137,310 | 98.36% |
| Number of real estate agents | 382 | 423 | 381 | (41) | (9.69%) | 1 | 0.26% |
| Loans originated, mortgage | $ 165,439 | $ 64,865 | $ 140,554 | $ 100,574 | 155.05% | $ 24,885 | 17.70% |
| Loans originated, joint venture | 184,447 | 114,044 | 126,675 | 70,403 | 61.73% | 57,772 | 45.61% |
| Total loans originated | $ 349,886 | $ 178,909 | $ 267,229 | $ 170,977 | 95.57% | $ 82,657 | 30.93% |
| Number of loans, mortgage | 745 | 248 | 610 | 497 | 200.40% | 135 | 22.13% |
| Number of loans, joint venture | 867 | 528 | 587 | 339 | 64.20% | 280 | 47.70% |
| Total number of loans | 1,612 | 776 | 1,197 | 836 | 107.73% | 415 | 34.67% |
| Average loan amount, mortgage | $ 222 | $ 262 | $ 230 | $ (40) | (15.27%) | $ (8) | (3.62%) |
| Average loan amount, joint venture | 213 | 216 | 216 | (3) | (1.39%) | (3) | (1.42%) |
| Average loan amount | $ 217 | $ 231 | $ 223 | $ (14) | (6.06%) | $ (6) | (2.78%) |
| Average number of originators, mortgage | 48 | 23 | 45 | 25 | 108.70% | 3 | 6.67% |
| Average number of originators, joint venture | 38 | 36 | 37 | 2 | 5.56% | 1 | 2.70% |
| Average number of originators | 86 | 59 | 82 | 27 | 45.76% | 4 | 4.88% |

| | Six Months Ended June 30, 2012 | Six Months Ended June 30, 2011 | Increase/(Decrease) 2012 over 2011 Amount | Increase/(Decrease) 2012 over 2011 Percent |
|---|---|---|---|---|
| Residential mortgage brokerage income, net | $ 12,579 | $ 5,034 | $ 7,545 | 149.88% |
| Real estate brokerage income, net | 2,735 | 2,692 | 43 | 1.60% |
| Title insurance and settlement fees | 887 | 799 | 88 | 11.01% |
| Property management fees, net | 3,931 | 3,720 | 211 | 5.67% |
| Income from unconsolidated subsidiary | 254 | 273 | (19) | (6.96%) |
| Net interest and other income | 1,703 | 1,032 | 671 | 65.02% |
| Total revenue | 22,089 | 13,550 | 8,539 | 63.02% |
| Salaries and employee benefits | 8,686 | 6,405 | 2,281 | 35.61% |
| Occupancy expense | 1,203 | 1,191 | 12 | 1.01% |
| Furniture and equipment | 391 | 406 | (15) | (3.69%) |
| Amortization of intangible assets | 338 | 454 | (116) | (25.55%) |
| Other expenses | 4,394 | 3,264 | 1,130 | 34.62% |
| Total expenses | 15,012 | 11,720 | 3,292 | 28.09% |
| Income before income tax, corporate allocation and noncontrolling interest | 7,077 | 1,830 | 5,247 | 286.72% |
| Corporate allocation | (198) | (135) | (63) | 46.67% |
| Income before income tax provision and noncontrolling interest | 6,879 | 1,695 | 5,184 | 305.84% |
| Provision for income tax expense | 2,370 | 1,066 | 1,304 | 122.33% |
| Net income | 4,509 | 629 | 3,880 | 616.84% |
| Noncontolling interest | (662) | 1,027 | (1,689) | (164.46%) |
| Net income attributable to TowneBank | $ 3,847 | $ 1,656 | $ 2,191 | 132.30% |
| Key data: | | | | |
| Number of units sold | 1,528 | 1,453 | 75 | 5.16% |
| Volume of units sold | $ 416,516 | $ 382,111 | $ 34,405 | 9.00% |
| Number of real estate agents | 763 | 423 | 340 | 80.38% |
| Loans originated, mortgage | $ 305,993 | $ 129,116 | $ 176,877 | 136.99% |
| Loans originated, joint venture | 311,122 | 201,519 | 109,603 | 54.39% |
| Total loans originated | $ 617,115 | $ 330,635 | $ 286,480 | 86.65% |
| Number of loans, mortgage | 1,355 | 505 | 850 | 168.32% |
| Number of loans, joint venture | 1,454 | 951 | 503 | 52.89% |
| Total number of loans | 2,809 | 1,456 | 1,353 | 92.93% |
| Average loan amount, mortgage | $ 226 | $ 256 | $ (29) | (11.40%) |
| Average loan amount, joint venture | 214 | 212 | 2 | 0.93% |
| Average loan amount | $ 220 | $ 227 | $ (8) | (3.66%) |

*Mortgage.* The loan volume for the combined mortgage operations increased in the quarter ended June 30, 2012 as compared to the same period in 2011. Total loans originated in the second quarter of 2012 were $349.89 million, a 95.57% increase, or $170.98 million from $178.91 million in the comparative period of 2011. This was an $82.66 million, or 30.93%, increase compared to the volume for the quarter ended March 31, 2012. Refinance activity comprised $99.09 million of loan volume for the quarter ended June 30, 2012, while purchases accounted for the remaining $250.80 million in loan volume for the quarter. For the quarters ended June 30, 2011 and March 31, 2012, refinance volume was $23.86 million and $106.89 million, respectively, while purchase volume was $155.05 million and $160.34 million, respectively.

***Insurance Segment.*** The Insurance segment is comprised of property and casualty and group benefit divisions. The Insurance segment represented 5.66%, or $539,000 million, of total consolidated net income at June 30, 2012 and 7.50%, or $563,000, at June 30, 2011.

Earnings before income taxes and noncontrolling interests for the three months ended June 30, 2012 for the Insurance segment were $1.07 million, increasing $23,000, or 2.21%, from comparative 2011. The increase was primarily attributable to the effects of the Stan Taylor acquisition, which resulted in additional net commission income of $352,000. The increase in expenses was partially offset by an increase in other operating expenses due to a one-time $500,000 charge related to the final settlement of the 2009 Taylor Johnson Insurance Group purchase agreement. Operating expenses also included $280,000 in expenses related to the effects of the Stan Taylor acquisition. The decrease in earnings from the linked quarter was due to the $850,000 decrease in contingency and bonus income. 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) | | | |
|---|---|---|---|---|---|---|---|
| | | | | June 30, 2012 | | June 30, 2012 | |
| | June 30, | | March 31, | June 30, 2011 | | March 31, 2012 | |
| | 2012 | 2011 | 2012 | Amount | Percent | Amount | Percent |
| Net commission and fee income | | | | | | | |
| Property and casualty | $ 3,861 | $ 3,415 | $ 3,350 | $ 446 | 13.06% | $ 511 | 15.25% |
| Specialized benefit services | 124 | 98 | 127 | 26 | 26.53% | (3) | (2.36%) |
| Employee benefits | 1,353 | 1,393 | 1,460 | (40) | (2.87%) | (107) | (7.33%) |
| Total net commissions and fees | 5,338 | 4,906 | 4,937 | 432 | 8.81% | 401 | 8.12% |
| Contingency and bonus revenue | 323 | 197 | 1,173 | 126 | 63.96% | (850) | (72.46%) |
| Other income | 45 | 67 | 61 | (22) | (32.84%) | (16) | (26.23%) |
| Total revenues | $ 5,706 | $ 5,170 | $ 6,171 | $ 536 | 10.37% | $ (465) | (7.54%) |
| Salaries and employee benefits | $ 2,816 | $ 2,782 | $ 2,909 | $ 34 | 1.22% | $ (93) | (3.20%) |
| Occupancy expense | 233 | 214 | 232 | 19 | 8.88% | 1 | 0.43% |
| Furniture and equipment | 125 | 138 | 136 | (13) | (9.42%) | (11) | (8.09%) |
| Amortization of intangible assets | 311 | 282 | 311 | 29 | 10.28% | - | - |
| Other expenses | 1,118 | 649 | 616 | 469 | 72.27% | 502 | 81.49% |
| Total operating expenses | 4,603 | 4,065 | 4,204 | 538 | 13.23% | 399 | 9.49% |
| Income before income tax, corporate allocation and noncontrolling interest | 1,103 | 1,105 | 1,967 | (2) | (0.18%) | (864) | (43.92%) |
| Corporate allocation | (38) | (63) | (41) | 25 | (39.68%) | 3 | (7.32%) |
| Income before income tax provision and noncontrolling interest | 1,065 | 1,042 | 1,926 | 23 | 2.21% | (861) | (44.70%) |
| Provision for income tax expense | 383 | 384 | 719 | (1) | (0.26%) | (336) | (46.73%) |
| Net income | 682 | 658 | 1,207 | 24 | 3.65% | (525) | (43.50%) |
| Noncontrolling interest | (143) | (95) | (118) | (48) | 50.53% | (25) | 21.19% |
| Net income attributable to TowneBank | $ 539 | $ 563 | $ 1,089 | $ (24) | (4.26%) | $ (550) | (50.51%) |

## PART I. FINANCIAL INFORMATION
### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

| | Six Months Ended June 30, | | Increase/(Decrease) 2012 over 2011 | |
|---|---|---|---|---|
| | 2012 | 2011 | Amount | Percent |
| Net commission and fee income | | | | |
| Property and casualty | $ 7,211 | $ 6,420 | $ 791 | 12.32% |
| Specialized Benefit Services | 251 | 208 | $ 43 | 20.67% |
| Employee benefits | 2,813 | 2,805 | $ 8 | 0.29% |
| Total net commissions and fees | 10,275 | 9,433 | 842 | 8.93% |
| Contingency and bonus revenue | 1,495 | 1,765 | (270) | (15.30%) |
| Other income | 105 | 138 | (33) | (23.91%) |
| Total revenues | $ 11,875 | $ 11,336 | $ 539 | 4.75% |
| Salaries and employee benefits | $ 5,725 | $ 5,666 | $ 59 | 1.04% |
| Occupancy expense | 465 | 428 | 37 | 8.64% |
| Furniture and equipment | 261 | 263 | (2) | (0.76%) |
| Amortization of intangible assets | 622 | 564 | 58 | 10.28% |
| Other expenses | 1,733 | 1,252 | 481 | 38.42% |
| Total operating expenses | 8,806 | 8,173 | 633 | 7.75% |
| Income before income tax, corporate allocation and noncontrolling interest | 3,069 | 3,163 | (94) | (2.97%) |
| Corporate allocation | (79) | (107) | 28 | (26.17%) |
| Income before income tax provision and noncontrolling interest | 2,990 | 3,056 | (66) | (2.16%) |
| Provision for income tax expense | 1,102 | 1,137 | (35) | (3.08%) |
| Net income | 1,888 | 1,919 | (31) | (1.62%) |
| Noncontolling interest | (261) | (240) | (21) | 8.75% |
| Net income attributable to TowneBank | $ 1,627 | $ 1,679 | $ (52) | (3.10%) |

Salaries and employee benefits expense increased $34,000, or 1.22%, when comparing the three months ended June 30, 2012 to the same period for 2011. The increase was due to the Stan Taylor business combination, which resulted in salaries and employee benefit expenses of $196,000.

Occupancy expense increased $19,000, or 8.88%, when comparing the three months ended June 30, 2012 to the same period for 2011. The primary driver of the increase was the Stan Taylor business combination.

## ANALYSIS OF FINANCIAL CONDITION

***Overview.*** At June 30, 2012, total assets were $4.23 billion, which is $213.27 million, or 5.31%, greater than the period end balance for comparative 2011 and $86.78 million, or 2.09% greater than the balance at March 31, 2012. Our loan portfolio, less unearned income and deferred costs, made up 70.96% of our period end assets and totaled $3.0 billion at June 30, 2012. Average assets for the quarter ended June 30, 2012 were $4.13 billion, up $139.38 million, or 3.49%, from comparative June 30, 2011 and $54.96 million, or 1.35%, from the quarter ended March 31, 2012.

Average earning assets increased $139.43 million, or 3.88%, from $3.60 billion for the second quarter of 2011 to $3.74 billion for the second quarter of 2012. Compared to the first quarter of 2012, average earning assets increased $52.48 million.

Our average total deposits were $3.24 billion for second quarter 2012, reflecting growth of $167.34 million, or 5.45%, compared to second quarter 2011. Average noninterest bearing deposits, which increased $123.37 million, or 16.35%, grew at a significantly 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 June 30, 2012 were $124.68 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 second quarter of 2012 was $244.82 million, or 6.55%, of average total earning assets compared with $258.09 million, or 7.18%, of average total earning assets for comparative 2011. For the first quarter of 2012, the average balance of interest bearing deposits in other banks was $317.01 million, or 8.61%, 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 $348.19 million at June 30, 2012 compared with $226.22 million at June 30, 2011. The average balance for the 2012 period was $245.58 million compared to the 2011 period average of $362.48 million, or 6.57% and 10.08% of average earning assets, respectively. During the three months ended June 30, 2012, we had sales, maturities and calls totaling $58.82 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 $161.64 million at June 30, 2012 and $510.66 million at June 30, 2011. Our average balance for the 2012 period was $152.73 million compared with $164.50 million in the 2011 period, representing 4.09% and 4.57% of total average earning assets, respectively. These securities are held primarily for yield and pledging purposes. Similar to available-for-sale securities, held-to-maturity securities are reviewed quarterly for possible other-than-temporary impairment.

***Loans Held for Sale.*** At June 30, 2012, we held $152.33 million in mortgage loans originated and intended for sale in the secondary market, as compared with $43.55 million for comparative 2011 and $101.57 million for the quarter ended March 31, 2012.

Average loans held for sale were 3.40% and 1.19% of average earning assets for the quarters ended June 30, 2012 and 2011, respectively. Average loans held for sale were 2.44% of average earning assets for the quarter ended March 31, 2012. The majority of mortgage loans held for sale have been pre-committed to investors, which minimizes our interest rate risk.

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

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

***Loan Portfolio.*** Loans, net of unearned income and deferred costs, were $3.0 billion at June 30, 2012, which was $241.19 million, or 8.73%, above the $2.76 billion reported at June 30, 2011 and $126.80 million, or 4.41%, above the $2.88 billion at March 31, 2012. 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 77.09% for the quarter ended June 30, 2012 compared with 74.53% for 2011 and 75.50% for the quarter ended March 31, 2012.

***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 Accounting Standards Codification ("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 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 June 30, 2012, June 30, 2011, and March 31, 2012 was $40.37 million, $41.79 million, and $40.03 million, respectively. The allowance was equal to 1.34% of total loans outstanding at June 30, 2012, compared with 1.51% and 1.39% for June 30, 2011 and March 31, 2012. We believe the decline in the ratio is appropriate given the continued improvement in the risk profile of our loan portfolio. Further, we believe that early and aggressive action plans for loans with identified changes in credit metrics, combined with originating high quality new loans will facilitate continued improvement in our key credit metrics. Also reflecting improvement in our loan portfolio and supporting the adequacy of coverage levels of the allowance for loan losses, the allowance was equal to 79% of nonperforming loans at June 30, 2012, compared with 72% and 71% for June 30, 2011 and March 31, 2012. However, although overall economic conditions have shown some recent improvement, the residential real estate market remained stressed and risks to a full recovery remain. Given the combination of these noted factors, we believe that our allowance for loan losses is adequate to cover loan losses inherent in the loan portfolio at June 30, 2012

# 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 | | | Six Months Ended | |
|---|---|---|---|---|---|
| | June 30, | | March 31, | June 30, | June 30, |
| | 2012 | 2011 | 2012 | 2012 | 2011 |
| **Allowance for loan losses** | | | | | |
| Balance beginning of period | $ 40,034 | $ 40,021 | $ 39,740 | $ 39,740 | $ 38,660 |
| Loans charged off: | | | | | |
| Residential 1-4 family | (470) | (1,723) | (1,803) | (2,273) | (2,717) |
| Commercial real estate | (1,826) | (50) | (286) | (2,112) | (531) |
| Construction | (1,371) | (4,512) | (1,756) | (3,127) | (5,156) |
| Commercial and industrial | (328) | (34) | (380) | (708) | (431) |
| Consumer and other | (99) | (139) | (110) | (209) | (179) |
| Total | (4,094) | (6,458) | (4,335) | (8,429) | (9,014) |
| Loans recovered: | | | | | |
| Residential 1-4 family | 213 | 211 | 462 | 675 | 239 |
| Multifamily | - | 1 | - | - | 1 |
| Commercial real estate | 36 | 12 | 3 | 39 | 12 |
| Construction | 1 | 365 | 53 | 54 | 397 |
| Commercial and industrial | 13 | 35 | 10 | 23 | 65 |
| Consumer and other | 45 | 278 | 4 | 48 | 287 |
| Total | 308 | 902 | 532 | 839 | 1,001 |
| Net loans charged off | (3,786) | (5,556) | (3,803) | (7,590) | (8,013) |
| **Provision for loan losses** | 4,122 | 7,322 | 4,097 | 8,220 | 11,140 |
| Balance end of period | $ 40,370 | $ 41,787 | $ 40,034 | $ 40,370 | $ 41,787 |
| **Nonperforming assets** | | | | | |
| Nonperforming loans | $ 51,117 | $ 65,265 | $ 56,253 | $ 51,117 | $ 65,265 |
| Foreclosed property | 29,775 | 26,255 | 32,211 | 29,775 | 26,255 |
| Total nonperforming assets | $ 80,892 | $ 91,520 | $ 88,464 | $ 80,892 | $ 91,520 |
| Loans past due 90 days and still accruing interest | $ 112 | $ 492 | $ 184 | $ 112 | $ 492 |
| **Asset Quality Ratios** | | | | | |
| Allowance for loan losses to nonperforming loans | 0.79x | 0.64x | 0.71x | 0.79x | 0.72x |
| Allowance for loan losses to period end loans | 1.34% | 1.51% | 1.39% | 1.34% | 1.51% |
| Nonperforming loans to period end loans | 1.70% | 2.36% | 1.96% | 1.70% | 2.36% |
| Nonperforming assets to period end assets | 1.91% | 2.28% | 2.13% | 1.91% | 2.28% |
| Net charge-offs to average loans (annualized) | 0.52% | 0.83% | 0.54% | 0.53% | 0.61% |

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 June 30, 2012, we had $80.89 million in nonperforming assets, which amounted to 1.91% of total assets. Additionally, loans past due 90 days that were accruing interest totaled $112,000. Nonperforming assets consist of $51.12 million in nonperforming loans as well as $29.78 million in foreclosed property. Foreclosed property consists of 36 residential properties, 57 construction and development properties, and nine commercial properties.

At June 30, 2012, loans 60-89 days past due totaled $5.65 million. Additionally, there are other performing loans, totaling $52.81 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.

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 June 30, 2012, nonaccruing TDRs, which are included in nonperforming loans, totaled $20.15 million and accruing TDRs totaled $35.59 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.

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

| | June 30, 2012 | December 31, 2011 |
|---|---|---|
| 1-4 family residential real estate | $ 12,188 | $ 10,394 |
| Commercial real estate | 5,854 | 5,561 |
| Construction and land development | 30,041 | 36,712 |
| Commercial and industrial business loans | 2,556 | 2,644 |
| Consumer loans and other | 478 | 490 |
| Total nonperforming loans | $ 51,117 | $ 55,801 |

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

| | June 30, | | March 31, |
|---|---|---|---|
| | 2012 | 2011 | 2012 |
| **Real estate loans:** | | | |
| Residential 1-4 family | $ 10,455 | $ 11,141 | $ 10,962 |
| Commercial | 12,152 | 10,151 | 10,827 |
| Construction | 13,091 | 15,765 | 13,767 |
| Multi-family | 404 | 282 | 327 |
| Total real estate loans | 36,102 | 37,339 | 35,883 |
| **Commercial and industrial loans** | 3,854 | 3,960 | 3,704 |
| **Consumer loans and other** | 414 | 488 | 447 |
| **Total** | $ 40,370 | $ 41,787 | $ 40,034 |

***Deposits.*** Total deposits at June 30, 2012 were $3.33 billion, representing an increase of 7.45%, or $230.96 million, over June 30, 2011, and an increase of $77.79 million, or 2.39%, compared to March 31, 2012. 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 $3.24 billion during the second quarter of 2012 compared to $3.07 billion during the second quarter of 2011 and $3.18 billion during the first quarter of 2012.

Average noninterest bearing demand deposits as a percentage of average total deposits were 27.14% during the second quarter of 2012 and 24.33% during the same period in 2011. Average noninterest bearing demand deposits were 26.10% of average total deposits for the first quarter of 2012. The cost of interest bearing deposits was 0.74% for the second quarter of 2012 compared with 1.02% for the second quarter of 2011 and 0.75% for the first quarter of 2012.

## PART I. FINANCIAL INFORMATION
### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

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 | | | | | |
|---|---|---|---|---|---|---|
| | June 30, | | | | March 31, | |
| | 2012 | | 2011 | | 2012 | |
| Interest bearing demand and money market accounts | $ 1,060,116 | 0.41% | $ 842,810 | 0.57% | $ 1,012,019 | 0.45% |
| Regular savings | 194,517 | 0.51% | 156,263 | 0.75% | 194,495 | 0.57% |
| Certificates of deposit | 1,102,850 | 1.09% | 1,314,439 | 1.35% | 1,145,801 | 1.05% |
| Total interest bearing | 2,357,483 | 0.74% | 2,313,512 | 1.02% | 2,352,315 | 0.75% |
| Noninterest bearing | 878,114 | | 754,746 | | 830,626 | |
| Total | $ 3,235,597 | 0.54% | $ 3,068,258 | 0.77% | $ 3,182,941 | 0.55% |

| | Average Balance/Cost Rate Six Months Ended | | | |
|---|---|---|---|---|
| | June 30, 2012 | | June 30, 2011 | |
| Interest bearing demand and money market accounts | $ 1,036,068 | 0.43% | $ 826,952 | 0.56% |
| Regular savings | 194,506 | 0.54% | 149,550 | 0.74% |
| Certificates of deposit | 1,124,325 | 1.07% | 1,318,124 | 1.38% |
| Total interest bearing | 2,354,899 | 0.74% | $ 2,294,626 | 1.04% |
| Noninterest bearing | 854,370 | | 738,036 | |
| Total | $ 3,209,269 | 0.55% | $ 3,032,662 | 0.79% |

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 | | | | | |
|---|---|---|---|---|---|---|
| | June 30, | | | | March 31, | |
| | 2012 | | 2011 | | 2012 | |
| Interest bearing demand and money market accounts | $ 1,060,116 | 32.76% | $ 842,810 | 27.47% | $ 1,012,019 | 31.80% |
| Regular savings | 194,517 | 6.01% | 156,263 | 5.09% | 194,495 | 6.11% |
| Certificates of deposit | 1,102,850 | 34.08% | 1,314,439 | 42.84% | 1,145,801 | 36.00% |
| Total interest bearing | 2,357,483 | 72.86% | 2,313,512 | 75.40% | 2,352,315 | 73.90% |
| Noninterest bearing | 878,114 | 27.14% | 754,746 | 24.60% | 830,626 | 26.10% |
| Total | $ 3,235,597 | 100.00% | $ 3,068,258 | 100.00% | $ 3,182,941 | 100.00% |

# PART I. FINANCIAL INFORMATION

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

***Advances from the Federal Home Loan Bank of Atlanta.*** Borrowings of advances from the Federal Home Loan Bank of Atlanta ("FHLB") as of June 30, 2012 were $280.0 million, compared to $330.0 million at June 30, 2011 and $280.00 million at March 31, 2012. The average borrowing cost for the second quarter of 2012 was 4.20%, compared to 4.05% for the same period in 2011 and 4.20% at March 31, 2012. The scheduled maturity dates, call dates, and related fixed interest rates on advances from the FHLB at June 30, 2012 are summarized as follows (dollars in thousands).

| Maturity | Interest Rate | Call Date | Outstanding Amount |
|---|---|---|---|
| 03/06/2017 | 4.08% | 09/06/2012 | $ 100,000 |
| 05/18/2017 | 4.35% | 08/20/2012 | 80,000 |
| 05/18/2017 | 4.48% | 08/20/2012 | 80,000 |
| 01/29/2018 | 3.05% | - | 13,000 |
| 01/29/2018 | 3.05% | - | 7,000 |
| | | **Total FHLB Loans** | **$ 280,000** |

At June 30, 2012, certain residential HELOCS, second mortgages, and commercial mortgages secured by real estate with carrying values of $769.41 million collateralized the advances from the FHLB. At June 30, 2011, certain loans with carrying values of $660.65 million collateralized the advances from the FHLB. 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.

In addition to borrowings from the FHLB, we maintain various borrowing arrangements with financial institutions to support liquidity needs. As of June 30, 2012, we had no outstanding balances on these borrowing agreements with other financial institutions. Average total borrowings, including FHLB advances, during the second quarter of 2012 were $291.76 million compared with $344.67 million for the second quarter of 2011 and $291.46 million for the first quarter of 2012, while the average cost of these funds was 4.05%, 3.92% and 4.10%, 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 June 30, 2012. At June 30, 2011, the debentures totaled $13.80 million, and at December 31, 2011, they were $13.74 million.

# 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* on page 37 in this report.

On February 22, 2012, we declared a quarterly shareholder cash dividend of $0.08 per common share. The dividend was paid on April 12, 2012 to shareholders of record on March 30, 2012.

On May 30, 2012, we declared a quarterly shareholder cash dividend of $0.08 per common share. The dividend was paid on July 12, 2012 to shareholders of record on June 29, 2012. 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 (collectively, the "Agencies"). 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 12.29% for Tier I and 13.44% 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 June 30, 2012.

During the second quarter of 2012, the Agencies jointly issued three notices of proposed rulemaking ("NPRs") that would significantly revise the current regulatory capital requirements. The impact of these NPRs, if adopted, would result in higher risk-based and leverage capital requirements consistent with agreements reached by the Basel Committee on Banking Supervision, referred to as Basel III. The majority of the provisions contained within the NPRs would be phased-in over periods ranging from 3 to 10 years. The proposed NPRs are in a comment period through September 7, 2012, and subject to further modification by the Agencies. We are currently in the process of evaluating the impact of the proposed NPRs on our regulatory capital ratios; however, we anticipate that our capital ratios would continue to exceed the well-capitalized minimum requirements on a fully phased-in basis.

## PART I. FINANCIAL INFORMATION
### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

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

| | June 30, 2012 | June 30, 2011 | March 31, 2012 |
|---|---|---|---|
| **Tier I Capital:** | | | |
| Shareholders' equity (1)(2) | $ 545,703 | $ 506,807 | $ 537,027 |
| Less: goodwill and intangible assets | 113,704 | 113,411 | 114,311 |
| Total Tier I | 431,999 | 393,396 | 422,716 |
| **Tier II Capital:** | | | |
| Convertible subordinated debentures | - | 13,798 | - |
| Qualifying allowance for loan losses (3) | 40,370 | 39,540 | 40,034 |
| Total Tier II | 40,370 | 53,338 | 40,034 |
| **Total Risk Based Capital** | $ 472,369 | $ 446,734 | $ 462,750 |
| Total Assets | $ 4,230,993 | $ 4,017,719 | $ 4,144,218 |
| Total risk weighted assets | 3,513,744 | 3,160,923 | 3,350,166 |
| Average assets for leverage capital purposes | 4,014,412 | 3,875,325 | 3,958,846 |
| Risk Weighted Assets to Total Assets | 83.05% | 78.67% | 80.84% |
| Risk Based Capital Ratios: | | | |
| Tier I (4% minimum requirement) | 12.29% | 12.45% | 12.62% |
| Total (8% minimum requirement) | 13.44% | 14.13% | 13.81% |
| Tier I Leverage Ratio (4% minimum requirement) | 10.76% | 10.15% | 10.68% |

(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.

**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 June 30, 2012 | Three Months Ended June 30, 2011 | Six Months Ended June 30, 2012 | Six Months Ended June 30, 2011 |
|---|---|---|---|---|
| Return on average assets (GAAP basis) | 0.93% | 0.75% | 0.93% | 0.81% |
| Impact of excluding average goodwill and other intangibles and amortization | 0.02% | 0.03% | 0.03% | 0.02% |
| Return on average tangible assets | 0.95% | 0.78% | 0.96% | 0.83% |

| | Three Months Ended June 30, 2012 | Three Months Ended June 30, 2011 | Six Months Ended June 30, 2012 | Six Months Ended June 30, 2011 |
|---|---|---|---|---|
| Return on average equity (GAAP basis) | 7.04% | 5.90% | 7.12% | 6.29% |
| Impact of excluding average goodwill and other intangibles and amortization | 1.86% | 1.70% | 1.93% | 1.80% |
| Return on average tangible equity | 8.90% | 7.60% | 9.05% | 8.09% |

**PART I. FINANCIAL INFORMATION**
**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

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 June 30, | |
|---|---|---|
| | **2012** | **2011** |
| Book value (GAAP basis) | $ 12.93 | $ 12.73 |
| Impact of excluding goodwill and other intangibles and amortization | (3.62) | (3.90) |
| Tangible book value | $ 9.31 | $ 8.83 |

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## 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 June 30, 2012, we had $158.31 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 June 30, 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 June 30, 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 in Part I, Item 1A 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.**

| Exhibit No. | Description |
|---|---|
| (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 August 7, 2012 |

**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**

| | | |
|---|---|---|
| August 7, 2012 | By: | /s/ G. Robert Aston, Jr. |
| Date | | G. Robert Aston, Jr.<br>Chairman/Chief Executive Officer |
| August 7, 2012 | By: | /s/ Clyde E. McFarland, Jr. |
| Date | | Clyde E. McFarland, Jr.<br>Senior Executive Vice President/CFO |

**Exhibit (31.1)**

## CERTIFICATIONS

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

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended June 30, 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

**Exhibit (31.1)**
continued

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

| | |
|---|---|
| August 7, 2012 | /s/ G. Robert Aston, Jr. |
| Date | G. Robert Aston, Jr.<br>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.*

**Exhibit (31.2)**

## CERTIFICATIONS

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

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended June 30, 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.

| | |
|---|---|
| August 7, 2012 | /s/ Clyde E. McFarland, Jr. |
| Date | Clyde E. McFarland, Jr.<br>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.*

**Exhibit (32)**

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

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

1. Our Quarterly Report on Form 10-Q for the quarter ended June 30, 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.

| | |
|---|---|
| August 7, 2012 | /s/ G. Robert Aston, Jr. |
| Date | G. Robert Aston, Jr.<br>Chairman/Chief Executive Officer |
| August 7, 2012 | /s/ Clyde E. McFarland, Jr. |
| Date | Clyde E. McFarland, Jr.<br>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.*

Exhibit (99)

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 June 30, 2012 and 2011, the related consolidated statements of income, comprehensive income, equity and cash flows for the three-month and six-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
August 7, 2012

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