FEDERAL DEPOSIT INSURANCE CORPORATION
Washington, D. C. 20429

FORM 10-K

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

For the fiscal year ended December 31, 2012

FDIC Insurance Certificate Number: 35095

TOWNEBANK

(Exact name of registrant as specified in its charter)

VIRGINIA	**54-1910608**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
5716 High Street, Portsmouth, VA	**23703**
(Address of principal executive offices)	(Zip Code)

(757) 638-7500
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $1.667 per share	The NASDAQ Global Select Market

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. **YES** [ ] **NO** [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. **YES** [ ] **NO** [X]

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. **YES** [X] **NO** [ ]

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulations S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

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

Large accelerated filer ☐	Accelerated filer ☒	Non-accelerated filer ☐ (Do not check if a smaller reporting company)	Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). **YES** [ ] **NO** [X]

The aggregate market value of the common equity held by non-affiliates computed by reference to the price at which the common equity was last sold as of the last business day of the registrant's most completed second fiscal quarter was approximately $368,716,642.

Number of Shares of Common Stock Outstanding at February 28, 2013: 32,103,021 shares

DOCUMENTS INCORPORATED BY REFERENCE

(1) Portions of the Registrant's 2012 Annual Report to Shareholders are incorporated by reference into Parts I, II, and IV; and
(2) Portions of the Registrant's 2013 Proxy Statement for its Annual Meeting of Shareholders to be held May 22, 2013 are incorporated by reference into Part III.

TOWNEBANK

CROSS REFERENCE INDEX

FORM 10-K

Part I

Part II

Part III

Part IV

PART I

Forward-Looking Statements

This Annual Report on Form 10-K contains certain forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not historical facts, but instead represent only the beliefs, expectations, or opinions of TowneBank and its management regarding future events, many of which, by their nature, are inherently uncertain. Forward-looking statements may be identified by the use of such words as: "believe," "expect," "anticipate," "intend," "plan," "estimate," or words of similar meaning, or future or conditional terms, such as "will," "would," "should," "could," "may," "likely," "probably," or "possibly." These statements may address issues that involve significant risks, uncertainties, estimates, and assumptions made by management. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include competitive pressures in the banking industry that may increase significantly; changes in the interest rate environment that may reduce margins and/or the volumes and values of loans made or held as well as the value of other financial assets held; changes in the creditworthiness of customers and the possible impairment of the collectability of loans; general economic conditions, either nationally or regionally, that may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and/or a reduced demand for credit or other services; changes in the legislative or regulatory environment, including changes in accounting standards, that may adversely affect our business; costs or difficulties related to the integration of the business and the businesses we have acquired may be greater than expected; expected cost savings associated with pending or recently completed acquisitions may not be fully realized or realized within the expected time frame; our competitors may have greater financial resources and develop products that enable them to compete more successfully; changes in business conditions, changes in the securities market, and changes in our local economy with regard to our market area and its heavy concentration of U. S. military bases and related personnel. Any forward-looking statements made by us or on our behalf speak only as of the date they are made or as of the date indicated, and we do not undertake any obligation to update forward-looking statements as a result of new information, future events, or otherwise. For additional information on factors that could materially influence forward-looking statements included in this report, see the risk factors in "Item 1A. Risk Factors" in this report.

Item 1. BUSINESS

Overview

TowneBank began operations as a Virginia chartered bank in April 1999. We offer retail and commercial banking services to the Greater Hampton Roads region in southeastern Virginia and northeastern North Carolina. We place special emphasis on serving the financial needs of individuals and small- and medium-size businesses. We offer a diversified range of financial services through our banking and non-banking subsidiaries. Our principal subsidiaries include TowneBank Investment Corporation; Towne Investments, LLC; Towne Insurance Agency, LLC ("Towne Insurance"); TowneBank Commercial Mortgage, LLC; TFA Benefits; Out of Town, LLC, d/b/a Red Sky Travel Insurance ("Red Sky"); Towne Financial Services Group,, LLC; NewTowne Mortgage, LLC; Towne Mortgage of the Carolinas, LLC;

SimonTowne Mortgage, LLC; Corolla Classic Vacations, LLC (“Corolla”); Towne 1031 Exchange, LLC (“Towne 1031 Exchange”); Towne New Markets CDE, Inc.; and Prudential Towne Realty (“PTR”), which includes Lawyers Escrow and Title, LLC, d/b/a Virginia Home Title and Settlements (“Virginia Home Title”). We also have two controlled divisions: Towne Investment Group, which provides investment and asset management services, and TowneBank Mortgage, which originates mortgage loans and sells them to investors on the national secondary market. Unless indicated otherwise, the terms “Company,” “we,” “us,” and “our” refer to TowneBank and our consolidated subsidiaries.

Our foundation was built on providing banking services and, since inception, we have expanded to provide our members with complete residential real estate services, mortgage, personal and commercial insurance services, title-related services for both residential and commercial transactions, employee benefit services, and investment services.

Our common stock is listed on the NASDAQ Global Select Market under the symbol TOWN. Our bank’s main office is located at 5716 High Street, Portsmouth, Virginia 23703 (telephone number 757-638-7500), and our Corporate Administration and Member Service Center is located at 6001 Harbour View Boulevard, Suffolk, Virginia 23435 (telephone number 757-638-6700). We have established banking offices in Chesapeake, Hampton, Newport News, Norfolk, Portsmouth, Suffolk, Virginia Beach, Williamsburg, James City County, and York County in Virginia, along with Moyock, Grandy, Camden, Southern Shores, Corolla, and Kill Devil Hills in North Carolina. These locations are centrally located in core areas of each community, providing convenient access to both individual and business members.

Additional information relating to our business and our subsidiaries is included in the information on pages 14-18 and 95-97 in the 2012 Annual Report to Shareholders (“Annual Report”) filed as Exhibit 13 hereto and incorporated herein by reference.

Organization

We were organized and incorporated under the laws of the Commonwealth of Virginia on September 3, 1998, and commenced operations on April 8, 1999. We have three reportable segments: Banking, Realty, and Insurance.

Banking Segment. The Banking segment provides loan and deposit services to retail and commercial customers. We also provide commercial mortgage brokerage services and a variety of investment and asset management services. The Banking segment includes the operations of TowneBank Investment Corporation; Towne Investments, LLC; TowneBank Commercial Mortgage, LLC; Towne 1031 Exchange; Towne Investment Group; and Towne New Markets CDE, Inc.

Realty Segment. The Realty segment provides complete residential real estate services, originations of a variety of mortgage loans, resort property management, and commercial residential title insurance. It includes TowneBank Mortgage; Towne Mortgage, LLC; NewTowne Mortgage, LLC; SimonTowne Mortgage, LLC; Towne Mortgage of the Carolinas, LLC; Corolla; Virginia Home Title; and Prudential Towne Realty.

Insurance Segment. The Insurance segment provides property and casualty insurance as well as employee and group benefits through Towne Insurance and TFA Benefits. Through Towne Insurance, we offer a full line of commercial and consumer insurance products and financial services. Through TFA Benefits, we offer health, life dental, vision and disability plans to employers, brokers, and individuals.

Operating Philosophy

Our operating philosophy emphasizes the making of marketing and member decisions at the local level (within centrally mandated and monitored control standards) with administrative and operational decisions at the central Company level. In order to accomplish this, we have established a "TowneBanking Group" ("Banking Group") for each of our targeted markets.

We maintain a "hometown" banking image by providing each Banking Group with its own president, commercial loan officers, and local board of directors who are active and visible in their respective communities. It is the responsibility of each local board, acting under delegated authority of the Company's Board of Directors, to direct our overall development in their respective markets. The separate Banking Groups, with local decision-making authority, allow us to more effectively identify and respond to the financial needs of our members.

The Board of Directors believes that the separate Banking Groups strategy facilitates member service by ensuring that senior management is actively involved in each community and is available on a day-to-day basis to respond to the needs of the members in each community. From a member perspective, each TowneBanking Group is marketed as a separate bank headquartered in its respective community.

Our strategic plan places increased emphasis on developing and generating noninterest, or fee, income. Such development involves looking for opportunities to grow that income source, including acquisitions of non-bank financial service providers. Noninterest income includes income generated by our subsidiaries and divisions, as well as service charges on deposit accounts and gains on securities available for sale.

Services

We provide our members with high-quality, responsive, and technologically advanced services. Members have easy access to our decision-makers and enjoy continuity in service relationships, allowing fast response to meet their needs.

Banking and Other Financial Services. The foundation of our banking services is built on being a reliable and consistent source of credit with loans that are priced based upon the overall banking relationship. Our capitalization provides a lending capacity to meet the credit needs of our targeted market segment. Further, we have various loan participation agreements with other financial institutions should the need arise to meet the additional credit needs of our members.

Through our Banking segment, we offer a full range of deposit products, including checking accounts, Negotiable Order of Withdrawal ("NOW") accounts, savings accounts, and various types of time deposit services, which range from daily money market accounts to long-term certificates of deposit. The transaction accounts and certificates of deposit are tailored by market area at rates competitive to those offered in the area. In addition, we offer retirement account services, such as Individual Retirement

Accounts. All deposit accounts are insured by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation ("FDIC") up to the maximum amount allowed by law and are solicited from individuals, businesses, associations and organizations, and governmental authorities.

We also offer a full range of short- to medium-term personal and commercial loans. Personal loans include secured and unsecured loans for financing automobiles, home improvements, education, and personal investments. Commercial loans include secured and unsecured loans for working capital (including inventory and receivables), business expansion (including acquisition of real estate and improvements), and equipment and machinery purchases. Additionally, we originate fixed- and floating-rate mortgage loans, as well as real estate construction and acquisition loans. Through TowneBank Commercial Mortgage, LLC, we broker larger commercial loans that are not intended to remain in our portfolio.

Other services offered include safe deposit boxes, cash management services, travelers' checks, direct deposit of payroll and Social Security checks, and automatic drafts for various accounts. In addition, services to facilitate access to banking information, such as Internet banking and on-call banking, are offered.

Through Towne 1031 Exchange, we offer the ability to serve as a qualified intermediary assisting investors with tax-deferred exchanges under Section 1031 of the Internal Revenue Code. We provide all necessary documentation to accomplish tax deferral while the investors' proceeds are safely held in accounts established at TowneBank awaiting reinvestment as required by Internal Revenue Service regulations.

Through Towne Investment Group, we offer other financial services, such as financial, retirement, and estate planning. We also offer assistance on a variety of investment options, including alternative investments, annuities, margin accounts, convertible bonds, and pension and profit sharing plans. Towne Investment Group is a full-service financial advisor that is supported by an affiliation with Raymond James Financial, Inc., a full-service broker-dealer.

Realty Services. The full spectrum of services offered in our Realty segment allows us to realize certain operational synergies in providing quality residential real estate services, originations of a variety of residential mortgages, and title services for residential and commercial title transactions. We plan to continue to pursue economically advantageous acquisitions and other strategic opportunities to grow our businesses.

We assist customers with the process of buying or selling a home. Additionally, we also provide other realty-related services, including relocation services for individuals and families, including those in the military; and property management services for single-family homes, condominiums, townhomes, apartments, offices, vacation rentals, and retail establishments. Corolla Classic Vacations specializes in resort property management, offering vacation rentals with many of the most distinctive resort properties in the northern Outer Banks of North Carolina. TowneBank Mortgage processes residential mortgage loans locally, from acceptance of the application to the closing of the loan and disbursement of the funds. Once finalized, they are packaged and sold principally in the secondary market through purchase commitments from investors that subject us to only *de minimis* market risk. In addition to relocation and property management services, we offer title and settlement services, perform real estate closings for residential properties, and issue title insurance policies for both residential and commercial transactions.

Insurance Services. The Insurance segment provides individual and business members with a wide array of insurance products, including life, property, casualty, and vehicle insurance. Through Red Sky we offer travel, medical, and baggage protection insurance for travelers to the coastal region of the Outer Banks of North Carolina via vacation property management companies. Through TFA Benefits, using nationally recognized carriers, we also offer employee benefit programs, including medical, dental, vision, life, and disability insurance tailored to the members' unique needs. To further meet the needs of our members, we can also serve as an administrator for health care and dependent care flexible benefit plans, allowing members' employees to pay insurance premiums, childcare expenses, and/or health care expenses with tax-free dollars.

Competition

Because we offer a wide variety of services, we compete with other financial institutions as well as other financial service providers, real estate companies, mortgage loan originators, and insurance companies. Competition is generally based on pricing and quality of products and services offered, level of service, convenience, availability of services, and the degree of expertise and personal manner in which services are offered.

Commercial banking in our market area is highly competitive. We face competition from other banks, thrift institutions, credit unions, consumer finance companies, insurance companies, real estate companies, and other financial institutions in our targeted market areas. Some of these competitors are not subject to the same degree of regulation that is imposed upon us. Many have broader geographic markets and substantially greater resources and can offer more diversified products and services.

Despite the intense level of competition, we believe that the existing and future banking and financial services market in our market area represents excellent opportunities for a locally-owned and managed financial services company. Among other factors, the economic outlook for the area and the size and growth potential of the existing market for banking and other financial services point to a growing demand for such services. Further, in view of the continuing trend in the financial services industry toward consolidations into larger, sometimes impersonal, national institutions, our company fulfills a market for the personal and customized financial services an independent, locally-run company can offer.

Market Area

Our primary service area is the Greater Hampton Roads region of Virginia and northeastern North Carolina. This market includes the Virginia cities and counties of Chesapeake, Gloucester County, Hampton, James City County, Newport News, Norfolk, Poquoson, Portsmouth, Suffolk, Virginia Beach, Williamsburg, and York County, and the North Carolina cities and counties of Moyock, Grandy, Camden, Southern Shores, Corolla, and Kill Devil Hills. The region has a diverse, well-rounded economy supported by a solid manufacturing base, however, due to a substantial military presence, the U.S. government has a significant impact on the economy of our region.

Leading employers in the private sector include Stihl, Inc. (chain saws), Sumitomo Machinery Corporation of America (industrial motor drives), Canon Virginia, Inc. (copiers, laser printers, and supplies), Dollar Tree Stores, Inc. (retail), Lumber Liquidators, Inc. (hardwood flooring retailer), Norfolk Southern Corporation (transportation), and Mitsubishi Corporation (various manufacturing operations).

The U.S. Navy's Atlantic Fleet is headquartered at the Norfolk Naval Base, the largest Navy base in the world, and Portsmouth is the home of the Norfolk Naval Shipyard, the Navy's largest ship repair yard, and the Portsmouth Naval Medical Center, the U.S. Navy's largest hospital. In Newport News, Newport News Shipbuilding, a division of Huntington Ingalls Industries, is the nation's sole designer, builder, and refueler of nuclear-powered aircraft carriers and one of only two shipyards capable of designing and building nuclear-powered submarines. The area is also home to the National Aeronautics & Space Administration/Langley Research Center in Hampton, the Colonial Williamsburg Foundation (hotels and museums), three marine terminals owned by the Virginia Port Authority (shipping), and the Anheuser-Busch Williamsburg Brewery (beverage). Furthermore, the U.S. Army, Air Force, and Coast Guard each have a significant presence in Greater Hampton Roads with bases in the region.

The primary service area is encompassed by the Virginia Beach-Norfolk-Newport News, VA-NC Metropolitan Statistical Area, the 36th largest metropolitan area in the United States, with a population of approximately 1.68 million as of July 2011. Several colleges and universities, medical centers, and arts and entertainment facilities contribute to a valued quality of life in the region.

Concentrations

The majority of our depositors are located and doing business in our targeted market areas, and we lend a substantial portion of our capital and deposits to individual and business borrowers in these market areas. Any factors adversely affecting the economy of the Greater Hampton Roads area could, in turn, adversely affect our performance. A geographic concentration exists with our loan portfolio, as most of our business activity is with members in the Hampton Roads area. There were no significant concentrations in any one customer; however, we have a concentration in residential construction and acquisition and development loans.

Governmental Monetary Policies

Our earnings and growth are affected not only by general economic conditions, but also by the monetary policies of various governmental regulatory authorities, particularly the Board of Governors of the Federal Reserve System ("Federal Reserve"). The Federal Reserve implements national monetary policy through its open market operations in United States government securities, control of the discount rate, and establishment of reserve requirements against both member and nonmember financial institutions' deposits.

These actions have a significant effect on the overall growth and distribution of loans, investments, and deposits, and rates earned on loans or paid on deposits. Federal Reserve monetary policies have had a significant effect on the operating results of commercial banks in the past and are expected to do so in the future. Management is unable to predict the effect of possible changes in monetary policies upon our future operating results.

Development of Business

The following is a summary of the major developments in our business since January 1, 2012:

- TowneBank remained in third place, ahead of Bank of America and BB&T, in the latest Hampton Roads Annual Market Share Report released by the FDIC. The report ranks institutions by share of FDIC-insured deposits in the Hampton Roads metropolitan area as of June 30, 2012. TowneBank had a 15.15% share of deposits in Hampton Roads and was the only community bank with a share greater than 5%.

- Towne Insurance was selected as part of an elite group of independent insurance agencies around the United States to participate in the Independent Insurance Agents & Brokers of America ("IIABA") "Best Practices" Study Group. Each year the IIABA and Reagan Consulting, an Atlanta-based management consulting firm, join forces to study the country's leading agencies in six revenue categories. The agencies comprising the study groups are selected every third year through a comprehensive nomination and qualifying process and awarded a "Best Practices Agency" designation. The agency was nominated by either an IIABA-affiliated state association or an insurance company, and qualified based on its operational excellence.

- During 2012, TowneBank completed construction on the building that serves as the site for the Towne University School of Banking, Insurance, and Real Estate. In 2011, the Company completed the expansion of its Member Service Center in Suffolk, with the 44,000-square-foot building opening in the fourth quarter of 2011. The expanded facility was created to support the continued expansion of the Company by providing much-needed space for growth in account and loan processing, credit analysis, deposit services, electronic banking, and technology.

- Effective December 31, 2012, TowneBank acquired The Clement Companies, an independent insurance agency that is affiliated with Towne Insurance. The purchase price was $6.30 million in cash and stock.

We anticipate concentrating on the further development of each market by opening additional banking offices as business and other conditions warrant, and by expanding into new markets as opportunities arise. The regulatory approval process for the opening of additional banking offices takes into account a number of factors, including, among others, a determination that we have capital in an amount deemed necessary to warrant additional expansion, and a finding that the public interest will be served. Additionally, we will continue to place a focus on the development of noninterest income sources and will look for growth opportunities, which could include additional acquisitions of non-bank financial service providers.

Regulation

We are regulated extensively under both federal and state law. The following is a brief summary of the material statutes, acts, rules, and regulations that affect us. This summary is qualified in its entirety by reference to the full text of the statutes, acts, rules, regulations, and policies that are referenced below. Changes in statutes, acts, rules, regulations, or regulatory policies could have a material effect on our business.

General. We are organized as a Virginia chartered banking corporation and are regulated and supervised by the Bureau of Financial Institutions of the Virginia State Corporation Commission ("Bureau of Financial Institutions"). In addition, we are regulated and supervised by the FDIC, which serves as our primary federal regulator. The Bureau of Financial Institutions and the FDIC conduct regular examinations of us, reviewing the adequacy of our loan loss reserves, the quality of our loans and investments, the appropriateness of management practices, compliance with laws and regulations, and other aspects of our operations. In addition to these regular examinations, we must furnish to the FDIC quarterly and annual reports containing detailed financial statements and schedules. Federal and Virginia banking laws and regulations govern all areas of our operations, including reserves, loans, mortgages, capital, issuance of securities, payment of dividends, and establishment of branches. The FDIC and the Bureau of Financial Institutions have authority to impose penalties, initiate civil and administrative actions, and take other steps intended to prevent us from engaging in unsafe or unsound practices. In this regard, the FDIC has adopted capital adequacy requirements.

Capital Requirements. The federal bank regulatory agencies have adopted risk-based capital requirements for assessing bank capital adequacy. Virginia chartered banks must also satisfy the capital requirements adopted by the Bureau of Financial Institutions. The federal capital standards define capital and establish minimum capital requirements in relation to assets and off-balance-sheet exposure as adjusted for credit risk.

The risk-based capital standards currently in effect are designed to make regulatory capital requirements more sensitive to differences in risk profile among bank holding companies and banks, to account for off-balance-sheet exposure, and to minimize disincentives for holding liquid assets. Assets and off-balance-sheet items are assigned to broad risk categories, each with appropriate risk weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance-sheet items.

The minimum standard for the ratio of capital to risk-weighted assets (including certain off-balance-sheet obligations, such as stand-by letters of credit) is 8.0%. At least half of the risk-based capital must consist of common shareholders' equity, excluding unrealized gains or losses on debt securities available for sale and unrealized gains on equity securities available for sale, plus qualifying perpetual preferred stock less deductions for goodwill and various other intangibles ("Tier 1 capital"). The remainder ("Tier 2 capital") may consist of a limited amount of subordinated debt, certain hybrid capital instruments and other debt securities, preferred stock, and a limited amount of the general valuation allowance for loan losses. The sum of Tier 1 capital and Tier 2 capital is "total risk-based capital." The FDIC has also adopted regulations that supplement the risk-based guidelines to include a minimum leverage ratio of Tier 1 capital to quarterly average assets of 4.0%.

At December 31, 2012, we had the following risk-based capital and leverage ratios relative to regulatory minimums.

Ratio	TowneBank	Minimum	Well Capitalized
Tier 1 risk-based capital	12.60%	4.00%	6.00%
Total risk-based capital	13.75%	8.00%	10.00%
Leverage	10.40%	4.00%	5.00%

The FDIC is authorized by federal legislation and regulations to take various enforcement actions against any undercapitalized insured depository institution and any insured depository institution that fails to submit an acceptable capital restoration plan or fails to implement a plan accepted by the FDIC. These powers include, among other things, requiring a bank to be recapitalized, prohibiting asset growth, restricting interest rates paid, requiring prior approval of capital distributions, requiring divestiture by the institution of its subsidiaries, requiring new election of directors, and requiring the dismissal of directors and officers.

Dividends. The amount of dividends payable depends upon our earnings and capital position and is limited by federal and state laws, regulations, and policies. In addition, under Virginia law, the Bureau of Financial Institutions may limit the ability of the bank to pay dividends. No dividend may be declared or paid that would impair a bank's paid-in capital.

The Bureau of Financial Institutions and the FDIC have the general authority to limit dividends paid if such payments are deemed to constitute an unsafe and unsound practice. In particular, Section 38 of the Federal Deposit Insurance Act would prohibit us from making a dividend if we were "undercapitalized" or if such dividend would result in us becoming "undercapitalized."

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act is intended to effect a fundamental restructuring of federal banking regulation. Among other things, the Dodd-Frank Act creates a new Financial Stability Oversight Council to identify systemic risks in the financial system and gives federal regulators new authority to take control of and liquidate financial firms. The Dodd-Frank Act additionally creates a new independent federal regulator to administer federal consumer protection laws. The Dodd-Frank Act is expected to have a significant impact on our business operations as its provisions take effect. The Dodd-Frank Act includes provisions for, among other things:

- ***Deposit Insurance.*** The Dodd-Frank Act permanently increases the maximum deposit insurance amount for banks, savings institutions, and credit unions to $250,000 per depositor, and extended unlimited deposit insurance to noninterest-bearing transaction accounts through December 31, 2012. The Dodd-Frank Act also broadens the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020, and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Effective one year from the date of enactment, the Dodd-Frank Act eliminated the federal statutory prohibition against the payment of interest on business checking accounts.

- ***Corporate Governance.*** The Dodd-Frank Act requires publicly traded companies, like the Company, to give stockholders a non-binding vote on executive compensation at their first annual meeting taking place six months after the date of enactment, and at least every three years thereafter, and on so-called "golden parachute" payments in connection with approvals of mergers and acquisitions, unless previously voted on by shareholders. The new legislation also authorizes the Securities and Exchange Commission ("SEC") to promulgate rules that would allow stockholders to nominate their own candidates using a company's proxy materials. Additionally, the Dodd-Frank Act directs the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of $1.0 billion, regardless of whether the company is publicly traded or not. The Dodd-Frank Act gives the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

- ***Interstate Branching.*** The Dodd-Frank Act authorizes national and state banks to establish branches in other states to the same extent as a bank chartered by that state is permitted to branch. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks are now able to enter new markets more freely.

- ***Limits on Derivatives.*** The Dodd-Frank Act prohibits state-chartered banks from engaging in derivatives transactions unless the loans to one borrower limits of the state in which the bank is chartered take into consideration credit exposure to derivatives transactions. For this purpose, derivative transaction includes any contract, agreement, swap, warrant, note, or option that is based in whole or in part on the value of, any interest in, or any quantitative measure, or the occurrence of any event relating to, one or more commodities securities, currencies, interest or other rates, indices or other assets.

- ***Transactions with Affiliates and Insiders.*** The Dodd-Frank Act expands the definition of affiliate for purposes of quantitative and qualitative limitations of Section 23A of the Federal Reserve Act to include mutual funds advised by a depository institution or its affiliates. The Dodd-Frank Act applies Section 23A and Section 22(h) of the Federal Reserve Act (governing transactions with insiders) to derivative transactions, repurchase agreements, and securities lending and borrowing transactions that create credit exposure to an affiliate or an insider. Any such transactions with affiliates must be fully secured. The previous exemption from Section 23A for transactions with financial subsidiaries has been eliminated. The Dodd-Frank Act additionally prohibits an insured depository institution from purchasing an asset from or selling an asset to an insider unless the transaction is on market terms and, if representing more than 10% of capital, is approved in advance by the disinterested directors.

- ***Debit Card Interchange Fees.*** Effective July 21, 2011, the Dodd-Frank Act required that the amount of any interchange fee charged by a debit card issuer with respect to a debit card transaction must be reasonable and proportional to the cost incurred by the issuer. The Federal Reserve issued new standards that took effect on October 1, 2011, and apply to issuers that have assets of $10 billion or more. Under the rule, the maximum permissible interchange fee for an electronic debit transaction is the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction. The Federal Reserve rules also allow for an upward adjustment of no more than 1 cent to an issuer's debit card interchange fee if the issuer develops and implements policies and procedures reasonably designed to achieve certain fraud-prevention standards. While the restrictions on interchange fees do not apply to banks that, together with their affiliates, have assets of less than $10 billion, the rule could affect the competitiveness of debit cards issued by smaller banks.

- ***Consumer Financial Protection Bureau.*** The Dodd-Frank Act creates a new, independent federal agency called the Consumer Financial Protection Bureau ("CFPB"), which is granted broad rule-making, supervisory, and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act, and certain other statutes. The CFPB will have examination and primary enforcement authority with respect to depository institutions with $10 billion or more in assets. Smaller institutions will be subject to rules promulgated by the CFPB but will continue to be examined and supervised by federal banking regulators for consumer compliance purposes.

The Dodd-Frank Act, and the rules and regulations recently issued and to be issued under the act, will significantly affect banks and other financial institutions. However, because much of the Dodd-Frank Act will be phased in over time and will not become effective until federal agency rule-making initiatives are completed, we cannot fully assess the impact of the Dodd-Frank Act on the Company. We do believe, however, that short- and long-term compliance costs for the Company will be greater because of the Dodd-Frank Act.

Basel III. In December 2010, the Basel Committee on Banking Supervision published the final texts of the frameworks for the regulation of capital and liquidity of internationally active banking organizations. These new frameworks are generally referred to as “Basel III.” In June 2011, the federal banking agencies adopted a rule applicable to only large, internationally active banks, requiring their risk-based capital to meet the higher of the minimum requirements under the advanced approaches or under the risk-based capital rules generally applicable to United States banks. In December 2011, the Federal Reserve announced its intention to implement substantially all of the Basel III rules that would generally be applicable to institutions with greater than $50 billion in assets.

In June 2012, the Federal Reserve, the FDIC, and the Office of the Comptroller of the Currency jointly issued three notices of proposed rulemaking (“NPRs”) that would significantly revise the current regulatory capital requirements, if implemented. The impact of these NPRs, if adopted, would result in higher risk-based and leverage capital requirements consistent with Basel III. The majority of the provisions contained within the NPRs would be phased in over periods ranging from three to 10 years. The proposed NPRs were in a comment period through October 22, 2012, and are subject to further modification by the federal banking agencies. The agencies initially indicated that the NPRs would be phased in beginning January 1, 2013. However, due to the volume of public comments received, the agencies elected not to begin implementing the rules on January 1, 2013 and have provided no further guidance on a new effective date. The regulations ultimately implemented may be substantially different from the proposed rules issued in June 2012. The provisions of the proposed regulatory changes include the following:

- ***Capital Requirements.*** The proposed rules would introduce a new capital measure called “Common Equity Tier 1 Capital” (“CET1”) consisting of common stock and related surplus, retained earnings, accumulated other comprehensive income and, subject to certain adjustments, minority common equity interests in subsidiaries. The Company would be required to maintain (i) CET1 equal to 4.5% of risk-weighted assets, plus a 2.5% “capital conservation buffer” (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets. Institutions that do not maintain the required capital buffer would be subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement would be phased in over a four-year period beginning in 2016.

- ***Prompt Corrective Action Regulations.*** The prompt corrective action regulations would be amended to incorporate a CET1 requirement and to raise the capital requirements for certain capital categories. In order to be adequately capitalized for purposes of the prompt corrective action rules, a banking organization would be required to have at least an 8% Total Risk-Based Capital Ratio, a 6% Tier I Risk-Based Capital Ratio, a 4.5% Common Equity Tier I Risk-Based Capital Ratio, and a 4% Tier I Leverage Ratio. To be well capitalized, a banking organization would be required to have at least a 10% Total Risk-Based Capital Ratio, an 8% Tier I Risk-Based Capital Ratio, a 6.5% Common Equity Tier I Risk-Based Capital Ratio, and a 5% Tier I Leverage Ratio.

- ***Additional Deductions from Capital.*** The proposed rules provide for a number of deductions from and adjustments to CET1. These include the requirement that mortgage servicing rights, goodwill and certain other intangible assets, net of associated deferred tax liabilities, deferred tax assets dependent on future taxable income, and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1, or all such categories in the aggregate exceed 15% of CET1. Under current capital standards, the effects of accumulated other comprehensive income items included in capital are excluded for the purposes of determining regulatory capital ratios, while under the proposed rules the effects of certain accumulated other comprehensive items are not excluded, which could result in significant variations in the level of capital. Defined benefit pension fund assets, net of any associated deferred tax liability, would be deducted from CET1 unless the banking organization has unrestricted and unfettered access to such assets.

- ***Risk-Weighting Categories.*** The proposed rules would expand the risk-weighting categories from the current four Basel I-derived categories (0%, 20%, 50%, and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets. The proposal would apply a 250% risk-weighting to mortgage servicing rights, deferred tax assets that cannot be realized through net operating loss carrybacks, and significant (greater than 10%) investments in other financial institutions. The proposal also would also change the risk-weighting for residential mortgages and would create a new 150% risk-weighting category for “high volatility commercial real estate loans” which are credit facilities for the acquisition, construction, or development of real property other than one- to four-family residential properties or commercial real projects where: (i) the loan-to-value ratio is not in excess of interagency real estate lending standards, and (ii) the borrower has contributed capital equal to not less than 15% of the real estate’s “as completed” value before the loan was made.

We are currently in the process of evaluating the impact of the proposed NPRs on our regulatory capital ratios; however, we believe that we would meet all capital adequacy requirements on a fully phased-in basis if the requirements were currently effective.

Capital Purchase Program. In accordance with its stated purpose of restoring liquidity and stability to the financial system of the United States, the Emergency Economic Stabilization Act of 2008 ("EESA") was enacted on October 3, 2008. EESA authorized the United States Department of the Treasury (the "U.S. Treasury") to provide up to $700 billion in funding for the financial services industry.

Pursuant to authority under EESA, the U.S. Treasury created the Troubled Asset Relief Program ("TARP") Capital Purchase Program (" CPP") under which the U.S. Treasury invested in senior preferred stock of U.S. banks and savings associations or their holding companies. Qualifying financial institutions could issue senior preferred stock with a value equal to not less than 1% of risk-weighted assets and not more than the lesser of $25 billion or 3% of risk-weighted assets. The senior preferred stock pays dividends at the rate of 5% per annum until the fifth anniversary of the investment and, thereafter, at the rate of 9% per annum. As initially provided for under the CPP, the senior preferred stock could not be redeemed for three years except with the proceeds from an offering of common stock or preferred stock qualifying as Tier 1 capital in an amount equal to not less than 25% of the amount of the senior preferred (a "qualified equity offering"). However, the CPP was amended by the American Recovery and Reinvestment Act of 2009 so that a participating financial institution could redeem the senior preferred stock without a qualified equity offering, subject to the approval of its primary federal regulator.

In connection with the issuance of the senior preferred, participating institutions were required to issue to the U.S. Treasury immediately exercisable 10-year warrants to purchase common stock with an aggregate market price equal to 15% of the amount of senior preferred. The U.S. Treasury could only exercise or transfer one-half of the warrants prior to the earlier of December 31, 2009, or the date the issuing financial institution received proceeds equal to the senior preferred investment from one or more offerings of common or preferred stock qualifying as Tier 1 capital. The U.S. Treasury will not exercise voting rights with respect to any shares of common stock acquired through exercise of the warrants.

On December 12, 2008, TowneBank issued preferred stock and a warrant to purchase its common stock to the Treasury as a participant in the TARP CPP. The initial exercise price of the warrants is $21.31. As a result of our participation in TARP, we were subject to certain restrictions and direct oversight by the U.S. Treasury. Upon our repurchase of the TARP preferred stock on September 22, 2011, we are no longer subject to the TARP-related restrictions on dividends, stock repurchases, or executive compensation.

Small Business Lending Fund. On September 22, 2011, the Company entered into a Securities Purchase Agreement with the U. S. Treasury, pursuant to which the Company sold and issued 76,458 shares of the Company's Senior Non-Cumulative Perpetual Preferred Stock, Series C ("Series C Preferred Stock"), liquidation value of $1,000 per share, for a total purchase price of $76.46 million. The issuance was pursuant to the Small Business Lending Fund program, a $30 billion fund established under the Small Business Jobs Act of 2010 that was created to encourage lending to small businesses by providing capital to qualified community banks with assets of less than $10 billion.

The holder of the Series C Preferred Stock is entitled to receive non-cumulative dividends, payable quarterly, on January 1, April 1, July 1, and October 1 of each year. The dividend rate can fluctuate on a quarterly basis during the first 10 quarters during which the Series C Preferred Stock is outstanding, based upon changes in the level of “Qualified Small Business Lending” (“QSBL”) by the Company as compared to the Company’s baseline QSBL level, which was established at the closing of the securities issuance. The dividend rate for the initial dividend period has been set at 5%. For the second through tenth calendar quarters, the dividend rate may be adjusted to between 1% and 5% per annum based upon the increase in QSBL as compared to the initial baseline. For the eleventh calendar quarter through four and one-half years after issuance, the dividend rate will be fixed at between 1% and 7% based upon the level of QSBL compared to the baseline. After four and one-half years from the issuance, the dividend rate will increase to 9%. Due to the Company’s loan growth, the blended rate for the period from closing through December 31, 2011, was 4.63%, with the rate reduced to 3.92% for the first quarter of 2012, 2.28% for the second quarter of 2012, 1.0% for the third and fourth quarters of 2012, and 1.0% for the first quarter of 2013.

If the Company has not declared and paid an aggregate of six dividend payments on the Series C Preferred Stock, whether or not consecutive, the holder of the Series C Preferred Stock will have the right to elect two directors to the Company’s Board of Directors. The Series C Preferred Stock may be redeemed at any time at the Company’s option, at a redemption price of 100% of the liquidation amount plus accrued but unpaid dividends to the date of redemption for the current period, subject to the approval of the FDIC.

On September 22, 2011, the Company used the proceeds from the sale and issuance of the Series C Preferred Stock to repurchase all 76,458 outstanding shares of its TARP preferred stock for a redemption price of $76.46 million, plus accrued but unpaid dividends. The warrants to purchase common shares, which were issued together with the preferred shares in the fourth quarter of 2008 and with an allocated fair value of $4.13 million, remain outstanding.

FDIC Insurance Assessments. Substantially all of our members’ deposit accounts are insured up to applicable limits by the Deposit Insurance Fund (the “DIF”) of the FDIC and are subject to deposit insurance assessments to maintain the DIF. The FDIC utilizes a risk-based assessment system that imposes insurance premiums based upon a risk matrix that takes into account a bank’s capital level and supervisory ratings (“CAMELS ratings”). The risk matrix utilizes four risk categories which are distinguished by capital levels and supervisory ratings.

The FDIC’s risk-based premium system provides for quarterly assessments. Each insured institution is placed in one of four risk categories depending on supervisory and capital considerations. Within its risk category, an institution is assigned to an initial base assessment rate, which is then adjusted to determine its final assessment rate based on its brokered deposits, secured liabilities, and unsecured debt. The FDIC recently amended its deposit insurance regulations (i) to change the assessment base for insurance from domestic deposits to average assets minus average tangible equity, and (ii) to lower overall assessment rates. The revised assessment rates are between 2.5 to 9 basis points for banks in the lowest risk category, and between 30 to 45 basis points for banks in the highest risk category. The amendments became effective for the quarter beginning April 1, 2011, with the new assessment methodology being reflected in the premium invoices due September 30, 2011.

In November 2009, the FDIC issued a rule that required all insured depository institutions, with limited exceptions, to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009 through the fourth quarter of 2012. As of December 31, 2012, $1.81 million in pre-paid deposit insurance is included in other assets in the accompanying consolidated balance sheets.

FDIC insurance expense totaled $3.16 million, $3.78 million, and $3.87 million in 2012, 2011, and 2010. FDIC insurance expense includes deposit insurance assessments and Financing Corporation ("FICO") assessments related to outstanding FICO bonds. FICO is a mixed-ownership government corporation established to recapitalize a predecessor to the Deposit Insurance Fund. The current annualized assessment rate is 0.66 basis points, or approximately 0.165 basis points per quarter. These assessments will continue until the Financing Corporation bonds mature in 2019.

FDIC Temporary Liquidity Guarantee Program ("TLGP"). In November 2008, the FDIC adopted a final rule relating to the TLGP. The TLGP was announced by the FDIC in October 2008, preceded by the determination of systemic risk by the Secretary of the U.S. Treasury, as an initiative to counter the system-wide crisis in the nation's financial sector. Under the TLGP, the FDIC (i) guaranteed, through the earlier of maturity or December 31, 2012, certain newly issued senior unsecured debt issued by participating institutions, and (ii) provided full FDIC deposit insurance coverage for noninterest-bearing transaction deposit accounts, NOW accounts paying less than 0.5% interest per annum, and Interest on Lawyers Trust Accounts ("IOLTA") accounts held at participating FDIC-insured institutions through December 31, 2010. TowneBank elected to participate in both guarantee programs.

The Dodd-Frank Act included a two-year extension of the TLGP, though the extension did not apply to all accounts covered under the current program. The extension through December 31, 2012, applied only to noninterest-bearing transaction accounts. As of January 1, 2013, funds in noninterest-bearing transaction accounts no longer receive unlimited deposit insurance coverage, but are FDIC-insured up to the standard maximum deposit insurance amount of $250,000.

Community Reinvestment Act. Banks are subject to the provisions of the Community Reinvestment Act of 1977 ("CRA") that requires the appropriate federal bank regulatory agency, the FDIC in our case, to assess our record in meeting the credit needs of the communities we serve.

The CRA assessment is required by any bank that has applied to, among other things, establish a new branch office that will accept deposits, relocate an existing office, or merge, consolidate with, acquire the assets, or assume the liabilities of a federally-regulated financial institution. We received an "Outstanding" rating in our last CRA examination.

Federal Deposit Insurance Corporation Improvement Act. The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") became effective July 2, 1993. FDICIA requires insured institutions with $1 billion or more in total assets at the beginning of their fiscal year to submit independently audited annual reports to the FDIC and the appropriate agency.

These publicly-available reports must include: (a) annual financial statements prepared in accordance with accounting principles generally accepted in the United States and such other disclosure requirements as required by the FDIC or the appropriate agency, and (b) a management report signed by the Chief Executive Officer and the Chief Financial Officer or Chief Accounting Officer of the institution that contains a statement of management's responsibilities for: (i) preparing the annual financial statements;

(ii) establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (iii) complying with the laws and regulations designated by the FDIC relating to safety and soundness, and an assessment of: (aa) the effectiveness of the system of internal control and procedures for financial reporting as of the end of the fiscal year, and (bb) the institution's compliance during the fiscal year with applicable laws and regulations designated by the FDIC relating to safety and soundness.

With respect to any internal control report, the institution's independent public accountants must attest to, and report separately on, certain assertions of the institution's management contained in such report. Any attestation by the independent accountant is to be made in accordance with auditing standards generally accepted in the United States for attestation engagements.

USA Patriot Act of 2001. In October 2001, the USA Patriot Act of 2001 (the "Patriot Act") was enacted in response to the terrorist attacks in New York, Pennsylvania, and Washington, D.C., that occurred on September 11, 2001. The Patriot Act is intended to strengthen U.S. law enforcement and the intelligence communities' abilities to work cohesively to combat terrorism on a variety of fronts. The Patriot Act contains sweeping anti-money-laundering and financial transparency laws and imposes various regulations, including standards for verifying client identification at account opening and rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. The continuing impact of the Patriot Act and related regulations and policies on financial institutions of all kinds is significant and wide-ranging.

Incentive Compensation. In June 2010, the federal banking agencies issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of financial institutions do not undermine the safety and soundness of such institutions by encouraging excessive risk-taking. The *Interagency Guidance on Sound Incentive Compensation Policies*, which covers all employees who have the ability to materially affect the risk profile of a financial institution, either individually or as part of a group, is based upon the key principles that a financial institution's incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the institution's ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the financial institution's board of directors.

The Federal Reserve will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of financial institutions, such as the Company, that are not "large, complex banking organizations." These reviews will be tailored to each financial institution based on the scope and complexity of the institution's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the institution's supervisory ratings, which can affect the institution's ability to make acquisitions and take other actions. Enforcement actions may be taken against a financial institution if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the institution's safety and soundness, and the financial institution is not taking prompt and effective measures to correct the deficiencies. At December 31, 2012, the Company had not been made aware of any instances of non-compliance with the new guidance.

Reporting Obligation Under Securities Laws. We are subject to the periodic reporting requirements of the Securities Exchange Act of 1934 ("Exchange Act") as adopted by the FDIC, including the filing of annual, quarterly, and other reports with the FDIC. As an Exchange Act reporting bank with over $500 million in assets, we are directly affected by the Sarbanes-Oxley Act of 2002 and regulations promulgated thereunder, which are aimed at improving corporate governance and reporting procedures. We are complying with the rules and regulations implemented pursuant to the Sarbanes-Oxley Act and intend to comply with any applicable rules and regulations implemented in the future.

Employees

As of December 31, 2012, we had 1,221 full-time equivalent employees, excluding real estate agents. There were 378 real estate sales agents at December 31, 2012. Our real estate agents are independent contractors and not included as our employees. None of our employees are represented by any collective bargaining agreements, and relations with employees are considered good.

Available Information

Our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports are filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act and are accessible at no cost on our website, www.townebank.com, as soon as reasonably practicable after those reports have been filed with or furnished to the FDIC. These materials are available free of charge in print to stockholders who request them by writing to: TowneBank, Attn: Clyde E. McFarland, Jr., 6001 Harbour View Boulevard, Suffolk, Virginia 23435. A copy of the statements of beneficial ownership of our equity securities filed by our directors, officers, and 10% or greater shareholders under Section 16 of the Exchange Act may also be obtained through our website. The information contained on our website is not a part of or included in this Form 10-K.

The public may read and copy any of the reports that are filed with the FDIC at the FDIC's Accounting and Securities Disclosure Section, Division of Supervision and Consumer Protection, 550 17th Street, N.W., Washington, D.C. 20429. The public may contact the FDIC at 202-898-8913 should they require a copy of a filing be sent directly to them.

Item 1A. RISK FACTORS

In addition to the other information contained in this report, the following risks may affect us. This listing should not be considered all-inclusive. Additional risks and uncertainties, including those not presently known to us or that we currently consider immaterial, may also impair our business, financial condition, or operating results.

Dependence on uncontrollable economic conditions could have a material adverse impact on our financial condition and results of operations.

Like all financial institutions, we are subject to the effects of any economic downturn. Substantially all of our business is located in the Greater Hampton Roads region. As a result, the financial condition and results of operations may be affected by changes in the Hampton Roads economy. Although it is anticipated that economic conditions will continue to be favorable in the Hampton Roads area as compared to the overall national economy, no assurance can be given that these economic conditions will continue. Adverse changes in economic conditions in the Hampton Roads area would likely impair the ability to collect loans and could otherwise have a material adverse effect on our financial condition and results of operations. There has been a slowdown in the housing market across our geographic footprint, reflecting declining prices and excess inventories of houses to be sold. While conditions have improved since the recession, there can be no assurance that this improvement will continue, and further declines may have a negative effect on our financial conditions and results of operations.

Changes in defense spending by the federal government as a result of congressional budget cuts could adversely impact the economy in Greater Hampton Roads.

The U.S. military has a major presence in Greater Hampton Roads. As a result, the U.S. military is an important aspect of the economies in which we operate. Proposals to cut defense and other security spending could have an adverse impact on the economies in which we operate, which could adversely affect our business, financial condition, and results of operations.

Changes in interest rates could have a negative impact on our results of operations.

Our profitability is dependent to a large extent on our net interest income, which is the difference between interest income on interest-earning assets and interest expense on interest-bearing liabilities. Our net interest income is impacted by changes in market rates of interest, changes in credit spreads, changes in the shape of the yield curve, the interest rate sensitivity of our assets and liabilities, prepayments on our loans and investments, and the mix of our funding sources and assets.

Our interest-earning assets and interest bearing liabilities may react in different degrees to changes in market interest rates. Interest rates on some types of assets and liabilities may fluctuate prior to changes in broader market interest rates, while rates on other types may lag behind. The result of these changes to rates may cause differing spreads on interest earning assets and interest-bearing liabilities. Any substantial, unexpected, or prolonged change in market interest rates could have a material adverse effect on our business, financial condition, and results of operations. While we take measures intended to manage the risks from changes in market interest rates, we cannot control or accurately predict changes in the rates of interest or be sure our protective measures are adequate.

The repeal of federal prohibitions on payment of interest on demand deposits could increase our interest expense.

All federal prohibitions on the ability of financial institutions to pay interest on demand deposit accounts were repealed as part of the Dodd-Frank Act beginning on July 21, 2011. As a result, some financial institutions have commenced offering interest on demand deposits to compete for customers. Our interest expense will increase and net interest margin will decrease if we begin offering interest on demand deposits to attract additional customers or maintain current customers, which could have a material adverse effect on our financial condition and results of operations.

The value of our goodwill and other intangible assets may decline in the future.

As of December 31, 2012, we had $119.0 million of goodwill and other intangible assets. A significant decline in our expected future cash flows, a significant adverse change in the business climate, slower growth rates, or a significant and sustained decline in the price of our common stock may necessitate taking charges in the future related to the impairment of our goodwill and other intangible assets. If we were to conclude that a future write-down of goodwill and other intangible assets is necessary, we would record the appropriate charge, which could have a material adverse effect on our financial condition and results of operations.

Loss of any of our key personnel could disrupt our operations and result in reduced revenues.

We are a relationship-driven organization. A key aspect of our business strategy is to have our senior officers have primary contact with our customers. Our growth and development to date have been, in large part, a result of these personalized relationships with our customer base.

The senior officers have considerable experience in the banking industry and related financial services and are extremely valuable and would be difficult to replace. The loss of the services of these officers could have a material adverse effect upon future prospects. Although we have entered into employment contracts with our Chairman and Chief Executive Officer and our other senior executive officers, and purchased key man life insurance policies to mitigate the risk of an unforeseen departure or death of certain of our senior executive officers, we cannot offer any assurance that they and other key employees will remain employed by us. The unexpected loss of services of one or more of these key employees could have a material adverse effect on operations and possibly result in reduced revenues.

Reliance on certain external vendors could adversely affect our operations.

We are reliant upon certain external vendors to provide products and services necessary to maintain our day-to-day operations. Accordingly, our operations are exposed to risk that these vendors will not perform in accordance with the contracted arrangements under service-level agreements. We maintain a system of comprehensive policies and a control framework designed to monitor vendor risks including, among other things, (i) changes in the vendor's organizational structure, (ii) changes in the vendor's financial condition, (iii) changes in the vendor's support for existing products and services, and (iv) changes in the vendor's strategic focus. While we believe these policies and procedures help to mitigate risk, the failure of an external vendor to perform in accordance with the contracted arrangements under service-level agreements could be disruptive to our operations, which could have a material adverse impact on our business and, in turn, our financial condition and results of operations.

We are subject to environmental liability risk associated with our lending activities.

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property's value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Environmental reviews of real property before initiating foreclosure actions may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

Severe weather, natural disasters, acts of war, or terrorism and other external events could significantly impact our business.

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. In addition, such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue, and/or cause us to incur additional expenses. The occurrence of any such event in the future could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Security breaches and other disruptions could compromise our information and expose us to liability, which could damage our reputation and our business.

We rely on the secure processing, storage, and transmission of confidential and other information in our computer systems and networks. While we have policies and procedures designed to prevent or limit the effect of a possible security breach, our computer systems, software, and networks may be vulnerable to unauthorized access, computer viruses or other malicious code, and other events that could have a security impact. If one or more of such events occur, this potentially could jeopardize our or our customers' confidential and other information processed and stored in, and transmitted through, our computer systems and networks, or otherwise cause interruptions or malfunctions in our or our customers' operations. We may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures, and we may be subject to litigation and financial losses that are either not insured against or not fully covered through any insurance maintained by us.

Security breaches in our Internet banking activities could further expose us to possible liability and damage our reputation. Any compromise of our security also could deter customers from using our Internet banking services that involve the transmission of confidential information. We have implemented security systems to provide the security and authentication necessary to effect secure transmission of data. These precautions may not protect our systems from compromises or breaches of our security measures that could result in damage to our reputation and our business.

Failure of our internal and disclosure controls and procedures could have a material adverse effect on our results of operation and financial condition.

Effective internal and disclosure controls and procedures are necessary to provide reliable financial reports and effectively prevent fraud and to operate successfully as a public company. Our management regularly reviews and updates our internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of our controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on our results of operations and financial condition.

Restrictions relating to the acquisition of our common stock may discourage an acquisition.

Certain provisions of our articles of incorporation and bylaws could delay or frustrate the removal of incumbent directors and could make a merger, tender offer, or proxy contest more difficult, even in instances where shareholders deem the proposed transaction to be beneficial to their interests. These provisions, among others, provide for staggered terms for the Board of Directors and that a plan of merger, share exchange, sale of all or substantially all of our assets, or similar transaction must be approved and recommended by the affirmative vote of two-thirds of the directors in office or by the affirmative vote of the holders of 80% of our outstanding shares, and limit the ability of shareholders to call a special meeting. In addition, certain provisions of state and federal law may also have the effect of discouraging or prohibiting a future takeover attempt in which our shareholders might otherwise receive a substantial premium for their shares over then-current market prices. To the extent that these provisions discourage or prevent takeover attempts, they may tend to reduce the market price for our common stock and the notes.

Liquidity could be impaired by an inability to access the capital markets or an unforeseen outflow of cash.

Liquidity is essential to our businesses. Due to circumstances that we may be unable to control, such as a general market disruption or an operational problem that affects third parties or TowneBank, our liquidity could be impaired by an inability to access the capital markets or an unforeseen outflow of cash.

Continued growth may require raising additional capital, which may dilute current shareholders' ownership percentage.

In order to meet applicable regulatory capital requirements, we may, from time to time, need to raise additional capital to support continued growth. If selling our equity securities raises additional funds, the relative ownership interests of our existing shareholders would likely be diluted.

If we are unable to redeem the Series C Preferred Stock after four and one-half years from issuance, the cost of this capital to us will increase substantially.

If we are unable to redeem the Series C Preferred Stock prior to four and one-half years from September 22, 2011, the cost of this capital to us will increase substantially on that date to 9.0% per annum. Depending on our financial condition at the time, this increase in the annual dividend rate on the Series C Preferred Stock could have a material negative effect on our earnings.

Risks associated with acquisitions and the resulting integrations may affect costs and revenue.

A component of our business strategy includes growth through acquisitions. Costs or difficulties related to integrating the acquired business with the Company might be greater than expected. Further, expected revenue and/or operational synergies and cost savings associated with pending or recently completed acquisitions may not be fully realized or realized within the expected timeframe. We cannot provide assurance that we will be successful in overcoming these risks or any other issues encountered in connection with acquisitions.

Attractive acquisition or expansion opportunities may not be available to us in the future.

We may consider acquiring other businesses or expanding into new product lines that we believe will help us fulfill our strategic objectives. We expect that other banking and financial companies, some of which have significantly greater resources, will compete with us to acquire financial services businesses. This competition could increase prices for potential acquisitions that we believe are attractive. Acquisitions may also be subject to various regulatory approvals. If we fail to receive the appropriate regulatory approvals, we will not be able to consummate acquisitions that we believe are in our best interests.

Focus on commercial loans may increase the risk of substantial credit losses.

We offer a variety of loan products, including residential mortgage, consumer, construction, and commercial loans. At December 31, 2012, approximately 52.97% of loans were commercial loans, including those secured by commercial real estate. It is expected that, as we grow, this percentage will remain fairly constant.

Commercial lending is more risky than mortgage and consumer lending because loan balances are greater and the borrower’s ability to repay is contingent on the successful operation of a business. Risk of loan defaults is unavoidable in the banking industry. We attempt to limit exposure to this risk by monitoring carefully the amount of loans in specific industries and by exercising prudent lending practices. However, the risk that substantial credit losses could result in reduced earnings or losses cannot be eliminated.

Our allowance for loan losses may prove to be insufficient to absorb potential losses in the loan portfolio.

We maintain an allowance for loan losses that is believed to be adequate to provide for any potential losses in our loan portfolio. Our management determines the amount of this allowance through a periodic review and consideration of several factors, including:

- an ongoing review of the quality, size, and diversity of the loan portfolio;
- an evaluation of nonperforming loans;
- our historical loan loss experience; and

• the amount and quality of collateral, including guarantees securing the loans.

Although we believe our loan loss allowance is adequate to absorb probable losses in the loan portfolio, we cannot predict such losses or that our allowance will be adequate. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans, and other factors, both within and outside of the Company’s control, may require an increase in the allowance for loan losses. Increases in loan losses could have a material adverse effect on our financial condition and results of operations.

Deteriorating credit quality has adversely impacted us and may continue to adversely impact us.

We have seen an increase in past-due loans and nonperforming assets in recent years. We believe this trend is unlikely to significantly improve until there is a sustained improvement in local economic conditions. Further deterioration in the quality of our loan portfolio can have a material adverse effect on our capital, financial condition, and results of operations.

Our credit standards and ongoing credit assessment processes might not protect us from significant credit losses.

We take credit risk by virtue of making loans and leases and extending loan commitments and letters of credit. We manage credit risk through a program of underwriting standards, the review of certain credit decisions, and an ongoing process of assessment of the quality of the credit already extended. Our exposure to credit risk is managed through the use of consistent underwriting standards that emphasize local lending while avoiding highly leveraged transactions as well as excessive industry and other concentrations. Our credit administration function employs risk management techniques to help ensure that problem loans and leases are promptly identified. While these procedures are designed to provide us with the information needed to implement policy adjustments where necessary and to take appropriate corrective actions, there can be no assurance that such measures will be effective in avoiding undue credit risk.

We rely upon independent appraisals to determine the value of the real estate which secures a significant portion of our loans, and the values indicated by such appraisals may not be realizable if we are forced to foreclose upon such loans.

A significant portion of our loan portfolio consists of loans secured by real estate. We rely upon independent appraisers to estimate the value of such real estate. Appraisals are only estimates of value and the independent appraisers may make mistakes of fact or judgment which adversely affect the reliability of their appraisals. In addition, events occurring after the initial appraisal may cause the value of the real estate to increase or decrease. As a result of any of these factors, the real estate securing some of our loans may be more or less valuable than anticipated at the time the loans were made. If a default occurs on a loan secured by real estate that is less valuable than originally estimated, we may not be able recover the outstanding balance of the loan.

Strong competition in our primary market areas may limit asset growth and profitability.

We encounter strong competition from other financial institutions in our primary market area. In addition, established financial institutions not already operating in our primary market area may open branches at future dates. In the conduct of certain aspects of our business, we also compete with savings institutions, credit unions, mortgage banking companies, consumer finance companies, insurance companies, real estate companies, and other institutions, some of which are not subject to the same degree of regulation or restrictions as are imposed upon us. Many of these competitors have substantially greater resources and lending limits than we have and offer services that we do not provide. In addition, many of these competitors have numerous branch offices located throughout their extended market areas that provide them with a competitive advantage. No assurance can be given that such competition will not have an adverse impact on the financial condition and results of operations.

Recent legislative reforms can result in our business becoming subject to significant and extensive additional regulations, which could adversely affect our results of operations and financial condition.

The Dodd-Frank Act will continue to result in significant changes in the regulation of financial institutions. As disclosed earlier in this Form 10-K, the act contains numerous provisions that will affect all banks and bank holding companies, and will fundamentally change the system of regulatory oversight. Some of these provisions under the Dodd-Frank Act may have the consequence of increasing our expenses, decreasing our revenues, and changing the activities in which we choose to engage. The legislative and regulatory changes affecting capital, liquidity, supervision, permissible activities, corporate governance and compensation, changes in fiscal policy, and steps to eliminate government support for banking organizations may have long-term effects on the business model and profitability of banking organizations that cannot now be foreseen. The specific impact of the Dodd-Frank Act on our current activities or new financial activities we may consider in the future, our financial performance, and the markets in which we operate will depend on the manner in which the relevant agencies develop and implement the required rules and the reaction of market participants to these regulatory developments.

Proposed rules may require higher capital levels, impacting our profitability, lending, and ability to pay dividends on our securities.

In June 2012, the federal banking agencies issued three Notices of Proposed Rulemaking that would revise and replace the current capital rules to align with the Basel III capital standards and meet certain requirements of the Dodd-Frank Act. Certain requirements of the proposed NPRs would establish more restrictive capital definitions, higher risk-weightings for certain asset classes, capital buffers, and higher minimum capital ratios. The potential impact of Basel III includes, but is not limited to, reduced lending and negative pressure on profitability and return on equity due to the higher capital requirements. To the extent the Company is required to increase capital in the future to comply with Basel III, our ability to pay dividends may be reduced. The comment period on the NPRs ended on October 22, 2012. On November 9, 2012, the federal banking agencies announced that the proposed rules would not become effective on January 1, 2013, but did not indicate the likely new effective date.

The December 31, 2012 expiration of the FDIC's Transaction Account Guarantee Program could negatively impact our liquidity and cost of funds.

Under the FDIC's Transaction Account Guarantee Program, certain noninterest-bearing transaction accounts, including those of consumers and businesses, were insured by the FDIC over and above the customary $250,000 limit. This program expired on December 31, 2012. The expiration of the program could cause depositors to withdraw deposits in excess of FDIC-insured levels.

Extensive government regulation and monetary policy could adversely affect operations.

As part of the financial services industry, we are subject to extensive governmental supervision, regulation, and control that have materially affected the business of financial institutions in the past and are likely to do so in the future. Regulations affecting the financial services industry and, therefore, us may be changed at any time, and the interpretation of those regulations by examining authorities of the financial services industry is also subject to change. There can be no assurance that future changes in legislation, administrative regulations, or governmental policy will not adversely affect the financial services industry and our business.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

Our bank's main office is located in Portsmouth, Virginia, and our Corporate Administration and Member Service Center is located in Suffolk, Virginia; we own both of these locations. We occupy an additional 65 properties, of which we own 23, in the cities and counties in which we operate. Additional information with respect to the amounts at which company premises and equipment are carried and commitments under long-term leases is set forth in Note 6 on page 71 in the Annual Report and incorporated herein.

Item 3. 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 4. MINE SAFETY DISCLOSURES

Not applicable.

Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER'S PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock is listed on the NASDAQ Global Select Market under the symbol TOWN. The following chart shows the high and low quarterly closing sale prices in 2012 and 2011 for the Company's common stock.

	2012		2011	
Quarter	High	Low	High	Low
First	$ 14.52	$ 12.34	$ 16.92	$ 13.78
Second	14.04	11.83	15.73	12.46
Third	15.86	13.76	14.32	10.52
Fourth	15.90	14.07	13.47	10.82

Holders

As of December 31, 2012, we had issued and outstanding 31,469,709 shares of common stock. These shares were held by approximately 9,215 shareholders of record.

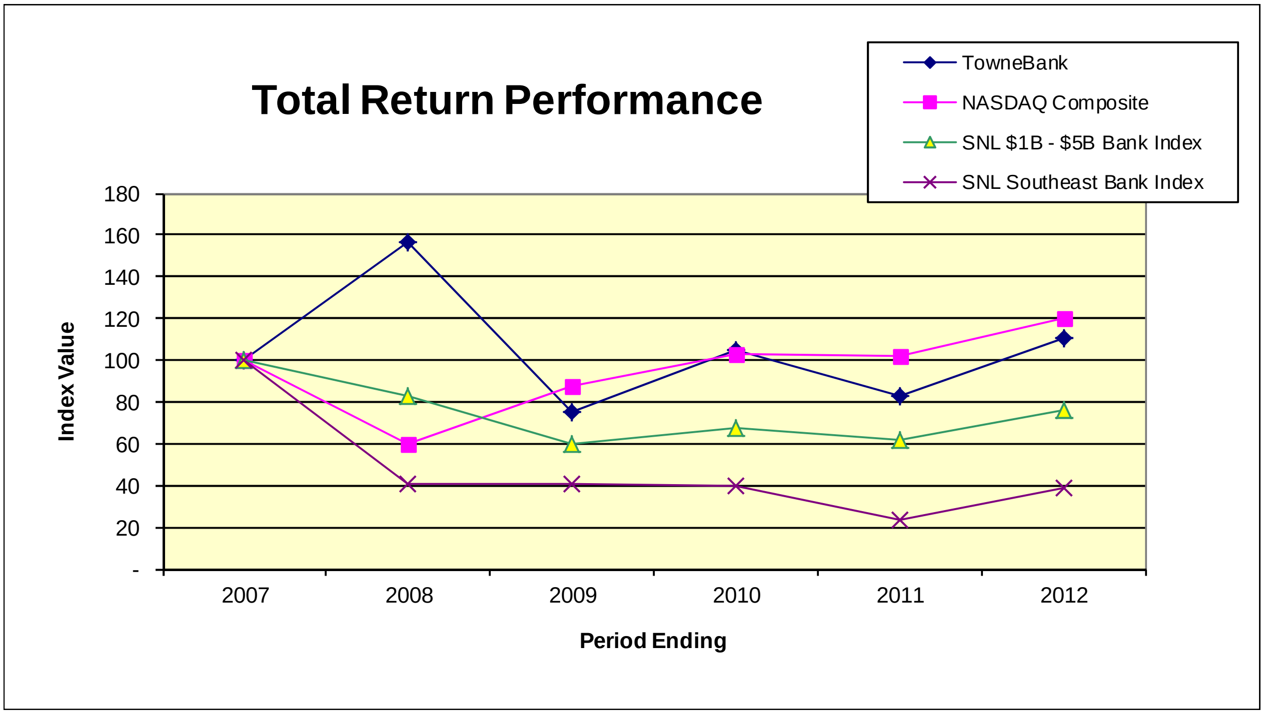
Dividends

During 2011 and the first three quarters of 2012, we paid cash dividends of $0.08 per share on a quarterly basis. In November 2012 our Board of Directors declared a quarterly cash dividend of $0.09 per share. In April 2012, we declared a special shareholder stock dividend of 3% per common share. The dividend was paid on June 12, 2012, to shareholders of record on May 25, 2012. All dividends paid are limited by the requirement to meet capital guidelines issued by regulatory authorities, and future declarations are subject to financial performance and regulatory guidelines.

Our future dividend policy is subject to the discretion of the Board of Directors and will depend upon a number of factors, including future earnings, financial condition, cash requirements, and general business conditions. We are also subject to certain restrictions imposed by the reserve and capital requirements of federal and Virginia banking statutes and regulations.

Stock Performance Graph

The following stock performance graph presents the cumulative total return comparison through December 31, 2012, of stock appreciation for our common stock, the NASDAQ Composite Index measuring all NASDAQ domestic and international-based common type stocks listed on the NASDAQ Stock Market ("NASDAQ Composite"), the SNL Securities index including banks between $1 billion and $5 billion in total assets ("SNL $1B-$5B Bank Index"), and the SNL Securities index including only banks in the Southeast ("SNL Southeast Bank Index"). Returns assume an initial investment of $100 at the market close of December 31, 2007, and reinvestment of dividends.



Index	12/31/2007	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012
TowneBank	$ 100.00	$ 156.68	$ 75.60	$ 105.03	$ 82.94	$ 110.60
NASDAQ Composite	100.00	60.02	87.24	103.08	102.26	120.42
SNL $1B - $5B Bank Index	100.00	82.94	59.45	67.39	61.46	75.78
SNL Southeast Bank Index	100.00	40.48	40.65	39.47	23.09	38.36

Item 6. SELECTED FINANCIAL DATA

Reference is made to the information in the section entitled, "Selected Financial Highlights," of our Annual Report for the year ended December 31, 2012, which is incorporated herein by reference.

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

Reference is made to the information in the section entitled, "Management's Discussion and Analysis" on pages 4–35 of our Annual Report, which is incorporated herein by reference.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Reference is made to the information in the section entitled, "Management's Discussion and Analysis," under subsections "Interest Sensitivity," "Market Risk Management," "Earnings Simulation Analysis," "Market Value Simulation," and "Credit Risk Elements" on pages 31–33 of our Annual Report, which is incorporated herein by reference.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Reference is made to the information in the sections entitled, "Management's Report on Internal Control," "Report of Independent Registered Public Accounting Firm," and "Consolidated Financial Statements and Notes" of our Annual Report, which is incorporated herein by reference.

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

Item 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures. An evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) was carried out as of December 31, 2012, under the supervision and with the participation of our Chief Executive Officer, Chief Financial Officer, and several other members of our senior management. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective as of the end of the period covered by this report.

Management's Report on Internal Control Over Financial Reporting. The annual report of management on the effectiveness of our internal control over financial reporting and the attestation report thereon issued by our independent registered public accounting firm are set forth under "Management's Report on Internal Control" and "Report of Independent Registered Public Accounting Firm" on pages 36-39 of our Annual Report, which is incorporated herein by reference.

Changes in Internal Control Over Financial Reporting. There were no changes in our internal controls over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. OTHER INFORMATION

None.

PART III

Item 10. DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE

Reference is made to the information in the sections entitled, "Election of Directors," "Section 16(a) Beneficial Ownership Reporting Compliance," and "Board of Directors and Committees: *Audit Committee*" of our Proxy Statement for the Annual Meeting of Stockholders to be held May 23, 2013 ("Proxy Statement"), which sections are incorporated herein by reference. The following information is provided for those executive officers who are not directors.

Name (Age)	Principal Occupation During Past Five Years
Keith D. Horton (58)	Senior Executive Vice President and Chief Administrative Officer since January 2005; Executive Vice President of Operations from 1999 to January 2005.
William B. Littreal (43)	Senior Executive Vice President and Chief Operating Officer since April 2011; Executive Vice President and Director of Finance from April 2008 to April 2011.
Clyde E. McFarland, Jr. (58)	Senior Executive Vice President and Chief Financial Officer since January 2005; Executive Vice President and Chief Financial Officer from 1999 to January 2005.
U. Starr Oliver (61)	Senior Executive Vice President and Chief Marketing and Human Resources Officer since May 2011; Executive Vice President of Marketing and Retail Banking from 1999 to May 2011.
Philip M. Rudisill (47)	Senior Executive Vice President and Chief Credit Officer since July 2011; Senior Executive Vice President of Corporate Administration from March 2006 to July 2011.

PART III

Code of Ethical Conduct

We have adopted a Code of Ethical Conduct that applies to our Chief Executive Officer and other executive and senior financial officers, including our Chief Financial Officer, Senior Vice President of Accounting, Corporate Treasurer, Internal Audit members, any person Assistant Vice President and above in an Accounting/Financial position, Senior Financial Analyst, any Regulation O executive officers along with any person serving in an equivalent position regardless of whether or not they are designated as executive officers for Regulation O purposes, or any persons serving in equivalent positions within the Company. The Code of Ethical Conduct is included as Exhibit 14. Any changes in or waivers from our Code of Ethical Conduct applicable to the Chief Executive Officer and any other executive or senior financial officer shall be promptly disclosed through a filing with the FDIC on Form 8-K.

A written copy of our Code of Ethical Conduct is available free of charge to stockholders who request it by writing to: TowneBank, Attn: Clyde E. McFarland, Jr., 6001 Harbour View Boulevard, Suffolk, Virginia 23435. We also provide this information on our website, www.townebank.com, under Investor Relations, Governance Documents, Code of Conduct.

Item 11. EXECUTIVE COMPENSATION

The information required by this item is incorporated herein by reference to our definitive proxy statement for our 2013 Annual Meeting of Stockholders to be filed with the FDIC within 120 days of the end of our fiscal year.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information concerning security ownership of certain beneficial owners and management required by this item is incorporated herein by reference to our definitive proxy statement for our 2013 Annual Meeting of Stockholders to be filed with the FDIC within 120 days of the end of our fiscal year.

The following table summarizes information, as of December 31, 2012, relating to our stock incentive plans, pursuant to which grants of options to acquire shares of common stock may be awarded from time to time.

	Number of securities to be issued upon exercise of outstanding options, warrants, and rights (A)	Weighted average exercise price of outstanding options, warrants, and rights (B)	Number of securities remaining available for future issuance under equity compensation plans [(1)] (C)
Equity compensation plans approved by security holders	574,465	$18.83	3,863,353
Equity compensation plans not approved by security holders	-	-	-
Total	574,465	$18.83	3,863,353

(1) Consists of shares available for future issuance under the TowneBank 2008 Stock Incentive Plan.

Item 13. CERTAIN RELATIONSHIPS, RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Reference is made to the information in the sections entitled, “Related Party Transactions,” “Election of Directors,” and “Board of Directors and Committees” of the Proxy Statement, which sections are incorporated herein by reference.

Item 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Reference is made to the information in the section entitled, “Accounting Firm Fees,” of the Proxy Statement, which section is incorporated herein by reference.

PART IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

a) The following documents are filed as part of this report.

(1) Financial Statements

The following documents are included in the 2012 Annual Report to Shareholders and are incorporated by reference in this report:

Report of Independent Registered Public Accounting Firm
Management's Report on Internal Control
Consolidated Balance Sheets
Consolidated Statements of Income
Consolidated Statements of Comprehensive Income
Consolidated Statements of Equity
Consolidated Statements of Cash Flows
Notes to Consolidated Financial Statements

(2) Financial Statement Schedules

All financial statement schedules as required by Item 8 and Item 15 of Form 10-K have been omitted because the information requested is not required, not applicable, or is shown in the Consolidated Financial Statements or Notes thereto.

(3) Exhibits

The following exhibits are filed as part of this Form 10-K and this list includes the Exhibit Index.

Exhibit No.	Description
3.1	Articles of Incorporation, as amended (incorporated herein by reference to Exhibit 3.1 to our Form 10-Q, previously filed with the FDIC on November 7, 2011).
3.2	Bylaws, as amended (incorporated herein by reference to Exhibit 3.2 to our Form 8-K, previously filed with the FDIC on November 28, 2007).
4.1	Warrant for Purchase of Shares of Common Stock (incorporated herein by reference to Exhibit 4.1 to our Form 8-K, previously filed with the FDIC on December 12, 2008).
4.2	Form of Certificate for Series C Preferred Stock (incorporated herein by reference to Exhibit 4.1 to our Form 8-K, previously filed with the FDIC on September 23, 2011).
10.1	TowneBank 1999 Stock Incentive Plan, as amended and restated effective March 24, 2004 (incorporated herein by reference to Exhibit 10.1 to our 2004 Form 10-K, previously filed with the FDIC on March 22, 2005).
10.2	Employment Agreement, dated October 1, 2005, between TowneBank and Jacqueline B. Amato (incorporated herein by reference to Exhibit 10 to our Form 8-K, previously filed with the FDIC on February 15, 2006).

Exhibits continued

10.3	Form of Employment Agreement entered into between TowneBank and each of G. Robert Aston, Jr., Anne C. H. Conner, J. Morgan Davis, Philip M. Rudisill, and William D. Sessoms (incorporated herein by reference to Exhibit 10.5 to our 2002 Form 10-K, previously filed with the FDIC on March 26, 2003).
10.4	Form of Employment Agreement entered into between TowneBank and each of Doug Burgoyne, William I. Foster, III, Thomas L. Hasty, III, William T. Hodsden, Keith D. Horton, Clyde E. McFarland, Jr., U. Starr Oliver, and P. Ward Robinett, Jr. (incorporated herein by reference to Exhibit 10.4 to our 2002 Form 10-K, previously filed with the FDIC on March 26, 2003).
10.5	Form of Change in Control Agreement entered into between TowneBank and each of G. Robert Aston, Jr., Anne C. H. Conner, J. Morgan Davis, Philip M. Rudisill, and William D. Sessoms (incorporated herein by reference to Exhibit 10.4 to our 2003 Form 10-K, previously filed with the FDIC on February 25, 2004).
10.6	Form of Change in Control Agreement entered into between TowneBank and each of Doug Burgoyne, William I. Foster, III, Thomas L. Hasty, III, William T. Hodsden, Keith D. Horton, Clyde E. McFarland, Jr., U. Starr Oliver, and P. Ward Robinett, Jr. (incorporated herein by reference to Exhibit 10.5 to our 2004 Form 10-K, previously filed with the FDIC on February 23, 2005).
10.7	Employment Agreement, dated April 19, 2011, between TowneBank and William B. Littreal (incorporated herein by reference to Exhibit 10.1 to our Form 8-K, previously filed with the FDIC on April 20, 2011).
10.8	Form of Supplemental Executive Retirement Plan (incorporated herein by reference to Exhibit 10.7 to our 2008 Form 10-K, previously filed with the FDIC on March 13, 2009).
10.9	TowneBank 2008 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.8 to our 2008 Form 10-K, previously filed with the FDIC on March 13, 2009).
10.10	Letter Agreement, dated as of December 12, 2008, including Securities Purchase Agreement - Standard Terms incorporated by reference therein, between TowneBank and the United States Department of the Treasury (incorporated herein by reference to Exhibit 10.1 to our Form 8-K, previously filed with the FDIC on December 12, 2008).
10.11	Securities Purchase Agreement, dated September 22, 2011, between the Company and the Secretary of the Treasury (incorporated herein by reference to Exhibit 10.1 to our Form 8-K, previously filed with the FDIC on September 23, 2011).
10.12	Repurchase Document, dated September 22, 2011, between the Company and the Treasury (incorporated herein by reference to Exhibit 10.2 to our Form 8-K, previously filed with the FDIC on September 23, 2011).

Exhibits continued

11	Statement re: Computation of Per Share Earnings (incorporated by reference to our 2012 Annual Report to Shareholders).
13	2012 Annual Report to Shareholders.
14	Code of Ethical Conduct.
21	Subsidiaries of TowneBank.
31.1	CEO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	CFO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification Pursuant to 18 U.S.C. Section 1350, as adopted by Section 906 of the Sarbanes-Oxley Act of 2002.

b) See (a)(3) above for all exhibits filed herewith and the Exhibit Index.

c) All schedules are omitted as the required information is not applicable or the information is presented in the Consolidated Financial Statements or related Notes.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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
Registrant

March 12, 2013	/s/ G. Robert Aston, Jr.
Date	By: G. Robert Aston, Jr. Chairman of the Board/Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 12, 2013:

SIGNATURES

/s/ Jacqueline B. Amato Jacqueline B. Amato	Chairman and CEO of TowneBank Mortgage, Director
/s/ G. Robert Aston, Jr. G. Robert Aston, Jr.	Chairman of the Board, Chief Executive Officer, Director
/s/ E. Lee Baynor E. Lee Baynor	Director
/s/ Richard S. Bray Richard S. Bray	Director
/s/ Thomas C. Broyles Thomas C. Broyles	Vice Chairman of the Board, Director

/s/ Bradford L. Cherry Bradford L. Cherry	Director
/s/ Anne C. H. Conner Anne C. H. Conner	President of TowneBank Williamsburg, Director
/s/ J. Morgan Davis J. Morgan Davis	President and Chief Banking Officer, Director
/s/ Douglas D. Ellis Douglas D. Ellis	Director
/s/ John W. Failes John W. Failes	Vice Chairman of the Board, Director
/s/ Paul J. Farrell Paul J. Farrell	Director
/s/ Andrew S. Fine Andrew S. Fine	Director
/s/ William I. Foster, III William I. Foster, III	President of TowneBank Virginia Beach, Director
/s/ Paul D. Fraim Paul D. Fraim	Director

/s/ Gordon L. Gentry, Jr. Gordon L. Gentry, Jr.	Director
/s/ Ernest F. Hardee Ernest F. Hardee	Vice Chairman of the Board, Director
/s/ John R. Lawson, II John R. Lawson, II	Director
/s/ Harry T. Lester Harry T. Lester	Director
/s/ W. Ashton Lewis W. Ashton Lewis	Director
/s/ Stephanie J. Marioneaux Stephanie J. Marioneaux	Director
/s/ Clyde E. McFarland, Jr. Clyde E. McFarland, Jr.	Senior Executive Vice President, Chief Financial Officer
/s/ Juan M. Montero, II Juan M. Montero, II	Director
/s/ R. Scott Morgan R. Scott Morgan	Director

/s/ Thomas K. Norment, Jr. Thomas K. Norment, Jr.	Director
/s/ R.V. Owens, III R.V. Owens, III	Director
/s/ P. Ward Robinett, Jr P. Ward Robinett, Jr.	President of TowneBank Portsmouth/Suffolk, Director
/s/ Wayne K. Sawyer Wayne K. Sawyer	Director
/s/ William D. Sessoms, Jr. William D. Sessoms, Jr.	President and CEO of Towne Financial Services Group, Director
/s/ Richard B. Thurmond Richard B. Thurmond	Director
/s/ Alan S. Witt Alan S. Witt	Director
/s/ F. Lewis Wood F. Lewis Wood	Director

TOWNEBANK

2012 Annual Report

TowneBank

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BUSINESS PROFILE

TowneBank was organized in 1998 under the laws of the Commonwealth of Virginia to engage in a general retail and commercial banking business and began operations on April 8, 1999. We place special emphasis on serving the financial needs of small- and medium-size businesses, professionals, and individuals in the Greater Hampton Roads region in southeastern Virginia and northeastern North Carolina. We offer a full range of banking and related financial services through our controlled divisions and subsidiaries that include TowneBank Investment Corporation; Towne Investments, LLC; Towne Insurance Agency, LLC ("Towne Insurance"); TowneBank Commercial Mortgage, LLC; TFA Benefits; Out of Town, LLC, d/b/a Red Sky Travel Insurance ("Red Sky"); Towne Mortgage, LLC; NewTowne Mortgage, LLC; Towne Mortgage of the Carolinas, LLC; SimonTowne Mortgage, LLC; Corolla Classic Vacations, LLC ("Corolla"); Towne 1031 Exchange, LLC; Towne New Markets CDE, Inc.; and Prudential Towne Realty ("PTR"), which includes Lawyers Escrow and Title, LLC, d/b/a Virginia Home Title and Settlements, Towne Investment Group, which provides investment and asset management services; and TowneBank Mortgage, which originates mortgage loans and sells them to investors on the national secondary market. Unless indicated otherwise, the terms "Company," "we," "us," and "our" refer to TowneBank and our consolidated 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.

CORPORATE MISSION STATEMENT

TowneBank will be a relationship and friendship-driven local bank focused on basic human values that will serve to create a warm sense of belonging and financial well-being among our family of members.

We will offer a competitive array of business and personal financial services, delivered only with the highest ethical standards. Our commitment to exquisite service for our members will lead to our ability to create a reasonable rate of return for our shareholders, a bright future for our dedicated bankers, and a leadership role for our bank in promoting the social, cultural, and economic well-being of our community.

TOWNEBANK
SELECTED FINANCIAL HIGHLIGHTS

Period Ended December 31,	2012	2011	2012/2011 Increase/(Decrease)	
(Dollars in thousands, except per share data)				
Results of Operations:				
Net interest income	$ 144,284	$ 136,222	$ 8,062	5.92%
Noninterest income (1)	81,184	64,052	17,132	26.75%
Noninterest expenses	158,749	144,820	13,929	9.62%
Provision for loan losses	16,155	13,602	2,553	18.77%
Net income	37,931	33,321	4,610	13.84%
Net income per common share - basic (2)	1.03	0.77	0.26	33.77%
Net income per common share - diluted (2)	1.03	0.76	0.27	35.53%
Period End Data:				
Total assets	$ 4,405,923	$ 4,081,770	$ 324,153	7.94%
Total assets - tangible	4,286,921	3,966,832	320,089	8.07%
Earning assets (3)	4,033,813	3,712,187	321,626	8.66%
Loans (net of unearned income and deferred costs)	3,133,507	2,793,193	340,314	12.18%
Allowance for loan losses	40,427	39,740	687	1.73%
Goodwill and other intangibles	119,002	114,938	4,064	3.54%
Noninterest-bearing deposits	978,818	839,211	139,607	16.64%
Interest-bearing deposits	2,401,234	2,351,576	49,658	2.11%
Total deposits	3,380,052	3,190,787	189,265	5.93%
Equity	559,879	520,489	39,390	7.57%
Equity - tangible	440,877	405,551	35,326	8.71%
Book value per share (2)	13.30	12.65	0.65	5.14%
Book value per share - tangible (2)	9.52	8.82	0.70	7.94%
Cash dividends declared per share (2)	0.33	0.31	0.02	6.45%
Daily Average Balances:				
Total assets	$ 4,201,452	$ 3,990,783	$ 210,669	5.28%
Total assets - tangible	4,087,602	3,877,103	210,499	5.43%
Earning assets (3)	3,811,846	3,604,641	207,205	5.75%
Loans (net of unearned income)	2,910,406	2,678,004	232,402	8.68%
Allowance for loan losses	40,100	40,928	(828)	(2.02%)
Goodwill and other intangibles	113,850	113,680	170	0.15%
Noninterest-bearing deposits	904,512	781,992	122,520	15.67%
Interest-bearing deposits	2,370,003	2,308,099	61,904	2.68%
Total deposits	3,274,515	3,090,091	184,424	5.97%
Total equity	545,566	511,724	33,842	6.61%
Total equity - tangible	431,716	398,045	33,671	8.46%
Key Ratios:				
Return on average assets	0.90%	0.83%	0.07%	8.43%
Return on average tangible assets	0.93%	0.86%	0.07%	8.14%
Return on average equity	6.95%	6.51%	0.44%	6.76%
Return on average tangible equity	8.79%	8.37%	0.42%	5.02%
Net interest margin (3)(4)	3.92%	3.94%	(0.02%)	(0.51%)
Efficiency ratio (1)	70.41%	72.31%	(1.90%)	(2.63%)
Average earning assets/total average assets	90.73%	90.32%	0.41%	0.45%
Average loans/average deposits	88.88%	86.66%	2.22%	2.56%
Average noninterest deposits/total average deposits	27.62%	25.31%	2.31%	9.13%
Allowance for loan losses/period end loans	1.29%	1.42%	(0.13%)	(9.15%)
Period end equity/period end total assets	12.71%	12.75%	(0.04%)	(0.31%)

Notes:

(1) Excludes investment securities gains of $3.01 million in 2012 and $3.68 million in 2011.
(2) Prior period was restated to reflect 3% common stock dividend paid June 12, 2012.
(3) Includes bank-owned life insurance.
(4) Presented on a tax-equivalent basis.

TOWNEBANK
SELECTED FINANCIAL HIGHLIGHTS

Period Ended December 31,	2010	2009	2008
(Dollars in thousands, except per share data)			
Results of Operations:			
Net interest income	$ 122,635	$ 100,343	$ 87,127
Noninterest income (1)	60,089	51,589	40,907
Provision for loan losses	22,565	12,891	7,022
Net income	30,276	26,759	23,894
Net income per common share - basic (2)	0.72	0.65	0.90
Net income per common share - diluted (2)	0.71	0.64	0.89
Period End Data:			
Total assets	$ 3,871,018	$ 3,606,451	$ 3,133,578
Total assets - tangible	3,762,072	3,506,514	3,061,545
Earning assets (3)	3,537,322	3,295,462	2,911,658
Loans (net of unearned income and deferred costs)	2,731,352	2,565,910	2,350,186
Allowance for loan losses	38,660	33,793	27,503
Goodwill and other intangibles	108,946	99,937	72,033
Noninterest-bearing deposits	706,040	572,228	475,290
Interest-bearing deposits	2,248,474	1,989,474	1,763,378
Total deposits	2,954,514	2,561,702	2,238,668
Shareholders' equity	499,512	464,321	419,763
Shareholders' equity - tangible	390,566	364,384	347,730
Book value per share (2)	12.10	11.52	11.40
Book value per share - tangible (2)	8.44	7.99	8.55
Cash dividends declared per share (2)	0.31	0.31	0.31
Daily Average Balances:			
Total assets	$ 3,721,155	$ 3,432,368	$ 2,778,722
Total assets - tangible	3,622,944	3,350,603	2,706,140
Earning assets (3)	3,392,093	3,190,132	2,541,753
Loans (net of unearned income)	2,587,287	2,440,060	2,059,351
Allowance for loan losses	35,158	28,841	23,745
Goodwill and other intangibles	98,211	81,764	72,582
Noninterest-bearing deposits	649,840	566,435	484,735
Interest-bearing deposits	2,101,692	1,953,497	1,537,759
Total deposits	2,751,532	2,519,931	2,022,494
Shareholders' equity	490,572	437,556	296,749
Shareholders' equity - tangible	392,361	355,792	224,167
Key Ratios:			
Return on average assets	0.81%	0.78%	0.86%
Return on average tangible assets	0.84%	0.80%	0.88%
Return on average equity	6.17%	6.12%	8.05%
Return on average tangible equity	7.72%	7.52%	10.66%
Net interest margin (3)(4)	3.76%	3.29%	3.60%
Efficiency ratio (1)	67.18%	73.58%	71.28%
Average earning assets/total average assets	91.16%	92.94%	91.47%
Average loans/average deposits	94.03%	96.79%	101.82%
Average noninterest deposits/total average deposits	23.62%	22.48%	23.97%
Allowance for loan losses/period end loans	1.42%	1.32%	1.17%
Period end equity/period end total assets	12.90%	12.87%	13.39%

Notes:

(1) Excludes investment securities gains of $5.96 million, $11.15 million, and $2.96 million in 2010, 2009, and 2008, respectively.

(2) Prior period was restated to reflect 3% common stock dividend paid June 12, 2012.

(3) Includes bank-owned life insurance.

(4) Presented on a tax-equivalent basis.

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.

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 presented have been restated for all periods to reflect the stock dividend.

The following is a summary of the Company's 2012 financial performance:

- Net income increased to $37.93 million compared with $33.32 million in 2011. Net income available to common shareholders for 2012 was $31.71 million after preferred stock dividend payments of $6.23 million. Fully diluted earnings rose to $1.03 per common share as compared to $0.76 per common share in 2011.

- Net interest income increased $8.06 million, or 5.92%, primarily due to the growth in earning assets and the positive effect from the repricing of interest-bearing liabilities.

- The provision for loan losses increased $2.55 million, or 18.77%, from 2011. The increase was primarily attributable to an increase in net charge-offs combined with growth in the loan portfolio. These factors were partially offset by improvements in certain credit quality metrics. The loan loss reserve was 1.29% of loans at December 31, 2012, down from 1.42% at year-end 2011.

- Excluding gains on investment securities, noninterest income increased by $17.13 million, or 26.75%, over 2011. This increase was driven by a $14.36 million increase in residential mortgage banking income primarily as a result of the November 1, 2011, acquisition of Benchmark Mortgage, Inc. ("Benchmark"), a mortgage company affiliated with TowneBank Mortgage, and other expansions of our mortgage operations. Also contributing to the increase was continued growth in our Insurance segment, primarily due to our acquisition of Stanton Taylor Agency, Inc. ("Stan Taylor") on October 3, 2011.

- Noninterest expense increased $13.93 million, or 9.62%, compared to 2011. The increase was predominantly driven by acquisitions and expansions in our Insurance and Real Estate segments, which led to higher personnel costs and occupancy expenses.

- The effective tax rate decreased to 26.91% in 2012 compared to 27.64% in 2011. The decrease was primarily a result of increased federal tax credits from community reinvestment activity and was partially offset by the effect of higher taxable income.

2012 ACQUISITION

Effective December 31, 2012, TowneBank acquired The Clement Companies ("Clement"), an independent insurance agency that is affiliated with Towne Insurance. The purchase price was $6.30 million in cash and stock.

CRITICAL ACCOUNTING POLICIES

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

Allowance for Loan Losses: The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. Increases and decreases in the allowance due to changes in the measurement of impaired loans, if applicable, are included in the provision for loan losses. We periodically evaluate the adequacy of the allowance for loan losses in order to maintain the allowance at a level that is sufficient to absorb probable credit losses. The amount of allowance is based on management's evaluation of the collectability of the loan portfolio, including the nature of the loan portfolio, credit concentrations, trends in historical loss experience, specific impaired loans, and external influences such as changes in economic conditions.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses. Such agencies may require us to recognize additions to the allowance based on their judgments of information available to them at the time of their examination. Although management believes that we use the best information available to evaluate the adequacy of the allowance, unknown market or borrower circumstances could result in adjustments and net earnings being significantly affected if conditions differ substantially from the assumptions used by management in determining the adequacy of the allowance.

Other Real Estate Owned: Other real estate owned ("OREO"), which is included in other assets on the balance sheet, consists primarily of commercial and residential real estate that has been obtained in partial or full satisfaction of loan obligations. OREO is carried at the fair value of the property, less estimated selling costs, with any difference between the fair value of the property, less estimated selling costs, and the carrying value of the loan recorded through a charge to the allowance for loan losses upon transfer to OREO. Subsequent write-downs required for declines in value are recorded through a valuation allowance, or taken directly to the asset, charged to other noninterest expense.

Deferred Income Taxes: Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets, including tax loss and credit carry-forwards, and deferred tax liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Deferred income tax expense (benefit) represents the change during the period in the deferred tax assets and deferred tax liabilities.

We use the asset and liability method in accounting for income taxes. This method recognizes the amount of taxes payable or refundable for the current year and recognizes deferred tax liabilities and assets for the expected future tax consequences of events and transactions that have been recognized in our financial statements or tax returns.

Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Realization of the deferred income tax asset is dependent on generating sufficient taxable income in future years, and, as such, material changes could impact our financial condition and results of operations.

Estimates of Fair Value of Financial Instruments: The estimation of fair value is significant to certain assets, including loans held for sale, available-for-sale securities, and on-balance-sheet commitments to originate loans held for sale. These assets and liabilities are recorded either at fair value or at the lower of cost or fair value, as applicable. The 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. The fair values of available-for-sale securities 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. The fair values of commitments to originate loans held for sale are based on fees currently charged to enter into similar agreements and, for fixed-rate commitments, also consider the difference between current levels of interest rates and committed rates.

Fair values can be volatile and may be influenced by a number of factors, including market interest rates, prepayment speeds, discount rates, and market conditions. Since these factors can change significantly and rapidly, fair values are difficult to predict and subject to material changes that could impact our financial condition and results of operations.

Goodwill and Other Intangibles: We record all assets and liabilities acquired in purchase acquisitions, including goodwill, intangibles with indefinite lives, and other intangibles, at fair value as required by Accounting Standards Codification Topic ("ASC") 805, *Business Acquisitions*. The initial recording of goodwill and other intangibles requires subjective decisions concerning estimates of the fair value of the acquired assets and liabilities.

Goodwill is reviewed for potential impairment at the reporting unit level (one level below the business segments identified on pages 14-18) on an annual basis, or more often if events or circumstances indicate there may be impairment. Testing is conducted in two steps: identifying the potential impairment and then, if necessary, identifying the amount of impairment. The first step compares the fair value of the reporting unit to its carrying amount. If the fair value is less than the carrying amount, a second test is conducted by comparing the implied fair value of reporting unit goodwill with the carrying amount of that goodwill. If the carrying amount exceeds the implied fair value, an impairment loss is recognized in an amount equal to that excess.

Other identifiable intangible assets are evaluated for impairment if events or changes in circumstances indicate a possible impairment. Such evaluation is based on undiscounted cash flow projections, which may extend far into the future and, by their nature, are difficult to determine over an extended timeframe. Fair value may be influenced by market prices, comparison to similar assets, market multiples, discounted cash flow analysis, and other determinants. Factors that may significantly affect the estimates include, among others, competitive forces, customer behaviors and attrition, changes in revenue growth trends, cost structures and technology, changes in discount rates, and specific industry or market sector conditions. Other key judgments in accounting for intangibles include useful life and classification between goodwill and intangibles with indefinite lives or other intangibles that require amortization.

ANALYSIS OF RESULTS OF OPERATIONS

Consolidated Performance Summary

Results of Operations: We reported net income for the years ended December 31, 2012, 2011, and 2010 of \$37.93 million, \$33.32 million, and \$30.28 million, respectively. Diluted earnings per share were \$1.03, \$0.76, and \$0.71 for the years ended December 31, 2012, 2011, and 2010, respectively. Earnings per share were impacted in 2011 by the acceleration of the discount on the repurchased Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series B ("Series B Preferred Stock"), which reduced net income available to common shareholders by \$1.86 million.

Profitability, as measured by our return on average assets ("ROA") was 0.90%, 0.83%, and 0.81% for the years ended December 31, 2012, 2011, and 2010, respectively. Return on average tangible assets was 0.93%, 0.86%, and 0.84% for the same respective periods. ROA was positively affected by the increase in noninterest income as the growth in average assets was outpaced by net income growth.

Return on average equity ("ROE") was 6.95%, 6.51%, and 6.17% for years ended December 31, 2012, 2011, and 2010, respectively; while return on average tangible equity was 8.79%, 8.37%, and 7.72% for the same respective years. ROE was impacted by the 13.84% increase in TowneBank's net income from 2011 as compared to the 6.61% increase in average equity.

Our operating income, calculated as net interest income and noninterest income less gains on investment securities, was \$225.47 million for the year ended December 31, 2012, compared to \$200.27 million and \$182.72 million for 2011 and 2010, respectively.

Net Interest Income: Net interest income, the major source of our earnings, is the income generated by interest-earning assets reduced by the total interest cost of the funds incurred to carry them. It is impacted by market interest rates and the mix and volume of earning assets and interest-bearing liabilities. The yields and rates in this discussion and in the following tables include income from bank-owned life insurance ("BOLI"), a non-GAAP measure, and 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.

Our balance sheet is currently in an asset-sensitive balance sheet position, meaning that earning assets generally reprice more quickly than interest-bearing liabilities. Therefore, our net interest margin is likely to increase in sustained periods of rising interest rates and decrease in sustained periods of declining interest rates. If we were in a liability-sensitive balance sheet position, which implies that liabilities, such as deposits, will reprice more quickly than assets, net interest margin could be negatively affected in an increasing interest rate environment and positively affected in a decreasing rate environment. We are primarily funded by core deposits, with noninterest-bearing demand deposits historically being a significant source of funds. This lower-cost funding base is expected to have a positive impact on the Company's net interest income and net interest margin in a rising interest rate environment. We currently believe it is likely the federal funds rate and the prime interest rate will remain at the current, historically-low levels for the foreseeable future; however, there can be no assurance to that effect or as to the magnitude of any change in market interest rates should a change occur, as such changes are dependent upon a variety of factors that are beyond our control, including the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Net interest income, on a tax-equivalent basis, was $149.37 million for the year ended December 31, 2012, which was $7.23 million, or 5.08%, above the $142.15 million reported in the previous year. In comparison to the prior year, net interest income improved primarily as a result of lower funding costs.

Interest income, on a tax-equivalent basis, was $178.60 million for the year ended December 31, 2012, which was $199,000, or 0.11%, more than $178.40 million for the year ended December 31, 2011. Average earning assets grew to $3.81 billion in 2012 from $3.60 billion in 2011, an increase of $207.21 million or 5.75%. The yield on earning assets was 4.69% in the year ended December 31, 2012, which compared to 4.95% in the prior year. The effects of lower yields across all categories were offset by the increased balances in earning assets, primarily in average loans held for sale, which increased $65.47 million, or 124.16%, and average loans held for investment, net of unearned income and excluding nonaccrual loans, which increased $232.40 million, or 8.68%. Interest income was also positively impacted by the accretion recognized due to the call of several trust preferred corporate securities held by the Company, with total recorded balances of $20.24 million. The called securities had yields ranging from 6.90% to 10.00%. Trust preferred corporate securities generally have a higher yield than other security types, which may put downward pressure in future periods on net interest income and the net interest margin if lower yielding assets are acquired in place of the called securities.

Interest expense, for the year ended December 31, 2012, was down $7.03 million, or 19.39%, at $29.22 million compared to $36.25 million for the year ended December 31, 2011. The balance of average interest-bearing liabilities increased to $2.69 billion in 2012 from $2.64 billion in 2011, an increase of $47.87 million, or 1.81%. The higher balance was offset by a drop in the average rate paid, from 1.37% in 2011 to 1.09% in 2012. The decline was driven by lower costs in all deposit categories, a decrease in the average balance of certificates of deposit, and the redemption of our convertible subordinated debentures.

Net interest margin, which is net interest income expressed as a percentage of average earning assets, was 3.92% in the year ended December 31, 2012, which was two basis points lower than the 3.94% a year ago. The decrease was driven by the fall in yields on earning assets, but was mostly offset by the improvement in rates on interest-bearing liabilities. Net interest margin will be impacted by future changes in short-term and long-term interest rate levels, as well as the impact from the competitive environment.

The purpose of volume and rate analysis is to describe the impact on interest income resulting from changes in average balances and average interest rates from those in effect during the previous year. The following tables include average balances, interest income and expense, average yields and costs, and volume and rate analysis (dollars in thousands):

	Year Ended December 31,								
	2012			2011			2010		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate (1)	Average Balance	Interest Income/ Expense	Average Yield/ Rate (1)	Average Balance	Interest Income/ Expense	Average Yield/ Rate (1)
Assets:									
Loans (net of unearned income and deferred costs), excluding nonaccrual loans (2)	$ 2,910,406	$ 157,053	5.40%	$ 2,678,004	$ 154,015	5.75%	$ 2,587,287	$ 148,500	5.74%
Taxable investment securities	260,630	6,163	2.36%	360,288	10,135	2.81%	451,540	12,305	2.73%
Tax-exempt investment securities	159,322	7,248	4.55%	146,556	7,214	4.92%	115,237	6,144	5.33%
Interest-bearing deposits	309,098	783	0.25%	313,950	802	0.26%	107,307	298	0.28%
Mortgage loans held for sale	118,206	4,173	3.53%	52,734	2,267	4.30%	83,015	3,617	4.36%
Bank-owned life insurance	54,184	3,175	5.86%	53,109	3,963	7.46%	47,707	3,285	6.88%
Total earning assets	3,811,846	178,595	4.69%	3,604,641	178,396	4.95%	3,392,093	174,149	5.13%
Less: allowance for loan losses	(40,100)			(40,928)			(35,158)		
Total nonearning assets	429,706			427,070			364,220		
Total assets	$ 4,201,452			$ 3,990,783			$ 3,721,155		
Liabilities and Equity:									
Interest-bearing deposits									
Demand and money market	$ 1,064,840	$ 4,242	0.40%	$ 880,169	$ 4,944	0.56%	$ 613,746	$ 3,074	0.50%
Savings	194,933	1,000	0.51%	163,905	1,173	0.72%	89,954	667	0.74%
Certificates of deposit	1,110,230	11,507	1.04%	1,264,025	16,236	1.28%	1,397,992	26,383	1.89%
Total interest-bearing deposits	2,370,003	16,749	0.71%	2,308,099	22,353	0.97%	2,101,692	30,124	1.43%
FHLB advances and repurchase agreements	318,494	12,236	3.84%	321,682	12,746	3.96%	393,360	14,214	3.61%
Convertible subordinated capital debentures	2,950	237	8.03%	13,792	1,152	8.35%	29,311	2,222	7.58%
Total interest-bearing liabilities	2,691,447	29,222	1.09%	2,643,573	36,251	1.37%	2,524,363	46,560	1.84%
Noninterest-bearing liabilities									
Demand deposits	904,512			781,992			649,840		
Other noninterest-bearing liabilities	59,927			53,494			56,380		
Total liabilities	3,655,886			3,479,059			3,230,583		
Shareholders' equity	545,566			511,724			490,572		
Total liabilities and equity	$ 4,201,452			$ 3,990,783			$ 3,721,155		
Net interest income (tax-equivalent basis)		$ 149,373			$ 142,145			$ 127,589	
Reconcilement of Non-GAAP Financial Measures									
Bank-owned life insurance		(3,175)			(3,963)			(3,285)	
Tax-equivalent basis adjustment		(1,914)			(1,960)			(1,669)	
Net interest income (GAAP)		$ 144,284			$ 136,222			$ 122,635	
Interest rate spread (3)			3.60%			3.58%			3.29%
Interest expense as a percent of average earning assets			0.77%			1.01%			1.37%
Net interest margin (tax-equivalent basis) (4)			3.92%			3.94%			3.76%
Total cost of deposits			0.51%			0.72%			1.09%

(1) Yields and interest income are presented on a taxable-equivalent basis using the federal statutory tax rate of 35%.
(2) Excludes average nonaccrual loans of $54.44 million in 2012, $64.39 million in 2011, and $46.15 million in 2010.
(3) Interest rate spread is the average yield earned on earning assets less the average rate paid on interest-bearing liabilities.
(4) Net interest margin is net interest income expressed as a percentage of average earning assets.

Provision for Loan Losses: The provision for loan losses is charged against earnings in order to establish and maintain the allowance for loan losses at a level that reflects management's evaluation of the risk inherent in the portfolio. Management considers continuing assessments of nonperforming and "watch list" loans, analytical reviews of loan loss experience in relation to outstanding loans, and management's judgment with respect to current and expected economic conditions and their impact on the existing loan portfolio. The provisions for loan losses recorded in 2012, 2011, and 2010 were $16.16 million, $13.60 million, and $22.57 million, respectively. Net charge-offs were $15.47 million, $12.52 million, and $17.70 million for 2012, 2011, and 2010, respectively. The increase in the provision for loan losses from 2011 was primarily attributable to an increase in net charge-offs combined with growth in the loan portfolio. These factors were partially offset by improvements in certain credit quality metrics. The allowance for loan losses as a percentage of period-end loans was 1.29% and 1.42% at December 31, 2012 and 2011, respectively. For further discussion and analysis of the loan portfolio and the allowance for loan losses, see the "Analysis of Financial Condition" section found later in this report. Also, see Note 4 "Loans and Allowance for Loan Losses" in the Notes to Consolidated Financial Statements.

Noninterest Income: Total noninterest income for the year ended December 31, 2012, was $84.19 million, or $16.46 million and 24.30% higher than 2011. Excluding gains and losses on investment securities, total noninterest income increased by $17.13 million, or 26.75%, over 2011. Total noninterest income for the year ended December 31, 2011, was $67.73 million, representing a $1.68 million, or 2.55%, increase from 2010. Excluding gains and losses on investment securities, total noninterest income increased by $3.96 million, or 6.60%, over 2010. Included in noninterest income were gains on investment securities of $3.01 million in 2012, $3.68 million in 2011, and $5.96 million in 2010. Noninterest income, excluding securities gains or losses, for the year ended December 31, 2012, was 36.01% of total operating income, compared with 31.98% for 2011 and 32.89% for 2010.

The following table provides an analysis of noninterest income (dollars in thousands):

				2012/2011 Increase/(Decrease)		2011/2010 Increase/(Decrease)	
For the Year Ended December 31,	**2012**	**2011**	**2010**	**Amount**	**%**	**Amount**	**%**
Residential mortgage brokerage income, net	$ 26,998	$ 12,642	$ 12,998	$ 14,356	113.56%	$ (356)	(2.74%)
Real estate brokerage and property management income, net	11,515	11,496	11,155	19	0.17%	341	3.06%
Insurance commissions and other title fees and income, net	23,458	22,546	20,189	912	4.05%	2,357	11.67%
Service charges on deposit accounts	7,798	7,211	6,556	587	8.14%	655	9.99%
Credit card merchant fees	3,578	2,828	2,261	750	26.52%	567	25.08%
Other income							
Other	1,885	1,689	1,718	196	11.60%	(29)	(1.69%)
Towne Investment income, net	1,954	1,608	1,342	346	21.52%	266	19.82%
Bank-owned life insurance income	2,064	2,576	2,157	(512)	(19.88%)	419	19.43%
Service fees on loans	1,026	778	813	248	31.88%	(35)	(4.31%)
Towne Mortgage LLC income, net	527	410	703	117	28.54%	(293)	(41.68%)
Commerical mortgage brokerage fees, net	381	268	148	113	42.16%	120	81.08%
Other real estate income	-	-	49	-	N/M	(49)	(100.00%)
Total other income	7,837	7,329	6,930	508	6.93%	399	5.76%
Noninterest income before securities gain/(loss)	81,184	64,052	60,089	17,132	26.75%	3,963	6.60%
Gain/(loss) on securities available for sale	3,005	3,681	5,961	(676)	(18.36%)	(2,280)	(38.25%)
Total noninterest income	$ 84,189	$ 67,733	$ 66,050	$ 16,456	24.30%	$ 1,683	2.55%

N/M = not meaningful

For the year ended December 31, 2012, residential mortgage banking income, net of commission expense, was $27.0 million, reflecting an increase of $14.36 million, or 113.56%, compared to 2011, which was $356,000, or 2.74%, less than 2010. The increase from the prior year was primarily due to the November 1, 2011, acquisition of Benchmark, a mortgage company affiliated with TowneBank Mortgage, and other expansions of our mortgage operations resulting in additional net mortgage banking income of $10.38 million as compared to 2011. Additionally, moderate improvements in the housing market and historically low mortgage interest rates contributed to a higher volume in purchase and refinancing transactions and a corresponding increase in net mortgage banking income from the prior year. Also, the Company recognized gains on rate lock commitments of $1.24 million in 2012. The decrease in net mortgage banking income in 2011 from 2010 was attributable to lower volume in purchase and refinancing transactions, which led to a corresponding decrease in net mortgage banking income. For further information, refer to our discussion of the Realty segment on page 15 of this Annual Report, which provides a comparative schedule of operations.

Real estate brokerage and property management income, net of commission expense, for the year ended December 31, 2012, was $11.52 million, an increase of $19,000, or 0.17%, from 2011, which was $341,000, or 3.06%, higher than 2010. The variance from the prior year is primarily attributable to a slight increase in net property management fee income. Real estate brokerage income was flat as an increase in income was offset by a corresponding increase in commission expenses. The total volume of units sold increased by $22.69 million, or 2.74%, while the number of units sold rose to 3,224, an increase of 152 units, or 4.95%, from 2011. The increase in 2011 from 2010 was primarily attributable to an increase in net property management fee income, which was partially offset by a slight decrease in real estate brokerage income resulting from an increase in commission expenses.

For the year ended December 31, 2012, insurance commissions and other title income, net of commission expense, was $23.46 million, which was $912,000, or 4.05%, higher than comparative 2011. The increase from the prior year was largely due to an increase in property and casualty insurance commissions related to the acquisition of Stan Taylor, effective October 3, 2011. Stan Taylor contributed commission income of $1.17 million in 2012, an increase of $904,000 over 2011. The year ended December 31, 2012, included contingency income from property and casualty insurance of $1.32 million compared to $1.65 million and $1.75 million for 2011 and 2010, respectively. When compared to 2010, insurance commissions for the year ended December 31, 2011, were $2.36 million, or 11.67%, higher, largely due to the acquisition of Stan Taylor and W.T. Chapin, Inc. ("Chapin") on January 14, 2011, which contributed commission income of $270,000 and $2.03 million, respectively.

Service charges on deposit accounts were $7.80 million for 2012, compared with $7.21 million and $6.56 million for 2011 and 2010, respectively. The increases reflect the 5.97% and 12.30% increase in average deposits over the years ended December 31, 2012 and 2011, respectively.

For the year ended December 31, 2012, credit card merchant fees totaled $3.58 million, which was $750,000, or 26.52%, above comparative 2011, which was $567,000, or 25.08%, more than 2010. The increases in both years were primarily due to higher transaction volume.

Other noninterest income for the year ended December 31, 2012, was $7.84 million compared with $7.33 million for the year ended December 31, 2011, and $6.93 million for the year ended December 31, 2010. Other noninterest income includes income generated by Towne Investment Group, net of commission expense of $1.95 million, $1.61 million, and $1.34 million for the years ended December 31, 2012, 2011, and 2010, respectively.

Noninterest Expense: Total noninterest expense for 2012 was $158.75 million, which was $13.93 million, or 9.62%, higher than 2011. The primary components of 2012 noninterest expense were salaries and employee benefits of $89.67 million, occupancy expenses of $14.38 million, furniture and equipment expenses of $6.47 million, advertising and marketing expenses of $4.82 million, foreclosed property expenses of $4.61 million, and professional fees of $4.61 million. In comparison to 2011, a significant portion of the increase in total noninterest expense is due to the October 3, 2011, acquisition of the Stan Taylor insurance agency, which resulted in additional expenses of $877,000, primarily in salaries and benefits, and the November 1, 2011, acquisition of Benchmark and other expansions of our mortgage operations, which resulted in additional expenses of $7.40 million, primarily in salaries and benefits. Excluding the costs associated with the acquisitions and expansions, noninterest expense increased $5.66 million, or 3.91%, from 2011. The increase in total noninterest expense from 2010 to 2011 was due to the December 3, 2010, acquisition of the deposit accounts and certain assets of The Bank of Currituck, which resulted in additional expenses of $5.78 million, the acquisitions of Chapin and Stan Taylor, which resulted in additional expenses of $1.56 million and $283,000, respectively, and the acquisition of Benchmark and other expansions of our mortgage operations, which resulted in additional expenses of $1.21 million. Additionally, a full year of expenses related to the 2010 openings of our new Virginia Beach and Suffolk banking centers resulted in an increase of $988,000.

Total noninterest expense to total operating revenue, excluding securities gains and losses, was 70.41% for the year ended December 31, 2012, compared with 72.31% for 2011 and 67.18% for 2010.
The following table provides an analysis of noninterest expense (dollars in thousands):

				2012/2011 Increase/(Decrease)		2011/2010 Increase/(Decrease)	
For the year ended December 31,	**2012**	**2011**	**2010**	**Amount**	**%**	**Amount**	**%**
Salaries and benefits	$ 89,669	$ 79,558	$ 69,085	$ 10,111	12.71%	$ 10,473	15.16%
Occupancy	14,384	13,879	11,931	505	3.64%	1,948	16.33%
Furniture and equipment	6,467	5,805	5,312	662	11.40%	493	9.28%
Other expenses							
Advertising and marketing	4,818	3,775	4,056	1,043	27.63%	(281)	(6.93%)
Charitable contributions	3,574	3,174	2,704	400	12.60%	470	17.38%
Telephone and postage	3,527	3,112	2,731	415	13.34%	381	13.95%
Outside processing	3,019	2,974	2,446	45	1.51%	528	21.59%
Professional fees	4,606	4,176	2,963	430	10.30%	1,213	40.94%
Other	7,787	5,957	4,708	1,830	30.72%	1,249	26.53%
Stationery and office supplies	2,048	1,925	1,775	123	6.39%	150	8.45%
Amortization expense of intangibles	2,251	2,651	2,675	(400)	(15.09%)	(24)	(0.90%)
Foreclosed property expenses	4,612	5,822	950	(1,210)	(20.78%)	4,872	512.84%
FDIC and other insurance	3,729	4,251	4,525	(522)	(12.28%)	(274)	(6.06%)
Software expense	4,227	3,457	3,120	770	22.27%	337	10.80%
Travel/Meals/Entertainment	981	820	655	161	19.63%	165	25.19%
Directors' expense	1,179	1,526	944	(347)	(22.74%)	582	61.65%
Bank franchise tax/SCC fees	1,871	1,958	2,165	(87)	(4.44%)	(207)	(9.56%)
Total other expenses	48,229	45,578	36,417	2,651	5.82%	9,161	25.16%
Total noninterest expense	$ 158,749	$ 144,820	$ 122,745	$ 13,929	9.62%	$ 22,075	17.98%

Salaries and employee benefits, the largest portion of noninterest expense, were $89.67 million, representing 56.48% of total noninterest expense for the year ended December 31, 2012. This was a $10.11 million, or 12.71%, increase over comparative 2011. The increase from comparative periods of the prior year is due to the addition of staff resulting from the expansion of our insurance and mortgage businesses, an increase in profit sharing and incentive compensation, an increase in expense related to the management deferred compensation plan, and cost-of-living raises for employees. Salaries and benefits expense for the year ended December 31, 2011, was $79.56 million, up 15.16%, or $10.47 million, over 2010. The increase was due to a combination of factors, including the addition of employees to service customers in our new banking centers, the addition of staff resulting from the Chapin, Stan Taylor, Benchmark, and Bank of Currituck business combinations, the acceleration of retirement plan expenses for certain employees who retired in 2011, and cost-of-living raises for employees.

In our Banking segment, we had a total of 637 full-time equivalent employees ("FTE") at December 31, 2012, which was up from 625 and 581 at December 31, 2011 and 2010, respectively. In our non-Banking segments at December 31, 2012, we had a total of 584 FTEs, excluding real estate sales agents, which was up from 506 and 413 at December 31, 2011 and 2010, respectively. Real estate agents are independent contractors and, therefore, not included as the Company's employees. There were 378 real estate agents at December 31, 2012. Total operating revenue, excluding securities gains per full-time equivalent employee, was approximately $185,000, $177,000, and $183,000 for the years ended December 31, 2012, 2011, and 2010, respectively.

For the year ended December 31, 2012, occupancy expense totaled $14.38 million, representing an increase of $505,000, or 3.64%, over comparative 2011. Occupancy expense for 2011 was $1.95 million, or 16.33%, over the 2010 amount of $11.93 million. The primary driver of the increase in occupancy expense in 2012 was the expansion of mortgage operations combined with an increase in depreciation expense related to the expansion of our Member Service Center in Suffolk, Virginia. The increase in 2011 over 2010 was due to the acquisition of branches in the Bank of Currituck transaction and a full year of expenses related to the opening of new banking centers in Suffolk, Virginia Beach, and Williamsburg during 2010.

Furniture and equipment expense was $6.47 million for 2012, or $662,000 and 11.40%, higher than 2011. Furniture and equipment expense was $5.81 million for 2011, or $493,000 and 9.28%, higher than comparative 2010. Increases in both comparative periods were related to furnishing new facilities and the associated depreciation expense on the capitalized furnishings utilized in those facilities.

Other expenses for 2012 were $48.23 million, which was $2.65 million, or 5.82%, higher than the 2011 amount of $45.58 million. The primary drivers of the increase were expenses related to advertising and marketing, which were higher by $1.04 million, an increase in software expense of $770,000, and an increase in other expenses of $1.83 million, primarily due to increases in merger and acquisition costs, certain miscellaneous loan expenses, and a one-time impairment charge 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 a decrease of $1.21 million in expenses related to foreclosed properties. Other expenses for 2011 were $45.58 million, or 25.16%, higher than the 2010 amount of $36.42 million due to increases in professional fees, foreclosed property expenses, and directors' expenses.

Income Taxes: Income taxes for the year ended December 31, 2012, were $13.96 million. This was $1.24 million higher than the 2011 amount of $12.73 million, which was $270,000 higher than the 2010 amount of $12.46 million. The effective tax rate for 2012 was 26.91% versus 27.64% for 2011 and 29.15% for 2010. The rate decreases in 2012 and 2011 were primarily a result of increased federal tax credits from community reinvestment activity, while the 2011 increase was also related to increased income from qualified tax-exempt municipal obligations. Refer to Note 19 in the Notes to Consolidated Financial Statements for a discussion regarding the components of the statutory rate and the deferred tax composition.

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 24 in the Notes to Consolidated Financial Statements.

Banking Segment: For the year ended December 31, 2012, the Banking segment represented 76.29%, or $28.94 million, of our total consolidated net income, compared to 83.90% and 80.38% for 2011 and 2010.

Earnings for the year ended December 31, 2012, for the Banking segment were $28.94 million, increasing $981,000, or 3.51%, from 2011. The increase in earnings was primarily driven by an increase in net interest income of $6.80 million, or 5.05%, and an increase in service charges on deposit accounts and credit card merchant fees. Comparatively, earnings for the year ended December 31, 2011, for the Banking segment were $27.96 million, increasing $3.62 million, or 14.87%, over 2010. The increase was primarily due to a $14.24 million, or 11.81%, increase in net interest income and a decrease in the provision for loan losses.

The increase in earnings was partially offset by a $2.55 million increase in the provision for loan losses, and an increase in noninterest expenses of $4.84 million, or 4.68%. The primary factors in the rise in noninterest expenses were additional salaries and employee benefit expenses of $3.98 million, an increase in advertising and marketing expense of $1.05 million, which were partially offset by a decrease in foreclosed property expenses of $1.21 million. For the year ended December 31, 2011, noninterest expenses increased $18.97 million, or 22.49%, over 2010. The primary factors in the increase were increases in salaries and benefits of $8.12 million, an increase in occupancy expenses of $2.37 million, and increases in foreclosed property expenses of $4.87 million.

The following chart presents the revenue and expenses for the Banking segment (dollars in thousands):

	Year Ended December 31,			Increase/(Decrease)			
				2012 over 2011		2011 over 2010	
	2012	2011	2010	Amount	Percent	Amount	Percent
Revenue							
Net interest income	$ 141,517	$ 134,720	$ 120,485	$ 6,797	5.05%	$ 14,235	11.81%
Noninterest income							
Service charges on deposit accounts	7,798	7,211	6,556	587	8.14%	655	9.99%
Credit card merchant fees	3,578	2,828	2,261	750	26.52%	567	25.08%
Other income	5,297	5,277	4,337	20	0.38%	940	21.67%
Subtotal	16,673	15,316	13,154	1,357	8.86%	2,162	16.44%
Gain (loss) on investment securities	3,005	3,681	5,961	(676)	(18.36%)	(2,280)	(38.25%)
Total noninterest income	19,678	18,997	19,115	681	3.58%	(118)	(0.62%)
Total revenue	161,195	153,717	139,600	7,478	4.86%	14,117	10.11%
Provision for loan losses	16,155	13,602	22,565	2,553	18.77%	(8,963)	(39.72%)
Expenses							
Salaries and employee benefits	58,685	54,703	46,581	3,982	7.28%	8,122	17.44%
Occupancy expense	10,891	10,568	8,195	323	3.06%	2,373	28.96%
Furniture and equipment	5,194	4,446	3,895	748	16.82%	551	14.15%
Advertising and marketing	3,099	2,048	2,299	1,051	51.32%	(251)	(10.92%)
Charitable contributions	3,452	3,050	2,595	402	13.18%	455	17.53%
Outside processing	2,193	2,360	2,068	(167)	(7.08%)	292	14.12%
Foreclosed property expenses	4,612	5,822	950	(1,210)	(20.78%)	4,872	512.84%
FDIC and other insurance	3,757	4,257	4,453	(500)	(11.75%)	(196)	(4.40%)
Professional fees	2,911	2,766	1,744	145	5.24%	1,022	58.60%
Telephone and postage	2,259	1,503	1,714	756	50.30%	(211)	(12.31%)
Other expenses	11,146	11,836	9,890	(690)	(5.83%)	1,946	19.68%
Total expenses	108,199	103,359	84,384	4,840	4.68%	18,975	22.49%
Income before income tax expense and corporate allocation	36,841	36,756	32,651	85	0.23%	4,105	12.57%
Corporate allocation	565	468	483	97	20.73%	(15)	(3.11%)
Income before income tax provision	37,406	37,224	33,134	182	0.49%	4,090	12.34%
Provision for income tax expense	(8,468)	(9,267)	(8,797)	799	(8.62%)	(470)	5.34%
Net income	$ 28,938	$ 27,957	$ 24,337	$ 981	3.51%	$ 3,620	14.87%

Realty Segment: For the year ended December 31, 2012, the Realty segment represented 17.78%, or $6.74 million, of our total consolidated net income compared to 7.93%, or $2.64 million, for 2011, and 10.35%, or $3.13 million, for 2010. Earnings before income tax provision and noncontrolling interest for the year ended December 31, 2012, for the Realty segment were $12.22 million, increasing 254.78% from comparative 2011, which decreased 36.02% from comparative 2010. Total revenue increased to $44.92 million in 2012 from $28.67 million and $30.20 million in 2011 and 2010, respectively. The increase in revenue is largely due to an improvement in net mortgage banking income as a result of increased volume in purchase and refinancing transactions. As discussed previously, mortgage volumes were positively affected by moderate improvements in the housing market and historically low mortgage interest rates. Additionally, the Company recognized a gain on rate lock commitments of $1.24 million in 2012, and the expansion of our mortgage operations resulted in additional net mortgage banking income of $10.37 million as compared to 2011. A majority of the decrease in revenue in 2011 from 2010 was due to due to a decrease in net interest income as a corporate initiative led to less cash being held at the subsidiary level. Also contributing to the decrease was a decline in net mortgage banking income as a result of decreased volume in mortgage refinancing transactions.

Expenses for the Realty segment increased 29.53%, or $7.37 million, when compared to 2011, which increased 1.76%, or $431,000, when compared to 2010. The increase from the comparative period in 2011 is primarily due to additional noninterest expenses of $7.36 million related to the expansion of our mortgage operations, including a $5.11 million increase in salaries and employee benefits. The increase in 2011 from 2010 was primarily due to higher noninterest expenses related to the Benchmark acquisition in our mortgage reporting unit and increases in our resort rental reporting unit. The increase was partially offset by a decrease in occupancy expense and a decrease in amortization of intangible assets related to the closure of several redundant real estate offices subsequent to the Prudential Towne Realty business combination in 2009.

The following chart presents the revenue and expenses for the Realty segment (dollars in thousands):

	Year Ended December 31,			Increase/(Decrease) 2012 over 2011		Increase/(Decrease) 2011 over 2010	
	2012	**2011**	**2010**	**Amount**	**Percent**	**Amount**	**Percent**
Revenue							
Residential mortgage brokerage income, net	$ 27,546	$ 12,799	$ 13,293	$ 14,747	115.22%	$ (494)	(3.72%)
Real estate brokerage income, net	5,367	5,371	5,571	(4)	(0.07%)	(200)	(3.59%)
Title insurance and settlement fees	1,830	1,681	1,913	149	8.86%	(232)	(12.13%)
Property management fees, net	6,148	6,125	5,584	23	0.38%	541	9.69%
Income from unconsolidated subsidiary	578	410	703	168	40.98%	(293)	(41.68%)
Net interest and other income	3,455	2,287	3,137	1,168	51.07%	(850)	(27.10%)
Total revenue	44,924	28,673	30,201	16,251	56.68%	(1,528)	(5.06%)
Expenses							
Salaries and employee benefits	18,973	13,565	13,024	5,408	39.87%	541	4.15%
Occupancy expense	2,547	2,417	2,919	130	5.38%	(502)	(17.20%)
Furniture and equipment	778	812	921	(34)	(4.19%)	(109)	(11.83%)
Amortization of intangible assets	663	907	1,155	(244)	(26.90%)	(248)	(21.47%)
Other expenses	9,346	7,241	6,492	2,105	29.07%	749	11.54%
Total expenses	32,307	24,942	24,511	7,365	29.53%	431	1.76%
Income before income tax, corporate allocation, and noncontrolling interest	12,617	3,731	5,690	8,886	238.17%	(1,959)	(34.43%)
Corporate allocation	(402)	(288)	(309)	(114)	39.58%	21	(6.80%)
Income before income tax provision and noncontrolling interest	12,215	3,443	5,381	8,772	254.78%	(1,938)	(36.02%)
Provision for income tax	(3,995)	(1,626)	(1,768)	(2,369)	145.71%	142	(8.03%)
Net income	8,220	1,817	3,613	6,403	352.39%	(1,796)	(49.71%)
Noncontrolling interest	(1,475)	824	(480)	(2,299)	N/M	1,304	N/M
Net income attributable to TowneBank	$ 6,745	$ 2,641	$ 3,133	$ 4,104	155.40%	$ (492)	(15.70%)

N/M = not meaningful

The following chart shows the key data for the Realty segment (dollars in thousands):

	Year Ended December 31,			Increase/(Decrease)			
				2012 over 2011		2011 over 2010	
	2012	2011	2010	Amount	Percent	Amount	Percent
Key data							
Number of units sold	3,224	3,072	2,883	152	4.95%	189	6.56%
Volume of units sold	$ 849,986	$ 827,300	$ 817,049	$ 22,686	2.74%	$ 10,251	1.25%
Number of real estate agents	378	394	431	(16)	(4.06%)	(37)	(8.58%)
Loans originated, mortgage	$ 655,386	$ 317,462	$ 461,673	$ 337,924	106.45%	$ (144,211)	(31.24%)
Loans originated, joint ventures	671,664	453,565	487,201	218,099	48.09%	(33,636)	(6.90%)
Total loans originated	$ 1,327,050	$ 771,027	$ 948,874	$ 556,023	72.11%	$ (177,847)	(18.74%)
Number of loans, mortgage	2,931	1,344	1,886	1,587	118.08%	(542)	(28.74%)
Number of loans, joint ventures	3,125	2,113	2,151	1,012	47.89%	(38)	(1.77%)
Total number of loans	6,056	3,457	4,037	2,599	75.18%	(580)	(14.37%)
Average loan amount, mortgage	$ 224	$ 236	$ 245	$ (13)	(5.13%)	$ (9)	(3.67%)
Average loan amount, joint ventures	215	215	226	0	0.00%	(11)	(4.87%)
Average loan amount	$ 219	$ 225	$ 235	$ (6)	(2.67%)	$ (12)	(5.11%)
Average number of originators, mortgage	52	27	28	25	92.59%	(1)	(3.57%)
Average number of originators, joint ventures	37	37	31	-	0.00%	6	19.35%
Average number of originators	89	64	59	25	39.06%	5	8.47%

Mortgage. The loan volume for the combined mortgage operations showed continued strength during the year ended December 31, 2012, as compared to 2011. Total loans originated in 2012 were $1.33 billion, a 72.19%, or $556.57 million, increase from $771.03 million in 2011, which was a $177.85 million, or 18.74%, decrease compared to the 2010 volume of $948.87 million. Refinance activity comprised $466.11 million of loan volume for the year ended December 31, 2012, while purchases accounted for the remaining $860.94 million in loan volume for the year. For the years ended December 31, 2011 and 2010, refinance volume was $214.12 million and $331.21 million, respectively, while purchase volume was $556.91 million and $617.66 million, respectively.

Insurance Segment: The Insurance segment comprises property and casualty and group benefits divisions. Effective December 31, 2012, TowneBank acquired Clement, an independent insurance agency that is affiliated with Towne Insurance.

The Insurance segment represented 5.93%, or $2.25 million, of our total consolidated net income in 2012; 8.17%, or $2.72 million, in 2011; and 9.27%, or $2.81 million, in 2010. Earnings before taxes and noncontrolling interest for the Insurance segment were $3.95 million in 2012, decreasing $918,000, or 18.87% from 2011. Factors contributing to the decrease included an increase in noninterest expenses of $352,000 at our travel insurance company due to salaries for new employees and increased professional fees, and a one-time $500,000 charge related to the final settlement of the 2009 Taylor Johnson Insurance Group purchase agreement. Also contributing to the variance from the prior year were the effects of the Stan Taylor acquisition, which resulted in additional net commission income of $904,000 and additional noninterest expense of $877,000. In 2011, earnings before taxes and noncontrolling interest for the Insurance segment were $4.87 million, increasing $6,000, or 0.12%, from 2010. The increase was primarily attributable to the acquisition of Chapin and Stan Taylor, which contributed additional commission income of $2.30 million. The additional revenues were offset by an increase in noninterest expenses of $2.67 million, of which $1.84 million was attributable to increases in salaries and employee benefits and other operating expenses related to the acquisitions. Also contributing to the variances in both comparative periods was a decrease in contingency and bonus revenue of $328,000, or 16.68%, in 2012, and a decrease of $150,000, or 7.09%, in

2011. Contingent commissions primarily consist of amounts received from various property and casualty insurance carriers. The carriers use several non-client-specific factors to determine the amount of the contingency payments. Such factors include the aggregate loss performance of insurance policies previously placed and the volume of business, among other things. Such commissions are seasonal in nature and are mostly received during the first quarter of each year.

The following chart presents the revenue and expenses for the Insurance segment (dollars in thousands):

	Year Ended December 31,			Increase/(Decrease) 2012 over 2011		2011 over 2010	
	2012	2011	2010	Amount	Percent	Amount	Percent
Revenue							
Net commission and fee income							
Property and casualty	$ 13,548	$ 12,703	$ 10,291	$ 845	6.65%	$ 2,412	23.44%
Group benefits	5,533	5,465	5,435	68	1.24%	30	0.55%
Specialized benefit services	512	447	406	65	14.54%	41	10.10%
Total net commissions and fees	19,593	18,615	16,132	978	5.25%	2,483	15.39%
Contingency and bonus revenue	1,639	1,967	2,117	(328)	(16.68%)	(150)	(7.09%)
Other income	1,122	983	635	139	14.14%	348	54.80%
Total revenue	22,354	21,565	18,884	789	3.66%	2,681	14.20%
Expenses							
Salaries and employee benefits	12,010	11,290	9,480	720	6.38%	1,810	19.09%
Occupancy expense	946	894	817	52	5.82%	77	9.42%
Furniture and equipment	495	547	496	(52)	(9.51%)	51	10.28%
Amortization of intangible assets	1,245	1,164	988	81	6.96%	176	17.81%
Other expenses	3,547	2,624	2,069	923	35.18%	555	26.82%
Total expenses	18,243	16,519	13,850	1,724	10.44%	2,669	19.27%
Income before income tax, corporate allocation, and noncontrolling interest	4,111	5,046	5,034	(935)	(18.53%)	12	0.24%
Corporate allocation	(163)	(180)	(174)	17	(9.44%)	(6)	3.45%
Income before income tax provision and noncontrolling interest	3,948	4,866	4,860	(918)	(18.87%)	6	0.12%
Provision for income tax expense	(1,501)	(1,833)	(1,891)	332	(18.11%)	58	(3.07%)
Net income	2,447	3,033	2,969	(586)	(19.32%)	64	2.16%
Noncontrolling interest	(199)	(310)	(163)	111	(35.81%)	(147)	90.18%
Net income attributable to TowneBank	$ 2,248	$ 2,723	$ 2,806	$ (475)	(17.44%)	$ (83)	(2.96%)

Salaries and employee benefits expense increased $720,000, or 6.38%, when comparing 2012 to 2011, which increased $1.81 million, or 19.09%, compared to 2010.

Occupancy expense increased $52,000, or 5.82%, when comparing 2011 to 2010, which increased $77,000, or 9.42%, over 2010.

Amortization of intangible assets increased $81,000, or 6.96%, during the year ended December 31, 2012, compared to 2011, which was $176,000, or 17.81%, more than 2010. The 2011 increase was driven by the amortization of intangible assets related to the Stan Taylor acquisition, while the 2011 increase was driven by the Chapin acquisition.

ANALYSIS OF FINANCIAL CONDITION

Overview: Our total assets increased $324.15 million, or 7.94%, to $4.41 billion at December 31, 2012, from $4.08 billion at December 31, 2011. Our loan portfolio grew by a higher rate of 12.18%, or $340.31 million, to $3.13 billion at December 31, 2012, from $2.79 billion at December 31, 2011.

Our total average assets were $4.20 billion for 2012, reflecting an increase of $210.67 million, or 5.28%, compared to the 2011 average of $3.99 billion. Total average assets for 2011 increased $269.63 million, or 7.25%, compared to the 2010 average of $3.72 billion. Average earning assets were $3.81 billion, including BOLI assets, in 2012, reflecting an increase of $207.21 million, or 5.75%, compared to 2011.

Our average total deposits were $3.27 billion in 2012, reflecting growth of $184.43 million, or 5.97%, compared to 2011. Retail deposits, excluding noncore Certificate of Deposit Account Registry Service ("CDARS") and brokered deposits, increased by $292.56 million, or 10.03%, while noncore CDARS and brokered deposits decreased by $103.30 million, or 37.85%. Average noninterest-bearing deposits, which increased $122.52 million, or 15.67%, grew at a significantly higher rate than interest-bearing deposits in 2012, which grew $61.90 million, or 2.68%.

Securities: Our securities consist of available-for-sale securities, held-to-maturity securities, and trading securities. Our available-for-sale securities portfolio, which is held primarily for earnings, liquidity, and asset/liability management purposes, is reported at fair value based on market prices for similar instruments. Our held-to-maturity securities portfolio, which is held primarily for yield and pledging purposes, is valued at amortized cost. Our trading securities are held primarily for sale in the near term and are carried at their fair values, with unrealized gains and losses included immediately in other income. Our investment portfolio totaled $641.43 million as of December 31, 2012, with a balance of $450.14 million in available-for-sale, $155.48 million in held-to-maturity, $12.58 million in trading, and $23.22 million in Federal Home Loan Bank stock. Average yield on available-for-sale securities was 0.88% at December 31, 2012, compared with 1.67% at December 31, 2011, and 2.81% at December 31, 2010. Average yield on held-to-maturity securities was 3.46% at December 31, 2012, compared to 4.34% at December 31, 2011, and 4.47% at December 31, 2010.

Our available-for-sale securities portfolio consists of U.S. Treasury obligations, U.S. agency securities, municipal securities, mortgage-backed securities, and trust preferred corporate obligations. Our held-to-maturity portfolio consists of municipal securities, trust preferred corporate obligations, and industrial revenue bonds. Our investment activities are governed internally by a written and Board-approved investment policy, which is administered by our Asset-Liability Committee ("ALCO"). The ALCO generally meets quarterly to review the economic environment, to assess current activities for appropriateness, and to establish investment strategies.

Investment strategies are established by the ALCO in consideration of the interest rate cycle, balance sheet mix, actual and anticipated loan demand, funding options, and our overall interest rate sensitivity. In general, the investment portfolio is managed in a manner appropriate with the attainment of the following goals: (i) to provide a sufficient margin of liquid assets to cover unanticipated deposit and loan fluctuations, seasonal funds flow variations, and overall funds management objectives; (ii) to provide eligible securities to secure public funds, trust deposits, and repurchase agreements as prescribed by law; and (iii) to earn the maximum return on funds invested that is commensurate with meeting the requirements of (i) and (ii).

The following table provides information regarding the composition of our securities portfolio, showing selected maturities and yields (dollars in thousands). For more information, refer to Note 3 of the Notes to Consolidated Financial Statements.

Year Ended December 31,	**2012**			**2011**			**2010**		
	Amortized Cost	**Estimated Fair Value**	**Weighted Average Yield**	**Amortized Cost**	**Estimated Fair Value**	**Weighted Average Yield**	**Amortized Cost**	**Estimated Fair Value**	**Weighted Average Yield**
Securities Available for Sale:									
U.S. agency securities	$ 3,219	$ 3,306	2.83%	$ 65,489	$ 67,135	1.73%	$ 100,982	$ 100,425	2.16%
U.S. Treasury notes	300,000	300,000	0.00%	120,001	120,000	(0.03%)	-	-	-
Municipal securities	38,854	40,084	3.10%	34,817	35,909	3.20%	26,794	27,078	4.21%
Trust preferred corporate securities	4,480	4,889	4.61%	6,981	7,137	7.93%	6,988	7,340	7.92%
Other corporate securities	488	488	0.67%	582	582	1.34%	578	581	0.03
Mortgage-backed securities	100,490	101,377	2.42%	97,977	99,310	2.70%	286,362	286,711	2.78%
Total securities available for sale	447,531	450,144	0.88%	325,847	330,073	1.67%	421,704	422,135	2.81%
Securities Held to Maturity:									
Trust preferred corporate securities	500	688	8.75%	15,701	16,545	7.83%	19,470	20,361	7.83%
Municipal securities	62,062	67,409	3.92%	63,272	66,875	3.93%	52,739	49,576	3.81%
Industrial revenue bonds	92,919	93,861	3.12%	74,939	75,033	3.96%	77,032	77,032	4.08%
Total securities held to maturity	155,481	161,958	3.46%	153,912	158,453	4.34%	149,241	146,969	4.47%
Total Portfolio	$ 603,012	$ 612,102	1.54%	$ 479,759	$ 488,526	2.53%	$ 570,945	$ 569,104	3.24%

(continued on next page)

The following table indicates the maturities of securities at December 31, 2012 (dollars in thousands):

	Available for sale			Held to maturity		
	Amortized Cost	Fair Market Value	Weighted Average Yield	Amortized Cost	Fair Market Value	Weighted Average Yield
U.S. Treasury & U.S. agency securities						
Due in one year or less	$ 301,006	$ 301,010	0.01%	$ -	$ -	-
After one year through five years	-	-	-	-	-	-
After five years through ten years	2,213	2,296	3.74%	-	-	-
After ten years	-	-	-	-	-	-
Municipal securities						
Due in one year or less	-	-	-	-	-	-
After one year through five years	17,221	17,503	2.04%	780	800	4.23%
After five years through ten years	6,632	6,925	3.43%	7,769	8,316	3.72%
After ten years	15,001	15,656	4.17%	53,513	58,293	3.95%
Mortgage-backed securities						
Due in one year or less	-	-	-	-	-	-
After one year through five years	-	-	-	-	-	-
After five years through ten years	10,594	10,718	1.62%	-	-	-
After ten years	89,896	90,659	2.51%	-	-	-
Trust preferred corporate securities						
Due in one year or less	-	-	-	-	-	-
After one year through five years	2,505	2,547	1.87%	-	-	-
After five years through ten years	-	-	-	-	-	-
After ten years	1,975	2,342	8.09%	500	688	8.75%
Industrial revenue bonds						
Due in one year or less	-	-	-	16,763	16,984	2.67%
After one year through five years	-	-	-	29,170	30,870	3.22%
After five years through ten years	-	-	-	764	848	4.38%
After ten years	-	-	-	46,222	45,159	3.20%
Other securities						
Due in one year or less	-	-	-	-	-	-
After one year through five years	250	250	1.30%	-	-	-
After five years through ten years	-	-	-	-	-	-
After ten years	-	-	-	-	-	-
No stated maturity	238	238	0.00%	-	-	-
Total Portfolio	$ 447,531	$ 450,144	0.88%	$ 155,481	$ 161,958	3.46%

Loans Held for Sale: At December 31, 2012, we held $132.55 million in mortgage loans originated and intended for sale in the secondary market, compared with $109.45 million at December 31, 2011. Average loans held for sale were 3.10% and 1.46% of average earning assets for the years ended December 31, 2012 and 2011, respectively. The majority of loans held for sale have been pre-committed to investors, minimizing 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: Our loan portfolio, net of the allowance for loan losses, totaled $3.09 billion on December 31, 2012. As a percentage of total average earning assets, average loans were 76.35% in 2012, compared with 74.29% in 2011 and 76.27% in 2010. Lending activities represent our primary source of income. Factors that contributed to the increase in our loan demand were improvements in our local economy and the efforts of our experienced loan officers in developing new loan relationships, combined with the support of existing customers and directors. The following tables provide the balance and composition of the loan portfolio by major classification for the periods indicated (dollars in thousands):

Year Ended December 31,	**2012**	**2011**	**2010**	**2009**	**2008**
Real estate loans					
1-4 family residential	$ 754,593	$ 709,129	$ 714,122	$ 634,960	$ 589,075
Commercial	1,231,819	1,072,187	952,727	866,165	737,244
Construction and land development	618,562	557,630	657,341	652,221	617,390
Multifamily	57,831	48,321	41,441	41,652	30,079
Total real estate loans	2,662,805	2,387,267	2,365,631	2,194,998	1,973,788
Commercial and industrial loans	427,994	362,830	322,027	321,498	329,716
Consumer loans and other	42,708	43,096	43,694	49,414	46,682
Loans, net of unearned income and deferred costs	$ 3,133,507	$ 2,793,193	$ 2,731,352	$ 2,565,910	$ 2,350,186

Year Ended December 31,	**2012**	**2011**	**2010**	**2009**	**2008**
Real estate loans					
1-4 family residential	24.08%	25.39%	26.14%	24.75%	25.07%
Commercial	39.31%	38.39%	34.88%	33.77%	31.37%
Construction and land development	19.74%	19.96%	24.07%	25.42%	26.27%
Multifamily	1.85%	1.73%	1.52%	1.62%	1.28%
Total real estate loans	84.98%	85.47%	86.61%	85.55%	83.98%
Commercial and industrial loans	13.66%	12.99%	11.79%	12.53%	14.03%
Consumer loans and other	1.36%	1.54%	1.60%	1.92%	1.99%
Loans, net of unearned income and deferred costs	100.00%	100.00%	100.00%	100.00%	100.00%

The table below provides the maturity and sensitivity of the loan portfolio at December 31, 2012 (in thousands):

	Due in one year or less	Due after one year through five years	Due after five years	Totals	Due after one year Fixed Rates	Due after one year Adjustable Rates
Real estate loans						
1-4 family residential	$ 94,225	$ 70,966	$ 589,402	$ 754,593	$ 270,033	$ 390,335
Commercial	137,983	84,527	1,009,309	1,231,819	944,070	149,766
Construction and land development	440,871	89,788	87,903	618,562	98,448	79,243
Multifamily	5,274	5,805	46,752	57,831	47,381	5,176
Total real estate loans	678,353	251,086	1,733,366	2,662,805	1,359,932	624,520
Commercial and industrial loans	238,850	85,189	103,955	427,994	144,388	44,756
Consumer loans and other	20,466	12,983	9,259	42,708	18,307	3,935
Loans, net of unearned income and deferred costs	$ 937,669	$ 349,258	$ 1,846,580	$ 3,133,507	$ 1,522,627	$ 673,211

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

The allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with 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. Absent the extension of our look-back periods, early cycle losses during 2010 would be excluded from the determination of the historical loss rates. 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.

The allowance for loan losses at December 31, 2012, 2011, and 2010 was $40.43 million, $39.74 million, and $38.66 million, respectively. The allowance was equal to 1.29% of total loans outstanding at December 31, 2012, compared with 1.42% at December 31, 2011 and 2010, respectively. The decline in the ratio of the allowance to total loans outstanding from year-end 2011 was significantly impacted by a reduction in specific reserves related to improved valuations and charge-offs of loans with reserves, as general reserves as a percentage of total loans outstanding remained relatively unchanged from the prior year. 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. Further, we believe that early and aggressive action plans for loans with identified changes in credit metrics, combined with originating high-quality new loans will facilitate continued improvement in our key credit metrics. Reflective of improving metrics, classified loans, defined as loans in the substandard and doubtful categories, decreased to 3.09% of total loans at December 31, 2012, from 3.93% at December 31, 2011, and loans 30 to 89 days past due fell to $8.70 million at December 31, 2012, from $16.43 million at December 31, 2011. Also reflecting improvement in our loan portfolio and supporting the adequacy of coverage levels of the allowance for loan losses, the allowance was equal to 99% of nonperforming loans at December 31, 2012, compared with 71% at December 31, 2011. Although overall economic conditions have shown some recent improvement, the residential real estate market remained stressed and risks to a full recovery remain. Given the combination of these noted factors, we believe that our allowance for loan losses is adequate to cover loan losses inherent in the loan portfolio at December 31, 2012.

The following table provides a summary of the activity in the allowance for loan losses for the periods indicated (dollars in thousands):

Year Ended December 31,	**2012**	**2011**	**2010**	**2009**	**2008**
Balance beginning of period	$ 39,740	$ 38,660	$ 33,793	$ 27,503	$ 21,323
Loans charged off:					
1-4 family residential real estate	(4,640)	(4,837)	(5,932)	(1,749)	(385)
Multifamily	(345)	-	(95)	-	-
Commercial real estate	(3,295)	(1,093)	(1,933)	(310)	-
Construction and land development	(5,989)	(7,562)	(7,294)	(4,050)	(22)
Commercial and industrial	(1,791)	(374)	(1,274)	(722)	(279)
Consumer and other	(504)	(318)	(1,867)	(310)	(284)
Total	(16,564)	(14,184)	(18,395)	(7,141)	(970)
Loans recovered:					
Residential 1-4 family	860	346	123	156	7
Multifamily	-	15	64	71	-
Commercial real estate	60	3	-	-	-
Construction and land development	54	851	332	215	-
Commercial and industrial	66	120	157	77	89
Consumer and other	56	327	21	21	32
Total	1,096	1,662	697	540	128
Net loans (charged off)/recovered	(15,468)	(12,522)	(17,698)	(6,601)	(842)
Provision for loan losses	16,155	13,602	22,565	12,891	7,022
Balance end of period	$ 40,427	$ 39,740	$ 38,660	$ 33,793	$ 27,503
Nonperforming assets:					
Nonperforming loans	$ 40,691	$ 55,801	$ 57,167	$ 42,150	$ 2,817
Foreclosed property	30,297	29,819	20,452	2,043	980
Total nonperforming assets	$ 70,988	$ 85,620	$ 77,619	$ 44,193	$ 3,797
Loans past due 90 days accruing interest	$ 222	$ 1	$ 1,229	$ 1,702	$ 847
Asset Quality Ratios					
Allowance for loan losses to nonperforming loans	.99x	.71x	.68x	.80x	9.76x
Allowance to nonperforming assets	.57x	.46x	.50x	.76x	7.24x
Allowance for loan losses to period end loans	1.29%	1.42%	1.42%	1.32%	1.17%
Allowance for loan losses to period end loans excluding purchased loans	1.31%	1.45%	1.46%	1.32%	1.17%
Nonperforming loans to period end loans	1.30%	2.00%	2.09%	1.64%	0.12%
Nonperforming assets to period end assets	1.61%	2.10%	2.01%	1.23%	0.12%
Net charge-offs to average loans	0.52%	0.46%	0.67%	0.27%	0.04%

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 December 31, 2012, we had $70.99 million in nonperforming assets, which amounted to 1.61% of total assets. Nonperforming assets consist of $40.69 million in nonperforming loans, as well as $30.30 million in foreclosed property at December 31, 2012. Nonperforming loans decreased by $15.11 million, or 27. 08%, from December 31, 2011, as additions to nonaccrual loans during 2012 were more than offset by the impact on such loans from payments received and charge-offs. The majority of the decrease was in construction and land development as paydowns of $2.07 million, charge-offs of $5.99 million, and transfers to OREO of $4.48 million substantially outpaced new nonperforming loans. Additionally, subsequent to year-end 2012 the Company is in the process of foreclosing on two construction and land development borrower relationships with a net recorded balance of $20.53 million at December 31, 2012. The balances were included in nonperforming loans at year-end and the transactions are not expected to have a material impact on the Company's earnings. Foreclosed property consists of 29 residential properties, 52 construction and development properties, nine commercial properties, and one multifamily property. Additionally, loans past due 90 days or more that are accruing interest totaled $222,000.

At December 31, 2012, loans 60 to 89 days delinquent, excluding nonperforming loans, totaled $2.65 million. Additionally, there are other performing loans, totaling $53.92 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 December 31, 2012, nonaccruing TDRs, which are included in nonperforming loans, totaled $25.30 million, and accruing TDRs totaled $38.91 million. Nonaccruing loans that are modified can be placed back on accrual status when both principal and interest are current, there is a sustained repayment performance of six months or greater, and it is probable that we will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

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

	December 31, 2012	December 31, 2011
Construction and land development	$ 27,498	$ 36,712
Commercial real estate	5,044	5,561
1-4 family residential real estate	7,337	10,394
Commercial and industrial business loans	429	2,644
Consumer loans and other	383	490
Total nonperforming loans	$ 40,691	$ 55,801

Allocation of the Allowance for Loan Losses: At December 31, 2012, all of the allowance for loan losses was allocated to specific loan categories. Management monitors whether or not the allowance for loan loss allocation model, as a whole, calculates an appropriate level of allowance for loan losses that moves in direct correlation to the general macroeconomic and loan portfolio conditions the Company experiences over time. This allocation of the allowance for loan losses is calculated on an approximate basis and is not intended as an indication of the specific amounts, by loan classification, to be charged to the allowance. The entire amount of the allowance is available to absorb losses occurring in any category of loans. The following table provides a breakdown of the allowance for loan losses among the various loan types for the periods indicated (in thousands):

Year Ended December 31,	2012	2011	2010	2009	2008
Real estate loans:					
1-4 family residential	$ 10,722	$ 10,837	$ 9,543	$ 7,094	$ 5,457
Commercial	12,521	10,578	12,827	10,018	7,104
Construction	11,691	13,623	10,984	7,726	6,423
Multifamily	589	395	557	416	248
Total real estate loans	35,523	35,433	33,911	25,254	19,232
Commercial loans	4,378	3,842	4,008	7,330	7,187
Loans to individuals and other	526	465	741	1,209	1,084
Total	$ 40,427	$ 39,740	$ 38,660	$ 33,793	$ 27,503

In the opinion of management, the allowance was adequate at December 31, 2012, based on known conditions. However, the allowance may be increased or decreased in the future based on loan balances outstanding, changes in internally generated credit quality ratings of the loan portfolio, changes in the value of collateral, and changes in general economic conditions and other risk factors.

Allowance for Loan Losses Policy and Methodology: Our allowance for loan loss methodology is based on guidance provided by various regulatory agencies and includes allowance allocations calculated in accordance with ASC 310, *Receivables*, and allowance allocations calculated in accordance with ASC 450, *Contingencies*. Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools, and specific loss allocations, with adjustments for current events and conditions. The Company's process for determining the appropriate level of the allowance for possible loan losses is designed to account for credit deterioration as it occurs. Our objective is to maintain a loan portfolio that is diverse in terms of loan type, industry concentration, and borrower concentration in order to reduce overall credit risk by minimizing the adverse impact of any single event or combination of related events.

Commercial lending may involve a higher degree of risk as compared to other types of lending because repayment usually depends on the cash flows generated by a borrower's business, and the debt service capacity of a business can deteriorate because of downturns in national and local economic conditions. Additionally, construction and development lending involves an elevated degree of risk because loans are generally made to builders for specific construction projects, and successful repayment of these types of loans is generally dependent upon the sale of the constructed property. To control risk, initial and continuing financial analysis of a borrower's financial information is required. While management uses the best information available to establish the allowance for loan losses, future adjustments to the allowance methodology may be necessary if economic conditions differ substantially from the assumptions used in making the valuations, or if required by regulators based upon information at the time of their examinations.

Such adjustments to original estimates, as necessary, are made in the period in which these factors and other relevant considerations indicate that loss levels may vary from previous estimates.

Deposits: Customer deposits are attractive sources of liquidity because of their stability, low average cost, and the ability to generate fee income through the cross-sale of other services to the depositors. Deposits are attracted principally from customers within our market area through the offering of a broad selection of deposit instruments, including demand deposits, negotiable order of withdrawal accounts, savings accounts, money rate savings, certificates of deposit, and individual retirement accounts. Deposit account terms vary with respect to the minimum balance required, the time period the funds must remain on deposit, and service charge schedules.

Interest rates paid on specific deposit types are set by considering the (i) interest rates offered by competitors, (ii) anticipated amount and timing of funding needs, (iii) availability of and cost of alternative sources of funding, and (iv) anticipated future economic conditions and interest rates.

Deposit accounts held as of December 31, 2012, totaled $3.38 billion. This represented an increase of $189.27 million, or 5.93%, over 2011, which was $3.19 billion, or 8.00%, over 2010. Deposit accounts represent our primary source of funds and are provided by individuals, professionals, and small- to medium-sized businesses in the Greater Hampton Roads area and northeastern North Carolina. The deposits consist of demand deposits, interest-bearing checking accounts, money market deposit accounts, and time deposits. Some of our interest-bearing deposits were obtained through brokered transactions and our participation in CDARS. We had brokered time deposits of $79.98 million and CDARS deposits of $89.67 million at December 31, 2012. Retail deposits, excluding noncore CDARS and brokered deposits, increased by $292.56 million, or 10.03%, while noncore CDARS and brokered deposits decreased by $103.30 million, or 37.85%, as the Bank reduced its reliance on wholesale funding sources.

The following tables provide the average balance and cost rate of interest-bearing deposits in addition to maturities of certificates of deposit of $100,000 and greater for the periods indicated (dollars in thousands). See Note 9 in the Notes to Consolidated Financial Statements for additional information on deposits.

	Average Balance			Average Cost Rate		
For the Year Ended December 31,	**2012**	**2011**	**2010**	**2012**	**2011**	**2010**
Noninterest-bearing demand deposits	$ 904,512	$ 781,992	$ 649,840	-	-	-
Demand and money markets	1,064,840	880,169	613,746	0.40%	0.56%	0.50%
Savings	194,933	163,905	89,954	0.51%	0.72%	0.74%
Certificates of deposit:						
Less than $100,000	612,975	424,537	629,409	1.05%	1.74%	1.90%
$100,000 or more	497,255	839,488	768,583	1.02%	1.05%	1.88%
Total interest-bearing deposits	2,370,003	2,308,099	2,101,692	0.71%	0.97%	1.43%
Total deposits	$3,274,515	$3,090,091	$ 2,751,532	0.51%	0.72%	1.09%

Average noninterest-bearing demand deposits were 27.62% of average total deposits during the year ended December 31, 2012, and 25.31% and 23.62% during the same period in 2011 and 2010, respectively. This change is attributable to historically low rates and is consistent with the decrease in the Company's cost of funds. The average cost of interest-bearing deposits was 0.71% for the year ended December 31, 2012, compared with 0.97% for 2011, and 1.43% for 2010.

Advances from the Federal Home Loan Bank: Our ability to borrow funds through nondeposit sources provides additional flexibility in meeting the liquidity needs of customers while enhancing our cost of funds structure. Average funds borrowed were $305.96 million and $307.10 million for the years ended December 31, 2012 and 2011, respectively. The balance at December 31, 2012, of $380.00 million, increased $100.0 million from the balance at December 31, 2011, of $280.0 million. Refer to Note 10 in the Notes to Consolidated Financial Statements for additional disclosures related to borrowing arrangements.

Convertible Subordinated Capital Notes: The Company had no convertible subordinated capital debentures at December 31, 2012. At December 31, 2011, the debentures totaled $13.74 million. 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). Average total convertible subordinated capital debentures for the year ended December 31, 2012, were $2.95 million, compared with $13.79 million for 2011. The average cost of these debentures was 8.03% and 8.35%, respectively. Convertible subordinated capital debentures are unsecured debt that has a lesser priority than that of other debt claims and are not insured by the Federal Deposit Insurance Corporation (the "FDIC") or any other governmental agency. Refer to Note 10 of the Notes to Consolidated Financial Statements for information on convertible subordinated capital debentures.

Liquidity: Liquidity represents our ability to provide funds to meet customer demand 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.

We maintained an average of $309.10 million outstanding in overnight interest-bearing deposits during 2012, compared with $313.95 million for 2011. We intend to maintain sufficient liquidity at all times to meet our funding commitments and growth plans. During 2012, we primarily funded our growth in total assets with deposit growth.

Capital Resources: Federal banking laws set forth certain regulatory capital requirements that apply to us. Within the framework established by the law, we qualify for the classification "well-capitalized," which is the highest regulatory classification.

On September 22, 2011, the Company entered into a Securities Purchase Agreement with the Secretary of the U. S. Treasury Department, pursuant to which the Company sold and issued 76,458 shares of the Company's Senior Non-Cumulative Perpetual Preferred Stock, Series C ("Series C Preferred Stock"), liquidation value of $1,000 per share, for a total purchase price of $76.46 million. The issuance was pursuant to the Small Business Lending Fund program, a $30 billion fund established under the Small Business Jobs Act of 2010 that was created to encourage lending to small businesses by providing capital to qualified community banks with assets of less than $10 billion.

The holder of the Series C Preferred Stock is entitled to receive non-cumulative dividends, payable quarterly, on January 1, April 1, July 1, and October 1 of each year. The dividend rate can fluctuate on a quarterly basis during the first ten quarters during which the Series C Preferred Stock is outstanding, based upon changes in the level of "Qualified Small Business Lending" ("QSBL") by the Company as compared to the Company's baseline QSBL level, which was established at the closing of the securities issuance. The dividend rate for the initial dividend period has been set at 5%. For the second through tenth calendar quarters, the dividend rate may be adjusted to between 1% and 5% per annum based upon the increase in QSBL as compared to the initial baseline. For the eleventh calendar quarter through four and one-half years after issuance, the dividend rate will be fixed at between 1% and 7% based upon the level of QSBL compared to the baseline. After four and one-half years from the issuance, the dividend rate will increase to 9%. Due to the Company's loan growth, the blended rate for the period from closing through December 31, 2011, was 4.63%, with the rate reduced to 3.92% for the first quarter of 2012, 2.28% for the second quarter of 2012, 1.0% for the third and fourth quarters of 2012, and 1.0% for the first quarter of 2013.

If the Company has not declared and paid an aggregate of six dividend payments on the Series C Preferred Stock, whether or not consecutive, the holder of the Series C Preferred Stock will have the right to elect two directors to the Company's Board of Directors. The Series C Preferred Stock may be redeemed at any time at the Company's option, at a redemption price of 100% of the liquidation amount plus accrued but unpaid dividends to the date of redemption for the current period, subject to the approval of the FDIC.

On September 22, 2011, the Company used the proceeds from the sale and issuance of the Series C Preferred Stock to repurchase all 76,458 outstanding shares of its Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series B, liquidation amount $1,000 per share ("Series B Preferred Stock"), for a redemption price of $76.46 million, plus accrued but unpaid dividends. The Series B Preferred Stock was issued in the fourth quarter of 2008 to the U.S. Treasury Department under the Capital Purchase Program. In connection with the issuance of the senior preferred, participating institutions were required to issue to the U.S. Treasury immediately exercisable 10-year warrants to purchase common stock with an aggregate market price equal to 15% of the amount of senior preferred. The warrants to purchase common shares, which were issued with an allocated fair value of $4.13 million, remain outstanding and are included in paid-in capital on the balance sheet. With the repurchase of all shares of the Series B Preferred Stock, the remaining accretion of the discount of $1.86 million was accelerated into the third quarter of 2011 and reduced income available to common shareholders.

In August 2008, the Company issued 598,542 shares of 8% Non-Cumulative Convertible Preferred Stock, Series A (the "Series A Preferred Stock"), at a purchase price of $100 per share. The Series A Preferred Stock pays a non-cumulative dividend of 8% per year. Each share of the Series A Preferred Stock may be converted at any time, at the option of the holder, into shares of common stock equal to the purchase price divided by $18.02.

Additional information concerning our capital resources is contained in Note 16 of the Notes to Consolidated Financial Statements.

Contractual Obligations, Contingent Liabilities, and Commitments: The following table summarizes our significant contractual obligations, contingent liabilities, and certain other commitments outstanding as of December 31, 2012 (in thousands):

	Payments due by period				
Contractual Obligations	**Total**	**Less than 1 year**	**1 - 3 years**	**3 - 5 years**	**More than 5 years**
Operating lease obligations	$ 34,892	$ 6,280	$ 10,513	$ 6,722	$ 11,377
Other long-term liabilities reflected on the registrant's balance sheet under GAAP					
FHLB advances	438,349	12,903	58,762	312,683	54,001
Other commitments					
Standby letters of credit	37,261	37,261	-	-	-
Commitments to extend credit	891,737	891,737	-	-	-
Total contractual obligations	$ 1,402,239	$ 948,181	$ 69,275	$ 319,405	$ 65,378

Impact of Inflation and Changing Prices: The financial statements and related data presented herein have been prepared in accordance with generally accepted accounting principles. These principles dictate that financial position and operating results be measured in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation. A financial institution's assets and liabilities are primarily monetary in nature. As a result, general levels of inflation typically have a less significant effect on financial performance than do changes in interest rates; however, noninterest expenses tend to rise in periods of general inflation.

Return on Equity and Assets: The annualized ratio of operating income to average total assets and average shareholders' equity and average equity to average assets for the periods indicated are as follows:

Year Ended December 31,	**2012**	**2011**	**2010**
Return on average assets	0.90%	0.83%	0.81%
Return on average equity	6.95%	6.51%	6.17%
Average equity to average assets	12.99%	12.82%	13.18%

Interest Sensitivity: 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.

We 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 protect ourselves from unanticipated rate movements, by understanding the dynamic nature of our balance sheet components.

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. At December 31, 2012, we had $401.68 million more liabilities than assets subject to repricing within one year and, therefore, were in a liability-sensitive position.

Market Risk Management: 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 the management of interest rate risk 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. Our 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 and liability management process is designed to achieve relatively stable net interest margins and assure liquidity by coordinating the volumes, maturities, and/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. In addition, funding and balance sheet management strategies are adopted with the intent to ensure that the potential impact on earnings and liquidity due to fluctuations in interest rates are within acceptable standards.

We currently do not use off-balance-sheet financial instruments to manage interest rate sensitivity and net interest income.

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

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

Change in Prime Rate	% Change in Net Interest Income
+ 200 basis points	2.63%
- 200 basis points	(10.99%)

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

Change in Prime Rate	Change in Net Market Value (dollars in thousands)
+ 200 basis points	$ (86,915)
- 200 basis points	$ (57,654)

Credit Risk Elements: We place a loan in nonaccrual status when management believes, after considering economic and business conditions and collections efforts, that the borrower's financial condition is such that full collection of principal and interest is doubtful or when the loan is past due for 90 days or more, unless the debt is both well-secured and in the process of collection.

FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements with respect to our plans, objectives, future performance, and business, which are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Words such as "expects," "anticipates," "believes," "estimates," and other similar expressions or future or conditional verbs such as "will," "should," "would," and "could" are intended to identify such forward-looking statements. These forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties and are based on the beliefs and assumptions of our management.

Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include, among others, the following:

- competitive pressures in the banking industry may increase significantly;
- changes in the interest rate environment may reduce margins and/or the volumes and values of loans made or held, as well as the value of other financial assets held;
- changes in the creditworthiness of customers and the possible impairment of the collectability of loans;
- general economic conditions, either nationally or regionally, may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and/or a reduced demand for credit or other services;

- changes in the legislative or regulatory environment, including changes in accounting standards, may adversely affect our businesses;
- costs or difficulties related to the integration of the business and the businesses we have acquired may be greater than expected;
- expected cost savings associated with pending or recently completed acquisitions may not be fully realized or realized within the expected time frame;
- our competitors may have greater financial resources and develop products that enable them to compete more successfully;
- changes in business conditions;
- changes in the securities market; and
- changes in our local economy with regard to our market area and its heavy concentration of U.S. military bases and related personnel.

We do not undertake and specifically disclaim any obligation to publicly update or revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

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 our calculation of return on average tangible assets and return on average tangible equity. This adjustment allows management to review the Company's core operating results and core capital position.

Year Ended December 31,	**2012**	**2011**
Return on average assets (GAAP basis)	0.90%	0.83%
Impact of excluding average goodwill and other intangibles	0.03%	0.03%
Return on average tangible assets	0.93%	0.86%
Return on average equity (GAAP basis)	6.95%	6.51%
Impact of excluding average goodwill and other intangibles	1.84%	1.86%
Return on average tangible equity	8.79%	8.37%

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, the Company excludes goodwill and other intangible assets, allowing management to review its core capital position.

	Per share	
Year Ended December 31,	**2012**	**2011**
Book value (GAAP basis)	$ 13.30	$ 13.03
Impact of excluding average goodwill and other intangibles	(3.78)	(3.95)
Tangible book value	$ 9.52	$ 9.08

When computing the efficiency ratio (noninterest expense divided by the sum of net interest income and noninterest income, excluding securities gains or losses), management excludes the gains and losses on securities because of the uncertainty of the amount of gain or loss recognized.

Year Ended December 31,	**2012**	**2011**
Efficiency ratio (GAAP basis)	69.48%	71.01%
Impact of excluding securities gains/(losses)	0.93%	1.30%
Efficiency ratio, as reported	70.41%	72.31%

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
TowneBank
Suffolk, Virginia

We have audited the accompanying consolidated balance sheets of *TowneBank* and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, equity, and cash flows for each of the years in the three-year period ended December 31, 2012. We also have audited *TowneBank's* internal control over financial reporting as of December 31, 2012, including controls over the preparation of regulatory financial statements in accordance with the instructions for Consolidated Reports of Condition and Income (Call Report) of the Federal Financial Institutions Examination Council, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). *TowneBank's* management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control. Our responsibility is to express an opinion on these financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed 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. Because management's assessment and our audit were conducted to also meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), management's assessment and our audit of the Company's internal control over financial reporting included controls over the preparation of financial statements in accordance with the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income (call report). A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and call report instructions, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of *TowneBank* and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, *TowneBank* maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We do not express an opinion or any other form of assurance on management's statements in the accompanying Management's Report on Internal Control in the section Compliance with Designated Laws and Regulations.

/s/ Dixon Hughes Goodman LLP

March 12, 2013

INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of TowneBank is responsible for the preparation and fair presentation of the financial statements and other financial information contained in this report. The accompanying consolidated financial statements were prepared in conformity with accounting principles generally accepted in the United States of America and include, as necessary, best estimates and judgments by management. Management also prepared other information in the Annual Report and is responsible for its accuracy and consistency with the consolidated financial statements. Our management is responsible for establishing and maintaining adequate internal control over financial reporting and for our compliance with laws and regulations relating to safety and soundness designated by the Federal Deposit Insurance Corporation ("FDIC"). Our internal control system was designed to provide reasonable assurance to our management and Board of Directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

We maintain systems of controls that we believe are reasonably designed to provide our management with timely and accurate information about our operations. The system of internal controls includes, but is not limited to, maintaining internal audit and compliance functions; establishing formal written policies, procedures, and codes of conduct; training personnel; and segregating key duties and functions, where appropriate.

The Audit and Risk Management Committee of the Board of Directors participates in the adequacy of the system of internal controls and financial reporting. The Audit and Risk Management Committee consists of independent directors who meet regularly with management, the internal auditor, the Chief Risk Officer, and the independent auditors to review the scope of their work and findings.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2012, including controls over regulatory financial statements in accordance with the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income ("Call Report"). In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control – Integrated Framework. Based on our assessment we believe that, as of December 31, 2012, our internal control over financial reporting is effective based on those criteria.

Financial Statements

Our management is responsible for the preparation, integrity, and fair presentation of our published consolidated financial statements as of December 31, 2012, and for the year then ended. The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and, as such, include amounts, some of which are based on management's judgments and estimates.

Compliance with Laws and Regulations

Our management is also responsible for compliance with federal and state laws and regulations concerning dividend restrictions and federal laws and regulations concerning loans to insiders designated by the FDIC as safety and soundness laws and regulations. Management assessed our compliance with the designated laws and regulations. Based on this assessment, our management believes that we complied, in all significant respects, with the designated laws and regulations relating to safety and soundness for the year ended December 31, 2012.

Dixon Hughes Goodman LLP, the registered public accounting firm that performed our financial statement audit, has issued an attestation report on our assessment of our internal controls over financial reporting. A copy of this report, which is combined with the report expressing an opinion on the consolidated financial statements, precedes.

March 12, 2013

/s/ G. Robert Aston, Jr.

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

/s/ Clyde E. McFarland, Jr.

Clyde E. McFarland, Jr.
Senior Executive Vice President and Chief Financial Officer

CONSOLIDATED BALANCE SHEETS
(dollars in thousands, except share data)
December 31, 2012 and 2011

ASSETS	2012	2011
Cash and due from banks	$ 127,967	$ 312,149
Interest-bearing deposits in financial institutions	1,326	1,995
Total Cash and Cash Equivalents	129,293	314,144
Securities available for sale, at fair value	450,144	330,073
Securities held to maturity, at amortized cost	155,481	153,912
Trading account securities	12,583	10,854
Federal Home Loan Bank stock, at amortized cost	23,223	20,445
Total Securities	641,431	515,284
Mortgage loans held for sale	132,551	109,453
Loans, net of unearned income and deferred costs:	3,133,507	2,793,193
Less: allowance for loan losses	(40,427)	(39,740)
Net Loans	3,093,080	2,753,453
Premises and equipment, net	144,939	134,047
Goodwill	102,912	98,127
Other intangible assests, net	16,091	16,811
Bank-owned life insurance policies	55,379	53,315
Other assets	90,247	87,136
TOTAL ASSETS	$ 4,405,923	$ 4,081,770
LIABILITIES AND EQUITY		
Deposits:		
Noninterest-bearing demand	$ 978,818	$ 839,211
Interest-bearing:		
Demand and money market accounts	1,141,189	991,084
Savings	200,725	192,133
Certificates of deposit	1,059,320	1,168,359
Total Deposits	3,380,052	3,190,787
Advances from the Federal Home Loan Bank	380,000	280,000
Convertible subordinated capital debentures	-	13,740
Repurchase agreements and other borrowings	12,049	11,790
Total Borrowings	392,049	305,530
Other liabilities	73,943	64,964
TOTAL LIABILITIES	3,846,044	3,561,281
Preferred stock, $5.00 par value		
Authorized shares - 2,000,000		
Issued and outstanding shares 657,911 in 2012		
and 659,945 in 2011	134,304	134,507
Common stock, $1.667 par value		
Authorized shares - 45,000,000		
Issued and outstanding shares 31,469,709 in 2012		
and 29,145,226 in 2011	52,460	48,585
Capital surplus	261,496	233,895
Retained earnings	103,834	94,453
Accumulated other comprehensive income	816	2,754
TOTAL SHAREHOLDERS' EQUITY	552,910	514,194
Noncontrolling interest	6,969	6,295
TOTAL EQUITY	559,879	520,489
TOTAL LIABILITIES AND EQUITY	$ 4,405,923	$ 4,081,770

See accompanying Notes to Consolidated Financial Statements.

TOWNEBANK
CONSOLIDATED STATEMENTS OF INCOME
(dollars in thousands, except per share data)
For the Years Ended December 31, 2012, 2011, and 2010

	2012	2011	2010
INTEREST INCOME:			
Loans, including fees	$ 156,979	$ 153,905	$ 148,353
Investment securities	11,571	15,499	16,927
Interest-bearing deposits in financial institutions and federal funds sold	783	802	298
Mortgage loans held for sale	4,173	2,267	3,617
Total interest income	173,506	172,473	169,195
INTEREST EXPENSE:			
Deposits	16,749	22,353	30,124
Advances from the Federal Home Loan Bank	12,233	12,817	14,308
Convertible subordinated capital debentures	237	1,152	2,222
Repurchase agreements and other borrowings	3	(71)	(94)
Total interest expense	29,222	36,251	46,560
Net interest income	144,284	136,222	122,635
PROVISION FOR LOAN LOSSES	16,155	13,602	22,565
Net interest income after provision for loan losses	128,129	122,620	100,070
NONINTEREST INCOME:			
Residential mortgage brokerage income, net	26,998	12,642	12,998
Real estate brokerage and property management income, net	11,515	11,496	11,155
Insurance commissions and other title fees and income, net	23,458	22,546	20,189
Service charges on deposit accounts	7,798	7,211	6,556
Credit card merchant fees, net	3,578	2,828	2,261
Other income	7,837	7,329	6,930
Gain on investment securities	3,005	3,681	5,961
Total noninterest income	84,189	67,733	66,050
NONINTEREST EXPENSE:			
Salaries and employee benefits	89,669	79,558	69,085
Occupancy	14,384	13,879	11,931
Furniture and equipment	6,467	5,805	5,312
Other expenses	48,229	45,578	36,417
Total noninterest expense	158,749	144,820	122,745
Income before income tax expense & noncontrolling interest	53,569	45,533	43,375
Provision for income tax expense	13,964	12,726	12,456
Net income	$ 39,605	$ 32,807	$ 30,919
Net (income) loss attributable to noncontrolling interest	(1,674)	514	(643)
Net income attributable to TowneBank	37,931	33,321	30,276
Preferred stock dividends and accretion	6,226	10,434	9,355
Net income available to common shareholders	$ 31,705	$ 22,887	$ 20,921
Per common share information			
Basic earnings	$ 1.03	$ 0.77	$ 0.72
Diluted earnings	$ 1.03	$ 0.76	$ 0.71
Cash dividends declared	$ 0.33	$ 0.31	$ 0.31

See accompanying Notes to Consolidated Financial Statements.

TOWNEBANK

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

For the Years Ended December 31, 2012, 2011, and 2010

	2012	2011	2010
Net income	$ 39,605	$ 32,807	$ 30,919
Other comprehensive income (loss)			
Unrealized gains on securities:			
Unrealized holding gains arising during the period	259	7,475	8,916
Deferred tax expense	(91)	(2,616)	(3,120)
Realized gains reclassified into earnings	(1,881)	(3,681)	(5,961)
Deferred tax benefit	658	1,288	2,086
Change in unrealized gains (losses), net of tax	(1,055)	2,466	1,921
Defined benefit retirement plan			
Actuarial loss	(1,359)	-	-
Deferred tax benefit	476	-	-
Change in defined benefit retirement plan, net of tax	(883)	-	-
Other comprehensive income (loss), net of tax	(1,938)	2,466	1,921
Comprehensive income	$ 37,667	$ 35,273	$ 32,840

See accompanying Notes to Consolidated Financial Statements.

TOWNEBANK

CONSOLIDATED STATEMENTS OF EQUITY

(dollars in thousands, except share data)

For the Years Ended December 31, 2012, 2011, and 2010

	Common Shares	Preferred Stock	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interest	Total
Balance, December 31, 2009	**27,451,172**	**$ 131,782**	**$ 45,762**	**$ 212,372**	**$ 69,341**	**$ (1,633)**	**$ 6,697**	**$ 464,321**
Net Income		-	-	-	30,276	-	643	30,919
Unrealized gain on securities, net of tax expense of $1,034	-	-	-	-	-	1,921	-	1,921
Cash dividends declared on common stock	-	-	-	-	(9,262)	-	-	(9,262)
Cash dividends declared on preferred stock	-	-	-	-	(8,527)	-	-	(8,527)
Directors' deferred compensation	(68,095)	-	(113)	113	-	-	-	-
Distribution of interests in joint ventures	-	-	-	-	-	-	(159)	(159)
Conversion of preferred stock into common stock	17,018	(317)	27	293	-	-	-	3
Accretion of preferred stock discount	-	828	-	-	(828)	-	-	-
Issuance of common stock - stock compensation plans	215,776	-	363	1,946	-	-	-	2,309
Conversion of convertible debt into common stock	1,115,740	-	1,857	14,240	-	-	-	16,097
Issuance of common stock	162,049	-	270	1,620	-	-	-	1,890
Balance, December 31, 2010	**28,893,660**	**$ 132,293**	**$ 48,166**	**$ 230,584**	**$ 81,000**	**$ 288**	**$ 7,181**	**$ 499,512**
Net loss attributable to noncontrolling interest related to prior years	-	-	-	-	-	-	(948)	-
Net income attributable to noncontrolling interest in current year	-	-	-	-	-	-	434	-
Net Income	-	-	-	-	33,321	-	(514)	32,807
Unrealized gain on securities, net of tax expense	-	-	-	-	-	2,466	-	2,466
Cash dividends declared on common stock	-	-	-	-	(9,434)	-	-	(9,434)
Cash dividends declared on preferred stock	-	-	-	-	(7,953)	-	-	(7,953)
Directors' deferred compensation	(65,219)	-	(108)	109	-	-	-	1
Distribution of interests in joint ventures	-	-	-	-	-	-	(372)	(372)
Issuance of common stock - acquisitions	146,440	-	244	1,701	-	-	-	1,945
Conversion of preferred stock into common stock	14,243	(267)	24	240	-	-	-	(3)
Accretion of preferred stock discount	-	2,481	-	-	(2,481)	-	-	-
Redemption of preferred stock	-	(76,458)	-	-	-	-	-	(76,458)
Issuance of preferred stock	-	76,458	-	-	-	-	-	76,458
Issuance of common stock - stock compensation plans	145,710	-	241	1,127	-	-	-	1,368
Issuance of common stock	10,392	-	18	134	-	-	-	152
Balance, December 31, 2011	**29,145,226**	**$ 134,507**	**$ 48,585**	**$ 233,895**	**$ 94,453**	**$ 2,754**	**$ 6,295**	**$ 520,489**
Net income	-	-	-	-	37,931	-	1,674	39,605
Other comprehensive loss, net of taxes	-	-	-	-	-	(1,938)	-	(1,938)
Cash dividends declared on common stock	-	-	-	-	(10,419)	-	-	(10,419)
Cash dividends declared on preferred stock	-	-	-	-	(6,226)	-	-	(6,226)
Stock dividend on common stock	919,923	-	1,536	10,351	(11,905)	-	-	(18)
Directors' deferred compensation	(76,497)	-	(127)	127	-	-	-	-
Distribution of interests in joint ventures, net	-	-	-	-	-	-	(1,000)	(1,000)
Issuance of common stock - acquisitions	100,000	-	167	1,382	-	-	-	1,549
Conversion of preferred stock into common stock	11,037	(203)	27	185	-	-	-	9
Conversion of convertible debt into common stock	1,028,058	-	1,718	12,042	-	-	-	13,760
Issuance of common stock - stock compensation plans	341,962	-	554	3,514	-	-	-	4,068
Balance, December 31, 2012	**31,469,709**	**$ 134,304**	**$ 52,460**	**$ 261,496**	**$ 103,834**	**$ 816**	**$ 6,969**	**$ 559,879**

See accompanying Notes to Consolidated Financial Statements.

TOWNEBANK

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

For the Years Ended December 31, 2012, 2011, and 2010

OPERATING ACTIVITIES:	**2012**	**2011**	**2010**
Net income	$ 39,605	$ 32,807	$ 30,919
Adjustments to reconcile net income to net cash from operating activities:			
Net amortization of securities	2,448	3,612	2,810
Investment securities gains	(3,005)	(3,681)	(5,961)
Depreciation, amortization, and other intangible amortization	11,576	10,987	9,781
Provision for loan losses	16,155	13,602	22,565
Bank-owned life insurance income	(2,064)	(2,576)	(2,157)
Deferred income tax expense (benefit)	1,404	(936)	(4,032)
Share-based compensation expense	1,542	1,350	1,012
Purchases of trading account securities	(560)	-	-
Loss on sale and write-down of foreclosed assets	2,308	3,902	1,133
Originations of mortgage loans held for sale	(1,226,287)	(721,642)	(873,256)
Proceeds from sales of mortgage loans held for sale	1,242,103	696,996	899,685
Gain on sales of mortgage loans held for sale	(38,914)	(19,779)	(19,236)
Changes in:			
Interest receivable	193	814	(269)
Other assets	(14,895)	(16,192)	(20,104)
Interest payable	(753)	(1,358)	(2,155)
Other liabilities	9,480	7,716	4,752
Net cash from (used for) operating activities	40,336	5,622	45,487
INVESTING ACTIVITIES:			
Purchase of available-for-sale securities	(688,988)	(226,579)	(435,186)
Purchase of held-to-maturity securities	(21,879)	(365,247)	(51,627)
Sale of available-for-sale securities	44,939	231,750	437,451
Proceeds from maturities, calls, and prepayments of available-for-sale securities	518,527	94,067	85,322
Proceeds from maturities, calls, and prepayments of held-to-maturity securities	20,758	360,691	25,373
Net increase in loans	(355,782)	(74,309)	(104,268)
Purchases of premises and equipment	(20,609)	(27,303)	(26,643)
Proceeds from sales of premises and equipment	416	281	920
Distribution of interest in joint ventures, net	(1,000)	(372)	(158)
Proceeds from sales of foreclosed assets	9,401	4,631	1,267
Acquisition of business, net of cash acquired	(3,239)	(5,468)	34,927
Net cash used for investing activities	(497,456)	(7,858)	(32,622)
FINANCING ACTIVITIES:			
Net increase in deposit accounts	189,265	236,274	238,126
Net change in borrowings	100,279	(53,043)	(150,893)
Proceeds from share-based compensation activity	2,526	18	1,371
Proceeds (payments) from issuance of common stock	(9)	3	1,893
Proceeds from issuance of preferred stock	-	76,458	-
Redemption of preferred stock	-	(76,458)	-
Cash dividends paid	(19,792)	(17,348)	(17,610)
Net cash from financing activities	272,269	165,904	72,887
Change in cash and cash equivalents	(184,851)	163,668	85,752
Cash and cash equivalents at beginning of year	314,144	150,476	64,724
Cash and cash equivalents at end of year	$ 129,293	$ 314,144	$ 150,476
Supplemental cash flow information:			
Cash paid for interest	$ (2,719)	$ 37,609	$ 48,716
Cash paid for income taxes	$ 11,399	$ 13,066	$ 16,000
Noncash financing and investing activities:			
Net unrealized gain (loss) on available-for-sale securities	$ 1,055	$ 2,466	$ 1,921
Common stock issued in connection with business acquisition	$ 1,549	$ 1,945	$ -
Common stock issued in connection with conversion of convertible subordinated capital debentures	$ 13,760	$ 146	$ 16,097

See accompanying Notes to Consolidated Financial Statements.

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business: TowneBank (the "Company") was organized and incorporated under the laws of the Commonwealth of Virginia on September 1, 1998, and commenced operations on April 8, 1999. The Company, through its banking and non-banking subsidiaries, provides a diverse range of financial services and products throughout the greater Hampton Roads region and northeastern North Carolina.

Basis of presentation: The consolidated financial statements include the accounts of the Company and all other entities in which the Company has a controlling financial interest. The accompanying consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP") and prevailing practices of the banking industry. All significant intercompany balances and transactions have been eliminated in consolidation. The following is a summary of the significant accounting and reporting policies used in preparing the consolidated financial statements.

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

To maintain consistency and comparability, certain amounts from prior periods have been reclassified to conform to current period presentation with no effect on net income or shareholders' equity as previously reported. On April 25, 2012, TowneBank's Board of Directors declared a special shareholder stock dividend of 3% per common share payable on June 12, 2012 to shareholders of record on May 25, 2012. All share and per share amounts included in the accompanying consolidated financial statements and footnotes have been restated for all periods presented to reflect the stock dividend.

Use of estimates: The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates and assumptions. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, valuation of other real estate owned ("OREO"), deferred income taxes, fair value estimates, and goodwill and other intangibles.

Cash and cash equivalents: For purposes of reporting cash flows, the Company considers cash and due from banks, interest-bearing deposits in financial institutions, and federal funds sold as cash and cash equivalents. Generally, federal funds and securities purchased under agreements to resell are purchased and sold for one-day periods. The Company is required to maintain average reserve balances in cash with the Federal Reserve Bank of Richmond; required reserves were $13.04 million and $6.18 million at December 31, 2012 and 2011, respectively.

Investment securities: Investment securities are classified in three categories and accounted for as follows:

a) Debt securities that the Company has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.

b) Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings.

c) Debt and equity securities not classified as either held-to-maturity or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized holding gains and losses excluded from earnings and reported as other comprehensive income, a separate component of shareholders' equity, until realized.

Gains and losses on sales of securities are computed based on specific identification of the adjusted cost of each security and included in noninterest income. Amortization of premiums and accretion of discounts are computed by the effective yield method and included in interest income. Other-than-temporary declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost, if any, are included in earnings as realized losses.

The Company evaluates its investment securities portfolio on a quarterly basis for indicators of other-than-temporary impairment ("OTTI"). Management assesses whether OTTI has occurred when the fair value of a debt security is less than the amortized cost basis at the balance sheet date. Management reviews the amount of unrealized loss, the length of time the security has been in an unrealized loss position, the credit rating history, market trends of similar security classes, time remaining to maturity, and the source of both interest and principal payments to identify securities which could potentially be impaired. OTTI is considered to have occurred (1) if management intends to sell the security; (2) if it is more likely than not management will be required to sell the security before recovery of its amortized cost basis; or (3) the present value of expected cash flows are not sufficient to recover all contractually required principal and interest payments. For securities that management does not expect to sell, or it is not more likely than not to be required to sell, the OTTI is separated into credit and noncredit components. A discounted cash flow analysis, which includes evaluating the timing of the expected cash flows, is completed for all debt securities subject to credit impairment. The measurement of the credit loss component is equal to the difference between the debt security's cost basis and the present value of its expected future cash flows discounted at the security's effective yield. The credit-related OTTI, represented by the expected loss in principal, is recognized in noninterest income. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit-related and, therefore, are recognized in other comprehensive income ("OCI"). Management believes that it will fully collect the carrying value of securities on which noncredit-related impairment has been recognized in OCI. Noncredit-related OTTI results from other factors, including increased liquidity spreads and extension of the security. For securities which management does expect to sell, or if it is more likely than not the Company will be required to sell the security before recovery of its amortized cost basis, any OTTI is recognized in earnings. Once an OTTI is recorded, when future cash flows can be reasonably estimated, future cash flows are re-allocated between interest and principal cash flows to provide for a level-yield on the security.

Loans: Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or pay-off, generally are stated at the amount of outstanding principal less unamortized fees and costs on originated loans, unearned income, and participation interests sold to other lending institutions. Interest on loans is accrued and credited to income based upon the principal amount outstanding. Fees collected and costs incurred in connection with loans originated are deferred and recognized as interest income over the term of the loan as an adjustment of yield.

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

The allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with Accounting Standards Codification Topic (“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 assign internal risk grades to all loans as a component of the approval process. Based on the size of the loan, senior credit officers and the peer review committees review the classification to ensure accuracy and consistency of classifications, which are then validated by the chief risk 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 light of the current economic environment, management determined that the extension of the look-back period was appropriate due to the risks inherent in the loan portfolio. Absent the extension of the look-back periods, early cycle losses during 2010 would be excluded from the determination of the historical loss rates. Management believes this period remains a relevant indicator of the current credit cycle and in determining the risks in the loan portfolio. The Company will continue to evaluate the appropriateness of the look-back period utilized in order to capture the inherent risks in the loan portfolio. This refinement of the historical loss calculation period did not have a material impact on the Company’s 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 the Company. 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. Management considers the current level of allowance for loan losses adequate to absorb losses inherent in the loan portfolio. Management's determination of the adequacy of the allowance for loan losses, which is based on the factors and risk identification procedures previously discussed, requires the use of judgments and estimations that may change in the future. Changes in the factors used by management to determine the adequacy of the allowance or the availability of new information could cause the allowance for loan losses to be adjusted in future periods.

Loans acquired: Loans acquired through the completion of a transfer, including loans acquired in a business combination, that have evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments receivable, are initially recorded at fair value (as determined by the present value of expected future cash flows) with no valuation allowance. Loans are evaluated individually to determine if there is evidence of deterioration of credit quality since origination. Loans where there is evidence of deterioration of credit quality since origination may be aggregated and accounted for as a pool of loans, if the loans being aggregated have common risk characteristics. The difference between the undiscounted cash flows expected at acquisition and the investment in the loan, or the "accretable yield," is recognized as interest income on a level-yield method over the life of the loan. Contractually required payments for interest and principal that exceed the undiscounted cash flows expected at acquisition, or the "nonaccretable difference," are not recognized as a yield adjustment or as a loss accrual or a valuation allowance. Significant increases in expected cash flows subsequent to the initial investment are recognized prospectively through adjustment of the yield on the loan over its remaining life. Decreases in expected cash flows are recognized immediately as impairment. If the Company does not have the information necessary to reasonably estimate cash flows to be expected, it may use the cost recovery method or cash basis method of income recognition. Valuation allowances on these impaired loans reflect only losses incurred after the acquisition (meaning the present value of all cash flows expected at acquisition that ultimately are not to be received).

For purchased loans that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value. Loans may be aggregated and accounted for as a pool of loans if the loans being aggregated have common risk characteristics. Subsequent to the purchase date, the methods utilized to estimate the required allowance for credit losses for these loans is similar to originated loans; however, the Company records a provision for loan losses only when the required allowance exceeds any remaining credit discounts. The difference between the initial fair value at acquisition and the undiscounted expected cash flows is recorded in interest income over the life of the loans using a method that approximates the effective interest method.

Mortgage loans held for sale: Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

Premises and equipment: Premises and equipment are stated at cost, less accumulated depreciation. Leasehold improvements are amortized over the lives of the respective leases or the estimated useful life of the leasehold improvement, whichever is less.

For financial reporting purposes, depreciation is computed by the straight-line method over the estimated useful lives of the assets. For income tax purposes, the modified accelerated cost recovery system is used. Costs of maintenance and repairs are charged to expense as incurred. Costs of replacing structural parts of major units are considered individually and are expensed or capitalized as the facts dictate.

Fixed assets may be retired and disposed of by sale, trade, abandonment, or through a casualty loss such as a fire or storm. At retirement, the cost of the asset and its related accumulated depreciation are removed from the accounts. The type of disposal will determine the specific treatment of the asset.

Goodwill and other intangibles: Goodwill is not subject to amortization, but is subject to an annual assessment for impairment by applying a fair-value-based test as required by the Financial Accounting Standards Board (the "FASB") ASC 350, *Goodwill and Other Intangible Assets*. Additionally, under ASC 350, acquired intangible assets are separately recognized if the benefit of the assets can be sold, transferred, licensed, rented, or exchanged, and amortized over their useful life.

Goodwill is tested for impairment at the reporting unit level on an annual basis as of August 31, or more often if events or circumstances indicate there may be impairment. Testing is conducted in two steps: identifying the potential impairment and then, if necessary, identifying the amount of impairment. The first step (step 1) compares the fair value of the reporting unit to its carrying amount. If the fair value is less than the carrying amount, a second test is conducted by comparing the implied fair value of goodwill with the carrying amount of that goodwill. If the carrying amount exceeds the implied fair value, an impairment loss is recognized in an amount equal to that excess. For our annual impairment testing conducted during 2012, we identified five reporting units with goodwill: Prudential Towne Realty, property and casualty insurance division, benefits insurance division, Corolla Classic Vacations, and Banking. For purposes of performing step one of the goodwill impairment test, the Company primarily uses the income approach to value its reporting units. The income approach consists of discounting projected long-term future cash flows, which are derived from internal forecasts and economic expectations for the respective reporting units. The significant inputs to the income approach include expected future cash flows, the long-term target tangible equity to tangible assets ratio, and the discount rate. Discount rates are unique to each reporting unit and are based upon the cost of capital specific to the industry in which the reporting unit operates. Management evaluated the sensitivity of the significant assumptions in its impairment analysis, including consideration of the effect of changes in estimated future cash flows or the discount rate for each reporting unit. Based on our analysis, we determined there is no goodwill impairment as the fair value for all reporting units was in excess of the respective reporting unit's carrying value as of August 31, 2012. The fair value of each of the Company's reporting units exceeded its respective carrying value by at least 8.5%.

The second step (step 2) of impairment testing is necessary only if the reporting unit does not pass Step 1. Step 2 compares the implied fair value of the reporting unit goodwill with the carrying amount of the goodwill for the reporting unit. The implied fair value of goodwill is determined in the same manner as goodwill that is recognized in a business combination. Significant judgment and estimates are involved in estimating the fair value of the assets and liabilities of the reporting unit. As none of the reporting units failed step 1, step 2 was not applicable during 2012 testing. The Company monitored events and circumstances during the fourth quarter of 2012, and it determined that there were no triggering events requiring an updated impairment test as of December 31, 2012.

Significant judgment is applied when goodwill is assessed for impairment. This judgment includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparables, incorporating general economic and market conditions, and selecting an appropriate control premium. The selection and weighting of the various fair value techniques may result in a higher or lower fair value. Judgment is applied in determining the weightings that are most representative of fair value.

Intangible assets are amortized or tested for impairment based on whether they have finite or indefinite lives. Intangibles that have finite lives are amortized on a straight-line basis over their useful life and tested for impairment whenever events or circumstances indicate the carrying amount of the assets may not be recoverable. Intangibles with indefinite lives are tested annually for impairment. Note 7 provides additional information related to goodwill and other intangibles.

Other Real Estate Owned: OREO, which is included in other assets on the balance sheet, consists primarily of commercial and residential real estate that has been obtained in partial or full satisfaction of loan obligations. OREO is carried at the fair value of the property, less estimated selling costs, with any difference between the fair value of the property, less estimated selling costs, and the carrying value of the loan recorded through a charge to the allowance for loan losses. Subsequent write-downs required for declines in value are recorded through a valuation allowance, or taken directly to the asset, charged to other noninterest expense.

Transfers of financial assets: Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (i) the asset has been isolated from the Company, (ii) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred asset, and (iii) an agreement to repurchase the transferred asset before its maturity does not exist.

Credit-related financial instruments: In the ordinary course of business, the Company has entered into commitments to extend credit, including commitments under credit card arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded. They are considered in calculating the provision for loan losses.

Rate lock commitments: The Company enters into commitments to originate loans whereby the interest rate on the loan is determined prior to funding (rate lock commitments). The commitments are generally for periods of 60 days and are at market rates. In order to mitigate the risk from interest rate fluctuations, the Company enters 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.

Revenue recognition: Revenue earned on interest-earning assets is recognized based on the effective yield of the financial instrument.

Service charges on deposit accounts are recognized as charged. Credit-related fees, including letter of credit fees, are recognized in noninterest income when earned.

Insurance commission income is recorded as of the effective date of insurance coverage or the billing date, whichever is later. Contingent commissions are recognized when determinable, which is generally when such commissions are received or when the Company receives data from the insurance companies that allows the reasonable estimation of these amounts. The income effects of subsequent premium and fee adjustments are recorded when the adjustments become known.

Real estate commissions are earned by the Company's real estate brokerage business upon the closing of a real estate transaction (i.e., purchase or sale of a home). The real estate commissions are recorded net of commissions paid to real estate agents, which are recognized concurrently with the associated revenues.

The Company provides title and closing services, which include title search procedures for title insurance policies, home sale escrow, and other closing services. Title revenues, which are recorded net of amounts remitted to third-party insurance underwriters, and title and closing service fees are recorded at the time a home sale transaction or refinancing closes.

Investment fund servicing fees are primarily based on a percentage of the fair value of the fund assets serviced.

Income recognition on impaired and nonaccrual loans: Commercial loans, including impaired loans, are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. Residential mortgage loans and other consumer loans are classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 120 days, unless the debt is both well-secured and in the process of collection. If a loan or a portion of a loan is classified as doubtful or is partially charged off, the loan is generally classified as nonaccrual. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccrual, if repayment in full of principal and/or interest is unlikely.

While a loan is classified as nonaccrual and the probability of collecting the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to principal outstanding. When the probability of collecting the recorded loan balance is expected, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate. Cash interest receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance by the borrower in accordance with the contractual terms of interest and principal.

Advertising costs: Advertising costs are expensed as incurred.

Segment information: Operating segments as defined by ASC 280, *Segment Reporting*, are components of an enterprise for which separate financial information is available that is evaluated regularly by the chief operating decision-maker in deciding how to allocate resources and in assessing performance. The accounting policies of operating segments are the same as those described elsewhere in this footnote. Revenue for all segments is derived from external sources. See Note 24 for further discussion of the Company's operating segments.

Mergers and acquisitions: Mergers and acquisitions are accounted for using the purchase method, as required by ASC 805, *Business Combinations*. Under this method, the cost of the acquired entity will be allocated to the assets acquired and liabilities assumed based on their fair values at the date of acquisition. The excess of the cost over the fair value of the acquired net assets is recognized as goodwill. See Note 2 for further discussion on the Company's mergers and acquisitions.

Income taxes: Income taxes are accounted for under the asset and liability method. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities that result in future taxable or deductible amounts. The effect on deferred taxes of a change in tax rates is recognized in the year of enactment and is measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized in the near term. Note 19 provides additional information on the Company's income taxes.

Comprehensive income: Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income or loss. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with the operating net income or loss, are components of comprehensive income or loss. Other comprehensive income or loss includes unrealized gains and losses on available-for-sale securities and actuarial losses on our Supplemental Executive Retirement Plan ("SERP").

Share-based compensation: The Company has a share-based employee compensation plan, which is described in more detail in Note 13. The Company accounts for the plan using the fair value method, which requires that compensation cost relating to stock-based payment transactions be recognized in the financial statements over the vesting period. The compensation cost is measured based on the fair value of the instruments issued.

Earnings per share: Basic earnings per share are computed by dividing earnings available to common shareholders by the weighted-average number of common shares outstanding for the year, less the average number of nonvested restricted stock awards. Diluted earnings per share reflect the potential dilution from the issuance of additional shares of common stock caused by the exercise of stock options and restricted stock awards. Also considered in the calculation is the impact of the convertible subordinated capital debentures on earnings available to shareholders and weighted-average common shares outstanding. See Note 25 for further discussion on the Company's earnings per share.

Recent accounting pronouncements

In April 2011, the FASB issued Accounting Standards Update ("ASU") No. 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*. ASU No. 2011-03 modifies the criteria for determining when repurchase agreements would be accounted for as a secured borrowing rather than as a sale. Currently, an entity that maintains effective control over transferred financial assets must account for the transfer as a secured borrowing rather than as a sale. The provisions of ASU No. 2011-03 remove from the assessment of effective control the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee. The FASB believes that contractual rights and obligations determine effective control, and that there does not need to be a requirement to assess the ability to exercise those rights. ASU No. 2011-03 does not change the other existing criteria used in the assessment of effective control. The provisions of ASU No. 2011-03 are effective prospectively for transactions, or modifications of existing transactions, that occur on or after January 1, 2012. The adoption of this ASU did not have a material impact on the Company's financial statements.

In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.* ASU No. 2011-04 results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between U.S. GAAP and International Financial Reporting Standards ("IFRS"). The changes to U.S. GAAP as a result of ASU No. 2011-04 are as follows: (1) The concepts of highest and best use and valuation premise are only relevant when measuring the fair value of nonfinancial assets (that is, it does not apply to financial assets or any liabilities); (2) U.S. GAAP currently prohibits application of a blockage factor in valuing financial instruments with quoted prices in active markets. ASU No. 2011-04 extends that prohibition to all fair value measurements; (3) An exception is provided to the basic fair value measurement principles for an entity that holds a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk that are managed on the basis of the entity's net exposure to either of those risks. This exception allows the entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position; (4) Aligns the fair value measurement of instruments classified within an entity's shareholders' equity with the guidance for liabilities; and (5) Disclosure requirements have been enhanced for recurring Level 3 fair value measurements to disclose quantitative information about unobservable inputs and assumptions used, to describe the valuation processes used by the entity, and to describe the sensitivity of fair value measurements to changes in unobservable inputs and interrelationships between those inputs. In addition, entities must report the level in the fair value hierarchy of items that are not measured at fair value in the statement of condition but whose fair value must be disclosed. The provisions of ASU No. 2011-04 were effective for the Company's interim reporting period beginning January 1, 2012. The adoption of this ASU resulted in additional disclosures, but did not have a material impact on the Company's financial statements.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income.* The provisions of ASU No. 2011-05 allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. The statement(s) are required to be presented with equal prominence as the other primary financial statements. ASU No. 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders' equity, but does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The provisions of ASU No. 2011-05 were effective for the Company's interim reporting period beginning on or after December 15, 2011, with retrospective application required. The Company adopted the standard beginning with its 2011 year-end reporting, presenting other comprehensive income in a separate statement following the Consolidated Statements of Income.

In September 2011, the FASB issued ASU No. 2011-08, *Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment.* ASU No. 2011-08 modifies the manner in which the two-step impairment test of goodwill is applied. Under the updated guidance, an entity may assess qualitative factors (such as changes in management, key personnel, strategy, key technology, or customers) that may impact a reporting unit's fair value and lead to the determination that it is more likely than not that the fair value of a reporting unit is less than its carrying value, including goodwill. If an entity determines that it is more likely than not, it must perform an impairment test. The updated guidance is effective for the quarter ending March 31, 2012. The adoption of this guidance did not have a material impact on the Company's financial statements.

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

In July 2012, the FASB issued 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 is not expected to 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 is effective for the Company on January 1, 2013.

NOTE 2: MERGERS AND ACQUISITIONS

The Clement Companies: Effective December 31, 2012, the Company acquired The Clement Companies insurance agency that is affiliated with Towne Insurance Agency (Towne Insurance"), a wholly-owned subsidiary of TowneBank. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired business are included in the Company's Consolidated Statements of Income commencing 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.

Stanton Taylor Agency, Inc.: Effective October 3, 2011, the Company acquired the Stanton Taylor Agency, Inc. 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 October 3, 2011. The purchase price was $2.70 million in cash and common stock. The allocation of the purchase price resulted in tangible assets of $364,000, goodwill of $1.50 million, other intangible assets, including customer lists of $1.13 million, and assumed liabilities of $293,000.

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

Benchmark Mortgage, Inc.: Effective November 1, 2011, TowneBank acquired Benchmark Mortgage, Inc., an independent mortgage business that was merged with the operations of TowneBank Mortgage, a division of TowneBank's Realty segment. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired business are included in the Company's Consolidated Statements of Income commencing November 1, 2011. The purchase price was $385,000 in cash. The allocation of the purchase price resulted in tangible assets of $308,000 and a loan pipeline of $77,000. There was no goodwill ascribed to the transaction.

The Bank of Currituck: Effective December 3, 2010, TowneBank acquired all the deposit accounts of The Bank of Currituck ("Currituck") and its six banking offices in northeastern North Carolina, including three banking offices on the Outer Banks. Under the terms of the purchase agreement, TowneBank also purchased a substantial portion of the Moyock-headquartered bank's loan portfolio and all of its other banking assets. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets acquired and liabilities assumed in the transaction were recorded at their respective fair values as of the acquisition date. In accordance with the purchase agreement, TowneBank also was required to purchase and sell back certain loans in the amount of $21.15 million. However, because the transfer of the loans did not meet sale treatment under the accounting provisions of ASC 860, *Transfers and Servicing*, the transfer was treated as a secured borrowing, which was repaid at the time of the business combination. The results of operations of the acquired business are included in the Company's Consolidated Statements of Income after the acquisition date of December 3, 2010. The purchase price was $7.84 million in cash. Acquisition-related costs were $548,000 and were included in noninterest expense in the consolidated statement of income for the year ended December 31, 2010. Following the closing of the transaction, Currituck ceased operation as a commercial bank and is operating as Currituck Resolution Properties, Inc. (the "Resolution Company") in order to manage the assets it retained in this transaction, including certain loans and other real estate owned. Also in accordance with the purchase agreement, TowneBank entered into a secured credit facility with the Resolution Company, which consists of three components: (i) a revolving line of credit in the principal amount of $1.0 million to be used for working capital purposes; (ii) a second revolving line of credit in the principal amount of $1.0 million to be used as an interest reserve to support the interest owed on the loan; and (iii) a term loan, in the amount of $14.07 million, which was used to fund and support the Resolution Company's asset base and operations.

These acquisitions, when considered individually or in aggregate under relevant disclosure guidance, do not require the presentation of separate pro forma financial information.

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):

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	$ 447,531	$ 2,719	$ (106)	$ 450,144

December 31, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency securities	$ 65,489	$ 1,646	$ -	$ 67,135
U.S. Treasury notes	120,001	-	(1)	120,000
Municipal securities	34,817	1,092	-	35,909
Trust preferred and other corporate securities	7,563	156	-	7,719
Mortgage-backed securities issued by GSE	97,977	1,346	(13)	99,310
Total available-for-sale securities	$ 325,847	$ 4,240	$ (14)	$ 330,073

For the year ended December 31, 2012, proceeds from sales of securities available for sale were $44.94 million and resulted in gross realized gains of $1.88 million. The Company had no gross realized losses in 2012. For the years ended December 31, 2011 and 2010, proceeds from securities available for sale amounted to $231.75 million and $437.45 million, respectively, excluding prepayments related to mortgage-backed securities, and resulted in gross realized gains of $3.68 million and $5.96 million, respectively. The Company had no gross realized losses in 2011 or 2010.

Held-to-maturity securities

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

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	$ 155,481	$ 9,846	$ (3,369)	$ 161,958

December 31, 2011	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Trust preferred corporate securities	$ 15,701	$ 865	$ (21)	$ 16,545
Municipal securities	63,272	3,603	-	66,875
Industrial revenue bonds	74,939	1,941	(1,847)	75,033
Total held-to-maturity securities	$ 153,912	$ 6,409	$ (1,868)	$ 158,453

Trading securities

Trading securities represent mutual fund investments in a self-directed employee deferred compensation plan, which is structured as a rabbi trust. These investments are bought and sold as employees defer compensation, receive distributions, or make changes in the funds underlying their accounts. Realized and unrealized gains or losses are recorded in noninterest income. The Company had gains of $1.08 million in 2012 and no gains or losses in 2011 or 2010.

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):

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	-	-
	$ 447,531	$ 450,144	$ 155,481	$ 161,958

December 31, 2011	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 127,001	$ 127,000	$ 4,235	$ 4,237
Due after one year through five years	61,316	62,989	20,459	20,994
Due after five years through 10 years	25,632	26,185	16,186	17,068
Due after 10 years	111,316	113,317	113,032	116,154
	325,265	329,491	153,912	158,453
Other equity securities	582	582	-	-
	$ 325,847	$ 330,073	$ 153,912	$ 158,453

Pledged securities

At December 31, 2012 and 2011, the Company had investment securities with market values of $127.74 million and $221.56 million, respectively, pledged to secure federal, state, and municipal deposits. Additionally, the Company had no investment securities pledged to secure borrowings from the Federal Reserve Bank of Richmond ("FRB") at December 31, 2012 or 2011. The Company also had $18.21 million in investment securities pledged against repurchase agreements with commercial customers at December 31, 2012, compared to $21.80 million at December 31, 2011.

Unrealized losses

The following tables show the Company's gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position for the periods indicated (in thousands):

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	$ -	$ -	$ -	$ -	$ -	$ -
Industrial revenue bonds	22,862	3,369	-	-	22,862	3,369
Municipal securities	3,592	32	-	-	3,592	32
Mortgage-backed securities issued by GSE	26,587	74	-	-	26,587	74
Total temporarily impaired securities	$ 53,041	$ 3,475	$ -	$ -	$ 53,041	$ 3,475

December 31, 2011	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	$ 127,000	$ 1	$ -	$ -	$ 127,000	$ 1
Municipal securities	31,209	1,847	-	-	31,209	1,847
Mortgage-backed securities issued by GSE	6,047	13	-	-	6,047	13
Trust preferred corporate securities	6,559	21	-	-	6,559	21
Total temporarily impaired securities	$ 170,815	$ 1,882	$ -	$ -	$ 170,815	$ 1,882

U.S. Treasury obligations

The Company had no unrealized losses on U. S. Treasury obligations at December 31, 2012.

Municipal securities

The Company's unrealized losses on municipal securities were caused by interest rate fluctuations. At December 31, 2012, four securities had unrealized losses of $32,000. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on the credit quality of the issuers, and because it is the Company's intent to hold these securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

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

The Company's unrealized losses on investments in federal agency mortgage-backed securities were caused by interest rate fluctuations. At December 31, 2012, four securities experienced a total unrealized loss of $74,000. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Because our mortgage-related securities are backed by FNMA and FHLMC, which are GSEs, or are collateralized by securities backed by these agencies, and because it is the Company's intent to hold these securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell the securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

Trust preferred corporate securities

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

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

The Company is required to maintain an investment in the capital stock of the FHLB. The FHLB stock is stated at cost, as this is a restricted security without a readily determinable fair value. The Company had $23.22 million and $20.44 million of FHLB stock at December 31, 2012 and 2011, respectively. Based on the Company's review of the credit quality of the institution, the institution's ability to repurchase shares; and the Company's carrying value in the shares, the Company does not consider this investment other than temporarily impaired.

Industrial revenue bonds

The Company's unrealized losses on industrial revenue bonds were caused by interest rate fluctuations. At December 31, 2012, five bond issuances had total unrealized losses of $3.37 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 recognized an other than temporary impairment on non-cumulative perpetual preferred stock with an original recorded value of $250,000. The Company recognized an impairment on this security of $88,000 in 2012 after determining that it is more likely than not that the Company will sell the security before its anticipated recovery. The Company had no other unrealized losses in other investments or common stocks at December 31, 2012.

NOTE 4: LOANS AND ALLOWANCE FOR LOAN LOSSES

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

A summary of loan balances by major classification (in thousands):

December 31,	2012	2011
Real estate loans		
1-4 family residential	$ 754,593	$ 709,129
Commercial	1,231,819	1,072,187
Construction and land development	618,562	557,630
Multifamily	57,831	48,321
Total real estate loans	2,662,805	2,387,267
Commercial and industrial business	427,994	362,830
Consumer loans and other	42,708	43,096
Loans, net of unearned income and deferred costs	$ 3,133,507	$ 2,793,193

Unearned loan income was $2.47 million in excess of deferred loan costs at December 31, 2012, $2.02 million at December 31, 2011, and $1.65 million at December 31, 2010. There were $40.69 million, $55.80 million, and $57.17 million in nonaccrual loans at December 31, 2012, 2011, and 2010, respectively. The Company would have earned $1.07 million in 2012, $2.72 million in 2011, and $3.07 million in 2010, if interest on the loans had been accrued. Of total loans, $802.36 million were pledged as collateral to secure overnight borrowings with the FHLB, and $92.82 million were pledged to secure borrowings from the discount window at the FRB at December 31, 2012.

Allowance for Loan Losses

The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the balance sheet date. While portions of the allowance are attributed to specific portfolio segments, the entire allowance is available to absorb credit losses inherent in the total loan portfolio. The Company considers the allowance for loan losses of $40.43 million adequate to cover loan losses inherent in the loan portfolio at December 31, 2012.

The following table presents, by portfolio segment, the changes in the allowance for loan losses for the years ended December 31, 2012, 2011, and 2010 (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
December 31, 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	4,003	5,178	539	3,665	2,261	509	16,155
Losses charged off	(5,989)	(3,295)	(345)	(4,640)	(1,791)	(504)	(16,564)
Recoveries	54	60	-	860	66	56	1,096
Balance, end of year	$ 11,691	$ 12,521	$ 589	$ 10,722	$ 4,378	$ 526	$ 40,427
December 31, 2011							
Allowance for loan losses:							
Balance, beginning of year	$ 10,984	$ 12,827	$ 557	$ 9,543	$ 4,008	$ 741	$ 38,660
Provision charged to expense	9,350	(1,171)	(165)	5,785	88	(285)	13,602
Losses charged off	(7,562)	(1,093)	-	(4,837)	(374)	(318)	(14,184)
Recoveries	851	15	3	346	120	327	1,662
Balance, end of year	$ 13,623	$ 10,578	$ 395	$ 10,837	$ 3,842	$ 465	$ 39,740
December 31, 2010							
Allowance for loan losses:							
Balance, beginning of year	$ 7,726	$ 10,018	$ 416	$ 7,094	$ 7,330	$ 1,209	$ 33,793
Provision charged to expense	10,220	4,678	236	8,258	(2,205)	1,378	22,565
Losses charged off	(7,294)	(1,933)	(95)	(5,932)	(1,274)	(1,867)	(18,395)
Recoveries	332	64	-	123	157	21	697
Balance, end of year	$ 10,984	$ 12,827	$ 557	$ 9,543	$ 4,008	$ 741	$ 38,660

The following table presents, by portfolio segment, the allocation of the allowance for loan losses at December 31, 2012 and 2011 (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
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	$ 11,691	$ 12,521	$ 589	$ 10,722	$ 4,378	$ 526	$ 40,427
December 31, 2011							
Period-end balance allocated to:							
Loans individually evaluated for impairment	$ 4,583	$ 776	$ -	$ 1,302	$ 282	$ 165	$ 7,108
Loans collectively evaluated for impairment	9,040	9,802	395	9,535	3,560	300	32,632
Loans acquired with deteriorated credit quality	-	-	-	-	-	-	-
Balance, end of year	$ 13,623	$ 10,578	$ 395	$ 10,837	$ 3,842	$ 465	$ 39,740

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

December 31, 2012	Construction and Land Development	Commercial Real Estate	Multi-Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
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	3,702	194	4,204	-	-	9,613
Ending Balance	$ 618,562	$ 1,231,819	$ 57,831	$ 754,593	$ 427,994	$ 42,708	$ 3,133,507
December 31, 2011							
Ending balance: individually evaluated for impairment	$ 46,899	$ 17,500	$ -	$ 15,456	$ 2,864	$ 518	$ 83,237
Ending balance: collectively evaluated for impairment	508,982	1,048,549	48,126	688,746	359,966	42,578	2,696,947
Ending balance: loans acquired with deteriorated credit quality	1,749	6,138	195	4,927	-	-	13,009
Ending Balance	$ 557,630	$ 1,072,187	$ 48,321	$ 709,129	$ 362,830	$ 43,096	$ 2,793,193

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

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

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

	December 31, 2012				December 31, 2011			
	Purchased Impaired		Purchased Nonimpaired		Purchased Impaired		Purchased Nonimpaired	
	Accretable Yield	Carrying Amount of Loans	Accretable Yield	Carrying Amount of Loans	Accretable Yield	Carrying Amount of Loans	Accretable Yield	Carrying Amount of Loans
Balance at beginning of period	$ 2,134	$ 13,009	$ 7,408	$ 45,440	$ 1,046	$ 16,816	$ 11,756	$ 58,049
Accretion	(1,142)	1,142	(3,167)	3,167	(774)	774	(3,819)	3,819
Changes in expected cash flows that do not affect nonaccretable difference (1)	-	-	-	-	-	-	(529)	-
Reclassifications from nonaccretable balance, net	-	-	-	-	1,862	-	-	-
Payments received, net	-	(4,538)	-	(14,850)	-	(4,581)	-	(16,428)
Balance at end of period	$ 992	$ 9,613	$ 4,241	$ 33,757	$ 2,134	$ 13,009	$ 7,408	$ 45,440

(1) Represents changes in cash flows expected to be collected due to changes in prepayment assumptions and the impact of modifications.

At December 31, 2012, none of the purchased loans were classified as nonperforming assets. Therefore, interest income, through accretion of the difference between the carrying amount of the loans and the expected cash flows, is being recognized on all purchased loans. Any decreases in cash flows expected to be collected (other than due to decreases in interest rate indices and changes in prepayment assumptions), will be charged to the provision for loan losses, resulting in an increase to the allowance for loan losses. The outstanding unpaid principal balance for all purchased nonimpaired loans and purchased impaired loans as of December 31, 2012, was $33.88 million and $12.70 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 on impaired credits are refreshed each quarter as they become available, at which time management analyzes the resulting scores, as well as other external statistics and factors, to track loan performance.

The Company's internally assigned grades are as follows:

- Pass – Several pass credit grades comprise loans in this category, which are assigned based on varying levels of risk, ranging from credits that are secured by cash or marketable securities, to management attention credits which have all the characteristics of an acceptable credit risk but warrant more than the normal level of monitoring.
- Special Mention – Loans in this category are considered to have potential weaknesses that deserve management's attention. The borrower's ability to repay from the primary (intended) sources is currently adequate, but threatened by potential weaknesses which may, if not corrected, result in the 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 bank in terms of principal and interest repayment. The borrower's ability to repay in full, on the basis of currently existing facts, conditions, and values, is generally highly questionable and improbable.

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

December 31, 2012	Construction and Land Development	Commercial Real Estate	Multi-Family Real Estate	1-4 Family Residential Real Estate	Commercial and Industrial Business	Consumer Loans and Other	Total
Pass	$ 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	$ 618,562	$ 1,231,819	$ 57,831	$ 754,593	$ 427,994	$ 42,708	$ 3,133,507

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

Age Analysis of Past-Due Financing Receivables by Class

The following table includes an aging analysis of the recorded investment of past-due financing receivables as of 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
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

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

Impaired Loans

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

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

December 31, 2012	Unpaid Principal Balance	Recorded Investment	Specific Allowance	Average Recorded Investment	Interest Income Recognized
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.

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

(1) Included in the table above are accruing TDRs of $24.06 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled $21.39 million.

December 31, 2010	Unpaid Principal Balance	Recorded Investment	Specific Allowance	Average Recorded Investment	Interest Income Recognized
Loans without a specific valuation allowance					
Construction and land development	$ 41,106	$ 31,639	$ -	$ 43,096	$ 493
Commercial real estate	7,544	7,277	-	10,636	324
1-4 family residential real estate	9,953	8,376	-	9,962	254
Commercial and industrial business loans	832	411	-	846	1
Consumer loans and other	1,848	154	-	1,845	4
Total	$ 61,283	$ 47,857	$ -	$ 66,385	$ 1,076
Loans with a specific valuation allowance					
Construction and land development	$ 23,362	$ 22,994	$ 2,355	$ 21,132	$ 72
Commercial real estate	6,579	6,579	949	6,291	93
1-4 family residential real estate	1,547	1,547	440	1,264	12
Commercial and industrial business loans	626	626	543	333	19
Consumer loans and other	-	-	-	-	-
Total	$ 32,114	$ 31,746	$ 4,287	$ 29,020	$ 196
Total impaired loans					
Construction and land development	$ 64,468	$ 54,633	$ 2,355	$ 64,228	$ 565
Commercial real estate	14,123	13,856	949	16,927	417
1-4 family residential real estate	11,500	9,923	440	11,226	266
Commercial and industrial business loans	1,458	1,037	543	1,179	20
Consumer loans and other	1,848	154	-	1,845	4
Total	$ 93,397	$ 79,603	$ 4,287	$ 95,405	$ 1,272

(1) Included in the table above are accruing TDRs of $20.29 million, which the Company has designated as performing loans, while nonaccruing TDRs, which are also included in the above table of impaired loans, totaled $3.89 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.

The following table shows the loans modified in TDRs for the years ended December 31, 2012 and 2011 (in thousands, except number of loans):

	Year Ended December 31, 2012		
	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
Construction and land development	18	$ 9,007	$ 9,007
Commercial real estate	22	10,312	10,141
Multifamily real estate	1	345	345
1-4 family residential real estate	23	7,701	7,582
Commercial and industrial	3	696	413
Consumer loans and other	1	17	17
Total	68	$ 28,078	$ 27,505

	Year Ended December 31, 2011		
	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance
Construction and land development	17	$ 21,272	$ 20,412
Commercial real estate	11	8,258	8,161
Multifamily real estate	-	-	-
1-4 family residential real estate	11	2,796	2,359
Commercial and industrial	2	37	26
Consumer loans and other	2	11	11
Total	43	$ 32,374	$ 30,969

In accordance with the Company's adoption of the provisions of ASU No. 2011-02, the Company reassessed all loan modifications occurring since January 1, 2012, for identification as troubled debt restructurings. There were no additional TDRs identified in this reassessment. The restructured loans generally include terms to reduce the interest rate and extend payment terms. We have not forgiven any principal on the above loans. There were no loans that were restructured within the last 12 months that subsequently defaulted.

The specific reserve portion of the allowance for loan losses on TDRs is determined by discounting the restructured cash flows at the original effective rate of the loan before modification, or is based on the underlying collateral value less costs to sell, if repayment of the loan is collateral-dependent. If the resulting amount is less than the recorded book value, the Company either establishes a valuation allowance as a component of the allowance for loan losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio. At December 31, 2012, all significant impaired loans have been determined to be collateral-dependent.

Nonaccrual Loans

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

The table below presents a summary of the activity related to OREO (in thousands):

	Year Ended December 31,	
	2012	2011
Beginning balance	$ 29,819	$ 20,452
Additions	21,741	21,639
Sales	(18,955)	(8,370)
Valuation allowance	222	125
Loss on sale and write-downs	(2,530)	(4,027)
Ending balance	$ 30,297	$ 29,819

NOTE 6: PREMISES, EQUIPMENT, AND LEASES

A summary of the cost and accumulated depreciation of premises and equipment is as follows (in thousands):

	Useful Life	December 31, 2012	December 31, 2011
Land and improvements	-	$ 25,330	$ 24,821
Buildings and improvements	10 to 45 years	80,101	67,573
Autos	3 to 5 years	3,749	3,415
Computer equipment	2 to 5 years	8,760	8,688
Equipment	5 to 10 years	12,755	11,675
Furniture and fixtures	5 to 20 years	35,574	32,170
Leasehold improvements	Lesser of lease term or 15 years	20,689	20,938
Construction in progress	-	3,888	5,587
		190,846	174,867
Less accumulated depreciation		(45,907)	(40,820)
Net premises and equipment		$ 144,939	$ 134,047

Depreciation and leasehold amortization expense for the years ended December 31, 2012, 2011, and 2010 was $8.36 million, $7.42 million, and $6.20 million, respectively.

Various facilities and equipment are leased under noncancellable operating leases with initial remaining terms in excess of one year and an option for renewal. In addition to minimum rentals, certain leases have escalation clauses and include provisions for additional payments to cover taxes, insurance, and maintenance. The effects of scheduled rent increases, which are included in the minimum lease payments, are recognized on a straight-line basis over the lease term. Rental expense was $6.41 million for 2012, compared to $6.63 million for 2011, and $6.42 million for 2010.

Future minimum lease payments, by year and in the aggregate, under noncancellable operating facilities leases at December 31, 2012, are listed in the following chart (in thousands):

2013	$ 6,280
2014	5,627
2015	4,886
2016	3,534
2017	3,188
Thereafter	11,377
	$ 34,892

Rental income for the year ended December 31, 2012, was $536,000, compared to $529,000 for 2011, and $466,000 for 2010. Future minimum rental income, by year and in the aggregate, under noncancellable operating leases, was as follows at December 31, 2012 (in thousands):

2013	$	371
2014		282
2015		177
2016		132
2017		100
Thereafter		110
	$	1,172

NOTE 7: GOODWILL AND INTANGIBLE ASSETS

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

	December 31,			
	2012		2011	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Intangible assets subject to amortization				
Core deposit intangible	$ 417	$ 107	$ 4,094	$ 3,524
Non-compete agreements	1,456	1,222	1,456	1,144
Customer lists	19,450	7,351	17,920	5,579
Total intangible assets subject to amortization	21,323	8,680	23,470	10,247
Intangible assets not subject to amortization				
Trade names	217	-	357	-
Contractual agreements	3,231	-	3,231	-
Total intangible assets not subject to amortization	3,448	-	3,588	-
Total intangible assets	$ 24,771	$ 8,680	$ 27,058	$ 10,247

The aggregate amortization expense for intangible assets with finite lives for the year ended December 31, 2012, was $2.25 million, compared to $2.65 million for 2011, and $2.67 million for 2010. The estimated aggregate annual amortization expense for each of the five years subsequent to December 31, 2012, is as follows: 2013, $2.00 million; 2014, $1.87 million; 2015, $1.80 million; 2016, $1.50 million; and 2017, $1.34 million.

During 2012, the Company recorded $4.78 million in net increases to goodwill and $1.53 million in intangible assets. This represents the acquisition of the one company in 2012 and certain other adjustments to goodwill related to the Stan Taylor acquisition. The intangible assets acquired are finite-lived, consisting primarily of customer lists, which are amortized over eight years. These assets are included in the Company's Insurance segment.

During 2010, the Company recorded $146,000 of impairment charges for the title plant due to obsolescence. No impairment charges were recorded in 2012 or 2011. Also during 2010, the Company recorded $11.31 million in goodwill and $417,000 million in intangible assets. This represents the acquisition of The Bank of Currituck in 2010 and certain other adjustments to goodwill. The intangible assets acquired are finite-lived assets consisting of core deposit intangibles, which are amortized over an eight-year period. The assets are included in the Banking segment.

Impairment testing indicated that goodwill was not impaired in 2012 or 2011. Changes in the carrying amount of goodwill related to each of the Company's segments are as follows (in thousands):

	Bank	Realty	Insurance	Consolidated Totals
Balance, December 31, 2010	$ 57,296	$ 15,582	$ 19,075	$ 91,953
Additions to goodwill	-	240	4,345	4,585
Other adjustments	1,589	-	-	1,589
Balance, December 31, 2011	$ 58,885	$ 15,822	$ 23,420	$ 98,127
Additions to goodwill	-	-	4,762	4,762
Other adjustments	-	2	21	23
Balance, December 31, 2012	$ 58,885	$ 15,824	$ 28,203	$ 102,912

NOTE 8: BANK-OWNED LIFE INSURANCE POLICIES

The total carrying amount of bank-owned life insurance policies ("BOLI") as of December 31, 2012, was $55.38 million. The Company had $53.32 million of BOLI at December 31, 2011, and $52.74 million at December 31, 2010. The Company recognized BOLI income, included in other noninterest income, of $2.06 million, $2.58 million, and $2.16 million for the years ended December 31, 2012, 2011, and 2010, respectively. The Company has a related retirement plan, implemented in the fourth quarter of 2008, which provides retirement benefits to the executives covered under the plan. Although the retirement plan is technically unfunded, the life insurance policies are available to finance future benefits.

NOTE 9: DEPOSITS

A summary of time deposits by maturity at December 31, 2012, is shown in the following chart (dollars in thousands):

Maturity	Total
2013	$ 711,040
2014	168,498
2015	39,346
2016	21,526
2017 and thereafter	118,910
	$ 1,059,320

At year-end 2012, TowneBank had a total of $284.01 million in no-penalty time deposits as compared to $323.67 million at December 31, 2011. Some of the Company's officers and directors, and the respective companies in which the officers and directors have a financial interest, have deposit relationships with the Company. Related party deposits amounted to approximately $49.39 million and $45.41 million at December 31, 2012 and 2011, respectively.

NOTE 10: BORROWINGS

TowneBank is a member of the FHLB and may borrow funds based on criteria established by the FHLB. The FHLB may call these borrowings if the adjusted collateral balance falls below the borrowing level. The borrowing arrangements available from the FHLB could be either short- or long-term, depending on our related cost and needs.

Advances from the FHLB for the years ended December 31 are summarized as follows (dollars in thousands):

	2012	2011
Balance outstanding at end of year	$ 380,000	$ 280,000
Average balance outstanding	$ 305,956	$ 307,101
Maximum outstanding at any month-end	$ 380,000	$ 330,798
Average interest rate during the year	4.00%	4.17%
Average interest rate at end of year	3.35%	4.20%

The scheduled maturity dates, call dates, and related fixed interest rates on advances from the FHLB at December 31, 2012, are summarized as follows (dollars in thousands):

Maturity Date	Interest Rate	Call Date	Outstanding Amount
03/06/2017	4.08%	03/06/2013	$ 100,000
05/18/2017	4.35%	02/19/2013	80,000
05/18/2017	4.48%	02/19/2013	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
			$ 380,000

Total interest expense on FHLB advances for the years ended December 31, 2012, 2011, and 2010 was $12.23 million, $12.82 million, and $14.31 million, respectively.

Information concerning securities sold under agreements to repurchase and federal funds purchased is summarized as follows (dollars in thousands):

	2012	2011
Balance outstanding at end of year	$ 12,049	$ 11,790
Average balance outstanding	$ 12,517	$ 14,560
Maximum outstanding at any month-end	$ 13,738	$ 14,193
Average interest rate during the year	0.37%	0.42%
Average interest rate at end of year	0.25%	0.39%

Repurchase agreements totaled $12.05 million at December 31, 2012. They are classified as secured borrowings and generally mature within one business day from the transaction date. They are reflected as the amount of cash received in connection with the transaction. In addition, federal funds lines with other financial institutions were available at December 31, 2012, for short-term funding needs. Federal funds purchased are overnight, unsecured borrowings.

At December 31, 2012 and 2011, the Company had an unused line of credit with the FHLB totaling $941.78 million and $944.53 million, respectively. The FHLB advances are secured by a blanket floating lien on certain 1-4 family residential, multifamily, HELOCS, second mortgages, and commercial mortgages with carrying values of $802.36 million at December 31, 2012.

Further, the Company had loan participation lines and reverse repurchase agreements with various financial institutions available at December 31, 2012, which provide potential additional funding.

At January 1, 2010, the Company had three different convertible subordinated capital debentures: (i) Series I Towne Investment Notes, (ii) Series II Towne Investment Notes, and (iii) Series III Towne Investment Notes. During 2010, two of the debentures were called, and the Series III debenture was called during 2012. There were no convertible subordinated capital debentures outstanding at December 31, 2012, and the Company had one outstanding debenture in the amount of $13.74 million at December 31, 2011. Interest expense on debentures for the years ended December 31, 2012, 2011, and 2010, was $237,000, $1.15 million, and $2.22 million, respectively.

In early March 2002, TowneBank offered Series I Towne Investment Units (“Series I units”) to existing shareholders and customers in a subscription offering. Each Series I unit consisted of 84.97 shares of common stock priced at $11.77 per share and $1,000 in the aggregate, and one 15-year 6% convertible subordinated capital note in the principal amount of $1,000. Beginning in May 2004, the unit’s note and equity began trading separately. In the first quarter of 2010, TowneBank called the Series I Towne Investment Notes (“Series I notes”). The Series I notes were convertible into common stock at a conversion price of $14.38 per share (equal to a conversion rate of 69.54 shares per $1,000 principal amount of notes). At year-end 2011 and 2010, the Company had no outstanding accruing Series I notes.

During August 2004, TowneBank raised $48.95 million through the sale of Series II Towne Investment Units (“Series II units”) to existing shareholders and customers in a subscription offering. Each Series II unit consisted of 82.4 shares of common stock priced at $24.27 per share and $2,000 in the aggregate, and one 15-year 6.25% convertible subordinated capital note in the principal amount of $1,000. During the second quarter of 2010, TowneBank called the Series II Towne Investment Notes (“Series II notes”). The Series II notes were bearing interest at 6.25% and were convertible into common stock at a conversion price of $29.42 per share (equal to a conversion rate of 33.99 shares per $1,000 principal amount of notes). At year-end 2011 and 2010, the Company had no outstanding accruing Series II notes.

In October 2009, TowneBank raised $27.77 million through the sale of Series III Towne Investment Units (“Series III units”) to existing shareholders and customers in a subscription offering. Each Series III unit consisted of 150 shares of common stock priced at $13.38 per share and $2,000 in the aggregate, and one 10-year 8% convertible subordinated capital note (“Series III notes”) in the principal amount of $2,000. During the first quarter of 2012, TowneBank called all $13.60 million of outstanding Series III notes. The Series III notes were converted into shares of TowneBank common stock at the conversion price of $13.38 per share (equal to a conversion rate of 149.48 shares per $2,000 principal amount of notes). There were no convertible subordinated capital debentures at December 31, 2012, and $13.74 million at December 31, 2011.

NOTE 11: COMMITMENTS

TowneBank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk, which have not been recognized in the balance sheet. The contract amount of these instruments reflects the extent of the Company's involvement or "credit risk."

Our exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. Unless noted otherwise, collateral or other security is required to support financial instruments with credit risk.

Our contractual amounts are as follows (in thousands):

December 31,	2012	2011
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	$ 891,737	$ 840,256
Standby letters of credit	37,261	36,723
	$ 928,998	$ 876,979

Commitments to extend credit are agreements to lend to a customer as long as there is not a violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the counter-party. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, income-producing commercial properties, and real estate.

Standby letters of credit are conditional commitments issued to guarantee performance of a customer to a third party. The letters of credit are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral supporting those commitments is generally held, if deemed necessary. The Company provides an allowance for estimated losses from such provisions that management considered adequate at December 31, 2012. Management does not anticipate any material losses will arise from additional disbursements of the aforementioned lines or standby letters of credit.

NOTE 12: RETIREMENT PLANS

Defined Contribution Plan

The Company has a defined contribution 401(k) plan. All employees who are at least 18 years of age and have completed one quarter of a year of service are eligible to participate. Under the plan, employees may contribute a percentage of their annual salary, subject to statutory limitations, and the Company will make a discretionary match of the employees' contributions up to 6% of their salary. The Company matched employee contributions up to 4.50%, 4.50%, and 6.0% in the years ended December 31, 2012, 2011, and 2010, respectively. The Company may also make an additional discretionary contribution; there were no discretionary contributions for the years ended December 31, 2012, 2011, or 2010.

The Company made matching contributions of $2.66 million, $2.15 million, and $2.58 million for the years ended December 31, 2012, 2011, and 2010, respectively. The Company's matching contribution is in the form of the Company's common stock, which the Company issues or purchases on the open market at the prevailing prices.

Supplemental Executive Retirement Plan

On December 1, 2008, the Company implemented a noncontributory, unfunded SERP for certain officers and key employees. The SERP is intended to provide retirement benefits and post-retirement health benefits to the individuals covered under the plan. The SERP agreements with the officers provide that upon attainment of retirement age, generally at age 65, the participating officer will be entitled to receive a retirement benefit equal to either (i) a designated percentage, ranging from 30% to 50% of their base salary depending on their level of seniority, with an annual 4% increase until retirement, or (ii) a fixed targeted benefit amount. The retirement benefit is payable over a 15-year period, beginning at attainment of contractual retirement age. The SERP agreements provide for an annual vesting schedule until the participating officer reaches retirement age. In the case of a participating officer's voluntary termination of employment, disability, or termination for cause, the annual amount payable under the SERP is equal to the amount of the vested benefit earned as of the date of termination of employment. In the case of involuntary termination without cause or termination of employment for good reason by the participating officer, the participating officer becomes fully vested in the full retirement benefit. Upon termination of employment, payment of the retirement benefit does not begin until the participating officer reaches the designated retirement age set forth in the SERP agreement. In the event of death, the full amount of the retirement benefit is payable.

The following table sets forth changes in benefit obligations and financial data relative to the SERP. The accrued liability is recorded on the Consolidated Balance Sheets as a component of other liabilities (in thousands):

December 31,	**2012**	**2011**
Change in benefit obligation		
Benefit obligation, beginning of year	$ 10,907	$ 6,727
Service cost	2,515	3,774
Interest cost	476	406
Benefits paid	(105)	-
Net actuarial loss	1,359	-
Benefit obligation, end of year	$ 15,152	$ 10,907
Change in plan assets		
Fair value of plan assets, beginning of year	$ -	$ -
Employer contributions	105	-
Benefits paid	(105)	-
Fair value of plan assets, end of year	$ -	$ -
Funded status, end of year	$ (15,152)	$ (10,907)
Accumulated benefit obligation, end of year	$ 13,982	$ 10,069
Amounts recognized in other comprehensive income, pretax		
Net actuarial loss	$ 1,359	$ -

The components of the net periodic benefit cost for the SERP are as follows (in thousands):

	2012	**2011**	**2010**
Service cost	$ 2,515	$ 3,774	$ 3,227
Interest cost	476	406	190
Net periodic benefit cost	$ 2,991	$ 4,180	$ 3,417

Pre-tax amounts recognized in accumulated other comprehensive income that have not yet been recognized as a component of net periodic benefit cost consist of the following:

December 31,	**2012**	**2011**
Net actuarial loss	$ 1,359	$ -

Pre-tax amounts recorded in accumulated other comprehensive income as of December 31, 2012 that are expected to be recognized as a component of our net periodic benefit cost in 2013 consist of the following:

December 31,	**Expected Amortization in 2013**
Net actuarial loss	$ 166

The Company used certain weighted average assumptions to determine benefit obligations and net benefit costs, including discount rate and rate of increase in future compensation levels. The discount rate used to determine net periodic benefit cost and benefit obligation was 3.91% in 2012, and 5.75% in 2011 and 2010. The rate of increase in future compensation levels used was 4.0% in 2012, 2011, and 2010. When estimating the discount rate, we review yields available on high-quality, fixed-income debt instruments and use a yield curve model from which the discount rate is derived by applying the projected benefit payments under the plan to points on a published yield curve.

The following table sets forth expected future benefit payments, which include expected future service, for the periods indicated (in thousands):

Year	SERP
2013	$ 808
2014	995
2015	1,058
2016	1,382
2017	1,382
2018-2022	8,487

NOTE 13: SHARE-BASED COMPENSATION

The Company maintains a share-based compensation plan ("Plan") that provides for the granting of incentive and non-statutory stock options and restricted common stock. The Plan is administered by the Compensation Committee of the Board of Directors (the "Compensation Committee"). The maximum number of shares reserved under the Plan is equal to 20% of the fully diluted number of shares of the Company's common stock outstanding, or such lesser number of shares as the Compensation Committee shall determine. The Company has a policy of using authorized and unissued common shares to satisfy share option exercises and vesting of restricted stock awards. At December 31, 2012, approximately 3.86 million common shares were available for issuance under the Plan.

Stock options: For stock options granted under the Plan, the stock option price cannot be less than the fair market value of the stock on the date granted. The Compensation Committee determines the exercise price for certain awards, and it can be based on future service. An option's maximum contractual term is 10 years from the date of grant. Options and awards granted under the Plan are subject to vesting requirements ranging from two to 10 years.

The following tables summarize our stock option activity and related information:

For the Year Ended December 31,	2012		2011		2010	
	Number	Weighted-Average Exercise Price	Number	Weighted-Average Exercise Price	Number	Weighted-Average Exercise Price
Options outstanding, beginning balance	862,457	$16.22	869,175	$16.07	898,918	$15.80
Granted	-	-	34,572	14.68	10,300	14.81
Exercised	(254,462)	11.31	(14,057)	11.31	(33,140)	7.13
Forfeited	(33,530)	16.66	(27,233)	12.43	(6,903)	18.50
Options outstanding, ending balance	574,465	$18.38	862,457	$16.22	869,175	$16.07
Options exercisable at December 31,	421,228	$18.81	612,378	$15.92	565,406	$15.55

	Number	Weighted-Average Exercise Price
Unvested stock options, December 31, 2011	250,079	$16.93
Granted	-	-
Vested	(78,870)	16.16
Forfeited	(17,972)	17.78
Unvested stock options, December 31, 2012	153,237	$17.22

For the years ended December 31, 2011 and 2010, the weighted-average fair value of stock options granted was $5.44, and $4.82, respectively. There were no stock options granted in 2012. For the same periods, the total intrinsic value of options exercised was $592,000, $37,000, and $248,000, respectively. Additional information pertaining to options outstanding at December 31, 2012, is as follows:

	Number	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted-Average Remaining Contractual Life
Options outstanding	574,465	$ 18.38	$ 95,851	3.49 years
Options vested or expected to vest	566,237	$ 18.41	$ 91,464	3.46 years
Options exercisable	421,228	$ 18.81	$ 35,028	2.97 years

The grant-date fair value of each option grant is estimated using the Black-Scholes option pricing model. Use of a valuation model requires management to make certain assumptions with respect to selected model inputs. Expected volatility was calculated based on the historical volatility of the Company's stock over the most recent period of time equal to the expected term of the option. The average expected life was based on the contractual term of the option and expected employee exercise and post-vesting employment termination behavior based on historical patterns. The risk-free interest rate is based on U.S. Treasury zero-coupon issues with a remaining term equal to the expected life assumed at the date of grant. Forfeitures are estimated based on historical voluntary termination behavior.

The following table summarizes the assumptions used for the following years:

Years Ended December 31,	2012	2011	2010
Dividend yield	N/A	2.11%	2.10%
Expected life	N/A	7.67 years	7.12 years
Expected volatility	N/A	38.0%	34.0%
Risk-free interest rate	N/A	2.87%	2.76%

Cash received from exercises of stock options for the year ended December 31, 2011, was $159,000. The tax benefit realized for the tax deductions from stock option exercises for the year ended December 31, 2012, was $195,000, compared to $13,000 for 2011 and $51,000 for 2010. Compensation expense related to stock options for the years ended December 31, 2012, 2011, and 2010 was $284,000, $454,000, and $423,000, respectively. As of December 31, 2012, there was $667,000 of total unrecognized compensation cost related to unvested stock option awards; that cost is expected to be recognized over a period of 4.19 years.

Restricted stock awards (RSAs): Under the Plan, grantees of restricted stock awards have full voting rights on the shares and are entitled to receive cash and stock dividends. RSAs granted under the Plan are generally subject to vesting requirements ranging from three to ten years. The shares are subject to forfeiture if vesting and other contractual provision requirements are not met.

The following chart shows a summary of the restricted stock award activity and related information, assuming the weighted-average price being the weighted-average fair value at the date of grant for the year ended December 31, 2012:

	Number	Weighted-Average Price
Unvested RSAs, beginning balance	232,356	$ 13.71
Granted	116,895	13.62
Vested	(61,213)	14.26
Forfeited	(21,186)	10.38
Unvested RSAs, ending balance	266,852	$ 13.81

Compensation expense related to the awards for the years ended December 31, 2012, 2011, and 2010 was $1.26 million, $896,000, and $592,000, respectively. The total fair value of awards vested during 2012, 2011, and 2010 was $873,000, $166,000, and $408,000, respectively. As of December 31, 2012, there was $2.58 million of total unrecognized compensation cost related to unvested restricted stock awards; that cost is expected to be recognized over a period of 2.98 years.

NOTE 14: STOCK PURCHASE PLAN, DIVIDEND REINVESTMENT PLAN, AND DIVIDEND RESTRICTIONS

The Board of Directors approved and adopted the Member Stock Purchase and Dividend Reinvestment Plan to raise additional capital by providing a convenient and cost-effective way for shareholders, customers, and employees to purchase shares of TowneBank common stock. In connection with the member stock purchase component of the plan for the year ended December 31, 2012, the Company entered the open market and acquired 164,616 shares at an average price of $14.07 per share. In connection with the dividend reinvestment component of the plan for the year ended December 31, 2012, the Company entered the open market and acquired 389,317 shares at an average price of $14.27 per share.

In connection with the member stock purchase component of the plan for the year ended December 31, 2011, the Company entered the open market and acquired 195,645 shares at an average price of $13.23 per share. In connection with the dividend reinvestment component of the plan for the year ended December 31, 2011, the Company entered the open market and acquired 373,612 shares at an average price of $13.83 per share.

TowneBank, as a Virginia banking corporation, may pay cash dividends only out of retained earnings. In February 2012, the Company declared a quarterly cash dividend of $0.078 per common share. In May 2012, and August 2012, the Company declared quarterly cash dividends of $0.08 per common share. In December 2012, the Company declared a quarterly cash dividend of $0.09 per common share. In 2011 and 2010, the Company declared quarterly cash dividends of $0.078 per common share. The quarterly dividends were paid on January 11, 2010; April 12, 2010; July 12, 2010; October 12, 2010; and January 11, 2011; April 12, 2011; July 12, 2011; October 12, 2011; and January 12, 2012; April 12, 2012; July 12, 2012; October 12, 2012; and December 8, 2012.

Declaration of future cash dividends will depend on our earnings, our capital position, and other factors. 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.

Preferred Stock

On September 22, 2011, the Company entered into a Securities Purchase Agreement with the Secretary of the U.S. Treasury Department, pursuant to which the Company sold and issued 76,458 shares of the Company's Senior Non-Cumulative Perpetual Preferred Stock, Series C ("Series C Preferred Stock"), liquidation value of $1,000 per share, for a total purchase price of $76.46 million. The issuance was pursuant to the Small Business Lending Fund ("SBLF") program, a $30 billion fund established under the Small Business Jobs Act of 2010 that was created to encourage lending to small businesses by providing capital to qualified community banks with assets of less than $10 billion.

The holder of the Series C Preferred Stock is entitled to receive non-cumulative dividends, payable quarterly, on January 1, April 1, July 1, and October 1 of each year. The dividend rate can fluctuate on a quarterly basis during the first 10 quarters during which the Series C Preferred Stock is outstanding, based upon changes in the level of "Qualified Small Business Lending" ("QSBL") by the Company as compared to the Company's baseline QSBL level, which was established at the closing of the issuance. The dividend rate for the initial dividend period has been set at 5%. For the second through tenth calendar quarters, the dividend rate may be adjusted to between 1% and 5% per annum based upon the increase in QSBL as compared to the initial baseline. For the eleventh calendar quarter through four and one-half years after issuance, the dividend rate will be fixed at between 1% and 7% based upon the level of QSBL compared to the baseline. After four and one-half years from the issuance, the dividend rate will increase to 9%. Due to the Company's loan growth, the blended rate for the period from closing through December 31, 2011 was 4.63%, with the rate reduced to 3.92% for the first quarter of 2012, 2.28% for the second quarter of 2012, 1.0% for the third and fourth quarters of 2012, and 1.0% for the first quarter of 2013.

If the Company has not declared and paid an aggregate of six dividend payments on the Series C Preferred Stock, whether or not consecutive, the holder of the Series C Preferred Stock will have the right to elect two directors to the Company's Board of Directors. The Series C Preferred Stock may be redeemed at any time at the Company's option, at a redemption price of 100% of the liquidation amount plus accrued but unpaid dividends to the date of redemption for the current period, subject to the approval of the FDIC.

On September 22, 2011, the Company used the proceeds from the sale and issuance of the Series C Preferred Stock to repurchase all 76,458 outstanding shares of its Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series B, liquidation amount $1,000 per share ("Series B Preferred Stock"), for a redemption price of $76.46 million, plus accrued but unpaid dividends. The Series B Preferred Stock was issued in the fourth quarter of 2008 to the U.S. Treasury Department under the Capital Purchase Program. In connection with the issuance of the senior preferred, participating institutions were required to issue to the U.S. Treasury immediately exercisable 10-year warrants to purchase common stock with an aggregate market price equal to 15% of the amount of senior preferred. The warrants to purchase common shares, which were issued together with the preferred shares in the fourth quarter of 2008 and with an allocated fair value of $4.31 million, remain outstanding and are included in paid-in capital on the balance sheet. With the repurchase of all shares of the Series B Preferred Stock, the remaining accretion of the discount of $1.86 million was accelerated into the third quarter of 2011 and reduced income available to common shareholders.

Non-cumulative dividends on the Series B Preferred Stock were payable at a rate of 5% while outstanding. On January 28, 2009, the Company declared the first cash dividend of $8.75 per share of Series B Preferred

Stock, paid on February 17, 2009. The Company subsequently paid quarterly cash dividends of $12.50 per share of Series B Preferred Stock on May 15, 2009; August 17, 2009; November 16, 2009; February 16, 2010; May 14, 2010; August 16, 2010; November 15, 2010; February 15, 2011; May 16, 2011; and August 15, 2011.

In August 2008, the Company issued 598,542 shares of 8% Non-Cumulative Convertible Preferred Stock, Series A (the "Series A Preferred Stock"), liquidation value of $100 per share. The Series A Preferred Stock pays a non-cumulative dividend of 8% per year. Dividends are payable quarterly in cash, when, as, and if declared by the Board of Directors, on the first day of March, June, September, and December, commencing on December 1, 2008. Dividends on the Series A Preferred Stock began accruing August 15, 2008.

On October 10, 2008, the Company declared the first cash dividend of $2.33 per share of Series A Preferred Stock, paid on December 1, 2008, for the period August 15, 2008, through November 30, 2008. In 2012, 2011, and 2010, the Company declared quarterly cash dividends of $2.00 per share of Series A Preferred Stock. The quarterly dividends were paid on March 2, 2010; June 1, 2010; September 1, 2010; December 1, 2010; March 2, 2011; June 1, 2011; September 1, 2011; December 1, 2011; March 2, 2012; June 1, 2012; September 1, 2012; and December 1, 2012.

Each share of the Series A Preferred Stock may be converted at any time, at the option of the holder, into shares of common stock equal to the purchase price divided by $18.02 ("conversion price"). On or after September 11, 2011, the Company may cause some or all of the outstanding shares of the Series A Preferred Stock, at its option, at any time or from time to time, to be converted into shares of common stock if, for 20 trading days during any period of 30 consecutive trading days, the closing price of common stock exceeds 120% of the then-applicable conversion price. On September 1, 2013, all of the then-outstanding shares of the Series A Preferred Stock will automatically convert into common shares without regard to the then-market price of the common stock.

The following table presents the changes in the number of preferred shares for the years ended December 31, 2012 and 2011:

	Series A Preferred Shares	Series B Preferred Shares	Series C Preferred Shares
Balance, December 31, 2010	586,132	76,458	-
Conversion of preferred stock into common stock	(2,645)	-	-
Redemption of Series B Preferred Stock	-	(76,458)	-
Issuance of Series C Preferred Stock	-	-	76,458
Balance, December 31, 2011	583,487	-	76,458
Conversion of preferred stock into common stock	(2,034)	-	-
Balance, December 31, 2012	**581,453**	**-**	**76,458**

NOTE 15: OTHER EXPENSES

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

Year Ended December 31,	2012	2011	2010
Advertising and marketing	$ 4,818	$ 3,775	$ 4,056
Charitable contributions	3,574	3,174	2,704
Telephone and postage	3,527	3,112	2,731
Outside processing	3,019	2,974	2,446
Professional fees	4,606	4,176	2,963
Other	7,787	5,957	4,708
Stationery and office supplies	2,048	1,925	1,775
Amortization of intangible assets	2,251	2,651	2,675
Foreclosed property expenses	4,612	5,822	950
FDIC and other insurance	3,729	4,251	4,525
Software expense	4,227	3,457	3,120
Travel/Meals/Entertainment	981	820	655
Directors' expense	1,179	1,526	944
Bank franchise tax/SCC fees	1,871	1,958	2,165
	$ 48,229	$ 45,578	$ 36,417

NOTE 16: REGULATORY CAPITAL REQUIREMENTS

The Company is subject to various regulatory capital requirements. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by the regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. Management believes, as of December 31, 2012, that the Company meets all capital adequacy requirements to which it is subject.

As of December 31, 2012, the Company was categorized as "well-capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well-capitalized," the Company must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed our category.

A summary of our required and actual capital components follow (dollars in thousands):

As of December 31, 2012	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Action Provisions	
	Amount	Ratio %	Amount	Ratio %	Amount	Ratio %
Total risk-based capital (to risk-weighted assets)	$ 481,739	13.75%	$ 280,229	8.00%	$ 350,286	10.00%
Tier 1 capital (to risk-weighted assets)	$ 441,312	12.60%	$ 140,115	4.00%	$ 210,172	6.00%
Tier 1 leverage ratios (to average assets)	$ 441,312	10.40%	$ 169,790	4.00%	$ 212,238	5.00%

As of December 31, 2011	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Action Provisions	
	Amount	Ratio %	Amount	Ratio %	Amount	Ratio %
Total risk-based capital (to risk-weighted assets)	$ 456,277	14.17%	$ 257,542	8.00%	$ 321,928	10.00%
Tier 1 capital (to risk-weighted assets)	$ 402,797	12.51%	$ 128,771	4.00%	$ 193,157	6.00%
Tier 1 leverage ratios (to average assets)	$ 402,797	10.24%	$ 157,398	4.00%	$ 196,747	5.00%

NOTE 17: FAIR VALUE DISCLOSURES

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

Level 1 Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury securities that are highly liquid and are actively traded in over-the-counter markets.

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

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category generally includes certain private equity investments, retained residual interests in securitizations, residential mortgage servicing rights, interest rate lock commitments, asset-backed securities, and highly structured or long-term derivative contracts.

The 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. The Company used a weighted average closing ratio of 80%. The Company recognized a gain associated with the rate lock commitments of $1.24 million for the year ended December 31, 2012. Because the amounts associated with the rate lock commitments were determined to be immaterial, the Company did not record the value of the rate locks in any period prior to January 1, 2012. The carrying value of the interest rate lock commitments was $1.24 million at December 31, 2012.

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

	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

	December 31, 2011			
	Level 1	Level 2	Level 3	Total
U.S. agency securities	$ -	$ 67,135	$ -	$ 67,135
U.S. Treasury notes	-	120,000	-	120,000
Municipal securities	-	35,909	-	35,909
Mortgage-backed securities issued by GSE	-	99,310	-	99,310
Trust preferred and other corporate securities	4	7,715	-	7,719
Equity securities	10,854	-	-	10,854

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

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

December 31, 2011	Level 1	Level 2	Level 3	Total
Impaired loans	$ -	$ 26,033	$ 16,891	$ 42,924
Other real estate owned	$ -	$ 25,959	$ 3,860	$ 29,819

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

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

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

Foreclosed Property: The fair value of foreclosed property is estimated using Level 2 inputs based on observable market data or Level 3 inputs based on assumptions specific to the individual property. Level 3 inputs typically include unobservable inputs such as management-applied discounts used to further reduce values to a net realizable value or in situations where our appraisal date predates a likely change in market conditions. The discount rates used ranged from 6% to 14%.

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

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

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

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

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

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

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

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

Repurchase agreements: The carrying amount approximates fair value.

Federal funds purchased: The carrying amount approximates fair value.

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

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

December 31, 2012	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
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	4	450,140	-
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	-
Loans, net	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	-

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

NOTE 18: VARIABLE INTEREST ENTITIES

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

Low Income Housing Tax Credit Partnerships

As part of its community reinvestment initiatives, the Company invests within its footprint in 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 $47.83 million and $40.46 million in these partnerships were not included in the Consolidated Balance Sheets at December 31, 2012 and 2011, respectively. These limited partner interests had carrying values of $15.64 million and $11.68 million at December 31, 2012 and 2011, respectively, and are recorded in other assets on the Company's Consolidated Balance Sheets. The Company's maximum exposure to loss for these limited partner investments totaled $15.64 million and $11.68 million at December 31, 2012 and 2011, respectively.

Currituck Resolution Properties, Inc.

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

The Company concluded that the Resolution Company is a VIE because the equity investors do not have sufficient equity at risk for the entity to independently finance its activities, as evidenced by the amount of subordinated support provided by the Company. However, the Company determined that it is not the primary beneficiary of the Resolution Company as it does not have the power to direct the activities of the entity that most significantly impact the entity's economic performance. The Company does not have any contractual obligation to provide additional support to this entity, and its maximum exposure to loss was limited to (i) the current outstanding balance of the term loan, which was $3.50 million at December 31, 2012, and $8.05 million at December 31, 2011, and (ii) the commitments on the two revolving lines of credit, which were $387,000 as of December 31, 2011, and were $579,000 as of December 31, 2012. The total unconsolidated assets of the Resolution Company as of December 31, 2012 and 2011, were $13.17 million and $20.71 million, respectively.

NOTE 19: INCOME TAXES

The provision for income taxes charged to operations is listed in the following chart (in thousands):

For the Year Ended December 31,	2012	2011	2010
Current income tax expense			
Federal	$ (12,094)	$ (13,226)	$ (16,206)
State	(466)	(436)	(282)
Total current tax expense	(12,560)	(13,662)	(16,488)
Deferred income tax (expense) benefit			
Federal	(1,404)	936	4,032
State	-	-	-
Total deferred income tax (expense) benefit	(1,404)	936	4,032
Income tax expense	$ (13,964)	$ (12,726)	$ (12,456)

Differences between income tax expense calculated at the statutory rate and shown on the Consolidated Statements of Income are summarized as follows (dollars in thousands):

For the Year Ended December 31,	2012 $	2012 Rate	2011 $	2011 Rate	2010 $	2010 Rate
Federal income tax expense at statutory rate	$ (18,163)	(35.00%)	$ (16,114)	(35.00%)	$ (14,956)	(35.00%)
State income tax expense, net of federal benefit	(301)	(0.58%)	(436)	(0.95%)	(282)	(0.66%)
Tax advantaged income	2,768	5.33%	2,817	6.12%	2,363	5.53%
Tax credits	2,229	4.30%	1,417	3.08%	1,170	2.74%
Section 162(m) disallowance	(598)	(1.15%)	(252)	(0.55%)	(552)	(1.29%)
Other	101	0.19%	(158)	(0.34%)	(199)	(0.47%)
Income tax expense	$ (13,964)	(26.91%)	$ (12,726)	(27.64%)	$ (12,456)	(29.15%)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Management believes it is more likely than not that the Company will realize the benefits of the Company's deferred tax assets.

Significant components of deferred tax assets and deferred tax liabilities follow (in thousands):

Year Ended December 31,	**2012**	**2011**
Deferred tax assets:		
Allowance for loan losses	$ 14,150	$ 13,909
Stock-based compensation	1,345	1,397
Other	2,822	2,723
Accrued expenses	701	507
Retirement plan	5,426	3,903
Deferred compensation	5,199	4,993
Total deferred tax assets	29,643	27,432
Deferred tax liabilities:		
Loan costs	-	-
Depreciation	12,293	10,679
Noncompete and intangibles	880	685
Basis differences due to tax credits and partnerships	1,645	964
Unrealized gain on securities available for sale	907	1,472
Other	713	67
Total deferred tax liabilities	16,438	13,867
Net deferred tax assets	$ 13,205	$ 13,565

As of December 31, 2012, and December 31, 2011, the Company did not have any unrecognized tax benefits. The Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next 12 months. The Company recognizes interest and penalties related to unrecognized tax benefits as "Interest Expense" and "Other Expense," respectively, and not as part of the tax provision. The Company did not recognize any interest expense or penalties for the years ended December 31, 2012, 2011, and 2010. Additionally, there were no interest or penalties accrued at December 31, 2012 or 2011. The Company is no longer subject to examination for federal and state purposes for the tax years prior to 2009.

NOTE 20: ACCUMULATED OTHER COMPREHENSIVE INCOME

Activity within the balances of accumulated other comprehensive income (loss) is shown in following table for the years ended December 31 as follows (in thousands):

	Unrealized gains on securities	Defined benefit retirement plan	Accumulated other comprehensive income (loss), net of tax
Balance, December 31, 2009	$ (1,633)	$ -	$ (1,633)
Net change	1,921	-	1,921
Balance, December 31, 2010	288	-	288
Net change	2,466	-	2,466
Balance, December 31, 2011	2,754	-	2,754
Net change	(1,055)	(883)	(1,938)
Balance, December 31, 2012	$ 1,699	$ (883)	$ 816

NOTE 21: LEGAL CONTINGENCIES

Various legal actions arise from time to time in the normal course of our business. There were no significant asserted claims or assessments at December 31, 2012. Management was not aware of any unasserted claims or assessments that may be probable of assertion at December 31, 2012.

NOTE 22: OTHER RELATED PARTY TRANSACTIONS

Loans are made to the Company's executive officers and directors and their associates during the ordinary course of business. The aggregate amount of loans to such related parties totaled $218.95 million, $180.53 million, and $169.81 million as of December 31, 2012, 2011, and 2010, respectively. During 2012, new advances on all commitments to such parties totaled $343.68 million, adjustments for retired related parties totaled $4.42 million, and repayments amounted to $300.84 million. Included in the loans to related parties, at December 31, 2012, we had $47.53 million in unfunded commitments to extend credit to such related parties.

The Company rents space for various financial centers from affiliated companies. Rent expense related to these leases was $2.07 million, $2.00 million, and $2.20 million for the years ended December 31, 2012, 2011, and 2010, respectively.

In the ordinary course of business, the Company acquired certain goods and services from companies associated with its directors. Amounts paid to these companies during the years ended December 31, 2012, 2011, and 2010 approximated $7.54 million, $12.48 million, and $6.22 million, respectively.

NOTE 23: QUARTERLY FINANCIAL DATA (UNAUDITED)

Summarized unaudited quarterly financial data for the years ended December 31, 2012 and 2011, is as follows (in thousands, except per share data):

2012	Fourth	Third	Second	First
Interest income	$ 43,651	$ 44,216	$ 43,210	$ 42,428
Interest expense	7,040	7,232	7,306	7,643
Provision for loan losses	2,959	4,977	4,122	4,097
Noninterest income	18,995	21,674	20,743	19,771
Net gain (loss) on investment securities	(33)	508	1,753	778
Noninterest expense	40,346	40,231	40,640	37,532
Income before income tax expense and Noncontrolling interest	12,268	13,958	13,638	13,705
Income tax expense	2,446	4,063	3,401	4,054
Net income	9,822	9,895	10,237	9,651
Noncontrolling interest	(205)	(545)	(709)	(214)
Net income attributable to TowneBank	$ 9,617	$ 9,350	$ 9,528	$ 9,437
Net income per common share				
Basic	$ 0.24	$ 0.26	$ 0.26	$ 0.25
Diluted	$ 0.24	$ 0.26	$ 0.26	$ 0.25
Comprehensive income	$ 8,896	$ 10,346	$ 8,818	$ 9,607
Dividends	$ 0.09	$ 0.08	$ 0.08	$ 0.078

2011	Fourth	Third	Second	First
Interest income	$ 42,325	$ 43,027	$ 43,376	$ 43,745
Interest expense	8,048	8,941	9,613	9,649
Provision for loan losses	1,062	1,400	7,322	3,818
Noninterest income	15,970	16,823	15,493	15,766
Net gain (loss) on investment securities	3	(3)	3,629	53
Noninterest expense	37,104	37,089	36,322	34,305
Income before income tax expense and Noncontrolling interest	12,084	12,417	9,241	11,792
Income tax expense	3,105	3,610	2,613	3,398
Net income	8,979	8,807	6,628	8,394
Noncontrolling interest	8	(282)	877	(90)
Net income attributable to TowneBank	$ 8,987	$ 8,525	$ 7,505	$ 8,304
Net income per common share				
Basic	$ 0.23	$ 0.16	$ 0.17	$ 0.20
Diluted	$ 0.23	$ 0.16	$ 0.17	$ 0.20
Comprehensive income	$ 8,569	$ 10,058	$ 7,305	$ 9,341
Dividends	$ 0.078	$ 0.078	$ 0.078	$ 0.078

NOTE 24: 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.

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.

Information about reportable segments and reconciliation of such information to the consolidated financial statements follows (dollars in thousands):

For the Year Ended December 31, 2012	Bank	Realty	Insurance	Consolidated Totals
Net interest income	$ 141,517	$ 2,754	$ 13	$ 144,284
Provision for loan losses	16,155	-	-	16,155
Net interest income after provision for loan losses	125,362	2,754	13	128,129
Residential mortgage brokerage income, net	(548)	27,546	-	26,998
Real estate brokerage and property management income, net	-	11,515	-	11,515
Insurance commissions and other title fees and income, net	-	1,830	21,628	23,458
Other noninterest income	20,226	1,279	713	22,218
Noninterest expense	99,927	30,690	16,556	147,173
Depreciation and amortization	8,272	1,617	1,687	11,576
Income before income tax, corporate allocation, and noncontrolling interest	36,841	12,617	4,111	53,569
Corporate allocation	(565)	402	163	-
Income before income tax provision and noncontrolling interest	37,406	12,215	3,948	53,569
Income tax provision	8,468	3,995	1,501	13,964
Net income	28,938	8,220	2,447	39,605
Noncontrolling interest	-	(1,475)	(199)	(1,674)
Net income attributable to TowneBank	$ 28,938	$ 6,745	$ 2,248	$ 37,931
Net income as percentage of total	76.29%	17.78%	5.93%	100.00%
Assets	$ 4,140,727	$ 192,248	$ 72,948	$ 4,405,923
Efficiency ratio	67.12%	71.91%	81.61%	69.48%

For the Year Ended December 31, 2011	Bank	Realty	Insurance	Consolidated Totals
Net interest income	$ 134,720	$ 1,475	$ 27	$ 136,222
Provision for loan losses	13,602	-	-	13,602
Net interest income after provision for loan losses	121,118	1,475	27	122,620
Residential mortgage brokerage income, net	(157)	12,799	-	12,642
Real estate brokerage and property management income, net	-	11,496	-	11,496
Insurance commissions and other title fees and income, net	-	1,681	20,865	22,546
Other noninterest income	19,154	1,222	673	21,049
Noninterest expense	95,298	23,191	14,973	133,462
Depreciation and amortization	8,061	1,751	1,546	11,358
Income before income tax, corporate allocation, and noncontrolling interest	36,756	3,731	5,046	45,533
Corporate allocation	(468)	288	180	-
Income before income tax provision and noncontrolling interest	37,224	3,443	4,866	45,533
Income tax provision	9,267	1,626	1,833	12,726
Net income	27,957	1,817	3,033	32,807
Noncontrolling interest	-	824	(310)	514
Net income attributable to TowneBank	$ 27,957	$ 2,641	$ 2,723	$ 33,321
Net income as percentage of total	83.90%	7.93%	8.17%	100.00%
Assets	$ 3,856,997	$ 159,641	$ 65,132	$ 4,081,770
Efficiency ratio	67.24%	86.99%	76.60%	71.01%

For the Year Ended December 31, 2010	Bank	Realty	Insurance	Consolidated Totals
Net interest income	$ 120,485	$ 2,129	$ 21	$ 122,635
Provision for loan losses	22,565	-	-	22,565
Net interest income after provision for loan losses	97,920	2,129	21	100,070
Residential mortgage brokerage income, net	(295)	13,293	-	12,998
Real estate brokerage and property	-	11,155	-	11,155
Insurance commissions and other title	-	1,913	17,588	19,501
Other noninterest income	19,410	1,711	1,275	22,396
Noninterest expense	78,490	22,541	12,522	113,553
Depreciation and amortization	5,894	1,970	1,328	9,192
Income before income tax, corporate allocation, and noncontrolling interest	32,651	5,690	5,034	43,375
Corporate allocation	(483)	309	174	-
Income before income tax provision and noncontrolling interest	33,134	5,381	4,860	43,375
Income tax provision	8,797	1,768	1,891	12,456
Net income	24,337	3,613	2,969	30,919
Noncontrolling interest	-	(480)	(163)	(643)
Net income attributable to TowneBank	$ 24,337	$ 3,133	$ 2,806	$ 30,276
Net income as percentage of total	80.38%	10.35%	9.27%	100.00%
Assets	$ 3,697,894	$ 115,704	$ 57,420	$ 3,871,018
Efficiency ratio	60.45%	81.16%	73.34%	65.05%

The following table provides the change in net income and total assets for each segment, comparing December 31, 2012 and 2011 (dollars in thousands):

	Banking	Realty	Insurance	Consolidated
Net Income ($)	$ 981	$ 4,104	$ (475)	$ 4,610
Net Income (%)	3.51%	155.40%	(17.44%)	13.84%
Total Assets ($)	$ 283,730	$ 32,607	$ 7,816	$ 324,153
Total Assets (%)	7.36%	20.43%	12.00%	7.94%

NOTE 25: EARNINGS PER SHARE

The following chart summarizes information related to the computation of basic and diluted earnings per share (dollars in thousands, except per share data):

Year Ended December 31,	2012	2011	2010
Basic			
Net income, as reported	$ 37,931	$ 33,321	$ 30,276
Preferred stock dividends and accretion of discount	(6,226)	(10,434)	(9,355)
Net income available to common shareholders	$ 31,705	$ 22,887	$ 20,921
Average common shares outstanding (1)	30,772,130	29,773,173	29,227,715
Basic earnings per common share (1)	$ 1.03	$ 0.77	$ 0.72
Diluted			
Net income available to common shareholders	$ 31,705	$ 22,887	$ 20,921
Interest applicable to subordinated debt, net of tax (2)	154	714	720
Net income available to common shareholders, for diluted EPS	31,859	23,601	21,641
Average common shares outstanding (1)	30,772,130	29,773,173	29,227,715
Effect of dilutive securities:			
Stock compensation plans, net of tax benefit (1)(3)	52,025	63,536	77,555
Convertible subordinated debentures (1)(4)	219,465	1,057,736	1,065,588
Average diluted shares outstanding	31,043,620	30,894,444	30,370,857
Diluted earnings per common share (1)	$ 1.03	$ 0.76	$ 0.71

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

(2) Annualized interest on 8% convertible subordinated capital debentures (net of tax) is added to net income, since this interest would not be paid if the debentures were converted to common stock.

(3) Stock options and restricted stock shares totaling 24,092, 21,052, and 5,591 were excluded from the computation of diluted earnings per share during 2012, 2011, and 2010, respectively, because their inclusion would be antidilutive.

(4) Shares are assumed to have been converted since the beginning of the period.

The Series A Preferred Stock entitles the holders to convert their shares into 3,227,064 shares of common stock. These shares were not included in the computation of diluted earnings per share as the effect was anti-dilutive for all periods presented.

In conjunction with the Company’s issuance of the Series B Preferred Stock 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 all periods presented.

TOWNEBANK
SHAREHOLDER INFORMATION

ANNUAL MEETING

TowneBank's Annual Meeting of Stockholders will be held at 11:30 a.m. on Wednesday, May 22, 2013, at the Virginia Beach Convention Center, 1000 19th Street, Virginia Beach, Virginia 23451.

COMMON STOCK

The Company's Common Stock is listed on the NASDAQ Global Select Market under the symbol TOWN. The following are the quarterly high and low closing sale prices of the Company's common stock for the periods indicated.

	2012		2011	
Quarter	**High**	**Low**	**High**	**Low**
First	$ 14.52	$ 12.34	$ 16.92	$ 13.78
Second	14.04	11.83	15.73	12.46
Third	15.86	13.76	14.32	10.52
Fourth	15.90	14.07	13.47	10.82

INVESTOR RELATIONS

Our Annual Report, Form 10-K, and other corporate publications are available to shareholders on request, without charge, by writing:

Mr. Clyde E. McFarland, Jr.
Senior Executive Vice President and Chief Financial Officer
TowneBank
6001 Harbour View Boulevard
Suffolk, Virginia 23435
757-638-6801
email: Clyde.McFarland@townebank.net

These reports are also available on our website at http://www.townebank.com/investor_relations.

INDEPENDENT AUDITORS

Dixon Hughes Goodman LLP
1400 Wells Fargo Center
440 Monticello Avenue
Norfolk, Virginia 23510

TOWNEBANK
SHAREHOLDER INFORMATION

TRANSFER AGENT

Registrar and Transfer Company
10 Commerce Drive
Cranford, New Jersey 07016-3572
800-866-1340

CORPORATE COUNSEL

LeClairRyan
999 Waterside Drive, Suite 2525
Norfolk, Virginia 23510

Troutman Sanders L.L.P.
222 Central Park Avenue, Suite 2000
Virginia Beach, Virginia 23462

Exhibit (14)

TOWNEBANK
CHIEF EXECUTIVE OFFICER, EXECUTIVE OFFICERS and SENIOR FINANCIAL OFFICERS
CODE OF ETHICAL CONDUCT

Preface

The honesty, integrity, and sound judgment of the Chief Executive Officer (“CEO”), executive and senior financial officers are fundamental to the reputation and success of TowneBank. While all employees, officers, and directors are required to adhere to the TowneBank ***Standards of Conduct***, the professional and ethical conduct of the CEO, executive and senior financial officers is essential to the proper function and success of TowneBank as a leading financial services provider.

The CEO, executive and senior financial officers hold an important and elevated role in corporate governance. These individuals are key members of the management team, who are uniquely capable and empowered to ensure that the interests of stakeholders (including shareholders, clients, employees, suppliers, and citizens of the communities in which TowneBank operates) are appropriately balanced, protected, and preserved. The CEO, executive and senior financial officers fulfill this responsibility by prescribing and enforcing the policies and procedures employed in TowneBank's financial operations.

Code of Ethical Conduct

General standards of ethical behavior

The CEO, executive and senior financial officers of TowneBank performing accounting, audit, financial management, or similar functions must:

- Act with honesty and integrity, avoiding actual or apparent conflicts of interest in personal and professional relationships.

- Provide colleagues with information that is accurate, complete, objective, relevant, timely, and understandable.

- Comply with applicable laws, rules, and regulations of federal, state, and local governments (both United States and foreign) and other appropriate private and public regulatory agencies.

- Act in good faith, with due care, competence, and diligence, without misrepresenting material facts or allowing independent judgment to be subordinated.

- Respect the confidentiality of information acquired in the course of employment.

- Share knowledge and maintain skills necessary and relevant to TowneBank's needs.

- Proactively promote ethical and honest behavior within the workplace.

- Assure responsible use of and control of all assets, resources, and information in possession of TowneBank.

- Keep management informed of financial information of importance, including departures from sound policy, practice and accounting norms.

A.

B. Standards regarding financial records and reporting

The CEO, executive and senior financial officers of TowneBank performing accounting, audit, financial management, or similar functions must:

- Establish systems and procedures to ensure business transaction are recorded in accordance with Generally Accepted Accounting Principles, company policy and appropriate regulatory pronouncements and guidelines.

- Protect and maintain accounting records and information as required by applicable law, regulation, or regulatory guidelines.

- Inform the Board of Directors and the Audit Committee of any material information that affects the disclosures made by the Bank in its public filings.

- Report to the Board of Directors and the Audit Committee concerning (a) significant deficiencies in the design and operation of internal controls or (b) any fraud involving management or other employees with a significant role in the Bank's financial reporting, disclosures or internal controls.

The CEO, executive and senior financial officers are expected to adhere to both the TowneBank ***Standards of Conduct*** and the ***TowneBank Chief Executive Officer and Senior Financial Officers Code of Ethical Conduct*** at all times. The board of directors shall have the sole and absolute discretionary authority to approve any deviation or waiver from the ***Code of Ethical Conduct***. Any waiver and the grounds for such waiver for the CEO, executive or senior financial officer shall be promptly disclosed through a filing with the Federal Deposit Insurance Corporation on Form 8-K. Additionally, any change of this ***Code of Ethical Conduct*** shall be promptly disclosed to stockholders.

The policy is applicable to the Chief Executive Officer (CEO), Chief Financial Officer (CFO), Controller, Corporate Treasurer, Internal Audit members, any person Assistant Vice President and above in an Accounting/Financial position, Senior Financial Analyst, any Regulation O Executive Officers along with any person serving in an equivalent position regardless of whether or not they are designated as executive officers for Regulation O purposes, or any persons serving in equivalent positions within the Bank or any of its subsidiaries.

TOWNEBANK
CHIEF EXECUTIVE OFFICER, EXECUTIVE OFFICERS and SENIOR FINANCIAL OFFICERS
CODE OF ETHICAL CONDUCT

Please indicate that you have received, read and will abide by the ***TowneBank Chief Executive Officer, Executive Officer and Senior Financial Officers Code of Ethical Conduct*** by signing your name and dating the attached acknowledgment and returning it promptly to the Chairman and CEO of TowneBank.

ACKNOWLEDGMENT

I certify that I have received and read and that I will abide by the ***TowneBank Chief Executive Officer, Executive Officer and Senior Financial Officers Code of Ethical Conduct*** distributed to me on this ______________ day of ______________, 20___.

____
OFFICER

____
DATE

Exhibit (21)

Subsidiaries of TowneBank

Subsidiary	State of Incorporation
TowneBank Investment Corporation	Virginia
Towne Investments, LLC	Virginia
Charter Facilities Funding V	Virginia
TowneBank Woodview Investment Co., LLC	Virginia
TowneBank Woodview Investment Co. II, LLC	Virginia
TowneBank Heritage Forest, LLC	Virginia
Hamilton Place Towne I, LLC	Virginia
Hamilton Place Towne II, LLC	Virginia
Title Software, LLC	Virginia
Towne Financial Services Group, LLC	Virginia
GSH Residential Real Estate Corporation	Virginia
GSH Association Management LLC	Virginia
GSH NC Resort Management, LLC	Virginia
GSH NC Realty, LLC	Virginia
GSH Training Company, LLC	Virginia
Towne Realty LLC, t/a Prudential Towne Realty	Virginia
Lawyers Escrow & Title Agency, LLC	Virginia
Eastern Title Company, Inc.	Virginia
Colonial Virginia Title and Settlements, LLC	Virginia
GSH Referral Company, Inc.	Virginia
Virginia Home Title and Settlements, LLC	Virginia
PTR Referral, LLC	Virginia
Prudential Towne Realty at Stonehouse	Virginia
Towne Insurance Agency, LLC	Virginia
The Frieden Agency LLC, t/a TFA Benefits	Virginia
Benefit Design Group, LLC	Virginia
Beneflex Management, LLC	Virginia
W. Taylor Johnson, Inc.	Virginia
Towne Insurance Greenville, LLC	Virginia
Out of Towne, LLC	Virginia
W. Taylor Johnson Employee Benefit Company, Inc.	Virginia
TowneBank Commercial Mortgage, LLC	Virginia
Towne Hall, LLC	Virginia
Towne 1031 Exchange, LLC	Virginia
Towne New Markets CDE, Inc.	Virginia
Towne New Markets Sub CDE I, LLC	Virginia
Towne New Markets Sub CDE II, LLC	Virginia
Towne New Markets Sub CDE III, LLC	Virginia
Towne New Markets Sub CDE IV, LLC	Virginia
Towne New Markets Sub CDE V, LLC	Virginia
Towne New Markets Sub CDE VI, LLC	Virginia
Towne Mortgage, LLC	Virginia
NewTowne Mortgage, LLC	Virginia
SimonTowne Mortgage, LLC	Virginia

Subsidiaries of TowneBank (continued)

Subsidiary	State of Incorporation
Towne Mortgage of the Carolinas, LLC	North Carolina
Franklin Federal Mortgage Center, LLC	Virginia
Waterside Capital, LLC	Virginia
Southeastern Virginia Investment Properties, LLC	Virginia
Southeastern Virginia Properties Gateway I, LLC	Virginia
Southeastern Virginia Coastal Properties I, LLC	Virginia
Southeastern Virginia Properties, LLC	Virginia
Northeastern Virginia Properties, LLC	Virginia
Northeastern North Carolina Properties at Bermuda Bay, LLC	Virginia
Northeastern North Carolina Properties Bermuda Bay Development, LLC	Virginia
Northeastern North Carolina Properties at Hamilton Cay, LLC	Virginia
Northeastern North Carolina Properties at Heron’s Ridge, LLC	Virginia
Northeastern North Carolina Properties Oceanside Villas LLC	Virginia
Virginia Hotel Properties, LLC	Virginia
Virginia Properties Apartment and Land, LLC	Virginia
Community Premium Finance, LLC	Virginia
Stonehouse Towne, LLC	Virginia
Trip Preserver Assistance, LLC	Virginia
West Suffolk Properties, LLC	Virginia

Exhibit (31.1)

TOWNEBANK

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, G. Robert Aston, Jr., Chairman and Chief Executive Officer, certify that:

1. I have reviewed this annual report on Form 10-K 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 and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

TOWNEBANK

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

5. The registrant's other certifying officer 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 (or person performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of the internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize, and report financial information; and

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

March 12, 2013
Date

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

Exhibit (31.2)

TOWNEBANK

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Clyde E. McFarland, Jr., Senior Executive Vice President and Chief Financial Officer, certify that:

1. I have reviewed this annual report on Form 10-K 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 and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

TOWNEBANK

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

5. The registrant's other certifying officer 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 (or person performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of the internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize, and report financial information; and

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

March 12, 2013	/s/ Clyde E. McFarland, Jr.
Date	Clyde E. McFarland, Jr. Senior Executive Vice President/CFO

Exhibit (32)

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

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

1. Our Annual Report on Form 10-K for the year ended December 31, 2012 (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934; and

2. The information contained in the Report presents fairly, in all material respects, our financial condition and results of operations as of and for the period covered by the Report.

March 12, 2013	/s/ G. Robert Aston, Jr.
Date	G. Robert Aston, Jr. Chairman/Chief Executive Officer
March 12, 2013	/s/ Clyde E. McFarland, Jr.
Date	Clyde E. McFarland, Jr. Senior Executive Vice President/CFO

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