

FEDERAL DEPOSIT INSURANCE CORPORATION

Washington, D. C. 20429

FORM 10-Q

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

For the quarterly period ended September 30, 2013

FDIC Insurance Cert. Number: 35095

TOWNE BANK

(Exact name of registrant as specified in its charter)

VIRGINIA

(State or other jurisdiction of
incorporation or organization)

54-1910608

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

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

23703
(Zip Code)

(757) 638-7500

(Registrant's telephone number, including area code)

No Change

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

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

Yes ☒ No ☐

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

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

Large accelerated filer ☐

Accelerated filer ☒

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

Smaller reporting company ☐

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

Yes ☐ No ☒

The number of shares of the Company's common stock outstanding as of October 31, 2013 was 34,765,362 shares.

TOWNE BANK

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED BALANCE SHEETS (unaudited)

(Dollars in thousands, except share data)

	September 30,		December 31,
	2013	2012	2012
	(unaudited)		(audited)
ASSETS			
Cash and due from banks	\$ 162,688	\$ 274,481	\$ 127,967
Interest bearing deposits in financial institutions	1,105	1,574	1,326
Total Cash and Cash Equivalents	163,793	276,055	129,293
Securities available-for-sale, at fair value	533,762	335,500	450,144
Securities held-to-maturity, at amortized cost	158,471	155,912	155,481
Trading account securities	—	12,298	12,583
Federal Home Loan Bank stock, at amortized cost	22,830	23,223	23,223
Total Securities	715,063	526,933	641,431
Mortgage loans held for sale	77,448	124,785	132,551
Loans, net of unearned income and deferred costs:			
Real estate-residential 1-4 family	783,881	758,461	754,593
Real estate-commercial	1,373,494	1,216,859	1,231,819
Real estate-construction and development	462,739	585,760	618,562
Real estate-multi-family	85,783	57,327	57,831
Commercial	454,041	368,063	427,994
Consumer and other loans	48,266	43,671	42,708
Loans, net of unearned income and deferred costs	3,208,204	3,030,141	3,133,507
Less: Allowance for loan losses	(38,560)	(39,336)	(40,427)
Net Loans	3,169,644	2,990,805	3,093,080
Premises and equipment, net	152,713	140,744	144,939
Goodwill	104,518	98,129	102,912
Other intangible assets, net	16,167	15,068	16,091
Bank-owned life insurance policies	56,666	54,680	55,379
Other assets	114,893	91,110	90,247
TOTAL ASSETS	\$ 4,570,905	\$ 4,318,309	\$ 4,405,923
LIABILITIES AND EQUITY			
Liabilities			
Deposits:			
Noninterest-bearing demand	\$ 1,058,338	\$ 955,656	\$ 978,818
Interest-bearing:			
Demand and money market accounts	1,170,491	1,075,953	1,141,189
Savings	203,640	193,638	200,725
Certificates of deposit	1,048,990	1,079,878	1,059,320
Total Deposits	3,481,459	3,305,125	3,380,052
Advances from the Federal Home Loan Bank	389,344	380,000	380,000
Repurchase agreements and other borrowings	48,223	10,131	12,049
Total Borrowings	437,567	390,131	392,049
Other liabilities	74,470	69,447	73,943
TOTAL LIABILITIES	3,993,496	3,764,703	3,846,044
Shareholders' Equity			
Preferred stock, \$5.00 par: 2,000,000 shares authorized			
76,458 issued and outstanding at September 30, 2013,			
658,311 issued and outstanding at September 30, 2012 and			
657,911 issued and outstanding at December 31, 2012	76,458	134,344	134,304
Common stock, \$1.667 par: 45,000,000 shares authorized			
34,775,669 issued and outstanding at September 30, 2013,			
31,370,388 issued and outstanding at September 30, 2012 and			
31,469,709 issued and outstanding at December 31, 2012	57,971	52,294	52,460
Capital surplus	312,888	259,720	261,496
Retained earnings	122,576	98,440	103,834
Accumulated other comprehensive income (loss)	(586)	1,743	816
TOTAL SHAREHOLDERS' EQUITY	569,307	546,541	552,910
Noncontrolling interest	8,102	7,065	6,969
TOTAL EQUITY	577,409	553,606	559,879
TOTAL LIABILITIES AND EQUITY	\$ 4,570,905	\$ 4,318,309	\$ 4,405,923

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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
INTEREST INCOME:				
Loans, including fees	\$ 39,138	\$ 39,590	\$ 116,923	\$ 116,874
Investment securities	2,393	3,206	6,864	9,189
Interest bearing deposits in financial institutions and federal funds sold	202	189	526	543
Mortgage loans held for sale	962	1,231	2,876	3,249
Total Interest Income	42,695	44,216	127,189	129,855
INTEREST EXPENSE:				
Deposits	3,213	4,203	9,963	12,908
Advances from the Federal Home Loan Bank	3,309	3,010	9,722	8,980
Convertible subordinated capital debentures	—	—	—	237
Repurchase agreements and other borrowings	21	19	65	57
Total Interest Expense	6,543	7,232	19,750	22,182
Net Interest Income	36,152	36,984	107,439	107,673
PROVISION FOR LOAN LOSSES	328	4,977	3,696	13,196
Net Interest Income after Provision for Loan Losses	35,824	32,007	103,743	94,477
NONINTEREST INCOME:				
Residential mortgage banking income, net	6,725	7,329	23,461	19,573
Real estate brokerage and property management income, net	3,577	3,115	10,409	9,781
Insurance commissions and other title fees and income, net	7,477	5,978	22,297	18,385
Service charges on deposit accounts	2,256	2,047	6,471	5,755
Credit card merchant fees, net	968	931	2,726	2,834
Other income	1,985	2,274	5,841	5,861
Net gain (loss) on investment securities	150	508	546	3,038
Total Noninterest Income	23,138	22,182	71,751	65,227
NONINTEREST EXPENSE:				
Salaries and employee benefits	25,642	23,249	74,511	66,934
Occupancy expense	4,171	3,636	11,874	10,552
Furniture and equipment	1,931	1,621	5,477	4,778
Other expenses	11,635	11,725	35,930	36,139
Total Noninterest Expense	43,379	40,231	127,792	118,403
Income before income tax expense and noncontrolling interest	15,583	13,958	47,702	41,301
Provision for income tax expense	4,407	4,063	13,480	11,518
Net income	11,176	9,895	34,222	29,783
Net income attributable to noncontrolling interest	(758)	(545)	(2,133)	(1,468)
Net income attributable to TowneBank	\$ 10,418	\$ 9,350	\$ 32,089	\$ 28,315
Preferred stock dividends	1,340	1,355	4,036	4,872
Net income available to common shareholders	\$ 9,078	\$ 7,995	\$ 28,053	\$ 23,443
Per common share information				
Basic earnings	\$ 0.28	\$ 0.26	\$ 0.89	\$ 0.76
Diluted earnings	\$ 0.28	\$ 0.26	\$ 0.89	\$ 0.76
Cash dividends declared	\$ 0.10	\$ 0.08	\$ 0.28	\$ 0.24

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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income	\$ 11,176	\$ 9,895	\$ 34,222	\$ 29,783
Other comprehensive income (loss)				
Unrealized gains (losses) on securities				
Unrealized holding gains (losses) arising during the period	(328)	1,252	(3,199)	1,253
Deferred tax benefit (expense)	115	(438)	1,119	(438)
Realized gains reclassified into earnings	(88)	(6)	(89)	(1,968)
Deferred tax benefit	31	2	31	689
Net unrealized gains (losses)	(270)	810	(2,138)	(464)
Defined benefit retirement plan				
Actuarial gains (losses)	977	(553)	977	(841)
Deferred tax benefit (expense)	(342)	194	(342)	294
Amortization	28	—	155	—
Deferred tax expense	(10)	—	(54)	—
Change in defined benefit retirement plan, net of tax	653	(359)	736	(547)
Other comprehensive income (loss), net of tax	383	451	(1,402)	(1,011)
Comprehensive income	<u>\$ 11,559</u>	<u>\$ 10,346</u>	<u>\$ 32,820</u>	<u>\$ 28,772</u>

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)

	Nine Months Ended September 30,	
	2013	2012
OPERATING ACTIVITIES:		
Net income	\$ 34,222	\$ 29,783
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of securities	3,123	1,540
Investment securities gains	(546)	(3,038)
Depreciation, amortization, and other intangible amortization	9,201	8,602
Provision for loan losses	3,696	13,196
Bank-owned life insurance income	(1,287)	(1,365)
Deferred income tax expense	651	1,144
Share-based compensation expense	1,126	1,169
Purchases of trading account securities	(483)	(417)
Originations of mortgage loans held for sale	(1,110,882)	(910,290)
Proceeds from sales of mortgage loans held for sale	1,200,924	922,178
Gain on sales of mortgage loans held for sale	(34,938)	(27,220)
Loss on sale and write-down of foreclosed assets	884	1,443
Changes in:		
Interest receivable	1,240	223
Other assets	(27,018)	(11,884)
Interest payable	(1,170)	(966)
Other liabilities	(2,541)	5,199
Net cash provided by operating activities	<u>76,202</u>	<u>29,297</u>
INVESTING ACTIVITIES:		
Purchase of available-for-sale securities	(622,489)	(387,049)
Purchase of held-to-maturity securities	(13,433)	(19,656)
Sale of available-for-sale securities	—	44,777
Proceeds from maturities, calls, and prepayments of available-for-sale securities	533,045	333,351
Proceeds from maturities, calls, and prepayments of held-to-maturity securities	10,340	18,138
Net increase in loans	(80,260)	(250,548)
Purchase of premises and equipment	(15,682)	(13,860)
Proceeds from sales of premises and equipment	294	304
Distribution of interest in joint ventures	(1,000)	(698)
Proceeds from sales of foreclosed assets	13,409	5,641
Acquisition of business, net of cash acquired	(1,351)	—
Net cash used for investing activities	<u>(177,127)</u>	<u>(269,600)</u>
FINANCING ACTIVITIES:		
Net increase in deposit accounts	101,407	114,338
Net change in borrowings	45,531	98,361
Repurchase of warrants	(1,500)	—
Proceeds (payments) from issuance of common stock	(199)	2,537
Cash dividends paid	(9,814)	(13,022)
Net cash from financing activities	<u>135,425</u>	<u>202,214</u>
Change in cash and cash equivalents	34,500	(38,089)
Cash and cash equivalents at beginning of year	129,293	314,144
Cash and cash equivalents at end of period	<u>\$ 163,793</u>	<u>\$ 276,055</u>
Supplemental cash flow information:		
Cash paid for interest	\$ 20,167	\$ 23,148
Cash paid for income taxes	\$ 13,802	\$ 8,690
Noncash financing and investing activities:		
Transfer from loans to foreclosed property	\$ 28,756	\$ 13,742
Transfer from foreclosed property to premises and equipment	\$ 511	\$ —
Net unrealized loss on available-for-sale securities	\$ (2,138)	\$ (465)
Common stock issued in connection with conversion of convertible subordinated capital debentures	\$ 13	\$ 13,760

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED STATEMENT OF EQUITY

(Dollars in thousands)	Common Shares	Preferred Stock	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Non controlling Interest	Total
Balance, January 1, 2013	31,469,709	\$ 134,304	\$ 52,460	\$ 261,496	\$ 103,834	\$ 816	\$ 6,969	\$ 559,879
Net income	—	—	—	—	32,089	—	2,133	34,222
Other comprehensive loss, net of taxes	—	—	—	—	—	(1,402)	—	(1,402)
Cash dividends declared on common stock	—	—	—	—	(9,311)	—	—	(9,311)
Cash dividends declared on preferred stock	—	—	—	—	(4,036)	—	—	(4,036)
Director's deferred compensation	(52,069)	—	(86)	86	—	—	—	—
Distribution of interests in joint ventures	—	—	—	—	—	—	(1,000)	(1,000)
Repurchase of warrants	—	—	—	(1,500)	—	—	—	(1,500)
Conversion of preferred stock into common stock	3,226,744	(57,846)	5,378	52,468	—	—	—	—
Conversion of convertible debt into common stock	1,461	—	3	10	—	—	—	13
Issuance of common stock - acquisitions	10,180	—	17	135	—	—	—	152
Issuance of common stock - stock compensation plans	119,644	—	199	193	—	—	—	392
Balance, September 30, 2013	34,775,669	\$ 76,458	\$ 57,971	\$ 312,888	\$ 122,576	\$ (586)	\$ 8,102	\$ 577,409

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 2012 audited Consolidated Financial Statements and the 2012 Annual Report on Form 10-K. Results of operations for the period ended September 30, 2013 are not necessarily indicative of the results of operations for the full year or any other interim periods.

Reclassifications

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 dividend.

Recent Accounting Pronouncements

In July 2012, the Financial Accounting Standards Board (the “FASB”) issued Accounting Standards Update (“ASU”) No. 2012-02, *Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment*. ASU No. 2012-02 permits an entity to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform a quantitative impairment test. An entity would continue to calculate the fair value of an indefinite-lived intangible asset if the asset fails the qualitative assessment, while no further analysis would be required if it passes. The provisions of the new guidance are effective as of the beginning of our 2013 fiscal year. The adoption of this ASU did not have a material impact on the Company’s financial statements.

In February 2013, the FASB issued ASU No. 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. Under ASU No. 2013-02, an entity is required to provide information about the amounts reclassified out of Accumulated Other Comprehensive Income (“AOCI”) by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of AOCI by the respective line items of net income, but only if the amount reclassified is required to be reclassified in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional details about those amounts. ASU No. 2013-02 does not change the current requirements for reporting net income or other comprehensive income in the financial statements. ASU No. 2013-02 was effective for the Company on January 1, 2013.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In July 2013, the FASB issued ASU N0. 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*. The amendments in ASU 2013-11 to Topic 740, Income Taxes, provide guidance on the financial statement presentation of unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The adoption of this ASU is not expected to have a material impact on the Company's 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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Basic				
Net income, as reported	\$ 10,418	\$ 9,350	\$ 32,089	\$ 28,315
Preferred stock dividends	1,340	1,355	4,036	4,872
Net income available to common shareholders	\$ 9,078	\$ 7,995	\$ 28,053	\$ 23,443
Average common shares outstanding	32,244,260	31,118,698	31,604,766	30,657,440
Basic earnings per share amount	\$ 0.28	\$ 0.26	\$ 0.89	\$ 0.76
Diluted				
Net income available to common shareholders	\$ 9,078	\$ 7,995	\$ 28,053	\$ 23,443
Add: interest applicable to 8% subordinated debt, net of tax (1)	—	—	—	154
Net income available to common shareholders, for diluted EPS	\$ 9,078	\$ 7,995	\$ 28,053	\$ 23,597
Average common shares outstanding	32,244,260	31,118,698	31,604,766	30,657,440
Add shares if converted:				
Stock compensation plans, net of tax benefit (2)	58,752	56,652	46,193	60,932
Convertible subordinated debentures (3)	—	—	—	293,154
Average diluted shares outstanding	32,303,012	31,175,350	31,650,959	31,011,526
Diluted earnings per share amount	\$ 0.28	\$ 0.26	\$ 0.89	\$ 0.76

(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 4,070 and 1,909 were excluded from the computation of diluted earnings per share during the third quarter of 2013 and 2012, respectively, and 24,145 and 31,965 were excluded from the computation of diluted earnings per share during the nine months ended September 30, 2013 and 2012, respectively, because their inclusion would be anti-dilutive.

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

On September 1, 2013, all outstanding shares of the TowneBank 8% Non-Cumulative Convertible Preferred Stock, Series A ("Series A preferred stock") were mandatorily converted into 3.19 million shares of TowneBank common stock reflecting a conversion price of \$18.02 per share of common stock, plus cash in lieu of any fractional shares. These shares of the Series A preferred stock were not included in the computation of diluted earnings per share as the effect was anti-dilutive for all periods presented in the table above.

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 periods presented in the table above. On May 15, 2013, the Company repurchased the warrant from the U.S. Treasury Department for \$1.5 million. The transaction reduced additional paid-in capital within stockholders' equity by \$1.5 million. The warrant repurchase did not impact results of operations.

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.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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):

September 30, 2013

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency securities	\$ 219,613	\$ 107	\$ (1,953)	\$ 217,767
U.S. Treasury notes	200,000	—	—	200,000
Municipal securities	36,436	568	(279)	36,725
Trust preferred and other corporate securities	8,073	441	(9)	8,505
Mortgage-backed securities issued by GSE	70,315	598	(148)	70,765
Total available-for-sale securities	<u>\$ 534,437</u>	<u>\$ 1,714</u>	<u>\$ (2,389)</u>	<u>\$ 533,762</u>

December 31, 2012

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency securities	\$ 3,219	\$ 87	\$ —	\$ 3,306
U.S. Treasury notes	300,000	—	—	300,000
Municipal securities	38,854	1,262	(32)	40,084
Trust preferred and other corporate securities	4,968	409	—	5,377
Mortgage-backed securities issued by GSE	100,490	961	(74)	101,377
Total available-for-sale securities	<u>\$ 447,531</u>	<u>\$ 2,719</u>	<u>\$ (106)</u>	<u>\$ 450,144</u>

Held-to-maturity securities

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

September 30, 2013

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Trust preferred corporate securities	\$ 500	\$ 144	\$ —	\$ 644
Municipal securities	60,383	1,651	(65)	61,969
Industrial revenue bonds	97,588	2,158	(10,211)	89,535
Total held-to-maturity securities	<u>\$ 158,471</u>	<u>\$ 3,953</u>	<u>\$ (10,276)</u>	<u>\$ 152,148</u>

December 31, 2012

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Trust preferred corporate securities	\$ 500	\$ 188	\$ —	\$ 688
Municipal securities	62,062	5,347	—	67,409
Industrial revenue bonds	92,919	4,311	(3,369)	93,861
Total held-to-maturity securities	<u>\$ 155,481</u>	<u>\$ 9,846</u>	<u>\$ (3,369)</u>	<u>\$ 161,958</u>

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Maturities of investment securities

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

September 30, 2013

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 211,012	\$ 211,079	\$ 3,717	\$ 3,720
Due after one year through five years	230,846	228,924	54,743	51,564
Due after five years through 10 years	19,540	19,761	19,647	20,187
Due after 10 years	71,378	72,337	80,364	76,677
	532,776	532,101	158,471	152,148
Other equity securities	1,661	1,661	—	—
	<u>\$ 534,437</u>	<u>\$ 533,762</u>	<u>\$ 158,471</u>	<u>\$ 152,148</u>

December 31, 2012

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 301,006	\$ 301,010	\$ 16,763	\$ 16,984
Due after one year through five years	19,726	20,050	29,950	31,670
Due after five years through 10 years	19,440	19,939	8,533	9,164
Due after 10 years	106,872	108,658	100,235	104,140
	447,044	449,657	155,481	161,958
Other equity securities	487	487	—	—
	<u>\$ 447,531</u>	<u>\$ 450,144</u>	<u>\$ 155,481</u>	<u>\$ 161,958</u>

Trading securities

During the third quarter of 2013, the Company amended its non-qualified employee deferred compensation plan, which is structured as a rabbi trust, from a self-directed, diversified plan to a plan that does not permit diversification. Due to the change in the structure of the plan, the funds held in the plan are no longer accounted for as trading securities and are included in other assets on the balance sheet at September 30, 2013 and changes in the obligation are recorded in compensation expense. Prior to the plan amendment, employees were permitted to invest in mutual fund investments that were classified as trading securities. These investments were bought and sold as employees deferred compensation, received distributions, or made changes in the funds underlying their accounts. Realized and unrealized gains or losses were recorded in noninterest income. The Company had gains of \$62,000 and \$501,000 in the three-month periods ended September 30, 2013 and 2012, respectively, and gains of \$456,000 and \$1.03 million in the nine-month periods ended September 30, 2013 and 2012, respectively.

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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):

September 30, 2013	Less than 12 months		12 months or more		Total	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury obligations and direct obligations of U.S. government agencies	\$ 205,665	\$ 1,953	\$ —	\$ —	\$ 205,665	\$ 1,953
Municipal securities	16,215	269	1,706	74	17,921	343
Industrial revenue bonds	39,891	10,070	1,258	142	41,149	10,212
Mortgage-backed securities issued by GSE	31,412	148	—	—	31,412	148
Trust preferred corporate securities	1,978	9	—	—	1,978	9
Total temporarily impaired securities	\$ 295,161	\$ 12,449	\$ 2,964	\$ 216	\$ 298,125	\$ 12,665

December 31, 2012	Less than 12 months		12 months or more		Total	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury obligations and direct obligations of U.S. government agencies	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Municipal securities	3,592	32	—	—	3,592	32
Industrial revenue bonds	22,862	3,369	—	—	22,862	3,369
Mortgage-backed securities issued by GSE	26,587	74	—	—	26,587	74
Total temporarily impaired securities	\$ 53,041	\$ 3,475	\$ —	\$ —	\$ 53,041	\$ 3,475

U.S. Treasury obligations

The Company's unrealized losses on obligations of U.S. government agencies were caused by interest rate fluctuations. At September 30, 2013, 11 securities had unrealized losses of \$1.95 million. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on the credit quality of the issuers, and because it is the Company's intent to hold these securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Municipal securities

The Company's unrealized losses on municipal securities were caused by interest rate fluctuations. At September 30, 2013, 16 securities had unrealized losses of \$343,000. 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

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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 fluctuations. At September 30, 2013, eight securities had unrealized losses of \$148,000. The severity and duration of the unrealized loss will fluctuate with interest rates in the economy. Because our mortgage-related securities are backed by FNMA and FHLMC, which are GSEs, or are collateralized by securities backed by these agencies, and because it is the Company’s intent to hold these securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the security before its anticipated recovery, the Company does not consider this investment other than temporarily impaired.

Trust preferred corporate securities

The Company’s unrealized losses on trust preferred corporate securities were caused by interest rate fluctuations. At September 30, 2013, one security had an unrealized loss of \$9,000. The severity and duration of the unrealized loss will fluctuate with interest rates in the economy. Based on the credit quality of the issuer, and because it is the Company’s intent to hold the security until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the security before its anticipated recovery, the Company does not consider the investment other than temporarily impaired.

Industrial revenue bonds

The Company’s unrealized losses on industrial revenue bonds were caused by interest rate fluctuations. At September 30, 2013, 12 bond issuances had total unrealized losses of \$10.21 million. Based on the credit quality of the issuers, and because it is the Company’s intent to hold these bonds until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the bonds before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Other investments, including common stock

The Company had no unrealized losses in other investments or common stocks at September 30, 2013.

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

The Company is required to maintain an investment in the capital stock of the FHLB. The FHLB stock is stated at cost, as this is a restricted security without a readily determinable fair value. The Company had \$22.83 million and \$23.22 million of FHLB stock at September 30, 2013 and December 31, 2012, respectively. Based on the Company’s review of the credit quality of the institution, the institution’s ability to repurchase shares, and the Company’s carrying value in the shares, the Company does not consider this investment other than temporarily impaired.

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Note 4. Loans and Allowance for Loan Losses

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

Allowance for Loan Losses

The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the balance sheet date. While portions of the allowance are attributed to specific portfolio segments, the entire allowance is available to absorb credit losses inherent in the total loan portfolio. The Company considers the allowance for loan losses of \$38.56 million adequate to cover estimated loan losses inherent in the loan portfolio at September 30, 2013.

The following table presents, by portfolio segment, the changes in the allowance for loan losses for the three- and nine-month periods ended September 30, 2013 (in thousands):

Three Months Ended September 30, 2013	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	\$ 9,447	\$ 13,547	\$ 671	\$ 10,538	\$ 3,936	\$ 898	\$ 39,037
Provision charged to expense	(1,132)	634	259	349	537	(320)	327
Losses charged off	(65)	(127)	—	(645)	(125)	(7)	(969)
Recoveries	6	9	—	43	87	20	165
Balance, end of period	<u>\$ 8,256</u>	<u>\$ 14,063</u>	<u>\$ 930</u>	<u>\$ 10,285</u>	<u>\$ 4,435</u>	<u>\$ 591</u>	<u>\$ 38,560</u>
Nine Months Ended September 30, 2013							
Allowance for loan losses:							
Balance, beginning of year	\$ 11,691	\$ 12,521	\$ 589	\$ 10,722	\$ 4,378	\$ 526	\$ 40,427
Provision charged to expense	(2,140)	1,818	355	2,797	545	321	3,696
Losses charged off	(1,649)	(300)	(14)	(3,553)	(931)	(295)	(6,742)
Recoveries	354	24	—	319	443	39	1,179
Balance, end of period	<u>\$ 8,256</u>	<u>\$ 14,063</u>	<u>\$ 930</u>	<u>\$ 10,285</u>	<u>\$ 4,435</u>	<u>\$ 591</u>	<u>\$ 38,560</u>

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The following table presents, by portfolio segment, the changes in the allowance for loan losses for the three- and nine- month periods ended September 30, 2012:

	Construction		Multi-	1-4 Family	Commercial	Consumer	
Three Months Ended	and Land	Commercial	Family	Residential	and Industrial	Loans and	
September 30, 2012	Development	Real Estate	Real Estate	Real Estate	Business	Other	Total
Allowance for loan losses:							
Balance, beginning of period	\$ 13,091	\$ 12,152	\$ 404	\$ 10,455	\$ 3,854	\$ 414	\$ 40,370
Provision charged to expense	196	1,171	594	1,626	1,192	198	4,977
Losses charged off	(2,568)	(1,086)	(345)	(958)	(1,083)	(101)	(6,141)
Recoveries	—	8	—	99	18	5	130
Balance, end of period	<u>\$ 10,719</u>	<u>\$ 12,245</u>	<u>\$ 653</u>	<u>\$ 11,222</u>	<u>\$ 3,981</u>	<u>\$ 516</u>	<u>\$ 39,336</u>
Nine Months Ended							
September 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	2,736	4,818	603	2,842	1,889	308	13,196
Losses charged off	(5,691)	(3,198)	(345)	(3,231)	(1,791)	(310)	(14,566)
Recoveries	51	47	—	774	41	53	966
Balance, end of period	<u>\$ 10,719</u>	<u>\$ 12,245</u>	<u>\$ 653</u>	<u>\$ 11,222</u>	<u>\$ 3,981</u>	<u>\$ 516</u>	<u>\$ 39,336</u>

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The following table presents, by portfolio segment, the allocation of the allowance for loan losses at September 30, 2013 and December 31, 2012 (in thousands):

	Construction and Land Development	Commercial Real Estate	Multi- Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
September 30, 2013							
Period-end balance allocated to:							
Loans individually evaluated for impairment	\$ 961	\$ 1,555	\$ 8	\$ 1,501	\$ 367	\$ —	\$ 4,392
Loans collectively evaluated for impairment	7,295	12,508	922	8,784	4,068	591	34,168
Loans acquired with deteriorated credit quality	—	—	—	—	—	—	—
Balance, end of period	<u>\$ 8,256</u>	<u>\$ 14,063</u>	<u>\$ 930</u>	<u>\$ 10,285</u>	<u>\$ 4,435</u>	<u>\$ 591</u>	<u>\$ 38,560</u>
December 31, 2012							
Period-end balance allocated to:							
Loans individually evaluated for impairment	\$ 1,544	\$ 978	\$ —	\$ 1,246	\$ —	\$ 185	\$ 3,953
Loans collectively evaluated for impairment	10,147	11,543	589	9,476	4,378	341	36,474
Loans acquired with deteriorated credit quality	—	—	—	—	—	—	—
Balance, end of year	<u>\$ 11,691</u>	<u>\$ 12,521</u>	<u>\$ 589</u>	<u>\$ 10,722</u>	<u>\$ 4,378</u>	<u>\$ 526</u>	<u>\$ 40,427</u>

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

	Construction and Land Development	Commercial Real Estate	Multi- Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
September 30, 2013							
Ending balance: individually evaluated for impairment	\$ 15,988	\$ 23,765	\$ 360	\$ 17,938	\$ 961	\$ 76	\$ 59,088
Ending balance: collectively evaluated for impairment	445,754	1,347,255	85,423	762,339	452,177	48,190	3,141,138
Ending balance: loans acquired with deteriorated credit quality	997	2,474	—	3,604	903	—	7,978
Ending Balance	<u>\$ 462,739</u>	<u>\$1,373,494</u>	<u>\$ 85,783</u>	<u>\$ 783,881</u>	<u>\$ 454,041</u>	<u>\$ 48,266</u>	<u>\$3,208,204</u>
December 31, 2012							
Ending balance: individually evaluated for impairment	\$ 41,243	\$ 24,201	—	\$ 16,224	\$ 626	\$ 450	\$ 82,744
Ending balance: collectively evaluated for impairment	575,806	1,203,916	57,637	734,165	427,368	42,258	3,041,150
Ending balance: loans acquired with deteriorated credit quality	1,513	2,720	194	4,204	982	—	9,613
Ending Balance	<u>\$ 618,562</u>	<u>\$1,230,837</u>	<u>\$ 57,831</u>	<u>\$ 754,593</u>	<u>\$ 428,976</u>	<u>\$ 42,708</u>	<u>\$3,133,507</u>

Loans acquired in a transfer, including business combinations, where there is evidence of credit deterioration since origination and it is probable at the date of acquisition that we will not collect all

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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 nine months ended September 30, 2013 and 2012 (in thousands):

	September 30, 2013				September 30, 2012			
	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	\$ 992	\$ 9,613	\$ 4,241	\$ 33,757	\$ 2,134	\$ 13,009	\$ 7,408	\$ 45,440
Accretion	(560)	560	(1,707)	1,707	(909)	909	(2,451)	2,451
Reclassifications from nonaccretable balance, net	2,545	—	2,402	—	—	—	—	—
Payments received, net	—	(2,195)	—	(6,436)	—	(4,017)	—	(10,606)
Balance at end of period	<u>\$ 2,977</u>	<u>\$ 7,978</u>	<u>\$ 4,936</u>	<u>\$ 29,028</u>	<u>\$ 1,225</u>	<u>\$ 9,901</u>	<u>\$ 4,957</u>	<u>\$ 37,285</u>

At September 30, 2013, 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 September 30, 2013 was \$10.71 million and \$29.23 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.

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The Company's internally assigned grades are as follows:

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

The following tables represent credit exposures by internally assigned grades for the periods ended September 30, 2013 and December 31, 2012 (in thousands):

	Construction and Land Development	Commercial Real Estate	Multi- Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
September 30, 2013							
Pass	\$ 430,386	\$ 1,329,742	\$ 81,674	\$ 760,170	\$ 448,888	\$ 47,802	\$ 3,098,662
Special Mention	17,173	22,658	—	5,424	1,600	8	46,863
Substandard	15,180	21,094	4,109	18,287	3,553	456	62,679
Doubtful	—	—	—	—	—	—	—
Total	<u>\$ 462,739</u>	<u>\$ 1,373,494</u>	<u>\$ 85,783</u>	<u>\$ 783,881</u>	<u>\$ 454,041</u>	<u>\$ 48,266</u>	<u>\$ 3,208,204</u>
	Construction and Land Development	Commercial Real Estate	Multi- Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
December 31, 2012							
Pass	\$ 542,753	\$ 1,185,841	\$ 53,457	\$ 729,817	\$ 422,904	\$ 41,794	\$ 2,976,566
Special Mention	23,993	23,931	3,500	6,643	2,056	—	60,123
Substandard	51,779	22,047	874	17,715	3,034	913	96,362
Doubtful	37	—	—	418	—	1	456
Total	<u>\$ 618,562</u>	<u>\$ 1,231,819</u>	<u>\$ 57,831</u>	<u>\$ 754,593</u>	<u>\$ 427,994</u>	<u>\$ 42,708</u>	<u>\$ 3,133,507</u>

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Age Analysis of Past-Due Financing Receivables by Class

The following table includes an aging analysis of the recorded investment of past-due financing receivables as of September 30, 2013 and December 31, 2012. 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
September 30, 2013								
Construction and land development	\$ 432	\$ 1,323	\$ 28	\$ 5,681	\$ 7,464	\$ 455,275	\$ 462,739	\$ —
Commercial real estate	2,175	523	—	3,563	6,261	1,367,233	1,373,494	—
Multifamily real estate	—	—	—	—	—	85,783	85,783	—
1-4 family residential real estate	3,215	388	140	3,623	7,366	776,515	783,881	—
Commercial and industrial business loans	274	2	—	773	1,049	452,992	454,041	—
Consumer loans and other	327	18	—	43	388	47,878	48,266	—
Total	\$ 6,423	\$ 2,254	\$ 168	\$ 13,683	\$ 22,528	\$ 3,185,676	\$ 3,208,204	\$ —
December 31, 2012								
Construction and land development	\$ 311	\$ —	\$ 541	\$ 27,498	\$ 28,350	\$ 590,212	\$ 618,562	\$ —
Commercial real estate	1,430	1,882	—	5,044	8,356	1,223,463	1,231,819	—
Multifamily real estate	—	—	255	—	255	57,576	57,831	—
1-4 family residential real estate	3,428	703	321	7,337	11,789	742,804	754,593	185
Commercial and industrial business loans	522	49	—	429	1,000	426,994	427,994	—
Consumer loans and other	361	17	37	383	798	41,910	42,708	37
Total	\$ 6,052	\$ 2,651	\$ 1,154	\$ 40,691	\$ 50,548	\$ 3,082,959	\$ 3,133,507	\$ 222

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

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present value of expected future cash flows, discounted at the loan's effective interest rate, except when the sole (remaining) source of repayment for the loan is the operation or liquidation of the collateral. In these cases, management uses the current fair value of the collateral, less selling costs when foreclosure is probable, instead of discounted cash flows. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs, and unamortized premium or discount), impairment is recognized as a specific component to be provided for in the allowance for loan losses or the impaired balance on collateral dependent loans is charged-off if it is determined that such amount represents a confirmed loss.

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

Unearned loan income was \$2.26 million in excess of deferred loan costs at September 30, 2013, \$2.26 million at September 30, 2012, and \$2.47 million at December 31, 2012. There were \$13.68 million, \$51.52 million, and \$40.69 million in nonaccrual loans at September 30, 2013, September 30, 2012, and December 31, 2012, respectively. The Company would have earned \$69,000 in the third quarter of 2013 if interest on the loans had been accrued.

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

	Unpaid			Average	QTD	YTD
	Principal	Recorded	Specific	Recorded	Interest	Interest
September 30, 2013	Balance	Balance	Allowance	Investment	Income Recognized	Income Recognized
Loans without a specific valuation allowance						
Construction and land development	\$ 9,880	\$ 9,810	\$ —	\$ 10,511	\$ 124	\$ 398
Commercial real estate	16,857	16,365	—	16,894	279	709
Multi-family real estate	—	—	—	—	—	—
1-4 family residential real estate	11,679	11,318	—	11,768	144	427
Commercial and industrial business loans	1,086	594	—	1,116	20	38
Consumer loans and other	83	76	—	91	1	3
Total	\$ 39,585	\$ 38,163	\$ —	\$ 40,380	\$ 568	\$ 1,575
Loans with a specific valuation allowance						
Construction and land development	\$ 6,239	\$ 6,178	\$ 961	\$ 6,912	\$ 104	\$ 129
Commercial real estate	7,474	7,400	1,555	7,495	84	229
Multi-family real estate	360	360	8	364	6	18
1-4 family residential real estate	7,176	6,620	1,501	6,716	104	216
Commercial and industrial business loans	367	367	367	376	6	8
Consumer loans and other	—	—	—	—	—	—
Total	\$ 21,616	\$ 20,925	\$ 4,392	\$ 21,863	\$ 304	\$ 600
Total impaired loans						
Construction and land development	\$ 16,119	\$ 15,988	\$ 961	\$ 17,423	\$ 228	\$ 527
Commercial real estate	24,331	23,765	1,555	24,389	363	938
Multi-family real estate	360	360	8	364	6	18
1-4 family residential real estate	18,855	17,938	1,501	18,484	248	643
Commercial and industrial business loans	1,453	961	367	1,492	26	46
Consumer loans and other	83	76	—	91	1	3
Total	\$ 61,201	\$ 59,088	\$ 4,392	\$ 62,243	\$ 872	\$ 2,175

(1) Included in the table above are accruing TDRs of \$44.56 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled \$6.10 million.

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	Unpaid			Average	YTD
	Principal	Recorded	Specific	Recorded	Interest
	Balance	Balance	Allowance	Investment	Income
					Recognized
December 31, 2012					
Loans without a specific valuation allowance					
Construction and land development	\$ 23,374	\$ 20,315	\$ —	\$ 25,497	\$ 667
Commercial real estate	18,290	17,923	—	18,246	1,031
1-4 family residential real estate	11,410	10,867	—	11,534	464
Commercial and industrial business loans	947	626	—	924	53
Consumer loans and other	107	102	—	118	8
Total	\$ 54,128	\$ 49,833	\$ —	\$ 56,319	\$ 2,223
Loans with a specific valuation allowance					
Construction and land development	\$ 22,216	\$ 20,928	\$ 1,544	\$ 22,177	\$ 67
Commercial real estate	6,516	6,278	978	6,571	274
1-4 family residential real estate	5,875	5,357	1,246	5,901	269
Commercial and industrial business loans	—	—	—	—	—
Consumer loans and other	393	348	185	398	9
Total	\$ 35,000	\$ 32,911	\$ 3,953	\$ 35,047	\$ 619
Total impaired loans					
Construction and land development	\$ 45,590	\$ 41,243	\$ 1,544	\$ 47,674	\$ 734
Commercial real estate	24,806	24,201	978	24,817	1,305
1-4 family residential real estate	17,285	16,224	1,246	17,435	733
Commercial and industrial business loans	947	626	—	924	53
Consumer loans and other	500	450	185	516	17
Total	\$ 89,128	\$ 82,744	\$ 3,953	\$ 91,366	\$ 2,842

(1) Included in the table above are accruing TDRs of \$38.91 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled \$25.30 million.

Troubled Debt Restructurings

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

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The following table shows the loans modified in TDRs for the three and nine months ended September 30, 2013 and 2012 (in thousands, except number of loans):

	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	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	1	\$ 2,402	\$ 2,385	2	\$ 2,550	\$ 2,530
Commercial real estate	2	974	974	5	4,819	4,819
Multi-family real estate	—	—	—	1	365	365
1-4 family residential real estate	1	962	962	6	4,392	4,107
Commercial and industrial	—	—	—	1	2,000	2,000
Consumer loans and other	1	4	4	1	4	4
Total	5	\$ 4,342	\$ 4,325	16	\$ 14,130	\$ 13,825

	Three Months Ended September 30, 2012			Nine Months Ended September 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	4	\$ 2,309	\$ 2,309	17	\$ 7,970	\$ 7,970
Commercial real estate	9	3,173	3,010	18	8,143	7,972
Multi-family real estate	—	—	—	1	345	345
1-4 family residential real estate	2	1,630	1,630	15	5,523	5,417
Commercial and industrial	1	453	170	3	696	413
Consumer loans and other	—	—	—	1	17	17
Total	16	\$ 7,565	\$ 7,119	55	\$ 22,694	\$ 22,134

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 six commercial and industrial business loans that were restructured within the last 12 months that subsequently defaulted. The loans had recorded balances of \$3.05 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 September 30, 2013, 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

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principal or interest becomes 90 days past due, whichever occurs first, unless the debt is both well-secured and in the process of collection. Residential mortgage loans and other consumer loans are placed on nonaccrual status when full collection of principal and interest becomes doubtful, or when any portion of principal or interest becomes 120 days past due, whichever occurs first, unless the debt is both well-secured and in the process of collection. When loans are placed on nonaccrual status, interest receivable is reversed against interest income recognized in the current period, and any prior year unpaid interest is charged off against the 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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Beginning balance	\$ 47,596	\$ 29,775	\$ 30,297	\$ 29,819
Additions	919	5,474	32,272	16,094
Sales	(6,425)	(4,266)	(19,770)	(13,560)
Valuation allowance	(93)	—	(639)	—
Loss on sale and write-downs	(82)	(73)	(245)	(1,443)
Ending balance	<u>\$ 41,915</u>	<u>\$ 30,910</u>	<u>\$ 41,915</u>	<u>\$ 30,910</u>

Note 6. Segment Reporting

The Company has three reportable segments: Banking, Realty, and Insurance. The Banking segment provides loan and deposit services to retail and commercial customers throughout Hampton Roads and northeastern North Carolina and includes the operations of TowneBank Commercial Mortgage and Towne Investment Group. The Realty segment combines the operations of Prudential Towne Realty with TowneBank Mortgage, Lawyers Escrow and Title, LLC, d/b/a Virginia Home Title and Settlements, SimonTowne Mortgage, LLC, Towne Mortgage of the Carolinas, LLC, 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.

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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 September 30, 2013

	Banking	Realty	Insurance	Consolidated Totals
Net interest income	\$ 35,519	\$ 633	\$ —	\$ 36,152
Provision for loan losses	328	—	—	328
Net interest income after provision for loan losses	35,191	633	—	35,824
Residential mortgage banking income, net	(111)	6,836	—	6,725
Real estate brokerage and property management income, net	—	3,577	—	3,577
Insurance commissions and other title fees and income, net	—	545	6,932	7,477
Other noninterest income	4,531	437	391	5,359
Noninterest expense	27,003	10,635	5,741	43,379
Income before income tax, corporate allocation and noncontrolling interest	12,608	1,393	1,582	15,583
Corporate allocation	32	(153)	121	—
Income before income tax provision and noncontrolling interest	12,640	1,240	1,703	15,583
Provision for income tax expense	3,720	109	578	4,407
Net income	8,920	1,131	1,125	11,176
Noncontrolling interest	—	(665)	(93)	(758)
Net income attributable to TowneBank	\$ 8,920	\$ 466	\$ 1,032	\$ 10,418
Net income as percentage of total	85.62%	4.47%	9.91%	100.00%
Total assets	\$ 4,352,628	\$ 135,338	\$ 82,939	\$ 4,570,905

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Three Months Ended September 30, 2012

	Banking	Realty	Insurance	Consolidated Totals
Net interest income	\$ 36,172	\$ 812	\$ —	\$ 36,984
Provision for loan losses	4,977	—	—	4,977
Net interest income after provision for loan losses	31,195	812	—	32,007
Residential mortgage banking income, net	(119)	7,448	—	7,329
Real estate brokerage and property management income, net	—	3,115	—	3,115
Insurance commissions and other title fees and income, net	—	498	5,480	5,978
Other noninterest income	5,228	336	196	5,760
Noninterest expense	27,414	8,449	4,368	40,231
Income before income tax, corporate allocation and noncontrolling interest	8,890	3,760	1,308	13,958
Corporate allocation	139	(100)	(39)	—
Income before income tax provision and noncontrolling interest	9,029	3,660	1,269	13,958
Provision for income tax expense	2,404	1,160	499	4,063
Net income	6,625	2,500	770	9,895
Noncontrolling interest	—	(521)	(24)	(545)
Net income attributable to TowneBank	\$ 6,625	\$ 1,979	\$ 746	\$ 9,350
Net income as percentage of total	70.85%	21.17%	7.98%	100.00%
Total Assets	\$ 4,071,155	\$ 179,290	\$ 67,864	\$ 4,318,309

Nine Months Ended September 30, 2013

	Banking	Realty	Insurance	Consolidated Totals
Net interest income	\$ 105,533	\$ 1,906	\$ —	\$ 107,439
Provision for loan losses	3,696	—	—	3,696
Net interest income after provision for loan losses	101,837	1,906	—	103,743
Residential mortgage banking income, net	(311)	23,772	—	23,461
Real estate brokerage and property management income, net	—	10,409	—	10,409
Insurance commissions and other title fees and income, net	—	1,496	20,801	22,297
Other noninterest income	13,742	1,064	778	15,584
Noninterest expense	82,214	29,349	16,229	127,792
Income before income tax, corporate allocation and noncontrolling interest	33,054	9,298	5,350	47,702
Corporate allocation	661	(418)	(243)	—
Income before income tax provision and noncontrolling interest	33,715	8,880	5,107	47,702
Provision for income tax expense	9,005	2,631	1,844	13,480
Net income	24,710	6,249	3,263	34,222
Noncontrolling interest	—	(1,779)	(354)	(2,133)
Net income attributable to TowneBank	\$ 24,710	\$ 4,470	\$ 2,909	\$ 32,089
Net income as percentage of total	77.00%	13.93%	9.07%	100.00%
Total Assets	\$ 4,352,628	\$ 135,338	\$ 82,939	\$ 4,570,905

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Nine Months Ended September 30, 2012

	Banking	Realty	Insurance	Consolidated Totals
Net interest income	\$ 105,487	\$ 2,173	\$ 13	\$ 107,673
Provision for loan losses	13,196	—	—	13,196
Net interest income after provision for loan losses	92,291	2,173	13	94,477
Residential mortgage banking income, net	(454)	20,027	—	19,573
Real estate brokerage and property management income, net	—	9,781	—	9,781
Insurance commissions and other title fees and income, net	—	1,384	17,001	18,385
Other noninterest income	16,016	932	540	17,488
Noninterest expense	81,768	23,460	13,175	118,403
Income before income tax, corporate allocation and noncontrolling interest	26,085	10,837	4,379	41,301
Corporate allocation	417	(299)	(118)	—
Income before income tax provision and noncontrolling interest	26,502	10,538	4,261	41,301
Provision for income tax expense	6,387	3,530	1,601	11,518
Net income	20,115	7,008	2,660	29,783
Noncontrolling interest	—	(1,183)	(285)	(1,468)
Net income attributable to TowneBank	\$ 20,115	\$ 5,825	\$ 2,375	\$ 28,315
Net income as percentage of total	71.04%	20.57%	8.39%	100.00%
Total Assets	\$ 4,071,155	\$ 179,290	\$ 67,864	\$ 4,318,309

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 September 30, 2013, the amounts of off-balance sheet commitments to extend credit were \$863.74 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 September 30, 2013, standby letters of credit and financial guarantees were \$28.57 million.

Additionally, the Company had \$63.28 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 September 30, 2013.

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 \$61.66 million at September 30, 2013. The Company recognized a loss of \$818,000 and a gain of \$30,000 for the three-month periods ended September 30, 2013 and 2012, respectively, and recognized a loss of \$282,000 and a gain of \$1.21 million for the nine-month periods ended September 30, 2013 and

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2012, respectively, associated with rate lock commitments, which were recorded as noninterest income in the Company's Statements of Income.

Note 8. Mergers and Acquisitions

Insurance Agencies: Effective July 1, 2013, the Company acquired two insurance agencies, Hooker and Buchanon Incorporated and Yerkey Insurance Agency, Inc., that are affiliated with Towne Insurance Agency ("Towne Insurance"), a wholly-owned subsidiary of TowneBank. The acquisitions were accounted for as business combinations under the acquisition method of accounting in accordance with Accounting Standards Codification Topic ("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 businesses are included in the Company's Consolidated Statements of Income commencing July 1, 2013. The total purchase price for the transactions was \$2.73 million in cash and common stock. The allocation of the purchase price resulted in tangible assets of \$110,000, goodwill of \$1.61 million, other intangible assets, including customer lists of \$1.16 million, and assumed liabilities of \$1.30 million.

The Clement Companies: Effective December 31, 2012, the Company acquired The Clement Companies 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 1, 2013. The purchase price was \$6.30 million in cash and common stock. The allocation of the purchase price resulted in tangible assets of \$616,000, goodwill of \$4.76 million, other intangible assets, including customer lists of \$1.53 million, and assumed liabilities of \$611,000.

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 2012 Annual Report to the Stockholders for more information on the Company's goodwill and other intangibles.

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

	September 30,				December 31, 2012	
	2013		2012			
	Carrying Amount	Accumulated Amortization	Carrying Amount	Accumulated Amortization	Carrying Amount	Accumulated Amortization
Core deposit intangible	\$ 417	\$ 146	\$ 417	\$ 94	\$ 417	\$ 107
Non-compete agreements	1,456	1,275	1,456	1,204	1,456	1,222
Trade name	772	593	252	—	772	555
Customer lists	21,114	8,809	17,920	6,910	19,450	7,351
Total intangible assets subject to amortization	23,759	10,823	20,045	8,208	22,095	9,235
Contractual agreements	3,231	—	3,231	—	3,231	—
Total intangible assets not subject to amortization	3,231	—	3,231	—	3,231	—
Total intangible assets	\$ 26,990	\$ 10,823	\$ 23,276	\$ 8,208	\$ 25,326	\$ 9,235

Amortization expense for intangible assets was \$558,000 and \$507,000 for the three-month periods and \$1.59 million and \$1.74 million for the nine-month periods ended September 30, 2013 and 2012, respectively.

Changes in the net carrying amount of goodwill related to each of the Company's segments since December 31, 2012 are as follows (in thousands):

	Banking	Realty	Insurance	Consolidated Totals
Balance, December 31, 2012	\$ 58,884	\$ 15,825	\$ 28,203	\$ 102,912
Additions to goodwill	—	—	1,606	1,606
Other adjustments	—	—	—	—
Balance, September 30, 2013	\$ 58,884	\$ 15,825	\$ 29,809	\$ 104,518

Note 10. Bank-Owned Life Insurance Policies

The total carrying amount of bank-owned life insurance policies ("BOLI") as of September 30, 2013 was \$56.67 million. The Company had \$54.68 million and \$55.38 million of BOLI at September 30, 2012 and December 31, 2012, respectively. The Company recognized BOLI income, included in other noninterest income, of \$437,000 and \$467,000 for the three-month periods and \$1.29 million and \$1.36 million for the nine-month periods ended September 30, 2013 and 2012, 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.

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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 September 30, 2013	Three Months Ended September 30, 2012
Service cost	\$ 468	\$ 723
Interest cost	223	93
Amortization of actuarial loss	28	—
Net periodic postretirement benefit cost	<u>\$ 719</u>	<u>\$ 816</u>

	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Service cost	\$ 1,505	\$ 1,831
Interest cost	499	372
Amortization of actuarial loss	155	—
Net periodic postretirement benefit cost	<u>\$ 2,159</u>	<u>\$ 2,203</u>

Note 12. Accumulated Other Comprehensive Income (Loss)

Activity within the balances of accumulated other comprehensive income (loss) is shown in following table for the nine months ended September 30, 2013 and 2012 (in thousands):

	Unrealized gains (losses) on securities	Defined benefit retirement plan	Accumulated other comprehensive income (loss), net of tax
Balance, December 31, 2012	\$ 1,699	\$ (883)	\$ 816
Net change	(2,138)	736	(1,402)
Balance, September 30, 2013	<u>\$ (439)</u>	<u>\$ (147)</u>	<u>\$ (586)</u>

	Unrealized gains on securities	Defined benefit retirement plan	Accumulated other comprehensive income, net of tax
Balance, December 31, 2011	\$ 2,754	\$ —	\$ 2,754
Net change	(464)	(547)	(1,011)
Balance, September 30, 2012	<u>\$ 2,290</u>	<u>\$ (547)</u>	<u>\$ 1,743</u>

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Note 13. Other Expenses

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Advertising and marketing	\$ 1,477	\$ 1,165	\$ 4,383	\$ 3,574
Other	1,575	2,372	4,969	5,740
Charitable contributions	749	789	2,664	2,836
Outside processing	787	787	2,577	2,205
Professional fees	1,034	1,153	3,225	3,561
Stationery and supplies	615	459	1,732	1,555
FDIC and other insurance	1,076	915	2,893	2,715
Foreclosed property expenses	582	664	2,436	3,364
Software expense	1,067	1,040	3,187	3,197
Telephone and postage	1,032	880	2,883	2,654
Amortization-intangibles	558	507	1,587	1,743
Bank franchise tax/SCC fees	478	475	1,428	1,396
Directors fees and expenses	295	282	883	886
Travel/meals/entertainment	310	237	1,083	713
Total other expenses	<u>\$ 11,635</u>	<u>\$ 11,725</u>	<u>\$ 35,930</u>	<u>\$ 36,139</u>

Note 14. Variable Interest Entities

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

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Low Income Housing Tax Credit Partnerships

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

For each of the partnerships, the Company acts strictly in a limited partnership capacity. The Company has determined that it is not the primary beneficiary of these partnerships because it does not have the power to direct the activities of the entity that most significantly impact the entity's economic performance. The Company accounts for its limited partner interests in accordance with the accounting guidance for investments in affordable housing projects. Partnership assets of \$46.10 million, \$46.68 million, and \$47.83 million in these partnerships were not included in the Consolidated Balance Sheets at September 30, 2013, September 30, 2012, and December 31, 2012, respectively. These limited partner interests had carrying values of \$14.55 million, \$15.07 million, and \$15.64 million at September 30, 2013, September 30, 2012, and December 31, 2012, 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 \$14.55 million, \$15.07 million, and \$15.64 million at September 30, 2013, September 30, 2012, and December 31, 2012, respectively.

Note 15. Fair Value Disclosures

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

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

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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 nine-month periods ending September 30, 2013, the Company used a weighted average closing ratio of 80%. The Company recognized a loss associated with the rate lock commitments of \$818,000 for the three-month period ended September 30, 2013, and a loss of \$282,000 for the nine-month period ended September 30, 2013, respectively. The carrying value of the interest rate lock commitments was \$962,000 at September 30, 2013 and \$1.24 million at December 31, 2012.

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

	September 30, 2013			
	Level 1	Level 2	Level 3	Total
U.S. agency securities	\$ —	\$ 217,767	\$ —	\$ 217,767
U.S. Treasury notes	—	200,000	—	200,000
Municipal securities	—	36,725	—	36,725
Mortgage-backed securities issued by GSE	—	70,765	—	70,765
Trust preferred and other corporate securities	5	8,500	—	8,505
Interest rate lock commitments	—	—	962	962

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	December 31, 2012			
	Level 1	Level 2	Level 3	Total
U.S. agency securities	\$ —	\$ 3,306	\$ —	\$ 3,306
U.S. Treasury notes	—	300,000	—	300,000
Municipal securities	—	40,084	—	40,084
Mortgage-backed securities issued by GSE	—	101,377	—	101,377
Trust preferred and other corporate securities	4	5,373	—	5,377
Equity securities	12,583	—	—	12,583
Interest rate lock commitments	—	—	1,244	1,244

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 September 30, 2013 (in thousands):

September 30, 2013	Level 1	Level 2	Level 3	Fair Value
Impaired loans	\$ —	\$ 16,865	\$ —	\$ 16,865
Other real estate owned	\$ —	\$ 23,559	\$ 18,356	\$ 41,915

December 31, 2012	Level 1	Level 2	Level 3	Fair Value
Impaired loans	\$ —	\$ 21,387	\$ 17,429	\$ 38,816
Other real estate owned	\$ —	\$ 23,290	\$ 7,007	\$ 30,297

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.

Mortgage 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.

Other Real Estate Owned: 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 6% to 14%.

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Item 1. Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Cash and due from banks, interest-bearing deposits in financial institutions, and federal funds sold:

The carrying amount approximates fair value.

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

Industrial revenue bonds are classified as Level 3 and as such use significant estimates to determine the fair value of these securities. The Company values these securities using a discounted cash flow approach based on assumptions that are generally not observable in the current markets.

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

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

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

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.

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

	Carrying	Estimated			
	Value	Fair Value	Level 1	Level 2	Level 3
September 30, 2013					
Cash and due from banks	\$ 162,688	\$ 162,688	\$ 162,688	\$ —	\$ —
Interest-bearing deposits in financial institutions	1,105	1,105	1,105	—	—
Securities available for sale	533,762	533,762	5	533,757	—
Securities held to maturity	158,471	152,148	—	62,613	89,535
Trading securities	—	—	—	—	—
Mortgage loans held for sale	77,448	77,411	—	77,411	—
Net Loans	3,169,644	3,337,816	—	—	3,337,816
Interest receivable	10,245	10,245	—	10,245	—
Deposits	3,481,459	3,088,054	—	3,088,054	—
Advances from the Federal Home Loan Bank of Atlanta	389,344	419,071	—	419,071	—
Repurchase agreements and other borrowings	48,223	48,223	—	48,223	—
Interest payable	2,302	2,302	—	2,302	—
	Carrying	Estimated			
	Value	Fair Value	Level 1	Level 2	Level 3
December 31, 2012					
Cash and due from banks	\$ 127,967	\$ 127,967	\$ 127,967	\$ —	\$ —
Interest-bearing deposits in financial institutions	1,326	1,326	1,326	—	—
Securities available for sale	450,144	450,144	5	450,139	—
Securities held to maturity	155,481	161,958	—	68,097	93,861
Trading securities	12,583	12,583	12,583	—	—
Mortgage loans held for sale	132,551	132,551	—	132,551	—
Net Loans	3,093,080	3,198,588	—	—	3,198,588
Interest receivable	11,292	11,292	—	11,292	—
Deposits	3,380,052	3,154,645	—	3,154,645	—
Advances from the Federal Home Loan Bank of Atlanta	380,000	421,458	—	421,458	—
Repurchase agreements and other borrowings	12,049	12,049	—	12,049	—
Interest payable	2,719	2,719	—	2,719	—

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Selected Quarterly Information (unaudited) TOWNEBANK

(Dollars in thousands, except per share data)

	Third Quarter 2013	Second Quarter 2013	First Quarter 2013	Fourth Quarter 2012	Third Quarter 2012
Results of Operations:					
Interest income	\$ 42,695	\$ 42,591	\$ 41,903	\$ 43,651	\$ 44,216
Interest expense	6,543	6,514	6,693	7,040	7,232
Net interest income	36,152	36,077	35,210	36,611	36,984
Provision for loan losses	328	(202)	3,571	2,959	4,977
Net interest income after provision for loan losses	35,824	36,279	31,639	33,652	32,007
Noninterest income:					
Residential mortgage banking income, net	6,725	8,918	7,818	7,424	7,329
Real estate brokerage and property management income, net	3,577	3,460	3,372	1,735	3,115
Insurance commissions and other title fees and income, net	7,477	6,838	7,982	5,073	5,978
Service charges on deposit accounts	2,256	2,185	2,030	2,044	2,047
Credit card merchant fees, net	968	905	853	744	931
Other income	1,985	2,157	1,699	1,975	2,274
Gain (loss) on investment securities	150	(208)	604	(33)	508
Total noninterest income	23,138	24,255	24,358	18,962	22,182
Noninterest expense:					
Salaries and benefits	25,642	25,244	23,626	22,735	23,249
Occupancy expense	4,171	3,930	3,772	3,832	3,636
Furniture and equipment	1,931	1,821	1,723	1,690	1,621
Other expenses	11,635	12,822	11,475	12,089	11,725
Total noninterest expense	43,379	43,817	40,596	40,346	40,231
Income before noncontrolling interest and income tax	15,583	16,717	15,401	12,268	13,958
Provision for income tax expense	4,407	4,707	4,366	2,446	4,063
Net income	11,176	12,010	11,035	9,822	9,895
Net income from noncontrolling interest	(758)	(811)	(564)	(206)	(545)
Net income attributable to TowneBank	\$ 10,418	\$ 11,199	\$ 10,471	\$ 9,616	\$ 9,350
Net income available to common shareholders	\$ 9,078	\$ 9,855	\$ 9,119	\$ 8,262	\$ 7,995
Per Share Data:					
Net income:					
Basic	\$ 0.28	\$ 0.32	\$ 0.29	\$ 0.27	\$ 0.26
Diluted	0.28	0.31	0.29	0.27	0.26
Book value at period end	14.17	13.61	13.47	13.30	13.14
Tangible book value at period end	10.70	9.87	9.72	9.52	9.53
Cash dividends declared	0.10	0.09	0.09	0.08	0.08
Common Stock Closing Price:					
High	\$ 17.13	\$ 15.50	\$ 16.00	\$ 15.90	\$ 15.86
Low	14.05	13.43	14.40	14.07	13.76
Close	14.42	14.72	14.97	15.49	15.33
Selected Financial Ratios:					
Return on average assets	0.90%	1.01%	0.98%	0.88%	0.88%
Return on average tangible assets	0.93%	1.04%	1.01%	0.90%	0.90%
Return on average equity	7.17%	7.85%	7.51%	6.85%	6.73%
Return on average tangible equity	9.08%	9.90%	9.50%	8.59%	8.47%
Net interest margin (tax-equivalent basis) (1)	3.53%	3.67%	3.72%	3.82%	3.95%
Daily Averages:					
Total assets	\$ 4,580,200	\$ 4,439,414	\$ 4,344,104	\$ 4,362,506	\$ 4,239,838
Total tangible assets	4,459,213	4,321,112	4,225,287	4,249,403	4,126,309
Loans, net of unearned income, excluding nonaccrual loans	3,168,042	3,150,527	3,102,257	3,020,532	2,958,789
Total earning assets (1)	4,185,420	4,064,556	3,963,000	3,976,463	3,850,305
Total deposits	3,493,377	3,377,077	3,314,687	3,345,262	3,332,845
FHLB advances	389,409	382,505	380,000	380,000	283,261
Total equity	576,257	571,955	565,871	558,265	552,541
Tangible equity	455,270	453,653	447,054	445,162	439,012
Basic weighted average shares outstanding	32,244,260	31,271,368	31,263,667	31,117,019	31,118,698
Diluted weighted average shares outstanding	32,303,012	31,296,840	31,330,480	31,184,036	31,175,350

(1) Includes bank-owned life insurance.

PART I. FINANCIAL INFORMATION

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

Our Management's Discussion and Analysis of Financial Condition and Results of Operations is intended to assist readers in understanding and evaluating our consolidated results of operations and financial condition. The following should be read in conjunction with our 2012 audited Consolidated Financial Statements and the 2012 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 2012 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 September 30, 2013:

- Net income for the three months ended September 30, 2013 was \$10.42 million, or \$0.28 per common diluted share, compared with \$9.35 million, or \$0.26 per diluted share, in the same period in 2012. Net income for the nine months ended September 30, 2013 was \$32.09 million, or \$0.89 per common diluted share, compared with \$28.32 million, or \$0.76 per common diluted share, in the nine

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

months ended September 30, 2012. Net income available to common shareholders for the third quarter of 2013 was \$9.08 million after preferred dividend payments compared with \$8.00 million in the same period of 2012.

- Net interest income decreased \$832,000, or 2.25%, in the third quarter of 2013 from the comparable period in 2012. The decrease was primarily due to the decline in yields in earning assets and was partially offset by the continued decline in funding costs.
- The provision for loan losses decreased \$4.65 million, or 93.41%, from the comparative three-month period of 2012, and decreased \$9.50 million, or 71.99% from the comparative nine-month period of 2012. The loan loss reserve decreased to 1.20% of loans at September 30, 2013 from 1.23% at June 30, 2013 and 1.30% at September 30, 2012. The decrease in the provision for loan losses in the current year periods from the comparative prior periods was primarily a result of continued improvements in credit quality combined with a moderation in the pace of loan growth since year-end.
- Excluding gains on investment securities, noninterest income for the three- and nine-month periods ended September 30, 2013 increased by \$1.31 million, or 6.06%, and \$9.02 million, or 14.50%, respectively, compared to the comparative periods in 2012. The increase from the comparable three-month period in the prior year was related to increases in our Insurance segment partially due to our acquisitions of two insurance agencies on July 1, 2013 and one agency on December 31, 2012 and increases in real estate brokerage income. The increase from the comparable nine-month period in the prior year was related to increases in our Insurance segment and increases in residential mortgage banking income.
- For the three- and nine-month periods ended September 30, 2013, noninterest expense increased \$3.15 million, or 7.82%, and \$9.39 million, or 7.93%, respectively, compared to the same periods in 2012. The increase from the prior year comparative periods was driven by growth in our operations support personnel, expansion of our mortgage operations, and insurance agency acquisitions, which led to higher personnel costs and occupancy expenses.
- Our effective tax rate decreased to 29.73% for the third quarter of 2013, a decrease from 30.29% in the comparative period of 2012. For the nine months ended September 30, 2013, the effective tax rate increased to 29.58% compared to 28.92% for the same period in 2012. The decrease from the prior year quarter was primarily a result of a slight increase in federal tax credits from community reinvestment activity combined with a decrease in disallowed expenses, which offset the increase in taxable income. The increase from the prior year nine-month period was a result of the increase in taxable income more than offsetting the increase in federal tax credits from community reinvestment activity.
- Due to our small-business loan growth, the Company qualified for the lowest dividend tier on its Senior Non-Cumulative Perpetual Preferred Stock, Series C ("Series C Preferred Stock"). The dividend rate on the Series C Preferred Stock will be fixed at 1% through the end of 2015.

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,

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assumptions, and estimates in certain circumstances that affect amounts reported in the consolidated financial statements and the accompanying footnotes. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from management's current judgments. We consider our policies for the allowance for loan losses, other real estate owned, deferred income taxes, estimates of fair value of financial instruments, and goodwill and other intangibles to be critical accounting policies. Refer to our 2012 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 0.90% for the third quarter of 2013 compared to 0.88% for the third quarter of 2012, and 1.01% for the second quarter of 2013. The annualized return on average tangible assets was 0.93%, 0.90%, and 1.04% for the same respective periods. ROA for the nine months ended September 30, 2013 was 0.96% compared to 0.91% for the nine months ended September 30, 2012. In comparison to the prior year periods, ROA was positively affected by the increase in noninterest income and the decrease in the provision for loan losses as the growth in average assets was outpaced by the increase in net income.

The annualized return on average equity ("ROE") was 7.17% for the third quarter of 2013, 6.73% for the third quarter of 2012, and 7.85% for the second quarter of 2013, while the annualized return on average tangible equity was 9.08%, 8.47%, and 9.90% for the same respective periods. ROE for the nine months ended September 30, 2013 was 7.51%, compared to 6.99% for the nine months ended September 30, 2012.

Operating income, calculated as net interest income and noninterest income less gains on investment securities, was \$59.14 million for the quarter ended September 30, 2013, which increased \$482,000, or 0.82%, compared to the quarter ended September 30, 2012. Operating income was \$60.54 million for the quarter ended June 30, 2013. For the nine months ended September 30, 2013, operating income was \$178.64 million, reflecting an increase of \$8.78 million, or 5.17% over comparative 2012.

Basic earnings per share were \$0.28 for the three months ended September 30, 2013 compared to \$0.26 in comparative 2012, while basic earnings per share for the nine months ended September 30, 2013 increased to \$0.89 from \$0.76 in comparative 2012. Diluted earnings per share increased to \$0.28 for the three months ended September 30, 2013 from \$0.26 in comparative 2012, while diluted earnings per share for the nine months ended September 30, 2013 increased to \$0.89 from \$0.76 in comparative 2012. Earnings per share were positively affected, as compared to the comparative prior year period, by the reduction of preferred dividends due to the Company's participation in the Small Business Lending Fund program. Due to the Company's loan growth, the blended dividend rate was 1.0% for both the third and second quarters of 2013, as well as the third quarter of 2012. Earnings per share were affected in the current period by an increase in common shares related to the mandatory conversion of the remaining shares of TowneBank 8% Non-Cumulative Convertible Preferred Stock, Series A ("Series A preferred stock") on September 1, 2013.

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

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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 \$37.27 million for the quarter ended September 30, 2013, which was \$952,000, or 2.49%, less than the year ago amount of \$38.22 million. On a linked quarter basis, tax-equivalent net interest income increased by \$68,000, or 0.18%, from the \$37.20 million reported for the second quarter of 2013. In comparison to the prior year comparative period, net interest income decreased due to declines in interest income, partially offset by lower funding costs. The increase from the linked period was primarily due to an increase in average earning assets, which was partially offset by the increase in average interest bearing liabilities.

Interest income, on a tax-equivalent basis, was \$43.81 million for the quarter ended September 30, 2013, which was \$1.64 million, or 3.61%, lower than the \$45.45 million reported for the period ended September 30, 2012. On a linked quarter basis, tax-equivalent interest income increased \$97,000, or 0.22%, from \$43.71 million in the second quarter of 2013. Average earning assets grew to \$4.19 billion in the quarter ended September 30, 2013, from \$3.85 billion in the comparative prior year quarter, an increase of \$335.12 million, or 8.70%. In the linked quarter comparison, average earning assets increased by \$120.86 million, or 2.97%, from \$4.06 billion in the second quarter of 2013. The yield on earning assets was 4.15% in the quarter ended September 30, 2013, which compared to 4.70% in the comparative prior year period and 4.31% in the linked period. Average loan balances, excluding nonaccrual loans, of \$3.17 billion were \$209.25 million, or 7.07%, higher in the third quarter of 2013 than in the same period a year ago, while loan yields declined by 43 basis points. In the linked quarter, loans grew \$17.52 million or 0.56% and loan yields were 10 basis points lower. The decrease in interest income from the comparative prior year period was driven by yield declines, which were seen in all categories except for interest-bearing deposits and loans held for sale. The decrease was partially offset by higher balances on loans and taxable securities. In the linked quarter comparison, the increase in interest income was primarily due to increases in interest income from taxable investment securities resulting from a combination of an increase in balances and rate improvements. The increase was partially offset by yield declines on loans.

Interest expense, for the quarter ended September 30, 2013, was \$6.54 million, which was \$689,000 or 9.53% below the \$7.23 million amount in the year ago quarter. The average balance of interest-bearing liabilities increased to \$2.88 billion in the third quarter of 2013 from \$2.69 billion in the comparative prior year quarter, an increase of 7.12%. On a linked quarter basis, interest expense increased by \$29,000, or 0.45%, from \$6.51 million in the second quarter of 2013. In the linked quarter, average interest bearing liabilities increased by \$100.45 million, or 3.62%, from \$2.78 billion in the quarter ended June 30, 2013. The decline in interest expense as compared to the prior year period was driven by lower costs in all deposit categories, offset by increased borrowings. In the linked quarter comparison, lower costs were more than offset by increases in average deposits and borrowings.

Net interest margin, which is net interest income expressed as a percentage of average earning assets, was 3.53% in the quarter ended September 30, 2013, which was 42 basis points lower than the 3.95% margin of the September 30, 2012 quarter and 14 basis points lower than the 3.67% margin of the June 30, 2013 quarter. The margin compression in comparison to both prior periods resulted from falling asset yields and growth in earning assets.

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

	Three Months Ended September 30, 2013			Three Months Ended June 30, 2013			Three Months Ended September 30, 2012		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
Assets:									
Loans (net of unearned income and deferred costs), excluding nonaccrual loans	\$ 3,168,042	\$ 39,143	4.90%	\$ 3,150,527	\$ 39,253	5.00%	\$ 2,958,789	\$ 39,623	5.33%
Taxable investment securities	371,817	1,102	1.19%	323,969	887	1.10%	232,796	1,784	3.07%
Tax-exempt investment securities	167,313	1,729	4.13%	169,341	1,751	4.14%	168,064	1,904	4.53%
Interest bearing deposits	318,944	202	0.25%	245,908	155	0.25%	297,355	189	0.25%
Loans held for sale	102,923	962	3.74%	118,863	1,010	3.40%	138,930	1,231	3.54%
Bank-owned life insurance	56,381	672	4.73%	55,948	657	4.71%	54,371	720	5.26%
Total earning assets	4,185,420	43,810	4.15%	4,064,556	43,713	4.31%	3,850,305	45,451	4.70%
Less: allowance for loan losses	(39,113)			(40,127)			(40,463)		
Total nonearning assets	433,892			414,985			429,996		
Total Assets	<u>\$ 4,580,199</u>			<u>\$ 4,439,414</u>			<u>\$ 4,239,838</u>		
Liabilities and Equity:									
Interest bearing deposits									
Demand and money market	\$ 1,177,446	\$ 762	0.26%	\$ 1,148,170	\$ 757	0.26%	\$ 1,084,821	\$ 1,108	0.41%
Savings	206,638	158	0.30%	206,671	169	0.33%	194,180	246	0.50%
Certificates of deposit	1,055,705	2,293	0.86%	999,191	2,328	0.93%	1,112,558	2,849	1.02%
Total interest bearing deposits	2,439,789	3,213	0.52%	2,354,032	3,254	0.55%	2,391,559	4,203	0.70%
Borrowings	438,739	3,330	3.04%	424,050	3,260	3.04%	295,620	3,029	4.01%
Total interest bearing liabilities	2,878,528	6,543	0.90%	2,778,082	6,514	0.94%	2,687,179	7,232	1.07%
Demand deposits	1,053,588			1,023,045			941,286		
Other noninterest bearing liabilities	71,826			66,332			58,832		
Total liabilities	4,003,942			3,867,459			3,687,297		
Shareholders' equity	576,257			571,955			552,541		
Total liabilities and equity	<u>\$ 4,580,199</u>			<u>\$ 4,439,414</u>			<u>\$ 4,239,838</u>		
Net interest income (tax-equivalent basis)		\$ 37,267			\$ 37,199			\$ 38,219	
Reconciliation of Non-GAAP Financial Measures									
Bank-Owned Life Insurance		(672)			(657)			(720)	
Tax-equivalent basis adjustment		(443)			(465)			(515)	
Net interest income (GAAP)		<u>\$ 36,152</u>			<u>\$ 36,077</u>			<u>\$ 36,984</u>	
Interest rate spread (1)			3.25%			3.37%			3.63%
Interest expense as a percent of average earning assets			0.62%			0.64%			0.75%
Net interest margin (tax equivalent basis) (2)			3.53%			3.67%			3.95%
Total cost of deposits			0.37%			0.39%			0.50%

(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.

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(Dollars in thousands)

	Increase/(Decrease) Three Months Ended September 30, 2013 Compared to Three Months Ended June 30, 2013			Increase/(Decrease) Three Months Ended September 30, 2013 Compared to Three Months Ended September 30, 2012		
	Volume	Rate (1)	Total	Volume	Rate (1)	Total
Assets:						
Loans	\$ 313	\$ (424)	\$ (111)	\$ 2,732	\$ (3,212)	\$ (480)
Taxable investment securities	138	78	216	745	(1,427)	(682)
Tax-exempt investment securities	(21)	(1)	(22)	(9)	(166)	(175)
Interest bearing deposits	48	(1)	47	12	1	13
Loans held for sale	(143)	95	(48)	(335)	66	(269)
Bank-owned life insurance	10	5	15	26	(74)	(48)
Total earning assets	345	(248)	97	3,171	(4,812)	(1,641)
Liabilities and Equity:						
Interest bearing deposits						
Demand and money market	23	(18)	5	90	(436)	(346)
Savings	—	(11)	(11)	14	(102)	(88)
Certificates of deposit	138	(172)	(34)	(138)	(417)	(555)
Total interest bearing deposits	161	(201)	(40)	(34)	(955)	(989)
Borrowings	78	(9)	69	1,170	(870)	300
Total interest bearing liabilities	239	(210)	29	1,136	(1,825)	(689)
Net interest income	\$ 106	\$ (38)	\$ 68	\$ 2,035	\$ (2,987)	\$ (952)

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

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	Nine Months Ended			Nine Months Ended			Nine Months Ended September 30, 2013		
	September 30, 2013			September 30, 2012			Compared with September 30, 2012		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Increase (Decrease)	Change due to Rate	Volume
Assets:									
Loans (net of unearned income and deferred costs), excluding nonaccrual loans	\$ 3,140,516	\$116,962	4.98%	\$ 2,873,429	\$116,968	5.44%	\$ (6)	\$ (6,872)	\$ 6,866
Taxable investment securities	316,370	2,973	1.25%	268,143	5,099	2.54%	(2,126)	(2,473)	347
Tax-exempt investment securities	168,720	5,218	4.12%	155,887	5,484	4.69%	(266)	(516)	250
Interest bearing deposits	278,613	526	0.25%	286,433	543	0.25%	(17)	1	(18)
Loans held for sale	111,633	2,876	3.44%	118,760	3,249	3.65%	(373)	(185)	(188)
Bank-owned life insurance	55,954	1,981	4.73%	53,921	2,100	5.20%	(119)	(158)	39
Total earning assets	4,071,806	130,536	4.29%	3,756,573	133,443	4.74%	(2,907)	(10,203)	7,296
Less: allowance for loan losses	(40,009)			(40,251)					
Total nonearning assets	423,640			431,054					
Total Assets	<u>\$ 4,455,437</u>			<u>\$ 4,147,376</u>					
Liabilities and Equity:									
Interest bearing deposits									
Demand and money market	\$ 1,152,841	\$ 2,400	0.28%	\$ 1,052,437	\$ 3,316	0.42%	\$ (916)	\$ (1,040)	\$ 124
Savings	206,733	544	0.35%	194,397	768	0.53%	(224)	(243)	19
Certificates of deposit	1,026,258	7,019	0.91%	1,120,374	8,824	1.05%	(1,804)	(1,093)	(711)
Total interest bearing deposits	2,385,832	9,963	0.56%	2,367,208	12,908	0.73%	(2,944)	(2,376)	(568)
Borrowings	419,082	9,787	3.11%	292,958	9,037	4.05%	750	(1,532)	2,282
Subordinated debentures	—	—	—%	3,941	237	8.02%	(238)	(119)	(119)
Total interest bearing liabilities	2,804,914	19,750	0.94%	2,664,107	22,182	1.11%	(2,432)	(4,027)	1,595
Demand deposits	1,009,870			883,553					
Other noninterest bearing liabilities	69,254			58,414					
Total liabilities	3,884,038			3,606,074					
Shareholders' equity	571,399			541,302					
Total liabilities and equity	<u>\$ 4,455,437</u>			<u>\$ 4,147,376</u>					
Net interest income (tax-equivalent basis)		\$110,786			\$111,261		\$ (475)	\$ (6,176)	\$ 5,701
Reconcilement of Non-GAAP Financial Measures									
Bank-Owned Life Insurance		(1,981)			(2,100)		119		
Tax-equivalent basis adjustment		(1,366)			(1,488)		122		
Net interest income (GAAP)		<u>\$107,439</u>			<u>\$107,673</u>		<u>\$ (234)</u>		
Interest rate spread (1)			3.34%			3.63%			
Interest expense as a percent of average earning assets			0.65%			0.79%			
Net interest margin (tax equivalent basis) (2)			3.64%			3.96%			
Total cost of deposits			0.39%			0.53%			

(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.

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Noninterest Income. Total noninterest income, excluding securities gains or losses, for the quarter ended September 30, 2013 was \$22.99 million, an increase of \$1.31 million, or 6.06%, compared to the same period in 2012 and a decrease of \$1.48 million, or 6.03%, compared to the second quarter of 2013. As a percentage of total operating income, noninterest income, excluding securities gains or losses, for the third quarter of 2013 was 38.87%, compared with 36.95% for comparative 2012 and 40.41% for the second quarter of 2013.

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 September 30,		Increase/(Decrease) 2013 over 2012	
	2013	2012	Amount	Percent
Residential mortgage banking income, net	\$ 6,725	\$ 7,329	\$ (604)	(8.24)%
Real estate brokerage and property management, net	3,577	3,115	462	14.83 %
Insurance commissions and other title fees and income, net	7,477	5,978	1,499	25.08 %
Service charges on deposit accounts	2,256	2,047	209	10.21 %
Credit card merchant fees, net	968	931	37	3.97 %
Other income	1,985	2,274	(289)	(12.71)%
Subtotal before gain on investment securities	22,988	21,674	1,314	6.06 %
Net gain (loss) on investment securities	150	508	(358)	(70.47)%
Total noninterest income	<u>\$ 23,138</u>	<u>\$ 22,182</u>	<u>\$ 956</u>	<u>4.31 %</u>

	Three Months Ended		Increase/(Decrease) Third Quarter 2013 over Second Quarter 2013	
	September 30, 2013	June 30, 2013	Amount	Percent
Residential mortgage banking income, net	\$ 6,725	\$ 8,918	\$ (2,193)	(24.59)%
Real estate brokerage and property management, net	3,577	3,460	117	3.38 %
Insurance commissions and other title fees and income, net	7,477	6,838	639	9.34 %
Service charges on deposit accounts	2,256	2,185	71	3.25 %
Credit card merchant fees, net	968	905	63	6.96 %
Other income	1,985	2,157	(172)	(7.97)%
Subtotal before gain on investment securities	22,988	24,463	(1,475)	(6.03)%
Net gain (loss) on investment securities	150	(208)	358	N/M
Total noninterest income	<u>\$ 23,138</u>	<u>\$ 24,255</u>	<u>\$ (1,117)</u>	<u>(4.61)%</u>

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	Nine Months Ended September 30,		Increase/(Decrease) 2013 over 2012	
	2013	2012	Amount	Percent
Residential mortgage banking income, net	\$ 23,461	\$ 19,573	\$ 3,888	19.86 %
Real estate brokerage and property management, net	10,409	9,781	628	6.42 %
Insurance commissions and other title fees and income, net	22,297	18,385	3,912	21.28 %
Service charges on deposit accounts	6,471	5,755	716	12.44 %
Credit card merchant fees, net	2,726	2,834	(108)	(3.81)%
Other income	5,841	5,861	(20)	(0.34)%
Subtotal before gain on sale of investment securities	71,205	62,189	9,016	14.50 %
Net gain on investment securities	546	3,038	(2,492)	(82.03)%
Total noninterest income	<u>\$ 71,751</u>	<u>\$ 65,227</u>	<u>\$ 6,524</u>	10.00 %

For the third quarter of 2013, residential mortgage banking income, net of commission expense was \$6.73 million, reflecting a decrease of \$604,000, or 8.24%, compared to the third quarter of 2012 and a decrease of \$2.19 million, or 24.59%, compared to the second quarter of 2013. For the nine-month period ended September 30, 2013, residential mortgage brokerage income, net of commission expense was \$23.46 million, reflecting an increase of \$3.89 million, or 19.86%, compared to the same period in 2012. The increase from prior year nine-month period was primarily due to the continued expansion of our mortgage operations, as the Company expanded into Pennsylvania in December 2012 and previously added enterprises are now fully operational. Also contributing to the increase were the continued improvements in the housing market, which led to a higher volume in purchase transactions in the first half of the current year. The decrease from the comparative three-month periods was primarily due to lower production volumes related to rising rates and lower revenue margins. Also factoring in the variance from the prior year periods was the loss recognized on rate lock commitments of \$818,000 for the quarter ended September 30, 2013, as compared to a loss of \$28,000 and a gain of \$30,000 recognized for the quarters ended June 30, 2013 and September 30, 2012, respectively.

Real estate brokerage and property management income, net of commission expense, for the third quarter of 2013 was \$3.58 million, which was \$462,000 or 14.83%, higher than comparative 2012, and \$117,000, or 3.38%, more than the second quarter of 2013. The increase for the nine-month period was \$628,000, or 6.42%, from the comparative period. The change from 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 \$89.64 million, or 40.97%, from the prior year quarter, and \$22.29 million, or 7.79%, from the linked quarter. The increase in real estate brokerage income in the linked quarter was due to a rise in property management fees of \$203,000. The increase in the nine-month period was primarily due to an increase in real estate brokerage income resulting from a rise in total volume of units sold of \$124.40 million, or 19.58%, from the prior year, which was partially offset by a decrease of \$106,000 in net property management fees.

For the third quarter of 2013, insurance commissions and other title income, net of commission expense was \$7.48 million, which was \$1.50 million, or 25.08%, higher than comparative 2012, and \$639,000, or 9.34%, higher than the second quarter 2013. For the nine-month period, insurance commissions and other title income, net of commission expense, was \$3.91 million, or 21.28%, higher than comparative 2012.

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The increase from both prior year periods was largely due to the acquisition of an insurance agency in December 2012 and two agencies in July 2013, which contributed additional commission and fee income of \$1.08 million and \$2.47 million for the three- and nine-month periods ending September 30, 2013. The increase in the linked quarter comparison is largely due to the acquisition of the agencies in July 2013, which contributed additional commission and fee income of \$420,000.

For the third quarter of 2013, credit card merchant fees totaled \$968,000, which was \$37,000, or 3.97%, higher than comparative 2012, and \$63,000, or 6.96%, higher than the second quarter of 2013. For the nine months ended September 30, 2013, credit card merchant fees totaled \$2.73 million, which was \$108,000, or 3.81%, lower than comparative 2012. For both periods, the variances were primarily related to changes in transaction volume.

Service charges on deposit accounts were \$2.26 million for the third quarter of 2013, compared with \$2.05 million for the comparative 2012, and \$2.19 million for the second quarter of 2013, respectively. For the nine months ended September 30, 2013, service charges on deposit accounts were \$6.47 million, which was \$716,000, or 12.44%, higher than comparative 2012. The increases reflect the 4.82% and 3.44% increases in average deposits from the third quarter of 2012 and the second quarter of 2013, respectively.

Other noninterest income for the three and nine months ended September 30, 2013 was \$1.99 million and \$5.84 million, respectively, and included income generated by Towne Investment Group, net of commission expense. For the three months ended September 30, 2013, net commission income totaled \$464,000 as compared to \$460,000 for the comparative period of 2012 and \$523,000 for Towne Investment Group for the second quarter of 2013.

Noninterest Expense. For the quarter ended September 30, 2013, total noninterest expense was \$43.38 million, which was \$3.15 million, or 7.82%, higher than comparative 2012 and \$438,000, or 1.0%, less than the quarter ended June 30, 2013. For the nine months ended September 30, 2013, total noninterest expense increased \$9.39 million, or 7.93%, from comparative 2012 to \$127.79 million.

As a percentage of operating income, noninterest expense was 73.35% for the third quarter of 2013, 68.59% for comparative 2012, and 72.38% for the quarter ended June 30, 2013. The primary components of noninterest expense in the third quarter of 2013 were salaries and employee benefits of \$25.64 million, occupancy expenses of \$4.17 million, furniture and equipment expenses of \$1.93 million, advertising and marketing expenses of \$1.48 million, and professional fees of \$1.03 million. In comparison to the prior periods, a significant portion of the increase in total noninterest expense is due to the insurance agency acquisitions in December 2012 and July 2013, which resulted in additional expenses of \$1.01 million as compared to the third quarter of 2012 and \$345,000 as compared to the second quarter of 2013. Also contributing to the increase from the third quarter of 2012, was the expansion of our mortgage operations into Pennsylvania, which resulted in additional expenses of \$690,000.

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

	Three Months Ended			Increase/(Decrease)			
				September 30, 2013 over September 30, 2012		September 30, 2013 over June 30, 2013	
	September 30,		June 30,	September 30, 2012		June 30, 2013	
	2013	2012	2013	Amount	Percent	Amount	Percent
Salaries and benefits	\$ 25,642	\$ 23,249	\$ 25,244	\$ 2,393	10.29 %	\$ 398	1.58 %
Occupancy expense	4,171	3,636	3,930	535	14.71 %	241	6.13 %
Furniture and equipment	1,931	1,621	1,821	310	19.12 %	110	6.04 %
Other							
Advertising and marketing	1,477	1,165	1,725	312	26.78 %	(248)	(14.38)%
Other	1,575	2,372	1,772	(797)	(33.60)%	(197)	(11.12)%
Charitable contributions	749	789	997	(40)	(5.07)%	(248)	(24.87)%
Outside processing	787	787	962	—	— %	(175)	(18.19)%
Professional fees	1,034	1,153	1,051	(119)	(10.32)%	(17)	(1.62)%
Stationery and supplies	615	459	625	156	33.99 %	(10)	(1.60)%
FDIC and other insurance	1,076	915	1,023	161	17.60 %	53	5.18 %
Foreclosed property expenses	582	664	1,020	(82)	(12.35)%	(438)	(42.94)%
Software expense	1,067	1,040	1,057	27	2.60 %	10	0.95 %
Telephone and postage	1,032	880	887	152	17.27 %	145	16.35 %
Amortization - intangibles	558	507	506	51	10.06 %	52	10.28 %
Bank franchise tax/SCC fees	478	475	469	3	0.63 %	9	1.92 %
Directors fees and expenses	295	282	290	13	4.61 %	5	1.72 %
Travel/meals/entertainment	310	237	438	73	30.80 %	(128)	(29.22)%
Total other expenses	11,635	11,725	12,822	(90)	(0.77)%	(1,187)	(9.26)%
Total noninterest expense	\$ 43,379	\$ 40,231	\$ 43,817	\$ 3,148	7.82 %	\$ (438)	(1.00)%

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	Nine Months Ended September 30,		Increase/(Decrease) 2013 over 2012	
	2013	2012	Amount	Percent
Salaries and benefits	\$ 74,511	\$ 66,934	\$ 7,577	11.32 %
Occupancy expense	11,874	10,552	1,322	12.53 %
Furniture and equipment	5,477	4,778	699	14.63 %
Other				
Advertising and marketing	4,383	3,574	809	22.64 %
Other	4,969	5,740	(771)	(13.43)%
Charitable contributions	2,664	2,836	(172)	(6.06)%
Outside processing	2,577	2,205	372	16.87 %
Professional fees	3,225	3,561	(336)	(9.44)%
Stationery and supplies	1,732	1,555	177	11.38 %
FDIC and other insurance	2,893	2,715	178	6.56 %
Foreclosed property expenses	2,436	3,364	(928)	(27.59)%
Software expense	3,187	3,197	(10)	(0.31)%
Telephone and postage	2,883	2,654	229	8.63 %
Amortization - intangibles	1,587	1,743	(156)	(8.95)%
Bank franchise tax/SCC fees	1,428	1,396	32	2.29 %
Directors fees and expenses	883	886	(3)	(0.34)%
Travel/meals/entertainment	1,083	713	370	51.89 %
Total other expenses	35,930	36,139	(209)	(0.58)%
Total noninterest expense	\$ 127,792	\$ 118,403	\$ 9,389	7.93 %

Salary and benefits expense, the largest portion of noninterest expense, was \$25.64 million, representing 59.11% of total noninterest expense for the quarter ended September 30, 2013 and 58.31% for the nine months ended September 30, 2013. Salary and benefits expense increased \$2.39 million, or 10.29%, and \$7.58 million, or 11.32%, over the comparative three- and nine-month periods in 2012 and \$398,000, or 1.58%, over the second quarter of 2013. The increase from both comparative periods of the prior year is primarily due to the addition of staff resulting from the insurance and mortgage expansions and increased operational support, an increase in payroll tax expense, and an increase in profit sharing and incentive expenses. The increase from the linked quarter is primarily due to increases related to our mortgage and insurance operations, and an increase in profit sharing and incentive expenses. The increase in the linked quarter was partially offset by a decrease in payroll taxes.

In our Banking segment we had a total of 663 full-time equivalent employees ("FTE") at September 30, 2013, which was up from 632 at September 30, 2012 and down from 683 at June 30, 2013. In our non-Banking segments at September 30, 2013, we had a total of 734 FTEs, excluding real estate sales agents, which was up from 583 at September 30, 2012 and down from 736 at June 30, 2013. Real estate sales agents are independent contractors, and therefore not included as our employees. Total operating income per FTE was \$42,000 for the quarter ended September 30, 2013, decreased from \$48,000 for the three-month period ended September 30, 2012, and decreased from \$43,000 for the three-month period ended June 30, 2013.

Occupancy expense for the third quarter of 2013 experienced a \$535,000, or 14.71% increase from the comparative quarter of 2012, and a \$241,000, or 6.13% increase from second quarter 2013. Occupancy expense for the nine months ended September 30, 2013 increased \$1.32 million, or 12.53%, from

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comparative 2012. The increase from the comparative periods in the prior year was primarily driven by increases related to our mortgage operations, higher maintenance and repair expenses, and increased depreciation expense. The increase from the sequential quarter was primarily a result of increases in rent expense and higher maintenance and repair expenses.

For the three- and nine-month periods ended September 30, 2013, furniture and equipment expense increased by \$310,000 and \$699,000, respectively, over comparative 2012 and by \$110,000 compared with the second quarter of 2013. Increases from comparative prior periods were related to furnishing new facilities and the associated depreciation expense on the capitalized furnishings utilized in those facilities.

Other noninterest expenses for the third quarter of 2013 saw a decrease of \$90,000, or 0.77%, compared to the same period in 2012, and a decrease for the first nine months 2013 of \$209,000, or 0.58%, compared to the same period in 2012, and a decrease of \$1.19 million, or 9.26%, when compared to second quarter of 2013. The primary drivers of the decrease from the comparative prior year periods were decreases in expenses related to foreclosed properties, professional fees, and other expenses due to an impairment charge taken in the third quarter of 2012 on a building that was razed on a bank-owned property that is intended to be the site of a future branch. The increases were partially offset by higher advertising and marketing expenses. The linked quarter decrease was driven by reductions in expenses related to foreclosed properties, advertising and marketing, and charitable contributions.

Provision for Income Taxes. We reported a provision for income tax expense of \$4.41 million, representing an effective tax rate of 29.73% in the third quarter of 2013. The provision for income tax expense was \$4.06 million for the third quarter of 2012, with an effective rate of 30.29%, and \$4.71 million, with an effective rate of 29.59% in the second quarter of 2013. For the year-to-date period of 2013, the effective tax rate increased to 29.58% compared to 28.92% for the same period in 2012. The decrease from the prior year comparable quarter was primarily a result of a slight increase in federal tax credits from community reinvestment activity combined with a decrease in disallowed expenses, which offset the increase in taxable income. The increase from the prior year nine-month period was a result of the increase in taxable income more than offsetting the increase in federal tax credits from community reinvestment activity.

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

Banking Segment. For the three months ended September 30, 2013, the Banking segment represented 85.62%, or \$8.92 million, of our total consolidated net income compared to 70.85%, or \$6.63 million, for comparative 2012. For the nine months ended September 30, 2013, the Banking segment represented 77.00%, or \$24.71 million, of our total consolidated net income compared to 71.04%, or \$20.12 million, for comparative 2012.

Pre-tax earnings for the three months ended September 30, 2013 for the Banking segment were \$12.64 million, increasing \$3.61 million, or 39.99%, from comparative 2012. The increase in earnings from the comparative 2012 quarter was primarily driven by decreases in the provision for loan losses of \$4.65 million and noninterest expenses of \$411,000, which were partially offset by decreases in net interest income of \$653,000 and noninterest income of \$689,000.

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Noninterest expenses decreased by \$411,000, or 1.50%, in the third quarter of 2013 compared to the third quarter of 2012. The increase in salaries and employee benefits expense of \$332,000, or 2.16% and furniture and equipment expense of \$206,000, or 15.88% was offset by a reduction in other expenses of \$1.02 million or 12.72%. The increase in salaries and employee benefits expense was mainly driven by additional credit administration and technology professionals. The increase in furniture and equipment expense is a result of additional depreciation expense. The decrease in other expenses was primarily due to an impairment charge taken in the third quarter of 2012 on a building that was razed on a bank-owned property that is intended to be the site of a future branch.

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)			
	September 30,		June 30, 2013	2013 over 2012		September over June	
	2013	2012		Amount	Percent	Amount	Percent
Net interest income	\$35,519	\$36,172	\$ 35,393	\$ (653)	(1.81)%	\$ 126	0.36 %
Service charges on deposit accounts	2,256	2,047	2,185	209	10.21 %	71	3.25 %
Credit card merchant fees	968	931	905	37	3.97 %	63	6.96 %
Other income	1,046	1,623	1,469	(577)	(35.55)%	(423)	(28.80)%
Net gain (loss) on investment securities	150	508	(208)	(358)	(70.47)%	358	(172.12)%
Total noninterest income	4,420	5,109	4,351	(689)	(13.49)%	69	1.59 %
Total revenue	39,939	41,281	39,744	(1,342)	(3.25)%	195	0.49 %
Provision for loan losses	328	4,977	(202)	(4,649)	(93.41)%	530	(262.38)%
Salaries and employee benefits	15,680	15,348	15,761	332	2.16 %	(81)	(0.51)%
Occupancy expense	2,795	2,720	2,797	75	2.76 %	(2)	(0.07)%
Furniture and equipment	1,503	1,297	1,441	206	15.88 %	62	4.30 %
Other expenses	7,025	8,049	8,314	(1,024)	(12.72)%	(1,289)	(15.50)%
Total noninterest expenses	27,003	27,414	28,313	(411)	(1.50)%	(1,310)	(4.63)%
Income before income tax and corporate allocation	12,608	8,890	11,633	3,718	41.82 %	975	8.38 %
Corporate allocation	32	139	322	(107)	(76.98)%	(290)	(90.06)%
Income before income tax provision	12,640	9,029	11,955	3,611	39.99 %	685	5.73 %
Provision for income tax expense	3,720	2,404	3,158	1,316	54.74 %	562	17.80 %
Net income	<u>\$ 8,920</u>	<u>\$ 6,625</u>	<u>\$ 8,797</u>	<u>\$ 2,295</u>	34.64 %	<u>\$ 123</u>	1.40 %
Efficiency ratio (1)	67.87%	67.24%	70.87%	0.63%	0.94 %	(3.00)%	(4.23)%

(1) Excludes gain on investment securities.

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	Nine Months Ended September 30,		Increase/(Decrease) 2013 over 2012	
	2013	2012	Amount	Percent
Net interest income	\$ 105,533	\$ 105,487	\$ 46	0.04 %
Service charges on deposit accounts	6,471	5,755	716	12.44 %
Credit card merchant fees	2,726	2,834	(108)	(3.81)%
Other income	3,688	3,935	(247)	(6.28)%
Gain on investment securities	546	3,038	(2,492)	(82.03)%
Total noninterest income	13,431	15,562	(2,131)	(13.69)%
Total revenue	118,964	121,049	(2,085)	(1.72)%
Provision for loan losses	3,696	13,196	(9,500)	(71.99)%
Salaries and employee benefits	46,434	44,621	1,813	4.06 %
Occupancy expense	8,287	7,969	318	3.99 %
Furniture and equipment	4,269	3,803	466	12.25 %
Other expenses	23,224	25,375	(2,151)	(8.48)%
Total expenses	82,214	81,768	446	0.55 %
Income before income tax and corporate allocation	33,054	26,085	6,969	26.72 %
Corporate allocation	661	417	244	58.51 %
Income before income tax provision	33,715	26,502	7,213	27.22 %
Provision for income tax expense	9,005	6,387	2,618	40.99 %
Net income	\$ 24,710	\$ 20,115	\$ 4,595	22.84 %
Efficiency ratio (1)	69.43%	69.29%	0.14%	0.20 %

(1) Excludes gain on investment securities.

Realty Segment. For the three and nine months ended September 30, 2013, the Realty segment had income before income tax provision and noncontrolling interest of \$1.24 million as compared to \$3.66 million for the comparative 2012 period. Total revenue decreased to \$12.03 million in 2013 from \$12.21 million in the third quarter of 2012, while revenue for the nine months ended September 30, 2013 increased \$4.35 million to \$38.65 million from the comparable period in 2012. The expansion of our mortgage operations resulted in an increase in net mortgage banking income of \$767,000 and \$2.51 million for the three and nine months ended September 30, 2012. There was a loss on rate lock commitments for \$818,000 and \$282,000 for the three and nine months ended September 30, 2013 compared to gains of \$30,000 and \$1.21 million when compared to the same periods in 2012. As discussed previously, we benefited from improving housing markets in the first half of the year, but rate increases and thinner margins have reduced revenue in the third quarter in comparison to both the quarter ended June 30, 2013 and September 30, 2012.

Expenses for the Realty segment increased 25.87%, or \$2.19 million and 25.10%, or \$5.89 million for the three- and nine-month periods ended September 30, 2013, when compared to the same periods in 2012. For the three- and nine- month periods ended September 30, 2013, new mortgage operations and the expansion of our processing centers has resulted in additional expenses of \$1.41 million and \$3.46 million, respectively. On a linked quarter basis, the new operations increased expenses by \$421,000.

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

	Three Months Ended			Increase/(Decrease)			
	September 30,		June 30,	September 30, 2013		September 30, 2013	
	2013	2012	2013	September 30, 2012		June 30, 2013	
	Amount	Amount	Amount	Amount	Percent	Amount	Percent
Residential mortgage banking income, net	\$ 6,836	\$ 7,448	\$ 9,043	\$ (612)	(8.22)%	\$ (2,207)	(24.41)%
Real estate brokerage income, net	1,855	1,408	1,941	447	31.75 %	(86)	(4.43)%
Title insurance and settlement fees	545	498	525	47	9.44 %	20	3.81 %
Property management fees, net	1,722	1,706	1,519	16	0.94 %	203	13.36 %
Income from unconsolidated subsidiary	193	175	167	18	10.29 %	26	15.57 %
Net interest and other income	877	974	883	(97)	(9.96)%	(6)	(0.68)%
Total revenue	12,028	12,209	14,078	(181)	(1.48)%	(2,050)	(14.56)%
Salaries and employee benefits	6,227	4,942	5,937	1,285	26.00 %	290	4.88 %
Occupancy expense	1,022	668	845	354	52.99 %	177	20.95 %
Furniture and equipment	273	190	225	83	43.68 %	48	21.33 %
Amortization of intangible assets	127	162	127	(35)	(21.60)%	—	— %
Other expenses	2,986	2,487	3,101	499	20.06 %	(115)	(3.71)%
Total expenses	10,635	8,449	10,235	2,186	25.87 %	400	3.91 %
Income before income tax, corporate allocation and noncontrolling interest	1,393	3,760	3,843	(2,367)	(62.95)%	(2,450)	(63.75)%
Corporate allocation	(153)	(100)	(133)	(53)	53.00 %	(20)	15.04 %
Income before income tax provision and noncontrolling interest	1,240	3,660	3,710	(2,420)	(66.12)%	(2,470)	(66.58)%
Provision for income tax benefit	109	1,160	1,143	(1,051)	(90.60)%	(1,034)	(90.46)%
Net income	1,131	2,500	2,567	(1,369)	(54.76)%	(1,436)	(55.94)%
Noncontrolling interest	(665)	(521)	(772)	(144)	27.64 %	107	(13.86)%
Net income attributable to TowneBank	\$ 466	\$ 1,979	\$ 1,795	\$ (1,513)	(76.45)%	\$ (1,329)	(74.04)%
Key data:							
Efficiency ratio	88.42%	69.20%	72.70%	19.22%	27.77 %	15.72%	21.62 %
Number of units sold	1,110	861	1,037	249	28.92 %	73	7.04 %
Volume of units sold	\$ 308,399	\$ 218,762	\$ 286,114	\$ 89,637	40.97 %	\$ 22,285	7.79 %
Number of real estate agents	366	362	360	4	1.10 %	6	1.67 %
Loans originated, mortgage	\$ 155,486	\$ 176,039	\$ 216,766	\$ (20,553)	(11.68)%	\$ (61,280)	(28.27)%
Loans originated, joint venture	232,835	191,055	217,846	41,780	21.87 %	14,989	6.88 %
Total loans originated	\$ 388,321	\$ 367,094	\$ 434,612	\$ 21,227	5.78 %	\$ (46,291)	(10.65)%
Number of loans, mortgage	716	806	1,052	(90)	(11.17)%	(336)	(31.94)%
Number of loans, joint venture	1,119	884	1,021	235	26.58 %	98	9.60 %
Total number of loans	1,835	1,690	2,073	145	8.58 %	(238)	(11.48)%
Average loan amount, mortgage	\$ 217	\$ 218	\$ 206	\$ (1)	(0.46)%	\$ 11	5.34 %
Average loan amount, joint venture	208	216	213	\$ (8)	(3.70)%	(5)	(2.35)%
Average loan amount	\$ 212	\$ 217	\$ 210	\$ (5)	(2.30)%	\$ 2	0.95 %
Average number of originators, mortgage	56	48	70	8	16.67 %	(14)	(20.00)%
Average number of originators, joint venture	62	38	44	24	63.16 %	18	40.91 %
Average number of originators	118	86	114	32	37.21 %	4	3.51 %

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	Nine Months Ended		Increase/(Decrease)	
	September 30,		2013 over 2012	
	2013	2012	Amount	Percent
Residential mortgage banking income, net	\$ 23,772	\$ 20,027	\$ 3,745	18.70 %
Real estate brokerage income, net	4,878	4,144	734	17.71 %
Title insurance and settlement fees	1,496	1,384	112	8.09 %
Property management fees, net	5,531	5,637	(106)	(1.88)%
Income from unconsolidated subsidiary	479	428	51	11.92 %
Net interest and other income	2,491	2,677	(186)	(6.95)%
Total revenue	38,647	34,297	4,350	12.68 %
Salaries and employee benefits	17,228	13,629	3,599	26.41 %
Occupancy expense	2,651	1,871	780	41.69 %
Furniture and equipment	750	580	170	29.31 %
Amortization of intangible assets	388	501	(113)	(22.55)%
Other expenses	8,332	6,879	1,453	21.12 %
Total expenses	29,349	23,460	5,889	25.10 %
Income before income tax, corporate allocation and noncontrolling interest	9,298	10,837	(1,539)	(14.20)%
Corporate allocation	(418)	(299)	(119)	39.80 %
Income before income tax provision and noncontrolling interest	8,880	10,538	(1,658)	(15.73)%
Provision for income tax expense	2,631	3,530	(899)	(25.47)%
Net income	6,249	7,008	(759)	(10.83)%
Noncontrolling interest	(1,779)	(1,183)	(596)	50.38 %
Net income attributable to TowneBank	\$ 4,470	\$ 5,825	\$ (1,355)	(23.26)%
Key data:				
Efficiency ratio	75.94%	68.40%	7.54%	11.02 %
Number of units sold	2,839	2,389	450	18.84 %
Volume of units sold	\$ 759,678	\$ 635,278	\$ 124,400	19.58 %
Number of real estate agents	366	375	(9)	(2.40)%
Loans originated, mortgage	\$ 551,132	\$ 482,032	\$ 69,100	14.34 %
Loans originated, joint venture	608,763	502,177	106,586	21.22 %
Total loans originated	\$ 1,159,895	\$ 984,209	\$ 175,686	17.85 %
Number of loans, mortgage	2,612	2,161	451	20.87 %
Number of loans, joint venture	2,901	2,338	563	24.08 %
Total number of loans	5,513	4,499	1,014	22.54 %
Average loan amount, mortgage	\$ 211	\$ 223	\$ (12)	(5.38)%
Average loan amount, joint venture	210	215	(5)	(2.33)%
Average loan amount	\$ 210	\$ 219	\$ (9)	(4.11)%

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Mortgage. The loan volume for the combined mortgage operations increased in the quarter ended September 30, 2013 as compared to the same period in 2012. Total loans originated in the third quarter of 2013 were \$388.32 million, a 5.78% increase, or \$21.23 million from \$367.09 million in the comparative period of 2012. This was a \$46.29 million, or 10.65%, decrease compared to the volume for the quarter ended June 30, 2013. Refinance activity comprised \$88.90 million of loan volume for the quarter ended September 30, 2013, while purchases accounted for the remaining \$299.42 million in loan volume for the quarter. For the quarters ended September 30, 2012 and June 30, 2013, refinance volume was \$127.76 million and \$100.07 million, respectively, while purchase volume was \$239.33 million and \$334.54 million, respectively.

Insurance Segment. The Insurance segment is comprised of property and casualty and group benefit divisions. The Insurance segment represented 9.91%, or \$1.03 million, of total consolidated net income at September 30, 2013 and 7.98%, or \$746,000, at September 30, 2012.

Earnings before income taxes and noncontrolling interests for the three months ended September 30, 2013 were \$1.70 million, increasing \$434,000, or 34.20%, from comparative 2012. Earnings before income taxes and noncontrolling interests for the nine months ended September 30, 2013 were \$5.11 million, increasing \$846,000, or 19.85%, from the same period in 2012. The primary factors affecting earnings in both periods were the acquisitions of three insurance companies within the past year.

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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)			
	September 30,		June 30,	September 30, 2013		September 30, 2013	
	2013		2013	September 30, 2012		June 30, 2013	
	2013	2012	2013	Amount	Percent	Amount	Percent
Net commission and fee income							
Property and casualty	\$ 5,055	\$ 4,102	\$ 4,178	\$ 953	23.23 %	\$ 877	20.99 %
Specialized benefit services	139	132	132	7	5.30 %	7	5.30 %
Employee benefits	1,830	1,304	1,757	526	40.34 %	73	4.15 %
Total net commissions and fees	7,024	5,538	6,067	1,486	26.83 %	957	15.77 %
Contingency and bonus revenue	47	74	378	(27)	(36.49)%	(331)	(87.57)%
Other income	252	64	65	188	293.75 %	187	287.69 %
Total revenues	7,323	5,676	6,510	1,647	29.02 %	813	12.49 %
Salaries and employee benefits	3,735	2,959	3,546	776	26.23 %	189	5.33 %
Occupancy expense	355	247	289	108	43.72 %	66	22.84 %
Furniture and equipment	156	133	156	23	17.29 %	—	— %
Amortization of intangible assets	415	311	363	104	33.44 %	52	14.33 %
Other expenses	1,080	718	915	362	50.42 %	165	18.03 %
Total operating expenses	5,741	4,368	5,269	1,373	31.43 %	472	8.96 %
Income before income tax, corporate allocation and noncontrolling interest	1,582	1,308	1,241	274	20.95 %	341	27.48 %
Corporate allocation	121	(39)	(189)	160	(410.26)%	310	(164.02)%
Income before income tax provision and noncontrolling interest	1,703	1,269	1,052	434	34.20 %	651	61.88 %
Provision for income tax expense	578	499	406	79	15.83 %	172	42.36 %
Net income	1,125	770	646	355	46.10 %	479	74.15 %
Noncontrolling interest	(93)	(24)	(39)	(69)	287.50 %	(54)	138.46 %
Net income attributable to TowneBank	\$ 1,032	\$ 746	\$ 607	\$ 286	38.34 %	\$ 425	70.02 %
Efficiency ratio	78.40%	76.96%	80.94%	1.44%	1.87 %	(2.54)%	(3.14)%

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	Nine Months Ended September 30,		Increase/(Decrease) 2013 over 2012	
	2013	2012	Amount	Percent
Net commission and fee income				
Property and casualty	\$ 13,460	\$ 11,315	\$ 2,145	18.96%
Specialized Benefit Services	397	382	15	3.93%
Employee benefits	5,429	4,115	1,314	31.93%
Total net commissions and fees	19,286	15,812	3,474	21.97%
Contingency and bonus revenue	1,912	1,570	342	21.78%
Other income	381	172	209	121.51%
Total revenues	21,579	17,554	4,025	22.93%
Salaries and employee benefits	10,849	8,684	2,165	24.93%
Occupancy expense	937	712	225	31.60%
Furniture and equipment	457	395	62	15.70%
Amortization of intangible assets	1,142	934	208	22.27%
Other expenses	2,844	2,450	394	16.08%
Total operating expenses	16,229	13,175	3,054	23.18%
Income before income tax, corporate allocation and noncontrolling interest	5,350	4,379	971	22.17%
Corporate allocation	(243)	(118)	(125)	105.93%
Income before income tax provision and noncontrolling interest	5,107	4,261	846	19.85%
Provision for income tax expense	1,844	1,601	243	15.18%
Net income	3,263	2,660	603	22.67%
Noncontrolling interest	(354)	(285)	(69)	24.21%
Net income attributable to TowneBank	\$ 2,909	\$ 2,375	\$ 534	22.48%
Efficiency ratio	75.21%	75.05%	0.16%	0.21%

Net commission and fee income for the quarter increased \$1.49 million, or 26.83% when compared to the same period in 2012, and increased \$3.47 million, or 21.97% for the nine months ended September 30, 2013. The increase from both prior year periods was impacted by the insurance agency acquisitions, which contributed additional commission and fee income of \$1.08 million and \$2.47 million for the three- and nine-month periods. Also contributing to the increase for the nine-month period comparison was an increase in contingency and bonus revenue of \$342,000, or 21.78%. 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.

Salaries and employee benefits expense increased \$776,000, or 26.23%, and \$2.17 million, or 24.93%, when comparing the three and nine months ended September 30, 2013 to the same periods for 2012. The increases were also driven by the insurance agency acquisitions, which resulted in additional salaries and employee benefit expenses of \$567,000 and \$1.46 million for the above mentioned three- and nine-month periods.

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Occupancy expense increased \$108,000 and \$225,000 for the three- and nine-month periods ended September 30, 2013, as a result of the insurance agency acquisitions.

Amortization of intangibles assets were up \$104,000 and \$208,000 for the three- and nine-month periods ended September 30, 2013, which was also as a result of the insurance agency acquisitions.

Other expenses also increased as a direct result of the insurance agency acquisitions. The increase for the three- and nine-month periods ended September 30, 2013 were \$362,000 and \$394,000, respectively, when compared to the same period in 2012.

ANALYSIS OF FINANCIAL CONDITION

Overview. At September 30, 2013, total assets were \$4.57 billion, which is \$252.60 million, or 5.85%, less than the period end balance for comparative 2012 and \$24.18 million, or 0.53%, greater than the balance at June 30, 2013. Our loan portfolio, less unearned income and deferred costs, made up 70.19% of our period end assets and totaled \$3.21 billion at September 30, 2013. Average assets for the quarter ended September 30, 2013 were \$4.58 billion, up \$340.36 million, or 8.03%, from comparative September 30, 2012 and up \$140.79 million, or 3.17%, from the quarter ended June 30, 2013.

Average earning assets increased \$335.12 million, or 8.70%, from \$3.85 billion for the third quarter of 2012 to \$4.19 billion for the third quarter of 2013. Compared to the second quarter of 2013, average earning assets increased \$120.86 million.

Our average total deposits were \$3.49 billion for third quarter 2013, reflecting growth of \$160.53 million, or 4.82%, compared to third quarter 2012. Growth continued in average noninterest bearing deposits, which increased \$112.30 million, or 11.93%, from September 30, 2012.

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 September 30, 2013 were \$147.72 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 third quarter of 2013 was \$318.94 million, or 7.62%, of average total earning assets compared with \$297.36 million, or 7.72%, of average total earning assets for comparative 2012. For the second quarter of 2013, the average balance of interest bearing deposits in other banks was \$245.91 million, or 6.05%, 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 \$533.76 million at September 30, 2013 compared with \$335.50 million at September 30, 2012. The average balance during the third quarter of 2013 was \$347.72 million compared to the 2012 period average of \$214.48 million, or 8.31% and 5.57% of average earning assets, respectively. During the three months ended September 30, 2013, we had sales, maturities and calls totaling \$210.48 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

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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 \$158.47 million at September 30, 2013 and \$155.91 million at September 30, 2012. The average balance during the third quarter of 2013 was \$155.19 million compared with \$155.44 million in the 2012 period, representing 3.71% and 4.04% 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 September 30, 2013, we held \$77.45 million in mortgage loans originated and intended for sale in the secondary market, as compared with \$124.79 million at September 30, 2012 and \$144.45 million at June 30, 2013. The decline from prior periods in the balance of loans held for sale is consistent with the decrease in mortgage origination volume in the third quarter of 2013.

Average loans held for sale were 2.46% and 3.61% of average earning assets for the quarters ended September 30, 2013 and 2012, respectively. Average loans held for sale were 2.92% of average earning assets for the quarter ended June 30, 2013. 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 \$3.21 billion at September 30, 2013, which was \$178.06 million, or 5.88%, above the \$3.03 billion reported at September 30, 2012 and \$28.09 million, or 0.88%, above the \$3.18 billion at June 30, 2013. Factors that contributed to the increase in loan demand from the prior year were the stabilization of our local economy, and the efforts of our loan officers in developing new loan relationships, combined with the support of existing customers and directors. As a percentage of total average earning assets, average loans were 75.69% for the quarter ended September 30, 2013 compared with 76.85% for 2012 and 77.51% for the quarter ended June 30, 2013.

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

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underlying collateral, current economic conditions, historical loan loss experience, and other current factors that warrant consideration in determining an adequate allowance.

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

It is our policy to recommend internal risk grades to all loans as a component of the approval process. Based on the size of the loan, senior credit officers and internal peer review committees 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.

During the third quarter of 2012, management updated the look-back period for calculating historical losses for all classes of loans from eight quarters to 12 quarters. In the current economic environment, we believe the extension of our look-back period was appropriate due to the risks inherent in our loan portfolio. We believe this period remains a relevant indicator of the current credit cycle and in determining the risks in the loan portfolio. As we progress through this economic cycle, we will continue to evaluate the appropriateness of the look-back period utilized as we seek to capture the inherent risks in our portfolio. This refinement of our historical loss calculation period did not have a material impact on our allowance for loan losses or provision expense.

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

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The allowance for loan losses at September 30, 2013, September 30, 2012, and June 30, 2013 was \$38.56 million, \$39.34 million, and \$39.04 million, respectively. The allowance was equal to 1.20% of total loans outstanding at September 30, 2013, compared with 1.30% and 1.23% at September 30, 2012 and June 30, 2013, respectively. We believe the decline in the ratio is appropriate given the continued improvement in the risk profile of our loan portfolio and diversification efforts in the loan portfolio. Reflective of improving credit quality, classified loans, defined as loans in the substandard and doubtful categories, decreased to 1.95% of total loans at September 30, 2013 from 3.36% at September 30, 2012, and 3.09% at December 31, 2012, and loans 60 to 89 days past due fell to \$2.25 million at September 30, 2013 from \$2.39 million and \$2.65 million at September 30, 2012 and December 31, 2012, respectively. Also supporting the adequacy of coverage levels of the allowance for loan losses, the allowance was equal to 282% of nonperforming loans at September 30, 2013, compared with 76% and 332% at September 30, 2012 and June 30, 2013, respectively. Although overall economic conditions have shown 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 September 30, 2013.

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

	Three Months Ended			Nine Months Ended	
	September 30,		June 30,	September 30,	September 30,
	2013	2012	2013	2013	2012
Allowance for loan losses					
Balance beginning of period	\$ 39,037	\$ 40,370	\$ 40,649	\$ 40,427	\$ 39,740
Loans charged off:					
Residential 1-4 family	(645)	(958)	(881)	(3,553)	(3,231)
Multifamily	—	(345)	—	(14)	(345)
Commercial real estate	(127)	(1,086)	(173)	(300)	(3,198)
Construction	(65)	(2,568)	(238)	(1,649)	(5,691)
Commercial and industrial	(125)	(1,083)	(34)	(931)	(1,791)
Consumer and other	(7)	(101)	(219)	(295)	(310)
Total	(969)	(6,141)	(1,545)	(6,742)	(14,566)
Loans recovered:					
Residential 1-4 family	43	99	62	319	774
Multifamily	—	—	—	—	—
Commercial real estate	9	8	8	24	47
Construction	6	—	4	354	51
Commercial and industrial	87	18	52	443	41
Consumer and other	20	5	9	39	53
Total	165	130	135	1,179	966
Net loans charged off	(804)	(6,011)	(1,410)	(5,563)	(13,600)
Provision for loan losses	327	4,977	(202)	3,696	13,196
Balance end of period	<u>\$ 38,560</u>	<u>\$ 39,336</u>	<u>\$ 39,037</u>	<u>\$ 38,560</u>	<u>\$ 39,336</u>
Nonperforming assets					
Nonperforming loans	\$ 13,683	\$ 51,519	\$ 11,746	\$ 13,683	\$ 51,519
Foreclosed property	41,914	30,910	47,596	41,914	30,910
Total nonperforming assets	<u>\$ 55,597</u>	<u>\$ 82,429</u>	<u>\$ 59,342</u>	<u>\$ 55,597</u>	<u>\$ 82,429</u>
Loans past due 90 days and still accruing interest	<u>—</u>	<u>—</u>	<u>—</u>	<u>168</u>	<u>—</u>
Asset Quality Ratios					
Allowance for loan losses to nonperforming loans	281.81%	76.35%	332.34%	281.81%	76.35%
Allowance for loan losses to period end loans	1.20%	1.30%	1.23%	1.20%	1.30%
Nonperforming loans to period end loans	0.43%	1.70%	0.37%	0.43%	1.70%
Nonperforming assets to period end assets	1.22%	1.91%	1.29%	1.22%	1.91%
Net charge-offs to average loans (annualized)	0.10%	0.79%	0.18%	0.36%	0.60%

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

At September 30, 2013, we had \$55.60 million in nonperforming assets, which amounted to 1.22% of total assets. Additionally, there were no loans past due 90 days or more that were accruing interest. Nonperforming assets consist of \$13.68 million in nonperforming loans as well as \$41.91 million in foreclosed property. Nonperforming loans increased by \$1.94 million from June 30, 2013, as transfers to other real estate owned ("OREO"), charge-offs, and payments received were outpaced by additions to nonaccrual loans during the third quarter of 2013. Nonperforming 1-4 family residential real estate loans decreased by \$476,000 as paydowns of \$987,000, charge-offs of \$645,000, and transfers to OREO of \$278,000 outpaced new nonperforming loans. Additionally, nonperforming construction and land development loans increased by \$2.21 million as new nonperforming loans of \$2.56 million outpaced paydowns of \$359,000 and charge-offs of \$65,000. At September 30, 2013, foreclosed property totaled \$41.91 million, a decrease from \$47.60 million at June 30, 2013 and an increase from \$30.91 million at September 30, 2012. The increase from the prior year was largely due to the foreclosure of two large construction and land development borrower relationships during the first quarter of 2013. The four largest foreclosed property developments represented 75.59% of total foreclosed property at September 30, 2013. Foreclosed property consists of 51 residential properties, 48 construction and development properties, and five commercial properties.

At September 30, 2013, loans 60-89 days past due, excluding nonperforming loans, totaled \$2.25 million. Additionally, there are other performing loans, totaling \$46.11 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 September 30, 2013, nonaccruing TDRs, which are included in nonperforming loans, totaled \$6.10 million and accruing TDRs totaled \$44.56 million. Nonaccruing loans that are modified can be placed back on accrual status when both principal and interest are current, there is a sustained repayment

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performance of six months or greater, and it is probable that we will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

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

	September 30, 2013	December 31, 2012
1-4 family residential real estate	\$ 3,623	\$ 7,337
Commercial real estate	3,563	5,044
Construction and land development	5,681	27,498
Commercial and industrial business loans	773	429
Consumer loans and other	43	383
Total nonperforming loans	<u>\$ 13,683</u>	<u>\$ 40,691</u>

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

	September 30, 2013	September 30, 2012	June 30, 2013
Real estate loans:			
Residential 1-4 family	\$ 10,285	\$ 11,222	\$ 10,538
Commercial	14,062	12,245	13,547
Construction	8,256	10,719	9,447
Multi-family	931	653	671
Total real estate loans	<u>33,534</u>	<u>34,839</u>	<u>34,203</u>
Commercial and industrial loans	<u>4,435</u>	<u>3,981</u>	<u>3,936</u>
Consumer loans and other	<u>591</u>	<u>516</u>	<u>898</u>
Total	<u>\$ 38,560</u>	<u>\$ 39,336</u>	<u>\$ 39,037</u>

Deposits. Total deposits at September 30, 2013 were \$3.48 billion, representing an increase of 5.34%, or \$176.33 million, over September 30, 2012, and a decrease of \$28.61 million, or 0.82%, compared to June 30, 2013. Total average deposits were \$3.49 billion during the third quarter of 2013 compared to \$3.33 billion during the third quarter of 2012, and \$3.38 billion during the second quarter of 2013.

Average noninterest bearing demand deposits as a percentage of average total deposits were 30.16% during the third quarter of 2013 and 28.24% during the same period in 2012. Average noninterest bearing demand deposits were 30.29% of average total deposits for the second quarter of 2013. The cost of interest bearing deposits was 0.52% for the third quarter of 2013 compared with 0.70% for the third quarter of 2012 and 0.55% for the second quarter of 2013.

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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								
	September 30,				June 30,				
	2013		2012		2013				
Interest bearing demand and money market accounts	\$	1,177,446	0.26%	\$	1,084,821	0.41%	\$	1,148,170	0.26%
Regular savings		206,638	0.30%		194,180	0.50%		206,671	0.33%
Certificates of deposit		1,055,705	0.86%		1,112,558	1.02%		999,191	0.93%
Total interest bearing		2,439,789	0.52%		2,391,559	0.70%		2,354,032	0.55%
Noninterest bearing		1,053,588			941,286			1,023,045	
Total	\$	3,493,377	0.37%	\$	3,332,845	0.50%	\$	3,377,077	0.39%

	Average Balance/Cost Rate					
	Nine Months Ended					
	September 30,				September 30,	
	2013		2012		2012	
Interest bearing demand and money market accounts	\$	1,152,841	0.28%	\$	1,052,437	0.42%
Regular savings		206,733	0.35%		194,397	0.53%
Certificates of deposit		1,026,258	0.91%		1,120,374	1.05%
Total interest bearing		2,385,832	0.56%		2,367,208	0.73%
Noninterest bearing		1,009,870			883,553	
Total	\$	3,395,702	0.39%	\$	3,250,761	0.53%

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								
	September 30,				June 30,				
	2013		2012		2013				
Interest bearing demand and money market accounts	\$	1,177,446	33.71%	\$	1,084,821	32.55%	\$	1,148,170	34.00%
Regular savings		206,638	5.92%		194,180	5.83%		206,671	6.12%
Certificates of deposit		1,055,705	30.22%		1,112,558	33.38%		999,191	29.59%
Total interest bearing		2,439,789	69.84%		2,391,559	71.76%		2,354,032	69.71%
Noninterest bearing		1,053,588	30.16%		941,286	28.24%		1,023,045	30.29%
Total	\$	3,493,377	100.00%	\$	3,332,845	100.00%	\$	3,377,077	100.00%

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Advances from the Federal Home Loan Bank of Atlanta. Advances from the Federal Home Loan Bank of Atlanta ("FHLB") as of September 30, 2013 were \$389.34 million, compared to \$380.00 million at September 30, 2012 and \$389.50 million at June 30, 2013. The average borrowing cost for the third quarter of 2013 was 3.33%, compared to 3.35% for the same period in 2012 and 3.33% for the second quarter of 2013. The scheduled maturity dates, call dates, and related fixed interest rates on advances from the FHLB at September 30, 2013 are summarized as follows (dollars in thousands):

Maturity	Interest Rate	Call Date	Outstanding Amount
03/06/2017	4.08%	12/06/2013	\$ 100,000
05/18/2017	4.35%	11/18/2013	80,000
05/18/2017	4.48%	11/18/2013	80,000
01/29/2018	3.05%	-	13,000
01/29/2018	3.05%	-	7,000
09/28/2015	0.55%	-	33,000
09/28/2017	0.95%	-	34,000
09/30/2019	1.44%	-	33,000
06/08/2026	2.38%	-	9,344
Total FHLB Loans			\$ 389,344

At September 30, 2013, certain residential HELOCS, second mortgages, and commercial mortgages secured by real estate with carrying values of \$765.83 million collateralized the advances from the FHLB. At September 30, 2012, certain loans with carrying values of \$776.48 million collateralized the advances from the FHLB. At June 30, 2013, certain residential HELOCS, second mortgages, and commercial mortgages secured by real estate with carrying values of \$759.75 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 September 30, 2013, we had no outstanding balances on these borrowing agreements with other financial institutions. Average total borrowings, including FHLB advances, during the third quarter of 2013 were \$438.74 million compared with \$295.62 million for the third quarter of 2012 and \$424.05 million for the second quarter of 2013, while the average cost of these funds was 3.04%, 4.01% and 3.04%, respectively.

Convertible Subordinated Capital Debentures. The Company had no convertible subordinated capital debentures at September 30, 2013 or December 31, 2012. During the first quarter of 2012, the Company 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 the Company's 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).

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 September 1, 2013, all outstanding shares of the Series A preferred stock were mandatorily converted into 3.19 million shares of TowneBank common stock reflecting a conversion price of \$18.02 per share of common stock, plus cash in lieu of any fractional shares.

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On February 27, 2013, we declared a quarterly shareholder cash dividend of \$0.09 per common share. The dividend was paid on April 12, 2013 to shareholders of record on March 29, 2013.

On May 29, 2013, we declared a quarterly shareholder cash dividend of \$0.09 per common share. The dividend was paid on July 12, 2013 to shareholders of record on June 28, 2013.

On August 28, 2013, we declared a quarterly shareholder cash dividend of \$0.10 per common share. The dividend was paid on October 11, 2013 to shareholders of record on September 27, 2013. 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 Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (the "FDIC"), and the Office of the Comptroller of the Currency. Per these guidelines, we consider our sources of liquidity to be adequate to meet our estimated needs and have sufficient alternative sources of liquidity to meet our funding commitments and growth plans.

An additional measure of capital adequacy is risk-based capital ratios. As indicated below, our risk-based capital ratios are 13.02% for Tier I and 14.11% 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 September 30, 2013.

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

	September 30,		June 30,
	2013	2012	2013
Tier I Capital:			
Shareholders' equity (1)(2)	\$ 577,996	\$ 551,864	\$ 572,357
Less: goodwill and intangible assets, net of deferred tax	119,259	111,996	116,596
Total Tier I	458,737	439,868	455,761
Tier II Capital:			
Qualifying allowance for loan losses (3)	38,560	39,336	39,037
Total Tier II	38,560	39,336	39,037
Total Risk Based Capital	\$ 497,297	\$ 479,204	\$ 494,798
Total Assets	\$ 4,570,905	\$ 4,318,309	\$ 4,595,087
Total risk weighted assets	3,524,069	3,415,756	3,545,726
Average assets for leverage capital purposes	4,460,941	4,127,842	4,322,818
Risk Weighted Assets to Total Assets	77.10%	79.10%	77.16%
Risk Based Capital Ratios:			
Tier I (4% minimum requirement)	13.02%	12.88%	12.85%
Total (8% minimum requirement)	14.11%	14.03%	13.95%
Tier I Leverage Ratio (4% minimum requirement)	10.28%	10.66%	10.54%

(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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Return on average assets (GAAP basis)	0.90%	0.88%	0.96%	0.91%
Impact of excluding average goodwill and other intangibles and amortization	0.03%	0.02%	0.03%	0.03%
Return on average tangible assets	0.93%	0.90%	0.99%	0.94%
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Return on average equity (GAAP basis)	7.17%	6.73%	7.51%	6.99%
Impact of excluding average goodwill and other intangibles and amortization	1.91%	1.74%	1.98%	1.86%
Return on average tangible equity	9.08%	8.47%	9.49%	8.85%

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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 September 30,	
	2013	2012
Book value (GAAP basis)	\$ 14.17	\$ 13.14
Impact of excluding goodwill and other intangibles and amortization	(3.47)	(3.61)
Tangible book value	<u>\$ 10.70</u>	<u>\$ 9.53</u>

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 September 30, 2013, we had \$235.65 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

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

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.

Item 4. Controls and Procedures

Controls and Procedures. As of September 30, 2013, 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 September 30, 2013. 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 2012 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 2012 Annual Report on Form 10-K.

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

None

Item 3. Defaults Upon Senior Securities.

None

Item 4. Mine Safety Disclosures.

Not applicable

Item 5. Other Information.

None

Item 6. Exhibits.

<u>Exhibit No.</u>	<u>Description</u>
(31.1)	Chief Executive Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
(31.2)	Chief Financial Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
(32)	Certification Pursuant to 18 U.S.C. Section 1350 as adopted by Section 906 of the Sarbanes-Oxley Act of 2002
(99)	Independent Accountants' Report by Dixon Hughes Goodman LLP, dated November 8, 2013

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

November 8, 2013

Date

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

G. Robert Aston, Jr.

Chairman of the Board/Chief Executive
Officer

November 8, 2013

Date

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

Clyde E. McFarland, Jr.

Senior Executive Vice President/Chief
Financial Officer

CERTIFICATIONS

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

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended September 30, 2013 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

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.

November 8, 2013

Date

/s/ G. Robert Aston, Jr.

G. Robert Aston, Jr.

Chairman of the Board/Chief Executive Officer

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

CERTIFICATIONS

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

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended September 30, 2013 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

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.

November 8, 2013

Date

/s/ Clyde E. McFarland, Jr.

Clyde E. McFarland, Jr.

Senior Executive Vice President/Chief Financial
Officer

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

**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 September 30, 2013 (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.

November 8, 2013

Date

/s/ G. Robert Aston, Jr.

G. Robert Aston, Jr.

Chairman of the Board/Chief Executive Officer

November 8, 2013

Date

/s/ Clyde E. McFarland, Jr.

Clyde E. McFarland, Jr.

Senior Executive Vice President/Chief Financial
Officer

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



Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Shareholders of *TowneBank*

We have reviewed the accompanying consolidated balance sheets of *TowneBank* and subsidiaries (the Company) as of September 30, 2013 and 2012, the related consolidated statements of income, comprehensive income, equity and cash flows for the three-month and nine-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, 2012, 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 12, 2013, 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, 2012, 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
November 8, 2013