

COMMUNITY FINANCIAL CORP /MD/  
Form 10-Q  
November 03, 2017

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

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

For the Quarterly Period Ended September 30, 2017

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-36094

**The Community Financial Corporation**

(Exact name of registrant as specified in its charter)

Maryland 52-1652138  
(State of other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

3035 Leonardtown Road, Waldorf, Maryland 20601  
(Address of principal executive offices) (Zip Code)

(301) 645-5601

(Registrant's telephone number, including area code)

Not applicable

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

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

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large Accelerated Filer  Accelerated Filer   
Non-accelerated Filer  Smaller Reporting Company   
(Do not check if a smaller reporting company)

Emerging growth company

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

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

Yes  No

As of October 26, 2017, the registrant had 4,649,658 shares of common stock outstanding.

**THE COMMUNITY FINANCIAL CORPORATION**

**FORM 10-Q**

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**PART 1 - FINANCIAL INFORMATION**  
**ITEM 1 – FINANCIAL STATEMENTS**

**CONSOLIDATED BALANCE SHEETS**

(dollars in thousands, except per share amounts)	September 30, 2017 (Unaudited)	December 31, 2016
<b>Assets</b>		
Cash and due from banks	\$ 15,627	\$ 9,948
Interest-bearing deposits with banks	1,577	1,315
Securities available for sale (AFS), at fair value	61,376	53,033
Securities held to maturity (HTM), at amortized cost	104,530	109,247
Federal Home Loan Bank (FHLB) stock - at cost	7,447	7,235
Loans receivable - net of allowance for loan losses of \$10,435 and \$9,860	1,136,004	1,079,519
Premises and equipment, net	21,751	22,205
Premises and equipment held for sale	-	345
Other real estate owned (OREO)	9,741	7,763
Accrued interest receivable	4,494	3,979
Investment in bank owned life insurance	29,206	28,625
Other assets	10,419	11,043
<b>Total Assets</b>	<b>\$ 1,402,172</b>	<b>\$ 1,334,257</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
<b>Deposits</b>		
Non-interest-bearing deposits	\$ 157,665	\$ 144,877
Interest-bearing deposits	940,336	893,948
<b>Total deposits</b>	<b>1,098,001</b>	<b>1,038,825</b>
Short-term borrowings	91,500	79,000
Long-term debt	55,514	65,559
Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs)	12,000	12,000
Subordinated notes - 6.25%	23,000	23,000
Accrued expenses and other liabilities	11,272	11,447
<b>Total Liabilities</b>	<b>1,291,287</b>	<b>1,229,831</b>
<b>Stockholders' Equity</b>		
Common stock - par value \$.01; authorized - 15,000,000 shares; issued 4,649,302 and 4,633,868 shares, respectively	46	46
Additional paid in capital	47,994	47,377
Retained earnings	64,375	58,100
Accumulated other comprehensive loss	(538)	(928)
Unearned ESOP shares	(992)	(169)

Total Stockholders' Equity	110,885	104,426
Total Liabilities and Stockholders' Equity	\$ 1,402,172	\$ 1,334,257

*See notes to Consolidated Financial Statements*

**CONSOLIDATED STATEMENTS OF INCOME (Unaudited)**

(dollars in thousands, except per share amounts )	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
<b>Interest and Dividend Income</b>				
Loans, including fees	\$ 12,671	\$ 11,460	\$ 37,051	\$ 33,175
Interest and dividends on investment securities	988	758	2,907	2,273
Interest on deposits with banks	21	5	39	15
<b>Total Interest and Dividend Income</b>	<b>13,680</b>	<b>12,223</b>	<b>39,997</b>	<b>35,463</b>
<b>Interest Expense</b>				
Deposits	1,563	1,209	4,234	3,486
Short-term borrowings	304	36	734	123
Long-term debt	805	834	2,414	2,422
<b>Total Interest Expense</b>	<b>2,672</b>	<b>2,079</b>	<b>7,382</b>	<b>6,031</b>
<b>Net Interest Income</b>	<b>11,008</b>	<b>10,144</b>	<b>32,615</b>	<b>29,432</b>
Provision for loan losses	224	698	980	1,689
<b>Net Interest Income After Provision For Loan Losses</b>	<b>10,784</b>	<b>9,446</b>	<b>31,635</b>	<b>27,743</b>
<b>Noninterest Income</b>				
Loan appraisal, credit, and miscellaneous charges	28	60	84	223
Gain on sale of asset	-	-	47	4
Net gains (losses) on sale of OREO	-	3	36	(440)
Net gains on sale of investment securities	-	-	133	39
Income from bank owned life insurance	196	199	581	593
Service charges	639	580	1,909	2,050
Gain on sale of loans held for sale	294	-	294	-
<b>Total Noninterest Income</b>	<b>1,157</b>	<b>842</b>	<b>3,084</b>	<b>2,469</b>
<b>Noninterest Expense</b>				
Salary and employee benefits	4,056	4,268	12,567	12,617
Occupancy expense	630	597	1,941	1,822
Advertising	156	290	404	509
Data processing expense	555	544	1,766	1,678
Professional fees	749	308	1,684	1,113
Depreciation of furniture, fixtures, and equipment	191	206	594	608
Telephone communications	46	43	142	133
Office supplies	26	33	86	105
FDIC Insurance	178	215	505	642
OREO valuation allowance and expenses	283	203	623	609
Other	572	604	2,039	2,007
<b>Total Noninterest Expense</b>	<b>7,442</b>	<b>7,311</b>	<b>22,351</b>	<b>21,843</b>
<b>Income before income taxes</b>	<b>4,499</b>	<b>2,977</b>	<b>12,368</b>	<b>8,369</b>



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Income tax expense	1,717	1,014	4,701	3,060
Net Income	\$ 2,782	\$ 1,963	\$ 7,667	\$ 5,309
Earnings Per Common Share				
Basic	\$ 0.60	\$ 0.43	\$ 1.66	\$ 1.16
Diluted	\$ 0.60	\$ 0.42	\$ 1.65	\$ 1.15
Cash dividends paid per common share	\$ 0.10	\$ 0.10	\$ 0.30	\$ 0.30

*See notes to Consolidated Financial Statements*

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)**

(dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net Income	\$ 2,782	\$ 1,963	\$ 7,667	\$ 5,309
Net unrealized holding gains (losses) arising during period, net of tax (benefit) expense of \$(32) and \$13, and \$257 and \$223, respectively.	(49 )	21	396	346
Reclassification adjustment for gains included in net income, net of tax benefit of \$(0) and \$(0), and \$(3) and \$(10), respectively.	-	-	(6 )	(20 )
Comprehensive Income	\$ 2,733	\$ 1,984	\$ 8,057	\$ 5,635

*See notes to Consolidated Financial Statements*

**CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**

(dollars in thousands)	Nine Months Ended September 30,	
	2017	2016
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 7,667	\$ 5,309
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan losses	980	1,689
Depreciation and amortization	1,201	1,144
Loans originated for resale	(2,529)	-
Proceeds from sale of loans originated for sale	2,823	-
Gain on sale of loans held for sale	(294)	-
Net (gains) loss on the sale of OREO	(36)	440
Gains on sales of investment securities	(133)	(39)
Gain on sale of asset	(47)	(4)
Net amortization of premium/discount on investment securities	332	395
Increase in OREO valuation allowance	576	366
Increase in cash surrender of bank owned life insurance	(581)	(593)
Increase in deferred income tax benefit	(805)	(417)
Increase in accrued interest receivable	(515)	(386)
Stock based compensation	399	240
Increase (decrease) in net deferred loan premiums	(636)	1,308
(Decrease) increase in accrued expenses and other liabilities	(175)	210
Decrease (increase) in other assets	1,198	(77)
<b>Net Cash Provided by Operating Activities</b>	<b>9,425</b>	<b>9,585</b>
<b>Cash Flows from Investing Activities</b>		
Purchase of AFS investment securities	(16,831)	(15,142)
Proceeds from redemption or principal payments of AFS investment securities	5,330	4,404
Purchase of HTM investment securities	(13,135)	(12,180)
Proceeds from maturities or principal payments of HTM investment securities	14,185	17,618
Net (decrease) increase of FHLB and FRB stock	(211)	759
Purchase of bank owned life insurance policies	-	-
Loans originated or acquired	(247,726)	(298,714)
Principal collected on loans	187,475	160,259
Purchase of premises and equipment	(742)	(3,757)
Proceeds from sale of OREO	903	2,770
Proceeds from sale of HTM investment securities	3,569	710
Proceeds from sale of AFS investment securities	3,702	2,464
Proceeds from disposal of asset	387	2,015
<b>Net Cash Used in Investing Activities</b>	<b>(63,094)</b>	<b>(138,794)</b>



**CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)****(continued)**

(dollars in thousands)	Nine Months Ended September 30,	
	2017	2016
<b>Cash Flows from Financing Activities</b>		
Net increase in deposits	\$ 59,176	\$ 104,676
Proceeds from long-term debt	10,000	15,000
Payments of long-term debt	(20,045)	(5,044)
Net increase in short term borrowings	12,500	19,500
Exercise of stock options	155	-
Dividends paid	(1,353)	(1,362)
Net change in unearned ESOP shares	(823)	-
Repurchase of common stock	-	(337)
Net Cash Provided by Financing Activities	59,610	132,433
Increase in Cash and Cash Equivalents	\$ 5,941	\$ 3,224
Cash and Cash Equivalents - January 1	11,263	11,139
Cash and Cash Equivalents - September 30	\$ 17,204	\$ 14,363
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash paid during the period for Interest	\$ 7,631	\$ 6,253
Income taxes	\$ 5,085	\$ 2,875
<b>Supplemental Schedule of Non-Cash Operating Activities</b>		
Issuance of common stock for payment of compensation	\$ 203	\$ 575
Transfer from loans to OREO	\$ 3,622	\$ 3,119
Financed amount of sale of OREO	\$ 200	\$ 1,830
Transfer of OREO to Fixed Assets	\$ -	\$ 372

*See notes to Consolidated Financial Statements*

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

### **NOTE 1 – BASIS OF PRESENTATION**

The consolidated financial statements of The Community Financial Corporation (the “Company”) and its wholly owned subsidiary, Community Bank of the Chesapeake (the “Bank”), and the Bank’s wholly owned subsidiary, Community Mortgage Corporation of Tri-County, included herein are unaudited.

The consolidated financial statements reflect all adjustments consisting only of normal recurring accruals that, in the opinion of management, are necessary to present fairly the Company’s financial condition, results of operations, and cash flows for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The Company believes that the disclosures are adequate to make the information presented not misleading. The balances as of December 31, 2016 have been derived from audited financial statements. There have been no significant changes to the Company’s accounting policies as disclosed in the 2016 Annual Report. The results of operations for the three and nine months ended September 30, 2017 are not necessarily indicative of the results of operations to be expected for the remainder of the year or any other period. Certain previously reported amounts have been reclassified to conform to the 2017 presentation.

These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company’s 2016 Annual Report on Form 10-K.

### **NOTE 2 – NATURE OF BUSINESS**

The Company provides a variety of financial services to individuals and businesses through its offices in Southern Maryland and Annapolis and Fredericksburg, Virginia. Its primary deposit products are demand, savings and time deposits, and its primary lending products are commercial and residential mortgage loans, commercial loans, construction and land development loans, home equity and second mortgages and commercial equipment loans.

The Company’s branches are located at its main office in Waldorf, Maryland, and 10 branch offices in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick, Lusby, California, Maryland; and Fredericksburg, Virginia. The Company maintains five loan production offices (“LPOs”) in Annapolis, La Plata, Prince Frederick and Leonardtown, Maryland; and Fredericksburg, Virginia. The Leonardtown LPO is co-located with the branch.

The Company closed its Central Park Fredericksburg branch during the third quarter of 2017. This location continues to serve as a loan production office and the branch closure did not have a material effect on operations. The Company offered branch employees open positions.

On July 31, 2017, the Company and Community Bank of the Chesapeake entered into an Agreement and Plan of Merger with County First Bank (“County First”). Merger related costs, which included mainly professional fees and investment banking costs, for the three months and nine months ended September 30, 2017 were \$239,000 and \$494,000, respectively. At June 30, 2017, County First had total assets of \$224 million, total deposits of \$209 million, and five branch offices in La Plata, Waldorf, New Market, Prince Frederick and California, Maryland. Pending receipt of the necessary regulatory and County First shareholder approvals, the merger is currently expected to close in the first quarter of 2018.

Under the terms of the merger agreement, which was approved by the Boards of Directors of each company, upon completion of the merger, County First Bank shareholders will be entitled to receive 0.9543 shares of The Community Financial Corporation common stock and \$1.00 in cash for each share of County First Bank common stock they hold. County First shareholders may also receive, in the aggregate, additional contingent cash consideration of up to \$2,154,303 (representing a maximum potential per share value of \$2.24) based upon the resolution of certain identified assets prior to closing. There can be no assurance that County First will sell, resolve or otherwise dispose of any of the identified assets or that County First shareholders will receive any contingent cash consideration.

**NOTE 3 – INCOME TAXES**

The Company files a consolidated federal income tax return with its subsidiaries. Deferred tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws and when it is considered more likely than not that deferred tax assets will be realized. It is the Company's policy to recognize accrued interest and penalties related to unrecognized tax benefits as a component of tax expense.

**NOTE 4 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)**

The following tables present the components of comprehensive income for the three and nine months ended September 30, 2017 and 2016. The Company's "other comprehensive" income was solely related to securities for the three and nine months ended September 30, 2017 and 2016.

(dollars in thousands)	Three Months Ended September 30, 2017			Three Months Ended September 30, 2016		
	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
Net unrealized holding gains (losses) arising during period	\$ (81 )	\$ (32 )	\$ (49 )	\$ 34	\$ 13	\$ 21
Reclassification adjustments	-	-	-	-	-	-
Other comprehensive income	\$ (81 )	\$ (32 )	\$ (49 )	\$ 34	\$ 13	\$ 21

(dollars in thousands)	Nine Months Ended September 30, 2017			Nine Months Ended September 30, 2016		
	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
Net unrealized holding gains arising during period	\$ 653	\$ 257	\$ 396	\$ 569	\$ 223	\$ 346
Reclassification adjustments	(9 )	(3 )	(6 )	(30 )	(10 )	(20 )
Other comprehensive income	\$ 644	\$ 254	\$ 390	\$ 539	\$ 213	\$ 326

The following table presents the changes in each component of accumulated other comprehensive loss, net of tax, for the three and nine months ended September 30, 2017 and 2016.

(dollars in thousands)	Three Months Ended	Three Months Ended	Nine Months Ended	Nine Months Ended
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Net Unrealized Gains And Losses	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses



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Beginning of period	\$ (489 )	\$ 54	\$ (928 )	\$ (251 )
Other comprehensive gains (losses), net of tax before reclassifications	(49 )	21	396	346
Amounts reclassified from accumulated other comprehensive loss	-	-	(6 )	(20 )
Net other comprehensive income (loss)	(49 )	21	390	326
End of period	\$ (538 )	\$ 75	\$ (538 )	\$ 75

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**NOTE 5 – EARNINGS PER SHARE (“EPS”)**

Basic earnings per common share represent income available to common shareholders, divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock options and are determined using the treasury stock method. At September 30, 2016, there were 20,911 options which were excluded from the calculation as their effect would be anti-dilutive, because the exercise price of the options were greater than the average market price of the common shares. All outstanding options expired on July 17, 2017.

Basic and diluted earnings per share have been computed based on weighted-average common and common equivalent shares outstanding as follows:

(dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net Income	\$2,782	\$1,963	\$7,667	\$5,309
Average number of common shares outstanding	4,633,391	4,590,664	4,631,571	4,591,926
Dilutive effect of common stock equivalents	26	31,915	1,929	29,702
Average number of shares used to calculate diluted EPS	4,633,417	4,622,579	4,633,500	4,621,628
Earnings Per Common Share				
Basic	\$0.60	\$0.43	\$1.66	\$1.16
Diluted	0.60	0.42	1.65	1.15

During the three months ended September 30, 2017, the Employee Stock Ownership Plan (“ESOP”) purchased 23,503 shares of the Company’s common shares for \$823,000. The ESOP has promissory notes with the Company for the purchase of TCFC common stock for the benefit of the participants in the Plan. Loan terms are at prime rate plus one-percentage point and amortize over seven (7) years. As principal is repaid, common shares are allocated to participants based on the participant account allocation rules described in the Plan. The Bank is a guarantor of the ESOP debt with the Company. Unencumbered shares held by the ESOP are treated as outstanding in computing earnings per share. Shares issued to the ESOP but pledged as collateral for loans obtained to provide funds to acquire the shares are not treated as outstanding in computing earnings per share.

**NOTE 6 – STOCK-BASED COMPENSATION**

The Company has stock-based incentive arrangements to attract and retain key personnel. In May 2015, the 2015 Equity Compensation Plan (the “Plan”) was approved by shareholders, which authorizes the issuance of restricted stock, stock appreciation rights, stock units and stock options to the Board of Directors and key employees. Compensation expense for service-based awards is recognized over the vesting period. Performance-based awards are recognized based on a vesting schedule and the probability of achieving goals specified at the time of the grant. The 2015 Plan replaced the 2005 Equity Compensation Plan.

Stock-based compensation expense totaled \$115,000 and \$399,000, respectively, for the three and nine months ended September 30, 2017 and \$80,000 and \$240,000, respectively, for the three and nine months ended September 30, 2016. Stock-based compensation expense consisted of the vesting of grants of restricted stock.

The Company has not granted any stock options since 2007 and all outstanding options expired on July 17, 2017. The following tables below summarize option activity and outstanding and exercisable options at and for the nine months ended September 30, 2017 and at and for the year ended December 31, 2016.

(dollars in thousands, except per share amounts)	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted-Average Contractual Life Remaining In Years
Outstanding at January 1, 2017	15,081	\$ 27.70	\$ -	
Exercised	(14,231)	27.70	134	
Expired	(350 )	27.70	-	
Forfeited	(500 )	27.70	-	
Outstanding at September 30, 2017	-	\$ -	\$ -	-
Exercisable at September 30, 2017	-	\$ -	\$ -	-

(dollars in thousands, except per share amounts)	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted-Average Contractual Life Remaining In Years
Outstanding at January 1, 2016	21,211	\$ 27.70	\$ -	
Forfeited	(6,130 )	27.70		
Outstanding at December 31, 2016	15,081	\$ 27.70	\$ 20	0.5

Exercisable at December 31, 2016	15,081	\$ 27.70	\$ 20	0.5
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The aggregate intrinsic value of outstanding stock options and exercisable stock options was \$20,000 at December 31, 2016. Aggregate intrinsic value represents the difference between the Company's closing stock price on the last trading day of the period, which was \$29.00 per share at December 31, 2016 and the exercise price multiplied by the number of options outstanding.

The fair value of the Company's outstanding employee stock options is estimated on the date of grant using the Black-Scholes option pricing model. The Company estimates expected market price volatility and expected term of the options based on historical data and other factors. The exercise price for options granted is set at the discretion of the committee administering the Plan, but is not less than the market value of the shares as of the date of grant. An option's maximum term is 10 years and the options vest at the discretion of the committee.

The Company granted restricted stock in accordance with the Plan. The vesting period for outstanding granted restricted stock is between three and five years. As of September 30, 2017 and December 31, 2016, unrecognized stock compensation expense was \$636,000 and \$810,000, respectively. The following tables summarize the unvested restricted stock awards outstanding at September 30, 2017 and December 31, 2016, respectively.

	Restricted Stock Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2017	47,881	\$ 20.41
Granted	6,752	30.20
Vested	(21,738)	20.13
Cancelled	(86 )	20.75
Nonvested at September 30, 2017	32,809	\$ 22.61

	Restricted Stock Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2016	37,048	\$ 19.83
Granted	27,403	21.00
Vested	(15,912)	20.09
Cancelled	(658 )	20.31
Nonvested at December 31, 2016	47,881	\$ 20.41

#### **NOTE 7 – GUARANTEED PREFERRED BENEFICIAL INTEREST IN JUNIOR SUBORDINATED DEBENTURES (“TRUPS”)**

On June 15, 2005, Tri-County Capital Trust II (“Capital Trust II”), a Delaware business trust formed, funded and wholly owned by the Company, issued \$5.0 million of variable-rate capital securities in a private pooled transaction. The variable rate is based on the 90-day LIBOR rate plus 1.70%. The Trust used the proceeds from this issuance, along with the \$155,000 for Capital Trust II’s common securities, to purchase \$5.2 million of the Company’s junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. These capital securities qualify as Tier I capital and are presented in the Consolidated Balance Sheets as “Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures.” Both the capital securities of Capital Trust II and the junior subordinated debentures are scheduled to mature on June 15, 2035, unless called by the Company.

On July 22, 2004, Tri-County Capital Trust I (“Capital Trust I”), a Delaware business trust formed, funded and wholly owned by the Company, issued \$7.0 million of variable-rate capital securities in a private pooled transaction. The variable rate is based on the 90-day LIBOR rate plus 2.60%. The Trust used the proceeds from this issuance, along with the Company’s \$217,000 capital contribution for Capital Trust I’s common securities, to purchase \$7.2 million of the Company’s junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. These debentures qualify as Tier I capital and are presented in the Consolidated Balance Sheets as “Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures.” Both the capital securities of Capital Trust I and the junior subordinated debentures are scheduled to mature on July 22, 2034, unless called by the Company.

**NOTE 8 – SUBORDINATED NOTES**

On February 6, 2015 the Company issued \$23.0 million of unsecured 6.25% fixed to floating rate subordinated notes due February 15, 2025 (“subordinated notes”). On February 13, 2015, the Company used proceeds of the offering to redeem all \$20 million of the Company’s outstanding preferred stock issued under the Small Business Lending Fund (“SBLF”) program. The subordinated notes qualify as Tier 2 regulatory capital and replaced SBLF Tier 1 capital. The subordinated notes are not listed on any securities exchange or included in any automated dealer quotation system and there is no market for the notes. The notes are unsecured obligations and are subordinated in right of payment to all existing and future senior debt, whether secured or unsecured. The notes are not guaranteed obligations of any of the Company’s subsidiaries.

Interest will accrue at a fixed per annum rate of 6.25% from and including the issue date to but excluding February 15, 2020. From and including February 15, 2020 to but excluding the maturity date interest will accrue at a floating rate equal to the three-month LIBOR plus 479 basis points. Interest is payable on the notes on February 15 and August 15 of each year, commencing August 15, 2015, through February 15, 2020, and thereafter February 15, May 15, August 15 and November 15 of each year through the maturity date or earlier redemption date.

The subordinated notes may be redeemed in whole or in part on February 15, 2020 or on any scheduled interest payment date thereafter and upon the occurrence of certain special events. The redemption price is equal to 100% of the principal amount of the subordinated notes to be redeemed plus accrued and unpaid interest to the date of redemption. Any partial redemption will be made pro rata among all holders of the subordinated notes. The subordinated notes are not subject to repayment at the option of the holders. The subordinated notes may be redeemed at any time, if (1) a change or prospective change in law occurs that could prevent the Company from deducting interest payable on the notes for U.S. federal income tax purposes, (2) a subsequent event occurs that precludes the notes from being recognized as Tier 2 Capital for regulatory capital purposes, or (3) the Company is required to register as an investment company under the Investment Company Act of 1940, as amended.

**NOTE 9 – OTHER REAL ESTATE OWNED (“OREO”)**

OREO assets are presented net of valuation allowances. The Company considers OREO as classified assets for regulatory and financial reporting. An analysis of OREO activity follows.

	Nine Months Ended September 30,		Year Ended December 31,
(dollars in thousands)	2017	2016	2016
Balance at beginning of year	\$ 7,763	\$ 9,449	\$ 9,449
Additions of underlying property	3,622	3,120	3,120
Disposals of underlying property	(1,068 )	(3,583 )	(3,860 )
Transfers to premises and equipment	-	-	(372 )

Valuation allowance	(576	)	(366	)	(574	)
Balance at end of period	\$ 9,741		\$ 8,620		\$ 7,763	

During the nine months ended September 30, 2017, additions of \$3.6 million consisted of \$3.0 million related to the foreclosure of a stalled residential development project. The Bank is working with a construction manager to stabilize and market the project. Further, additions included \$103,000 for residential lots and \$495,000 for a commercial office building. The Company disposed of four residential properties and multiple residential lots for proceeds of \$1.1 million and a gain of \$36,000 for the nine months ended September 30, 2017. The Bank provided \$200,000 in financing for one residential property and the three residential lots during the first quarter of 2017. The transaction qualified for full accrual sales treatment under ASC Topic 360-20-40 “Property Plant and Equipment – Derecognition”.

During the nine months ended September 30, 2016, additions of \$3.1 million consisted of \$977,000 for three residential properties and \$2.1 million for a deed in lieu of foreclosure on an improved commercial office building with multiple tenants. The Company recognized net losses on OREO disposals of \$440,000 for the nine months ended September 30, 2016. Disposals for the nine months ended September 30, 2016 consisted of properties with the following carrying values; \$106,000 for three residential lots, \$166,000 for one residential property, \$875,000 for three commercial properties, \$138,000 for a commercial lot and \$2.2 million for an apartment and condominium property. The Bank provided financing for the apartment and condominium purchase which qualified for full accrual sales treatment under ASC Topic 360-20-40 “Property Plant and Equipment – Derecognition”.



The Company had \$122,000 and \$353,000 of impaired loans secured by residential real estate for which formal foreclosure proceedings were in process as of September 30, 2017 and December 31, 2016, respectively.

Additions to the valuation allowances of \$576,000 and \$366,000 were taken to adjust properties to current appraised values for the nine months ended September 30, 2017 and 2016, respectively. OREO carrying amounts reflect management's estimate of the realizable value of these properties incorporating current appraised values, local real estate market conditions and related costs. Expenses applicable to OREO assets included the following.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars in thousands)	2017	2016	2017	2016
Valuation allowance	\$ 263	\$ 104	\$ 576	\$ 366
Operating expenses	20	99	47	243
	\$ 283	\$ 203	\$ 623	\$ 609

**NOTE 10 – SECURITIES**

	September 30, 2017			
(dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>Securities available for sale (AFS)</b>				
Asset-backed securities issued by GSEs and U.S. Agencies				
Residential Mortgage Backed Securities ("MBS")	\$7,475	\$ -	\$ 104	\$7,371
Residential Collateralized Mortgage Obligations ("CMOs")	39,255	11	620	38,646
U.S. Agency	11,041	5	237	10,809
Corporate equity securities	37	-	-	37
Bond mutual funds	4,457	56	-	4,513
<b>Total securities available for sale</b>	<b>\$62,265</b>	<b>\$ 72</b>	<b>\$ 961</b>	<b>\$61,376</b>
<b>Securities held to maturity (HTM)</b>				
Asset-backed securities issued by GSEs and U.S. Agencies				
Residential MBS	\$31,544	\$ 360	\$ 89	\$31,815
Residential CMOs	57,410	160	518	57,052
U.S. Agency	8,863	14	151	8,726
Asset-backed securities issued by Others:				
Residential CMOs	697	-	56	641
Callable GSE Agency Bonds	5,019	4	-	5,023
U.S. government obligations	997	-	-	997
<b>Total securities held to maturity</b>	<b>\$104,530</b>	<b>\$ 538</b>	<b>\$ 814</b>	<b>\$104,254</b>
	December 31, 2016			
(dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>Securities available for sale (AFS)</b>				
Asset-backed securities issued by GSEs and U.S. Agencies				
Residential MBS	\$4,377	\$ -	\$ 194	\$4,183
Residential CMOs	35,176	18	966	34,228
U.S. Agency	10,589	-	417	10,172
Corporate equity securities	37	-	-	37
Bond mutual funds	4,386	27	-	4,413
<b>Total securities available for sale</b>	<b>\$54,565</b>	<b>\$ 45</b>	<b>\$ 1,577</b>	<b>\$53,033</b>
<b>Securities held to maturity (HTM)</b>				
Asset-backed securities issued by GSEs and U.S. Agencies				
Residential MBS	\$34,735	\$ 367	\$ 569	\$34,533
Residential CMOs	63,060	135	802	62,393
U.S. Agency	6,717	-	253	6,464

Asset-backed securities issued by Others:

Residential CMOs	884	-	81	803
Callable GSE Agency Bonds	3,001	-	10	2,991
U.S. government obligations	850	-	-	850
Total securities held to maturity	\$109,247	\$ 502	\$ 1,715	\$ 108,034

At September 30, 2017, securities with an amortized cost of \$27.1 million were pledged to secure certain customer deposits. At September 30, 2017, securities with an amortized cost of \$4.1 million were pledged as collateral for advances from the Federal Home Loan Bank (“FHLB”) of Atlanta.

At September 30, 2017, greater than 99% of the asset-backed securities and agency bond portfolio was rated AAA by Standard & Poor’s or the equivalent credit rating from another major rating agency. AFS asset-backed securities issued by GSEs and U.S. Agencies had an average life of 4.62 years and average duration of 4.16 years and are guaranteed by their issuer as to credit risk. HTM asset-backed securities issued by GSEs and U.S. Agencies had an average life of 4.78 years and average duration of 4.27 years and are guaranteed by their issuer as to credit risk.

At December 31, 2016, securities with an amortized cost of \$21.5 million were pledged to secure certain deposits. At December 31, 2016, securities with an amortized cost of \$1.6 million were pledged as collateral for advances from the Federal Home Loan Bank (“FHLB”) of Atlanta.

At December 31, 2016, 99% of the asset-backed securities and agency bond portfolio was rated AAA by Standard & Poor’s or the equivalent credit rating from another major rating agency. AFS asset-backed securities issued by GSEs and U.S. Agencies had an average life of 4.96 years and average duration of 4.43 years and are guaranteed by their issuer as to credit risk. HTM asset-backed securities issued by GSEs and U.S. Agencies had an average life of 5.30 years and average duration of 4.71 years and are guaranteed by their issuer as to credit risk.

Management believes that AFS securities with unrealized losses will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity. Because our intention is not to sell the investments and it is not more likely than not that the Company will be required to sell the investments, management considers the unrealized losses in the AFS portfolio to be temporary.

The Company intends to, and has the ability to, hold the HTM securities with unrealized losses until they mature, at which time the Company will receive full value for the securities. Because our intention is not to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, management considers the unrealized losses in the held-to-maturity portfolio to be temporary.

No charges related to other-than-temporary impairment were made for the nine months ended September 30, 2017 and the year ended December 31, 2016.

During the nine months ended September 30, 2017 the Company recognized net gains on the sale of securities of \$133,000. The Company sold three AFS securities with aggregate carrying values of \$3.6 million and six HTM securities with aggregate carrying values of \$3.4 million, recognizing gains of \$9,000 and \$124,000, respectively.

During the nine months ended September 30, 2016 the Company recognized net gains on the sale of securities of \$39,000. The Company sold three AFS securities with aggregate carrying values of \$2.4 million and one HTM security with a carrying value of \$698,000, recognizing gains of \$31,000 and \$8,000, respectively.

The sale of HTM securities is permitted under ASC 320 “Investments - Debt and Equity Securities.” ASC 320 permits the sale of HTM securities for certain changes in circumstances. The Company will dispose of HTM securities using the safe harbor rule that allows for the sale of HTM securities that have principal payments paid down to less than 15% of original purchased par. ASC 320 10-25-15 indicates that a sale of a debt security after a substantial portion of the principal has been collected is equivalent to holding the security to maturity. In addition, the Company may dispose of HTM securities under ASC 320-10-25-6 due to a significant deterioration in the issues’ creditworthiness.

*AFS Securities*

Gross unrealized losses and estimated fair value by length of time that the individual AFS securities have been in a continuous unrealized loss position at September 30, 2017 were as follows:

	Less Than 12 Months		More Than 12 Months		Total	
September 30, 2017 (dollars in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
Asset-backed securities issued by GSEs and U.S. Agencies	\$34,899	\$ 521	\$17,240	\$ 440	\$52,139	\$ 961

At September 30, 2017, the AFS investment portfolio had an estimated fair value of \$61.4 million, of which \$52.0 million of the securities had some unrealized losses from their amortized cost.

AFS asset-backed securities issued by GSEs are guaranteed by the issuer and AFS U.S. government agency securities and bonds are guaranteed by the full faith and credit of the U.S. government. Total unrealized losses on the portfolio were \$961,000 of the portfolio amortized cost of \$57.8 million. AFS asset-backed securities issued by GSEs and U.S. Agencies with unrealized losses had an average life of 4.61 years and an average duration of 4.14 years. Management believes that the securities will either recover in market value or be paid off as agreed.

Gross unrealized losses and estimated fair value by length of time that the individual AFS securities have been in a continuous unrealized loss position at December 31, 2016 were as follows:

	Less Than 12 Months		More Than 12 Months		Total	
December 31, 2016 (dollars in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
Asset-backed securities issued by GSEs and U.S. Agencies	\$34,262	\$ 1,110	\$11,846	\$ 467	\$46,108	\$ 1,577

At December 31, 2016, the AFS investment portfolio had an estimated fair value of \$53.0 million, of which \$46.1 million of the securities had some unrealized losses from their amortized cost.

AFS asset-backed securities issued by GSEs are guaranteed by the issuer and AFS U.S. government agency securities and bonds are guaranteed by the full faith and credit of the U.S. government. Total unrealized losses on the portfolio were \$1.6 million of the portfolio amortized cost of \$50.1 million. AFS asset-backed securities issued by GSEs and U.S. Agencies with unrealized losses had an average life of 4.91 years and an average duration of 4.37 years. Management believes that the securities will either recover in market value or be paid off as agreed.

### *HTM Securities*

Gross unrealized losses and estimated fair value by length of time that the individual HTM securities have been in a continuous unrealized loss position at September 30, 2017 were as follows:

	Less Than 12 Months		More Than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
September 30, 2017 (dollars in thousands)						
Asset-backed securities issued by GSEs and U.S. Agencies	49,267	591	10,090	167	59,357	758
Asset-backed securities issued by Others	-	-	641	56	641	56
	\$49,267	\$ 591	\$10,731	\$ 223	\$59,998	\$ 814

At September 30, 2017, the HTM investment portfolio had an estimated fair value of \$104.2 million, of which \$60.0 million of the securities had some unrealized losses from their amortized cost. Of these securities, \$59.4 million were asset-backed securities issued by GSEs and U.S. Agencies and \$641,000 were asset-backed securities issued by others.

HTM asset-backed securities issued by GSEs and GSE agency bonds are guaranteed by the issuer and HTM U.S. government agency securities and bonds are guaranteed by the full faith and credit of the U.S. government. Total unrealized losses on the portfolio were \$758,000 of the portfolio amortized cost of \$97.8 million. The securities with unrealized losses had an average life of 4.67 years and an average duration of 4.19 years. Management believes that the securities will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity.

HTM asset-backed securities issued by others are collateralized mortgage obligation securities. The securities have credit support tranches that absorb losses prior to the tranches that the Company owns. The Company reviews credit support positions on its securities regularly. Total unrealized losses on the asset-backed securities issued by others were \$56,000 of the portfolio amortized cost of \$697,000. HTM asset-backed securities issued by others with unrealized losses had an average life of 2.97 years and an average duration of 2.46 years.

Gross unrealized losses and estimated fair value by length of time that the individual HTM securities have been in a continuous unrealized loss position at December 31, 2016 were as follows:

December 31, 2016 (dollars in thousands)	Less Than 12 Months		More Than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
Asset-backed securities issued by GSEs and U.S. Agencies	\$77,879	\$ 1,452	\$6,340	\$ 182	\$84,219	\$ 1,634
Asset-backed securities issued by Others	-	-	803	81	803	81
	\$77,879	\$ 1,452	\$7,143	\$ 263	\$85,022	\$ 1,715

At December 31, 2016, the HTM investment portfolio had an estimated fair value of \$108.0 million, of which \$85.0 million of the securities had some unrealized losses from their amortized cost. Of these securities, \$84.2 million were asset-backed securities issued by GSEs and U.S. Agencies. The remaining \$803,000 were asset-backed securities issued by others.

HTM asset-backed securities issued by GSEs are guaranteed by the issuer and HTM U.S. government agency securities and bonds are guaranteed by the full faith and credit of the U.S. government. Total unrealized losses on the portfolio were \$1.6 million of the portfolio amortized cost of \$108.4 million. The securities with unrealized losses had an average life of 5.06 years and an average duration of 4.49 years. Management believes that the securities will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity.



HTM asset-backed securities issued by others are collateralized mortgage obligation securities. The securities have credit support tranches that absorb losses prior to the tranches that the Company owns. The Company reviews credit support positions on its securities regularly. Total unrealized losses on the asset-backed securities issued by others were \$81,000 of the portfolio amortized cost of \$884,000. HTM asset-backed securities issued by others with unrealized losses had an average life of 4.15 years and an average duration of 3.29 years.

***Credit Quality of Asset-Backed Securities and Agency Bonds***

The tables below present the Standard & Poor's ("S&P") or equivalent credit rating from other major rating agencies for AFS and HTM asset-backed securities issued by GSEs and U.S. Agencies and others or bonds issued by GSEs or U.S. government agencies at September 30, 2017 and December 31, 2016 by carrying value. The Company considers noninvestment grade securities rated BB+ or lower as classified assets for regulatory and financial reporting. GSE asset-backed securities and GSE agency bonds with S&P AA+ ratings were treated as AAA based on regulatory guidance.

September 30, 2017		December 31, 2016	
Credit Rating	Amount	Credit Rating	Amount
(dollars in thousands)			
AAA	\$160,658	AAA	\$156,947
BB	697	BB	411
B+	-	B+	472
Total	\$161,355	Total	\$157,830

**NOTE 11 – LOANS**

Loans consist of the following:

(dollars in thousands)	September 30, 2017	%	December 31, 2016	%
Commercial real estate	\$ 712,840	62.24 %	\$ 667,105	61.25 %
Residential first mortgages	175,816	15.35 %	171,004	15.70 %
Residential rentals	110,905	9.68 %	101,897	9.36 %
Construction and land development	31,094	2.71 %	36,934	3.39 %
Home equity and second mortgages	22,334	1.95 %	21,399	1.97 %
Commercial loans	56,376	4.92 %	50,484	4.64 %
Consumer loans	541	0.05 %	422	0.04 %
Commercial equipment	35,500	3.10 %	39,737	3.65 %
	1,145,406	100.00 %	1,088,982	100.00 %
Less:				
Deferred loan fees and premiums	(1,033	) -0.09 %	(397	) -0.04 %
Allowance for loan losses	10,435	0.91 %	9,860	0.91 %
	9,402		9,463	
	\$ 1,136,004		\$ 1,079,519	

At September 30, 2017 and December 31, 2016, the Bank's allowance for loan losses totaled \$10.4 million and \$9.9 million, or 0.91% and 0.91%, respectively, of loan balances. Management's determination of the adequacy of the allowance is based on a periodic evaluation of the portfolio with consideration given to the overall loss experience, current economic conditions, size, growth and composition of the loan portfolio, financial condition of the borrowers and other relevant factors that, in management's judgment, warrant recognition in providing an adequate allowance.

Deferred loan fees and premiums include net deferred fees paid by customers of \$2.8 million and \$2.7 million at September 30, 2017 and December 31, 2016, respectively. These were offset by net deferred premiums for the purchase of residential first mortgages and deferred costs of \$3.8 million and \$3.1 million, respectively, at September 30, 2017 and December 31, 2016, respectively.

Prior to April 1, 2016, loans secured by residential rental property were included in the residential first mortgage and commercial real estate loan portfolios. Beginning in the second quarter of 2016, the Company segregated loans secured by residential rental property into a new loan portfolio segment. Residential rental property includes income producing properties comprising 1-4 family units and apartment buildings. The Company's decision to segregate the residential rental property portfolio for financial reporting was based on the growth and size of the portfolio and risk characteristics unique to residential rental properties. Comparative financial information was reclassified to conform to the classification presented.



### *Risk Characteristics of Portfolio Segments*

The Company manages its credit products and exposure to credit losses (credit risk) by the following specific portfolio segments (classes), which are levels at which the Company develops and documents its allowance for loan loss methodology. These segments are:

#### *Commercial Real Estate (“CRE”)*

Commercial and other real estate projects include office buildings, retail locations, churches, other special purpose buildings and commercial construction. Commercial construction balances were 5.4% and 9.3% of the CRE portfolio at September 30, 2017 and December 31, 2016, respectively. The Bank offers both fixed-rate and adjustable-rate loans under these product lines. The primary security on a commercial real estate loan is the real property and the leases that produce income for the real property. Loans secured by commercial real estate are generally limited to 80% of the lower of the appraised value or sales price at origination and have an initial contractual loan payment period ranging from three to 20 years.

Loans secured by commercial real estate are larger and involve greater risks than one-to four-family residential mortgage loans. Because payments on loans secured by such properties are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to a greater extent to adverse conditions in the real estate market or the economy.

#### *Residential First Mortgages*

Residential first mortgage loans are generally long-term loans, amortized on a monthly basis, with principal and interest due each month. The contractual loan payment period for residential loans typically ranges from ten to 30 years. The Bank’s experience indicates that real estate loans remain outstanding for significantly shorter time periods than their contractual terms. Borrowers may refinance or prepay loans at their option, without penalty. The Bank’s residential portfolio has both fixed-rate and adjustable-rate residential first mortgages. During the nine months ended September 30, 2017 and the year ended December 31, 2016, the Bank purchased residential first mortgages of \$22.2 million and \$64.2 million, respectively.

The annual and lifetime limitations on interest rate adjustments may limit the increases in interest rates on these loans. There are also credit risks resulting from potential increased costs to the borrower as a result of repricing of adjustable-rate mortgage loans. During periods of rising interest rates, the risk of default on adjustable-rate mortgage loans may increase due to the upward adjustment of interest cost to the borrower. The Bank’s adjustable rate residential first mortgage portfolio was \$58.0 million or 5.1% of total gross loans of \$1.15 billion at September 30, 2017 compared to \$45.6 million or 4.2% of total gross loans of \$1.09 billion at December 31, 2016.

*Residential Rentals*

Residential rental mortgage loans are amortizing, with principal and interest due each month. The loans are secured by income-producing 1-4 family units and apartments. As of September 30, 2017 and December 31, 2016, \$85.5 million and \$84.9 million, respectively, were 1-4 family units and \$25.4 million and \$17.0 million, respectively, were apartment buildings. Loans secured by residential rental properties are generally limited to 80% of the lower of the appraised value or sales price at origination and have an initial contractual loan payment period ranging from three to 20 years. The primary security on a residential rental loan is the property and the leases that produce income. During periods of rising interest rates, the risk of default on adjustable-rate mortgage loans may increase due to the upward adjustment of interest cost to the borrower. The Bank's adjustable rate residential rental portfolio was \$93.1 million or 8.1% of total gross loans of \$1.15 billion at September 30, 2017 compared to \$84.0 million or 7.7% of total gross loans of \$1.09 billion at December 31, 2016.

Loans secured by residential rental properties involve greater risks than 1-4 family residential mortgage loans. Although, there are similar risk characteristics shared with commercial real estate loans, the balances for the loans secured by residential rental properties are generally smaller. Because payments on loans secured by residential rental properties are often dependent on the successful operation or management of the properties, repayment of these loans may be subject to a greater extent to adverse conditions in the rental real estate market or the economy than similar owner occupied properties.

*Construction and Land Development*

The Bank offers loans for the construction of one-to-four family dwellings. Generally, these loans are secured by the real estate under construction as well as by guarantees of the principals involved. In addition, the Bank offers loans to acquire and develop land, as well as loans on undeveloped, subdivided lots for home building.

A decline in demand for new housing might adversely affect the ability of borrowers to repay these loans. Construction and land development loans are inherently riskier than providing financing on owner-occupied real estate. The Bank's risk of loss is affected by the accuracy of the initial estimate of the market value of the completed project as well as the accuracy of the cost estimates made to complete the project. In addition, the volatility of the real estate market has made it increasingly difficult to ensure that the valuation of land associated with these loans is accurate. During the construction phase, a number of factors could result in delays and cost overruns. If the estimate of construction costs proves to be inaccurate, the Bank may be required to advance funds beyond the amount originally committed to permit completion of the development. If the estimate of value proves to be inaccurate, a project's value might be insufficient to assure full repayment. As a result of these factors, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the project rather than the ability of the borrower or guarantor to repay principal and interest. If the Bank forecloses on a project, there can be no assurance that the Bank will be able to recover all of the unpaid balance of, and accrued interest on, the loan as well as related foreclosure and holding costs.

#### *Home Equity and Second Mortgage Loans*

The Bank maintains a portfolio of home equity and second mortgage loans. These products contain a higher risk of default than residential first mortgages as in the event of foreclosure, the first mortgage would need to be paid off prior to collection of the second mortgage. This risk has been heightened as the market value of residential property has declined.

#### *Commercial Loans*

The Bank offers commercial loans to its business customers. The Bank offers a variety of commercial loan products including term loans and lines of credit. Such loans are generally made for terms of five years or less. The Bank offers both fixed-rate and adjustable-rate loans under these product lines. When making commercial business loans, the Bank considers the financial condition of the borrower, the borrower's payment history of both corporate and personal debt, the projected cash flows of the business, the viability of the industry in which the consumer operates, the value of the collateral, and the borrower's ability to service the debt from income. These loans are primarily secured by equipment, real property, accounts receivable or other security as determined by the Bank.

Commercial loans are made on the basis of the borrower's ability to make repayment from the cash flows of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself.

#### *Consumer Loans*

Consumer loans consist of loans secured by automobiles, boats, recreational vehicles and trucks. The Bank also makes home improvement loans and offers both secured and unsecured personal lines of credit. Consumer loans entail

greater risk from other loan types due to being secured by rapidly depreciating assets or the reliance on the borrower's continuing financial stability.

#### *Commercial Equipment Loans*

These loans consist primarily of fixed-rate, short-term loans collateralized by a commercial customer's equipment or secured by real property, accounts receivable, or other security as determined by the Bank. When making commercial equipment loans, the Bank considers the same factors it considers when underwriting a commercial business loan. Commercial loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flows of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. In the case of business failure, collateral would need to be liquidated to provide repayment for the loan. In many cases, the highly specialized nature of collateral equipment would make full recovery from the sale of collateral problematic.



***Non-accrual and Past Due Loans***

Non-accrual loans as of September 30, 2017 and December 31, 2016 were as follows:

(dollars in thousands)	September 30, 2017					
	90 or Greater Days Delinquent	Number of Loans	Non-accrual Only Loans	Number of Loans	Total Non-accrual Loans	Total Number of Loans
Commercial real estate	\$1,112	4	\$ 271	1	\$ 1,383	5
Residential first mortgages	285	2	-	-	285	2
Residential rentals	332	3	-	-	332	3
Construction and land development	-	-	-	-	-	-
Home equity and second mortgages	165	2	-	-	165	2
Commercial loans	378	3	-	-	378	3
Commercial equipment	469	4	-	-	469	4
	\$2,741	18	\$ 271	1	\$ 3,012	19

(dollars in thousands)	December 31, 2016					
	90 or Greater Days Delinquent	Number of Loans	Non-accrual Only Loans	Number of Loans	Total Non-accrual Loans	Total Number of Loans
Commercial real estate	\$2,371	7	\$ -	-	\$ 2,371	7
Residential first mortgages	623	4	-	-	623	4
Residential rentals	577	4	-	-	577	4
Construction and land development	3,048	2	-	-	3,048	2
Home equity and second mortgages	61	2	-	-	61	2
Commercial loans	375	3	669	2	1,044	5
Commercial equipment	650	5	-	-	650	5
	\$7,705	27	\$ 669	2	\$ 8,374	29

Non-accrual loans (90 days or greater delinquent and non-accrual only loans) decreased \$5.4 million from \$8.4 million or 0.77% of total loans at December 31, 2016 to \$3.0 million or 0.26% of total loans at September 30, 2017. Non-accrual only loans are loans classified as non-accrual due to customer operating results or payment history. In accordance with the Company's policy, interest income is recognized on a cash basis for these loans.

At September 30, 2017, non-accrual loans of \$3.0 million included 19 loans, of which \$1.8 million, or 60% represented seven loans and four customer relationships. During the nine months ended September 30, 2017 non-accrual loans decreased \$3.0 million due to the foreclosure of a stalled residential development project. The Bank is working with a construction manager to stabilize and market the project. This loan relationship was also a troubled

debt restructures (“TDRs”). Additionally, during the third quarter of 2017, non-accrual loans decreased \$607,000 due to the foreclosure of a commercial office building. At December 31, 2016, non-accrual loans of \$8.4 million included 29 loans, of which \$6.4 million, or 77% of represented 15 loans and six customer relationships. Non-accrual loans included one TDRs totaling \$828,000 at September 30, 2017 and six TDRs totaling \$4.7 million at December 31, 2016. These loans are classified solely as non-accrual loans for the calculation of financial ratios.

Loan delinquency (90 days or greater delinquent and 31-89 days delinquent) decreased \$4.4 million from \$8.7 million, or 0.80% of loans, at December 31, 2016 to \$4.4 million, or 0.38% of loans, at September 30, 2017.

Non-accrual loans on which the recognition of interest has been discontinued, which did not have a specific allowance for impairment, amounted to \$2.4 million and \$7.8 million at September 30, 2017 and December 31, 2016, respectively. Interest due but not recognized on these balances at September 30, 2017 and December 31, 2016 was \$149,000 and \$947,000, respectively. Non-accrual loans with a specific allowance for impairment on which the recognition of interest has been discontinued amounted to \$631,000 and \$575,000 at September 30, 2017 and December 31, 2016, respectively. Interest due but not recognized on these balances at September 30, 2017 and December 31, 2016 was \$84,000 and \$156,000, respectively.

Past due loans as of September 30, 2017 and December 31, 2016 were as follows:

(dollars in thousands)	September 30, 2017					Total Loan Receivables	Loans > 90 Days and Accruing
	Current	31-60 Days	61-89 Days	90 or Greater Days	Total Past Due		
Commercial real estate	\$710,439	\$ -	\$1,289	\$ 1,112	\$ 2,401	\$712,840	\$ -
Residential first mortgages	175,216	-	315	285	600	175,816	-
Residential rentals	110,573	-	-	332	332	110,905	-
Construction and land dev.	31,094	-	-	-	-	31,094	-
Home equity and second mtg.	22,169	-	-	165	165	22,334	-
Commercial loans	55,998	-	-	378	378	56,376	-
Consumer loans	541	-	-	-	-	541	-
Commercial equipment	34,993	38	-	469	507	35,500	-
Total	\$1,141,023	\$ 38	\$1,604	\$ 2,741	\$ 4,383	\$1,145,406	\$ -

(dollars in thousands)	December 31, 2016					Total Loan Receivables	Loans > 90 Days and Accruing
	Current	31-60 Days	61-89 Days	90 or Greater Days	Total Past Due		
Commercial real estate	\$664,250	\$-	\$484	\$ 2,371	\$ 2,855	\$667,105	\$ -
Residential first mortgages	170,381	-	-	623	623	171,004	-
Residential rentals	101,309	-	11	577	588	101,897	-
Construction and land dev.	33,886	-	-	3,048	3,048	36,934	-
Home equity and second mtg.	21,175	130	33	61	224	21,399	-
Commercial loans	49,778	331	-	375	706	50,484	-
Consumer loans	420	-	2	-	2	422	-
Commercial equipment	39,044	42	1	650	693	39,737	-
Total	\$1,080,243	\$ 503	\$ 531	\$ 7,705	\$ 8,739	\$1,088,982	\$ -

**Impaired Loans and Troubled Debt Restructures (“TDRs”)**

Impaired loans, including TDRs, at September 30, 2017 and 2016 and at December 31, 2016 were as follows:

(dollars in thousands)	September 30, 2017					Quarter Average Recorded Investment	Quarter Interest Income Recognized	YTD Average Recorded Investment	YTD Interest Income Recognized
	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance				
Commercial real estate	\$24,233	\$ 19,824	\$ 4,211	\$ 24,035	\$ 155	\$ 24,153	\$ 319	\$ 24,399	\$ 799
Residential first mortgages	2,277	1,808	463	2,271	7	2,284	18	2,302	67
Residential rentals	2,669	2,271	397	2,668	21	2,673	22	2,711	77
Construction and land dev.	729	-	729	729	163	729	9	729	16
Home equity and second mtg.	225	225	-	225	-	225	2	226	5
Commercial loans	2,324	2,096	169	2,265	169	2,298	24	2,317	71
Commercial equipment	530	40	467	507	303	522	1	530	10
<b>Total</b>	<b>\$32,987</b>	<b>\$ 26,264</b>	<b>\$ 6,436</b>	<b>\$ 32,700</b>	<b>\$ 818</b>	<b>\$ 32,884</b>	<b>\$ 395</b>	<b>\$ 33,214</b>	<b>\$ 1,045</b>

(dollars in thousands)	December 31, 2016					Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance				
Commercial real estate	\$22,195	\$ 14,896	\$ 7,081	\$ 21,977	\$ 806	\$ 22,303	\$ 908		
Residential first mortgages	2,436	1,938	475	2,413	7	2,445	90		
Residential rentals	3,440	2,850	178	3,028	36	3,486	134		
Construction and land dev.	4,304	2,926	851	3,777	178	3,867	16		
Home equity and second mtg.	170	170	-	170	-	176	7		
Commercial loans	3,285	3,004	200	3,204	123	3,442	137		
Commercial equipment	855	652	139	791	139	815	17		
<b>Total</b>	<b>\$36,685</b>	<b>\$ 26,436</b>	<b>\$ 8,924</b>	<b>\$ 35,360</b>	<b>\$ 1,289</b>	<b>\$ 36,534</b>	<b>\$ 1,309</b>		

(dollars in thousands)	September 30, 2016					Quarter Average Recorded Investment	Quarter Interest Income Recognized	YTD Average Recorded Investment	YTD Interest Income Recognized
	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance				
Commercial real estate	\$21,956	\$ 19,719	\$ 2,208	\$ 21,927	\$ 456	\$ 21,994	\$ 242	\$ 22,184	\$ 653
Residential first mortgages	2,246	1,765	481	2,246	13	2,273	22	2,288	66
Residential rentals	3,858	3,222	237	3,459	50	3,470	35	3,623	102
Construction and land dev.	4,413	804	3,536	4,340	467	4,469	4	4,332	11
Home equity and second mtg.	124	124	-	124	-	125	1	126	4
Commercial loans	3,390	3,157	174	3,331	106	3,349	36	3,355	101
Commercial equipment	825	611	192	803	164	829	2	831	12
Total	\$36,812	\$ 29,402	\$ 6,828	\$ 36,230	\$ 1,256	\$ 36,509	\$ 342	\$ 36,739	\$ 949

TDRs, included in the impaired loan schedules above, as of September 30, 2017 and December 31, 2016 were as follows:

(dollars in thousands)	September 30, 2017		December 31, 2016	
	Dollars	Number of Loans	Dollars	Number of Loans
Commercial real estate	\$ 9,371	9	\$ 9,587	8
Residential first mortgages	532	2	545	2
Residential rentals	222	1	227	1
Construction and land development	729	2	3,777	4
Commercial loans	5	1	872	5
Commercial equipment	38	1	113	2
Total TDRs	\$ 10,897	16	\$ 15,121	22
Less: TDRs included in non-accrual loans	(828 )	(1 )	(4,673 )	(6 )
Total accrual TDR loans	\$ 10,069	15	\$ 10,448	16

TDRs decreased \$4.2 million from \$15.1 million at December 31, 2016 to \$10.9 million at September 30, 2017. TDRs that are included in non-accrual are classified solely as non-accrual loans for the calculation of financial ratios. The Company had specific reserves of \$253,000 on seven TDRs totaling \$3.0 million at September 30, 2017 and \$844,000 on nine TDRs totaling \$5.7 million at December 31, 2016. During the nine months ended September 30, 2017, TDR disposals, which included payoffs and refinancing decreased by seven loans totaling \$3.9 million, of which \$3.0 million related to the foreclosure of the stalled residential development project mentioned previously. TDR loan principal curtailment was \$279,000 for the nine months ended September 30, 2017. There were no TDRs added during the nine months ended September 30, 2017. Interest income in the amount of \$289,000 and \$357,000 was recognized on outstanding TDR loans for the nine months ended September 30, 2017 and the year ended December 31, 2016, respectively.

During the year ended December 31, 2016 the Company added one TDR loan totaling \$196,000. TDR disposals, which included payoffs and refinancing for the year ended December 31, 2016 decreased by nine loans or \$2.1 million. TDR loan principal curtailment was \$1.6 million for the year ended December 31, 2016.

**Allowance for Loan Losses**

The following tables detail activity in the allowance for loan losses at and for the three and nine months ended September 30, 2017 and 2016, respectively. An allocation of the allowance to one category of loans does not prevent the Company from using that allowance to absorb losses in a different category.

<b>(dollars in thousands)</b>	September 30, 2017				Ending Balance
	Beginning Balance	Charge-offs	Recoveries	Provisions	
<b>Three Months Ended</b>					
Commercial real estate	\$6,085	\$ (217 )	\$ 4	\$ 436	\$6,308
Residential first mortgages	1,300	-	-	(43 )	1,257
Residential rentals	335	-	-	289	624
Construction and land development	720	(1 )	-	(73 )	646
Home equity and second mortgages	112	(13 )	1	28	128
Commercial loans	814	-	-	(23 )	791
Consumer loans	5	-	-	2	7
Commercial equipment	1,063	(22 )	25	(392 )	674
	\$10,434	\$ (253 )	\$ 30	\$ 224	\$10,435
<b>Nine Months Ended</b>					
Commercial real estate	\$5,212	\$ (217 )	\$ 13	\$ 1,300	\$6,308
Residential first mortgages	1,406	-	-	(149 )	1,257
Residential rentals	362	(42 )	-	304	624
Construction and land development	941	(26 )	-	(269 )	646
Home equity and second mortgages	138	(14 )	1	3	128
Commercial loans	794	-	1	(4 )	791
Consumer loans	3	(2 )	-	6	7
Commercial equipment	1,004	(168 )	49	(211 )	674
	\$9,860	\$ (469 )	\$ 64	\$ 980	\$10,435

(dollars in thousands)	September 30, 2016				Ending Balance
	Beginning Balance	Charge-offs	Recoveries	Provisions	
<b>Three Months Ended</b>					
Commercial real estate	\$4,380	\$ -	\$ 48	\$ 619	\$ 5,047
Residential first mortgages	935	-	-	349	1,284
Residential rentals	613	-	-	(295 )	318
Construction and land development	1,044	-	-	46	1,090
Home equity and second mortgages	141	-	-	(26 )	115
Commercial loans	709	(200 )	1	422	932
Consumer loans	2	-	-	1	3
Commercial equipment	1,282	-	10	(418 )	874
	\$9,106	\$ (200 )	\$ 59	\$ 698	\$ 9,663
<b>Nine Months Ended</b>					
Commercial real estate	\$3,465	\$ -	\$ 53	\$ 1,529	\$ 5,047
Residential first mortgages	584	-	-	700	1,284
Residential rentals	538	-	-	(220 )	318
Construction and land development	1,103	(73 )	1	59	1,090
Home equity and second mortgages	142	-	5	(32 )	115
Commercial loans	1,477	(594 )	12	37	932
Consumer loans	2	(1 )	-	2	3
Commercial equipment	1,229	-	31	(386 )	874
	\$8,540	\$ (668 )	\$ 102	\$ 1,689	\$ 9,663



The following tables detail loan receivable and allowance balances disaggregated on the basis of the Company's impairment methodology at September 30, 2017 and 2016 and December 31, 2016.

(dollars in thousands)	September 30, 2017			December 31, 2016			September 30, 2016		
	Ending balance: individually evaluated for impairment	Ending balance: collectively evaluated for impairment	Total	Ending balance: individually evaluated for impairment	Ending balance: collectively evaluated for impairment	Total	Ending balance: individually evaluated for impairment	Ending balance: collectively evaluated for impairment	Total
<b>Loan Receivables:</b>									
Commercial real estate	\$24,035	\$688,805	\$712,840	\$21,977	\$645,128	\$667,105	\$21,927	\$603,577	\$625,504
Residential first mortgages	2,271	173,545	175,816	2,413	168,591	171,004	2,246	165,060	167,306
Residential rentals	2,668	108,237	110,905	3,028	98,869	101,897	3,459	95,829	99,287
Construction and land development	729	30,365	31,094	3,777	33,157	36,934	4,340	31,135	35,475
Home equity and second mortgages	225	22,109	22,334	170	21,229	21,399	124	21,334	21,458
Commercial loans	2,265	54,111	56,376	3,204	47,280	50,484	3,331	64,003	67,334
Consumer loans	-	541	541	-	422	422	-	422	422
Commercial equipment	507	34,993	35,500	791	38,946	39,737	803	33,829	34,632
	\$32,700	\$1,112,706	\$1,145,406	\$35,360	\$1,053,622	\$1,088,982	\$36,230	\$1,015,189	\$1,051,419
<b>Allowance for loan losses:</b>									
Commercial real estate	\$155	\$6,153	\$6,308	\$806	\$4,406	\$5,212	\$456	\$4,591	\$5,047
Residential first mortgages	7	1,250	1,257	7	1,399	1,406	13	1,271	1,284
Residential rentals	21	603	624	36	326	362	50	268	318
Construction and land development	163	483	646	178	763	941	467	623	1,090
Home equity and second mortgages	-	128	128	-	138	138	-	115	115
Commercial loans	169	622	791	123	671	794	106	826	932
Consumer loans	-	7	7	-	3	3	-	3	3
Commercial equipment	303	371	674	139	865	1,004	164	710	874
	\$818	\$9,617	\$10,435	\$1,289	\$8,571	\$9,860	\$1,256	\$8,407	\$9,663

During the fourth quarter of 2016, the Company expanded its factor scoring categories from three levels to five levels to capture additional movements in qualitative factors used to calculate the general allowance of each portfolio segment. No additional qualitative factors were added to the Company's methodology as part of this change. There

were no material changes to the existing allowance for loan losses by portfolio segment or in the aggregate as a result of the change.

***Credit Quality Indicators***

Credit quality indicators as of September 30, 2017 and December 31, 2016 were as follows:

**Credit Risk Profile by Internally Assigned Grade**

(dollars in thousands)	Commercial Real Estate		Construction and Land Dev.		Residential Rentals	
	9/30/2017	12/31/2016	9/30/2017	12/31/2016	9/30/2017	12/31/2016
Unrated	\$ 54,504	\$ 51,503	\$ 2,106	\$ 1,632	\$ 25,379	\$ 25,563
Pass	626,351	594,768	28,259	31,525	84,491	74,989
Special mention	8,517	-	-	-	-	-
Substandard	23,468	20,834	729	3,777	1,035	1,345
Doubtful	-	-	-	-	-	-
Loss	-	-	-	-	-	-
Total	\$ 712,840	\$ 667,105	\$ 31,094	\$ 36,934	\$ 110,905	\$ 101,897

(dollars in thousands)	Commercial Loans		Commercial Equipment		Total Commercial Portfolios	
	9/30/2017	12/31/2016	9/30/2017	12/31/2016	9/30/2017	12/31/2016
Unrated	\$ 10,443	\$ 11,266	\$ 11,155	\$ 11,769	\$ 103,587	\$ 101,733
Pass	42,813	36,221	22,843	27,290	804,757	764,793
Special mention	894	-	1,035	-	10,446	-
Substandard	2,226	2,997	467	541	27,925	29,494
Doubtful	-	-	-	137	-	137
Loss	-	-	-	-	-	-
Total	\$ 56,376	\$ 50,484	\$ 35,500	\$ 39,737	\$ 946,715	\$ 896,157

**Credit Risk Profile Based on Payment Activity**

(dollars in thousands)	Residential First Mortgages		Home Equity and Second Mtg.		Consumer Loans	
	9/30/2017	12/31/2016	9/30/2017	12/31/2016	9/30/2017	12/31/2016
Performing	\$ 175,531	\$ 170,381	\$ 22,169	\$ 21,338	\$ 541	\$ 422
Nonperforming	285	623	165	61	-	-
Total	\$ 175,816	\$ 171,004	\$ 22,334	\$ 21,399	\$ 541	\$ 422

A risk grading scale is used to assign grades to commercial relationships, which include commercial real estate, residential rentals, construction and land development, commercial loans and commercial equipment loans. Loans are graded at inception, annually thereafter when financial statements are received and at other times when there is an indication that a credit may have weakened or improved. Only commercial loan relationships with an aggregate exposure to the Bank of \$750,000 or greater are subject to being risk rated.

Home equity and second mortgages and consumer loans are evaluated for creditworthiness in underwriting and are monitored based on borrower payment history. Residential first mortgages are evaluated for creditworthiness during credit due diligence before being purchased. Residential first mortgages, home equity and second mortgages and consumer loans are classified as unrated unless they are part of a larger commercial relationship that requires grading or are troubled debt restructures or nonperforming loans with an Other Assets Especially Mentioned (“OAEM”) or higher risk rating due to a delinquent payment history.

Management regularly reviews credit quality indicators as part of its individual loan reviews and on a monthly and quarterly basis. The overall quality of the Bank's loan portfolio is assessed using the Bank's risk grading scale, the level and trends of net charge-offs, nonperforming loans and delinquencies, the performance of troubled debt restructured loans and the general economic conditions in the Company's geographical market. This review process is assisted by frequent internal reporting of loan production, loan quality, concentrations of credit, loan delinquencies and nonperforming and potential problem loans. Credit quality indicators and allowance factors are adjusted based on management's judgment during the monthly and quarterly review process. Loans subject to risk ratings are graded on a scale of one to ten. The Company considers loans classified substandard, doubtful and loss as classified assets for regulatory and financial reporting.

#### *Ratings 1 thru 6 - Pass*

Ratings 1 thru 6 have asset risks ranging from excellent low risk to adequate. The specific rating assigned considers customer history of earnings, cash flows, liquidity, leverage, capitalization, consistency of debt service coverage, the nature and extent of customer relationship and other relevant specific business factors such as the stability of the industry or market area, changes to management, litigation or unexpected events that could have an impact on risks.

#### *Rating 7 - OAEM (Other Assets Especially Mentioned) – Special Mention*

These credits, while protected by the financial strength of the borrowers, guarantors or collateral, have reduced quality due to economic conditions, less than adequate earnings performance or other factors which require the lending officer to direct more than normal attention to the credit. Financing alternatives may be limited and/or command higher risk interest rates. OAEM loans are the first adversely classified assets on our watch list. These relationships will be reviewed at least quarterly.

#### *Rating 8 - Substandard*

Substandard assets are assets that are inadequately protected by the sound worth or paying capacity of the borrower or of the collateral pledged. These assets have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified substandard. The loans may have a delinquent history or combination of weak collateral, weak guarantor strength or operating losses. When a loan is assigned to this category the Bank may estimate a specific reserve in the loan loss allowance analysis. These assets listed may include assets with histories of repossessions or some that are non-performing bankruptcies. These relationships will be reviewed at least quarterly.

#### *Rating 9 - Doubtful*

Doubtful assets have many of the same characteristics of Substandard with the exception that the Bank has determined that loss is not only possible but is probable and the risk is close to certain that loss will occur. When a loan is assigned to this category the Bank will identify the probable loss and the loan will receive a specific reserve in the loan loss allowance analysis. These relationships will be reviewed at least quarterly.

*Rating 10 - Loss*

Once an asset is identified as a definite loss to the Bank, it will receive the classification of “loss”. There may be some future potential recovery; however it is more practical to write off the loan at the time of classification. Losses will be taken in the period in which they are determined to be uncollectable.

## NOTE 12 – REGULATORY

Until April 18, 2016, the Bank was a member of the Federal Reserve System and its primary federal regulator was the Federal Reserve Board. As of that date, Community Bank of the Chesapeake, cancelled its stock in the Federal Reserve Bank of Richmond and terminated its status as a member of the Federal Reserve System. As of that date, the Bank's primary regulator became the Federal Deposit Insurance Corporation ("FDIC"), subject to regulation, supervision and regular examination by the Maryland Commissioner of Financial Regulation (the "Commissioner") and the FDIC.

The Company continues to be subject to regulation, examination and supervision by the Federal Reserve Board under the Bank Holding Company Act of 1956, as amended (the "BHCA"), and the regulations of the Federal Reserve Board.

On January 1, 2015, the Company and Bank became subject to the new Basel III Capital Rules with full compliance with all of the final rule's requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. In July 2013, the final rules were published (the "Basel III Capital Rules") establishing a new comprehensive capital framework for U.S. banking organizations. The rules implement the Basel Committee's December 2010 framework known as "Basel III" for strengthening international capital standards as well as certain provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions compared to the previous U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions' regulatory capital ratios. The Basel III Capital Rules also address risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios and replace the existing risk-weighting approach with a more risk-sensitive approach. The Basel III Capital Rules also implement the requirements of Section 939A of the Dodd-Frank Act to remove references to credit ratings from the federal banking agencies' rules.

The rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio ("Min. Ratio") of Total Capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer ("CCB") is also established above the regulatory minimum capital requirements. This capital conservation buffer began its phase-in period beginning January 1, 2016 at 0.625% of risk-weighted assets and will increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revise the definition and calculation of Tier 1 capital, Total Capital, and risk-weighted assets.

As of September 30, 2017 and December 31, 2016, the Company and Bank were well-capitalized under the regulatory framework for prompt corrective action under the new Basel III Capital Rules. Management believes, as of September 30, 2017 and December 31, 2016, that the Company and the Bank met all capital adequacy requirements to which they were subject.





The Company's and the Bank's actual regulatory capital amounts and ratios are presented in the following table.

Regulatory Capital and Ratios (dollars in thousands)	The Company		The Bank	
	September 30, 2017	December 31, 2017	September 30, 2016	December 31, 2016
Common Equity	\$ 110,885	\$ 104,426	\$ 140,386	\$ 136,109
AOCI Losses	538	928	538	928
Common Equity Tier 1 Capital	111,423	105,354	140,924	137,037
TRUPs	12,000	12,000	-	-
Tier 1 Capital	123,423	117,354	140,924	137,037
Allowable Reserve for Credit Losses and Other Tier 2 Adjustments	10,465	9,860	10,465	9,860
Subordinated Notes	23,000	23,000	-	-
Tier 2 Capital	\$ 156,888	\$ 150,214	\$ 151,389	\$ 146,897
Risk-Weighted Assets ("RWA")	\$ 1,135,911	\$ 1,104,505	\$ 1,132,251	\$ 1,102,116
Average Assets ("AA")	1,399,406	1,300,445	1,395,786	1,298,145

	<b>2019 Regulatory Min. Ratio + CCB <sup>(1)</sup></b>									
Common Tier 1 Capital to RWA	7.00	%	9.81	%	9.54	%	12.45	%	12.43	%
Tier 1 Capital to RWA	8.50		10.87		10.62		12.45		12.43	
Tier 2 Capital to RWA	10.50		13.81		13.60		13.37		13.33	
Tier 1 Capital to AA (Leverage)	<i>n/a</i>		8.82		9.02		10.10		10.56	

<sup>(1)</sup> These are the fully phased-in ratios as of January 1, 2019 that include the minimum capital ratio ("Min. Ratio") + the capital conservation buffer ("CCB"). The phase-in period is more fully described in the footnote above.

### NOTE 13 – FAIR VALUE MEASUREMENTS

The Company adopted FASB ASC Topic 820, “*Fair Value Measurements*” and FASB ASC Topic 825, “*The Fair Value Option for Financial Assets and Financial Liabilities*”, which provides a framework for measuring and disclosing fair value under generally accepted accounting principles. FASB ASC Topic 820 requires disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, whether the measurements are made on a recurring basis (for example, available for sale investment securities) or on a nonrecurring basis (for example, impaired loans).

FASB ASC Topic 820 defines fair value 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. FASB ASC Topic 820 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Company utilizes fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis such as loans held for investment and certain other assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Under FASB ASC Topic 820, the Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine the fair value. These hierarchy levels are:

Level 1 inputs - Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity’s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Company's quarterly valuation process. Transfers in and out of level 3 during a quarter are disclosed. There was one transfer from Level 2 to Level 3 in the fair value hierarchy for the three months ended March 31, 2017 for premises and equipment held for sale. This asset was sold during the three months ended June 30, 2017. There were no transfers between Level 1, 2 or 3 in the fair value hierarchy for the three months ended September 30, 2017 and for the year ended December 31, 2016. The Company changed its presentation during the year ended December 31, 2016, for loans and OREO from Level 2 to Level 3. No changes were made to the Company's valuation methodologies as a result of these changes. Comparative financial information was reclassified to conform to the classification presented in 2016.

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value:

### ***Securities Available for Sale***

Investment securities available for sale are recorded at fair value on a recurring basis. Standard inputs include quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities ("GSEs"), municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

### ***Loans Receivable***

The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Management estimates the fair value of impaired loans using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At September 30, 2017 and December 31, 2016, substantially all of the impaired loans were evaluated based upon the fair value of the collateral.

In accordance with FASB ASC 820, impaired loans where an allowance is established based on the fair value of collateral (loans with impairment) require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price (e.g., contracted sales price), the Company records the loan as nonrecurring Level 2. When the fair value of the impaired loan is derived from an appraisal, the Company records the loan as nonrecurring Level 3. Fair value is re-assessed at least quarterly or more frequently when circumstances occur that indicate a change in the fair value. The fair values of impaired loans that are not measured based on collateral values are measured using discounted cash flows and considered to be Level 3 inputs.

### ***Premises and Equipment Held For Sale***

Premises and equipment are adjusted to fair value upon transfer of the assets to premises and equipment held for sale. Subsequently, premises and equipment held for sale are carried at the lower of carrying value or fair value. Fair value is based upon independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price (e.g., contracted sales price), the Company records the asset as nonrecurring Level 2. When the fair value of premises and equipment is derived from an appraisal or a cash flow analysis, the Company records the asset at nonrecurring Level 3.

As of December 31, 2016, the Company had a small office condo under contract held for sale with a fair value of \$345,000 that was recorded as a non-recurring Level 2 asset at December 31, 2016. The contract on the property was cancelled during the three months ended March 31, 2017, and the asset was transferred and recorded as a non-recurring Level 3 asset. During the three months ended June 30, 2017, the property was sold for net proceeds of \$392,000 with a gain on the sale of \$47,000.

### ***Other Real Estate Owned ("OREO")***

OREO is adjusted for fair value upon transfer of the loans to foreclosed assets. Subsequently, OREO is carried at the lower of carrying value or fair value. Fair value is based upon independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an

observable market price (e.g., contracted sales price), the Company records the foreclosed asset as nonrecurring Level 2. When the fair value is derived from an appraisal, the Company records the foreclosed asset at nonrecurring Level 3.

***Assets and Liabilities Recorded at Fair Value on a Recurring Basis***

The tables below present the recorded amount of assets as of September 30, 2017 and December 31, 2016 measured at fair value on a recurring basis.

(dollars in thousands) Description of Asset	September 30, 2017			
	Fair Value	Level 1	Level 2	Level 3
Available for sale securities				
Asset-backed securities issued by GSEs and U.S. Agencies				
CMOs	\$38,646	\$ -	\$38,646	\$ -
MBS	7,371	-	7,371	-
U.S. Agency	10,809	-	10,809	-
Corporate equity securities	37	-	37	-
Bond mutual funds	4,513	-	4,513	-
Total available for sale securities	\$61,376	\$ -	\$61,376	\$ -

(dollars in thousands) Description of Asset	December 31, 2016			
	Fair Value	Level 1	Level 2	Level 3
Available for sale securities				
Asset-backed securities issued by GSEs and U.S. Agencies				
CMOs	\$34,228	\$ -	\$34,228	\$ -
MBS	4,183	-	4,183	-
U.S. Agency	10,172	-	10,172	-
Corporate equity securities	37	-	37	-
Bond mutual funds	4,413	-	4,413	-
Total available for sale securities	\$53,033	\$ -	\$53,033	\$ -

### *Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis*

The Company may be required to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. GAAP. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Assets measured at fair value on a nonrecurring basis as of September 30, 2017 and December 31, 2016 were included in the tables below.

(dollars in thousands) Description of Asset	September 30, 2017			
	Fair Value	Level 1	Level 2	Level 3
Loans with impairment				
Commercial real estate	\$4,055	\$ -	\$ -	\$4,055
Residential first mortgages	456	-	-	456
Residential rentals	376	-	-	376
Construction and land development	566	-	-	566
Commercial equipment	164	-	-	164
Total loans with impairment	\$5,617	\$ -	\$ -	\$5,617
Other real estate owned	\$9,741	\$ -	\$ -	\$9,741

(dollars in thousands) Description of Asset	December 31, 2016			
	Fair Value	Level 1	Level 2	Level 3
Loans with impairment				
Commercial real estate	\$6,275	\$ -	\$ -	\$6,275
Residential first mortgages	468	-	-	468
Residential rentals	142	-	-	142
Construction and land development	673	-	-	673
Commercial loans	77	-	-	77
Total loans with impairment	\$7,635	\$ -	\$ -	\$7,635
Premises and equipment held for sale	\$345	\$ -	\$ 345	\$ -
Other real estate owned	\$7,763	\$ -	\$ -	\$7,763

Loans with impairment had unpaid principal balances of \$6.5 million and \$8.9 million at September 30, 2017 and December 31, 2016, respectively, and include impaired loans with a specific allowance.

The following tables provide information describing the unobservable inputs used in Level 3 fair value measurements at September 30, 2017 and December 31, 2016.

September 30, 2017  
(dollars in thousands)

Description of Asset	Fair Value	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
Loans with impairment	\$ 5,617	Third party appraisals and in-house real estate evaluations of fair value	Management discount for property type and current market conditions	0%-50% (13%)
Other real estate owned	\$ 9,741	Third party appraisals and in-house real estate evaluations of fair value	Management discount for property type and current market conditions	0%-50% (13%)

December 31, 2016  
(dollars in thousands)

Description of Asset	Fair Value	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
Loans with impairment	\$ 7,635	Third party appraisals and in-house real estate evaluations of fair value	Management discount for property type and current market conditions	0%-50% (14%)
Other real estate owned	\$ 7,763	Third party appraisals and in-house real estate evaluations of fair value	Management discount for property type and current market conditions	0%-50% (12%)

#### NOTE 14 – FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. Therefore, any aggregate unrealized gains or losses should not be interpreted as a forecast of future earnings or cash flows. Furthermore, the fair values disclosed should not be interpreted as the aggregate current value of the Company.

#### Valuation Methodology



*Investment securities* - Fair values are based on quoted market prices or dealer quotes. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

*FHLB and FRB stock* – Fair values are at cost, which is the carrying value of the securities.

*Investment in bank owned life insurance (“BOLI”)* – Fair values are at cash surrender value.

*Loans receivable* – The fair values for non-impaired loans are estimated using discounted cash flow analyses, applying interest rates currently being offered for loans with similar terms and credit quality. Internal prepayment risk models are used to adjust contractual cash flows.

Management estimates the fair value of impaired loans using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. After evaluating the underlying collateral, the fair value is determined by allocating specific reserves from the allowance for loan losses to the impaired loans.

*Loans held for sale* – Fair values are derived from secondary market quotations for similar instruments. There were no loans held for sale at September 30, 2017 and December 31, 2016.

*Deposits* - The fair value of checking accounts, saving accounts and money market accounts were the amount payable on demand at the reporting date.

*Time certificates* - The fair value was determined using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar products.

*Long-term debt and short-term borrowings* - These were valued using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar borrowings.

*Guaranteed preferred beneficial interest in junior subordinated securities (TRUPs)* - These were valued using discounted cash flows. The discount rate was equal to the rate currently offered on similar borrowings.

*Subordinated notes* - These were valued using discounted cash flows. The discount rate was equal to the rate currently offered on similar borrowings.

*Off-balance sheet instruments* - The Company charges fees for commitments to extend credit. Interest rates on loans for which these commitments are extended are normally committed for periods of less than one month. Fees charged on standby letters of credit and other financial guarantees are deemed to be immaterial and these guarantees are expected to be settled at face amount or expire unused.

The Company's estimated fair values of financial instruments are presented in the following tables.

September 30, 2017	Carrying Amount	Fair Value	Fair Value Measurements		
			Level 1	Level 2	Level 3
Description of Asset (dollars in thousands)					
Assets					
Investment securities - AFS	\$61,376	\$61,376	\$-	\$61,376	\$-
Investment securities - HTM	104,530	104,254	997	103,257	-
FHLB Stock	7,447	7,447	-	7,447	-
Loans Receivable	1,136,004	1,101,979	-	-	1,101,979
Investment in BOLI	29,206	29,206	-	29,206	-
Liabilities					

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Savings, NOW and money market accounts	\$637,347	\$637,347	\$-	\$637,347	\$-
Time deposits	460,654	463,043	-	463,043	-
Long-term debt	55,514	58,187	-	58,187	-
Short term borrowings	91,500	91,198	-	91,198	-
TRUPs	12,000	8,500	-	8,500	-
Subordinated notes	23,000	23,000	-	23,000	-

December 31, 2016		Fair Value Measurements			
Description of Asset (dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Assets</b>					
Investment securities - AFS	\$53,033	\$53,033	\$-	\$53,033	\$-
Investment securities - HTM	109,247	108,034	850	107,184	-
FHLB Stock	7,235	7,235	-	7,235	-
Loans Receivable	1,079,519	1,066,975	-	-	1,066,975
Investment in BOLI	28,625	28,625	-	28,625	-
<b>Liabilities</b>					
Savings, NOW and money market accounts	\$606,033	\$606,033	\$-	\$606,033	\$-
Time deposits	432,792	433,242	-	433,242	-
Long-term debt	65,559	66,302	-	66,302	-
Short term borrowings	79,000	78,984	-	78,984	-
TRUPs	12,000	8,100	-	8,100	-
Subordinated notes	23,000	23,000	-	23,000	-

At September 30, 2017 and December 31, 2016, the Company had outstanding loan commitments and standby letters of credit of \$67.7 million and \$67.0 million, respectively and \$17.9 million and \$17.7 million, respectively. Additionally, at September 30, 2017 and December 31, 2016, customers had \$145.6 million and \$135.3 million, respectively, available and unused on lines of credit, which include lines of credit for commercial customers, home equity loans as well as builder and construction lines. Based on the short-term lives of these instruments, the Company does not believe that the fair value of these instruments differs significantly from their carrying values.

The fair value estimates presented herein are based on pertinent information available to management as of September 30, 2017 and December 31, 2016, respectively. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date and, therefore, current estimates of fair value may differ significantly from the amount presented herein.

#### **NOTE 15 – NEW ACCOUNTING STANDARDS**

Financial Accounting Standards Board (“FASB”) Accounting Standards Update (“ASU”). **ASU 2014-09 - Revenue from Contracts with Customers (Topic 606)**; and additional guidance issued as follows: ASU No. 2016-08; ASU No. 2016-10, ASU No. 2016-12, ASU No. 2016-20. In May 2014, the FASB and the International Accounting Standards Board (the “IASB”) jointly issued a comprehensive new revenue recognition standard that will supersede nearly all existing revenue recognition guidance under GAAP and International Financial Reporting Standards (“IFRS”). Previous revenue recognition guidance in GAAP consisted of broad revenue recognition concepts together with numerous revenue requirements for particular industries or transactions, which sometimes resulted in different accounting for

economically similar transactions. The additional ASUs were issued to clarify ASC Topic 606 during 2016 and defer the original effective date. ASU 2014-09 states that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This update affects entities that enter into contracts with customers to transfer goods or services or enter into contracts for the transfer of nonfinancial assets, unless those contracts are within the scope of other standards. The effective date for the ASUs is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted, but not before the original effective date of December 15, 2016. The standard permits the use of either the full retrospective or modified retrospective method. The Company expects to use the modified retrospective method effective January 1, 2018.

Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the Company does not expect the new guidance to have a material impact on revenue most closely associated with financial instruments, including interest income and expense. The Company is evaluating the impact of the updates on the consolidated financial statements and believes the adoption will not have a material impact on the consolidated financial statement. The Company's income from transactions in the scope of the update is insignificant.

**ASU 2016-01** - *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2016-1, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (viii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale. ASU 2016-1 will be effective on January 1, 2018 and the Company is evaluating its impact on the consolidated financial statements and will monitor developments and additional guidance.

**ASU 2016-02** - *Leases (Topic 842)*. ASU 2016-02 requires lessees to recognize a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 does not significantly change lease accounting requirements applicable to lessors; however, certain changes were made to align, where necessary, lessor accounting with the lessee accounting model and ASC Topic 606, "Revenue from Contracts with Customers." ASU 2016-02 will be effective on January 1, 2019 and will require transition using a modified retrospective approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The Company has several lease agreements for its branch and loan production offices, which are currently considered operating leases, and not recognized on the Company's consolidated balance sheet. The Company expects the new guidance will require these lease agreements to now be recognized on the consolidated balance sheet as a right-of-use asset with a corresponding lease liability. The Company's preliminary analysis is that there will be an impact to the Company's consolidated balance sheet; however, the Company is continuing to evaluate the potential impact of ASU 2016-02 on the consolidated financial statements.

**ASU 2016-05** - *Derivatives and Hedging (Topic 815) Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships*. ASU 2016-05 clarifies that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under ASC Topic 815 does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria continue to be met. ASU 2016-05 was effective on January 1, 2017 and did not have a significant impact on the consolidated financial statements because the Company's current operations do not include derivative and hedging contracts.

**ASU 2016-09** - *Improvements to Employee Share-Based Payment Accounting*. ASU 2016-09 is intended to simplify how share-based payments are accounted for and presented in the financial statements. The key provisions include: (i) a company will no longer record excess tax benefits and certain tax deficiencies in additional paid-in capital ("APIC"). Instead all excess tax benefits and tax deficiencies will be reported as income tax expense or benefit in the income

statement, and APIC pools will be eliminated. The guidance also eliminates the requirement that excess tax benefits be realized before companies can recognize them. In addition, the guidance requires companies to present excess tax benefits as an operating activity on the statement of cash flows rather than as a financing activity; (ii) a company can increase the amount of withholding to cover income taxes on awards and still qualify for the exception to liability classification for shares used to satisfy the employer's statutory income tax withholding obligation. The new guidance will also require an employer to classify the cash paid to a tax authority when shares are withheld to satisfy its statutory income tax withholding obligation as a financing activity on its statement of cash flows (current guidance did not specify how these cash flows should be classified); and (iii) a company can elect an accounting policy election for the impact of forfeitures on the recognition of expense for share-based payment awards. Forfeitures can be estimated, as required today, or recognized when they occur. ASU No. 2016-09 is effective for interim and annual reporting periods beginning after December 15, 2016. Early adoption is permitted, but all of the guidance must be adopted in the same period.

The Company adopted the guidance on January 1, 2017 and the impact was insignificant to income tax expense and deferred tax assets. In addition, the Company has elected to recognize forfeitures as they occur instead of estimating forfeitures as the previous guidance required. The update will result in a slight increase in volatility on income tax expense, depending on the amount and timing of share-based compensation award activity, such as the vesting of stock awards and the exercise of stock options.

**ASU 2016-13** - *Measurement of Credit Losses on Financial Instruments*. ASU No. 2016-13 significantly changes how entities will measure credit losses for most financial assets and certain other instruments that aren't measured at fair value through net income. The standard will replace today's "incurred loss" approach with an "expected loss" model. The new model, referred to as the current expected credit loss ("CECL") model, will apply to: (1) financial assets subject to credit losses and measured at amortized cost, and (2) certain off-balance sheet credit exposures. This includes, but is not limited to, loans, leases, held-to-maturity securities, loan commitments, and financial guarantees. The CECL model does not apply to available-for-sale ("AFS") debt securities. For AFS debt securities with unrealized losses, entities will measure credit losses in a manner similar to what they do today, except that the losses will be recognized as allowances rather than reductions in the amortized cost of the securities. As a result, entities will recognize improvements to estimated credit losses immediately in earnings rather than as interest income over time, as they do today. The ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans. ASU 2016-13 also expands the disclosure requirements regarding an entity's assumptions, models, and methods for estimating the allowance for loan and lease losses. In addition, entities will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by the year of origination. ASU No. 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2019; early adoption is permitted for interim and annual reporting periods beginning after December 15, 2018. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach). The Company is currently in the process of developing an understanding of ASU No. 2016-13 to evaluate the potential impact of this pronouncement on the Company's Consolidated Financial Statements and researching additional software resources that could assist with the implementation.

**ASU 2016-15** - *Classification of Certain Cash Receipts and Cash Payments*. ASU 2016-15 is intended to reduce diversity in practice in how eight particular transactions are classified in the statement of cash flows. ASU 2016-15 is effective for interim and annual reporting periods beginning after December 15, 2017. Early adoption is permitted, provided that all of the amendments are adopted in the same period. Entities will be required to apply the guidance retrospectively. If it is impracticable to apply the guidance retrospectively for an issue, the amendments related to that issue would be applied prospectively. As this guidance only affects the classification within the statement of cash flows, ASU 2016-15 is not expected to have a material impact on the Company's Consolidated Financial Statements.

**ASU 2017-04** - *Simplifying the Test for Goodwill Impairment* (January 2017). This guidance removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. Goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. All other goodwill impairment guidance will remain largely unchanged. ASU No. 2017-04 is effective for interim and annual reporting periods beginning after December 15, 2019, applied prospectively. Early adoption is permitted for any impairment tests performed after January 1, 2017. ASU No. 2017-04 is not expected to have a material impact on the Company's Consolidated Financial Statements as the Company does not presently have the intangible asset goodwill.

**ASU 2017-07** - *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost* (March 2017). Under this new guidance, employers will present the service cost component of the net periodic



benefit cost in the same income statement line item (e.g., salary and employee benefits) as other employee compensation costs arising from services rendered during the period. In addition, only the service cost component will be eligible for capitalization in assets. Employers will present the other components separately (e.g., other noninterest expense) from the line item that includes the service cost. ASU No. 2017-07 is effective for interim and annual reporting periods beginning after December 15, 2017. Early adoption is permitted, however, the Company has decided not to early adopt. Employers will apply the guidance on the presentation of the components of net periodic benefit cost in the income statement retrospectively. The guidance limiting the capitalization of net periodic benefit cost in assets to the service cost component will be applied prospectively. The Company expects to utilize the ASU's practical expedient which will allow the Company to estimate amounts for comparative periods using the information previously disclosed in their pension and other postretirement benefit plan footnote. ASU No. 2017-07 is not expected to have a material impact on the Company's Consolidated Financial Statements.

**ASU 2017-08** - *Premium Amortization on Purchased Callable Debt Securities* (March 2017). This ASU shortens the amortization period for the premium on certain purchased callable debt securities to the earliest call date. The new guidance does not change the accounting for purchased callable debt securities held at a discount; the discount continues to be amortized to maturity. ASU No. 2017-08 is effective for interim and annual reporting periods beginning after December 15, 2018; early adoption is permitted. The guidance calls for a modified retrospective transition approach under which a cumulative-effect adjustment will be made to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. The Company has reviewed its securities portfolio and determined the application of this guidance is not expected to have a material impact on the Company's Consolidated Financial Statements. The Company is evaluating the provisions of ASU No. 2017-08 to consider the impact of early adoption.

Item 2 – Management's Discussion and Analysis (“MD&A”) of Financial Condition and Results of Operations

**FORWARD-LOOKING STATEMENTS**

Certain statements contained in this report may not be based on historical facts and are “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements include, without limitation, those relating to proposed acquisition by The Community Financial Corporation of County First Bank pursuant to the Agreement and Plan of Merger, dated as of July 31, 2017, by and among The Community Financial Corporation, Community Bank of the Chesapeake and County First Bank, and The Community Financial Corporation’s, Community Bank of the Chesapeake’s and County First Bank’s future growth and management’s outlook or expectations for revenue, assets, asset quality, profitability, business prospects, net interest margin, non-interest revenue, allowance for loan losses, the level of credit losses from lending, liquidity levels, capital levels, or other future financial or business performance strategies or expectations. These forward looking statements may also include: management’s plan relating to the transaction; the expected completion of the transaction; the payment of any contingent cash consideration in the transaction; any statements of the plans and objectives of management for future operations, products or services, including the execution of integration plans relating to the transaction; any statement of expectation or belief; projections related to certain financial metrics; and any statement of assumptions underlying the foregoing. These forward-looking statements may be identified by reference to a future period(s) or by the use of forward-looking terminology, such as “anticipate,” “estimate,” “expect,” “foresee,” “may,” “might,” “will,” “would,” “could” or “intend,” future conditional verb tenses, and variations or negatives of such terms.

Forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause our actual results, performance or achievements to differ materially from our expectations of future results, performance or achievements, or industry results, expressed or implied by these forward-looking statements.

In addition to factors previously disclosed in The Community Financial Corporation’s reports filed with the Securities and Exchange Commission, including in our Annual Report on Form 10-K for the year ended December 31, 2016, and those identified elsewhere in this report, the following factors among others, could cause actual results to differ materially from forward-looking statements or historical performance: changes in The Community Financial Corporation’s and Community Bank of the Chesapeake’s operating or expansion strategy; availability of and costs associated with obtaining adequate and timely sources of liquidity; the ability to maintain credit quality; the effects of future economic, business and market conditions; weaker than anticipated market conditions in our primary market areas; changes in interest rates; governmental monetary and fiscal policies; changes in prices and values of real estate; legislative and regulatory changes, including changes in banking, securities and tax laws and regulations and their application by our regulators, including changes in the cost and scope of FDIC insurance; the failure of assumptions regarding the levels of non-performing assets and the adequacy of the allowance for loan losses; possible adverse rulings, judgments, settlements and other outcomes of pending litigation; the ability of Community Bank of the Chesapeake and County First Bank to collect amounts due under loan agreements; changes in consumer preferences; liquidity risks through an inability to raise funds through deposits, borrowings or other sources, or to maintain sufficient liquidity at the Company separate from the Bank’s liquidity; volatility in the capital and credit markets;

effectiveness of Community Bank of the Chesapeake's interest rate risk management strategies; the ability to obtain regulatory approvals and meet other closing conditions to the transaction, including approval by County First Bank's shareholders on the expected terms and schedule; delay in closing the transaction; difficulties and delays in integrating the County First Bank's business or fully realizing cost savings and other benefits of the transaction in the expected timeframes, if at all; business disruption following the transaction; inflation; customer acceptance of Community Bank of the Chesapeake's products and services; customer borrowing, repayment, investment and deposit practices; customer disintermediation; and the introduction, withdrawal, success and timing of business initiatives.

You are cautioned not to place undue reliance on the forward-looking statements contained in this document in that actual results could differ materially from those indicated in such forward-looking statements, due to a variety of factors. Any forward-looking statement speaks only as of the date of this Report, and we undertake no obligation to update these forward-looking statements to reflect events or circumstances that occur after the date of this Report. Forward-looking statements regarding the transaction are based upon currently available information.

### **Critical Accounting Policies**

Critical accounting policies are defined as those that involve significant judgments and uncertainties and could potentially result in materially different results under different assumptions and conditions. The Company considers its determination of the allowance for loan losses, the valuation of foreclosed real estate (OREO) and the valuation of deferred tax assets to be critical accounting policies.

The Company's Consolidated Financial Statements are prepared in accordance with accounting principles generally accepted in the United States of America and the general practices of the United States banking industry. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions and judgments are based on information available as of the date of the financial statements. Accordingly, as this information changes, the financial statements could reflect different estimates, assumptions and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments and, as such, have a greater possibility of producing results that could be materially different than originally reported.

Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When these sources are not available, management makes estimates based upon what it considers to be the best available information.

### ***Allowance for Loan Losses***

The allowance for loan losses is an estimate of the losses that exist in the loan portfolio. The allowance is based on two principles of accounting: (1) Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 450 "Contingencies," which requires that losses be accrued when they are probable of occurring and are estimable and (2) FASB ASC 310 "Receivables," which requires that losses be accrued when it is probable that the Company will not collect all principal and interest payments according to the contractual terms of the loan. The loss, if any, is determined by the difference between the loan balance and the value of collateral, the present value of expected future cash flows and values observable in the secondary markets.

The allowance for loan loss balance is an estimate based upon management's evaluation of the loan portfolio. The allowance includes a specific and a general component. The specific component consists of management's evaluation of certain classified and non-accrual loans and their underlying collateral. Management assesses the ability of the borrower to repay the loan based upon all information available. Loans are examined to determine a specific

allowance based upon the borrower's payment history, economic conditions specific to the loan or borrower and other factors that would impact the borrower's ability to repay the loan on its contractual basis. Depending on the assessment of the borrower's ability to pay and the type, condition and value of collateral, management will establish an allowance amount specific to the loan.

Management uses a risk scale to assign grades to commercial relationships, which include commercial real estate, residential rentals, construction and land development, commercial loans and commercial equipment loans. Commercial loan relationships with an aggregate exposure to the Bank of \$750,000 or greater are risk rated. Residential first mortgages, home equity and second mortgages and consumer loans are monitored on an ongoing basis based on borrower payment history. Consumer loans and residential real estate loans are classified as unrated unless they are part of a larger commercial relationship that requires grading or are troubled debt restructures or nonperforming loans with an Other Assets Especially Mentioned or higher risk rating due to a delinquent payment history.

The Company's commercial loan portfolio is periodically reviewed by regulators and independent consultants engaged by management.

In establishing the general component of the allowance, management analyzes non-impaired loans in the portfolio including changes in the amount and type of loans. This analysis reviews trends by portfolio segment in charge-offs, delinquency, classified loans, loan concentrations and the rate of portfolio segment growth. Qualitative factors also include an assessment of the current regulatory environment, the quality of credit administration and loan portfolio management and national and local economic trends. Based upon this analysis a loss factor is applied to each loan category and the Bank adjusts the loan loss allowance by increasing or decreasing the provision for loan losses.

Management has significant discretion in making the judgments inherent in the determination of the allowance for loan losses, including the valuation of collateral, assessing a borrower's prospects of repayment and in establishing loss factors on the general component of the allowance. Changes in loss factors have a direct impact on the amount of the provision and on net income. Errors in management's assessment of the global factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions. At September 30, 2017 and December 31, 2016, the allowance for loan losses was \$10.4 million and \$9.9 million, respectively, or 0.91% and 0.91%, respectively, of total loans. An increase or decrease in the allowance could result in a charge or credit to income before income taxes that materially impacts earnings.

For additional information regarding the allowance for loan losses, refer to Notes 1 and 6 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2016 and the discussion in this MD&A.

#### ***Other Real Estate Owned ("OREO")***

The Company maintains a valuation allowance on its other real estate owned. As with the allowance for loan losses, the valuation allowance on OREO is based on FASB ASC 450 "Contingencies," as well as the accounting guidance on impairment of long-lived assets. These statements require that the Company establish a valuation allowance when it has determined that the carrying amount of a foreclosed asset exceeds its fair value. Fair value of a foreclosed asset is measured by the cash flows expected to be realized from its subsequent disposition. These cash flows are reduced for the costs of selling or otherwise disposing of the asset.

In estimating the cash flows from the sale of OREO, management must make significant assumptions regarding the timing and amount of cash flows. For example, in cases where the real estate acquired is undeveloped land, management must gather the best available evidence regarding the market value of the property, including appraisals, cost estimates of development and broker opinions. Due to the highly subjective nature of this evidence, as well as the limited market, long time periods involved and substantial risks, cash flow estimates are highly subjective and subject to change. Errors regarding any aspect of the costs or proceeds of developing, selling or otherwise disposing of foreclosed real estate could result in the allowance being inadequate to reduce carrying costs to fair value and may require an additional provision for valuation allowances.

For additional information regarding OREO, refer to Notes 1 and 8 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2016.

#### ***Deferred Tax Assets***

The Company accounts for income taxes in accordance with FASB ASC 740, "Income Taxes," which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. FASB ASC 740 requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or the entire deferred tax asset will not be realized.

The Company periodically evaluates the ability of the Company to realize the value of its deferred tax assets. If the Company were to determine that it was not more likely than not that the Company would realize the full amount of the deferred tax assets, it would establish a valuation allowance to reduce the carrying value of the deferred tax asset to the amount it believes would be realized. The factors used to assess the likelihood of realization are the Company's forecast of future taxable income and available tax-planning strategies that could be implemented to realize the net deferred tax assets.

Failure to achieve forecasted taxable income might affect the ultimate realization of the net deferred tax assets. Factors that may affect the Company's ability to achieve sufficient forecasted taxable income include, but are not limited to, the following: increased competition, a decline in net interest margin, a loss of market share, decreased demand for financial services and national and regional economic conditions.

The Company's provision for income taxes and the determination of the resulting deferred tax assets and liabilities involve a significant amount of management judgment and are based on the best information available at the time. The Company operates within federal and state taxing jurisdictions and is subject to audit in these jurisdictions.

For additional information regarding income taxes and deferred tax assets, refer to Notes 1 and 12 in the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2016.

## **OVERVIEW**

Community Bank of the Chesapeake (the “Bank”) is headquartered in Southern Maryland with branches located in Maryland and Virginia. The Bank is a wholly owned subsidiary of The Community Financial Corporation (the “Company”).

The Company’s branches are located at its main office in Waldorf, Maryland, and 10 branch offices in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick, Lusby, California, Maryland; and Fredericksburg, Virginia. The Company maintains five loan production offices (“LPOs”) in Annapolis, La Plata, Prince Frederick and Leonardtown, Maryland; and Fredericksburg, Virginia. The Leonardtown LPO is co-located with the branch.

During 2016, the Company planned to increase the loan portfolio by at least 10% and control expenses. Due to the low interest rate environment for most of 2016, and its effect on net interest margin, the Company continued restructuring of operations to reduce costs. In the first quarter of 2016, the Company completed a redesign of the branch system. This redesign, combined with the closure of the King George facility allowed the Company to reduce branch employees by 15% from 73 at March 31, 2015 to 62 at March 31, 2016. The Company focused on reducing other expenses by streamlining internal processes and FTEs as well as by reviewing vendor relationships. The Company’s cost control efforts and continued asset growth created operating leverage and increased its earnings per share, return on average assets and return on equity.

The focus on expense control is a continuing initiative and during the second quarter of 2017, the Company announced the closing of its Central Park Fredericksburg branch. The branch closed in the third quarter of 2017. This location continues to serve as a loan production office and the branch closure did not have a material effect on operations. The Company offered branch employees open positions. Changing customer banking preferences, along with the opening of our downtown Fredericksburg branch influenced the decision to close the Central Park branch.

The Company’s efficiency ratio improved in every quarter of 2016. The efficiency ratio improved from 73.67% for the fourth quarter of 2015 to 64.38% for the fourth quarter of 2016. Year over year, the efficiency ratio improved 395 basis points to 67.40% from 71.35% for the years ended December 31, 2016 and 2015, respectively. The rate of expense growth was controlled at 2.6% during 2016 compared to 8.3% expense growth in 2015.

During the year ended December 31, 2016 loan growth was very strong with end of period gross loans increasing \$170.1 million, or 18.5% from \$918.9 million at December 31, 2015 to \$1,089.0 million at December 31, 2016. The increase in loan balances resulted in net interest income growing faster than operating expenses. Net interest income increased \$3.4 million or 9.2%, compared to noninterest expense growth of \$741,000 or 2.6%. The Company has a strong pipeline and is optimistic that continued loan growth, paired with expense control, should continue to increase



operating leverage during 2017.

Net income was \$7.7 million for the nine months ended September 30, 2017, an increase of \$2.4 million or 44.4%, compared to \$5.3 million for the nine months ended September 30, 2016. Earnings per common share (diluted) for the first nine months of 2017 were \$1.65 increasing \$0.50 from \$1.15 per common share (diluted) for the nine months ended September 30, 2016. The Company's returns on average assets and common stockholders' equity for the nine months ended September 30, 2017 were 0.75% and 9.38%, respectively, compared to 0.59% and 6.89%, respectively, for first nine months of 2016.

The Company continued to improve quarterly results, recording its eighth consecutive quarter of earnings growth. Net income of \$2.8 million for the three months ended September 30, 2017 increased \$239,000 compared to \$2.5 million of net income for the second quarter of 2017. Earnings per common share (diluted) at \$0.60 increased \$0.05 from \$0.55 per common share (diluted) for the three months ended June 30, 2017. The Company's returns on average assets and common stockholders' equity for the third quarter of 2017 were 0.80% and 9.99%, respectively, compared to 0.74% and 9.36%, respectively, and 0.70% and 8.78%, respectively, for the second and first quarters of 2017. The increase in net income in the third quarter compared to the second quarter was the result of increased operating revenues of \$180,000, decreases in the provision for loan losses of \$152,000 and noninterest expense of \$88,000. These increases to pretax earnings were offset by a higher income tax expense of \$181,000.

<sup>1</sup> Operating leverage occurs when the Company increases its assets, and by extension its net interest income, while limiting increases in noninterest expense. In order for this to be effective, the Company must simultaneously pursue the following: increase the asset size while maintaining asset quality, increase funding at an economically viable cost, and control noninterest expense growth.

<sup>2</sup> Efficiency Ratio - noninterest expense divided by the sum of net interest income and noninterest income.

The Company's loan portfolio increased to \$1,145.4 million at September 30, 2017, an increase of \$3.4 million compared to second quarter of 2017 ending loan balances of \$1,142.0 million. Since December 31, 2016, loans have grown \$56.4 million or 7% annualized to \$1,145.4 million at September 30, 2017. The Company experienced a seasonal slowdown in loan growth in the third quarter. Scheduled loan closings in the fourth quarter are expected to produce annual growth of 8% to 9% for 2017. The Company has a strong pipeline and is optimistic that continued loan growth, paired with expense control, should continue to increase operating leverage.

Net interest margin for the three months ended September 30, 2017 was stable compared to the second quarter of 2017, decreasing one basis point from 3.39% to 3.38%, respectively. The decrease was expected and attributable to a slightly faster increase in the Company's cost of funds compared to increased yields for loans and investments. The increase in cost of funds to 0.84% for the three months ended September 30, 2017 from 0.79% for the second quarter 2017 was primarily due to rising short-term wholesale funding rates during the first nine months of 2017. A positive trend in mitigating net interest rate compression was \$22.7 million in growth of average transaction deposits which increased from \$619.0 million in the second quarter to \$641.7 million in the third quarter of 2017. Transaction accounts include savings, money market and noninterest-bearing and interest-bearing demand accounts. The Company considers increasing transaction accounts over other funding choices as a key strategy to offset the current flat rate environment. Average transaction account costs increased three basis points during the quarter from 0.23% for the three months ended June 30, 2017 to 0.26% for the three months ended September 30, 2017.

Loan yields increased three basis points during the third quarter of 2017 to 4.49% compared to 4.46% for the previous quarter. Overall loan and investment yields increased during the third quarter from 4.16% during the second quarter of 2017 to 4.20% for the three months ended September 30, 2017. The increase in interest-earning yields was due to larger dollar growth in the higher yielding commercial real estate and residential rental portfolios compared to the residential first mortgage portfolio. In addition, the scheduled repricing of loans, the purchase of securities and the production of commercial real estate loans also contributed to increased yields. Yields in the commercial real estate portfolio, the Company's largest loan portfolio at \$712.8 million as of September 30, 2017, increased seven basis points during the third quarter to 4.46% compared to 4.39% in second quarter.

The Company's efficiency ratio continued to improve in the third quarter of 2017, decreasing to 61.18% for the three months ended September 30, 2017 from 62.83% for the three months ended June 30, 2017. In addition, the net operating expense ratio<sup>3</sup> has been below 2.0% for four consecutive quarters decreasing to 1.80% for the third quarter of 2017 compared to 1.89% for the second quarter of 2017, 1.94% for the first quarter of 2017 and 1.98% for the fourth quarter of 2016.

The Bank has increased assets through loan production. The Bank believes that its ability to offer fast, flexible, local decision-making will continue to attract significant new business relationships. The Bank focuses its business generation efforts on targeting small and medium sized commercial businesses with revenues between \$5.0 million and \$35.0 million as well as local municipal agencies and not-for-profits. The Bank's marketing is also directed towards increasing its balances of transactional deposit accounts, which are all deposit accounts other than certificates

of deposit. The Bank believes that increases in these account types will lessen the Bank's dependence on higher-cost funding, such as certificates of deposit and borrowings. Although management believes that this strategy will increase financial performance over time, increasing the balances of certain products, such as commercial lending and transaction accounts, may also increase the Bank's noninterest expense. The Bank recognizes that certain lending and deposit products increase the possibility of losses from credit and other risks.

***Proposed Acquisition of County First Bank***

On July 31, 2017, the Company and Community Bank of the Chesapeake entered into an Agreement and Plan of Merger with County First Bank ("County First"). Merger related costs, which included mainly professional fees and investment banking costs, for the three months and nine months ended September 30, 2017 were \$239,000 and \$494,000, respectively. These costs reduced diluted earnings per share by \$0.03 and \$0.07, respectively, for the three and nine months ended September 30, 2017. At June 30, 2017, County First had total assets of \$224 million, total deposits of \$209 million, and five branch offices in La Plata, Waldorf, New Market, Prince Frederick and California, Maryland. Pending receipt of the necessary regulatory and County First shareholder approvals, the merger is currently expected to close in the first quarter of 2018.

<sup>3</sup> Net Operating Expense Ratio - noninterest expense less noninterest income divided by average assets.

Under the terms of the merger agreement, which was approved by the Boards of Directors of each company, upon completion of the merger, County First Bank shareholders will be entitled to receive 0.9543 shares of The Community Financial Corporation common stock and \$1.00 in cash for each share of County First Bank common stock they hold. County First shareholders may also receive, in the aggregate, additional contingent cash consideration of up to \$2,154,303 (representing a maximum potential per share value of \$2.24) based upon the resolution of certain identified assets prior to closing. There can be no assurance that County First will sell, resolve or otherwise dispose of any of the identified assets or that County First shareholders will receive any contingent cash consideration.

### ***Economy***

The U.S. economy grew slowly throughout 2016. During the year ended 2016, the Federal Reserve only raised the target federal funds rate one time at the December 15, 2016 meeting from 0.50% to 0.75%. Interest rates were depressed for most of 2016, with the five and ten year U.S. Treasury rates falling to as low as 0.94% (July 2016) and 1.37% (July 2016). This had an impact on the Company's net interest margin and asset yields, which declined during 2016. Lower Treasury and bond yields in the 5 to 10 year range during 2016 put negative pressure on the re-pricing of the loan portfolio and the pricing of new loans. The downward trend in treasury rates had a positive impact on local deposit pricing through the third quarter of 2016. The Company was able to offset margin compression with average interest-earning asset growth of \$132.0 million, or 13.0%, to \$1,145.5 million. During the fourth quarter of 2016, interest rates began to rise with both the five year and the ten year U.S. Treasury rates increasing to 1.93% and 2.45%, respectively as of December 30, 2016. In 2017, interest rates have continued to increase and the Federal Reserve raised the target federal funds rate in March 2017 from 0.75% to 1.00%. During the second quarter of 2017 the target federal fund rate was raised to 1.25%. The FOMC is expected to raise the target federal funds rate in December 2017. During 2017 the trend has been a flattening yield curve. If the curve remains flat for an extended period of time or becomes flatter, there is a risk that rising short-term funding costs could outpace increasing loan and investment yields which would negatively impact net interest margin. During the third quarter of 2017, the Company mitigated interest margin compression by increasing lower cost transaction deposits at a greater rate than other more expensive funding sources.

The presence of federal government agencies, as well as significant government facilities, and the related private sector support for these entities, has led to faster economic growth in our market and lower unemployment compared to the nation as a whole. In addition, the Bank's entry into the greater Annapolis and Fredericksburg markets has provided the Bank with additional loan and deposit opportunities. These opportunities have positively impacted the Bank's organic growth between 2014 and the present.

For additional information regarding the local economy and its impact on the Company's business refer to the Business Section in the Company's Form 10-K for the year ended December 31, 2016 under the caption "Market Area" (*Part I. Item 1. Business Section – Market Area*).

## Selected Financial Information and Ratios

	Three Months Ended		Nine Months Ended			
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2017	September 30, 2016	September 30, 2016
<b>KEY OPERATING RATIOS</b>						
Return on average assets	0.80	% 0.63	% 0.75	% 0.59		%
Return on average common equity	9.99	7.48	9.38	6.89		
Average total equity to average total assets	7.97	8.37	7.96	8.52		
Interest rate spread	3.24	3.34	3.26	3.37		
Net interest margin	3.38	3.47	3.39	3.50		
Cost of funds	0.84	0.73	0.79	0.73		
Cost of deposits	0.58	0.48	0.53	0.48		
Cost of debt	2.34	2.63	2.27	2.67		
Efficiency ratio	61.18	66.55	62.61	68.47		
Non-interest expense to average assets	2.13	2.33	2.18	2.41		
Net operating expense to average assets	1.80	2.06	1.88	2.14		
Avg. int-earning assets to avg. int-bearing liabilities	116.64	117.49	116.67	117.62		
Net charge-offs to average loans	0.08	0.06	0.05	0.08		
<b>COMMON SHARE DATA</b>						
Basic net income per common share	\$0.60	\$ 0.43	\$1.66	\$ 1.16		
Diluted net income per common share	0.60	0.42	1.65	1.15		
Cash dividends paid per common share	0.10	0.10	0.30	0.30		
Weighted average common shares outstanding:						
Basic	4,633,391	4,590,664	4,631,571	4,591,926		
Diluted	4,633,417	4,622,579	4,633,500	4,621,628		

## Selected Financial Information and Ratios (continued)

(dollars in thousands, except per share amounts)	September 30, 2017	December 31, 2016	\$ Change	% Change	
<b>ASSET QUALITY</b>					
Total assets	\$ 1,402,172	\$ 1,334,257	\$ 67,915	5.1	%
Gross loans	1,145,406	1,088,982	56,424	5.2	
Classified Assets	39,172	39,246	(74 )	(0.2 )	
Allowance for loan losses	10,435	9,860	575	5.8	
Past due loans (PDLs) (31 to 89 days)	1,642	1,034	608	58.8	
Nonperforming loans (NPLs) (>=90 days)	2,741	7,705	(4,964 )	(64.4 )	
Non-accrual loans (a)	3,012	8,374	(5,362 )	(64.0 )	
Accruing troubled debt restructures (TDRs) (b)	10,069	10,448	(379 )	(3.6 )	
Other real estate owned (OREO)	9,741	7,763	1,978	25.5	
Non-accrual loans, OREO and TDRs	\$ 22,822	\$ 26,585	\$ (3,763 )	(14.2 )	
<b>ASSET QUALITY RATIOS</b>					
Classified assets to total assets	2.79	% 2.94	%		
Classified assets to risk-based capital	24.97	26.13			
Allowance for loan losses to total loans	0.91	0.91			
Allowance for loan losses to nonperforming loans	380.70	127.97			
Past due loans (PDLs) to total loans	0.14	0.09			
Nonperforming loans (NPLs) to total loans	0.24	0.71			
Loan delinquency (PDLs + NPLs) to total loans	0.38	0.80			
Non-accrual loans to total loans	0.26	0.77			
Non-accrual loans and TDRs to total loans	1.14	1.73			
Non-accrual loans and OREO to total assets	0.91	1.21			
Non-accrual loans, OREO and TDRs to total assets	1.63	1.99			

## Selected Financial Information and Ratios (continued)

(dollars in thousands, except per share amounts)	September 30, 2017	December 31, 2016	
<b>COMMON SHARE DATA</b>			
Book value per common share	\$ 23.85	\$ 22.54	
Common shares outstanding at end of period	4,649,302	4,633,868	
<b>OTHER DATA</b>			
Full-time equivalent employees	169	162	
Branches	11	12	
Loan Production Offices	5	5	
<b>REGULATORY CAPITAL RATIOS</b>			
Tier 1 capital to average assets	8.82	%	9.02 %
Tier 1 common capital to risk-weighted assets	9.81		9.54
Tier 1 capital to risk-weighted assets	10.87		10.62
Total risk-based capital to risk-weighted assets	13.81		13.60

(a) Non-accrual loans include all loans that are 90 days or more delinquent and loans that are non-accrual due to the operating results or cash flows of a customer. Non-accrual loans can include loans that are current with all loan payments.

(b) At September 30, 2017 and December 31, 2016, the Bank had total TDRs of \$10.9 million and \$15.1 million, respectively, with \$828,000 and \$4.7 million, respectively, in non-accrual status. These loans are classified as non-accrual loans for the calculation of financial ratios.

**COMPARISON OF RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2017 AND 2016**

*Earnings Summary*

Consolidated net income was \$2.8 million for the three months ended September 30, 2017, an increase of \$819,000 or 41.7%, compared to \$2.0 million for the three months ended September 30, 2016. Earnings per common share (diluted) at \$0.60 increased \$0.18 from \$0.42 per common share (diluted) for the three months ended September 30, 2016. The Company's returns on average assets and common stockholders' equity for the third quarter of 2017 were 0.80% and 9.99%, respectively, compared to 0.63% and 7.48%, respectively, for the third quarter of 2016. The \$819,000 increase in earnings was attributable to increased net interest income of \$864,000, a decrease to the provision for loan losses of \$474,000 and increased noninterest income of \$315,000, partially offset by increased noninterest expense of \$131,000 and income tax expense of \$703,000.

The Company has pursued a strategy of increasing operating leverage over the last several years. This occurs when the Company increases its assets, and by extension its net interest income, while limiting increases in noninterest expense. In order for this to be effective, the Company must simultaneously pursue the following: increase the asset size while maintaining asset quality, increase funding at an economically viable cost, and control noninterest expense growth.

Pretax operating income increased \$1.5 million, or 51.1%, to \$4.5 million in the third quarter of 2017 compared to \$3.0 million in the comparable quarter of 2016.

§ The continued increase in operating income and operating leverage was primarily due to the following:

Net interest income was \$11.0 million for the three months ended September 30, 2017, an increase of \$864,000, or 8.5%, compared to the three months ended September 30, 2016.

Interest income increased \$1.5 million. The increase was driven by increased average interest-earning assets including increased average loan balances. The Bank increased average net loan balances \$111.2 million to \$1,127.6 million in the third quarter of 2017 from \$1,016.4 million for the three months ended September 30, 2016. The effect of loan volume on interest income was partially offset by yield declines.

Interest expense increased \$593,000, which partially offset increased interest income. The primary reason for the increase in interest expense was larger average interest-bearing liability balances and an increase in the cost of wholesale and time based funding.



§ The average balances of interest-bearing liabilities increased \$122.2 million to \$1,117.9 million in the third quarter of 2017 from \$995.7 million for the three months ended September 30, 2016.

§ The Company's cost of funds, which includes noninterest-bearing funding, increased by 11 basis points from the comparable period to 0.84% for the three months ended September 30, 2017.

Wholesale and time based funding rates are typically more sensitive to rising interest rates than transactional deposits. Compared to the three months ended September 30, 2016, interest rates for the third quarter of 2017 increased by 15 basis points on certificates of deposit, while interest-bearing transactional deposits increased by eight basis points. The Company's Federal Home Loan Bank ("FHLB") short-term borrowings increased by 79 basis points for the comparable periods to 1.25% for the third quarter of 2017.

The Company controlled expense growth. Noninterest expense increased \$131,000, or 1.8%, to \$7.4 million for the three months ended September 30, 2017 compared to the same quarter of the prior year.

Third quarter 2017 net operating expense as a percentage of average assets and the efficiency ratio declined (improved) to 1.80% and 61.18%, respectively, from 2.06% and 66.55%, respectively for the third quarter of 2016. The net operating expense and efficiency ratios improved in each successive quarter during 2016 and in each quarter of 2017.

The Company's asset quality has continued to improve, which has had a positive impact on pretax earnings. The Company's improving credit metrics have partially offset the provisioning required to provide for loan growth. The provision for loan losses decreased \$474,000, or 67.9%, to \$224,000 for the three months ended September 30, 2017 compared to \$698,000 for the three months ended September 30, 2016.

Non-performing assets are trending down and have improved in each of the last seven quarters. Non-accrual loans and OREO have decreased \$4.3 million and as a percentage of assets to 0.91% of assets at September 30, 2017 compared to 1.33% at September 30, 2016. In addition, the Company's loan delinquency ratio has decreased to 0.38% of total loans from 0.81% for the same quarter end period in 2016.

**Net Interest Income**

The primary component of the Company's net income is its net interest income, which is the difference between income earned on assets and interest paid on the deposits and borrowings used to fund them. Net interest income is affected by the difference between the yields earned on the Company's interest-earning assets and the rates paid on interest-bearing liabilities, as well as the relative amounts of such assets and liabilities. Net interest income, divided by average interest-earning assets, represents the Company's net interest margin.

Net interest income increased \$864,000 to \$11.0 million for the three months ended September 30, 2017 compared to \$10.1 million for the three months ended September 30, 2016. Net interest income increased from the comparable period due to interest-earning asset growth, primarily in loans. Average loans increased \$111.2 million, or 10.9%, between the comparable periods. Overall interest-earning asset yields increased two basis points from 4.18% for the three months ended September 30, 2016 to 4.20% for the third quarter of 2017. During the same timeframe, the Company had increased margin compression with the cost of funds increasing 11 basis points to 0.84% for the three months ended September 30, 2017 compared to 0.73% for the three months ended September 30, 2016.

The net interest margin was 3.38% for the three months ended September 30, 2017, a nine basis point decrease from 3.47% for the three months ended September 30, 2016. The decrease in net interest margin was largely the result of a faster increase in the cost of funding (11 basis points) compared to the increase in interest-earning asset yields (two basis points).

The following table shows the components of net interest income and the dollar and percentage changes for the periods presented.

(dollars in thousands )	Three Months Ended September				
	2017	2016	\$ Change	% Change	
Interest and Dividend Income					
Loans, including fees	\$ 12,671	\$ 11,460	\$ 1,211	10.6	%
Taxable interest and dividends on investment securities	988	758	230	30.3	%
Interest on deposits with banks	21	5	16	320.0	%
Total Interest and Dividend Income	13,680	12,223	1,457	11.9	%
Interest Expenses					
Deposits	1,563	1,209	354	29.3	%
Short-term borrowings	304	36	268	744.4	%

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Long-term debt	805	834	(29 )	(3.5 )%
Total Interest Expenses	2,672	2,079	593	28.5 %
Net Interest Income (NII)	\$ 11,008	\$ 10,144	\$ 864	8.5 %

Interest and dividend income increased by \$1.5 million to \$13.7 million for the three months ended September 30, 2017 compared to \$12.2 million for the three months ended September 30, 2016, primarily due to increased income from the growth in the average balance of loans. Interest and dividend income also increased due to moderate growth in the average balance of investments and increased investment yields. Interest and dividend income on loans increased \$1.3 million due to growth of \$111.2 million in the average balance of loans from \$1,016.4 million for the three months ended September 30, 2016 to \$1,127.6 million for the three months ended September 30, 2017. Interest and dividend income on investments increased \$246,000 during the third quarter of 2017 compared to the same period in the prior year as average interest-earning investment balances increased and average yields increased 30 basis points to 2.29%. These increases to net interest income were partially offset by a decrease in average loan yields, which declined two basis points from 4.51% for the three months ended September 30, 2016 to 4.49% for the three months ended September 30, 2017, which resulted in a decrease in interest and dividend income of \$39,000.

During the second and third quarter of 2017, loan yields began to rise compared to 2016, influenced by increases in the federal funds target rate (1.25% as of June 15, 2017) and loan growth in higher yielding portfolios. The Company plans to continue to slow the growth of residential first mortgages in favor of increasing commercial loan growth for the balance of the year. This emphasis has positively impacted loan yields during 2017. Overall loan and investment yields increased during the third quarter from 4.16% during the second quarter of 2017 to 4.20% for the three months ended September 30, 2017. The increase in interest-earning yields was due to larger dollar growth in the higher yielding commercial real estate and residential rental portfolios compared to the residential first mortgage portfolio. In addition, the scheduled repricing of loans, the purchase of securities and the production of commercial real estate loans also contributed to increased yields. Yields in the commercial real estate portfolio, the Company's largest loan portfolio at \$712.8 million as of September 30, 2017, increased seven basis points during the third quarter to 4.46% compared to 4.39% in second quarter.

Interest expense increased \$593,000 to \$2.7 million for the three months ended September 30, 2017 compared to \$2.1 million for the three months ended September 30, 2016, due to an increase in the average balances of interest-bearing liabilities and increased funding costs between the comparable periods. The cost of funds and deposits averaged 0.84% and 0.58%, respectively, for the three months ended September 30, 2017, an increase of 11 and 10 basis points for both averages compared to the third quarter of 2016. During the three months ended September 30, 2017, interest expense increased \$265,000 caused by larger average balances of interest-bearing transaction deposit accounts, time deposits and debt compared to the same quarter of 2016. Additionally, interest expense increased a net of \$328,000 due to increased rates on interest-bearing transaction accounts, certificates of deposits, FHLB long-term and short-term borrowings and TRUPs which are indexed to 90 day LIBOR.

The Company controlled deposit costs by maintaining transaction deposits as a percentage of overall deposits. Average transaction deposits, which include savings, money market, interest-bearing demand and noninterest bearing demand accounts, for the three months ended September 30, 2017 increased \$46.3 million, or 7.8%, to \$641.7 million compared to \$595.4 million for the comparable period in 2016. Average transaction accounts as a percentage of total deposits were flat at 59.1% for the three months ended September 30, 2016 compared to 59.2% for the three months ended September 30, 2017.

The following table presents information on average balances and rates for deposits.

(dollars in thousands)	For the Three Months Ended September 30,			
	2017		2016	
	Average Balance	Average Rate	Average Balance	Average Rate
Savings	\$ 55,125	0.05 %	\$ 50,363	0.05 %
Interest-bearing demand and money market accounts	429,847	0.38 %	400,214	0.30 %
Certificates of deposit	443,048	1.03 %	412,683	0.88 %
Total interest-bearing deposits	928,020	0.67 %	863,260	0.56 %
Noninterest-bearing demand deposits	156,746		144,837	
	\$ 1,084,766	0.58 %	\$ 1,008,097	0.48 %

The following table shows the change in funding sources and the cost of funds for the comparable periods:

(dollars in thousands)	For the Three Months Ended September 30,							
	2017				2016			
	Average Balance	Average Rate	Percentage Funding	Average Balance	Average Rate	Percentage Funding		
Interest-bearing deposits	\$928,020	0.67 %	72.80 %	\$863,260	0.56 %	75.69 %		
Debt	189,927	2.34 %	14.90 %	132,464	2.63 %	11.61 %		

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Total interest-bearing liabilities	1,117,947	0.96%	87.70	%	995,724	0.84	%	87.30	%
Noninterest-bearing demand deposits	156,746		12.30	%	144,837			12.70	%
Total funds	\$1,274,693	0.84%	100.00	%	\$1,140,561	0.73	%	100.00	%

The following table presents information on the average balances of the Company's interest-earning assets and interest-bearing liabilities and interest earned or paid thereon for the three months ended September 30, 2017 and 2016, respectively. There are no tax equivalency adjustments.

	For the Three Months Ended September 30,							
	2017		Average		2016		Average	
dollars in thousands	Average	Interest	Yield/ Cost	Average	Interest	Yield/ Cost		
	Balance			Balance				
<b>Assets</b>								
<b>Interest-earning assets:</b>								
Commercial real estate	\$710,113	\$7,916	4.46 %	\$618,213	\$6,885	4.45 %		
Residential first mortgages	178,631	1,657	3.71 %	158,047	1,592	4.03 %		
Residential rentals	110,323	1,276	4.63 %	99,951	1,156	4.63 %		
Construction and land development	31,584	415	5.26 %	35,681	409	4.59 %		
Home equity and second mortgages	21,747	246	4.52 %	22,170	225	4.06 %		
Commercial and equipment loans	85,314	1,152	5.40 %	91,285	1,185	5.19 %		
Consumer loans	480	9	7.50 %	405	8	7.90 %		
Allowance for loan losses	(10,566 )	-	0.00 %	(9,344 )	-	0.00 %		
Loan portfolio (1)	1,127,626	12,671	4.49 %	1,016,408	11,460	4.51 %		
Investment securities, federal funds sold and interest-bearing deposits	176,360	1,009	2.29 %	153,443	763	1.99 %		
<b>Total Interest-Earning Assets</b>	<b>1,303,986</b>	<b>13,680</b>	<b>4.20 %</b>	<b>1,169,851</b>	<b>12,223</b>	<b>4.18 %</b>		
Cash and cash equivalents	18,199			13,166				
Other assets	74,274			71,948				
<b>Total Assets</b>	<b>\$1,396,459</b>			<b>\$1,254,965</b>				
<b>Liabilities and Stockholders' Equity</b>								
<b>Interest-bearing liabilities:</b>								
Savings	\$55,125	\$7	0.05 %	\$50,363	\$6	0.05 %		
Interest-bearing demand and money market accounts	429,847	412	0.38 %	400,214	297	0.30 %		
Certificates of deposit	443,048	1,144	1.03 %	412,683	904	0.88 %		
Long-term debt	58,019	352	2.43 %	65,578	386	2.35 %		
Short-term borrowings	96,908	304	1.25 %	31,886	37	0.46 %		
Subordinated Notes	23,000	359	6.24 %	23,000	359	6.24 %		
Guaranteed preferred beneficial interest in junior subordinated debentures	12,000	94	3.13 %	12,000	90	3.00 %		
<b>Total Interest-Bearing Liabilities</b>	<b>1,117,947</b>	<b>2,672</b>	<b>0.96 %</b>	<b>995,724</b>	<b>2,079</b>	<b>0.84 %</b>		
Noninterest-bearing demand deposits	156,746			144,837				
Other liabilities	10,409			9,419				
Stockholders' equity	111,357			104,985				
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$1,396,459</b>			<b>\$1,254,965</b>				
<b>Net interest income</b>		<b>\$11,008</b>			<b>\$10,144</b>			
Interest rate spread			3.24 %			3.34 %		
Net yield on interest-earning assets			3.38 %			3.47 %		

Ratio of average interest-earning assets to average interest bearing liabilities	116.64 %	117.49 %
Cost of funds	0.84 %	0.73 %
Cost of deposits	0.58 %	0.48 %
Cost of debt	2.34 %	2.63 %
(1) Average balance includes non-accrual loans		



The following table sets forth certain information regarding changes in interest income and interest expense of the Bank for the periods indicated. For each category of interest-earning asset and interest-bearing liability, information is provided on changes attributable to (1) changes in volume (changes in volume multiplied by old rate); and (2) changes in rate (changes in rate multiplied by old volume). Changes in rate-volume (changes in rate multiplied by the change in volume) have been allocated to changes due to volume.

**For the Three Months Ended September 30, 2017**

**compared to the Three Months Ended**

**September 30, 2016**

dollars in thousands	Volume	Due to Rate	Total
<b>Interest income:</b>			
Loan portfolio (1)	\$ 1,250	\$ (39 )	\$ 1,211
Investment securities, federal funds sold and interest bearing deposits	131	115	246
Total interest-earning assets	\$ 1,381	\$ 76	\$ 1,457
<b>Interest-bearing liabilities:</b>			
Savings	1	-	1
Interest-bearing demand and money market accounts	28	87	115
Certificates of deposit	78	162	240
Long-term debt	(46 )	12	(34 )
Short-term borrowings	204	63	267
Subordinated notes	-	-	-
Guaranteed preferred beneficial interest in junior subordinated debentures	-	4	4
Total interest-bearing liabilities	\$ 265	\$ 328	\$ 593
Net change in net interest income	\$ 1,116	\$ (252 )	\$ 864

(1) Average balance includes non-accrual loans

***Provision for Loan Losses***

The following table shows the dollar and percentage changes for the provision for loan losses for the periods presented.

(dollars in thousands)	Three Months Ended September 30,		\$ Change	% Change
	2017	2016		

Provision for loan losses	\$ 224	\$ 698	\$ (474 )	(67.9 )%
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The provision for loan losses decreased \$474,000 to \$224,000 for the three months ended September 30, 2017 compared to \$698,000 for the three months ended September 30, 2016. Net charge-offs for the quarter were flat increasing slightly from \$141,000 for the three months ended September 30, 2016 to \$224,000 for the three months ended September 30, 2017. Improvements to baseline charge-off factors for the periods used to evaluate the adequacy of the allowance as well as improvements in some qualitative factors, such as reductions in delinquency, were offset by increases in other qualitative factors, such as concentration to capital factors. Overall, these changes resulted in a lower provision for loan losses for the comparable periods.

See further discussion of the provision under the caption “Asset Quality” in the Comparison of Financial Condition section of Management’s Discussion and Analysis.

**Noninterest Income**

The following table shows the components of noninterest income and the dollar and percentage changes for the periods presented.

(dollars in thousands)	Three Months Ended September 30,			
	2017	2016	\$ Change	% Change
<b>Noninterest Income</b>				
Loan appraisal, credit, and miscellaneous charges	\$ 28	\$ 60	\$ (32 )	(53.3 )%
Net gains (losses) on sale of OREO	-	3	(3 )	(100.0 )%
Income from bank owned life insurance	196	199	(3 )	(1.5 )%
Service charges	639	580	59	10.2 %
Gain on sale of loans held for sale	294	-	294	n/a
<b>Total Noninterest Income</b>	<b>\$ 1,157</b>	<b>\$ 842</b>	<b>\$ 315</b>	<b>37.4 %</b>

Noninterest income increased \$315,000 to \$1.2 million for the three months ended September 30, 2017 from \$842,000 for the three months ended September 30, 2016. The Company sold the guaranteed portion of a U.S. Small Business Administration Loan for proceeds of \$2.8 million and recognized a gain of \$294,000 during the three months ended September 30, 2017.

**Noninterest Expense**

The following tables show the components of noninterest expense and the dollar and percentage changes for the periods presented.

(dollars in thousands)	Three Months Ended September 30,			
	2017	2016	\$ Change	% Change
Salary and employee benefits	\$ 4,056	\$ 4,268	\$ (212 )	(5.0 )%
OREO valuation allowance and expenses	283	203	80	39.4 %
Other operating expenses	3,103	2,840	263	9.3 %
<b>Total Noninterest Expense</b>	<b>\$ 7,442</b>	<b>\$ 7,311</b>	<b>\$ 131</b>	<b>1.8 %</b>

(dollars in thousands)	Three Months Ended September 30,			
	2017	2016	\$ Change	% Change
<b>Noninterest Expense</b>				
Salary and employee benefits	\$ 4,056	\$ 4,268	\$ (212 )	(5.0 )%
Occupancy expense	630	597	33	5.5 %
Advertising	156	290	(134 )	(46.2 )%
Data processing expense	555	544	11	2.0 %

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Professional fees	749	308	441	143.2	%
Depreciation of furniture, fixtures, and equipment	191	206	(15 )	(7.3 )	%
Telephone communications	46	43	3	7.0	%
Office supplies	26	33	(7 )	(21.2 )	%
FDIC Insurance	178	215	(37 )	(17.2 )	%
OREO valuation allowance and expenses	283	203	80	39.4	%
Other	572	604	(32 )	(5.3 )	%
Total Noninterest Expense	\$ 7,442	\$ 7,311	\$ 131	1.8	%

Noninterest expense averaged just below \$7.3 million per quarter during 2016. The Company focused during the prior year on controlling the growth of expenses by streamlining internal processes and reviewing vendor relationships. These efforts resulted in a reduction in nine FTEs, from 171 employees to 162 employees, during the year ended December 31, 2016. The Company's strategy to create operating leverage through continued asset growth combined with controlling the growth in expenses has continued during 2017.

For the three months ended September 30, 2017, noninterest expense increased 1.8%, or \$131,000, to \$7.4 million from \$7.3 million for the comparable period in 2016. Third quarter 2017 operating expenses included \$239,000 of merger related costs, comprising primarily of professional fees and investment banking costs, which reduced diluted earnings per share by \$0.03. The Company's efficiency ratio for the three months ended September 30, 2017 and 2016 was 61.18% and 66.55%, respectively. The Company's net operating expense ratio as a percentage of average assets for the three months ended September 30, 2017 and 2016 was 1.80% and 2.06%, respectively. These ratios have improved in each successive quarter since the three months ended December 31, 2015.

### ***Income Tax Expense***

For the three months ended September 30, 2017 and 2016, the Company recorded income tax expense of \$1.7 million and \$1.0 million, respectively. The Company's effective tax rates for the three months ended September 30, 2017 and 2016 were 38.16% and 34.06%, respectively. The increase in the effective tax rate was the result of tax-exempt income being relatively lower to total income and an increase in state income taxes due to higher Bank net income for the three months ended September 30, 2017 compared to the three months ended September 30, 2016.

**COMPARISON OF RESULTS OF OPERATIONS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2017 AND 2016**

*Earnings Summary*

Consolidated net income was \$7.7 million for the nine months ended September 30, 2017, an increase of \$2.4 million or 44.4%, compared to \$5.3 million for the nine months ended September 30, 2016. Earnings per common share (diluted) for the first nine months of 2017 were \$1.65 increasing \$0.50 from \$1.15 per common share (diluted) for the nine months ended September 30, 2016. The Company's returns on average assets and common stockholders' equity for the nine months ended September 30, 2017 were 0.75% and 9.38%, respectively, compared to 0.59% and 6.89%, respectively, for first nine months of 2016. The \$2.4 million increase in earnings was attributable to increased net interest income of \$3.2 million, a decrease to the provision for loan losses of \$709,000 and increased noninterest income of \$615,000, partially offset by, increased noninterest expense of \$508,000 and income tax expense of \$1.6 million.

The Company has pursued a strategy of increasing operating leverage over the last several years. This occurs when the Company increases its assets, and by extension its net interest income, while limiting increases in noninterest expense. In order for this to be effective, the Company must simultaneously pursue the following: increase the asset size while maintaining asset quality, increase funding at an economically viable cost, and control noninterest expense growth.

Pretax operating income increased \$4.0 million, or 47.8%, to \$12.4 million in the first nine months of 2017 compared to \$8.4 million in the comparable period of 2016.

§ The continued increase in operating income and operating leverage was primarily due to the following:

Net interest income was \$32.6 million for the nine months ended September 30, 2017, an increase of \$3.2 million, or 10.8%, compared to the nine months ended September 30, 2016.

Interest income increased \$4.5 million. The increase was driven by increased average interest-earning assets including increased average loan balances. The Bank increased average net loan balances \$140.0 million to \$1,107.6 million in the first nine months of 2017 from \$967.6 million for the nine months ended September 30, 2016. The effect of loan volume on interest income was partially offset by yield declines.

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Interest expense increased \$1.4 million, which partially offset increased interest income. The primary reason for the increase in interest expense was larger average interest-bearing liability balances and an increase in the cost of wholesale and time-based funding.

§ The average balances of interest-bearing liabilities increased \$144.8 million to \$1,099.2 million in the first nine months of 2017 from \$954.4 million for the nine months ended September 30, 2016.

§ The Company's cost of funds, which includes noninterest-bearing funding, increased by six basis points from the comparable period to 0.79% for the nine months ended September 30, 2017.

Wholesale and time-based funding rates are typically more sensitive to rising interest rates than transactional deposits. Compared to the nine months ended September 30, 2016, interest rates for the first nine months of 2017 increased by nine basis points to 0.95% on certificates of deposit, while interest-bearing transactional deposits increased by three basis points to 0.31%. Federal Home Loan Bank ("FHLB") short-term borrowings increased by 59 basis points to 1.08% for the nine months ended September 30, 2017 compared to 0.49% for the same period during 2016. The Company's increases in transaction deposits during the last twelve months have decreased downward pressure on net interest margin. The ability to increase transaction deposits faster than wholesale funding could mitigate possible downward pressure on net interest margin in a rising rate environment.

The Company controlled expense growth. Noninterest expense increased \$508,000, or 2.3%, to \$22.4 million for the nine months ended September 30, 2017 compared to the same period of the prior year.

During the first nine months of 2017, net operating expense as a percentage of average assets and the efficiency ratio declined (improved) to 1.88% and 62.61%, respectively, from 2.14% and 68.47%, respectively for the comparable nine months of 2016.

The Company's continued improvement in asset quality as well as slower 2017 loan growth, have positively impacted pretax earnings. The Company's improving credit metrics have partially offset the provisioning required to provide for loan growth. The provision for loan losses decreased \$709,000, or 42.0%, to \$980,000 for the nine months ended September 30, 2017 compared to \$1.7 million for the nine months ended September 30, 2016.

Non-performing assets are trending down and have improved in each of the last seven quarters. Non-accrual loans and OREO have decreased \$4.3 million and as a percentage of assets to 0.91% of assets at September 30, 2017 compared to 1.33% at September 30, 2016. In addition, the Company's loan delinquency ratio has decreased to 0.38% of total loans from 0.81% for the same quarter end period in 2016.

### ***Net Interest Income***

The primary component of the Company's net income is its net interest income, which is the difference between income earned on assets and interest paid on the deposits and borrowings used to fund them. Net interest income is affected by the difference between the yields earned on the Company's interest-earning assets and the rates paid on interest-bearing liabilities, as well as the relative amounts of such assets and liabilities. Net interest income, divided by average interest-earning assets, represents the Company's net interest margin.

Net interest income increased \$3.2 million to \$32.6 million for the nine months ended September 30, 2017 compared to \$29.4 million for the nine months ended September 30, 2016. Net interest income increased from the comparable period due to interest-earning asset growth, primarily in loans. Average loans increased \$140.1 million, or 14.5%, between the comparable periods. Overall interest-earning asset yields decreased five basis points from 4.21% for the nine months ended September 30, 2016 to 4.16% for the nine months ended September 30, 2017. During the same timeframe, the Company had increased margin compression with the cost of funds increasing six basis points to 0.79% for the nine months ended September 30, 2017 compared to 0.73% for the nine months ended September 30, 2016.

The net interest margin was 3.39% for the nine months ended September 30, 2017, an 11 basis point decrease from 3.50% for the nine months ended September 30, 2016. The decrease in net interest margin was largely the result of an increase in the cost of funding (six basis points) and a decrease in interest-earning asset yields (five basis points).



Yields on the loan portfolio decreased from 4.57% for the nine months ended September 30, 2016 to 4.46% for nine months ended September 30, 2017. Loan yields were reduced compared to the prior year due to the Bank's increased investment in residential mortgages during 2016, a competitive market for commercial loans and the flat rate curve for most of 2017.

During the second and third quarters of 2017, loan yields began to rise compared to the first quarter of 2017, influenced by increases in the federal funds target rate (1.25% as of June 15, 2017) and loan growth in higher yielding portfolios. The Company plans to continue to slow the growth of residential first mortgages in favor of increasing commercial loan growth for the balance of the year. Loan yields increased three basis points during the third quarter of 2017 to 4.49% compared to 4.46% for the previous quarter. Overall loan and investment yields increased during the third quarter from 4.16% during the second quarter of 2017 to 4.20% for the three months ended September 30, 2017. The increase in interest-earning yields was due to larger dollar growth in the higher yielding commercial real estate and residential rental portfolios compared to the residential first mortgage portfolio. In addition, the scheduled repricing of loans, the purchase of securities and the production of commercial real estate loans also contributed to increased yields. Yields in the commercial real estate portfolio, the Company's largest loan portfolio at \$712.8 million as of September 30, 2017, increased seven basis points during the third quarter to 4.46% compared to 4.39% in second quarter.

The following table shows the components of net interest income and the dollar and percentage changes for the periods presented.

(dollars in thousands)	Nine Months Ended September 30,		\$ Change	% Change	
	2017	2016			
Interest and Dividend Income					
Loans, including fees	\$ 37,051	\$ 33,175	\$ 3,876	11.7	%
Taxable interest and dividends on investment securities	2,907	2,273	634	27.9	%
Interest on deposits with banks	39	15	24	160.0	%
Total Interest and Dividend Income	39,997	35,463	4,534	12.8	%
Interest Expenses					
Deposits	4,234	3,486	748	21.5	%
Short-term borrowings	734	123	611	496.7	%
Long-term debt	2,414	2,422	(8 )	(0.3 )	%
Total Interest Expenses	7,382	6,031	1,351	22.4	%
Net Interest Income (NII)	\$ 32,615	\$ 29,432	\$ 3,183	10.8	%

Interest and dividend income increased by \$4.5 million to \$40.0 million for the nine months ended September 30, 2017 compared to \$35.5 million for the nine months ended September 30, 2016, primarily due to increased income from the growth in the average balance of loans. Interest and dividend income also increased due to moderate growth in the average balance of investments and increased investment yields. Interest and dividend income on loans increased \$4.7 million due to growth of \$140.0 million in the average balance of loans from \$967.6 million for the nine months ended September 30, 2016 to \$1,107.6 million for the nine months ended September 30, 2017. Interest and dividend income on investments increased \$658,000 during the first nine months of 2017 compared to the same period in the prior year as average interest-earning investment balances increased and average yields increased 28 basis points to 2.25%. These increases to net interest income were partially offset by a decrease in average loan yields, which declined 11 basis points from 4.57% for the nine months ended September 30, 2016 to 4.46% for the nine months ended September 30, 2017, which resulted in a decrease in interest and dividend income of \$809,000.

The reduction of overall loans yields was impacted by growth of the lower-yielding residential first mortgage portfolio over the last twelve months. Residential first mortgage yields decreased 28 basis points from 4.08% for the nine months ended September 30, 2016 to 3.79% for the nine months ended September 30, 2017. Additionally, average residential first mortgage balances as a percentage of the total loan portfolio increased from 15.0% for the nine months ended September 30, 2016 to 16.0% for the nine months ended September 30, 2017. Based on the Company's intentions to continue to slow the growth of the residential first mortgage portfolio in favor of more commercial loan growth, overall loan yields could be positively impacted.

Interest expense increased \$1.4 million to \$7.4 million for the nine months ended September 30, 2017 compared to \$6.0 million for the nine months ended September 30, 2016, due to an increase in the average balances of interest-bearing liabilities and increased funding costs between the comparable periods. The cost of funds and deposits averaged 0.79% and 0.53%, respectively, for the nine months ended September 30, 2017, an increase of six and five basis points for both averages compared to the first nine months of 2016. During the nine months ended September 30, 2017, interest expense increased \$848,000 caused by larger average balances of interest-bearing transaction deposit accounts, time deposits and debt compared to the same period of 2016. Additionally, interest expense increased \$575,000 due to increased rates on interest-bearing transaction accounts, certificates of deposits, short-term FHLB borrowings and TRUPs interest which is indexed to 90 day LIBOR. This increase was offset by a \$72,000 decrease in interest expense on long-term FHLB debt due to the maturing of higher interest rate debt during 2016.

The Company controlled deposit costs by maintaining transaction deposits as a percentage of overall deposits. Average transaction deposits, which include savings, money market, interest-bearing demand and noninterest bearing demand accounts, for the nine months ended September 30, 2017 increased \$62.9 million, or 11.2%, to \$622.3 million compared to \$559.4 million for the comparable period in 2016. Average transaction accounts as a percentage of total deposits increased from 57.8% for the nine months ended September 30, 2016 to 58.5% for the nine months ended September 30, 2017.

The following table presents information on average balances and rates for deposits.

(dollars in thousands)	For the Nine Months Ended September 30,					
	2017			2016		
	Average Balance	Average Rate		Average Balance	Average Rate	
Savings	\$ 53,369	0.05	%	\$ 48,290	0.09	%
Interest-bearing demand and money market accounts	418,148	0.34	%	371,113	0.30	%
Certificates of deposit	442,410	0.95	%	407,731	0.86	%
Total interest-bearing deposits	913,927	0.62	%	827,134	0.56	%
Noninterest-bearing demand deposits	150,757			140,031		
	\$ 1,064,684	0.53	%	\$ 967,165	0.48	%

The following table shows the change in funding sources and the cost of funds for the comparable periods:

(dollars in thousands)	For the Nine Months Ended September 30,									
	2017				2016					
	Average Balance	Average Rate	Percentage Funding		Average Balance	Average Rate	Percentage Funding			
Interest-bearing deposits	\$913,927	0.62	%	73.12	%	\$827,134	0.56	%	75.58	%
Debt	185,243	2.27	%	14.82	%	127,275	2.67	%	11.63	%
Total interest-bearing Liabilities	1,099,170	0.90	%	87.94	%	954,409	0.84	%	87.21	%
Noninterest-bearing demand deposits	150,757			12.06	%	140,031			12.79	%
Total funds	\$1,249,927	0.79	%	100.00	%	\$1,094,440	0.73	%	100.00	%

The following table presents information on the average balances of the Company's interest-earning assets and interest-bearing liabilities and interest earned or paid thereon for the nine months ended September 30, 2017 and 2016, respectively. There are no tax equivalency adjustments.

	For the Nine Months Ended September 30,							
	2017		Average		2016		Average	
dollars in thousands	Average Balance	Interest	Yield/ Cost		Average Balance	Interest	Yield/ Cost	
<b>Assets</b>								
<b>Interest-earning assets:</b>								
Commercial real estate	\$692,285	\$22,967	4.42 %		\$586,894	\$19,847	4.51 %	
Residential first mortgages	177,527	5,052	3.79 %		145,556	4,452	4.08 %	
Residential rentals	104,363	3,612	4.61 %		97,044	3,409	4.68 %	
Construction and land development	35,327	1,284	4.85 %		37,387	1,272	4.54 %	
Home equity and second mortgages	21,384	695	4.33 %		21,836	672	4.10 %	
Commercial and equipment loans	86,589	3,414	5.26 %		87,426	3,498	5.33 %	
Consumer loans	449	27	8.02 %		387	25	8.61 %	
Allowance for loan losses	(10,306 )	-	0.00 %		(8,962 )	-	0.00 %	
Loan portfolio (1)	1,107,618	37,051	4.46 %		967,568	33,175	4.57 %	
Investment securities, federal funds sold and interest-bearing deposits	174,813	2,946	2.25 %		155,033	2,288	1.97 %	
<b>Total Interest-Earning Assets</b>	<b>1,282,431</b>	<b>39,997</b>	<b>4.16 %</b>		<b>1,122,601</b>	<b>35,463</b>	<b>4.21 %</b>	
Cash and cash equivalents	14,555				11,567			
Other assets	72,597				72,384			
<b>Total Assets</b>	<b>\$1,369,583</b>				<b>\$1,206,552</b>			
<b>Liabilities and Stockholders' Equity</b>								
<b>Interest-bearing liabilities:</b>								
Savings	\$53,369	\$20	0.05 %		\$48,290	\$32	0.09 %	
Interest-bearing demand and money market accounts	418,148	1,073	0.34 %		371,113	837	0.30 %	
Certificates of deposit	442,410	3,141	0.95 %		407,731	2,616	0.86 %	
Long-term debt	59,783	1,028	2.29 %		58,804	1,083	2.46 %	
Short-term borrowings	90,460	734	1.08 %		33,471	123	0.49 %	
Subordinated Notes	23,000	1,078	6.25 %		23,000	1,078	6.25 %	
Guaranteed preferred beneficial interest in junior subordinated debentures	12,000	308	3.42 %		12,000	262	2.91 %	
<b>Total Interest-Bearing Liabilities</b>	<b>1,099,170</b>	<b>7,382</b>	<b>0.90 %</b>		<b>954,409</b>	<b>6,031</b>	<b>0.84 %</b>	
Noninterest-bearing demand deposits	150,757				140,031			
Other liabilities	10,700				9,336			
Stockholders' equity	108,956				102,776			
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$1,369,583</b>				<b>\$1,206,552</b>			
Net interest income		\$32,615				\$29,432		
Interest rate spread			3.26 %				3.37 %	
Net yield on interest-earning assets			3.39 %				3.50 %	

Ratio of average interest-earning assets to average interest bearing liabilities	116.67 %	117.62 %
Cost of funds	0.79 %	0.73 %
Cost of deposits	0.53 %	0.48 %
Cost of debt	2.27 %	2.67 %
(1) Average balance includes non-accrual loans		

The following table sets forth certain information regarding changes in interest income and interest expense of the Bank for the periods indicated. For each category of interest-earning asset and interest-bearing liability, information is provided on changes attributable to (1) changes in volume (changes in volume multiplied by old rate); and (2) changes in rate (changes in rate multiplied by old volume). Changes in rate-volume (changes in rate multiplied by the change in volume) have been allocated to changes due to volume.

**For the Nine Months Ended September 30, 2017**

**compared to the Nine Months Ended**

**September 30, 2016**

dollars in thousands	Volume	Due to Rate	Total
<b>Interest income:</b>			
Loan portfolio (1)	\$ 4,685	\$ (809 )	\$ 3,876
Investment securities, federal funds sold and interest bearing deposits	333	325	658
Total interest-earning assets	\$ 5,018	\$ (484 )	\$ 4,534
<b>Interest-bearing liabilities:</b>			
Savings	2	(14 )	(12 )
Interest-bearing demand and money market accounts	121	115	236
Certificates of deposit	246	279	525
Long-term debt	17	(72 )	(55 )
Short-term borrowings	462	149	611
Subordinated notes	-	-	-
Guaranteed preferred beneficial interest in junior subordinated debentures	-	46	46
Total interest-bearing liabilities	\$ 848	\$ 503	\$ 1,351
Net change in net interest income	\$ 4,170	\$ (987 )	\$ 3,183

(1) Average balance includes non-accrual loans

***Provision for Loan Losses***

The following table shows the dollar and percentage changes for the provision for loan losses for the periods presented.

(dollars in thousands)	Nine Months Ended September 30,		\$ Change	% Change
	2017	2016		

Provision for loan losses \$ 980 \$ 1,689 \$ (709 ) (42.0 )%

The provision for loan losses decreased \$709,000 to \$980,000 for the nine months ended September 30, 2017 compared to \$1.7 million for the nine months ended September 30, 2016. Net charge-offs for the first nine months of 2017 decreased \$161,000 from \$566,000 for the nine months ended September 30, 2016 to \$405,000 for the nine months ended September 30, 2017. Improvements to baseline charge-off factors for the periods used to evaluate the adequacy of the allowance as well as improvements in some qualitative factors, such as reductions in delinquency, were offset by increases in other qualitative factors, such as concentration to capital factors. Overall, these changes resulted in a lower provision for loan losses for the comparable periods.

See further discussion of the provision under the caption “Asset Quality” in the Comparison of Financial Condition section of Management’s Discussion and Analysis.



**Noninterest Income**

The following table shows the components of noninterest income and the dollar and percentage changes for the periods presented.

(dollars in thousands)	Nine Months Ended September 30,		\$ Change	% Change	
	2017	2016			
Noninterest Income					
Loan appraisal, credit, and miscellaneous charges	\$ 84	\$ 223	\$ (139 )	(62.3 )	%
Gain on sale of asset	47	4	43	1075.0	%
Net gains (losses) on sale of OREO	36	(440 )	476	(108.2 )	%
Net gains on sale of investment securities	133	39	94	241.0	%
Income from bank owned life insurance	581	593	(12 )	(2.0 )	%
Service charges	1,909	2,050	(141 )	(6.9 )	%
Gain on sale of loans held for sale	294	-	294	n/a	
Total Noninterest Income	\$ 3,084	\$ 2,469	\$ 615	24.9	%

Noninterest income was increased \$615,000 to \$3.1 million for the nine months ended September 30, 2017 from \$2.5 million for the nine months ended September 30, 2016. During the first nine months of 2016, the Company recognized losses of \$440,000 on the disposition of \$3.5 million in OREO compared to recognized gains of \$36,000 on dispositions of \$1.1 million for the nine months ended September 30, 2017. During the nine months ended September 30, 2017 the Company sold nine securities with aggregate carrying values of \$7.0 million and recognized gains of \$133,000. During the nine months ended September 30, 2016 the Company sold four securities with aggregate carrying values of \$3.1 million and recognized gains of \$39,000. Service charge income decreased due a reduction in wealth management income in 2017 and rents collected in the prior year on OREO properties. The Company sold the guaranteed portion of a U.S. Small Business Administration Loan for proceeds of \$2.8 million and recognized a gain of \$294,000 during the three months ended September 30, 2017.

**Noninterest Expense**

The following tables show the components of noninterest expense and the dollar and percentage changes for the periods presented.

(dollars in thousands)	Nine Months Ended September 30,		\$ Change	% Change	
	2017	2016			
Salary and employee benefits	\$ 12,567	\$ 12,617	\$ (50 )	(0.4 )	%
OREO valuation allowance and expenses	623	609	14	2.3	%
Other operating expenses	9,161	8,617	544	6.3	%
Total Noninterest Expense	\$ 22,351	\$ 21,843	\$ 508	2.3	%

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(dollars in thousands)	Nine Months Ended September 30,		\$ Change	% Change	
	2017	2016			
Noninterest Expense					
Salary and employee benefits	\$ 12,567	\$ 12,617	\$ (50 )	(0.4 )%	
Occupancy expense	1,941	1,822	119	6.5 %	
Advertising	404	509	(105 )	(20.6 )%	
Data processing expense	1,766	1,678	88	5.2 %	
Professional fees	1,684	1,113	571	51.3 %	
Depreciation of furniture, fixtures, and equipment	594	608	(14 )	(2.3 )%	
Telephone communications	142	133	9	6.8 %	
Office supplies	86	105	(19 )	(18.1 )%	
FDIC Insurance	505	642	(137 )	(21.3 )%	
OREO valuation allowance and expenses	623	609	14	2.3 %	
Other	2,039	2,007	32	1.6 %	
Total Noninterest Expense	\$ 22,351	\$ 21,843	\$ 508	2.3 %	

Noninterest expense averaged just below \$7.3 million per quarter during 2016. The Company focused during the prior year on controlling the growth of expenses by streamlining internal processes and reviewing vendor relationships. These efforts resulted in a reduction in nine FTEs, from 171 employees to 162 employees, during the year ended December 31, 2016. The Company's strategy to create operating leverage through continued asset growth combined with controlling the growth in expenses has continued during 2017.

For the nine months ended September 30, 2017, noninterest expense increased 2.3%, or \$508,000, to \$22.3 million from \$21.8 million for the comparable period in 2016. Salary and benefit costs were flat from the comparable period due to modest increases in base compensation, offset by lower year to date health insurance claims and the retirement of two senior management employees in the second quarter of 2017. Total growth in compensation and benefit costs was 2.7% and 3.2%, respectively for the years ended December 31, 2016 and 2015. Year to date 2017 operating expenses included \$494,000 of merger related costs, comprising primarily of professional fees and investment banking costs, which reduced diluted earnings per share by \$0.07.

Occupancy expense increased mainly as a result of scheduled lease rent increases. Data processing costs were modestly higher than the prior year primarily due to scheduled annual increases of the Company's core data processing systems. These increases were anticipated because of the Bank's larger balance sheet and increase in customer accounts. Advertising costs decreased primarily due to the scheduling of campaigns. The Company's efficiency ratio for the nine months ended September 30, 2017 and 2016 was 62.61% and 68.47%, respectively. The Company's net operating expense ratio as a percentage of average assets for the nine months ended September 30, 2017 and 2016 was 1.88% and 2.14%, respectively.

### ***Income Tax Expense***

For the nine months ended September 30, 2017 and 2016, the Company recorded income tax expense of \$4.7 million and \$3.1 million, respectively. The Company's effective tax rates for the nine months ended September 30, 2017 and 2016 were 38.01% and 36.56%, respectively. The increase in the effective tax rate was the result of tax-exempt income being relatively lower to total income for the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016.

**COMPARISON OF FINANCIAL CONDITION AT SEPTEMBER 30, 2017 AND DECEMBER 31, 2016****Assets**

Total assets at September 30, 2017 were \$1.40 billion, an increase of \$67.9 million or 6.8% annualized growth, compared to total assets of \$1.33 billion at December 31, 2016. The increase in total assets was primarily attributable to growth in loans. Net loans increased \$56.5 million, or 7.0% annualized growth, from \$1,079.5 million at December 31, 2016 to \$1,136.0 million at September 30, 2017, principally due to increases in commercial real estate and residential rentals portfolios. The differences in allocations between the cash and investment categories reflect operational needs. The following table shows the Company's assets and the dollar and percentage changes for the periods presented.

(dollars in thousands)	September 30, 2017	December 31, 2016	\$ Change	% Change	
Cash and due from banks	\$ 15,627	\$ 9,948	\$ 5,679	57.1	%
Interest-bearing deposits with banks	1,577	1,315	262	19.9	%
Securities available for sale (AFS), at fair value	61,376	53,033	8,343	15.7	%
Securities held to maturity (HTM), at amortized cost	104,530	109,247	(4,717 )	(4.3 )	%
FHLB stock - at cost	7,447	7,235	212	2.9	%
Loans receivable - net of ALLL	1,136,004	1,079,519	56,485	5.2	%
Premises and equipment, net	21,751	22,205	(454 )	(2.0 )	%
Premises and equipment held for sale	-	345	(345 )	(100.0 )	%
Other real estate owned (OREO)	9,741	7,763	1,978	25.5	%
Accrued interest receivable	4,494	3,979	515	12.9	%
Investment in bank owned life insurance	29,206	28,625	581	2.0	%
Other assets	10,419	11,043	(624 )	(5.7 )	%
Total Assets	\$ 1,402,172	\$ 1,334,257	\$ 67,915	5.1	%

The following is a breakdown of the Company's loan portfolio at September 30, 2017 and December 31, 2016:

(dollars in thousands)	September 30, 2017	%	December 31, 2016	%
Commercial real estate	\$ 712,840	62.24 %	\$ 667,105	61.25 %
Residential first mortgages	175,816	15.35 %	171,004	15.70 %
Residential rentals	110,905	9.68 %	101,897	9.36 %
Construction and land development	31,094	2.71 %	36,934	3.39 %
Home equity and second mortgages	22,334	1.95 %	21,399	1.97 %
Commercial loans	56,376	4.92 %	50,484	4.64 %

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Consumer loans	541	0.05 %	422	0.04 %
Commercial equipment	35,500	3.10 %	39,737	3.65 %
	1,145,406	100.00%	1,088,982	100.00%
Less:				
Deferred loan fees and premiums	(1,033	) -0.09 %	(397	) -0.04 %
Allowance for loan losses	10,435	0.91 %	9,860	0.91 %
	9,402		9,463	
	\$ 1,136,004		\$ 1,079,519	

**Asset Quality**

The following tables show asset quality ratios at September 30, 2017 and December 31, 2016.

(dollars in thousands, except per share amounts)	September 30, 2017	December 31, 2016	\$ Change	% Change	
<b>ASSET QUALITY</b>					
Total assets	\$ 1,402,172	\$ 1,334,257	\$ 67,915	5.1	%
Gross loans	1,145,406	1,088,982	56,424	5.2	
Classified Assets	39,172	39,246	(74 )	(0.2 )	
Allowance for loan losses	10,435	9,860	575	5.8	
Past due loans (PDLs) (31 to 89 days)	1,642	1,034	608	58.8	
Nonperforming loans (NPLs) (>=90 days)	2,741	7,705	(4,964 )	(64.4 )	
Non-accrual loans (a)	3,012	8,374	(5,362 )	(64.0 )	
Accruing troubled debt restructures (TDRs) (b)	10,069	10,448	(379 )	(3.6 )	
Other real estate owned (OREO)	9,741	7,763	1,978	25.5	
Non-accrual loans, OREO and TDRs	\$ 22,822	\$ 26,585	\$ (3,763 )	(14.2 )	
<b>ASSET QUALITY RATIOS</b>					
Classified assets to total assets	2.79	% 2.94	%		
Classified assets to risk-based capital	24.97	26.13			
Allowance for loan losses to total loans	0.91	0.91			
Allowance for loan losses to nonperforming loans	380.70	127.97			
Past due loans (PDLs) to total loans	0.14	0.09			
Nonperforming loans (NPLs) to total loans	0.24	0.71			
Loan delinquency (PDLs + NPLs) to total loans	0.38	0.80			
Non-accrual loans to total loans	0.26	0.77			
Non-accrual loans and TDRs to total loans	1.14	1.73			
Non-accrual loans and OREO to total assets	0.91	1.21			
Non-accrual loans, OREO and TDRs to total assets	1.63	1.99			

(a) Non-accrual loans include all loans that are 90 days or more delinquent and loans that are non-accrual due to the operating results or cash flows of a customer. Non-accrual loans can include loans that are current with all loan payments.

(b) At September 30, 2017 and December 31, 2016, the Bank had total TDRs of \$10.9 million and \$15.1 million, respectively, with \$828,000 and \$4.7 million, respectively, in non-accrual status. These loans are classified as non-accrual loans for the calculation of financial ratios.

The Company continues to pursue its approach of maximizing contractual rights with individual classified customer relationships. The objective is to move non-performing or substandard credits that are not likely to become performing or passing credits in a reasonable timeframe off the balance sheet. The Company is encouraging existing classified customers to obtain financing with other lenders or is enforcing its contractual rights. Management believes this strategy is in the best long-term interest of the Company. As a result of these efforts, non-accrual loans and OREO to total assets have decreased from 1.83% at December 31, 2015, to 1.21% at December 31, 2016, and to 0.91% at September 30, 2017. Non-accrual loans, OREO and TDRs to total assets decreased from 2.98% at December 31, 2015, to 1.99% at December 31, 2016, and to 1.63% at September 30, 2017.

Management considers classified assets to be an important measure of asset quality. The following is a breakdown of the Company's classified and special mention assets at September 30, 2017, June 30, 2017, March 31, 2017 and December 31, 2016, 2015, 2014 and 2013, respectively:

**Classified Assets and Special Mention Assets**

(dollars in thousands)	As of 09/30/2017	As of 06/30/2017	As of 03/31/2017	As of 12/31/2016	As of 12/31/2015	As of 12/31/2014	As of 12/31/2013
Classified loans							
Substandard	\$ 28,734	\$ 25,519	\$ 28,920	\$ 30,463	\$ 31,943	\$ 46,735	\$ 47,645
Doubtful	-	-	-	137	861	-	-
Loss	-	-	-	-	-	-	-
Total classified loans	28,734	25,519	28,920	30,600	32,804	46,735	47,645
Special mention loans	10,446	1,357	1,374	-	1,642	5,460	9,246
Total classified and special mention loans	\$ 39,180	\$ 26,876	\$ 30,294	\$ 30,600	\$ 34,446	\$ 52,195	\$ 56,891
Classified loans	28,734	25,519	28,920	30,600	32,804	46,735	47,645
Classified securities	697	740	791	883	1,093	1,404	2,438
Other real estate owned	9,741	9,154	6,747	7,763	9,449	5,883	6,797
Total classified assets	\$ 39,172	\$ 35,413	\$ 36,458	\$ 39,246	\$ 43,346	\$ 54,022	\$ 56,880
As a percentage of Total Assets	2.79 %	2.54 %	2.69 %	2.94 %	3.79 %	4.99 %	5.56 %
As a percentage of Risk Based Capital	24.97 %	22.81 %	23.91 %	26.13 %	30.19 %	39.30 %	43.11 %

Non-accrual loans (90 days or greater delinquent and non-accrual only loans) decreased \$5.4 million from \$8.4 million or 0.77% of total loans at December 31, 2016 to \$3.0 million or 0.26% of total loans at September 30, 2017. Non-accrual only loans are loans classified as non-accrual due to customer operating results or payment history. In accordance with the Company's policy, interest income is recognized on a cash basis for these loans.

At September 30, 2017, non-accrual loans of \$3.0 million included 19 loans, of which \$1.8 million, or 60% represented seven loans and four customer relationships. During the nine months ended September 30, 2017 non-accrual loans decreased \$3.0 million due to the foreclosure of a stalled residential development project. The Bank is working with a construction manager to stabilize and market the project. This loan relationship was also a troubled debt restructures ("TDRs"). Additionally, during the third quarter of 2017, non-accrual loans decreased \$607,000 due to the foreclosure of a commercial office building. At December 31, 2016, non-accrual loans of \$8.4 million included 29 loans, of which \$6.4 million, or 77% of represented 15 loans and six customer relationships. Non-accrual loans included one TDRs totaling \$828,000 at September 30, 2017 and six TDRs totaling \$4.7 million at December 31, 2016. These loans are classified solely as non-accrual loans for the calculation of financial ratios.



Loan delinquency (90 days or greater delinquent and 31-89 days delinquent) decreased \$4.4 million from \$8.7 million, or 0.80% of loans, at December 31, 2016 to \$4.4 million, or 0.38% of loans, at September 30, 2017.

TDRs decreased \$4.2 million from \$15.1 million at December 31, 2016 to \$10.9 million at September 30, 2017. TDRs that are included in non-accrual are classified solely as non-accrual loans for the calculation of financial ratios. The Company had specific reserves of \$253,000 on seven TDRs totaling \$3.0 million at September 30, 2017 and \$844,000 on nine TDRs totaling \$5.7 million at December 31, 2016. During the nine months ended September 30, 2017, TDR disposals, which included payoffs and refinancing decreased by seven loans totaling \$3.9 million, of which \$3.0 million related to the foreclosure of the stalled residential development project mentioned previously. TDR loan principal curtailment was \$279,000 for the nine months ended September 30, 2017. There were no TDRs added during the nine months ended September 30, 2017. The following is a breakdown by loan classification of the Company's TDRs at September 30, 2017 and December 31, 2016:

(dollars in thousands)	September 30, 2017		December 31, 2016	
	Dollars	Number of Loans	Dollars	Number of Loans
Commercial real estate	\$ 9,371	9	\$ 9,587	8
Residential first mortgages	532	2	545	2
Residential rentals	222	1	227	1
Construction and land development	729	2	3,777	4
Commercial loans	5	1	872	5
Commercial equipment	38	1	113	2
Total TDRs	\$ 10,897	16	\$ 15,121	22
Less: TDRs included in non-accrual loans	(828 )	(1 )	(4,673 )	(6 )
Total accrual TDR loans	\$ 10,069	15	\$ 10,448	16

The allowance for loan losses was 0.91% of gross loans at September 30, 2017 and December 31, 2016. Management's determination of the adequacy of the allowance is based on a periodic evaluation of the portfolio with consideration given to: overall loss experience; current economic conditions; size, growth and composition of the loan portfolio; financial condition of the borrowers; current appraised values of underlying collateral and other relevant factors that, in management's judgment, warrant recognition in determining an adequate allowance. Improvements to baseline charge-off factors for the periods used to evaluate the adequacy of the allowance as well as improvements in some qualitative factors, such as reductions in delinquency, were offset by increases in other qualitative factors, such as concentration to capital factors. The specific allowance is based on management's estimate of realizable value for particular loans. Management believes that the allowance is adequate.

The following is a breakdown of the Company's general and specific allowances as a percentage of gross loans at September 30, 2017 and December 31, 2016, respectively:

(dollar in thousands)	September 30, 2017	% of Gross Loans	December 31, 2016	% of Gross Loans
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General Allowance	\$ 9,617	0.84	% \$ 8,571	0.79	%
Specific Allowance	818	0.07	% 1,289	0.12	%
Total Allowance	\$ 10,435	0.91	% \$ 9,860	0.91	%

The historical loss experience factor is tracked over various time horizons for each portfolio segment. The following table provides net charge-offs as a percentage of average loans for the three and nine months ended September 30, 2017 and 2016, respectively, and a five-year trend:

(dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,							
	2017	2016	2017	2016	2017	2016	2015	2014	2013	2012
Average loans	\$ 1,127,626	\$ 1,016,408	\$ 1,107,618	\$ 967,568						
Net charge-offs	224	141	405	566						
Net charge-offs to average loans	0.08	% 0.06	% 0.05	% 0.08	%					
	Years Ended December 31,									
	2016	2015	2014	2013	2012					
Average loans	\$988,288	\$874,186	\$ 819,381	\$ 741,369	\$ 719,798					
Net charge-offs	1,039	1,374	2,309	1,049	1,937					
Net charge-offs to average loans	0.11	% 0.16	% 0.28	% 0.14	% 0.27	%				

The OREO balance was \$9.7 million at September 30, 2017, an increase of \$1.9 million compared to \$7.8 million at December 31, 2016. During the nine months ended September 30, 2017, additions of \$3.6 million consisted of \$3.0 million related to the foreclosure of a stalled residential development project. The Bank is working with a construction manager to stabilize and market the project. Further, additions included \$103,000 for residential lots and \$495,000 for a commercial office building. The Company disposed of four residential properties and multiple residential lots for proceeds of \$1.1 million and a gain of \$36,000 for the nine months ended September 30, 2017. The Bank provided \$200,000 in financing for one residential property and the three residential lots during the first quarter of 2017. The transaction qualified for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition". In addition, valuation allowances of \$576,000 were recognized to adjust properties to current appraised values. OREO carrying amounts reflect management's estimate of the realizable value of these properties incorporating current appraised values, local real estate market conditions and related costs.

At September 30, 2017, 99.6%, or \$160.7 million of the asset-backed securities and bonds issued by GSEs and U.S. Agencies and others were rated AAA by Standard & Poor's or the equivalent credit rating from another major rating agency compared to 99.4%, or \$156.9 million, at December 31, 2016. Debt securities are evaluated quarterly to determine whether a decline in their value is OTTI. No OTTI charge was recorded for the nine months ended September 30, 2017 and the year ended December 31, 2016, respectively. Classified securities decreased \$186,000 from \$883,000 at December 31, 2016 to \$697,000 at September 30, 2017.

Gross unrealized losses on HTM and AFS securities decreased from \$3.3 million at December 31, 2016 to \$1.8 million at September 30, 2017 (see Note 10 in Consolidated Financial Statements). Gross unrealized losses at

September 30, 2017 and December 31, 2016 for AFS securities were \$961,000 and \$1.6 million, respectively, of amortized cost of \$62.3 million and \$54.6 million, respectively. Gross unrealized losses at September 30, 2017 and December 31, 2016 for HTM securities were \$814,000 and \$1.7 million, respectively, of amortized cost of \$104.5 million and \$109.2 million, respectively. The change in unrealized losses was the result of changes in interest rates, while credit risks remained stable. The Bank holds over 96% of its AFS and HTM securities as asset-backed securities of GSEs or U.S. Agencies, GSE agency bonds or U.S. government obligations. The Company intends to, and has the ability to, hold both AFS and HTM securities with unrealized losses until they mature, at which time the Company will receive full value for the securities. The Company believes that the AFS and HTM securities with unrealized losses will either recover in market value or be paid off as agreed.

***Liabilities***

The following table shows the Company's liabilities and the dollar and percentage changes for the periods presented.

(dollars in thousands)	September 30, 2017	December 31, 2016	\$ Change	% Change	
Deposits					
Non-interest-bearing deposits	\$ 157,665	\$ 144,877	\$ 12,788	8.8	%
Interest-bearing deposits	940,336	893,948	46,388	5.2	%
Total deposits	1,098,001	1,038,825	59,176	5.7	%
Short-term borrowings	91,500	79,000	12,500	15.8	%
Long-term debt	55,514	65,559	(10,045)	(15.3)	)%
Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs)	12,000	12,000	-	0.0	%
Subordinated notes - 6.25%	23,000	23,000	-	0.0	%
Accrued expenses and other liabilities	11,272	11,447	(175)	(1.5)	)%
Total Liabilities	\$ 1,291,287	\$ 1,229,831	\$ 61,456	5.0	%

***Deposits and Borrowings***

Deposits increased by 7.6% annualized, or \$59.2 million, to \$1,098.0 million at September 30, 2017 compared to \$1,038.8 million at December 31, 2016. The Company uses both traditional and reciprocal brokered deposits. Traditional brokered deposits at September 30, 2017 and December 31, 2016 were \$137.6 million and \$131.0 million, respectively. Reciprocal brokered deposits are used to maximize FDIC insurance available to our customers. Reciprocal brokered deposits at September 30, 2017 and December 31, 2016 were \$99.6 million and \$70.7 million, respectively.

Details of the Company's deposit portfolio at September 30, 2017 and December 31, 2016 are presented below:

(dollars in thousands)	September 30, 2017		December 31, 2016		
	Balance	%	Balance	%	
Noninterest-bearing demand	\$ 157,665	14.36 %	\$ 144,877	13.95 %	
Interest-bearing:					
Demand	195,632	17.82 %	162,823	15.67 %	
Money market deposits	229,740	20.92 %	248,049	23.88 %	
Savings	54,310	4.95 %	50,284	4.84 %	
Certificates of deposit	460,654	41.95 %	432,792	41.66 %	
Total interest-bearing	940,336	85.64 %	893,948	86.05 %	
Total Deposits	\$ 1,098,001	100.00 %	\$ 1,038,825	100.00 %	

Transaction accounts	\$637,347	58.05 %	\$606,033	58.34 %
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FHLB long-term debt and short-term borrowings increased \$2.4 million from \$144.6 million at December 31, 2016 to \$147.0 million at September 30, 2017. The Company uses brokered deposits and other wholesale funding to supplement funding when loan growth exceeds core deposit growth and for asset-liability management purposes.

The Bank uses advances from the FHLB of Atlanta to supplement the supply of funds it may lend and to meet deposit withdrawal requirements. Advances from the FHLB are secured by the Bank's stock in the FHLB, a portion of the Bank's loan portfolio and certain investments. Generally, the Bank's ability to borrow from the FHLB of Atlanta is limited by its available collateral and also by an overall limitation of 30% of assets. Further, short-term credit facilities are available at the Federal Reserve Bank of Richmond and other commercial banks. FHLB long-term debt consists of adjustable-rate advances with rates based upon LIBOR, fixed-rate advances, and convertible advances. At September 30, 2017 and December 31, 2016, 100% of the Bank's long-term debt was fixed for rate and term, as the conversion optionality of the advances have either been exercised or expired.

***Stockholders' Equity***

The following table shows the Company's equity and the dollar and percentage changes for the periods presented.

(dollars in thousands)	September 30, 2017	December 31, 2016	\$ Change	% Change	
Common Stock at par of \$0.01	\$ 46	\$ 46	\$ -	0.0	%
Additional paid in capital	47,994	47,377	617	1.3	%
Retained earnings	64,375	58,100	6,275	10.8	%
Accumulated other comprehensive loss	(538	) (928	) 390	(42.0	)%
Unearned ESOP shares	(992	) (169	) (823	) 487.0	%
Total Stockholders' Equity	\$ 110,885	\$ 104,426	\$ 6,459	6.2	%

During the nine months ended September 30, 2017, stockholders' equity increased \$6.5 million to \$110.9 million. The increase in stockholders' equity was due to net income of \$7.7 million, a current year decrease in accumulated other comprehensive loss of \$390,000 and net stock related activities related to stock-based compensation of \$578,000. These increases to capital were partially offset by quarterly common dividends paid of \$1.4 million and the purchase of 23,503 shares of the Company's common shares for \$823,000 by the Employee Stock Ownership Plan ("ESOP") during the third quarter of 2017. The ESOP has promissory notes with the Company for the purchase of TCFC common stock for the benefit of the participants in the Plan. Loan terms are at prime rate plus one-percentage point and amortize over seven years. As principal is repaid, common shares are allocated to participants based on the participant account allocation rules described in the Plan. The Bank is a guarantor of the ESOP debt with the Company. Unencumbered shares held by the ESOP are treated as outstanding in computing earnings per share. Shares issued to the ESOP but pledged as collateral for loans obtained to provide funds to acquire the shares are not treated as outstanding in computing earnings per share.

Common stockholders' equity of \$110.9 million at September 30, 2017 resulted in a book value of \$23.85 per common share compared to \$22.54 at December 31, 2016. The Company remains well-capitalized at September 30, 2017 with a Tier 1 capital to average assets ratio of 8.82%.

**LIQUIDITY AND CAPITAL RESOURCES*****Capital Resources***

The Company has no business other than holding the stock of the Bank and does not have significant operating cash needs, except for the payment of dividends declared on common stock, and the payment of interest on subordinated debentures and subordinated notes, and noninterest expense.



The Company evaluates capital resources by our ability to maintain adequate regulatory capital ratios. The Company and the Bank annually update a three-year strategic capital plan. In developing its plan, the Company considers the impact to capital of asset growth, income accretion, dividends, holding company liquidity, investment in markets and people and stress testing.

During the three months ended September 30, 2017 and the year ended December 31, 2016, the Company performed an assessment using the new regulatory capital ratios and determined that the Company meets the new requirements specified in the Basel III rules upon full adoption of such requirements. In addition, our subsidiary bank made the election to continue to exclude most accumulated other comprehensive income ("AOCI") from capital in connection with its March 31, 2015 quarterly financial filing and, in effect, to retain the AOCI treatment under the prior capital rules.

Federal banking regulations require the Company and the Bank to maintain specified levels of capital. As of September 30, 2017 and December 31, 2016, the Company and Bank were well-capitalized under the regulatory framework for prompt corrective action under the new Basel III Capital Rules. Management believes, as of June 30, 2017 and December 31, 2016, that the Company and the Bank met all capital adequacy requirements to which they were subject. See Note 12 of the Consolidated Financial Statements.

### ***Liquidity***

Liquidity is defined as the ability to meet cash demands as they arise. Such needs can develop from loan demand, deposit withdrawals or acquisition opportunities. Potential obligations resulting from the issuance of standby letters of credit and commitments to fund future borrowings to loan customers are other factors affecting the Bank's and the Company's liquidity needs. Many of these obligations and commitments are expected to expire without being drawn upon; therefore the total commitment amounts do not necessarily represent future cash requirements affecting the Bank's and the Company's liquidity positions.

Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. Liquid assets include cash, federal funds sold, and short-term investments in cash deposits with other banks. Liquidity is also provided by access to funding sources, which include core depositors and brokered deposits. Other sources of funds include the ability to borrow, such as purchasing federal funds from correspondent banks, sales of securities under agreements to repurchase and advances from the FHLB.

The Company's principal sources of liquidity are cash on hand and dividends received from the Bank. The Bank is subject to various regulatory restrictions on the payment of dividends.

The Bank's principal sources of funds for investment and operations are net income, deposits, sales of loans, borrowings, principal and interest payments on loans, principal and interest received on investment securities and proceeds from the maturity and sale of investment securities. Its principal funding commitments are for the origination or purchase of loans, the purchase of securities and the payment of maturing deposits. Deposits are considered the primary source of funds supporting the Bank's lending and investment activities. The Bank also uses borrowings from the FHLB of Atlanta to supplement deposits. The amount of FHLB advances available to the Bank is limited to the lower of 30% of Bank assets or the amount supportable by eligible collateral including FHLB stock, loans and securities. In addition, the Bank has established lines of credit with the Federal Reserve Bank and commercial banks.

For additional information on these agreements, including collateral, see Note 11 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2016.

The Company's most liquid assets are cash, cash equivalents and federal funds sold. The levels of such assets are dependent on operating, financing and investment activities at any given time. The variations in levels of cash and cash equivalents are influenced by deposit flows and anticipated future deposit flows.

Cash and cash equivalents as of September 30, 2017 totaled \$17.2 million, an increase of \$5.9 million, or 52.8%, from the December 31, 2016 total of \$11.3 million. Changes to the level of cash and cash equivalents have minimal impact on operational needs as the Company has substantial sources of funds available from other sources.

During the nine months ended September 30, 2017, all financing activities provided \$59.6 million in cash compared to \$132.4 million in cash for the same period in 2016. The Company was provided \$72.8 million less cash from financing activities in the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016, primarily due to reduced deposit growth of \$45.5 million and slower growth in borrowings of \$27.0 million.

During the nine months ended September 30, 2017, all investing activities used \$63.1 million in cash compared to \$138.8 million in cash used for the same period in 2016. The decrease in cash used of \$75.7 million was primarily the result of net decreases in cash used of \$3.0 million for purchases of premises and equipment and \$78.2 million from loan activities. The Company purchased more premises and equipment in the first nine months of 2016 compared to the same period in 2017, mainly due to the construction of a new branch in downtown Fredericksburg, Virginia during the first half of 2016. Cash used decreased as principal received on loans for the nine months ended September 30, 2017 increased over the prior year comparable period. Principal collected on loans increased \$27.2 million from \$160.3 million for the nine months ended September 30, 2016 to \$187.5 million for the nine months ended September 30, 2017. Additionally, cash used decreased for the funding of loans originated, which decreased \$51.0 million from \$298.7 million for the nine months ended September 30, 2016 to \$247.7 million for the nine months ended September 30, 2017. These reductions in the amount of cash used were partially offset by a decrease in cash provided of \$3.5 million from the 2016 sales of the King George branch and OREO compared to less significant sales activity in 2017. Net cash provided decreased from \$4.8 million for the nine months ended September 30, 2016 to \$1.3 million for the nine months ended September 30, 2017. Net cash provided decreased by \$2.0 million for net securities transactions for the comparable periods.

Operating activities provided cash of \$9.4 million, or \$160,000 less cash, for the nine months ended September 30, 2017 compared to \$9.6 million of cash provided for the same period of 2016.

**ITEM 3 – Quantitative and qualitative Disclosure about Market Risk**

Interest rate risk is defined as the exposure to changes in net interest income and capital that arises from movements in interest rates. Depending on the composition of the balance sheet, increasing or decreasing interest rates can negatively affect the Company's results of operations and financial condition.

The Company measures interest rate risk over the short and long term. The Company measures interest rate risk as the change in net interest income ("NII") caused by a change in interest rates over twelve and twenty-four months. The Company's NII simulations provide information about short-term interest rate risk exposure. The Company also measures interest rate risk by measuring changes in the values of assets and liabilities due to changes in interest rates. The economic value of equity ("EVE") is defined as the present value of future cash flows from existing assets, minus the present value of future cash flows from existing liabilities. EVE simulations reflect the interest rate sensitivity of assets and liabilities over a longer time period, considering the maturities, average life and duration of all balance sheet accounts.

The Board of Directors has established an interest rate risk policy, which is administered by the Bank's Asset Liability Committee ("ALCO"). The policy establishes limits on risk, which are quantitative measures of the percentage change in NII and EVE resulting from changes in interest rates. Both NII and EVE simulations assist in identifying, measuring, monitoring and controlling interest rate risk and are used by management and the ALCO Committee to ensure that interest rate risk exposure will be maintained within Board policy guidelines. The ALCO Committee reports quarterly to the Board of Directors. Mitigating strategies are used to maintain interest rate risk within established limits.

The Company's interest rate risk ("IRR") model uses assumptions which include factors such as call features, prepayment options and interest rate caps and floors included in investment and loan portfolio contracts. Additionally, the IRR model estimates the lives and interest rate sensitivity of the Company's non-maturity deposits. These assumptions have a significant effect on model results. The assumptions are developed primarily based upon historical behavior of Bank customers. The Company also considers industry and regional data in developing IRR model assumptions. There are inherent limitations in the Company's IRR model and underlying assumptions. When interest rates change, actual movements of interest-earning assets and interest-bearing liabilities, loan prepayments, and withdrawals of time and other deposits, may deviate significantly from assumptions used in the model. The Company prepares a current base case and several alternative simulations at least quarterly. Current interest rates are shocked by +/- 100, 200, 300, and 400 basis points ("bp"). In addition, the Company simulates additional rate curve scenarios (e.g., bear flattener). The Company may elect not to use particular scenarios that it determines are impractical in a current rate environment. The Company's internal limits for parallel shock scenarios are as follows:

Shock in Basis Points	<b>Net Interest Income</b>	<b>Economic Value of Equity</b>
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	(“NII”)		(“EVE”)	
+ - 400	25	%	40	%
+ - 300	20	%	30	%
+ - 200	15	%	20	%
+ - 100	10	%	10	%

It is management’s goal to manage the portfolios of the Bank so that net interest income at risk over a twelve-month and twenty-four month period and the economic value of equity at risk do not exceed policy guidelines at the various interest rate shock levels. As of September 30, 2017, June 30, 2017, March 31, 2017 and December 31, 2016, the Company did not exceed any Board approved sensitivity limits. Measures of net interest income at risk produced by simulation analysis are indicators of an institution’s short-term performance in alternative rate environments. The below schedule estimates the changes in net interest income over a twelve month period for parallel rate shocks for up 200, 100 and down 100 scenarios:

#### Estimated Changes in Net Interest Income

Change in Interest Rates:	<b>+ 200 bp</b>		<b>+ 100 bp</b>		<b>- 100 bp</b>	
Policy Limit	(15.00	)%	(10.00	)%	(10.00	)%
September 30, 2017	(1.55	)%	(0.76	)%	(2.66	)%
June 30, 2017	(2.68	)%	(1.22	)%	(2.80	)%
March 31, 2017	(2.39	)%	(1.12	)%	(2.98	)%
December 31, 2016	(2.19	)%	(1.10	)%	1.51	)%

Measures of equity value at risk indicate the ongoing economic value of the Company by considering the effects of changes in interest rates on all of the Company's cash flows, and by discounting the cash flows to estimate the present value of assets and liabilities. The below schedule estimates the changes in the economic value of equity at parallel shocks for up 200, 100 and down 100 scenarios:

Estimated Changes in Economic Value of Equity (EVE)

Change in Interest Rates:	+ 200 bp	+ 100 bp	- 100 bp
Policy Limit	(20.00 )%	(10.00 )%	(10.00 )%
September 30, 2017	(15.20 )%	(7.18 )%	19.91 %
June 30, 2017	(14.43 )%	(6.80 )%	19.02 %
March 31, 2017	(14.71 )%	(6.79 )%	12.93 %
December 31, 2016	(13.22 )%	(5.64 )%	0.63 %

#### ITEM 4 – CONTROLS AND PROCEDURES

As of the end of the period covered by this report, management of the Company carried out an evaluation, under the supervision and with the participation of the Company's principal executive officer and principal financial officer, of the effectiveness of the Company's disclosure controls and procedures. Based on this evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934, as amended, (1) is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and (2) is accumulated and communicated to the Company's management, including its principal executive and financial officers as appropriate to allow timely decisions regarding required disclosure. It should be noted that the design of the Company's disclosure controls and procedures is based in part upon certain reasonable assumptions about the likelihood of future events, and there can be no reasonable assurance that any design of disclosure controls and procedures will succeed in achieving its stated goals under all potential future conditions, regardless of how remote, but the Company's principal executive and financial officers have concluded that the Company's disclosure controls and procedures are, in fact, effective at a reasonable assurance level. There were no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2017 that have materially affected, or are reasonable likely to materially affect, the Company's internal control over financial reporting.

**PART II - OTHER INFORMATION**

Item 1 – Legal Proceedings – The Company is not involved in any pending legal proceedings. The Bank is not involved in any pending legal proceedings other than routine legal proceedings occurring in the ordinary course of business. Such routine legal proceedings, in the aggregate, are believed by management to be immaterial to the financial condition and results of operations of the Company.

Item 1A – Risk Factors - In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, “Item 1A- Risk Factors” in the Form 10-K that we filed with the Securities and Exchange Commission, which could materially affect our business, financial condition or future results. The risks described are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

(a) Not applicable

(b) Not applicable

On May 4, 2015, the Board of Directors approved a repurchase plan (“2015 repurchase plan). The 2015 repurchase plan authorizes the repurchase of up to 250,000 shares of outstanding common stock. The 2015 repurchase plan will continue until it is completed or terminated by the Company’s Board of Directors. During the quarter ended December 31, 2015, the 2015 repurchase plan began with the termination of the 2008 repurchase program. As of September 30, 2017, 188,558 shares were available to be repurchased under the 2015 repurchase program. The following schedule shows that there were no repurchases during the three months ended September 30, 2017.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1-31, 2017	-	\$ -	-	188,558
August 1-31, 2017	-	-	-	188,558
September 1-30, 2017	-	-	-	188,558

Total	-	\$	-	-	188,558
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Item 3 – Default Upon Senior Securities - None

Item 4 – Mine Safety Disclosures – Not Applicable

Item 5 – Other Information - None

Item 6 – Exhibits

Exhibit 31 - Rule 13a-14(a) Certifications

Exhibit 32 - Section 1350 Certifications

Exhibit 101.0 - The following materials from the Company’s Quarterly Report on Form 10-Q for the quarter ended September 30, 2017, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Cash Flows; and (v) the Notes to the Consolidated Financial Statements.



**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**THE COMMUNITY FINANCIAL CORPORATION**

Date: November 3, 2017 By: /s/ William J. Pasenelli  
William J. Pasenelli  
President and Chief Executive Officer

Date: November 3, 2017 By: /s/ Todd L. Capitani  
Todd L. Capitani  
Chief Financial Officer