

COMMUNITY FINANCIAL CORP /MD/  
Form 10-Q  
November 04, 2016

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

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

For the Quarterly Period Ended September 30, 2016

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 0-18279

**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 or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

Yes  No

As of October 27, 2016, the registrant had 4,657,528 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)	September 30, 2016 (Unaudited)	December 31, 2015
<b>Assets</b>		
Cash and due from banks	\$ 12,957	\$ 9,059
Federal funds sold	-	225
Interest-bearing deposits with banks	1,406	1,855
Securities available for sale (AFS), at fair value	43,885	35,116
Securities held to maturity (HTM), at amortized cost	102,956	109,420
Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock - at cost	6,173	6,931
Loans receivable - net of allowance for loan losses of \$9,663 and \$8,540	1,041,910	909,200
Premises and equipment, net	22,758	20,156
Premises and equipment held for sale	-	2,000
Other real estate owned (OREO)	8,620	9,449
Accrued interest receivable	3,604	3,218
Investment in bank owned life insurance	28,429	27,836
Other assets	9,176	8,867
<b>Total Assets</b>	<b>\$ 1,281,874</b>	<b>\$ 1,143,332</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
<b>Deposits</b>		
Non-interest-bearing deposits	\$ 143,221	\$ 142,771
Interest-bearing deposits	868,354	764,128
<b>Total deposits</b>	<b>1,011,575</b>	<b>906,899</b>
Short-term borrowings	55,500	36,000
Long-term debt	65,573	55,617
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	10,243	10,033
<b>Total Liabilities</b>	<b>1,177,891</b>	<b>1,043,549</b>
<b>Stockholders' Equity</b>		
Common stock - par value \$.01; authorized - 15,000,000 shares; issued 4,656,989 and 4,645,429 shares, respectively	47	46
Additional paid in capital	47,107	46,809
Retained earnings	57,070	53,495

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Accumulated other comprehensive gain (loss)	75	(251	)	
Unearned ESOP shares	(316	)	(316	)
Total Stockholders' Equity	103,983	99,783		
Total Liabilities and Stockholders' Equity	\$ 1,281,874	\$ 1,143,332		

*See notes to Consolidated Financial Statements*

**CONSOLIDATED STATEMENTS OF INCOME (Unaudited)**

(dollars in thousands, except per share amounts )	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
<b>Interest and Dividend Income</b>				
Loans, including fees	\$ 11,460	\$ 10,336	\$ 33,175	\$ 30,886
Interest and dividends on investment securities	758	661	2,273	1,768
Interest on deposits with banks	5	5	15	11
<b>Total Interest and Dividend Income</b>	<b>12,223</b>	<b>11,002</b>	<b>35,463</b>	<b>32,665</b>
<b>Interest Expense</b>				
Deposits	1,209	1,068	3,486	3,098
Short-term borrowings	36	5	123	26
Long-term debt	834	845	2,422	2,361
<b>Total Interest Expense</b>	<b>2,079</b>	<b>1,918</b>	<b>6,031</b>	<b>5,485</b>
<b>Net Interest Income</b>	<b>10,144</b>	<b>9,084</b>	<b>29,432</b>	<b>27,180</b>
Provision for loan losses	698	501	1,689	1,071
<b>Net Interest Income After Provision For Loan Losses</b>	<b>9,446</b>	<b>8,583</b>	<b>27,743</b>	<b>26,109</b>
<b>Noninterest Income</b>				
Loan appraisal, credit, and miscellaneous charges	60	61	223	209
Gain on sale of asset	-	-	4	19
Net gains (losses) on sale of OREO	3	(2	) (440	) (20
Net gains (losses) on sale of investment securities	-	-	39	(1
Loss on premises and equipment held for sale	-	(426	) -	(426
Income from bank owned life insurance	199	206	593	616
Service charges	580	627	2,050	1,889
Gain on sale of loans held for sale	-	-	-	104
<b>Total Noninterest Income</b>	<b>842</b>	<b>466</b>	<b>2,469</b>	<b>2,390</b>
<b>Noninterest Expense</b>				
Salary and employee benefits	4,268	4,185	12,617	12,218
Occupancy expense	597	599	1,822	1,834
Advertising	290	164	509	450
Data processing expense	544	475	1,678	1,500
Professional fees	308	353	1,113	920
Depreciation of furniture, fixtures, and equipment	206	210	608	615
Telephone communications	43	56	133	141
Office supplies	33	38	105	108
FDIC Insurance	215	197	642	585
OREO valuation allowance and expenses	203	129	609	682
Other	604	625	2,007	1,809
<b>Total Noninterest Expense</b>	<b>7,311</b>	<b>7,031</b>	<b>21,843</b>	<b>20,862</b>



Income before income taxes	2,977	2,018	8,369	7,637
Income tax expense	1,014	735	3,060	2,822
Net Income	\$ 1,963	\$ 1,283	\$ 5,309	\$ 4,815
Preferred stock dividends	-	-	-	23
Net Income Available to Common Stockholders	\$ 1,963	\$ 1,283	\$ 5,309	\$ 4,792
Earnings Per Common Share				
Basic	\$ 0.43	\$ 0.28	\$ 1.16	\$ 1.03
Diluted	\$ 0.42	\$ 0.27	\$ 1.15	\$ 1.02
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,	
	2016	2015	2016	2015
Net Income	\$ 1,963	\$ 1,283	\$ 5,309	\$ 4,815
Net unrealized holding gains arising during period, net of tax expense of \$13 and \$151, and \$223 and \$201, respectively	21	230	346	308
Reclassification adjustment for gains included in net income, net of tax expense (benefit) of \$0 and \$0; \$(10) and \$0, respectively	-	-	(20 )	-
Comprehensive Income	\$ 1,984	\$ 1,513	\$ 5,635	\$ 5,123

*See notes to Consolidated Financial Statements*

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

(dollars in thousands)	Nine Months Ended September 30,	
	2016	2015
<b>Cash Flows from Operating Activities</b>		
Net income	\$5,309	\$4,815
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan losses	1,689	1,071
Depreciation and amortization	1,144	1,055
Provision for loss on premises held for sale	-	426
Loans originated for resale	-	(4,192 )
Proceeds from sale of loans originated for sale	-	4,296
Gain on sale of loans held for sale	-	(104 )
Net loss on the sale of OREO	440	20
(Gains) losses on sales of investment securities	(39 )	1
Gain on sale of asset	(4 )	(19 )
Net amortization of premium/discount on investment securities	395	157
Increase in OREO valuation allowance	366	447
Increase in cash surrender of bank owned life insurance	(593 )	(617 )
Increase in deferred income tax benefit	(417 )	(571 )
Increase in accrued interest receivable	(386 )	(91 )
Stock based compensation	240	182
(Increase) decrease in net deferred loan premiums	1,308	(4 )
Increase in accrued expenses and other liabilities	210	1,745
(Increase) decrease in other assets	(77 )	641
<b>Net Cash Provided by Operating Activities</b>	<b>9,585</b>	<b>9,258</b>
<b>Cash Flows from Investing Activities</b>		
Purchase of AFS investment securities	(15,142 )	(2,062 )
Proceeds from redemption or principal payments of AFS investment securities	4,404	5,409
Purchase of HTM investment securities	(12,180 )	(23,647 )
Proceeds from maturities or principal payments of HTM investment securities	17,618	14,099
Net decrease (increase) of FHLB and FRB stock	759	(243 )
Loans originated or acquired	(298,714)	(180,539)
Principal collected on loans	160,259	150,067
Purchase of premises and equipment	(3,757 )	(2,585 )
Proceeds from sale of OREO	2,770	930
Proceeds from sale of investment securities	3,174	66
Proceeds from disposal of premises and equipment and other assets	2,015	34
<b>Net Cash Used in Investing Activities</b>	<b>(138,794)</b>	<b>(38,471 )</b>



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

(dollars in thousands)	Nine Months Ended September 30,	
	2016	2015
<b>Cash Flows from Financing Activities</b>		
Net increase in deposits	\$ 104,676	\$ 12,895
Proceeds from long-term debt	15,000	-
Payments of long-term debt	(5,044)	(4,041)
Net increase in short term borrowings	19,500	12,000
Proceeds from subordinated notes	-	23,000
Redemption of Small Business Lending Fund Preferred Stock	-	(20,000)
Dividends paid	(1,362)	(1,456)
Net change in unearned ESOP shares	-	(28)
Repurchase of common stock	(337)	(448)
Net Cash Provided by Financing Activities	132,433	21,922
Increase (Decrease) in Cash and Cash Equivalents	\$ 3,224	\$ (7,291)
Cash and Cash Equivalents - January 1	11,139	21,373
Cash and Cash Equivalents - September 30	\$ 14,363	\$ 14,082
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash paid during the period for		
Interest	\$ 6,253	\$ 5,276
Income taxes	\$ 2,875	\$ 2,518
<b>Supplemental Schedule of Non-Cash Operating Activities</b>		
Issuance of common stock for payment of compensation	\$ 575	\$ 216
Transfer from loans to OREO	\$ 3,119	\$ 1,947
Transfer from OREO to loans	\$ 1,830	\$ -
Transfer of OREO to premises and equipment	\$ 372	\$ -
Transfer from premises and equipment to premises and equipment held for sale	\$ -	\$ 2,000

*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, 2015 have been derived from audited financial statements. There have been no significant changes to the Company’s accounting policies as disclosed in the 2015 Annual Report. The results of operations for the three and nine months ended September 30, 2016 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 restated to conform to the 2016 presentation.

These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company’s 2015 Annual Report.

### **NOTE 2 – NATURE OF BUSINESS**

The Company provides a variety of financial services to individuals and businesses through its offices in Southern Maryland 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 Bank conducts business through its main office in Waldorf, Maryland, and eleven 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 and Fredericksburg LPOs are co-located with branches. The Company’s second branch in Fredericksburg opened in April 2016.

The Company sold its King George, Virginia branch building and equipment to a credit union. The Company’s 2015 third quarter operating results reflect the financial impact of the transaction. The Company recorded an impairment of \$426,000 during the third quarter of 2015. The transaction closed on January 28, 2016.

### **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 GAIN (LOSS)**

The following tables present the components of comprehensive gain for the three and nine months ended September 30, 2016 and 2015. The Company's "other comprehensive" gain was solely related to securities for the three and nine months ended September 30, 2016 and 2015.

	<b>Three Months Ended</b>			<b>Three Months Ended</b>		
	<b>September 30, 2016</b>			<b>September 30, 2015</b>		
(dollars in thousands)	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
Net unrealized holding gains arising during period	\$ 34	\$ 13	\$ 21	\$ 381	\$ 151	\$ 230
Reclassification adjustments	-	-	-	-	-	-
Other comprehensive gain	\$ 34	\$ 13	\$ 21	\$ 381	\$ 151	\$ 230

  

	<b>Nine Months Ended September 30, 2016</b>			<b>Nine Months Ended September 30, 2015</b>		
	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
(dollars in thousands)						
Net unrealized holding gains arising during period	\$ 569	\$ 223	\$ 346	\$ 509	\$ 201	\$ 308
Reclassification adjustments	(30 )	(10 )	(20 )	-	-	-
Other comprehensive gain	\$ 539	\$ 213	\$ 326	\$ 509	\$ 201	\$ 308

The following table presents the changes in each component of accumulated other comprehensive gain (loss), net of tax, for the three and nine months ended September 30, 2016 and 2015.

	<b>Three Months Ended September 30, 2016</b>	<b>Three Months Ended September 30, 2015</b>	<b>Nine Months Ended September 30, 2016</b>	<b>Nine Months Ended September 30, 2015</b>
	Net Unrealized Gains And	Net Unrealized Gains And	Net Unrealized Gains And	Net Unrealized Gains And
(dollars in thousands)				



	Losses	Losses	Losses	Losses
Beginning of period	\$ 54	\$ (300	) \$ (251	) \$ (378 )
Other comprehensive gains (losses), net of tax before reclassifications	21	230	346	308
Amounts reclassified from accumulated other comprehensive income	-	-	(20	) -
Net other comprehensive gain (loss)	21	230	326	308
End of period	\$ 75	\$ (70	) \$ 75	\$ (70 )

**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 and 2015, there were 20,911 and 87,436 options, respectively, 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. The Company has not granted any stock options since 2007 and all options outstanding at September 30, 2016 were anti-dilutive. Unvested restricted stock is excluded from the calculation of basic earnings per share. At September 30, 2016 and 2015 there were 47,881 and 37,048 unvested shares of restricted stock.

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		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Net Income	\$ 1,963	\$ 1,283	\$ 5,309	\$ 4,815
Less: dividends paid and accrued on preferred stock	-	-	-	(23 )
Net income available to common shareholders	\$ 1,963	\$ 1,283	\$ 5,309	\$ 4,792
Average number of common shares outstanding	4,590,664	4,646,702	4,591,926	4,651,383
Dilutive effect of common stock equivalents	31,915	37,048	29,702	37,048
Average number of shares used to calculate diluted EPS	4,622,579	4,683,750	4,621,628	4,688,431

#### 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 \$80,000 and \$240,000 for the three and nine months ended September 30, 2016 and \$61,000 and \$182,000 for the three and nine months ended September 30, 2015. Stock-based compensation expense consisted of the vesting of grants of restricted stock.

All outstanding options are fully vested and the Company has not granted any stock options since 2007. All outstanding options as of September 30, 2016 expire on July 17, 2017. 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 following tables below summarize outstanding and exercisable options at September 30, 2016 and December 31, 2015.

(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	(300 )	27.70		
Outstanding at September 30, 2016	20,911	\$ 27.70	\$ -	0.8
Exercisable at September 30, 2016	20,911	\$ 27.70	\$ -	0.8

(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, 2015	87,436	\$ 23.60	\$ -	
Expired	(66,225)	22.29		
Outstanding at December 31, 2015	21,211	\$ 27.70	\$ -	1.5
Exercisable at December 31, 2015	21,211	\$ 27.70	\$ -	1.5

Options outstanding are all currently exercisable and are summarized as follows:

Shares Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
September 30, 2016 20,911	less than 1 year	\$ 27.70

The aggregate intrinsic value of outstanding stock options and exercisable stock options was \$0 at September 30, 2016 and December 31, 2015, respectively because all options outstanding were anti-dilutive.

The Company granted restricted stock and stock units in accordance with the Plan. The vesting period for outstanding granted restricted stock is between three and five years. As of September 30, 2016, unrecognized stock compensation expense was \$1.1 million. The following tables summarize the unvested restricted stock awards outstanding at September 30, 2016 and December 31, 2015, respectively.

	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 September 30, 2016 47,881 \$ 20.41

	Restricted Stock Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2015	29,472	\$20.83
Granted	28,040	18.63
Vested	(20,464 )	19.62
Nonvested at December 31, 2015	37,048	\$ 19.83

**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
	2016	2015	December 31, 2015
(dollars in thousands)			
Balance at beginning of year	\$ 9,449	\$ 5,883	\$ 5,883
Additions of underlying property	3,120	1,946	5,436
Disposals of underlying property	(3,583 )	(951 )	(1,206 )
Valuation allowance	(366 )	(447 )	(664 )
Balance at end of period	\$ 8,620	\$ 6,431	\$ 9,449

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 commercial office building was taken into OREO at fair value of the loan during the three months ended March 31, 2016 and had a ratified contract for its sale. That contract was voided during the second quarter of 2016. The Company plans to manage the property until its sale and will recognize miscellaneous rental income during the ownership and management of the property. During the nine months ended September 30, 2015, additions of \$1.9 million consisted of \$784,000 for five residential properties, \$372,000 for three residential lots and \$790,000 for commercial buildings.

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 was transferred from OREO to loans during the second quarter of 2015. The transaction qualified for full accrual sales treatment under ASC Topic 360-20-40 “Property Plant and Equipment – Derecognition”. The Company disposed of three residential properties and three finished residential lots at a loss of \$20,000 for the nine months ended September 30, 2015.

Additions to the valuation allowances of \$366,000 and \$447,000 were taken to adjust properties to current appraised values for the nine months ended September 30, 2016 and 2015, 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 include the following.



(dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Valuation allowance	\$ 104	\$ 73	\$ 366	\$ 447
Operating expenses	99	56	243	235
	\$ 203	\$ 129	\$ 609	\$ 682

**NOTE 10 – SECURITIES**

(dollars in thousands)	September 30, 2016			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Securities available for sale (AFS)				
Asset-backed securities issued by GSEs and U.S. Agencies				
Residential Mortgage Backed Securities ("MBS")	\$2,473	\$ 28	\$ -	\$ 2,501
Residential Collateralized Mortgage Obligations ("CMOs")	31,386	98	141	31,343
U.S. Agency	5,506	-	27	5,479
Corporate equity securities	37	-	-	37
Bond mutual funds	4,359	166	-	4,525
Total securities available for sale	\$43,761	\$ 292	\$ 168	\$ 43,885
Securities held to maturity (HTM)				
Asset-backed securities issued by GSEs and U.S. Agencies				
Residential MBS	\$34,092	\$ 1,202	\$ -	\$ 35,294
Residential CMOs	61,711	561	63	62,209
U.S. Agency	2,370	3	4	2,369
Asset-backed securities issued by Others:				
Residential CMOs	931	-	85	846
Total debt securities held to maturity	99,104	1,766	152	100,718
Callable GSE Agency Bonds	3,002	-	-	3,002
U.S. government obligations	850	-	-	850
Total securities held to maturity	\$102,956	\$ 1,766	\$ 152	\$ 104,570

(dollars in thousands)	December 31, 2015			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Securities available for sale (AFS)				
Asset-backed securities issued by GSEs				
Residential MBS	\$22	\$ 4	\$ -	\$ 26
Residential CMOs	31,182	39	557	30,664
Corporate equity securities	37	2	-	39
Bond mutual funds	4,289	98	-	4,387
Total securities available for sale	\$35,530	\$ 143	\$ 557	\$ 35,116
Securities held to maturity (HTM)				

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Asset-backed securities issued by GSEs				
Residential MBS	\$34,085	\$ 552	\$ 242	\$34,395
Residential CMOs	73,492	278	599	73,171
Asset-backed securities issued by Others:				
Residential CMOs	1,093	-	100	993
Total debt securities held to maturity	108,670	830	941	108,559
U.S. government obligations	750	-	-	750
Total securities held to maturity	\$109,420	\$ 830	\$ 941	\$109,309

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At September 30, 2016, certain asset-backed securities with an amortized cost of \$34.1 million were pledged to secure certain customer deposits. At September 30, 2016, asset-backed securities with an amortized cost of \$1.7 million were pledged as collateral for advances from the Federal Home Loan Bank (“FHLB”) of Atlanta.

At September 30, 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 4.14 years and average duration of 3.84 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 4.17 years and average duration of 3.84 years and are guaranteed by their issuer as to credit risk.

At December 31, 2015, certain asset-backed securities with an amortized cost of \$21.4 million were pledged to secure certain deposits. At December 31, 2015, asset-backed securities with an amortized cost of \$1.9 million were pledged as collateral for advances from the Federal Home Loan Bank (“FHLB”) of Atlanta.

At December 31, 2015, 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 4.39 years and average duration of 4.04 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 5.07 years and average duration of 4.58 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. Management believes that the losses are the result of general perceptions of safety and creditworthiness of the entire sector and a general disruption of orderly markets in the asset class.

Management has the ability and intent to hold the HTM securities with unrealized losses until they mature, at which time the Company will receive full value for the securities. Because management’s 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 during for the six months ended September 30, 2016 and the year ended December 31, 2015.

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. During the nine months ended September 30, 2015, the Company sold one HTM security with a carrying value of \$68,000 and recognized a loss of \$1,000.

The sale of HTM securities was 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, 2016 were as follows:

September 30, 2016	Less Than 12		More Than 12		Total	
(dollars in thousands)	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
	Value	Loss	Value	Loss	Value	Losses
Asset-backed securities issued by GSEs and U.S. Agencies	\$ 7,406	\$ 43	\$ 12,781	\$ 125	\$ 20,187	\$ 168

At September 30, 2016, the AFS investment portfolio had an estimated fair value of \$43.9 million, of which \$20.2 million of the securities had some unrealized losses from their amortized cost. The securities with unrealized losses were CMOs issued by GSEs and Small Business Administration bonds.

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 \$168,000 of the portfolio amortized cost of \$39.4 million. AFS asset-backed securities issued by GSEs and U.S. Agencies with unrealized losses had an average life of 4.19 years and an average duration of 3.87 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, 2015 were as follows:

December 31, 2015  (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	\$4,658	\$ 28	\$17,344	\$ 529	\$22,002

At December 31, 2015, the AFS investment portfolio had an estimated fair value of \$35.1 million, of which \$22.0 million of the securities had some unrealized losses from their amortized cost. The securities with unrealized losses were CMOs issued by GSEs.

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 asset-backed securities issued by GSEs were \$557,000 of the portfolio amortized cost of \$31.2 million. AFS asset-backed securities issued by GSEs and U.S. Agencies with unrealized losses had an average life of 4.45 years and an average duration of 4.04 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, 2016 were as follows:

September 30, 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	1,363	4	13,435	63	14,798	67
Asset-backed securities issued by Others	-	-	846	85	846	85
	\$1,363	\$ 4	\$14,281	\$ 148	\$15,644	\$ 152

At September 30, 2016, the HTM investment portfolio had an estimated fair value of \$104.6 million, of which \$15.6 million of the securities had some unrealized losses from their amortized cost. Of these securities, \$14.8 million were asset-backed securities issued by GSEs and U.S. Agencies. The remaining \$846,000 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 \$67,000 of the portfolio amortized cost of \$102.0 million. The securities with unrealized losses had an average life of 3.67 years and an average duration of 3.49 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 \$85,000 of the portfolio amortized cost of \$931,000. HTM asset-backed securities issued by others with unrealized losses have an average life of 3.96 years and an average duration of 3.14 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, 2015 were as follows:

December 31, 2015 (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	\$36,337	\$ 346	\$16,431	\$ 495	\$52,768	\$ 841
Asset-backed securities issued by Others	-	-	992	100	992	100
	\$36,337	\$ 346	\$17,423	\$ 595	\$53,760	\$ 941

At December 31, 2015, the HTM investment portfolio had an estimated fair value of \$109.3 million, of which \$53.8 million of the securities had some unrealized losses from their amortized cost. Of these securities, \$52.8 million were asset-backed securities issued by GSEs and the remaining \$992,000 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 asset-backed securities issued by GSEs were \$841,000 of the portfolio amortized cost of \$107.6 million. HTM asset-backed securities issued by GSEs and U.S. Agencies with unrealized losses had an average life of 5.42 years and an average duration of 4.78 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 \$100,000 of the portfolio amortized cost of \$1.1 million. HTM asset-backed securities issued by others with unrealized losses have an average life of 4.04 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, 2016 and December 31, 2015 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, 2016		December 31, 2015	
Credit Rating	Amount	Credit Rating	Amount
(dollars in thousands)			
AAA	\$141,347	AAA	\$138,267
BB	435	BB	518
B+	497	B+	-
CCC+	-	CCC+	575
Total	\$142,279	Total	\$139,360

**NOTE 11 – LOANS**

Loans consist of the following:

(dollars in thousands)	September 30, 2016	%	December 31, 2015	%
Commercial real estate	\$ 625,504	59.51 %	\$ 538,888	58.64 %
Residential first mortgages	167,306	15.91 %	131,401	14.30 %
Residential rentals	99,288	9.44 %	93,157	10.14 %
Construction and land development	35,475	3.37 %	36,189	3.94 %
Home equity and second mortgages	21,458	2.04 %	21,716	2.36 %
Commercial loans	67,334	6.40 %	67,246	7.32 %
Consumer loans	422	0.04 %	366	0.04 %
Commercial equipment	34,632	3.29 %	29,931	3.26 %
	1,051,419	100.00 %	918,894	100.00 %
Less:				
Deferred loan fees and premiums	(154	) -0.01 %	1,154	0.13 %
Allowance for loan losses	9,663	0.92 %	8,540	0.93 %
	9,509		9,694	
	\$ 1,041,910		\$ 909,200	

At September 30, 2016 and December 31, 2015, the Bank's allowance for loan losses totaled \$9.7 million and \$8.5 million, respectively or 0.92% and 0.93%, 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 \$2.6 million and \$2.6 million at September 30, 2016 and December 31, 2015, respectively. These were offset by net deferred premiums paid for the purchase of residential first mortgages and deferred costs of \$2.8 million and \$1.4 million, respectively, at September 30, 2016 and December 31, 2015.

The Company separated residential rentals into a new loan portfolio segment beginning in the second quarter of 2016. Residential rentals include income producing properties secured by 1-4 family units and apartment buildings. The Company's decision to segregate the residential rental portfolio for financial reporting and valuation purposes was based on the growth and size of the portfolio and risk characteristics unique to residential rental properties.

***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 8.6% and 6.1% of the CRE portfolio at September 30, 2016 and December 31, 2015, 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.

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 \$41.4 million or 3.9% of total gross loans of \$1.1 billion at September 30, 2016 compared to \$18.9 million or 2.1% of gross loans of \$918.9 million at December 31, 2015.

### *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, 2016 and December 31, 2015, \$83.3 million and \$80.8 million, respectively, were 1-4 family units and \$16.0 million and \$12.4 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.

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 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. 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, 2016 and December 31, 2015 were as follows:

(dollars in thousands)	September 30, 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	\$2,113	7	\$ -	-	\$ 2,113	7
Residential first mortgages	371	2	-	-	371	2
Residential rentals	591	4	-	-	591	4
Construction and land development	3,611	3	-	-	3,611	3
Home equity and second mortgages	17	1	-	-	17	1
Commercial loans	391	4	677	2	1,068	6
Commercial equipment	684	5	-	-	684	5
	\$7,778	26	\$ 677	2	\$ 8,455	28

  

(dollars in thousands)	December 31, 2015					
	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	\$2,875	7	\$ -	-	\$ 2,875	7
Residential first mortgages	1,948	7	-	-	1,948	7
Residential rentals	605	4	-	-	605	4
Construction and land development	3,555	3	-	-	3,555	3
Home equity and second mortgages	48	3	-	-	48	3
Commercial loans	1,361	8	693	2	2,054	10
Commercial equipment	348	4	-	-	348	4
	\$10,740	36	\$ 693	2	\$ 11,433	38

Non-accrual loans (90 days or greater delinquent and non-accrual only loans) decreased \$3.0 million from \$11.4 million or 1.24% of total loans at December 31, 2015 to \$8.5 million or 0.80% of total loans at September 30, 2016. 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.

The Company had 28 non-accrual loans at September 30, 2016 compared to 38 non-accrual loans at December 31, 2015. Non-accrual loans at September 30, 2016 included \$7.0 million, or 83% of non-accrual loans, attributed to 16 loans representing six customer relationships classified as substandard. Non-accrual loans at December 31, 2015 included \$8.1 million, or 71% of non-accrual loans, attributed to 19 loans representing six customer relationships classified as substandard. Of these loans at September 30, 2016 and December 31, 2015, \$3.6 million and \$3.8 million, respectively, represented a residential development project. During the second quarter of 2014, the Company deferred the collection of principal and interest on this project. The project is currently being continued with the support of non-bank investment, which has been used for vertical construction that has significantly improved the collateral value and the viability of the project. The loans remain classified as troubled debt restructures (“TDRs”) and non-accrual. In addition, at September 30, 2016 and December 31, 2015, the Company had three TDR loans totaling \$1.6 million and \$1.7 million, respectively, classified as non-accrual. These loans are classified solely as non-accrual loans for the calculation of financial ratios.

Non-accrual loans on which the recognition of interest has been discontinued, which did not have a specific allowance for impairment, amounted to \$4.5 million and \$10.5 million at September 30, 2016 and December 31, 2015, respectively. Interest due but not recognized on these balances September 30, 2016 and December 31, 2015 was \$318,000 and \$953,000, respectively. Non-accrual loans with a specific allowance for impairment on which the recognition of interest has been discontinued amounted to \$4.0 million and \$902,000 at September 30, 2016 and December 31, 2015, respectively. Interest due but not recognized on these balances at September 30, 2016 and December 31, 2015 was \$683,000 and \$34,000, respectively.



Past due loans as of September 30, 2016 and December 31, 2015 were as follows:

(dollars in thousands)	September 30, 2016					Total Past Due	Total Loan Receivables	Loans > 90 Days and Accruing
	Current	31-60 Days	61-89 Days	90 or Greater Days				
Commercial real estate	\$623,239	\$ -	\$ 152	\$ 2,113	\$ 2,265	\$ 625,504	\$ -	
Residential first mortgages	166,557	-	378	371	749	167,306	-	
Residential rentals	98,622	-	75	591	666	99,288	-	
Construction and land dev.	31,864	-	-	3,611	3,611	35,475	-	
Home equity and second mtg.	21,369	9	63	17	89	21,458	-	
Commercial loans	66,943	-	-	391	391	67,334	-	
Consumer loans	420	2	-	-	2	422	-	
Commercial equipment	33,904	44	-	684	728	34,632	-	
Total	\$1,042,918	\$ 55	\$ 668	\$ 7,778	\$ 8,501	\$ 1,051,419	\$ -	

  

(dollars in thousands)	December 31, 2015					Total Past Due	Total Loan Receivables	Loans > 90 Days and Accruing
	Current	31-60 Days	61-89 Days	90 or Greater Days				
Commercial real estate	\$536,013	\$ -	\$ -	\$ 2,875	\$ 2,875	\$ 538,888	\$ -	
Residential first mortgages	129,154	-	299	1,948	2,247	131,401	-	
Residential rentals	92,552	-	-	605	605	93,157	-	
Construction and land dev.	32,634	-	-	3,555	3,555	36,189	-	
Home equity and second mtg.	21,603	65	-	48	113	21,716	-	
Commercial loans	65,747	-	138	1,361	1,499	67,246	-	
Consumer loans	365	-	1	-	1	366	-	
Commercial equipment	29,138	152	293	348	793	29,931	-	
Total	\$907,206	\$ 217	\$ 731	\$ 10,740	\$ 11,688	\$ 918,894	\$ -	

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

Impaired loans, including TDRs, at September 30, 2016 and 2015 and at December 31, 2015 were as follows:

(dollars in thousands)	September 30, 2016					Related Allowance	Quarter Average Recorded Investment	Quarter Interest Income Recognized	YTD Average Recorded Investment	YTD Interest Income Recognized
	Unpaid Contractual Principal Balance	Recorded Investment No Allowance	Recorded Investment With Allowance	Total Recorded Investment						
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	
<b>Total</b>	<b>\$36,812</b>	<b>\$ 29,402</b>	<b>\$ 6,828</b>	<b>\$ 36,230</b>	<b>\$ 1,256</b>	<b>\$ 36,509</b>	<b>\$ 342</b>	<b>\$ 36,739</b>	<b>\$ 949</b>	

(dollars in thousands)	December 31, 2015					Related Allowance	Average Recorded Investment	Interest Income Recognized
	Unpaid Contractual Principal Balance	Recorded Investment No Allowance	Recorded Investment With Allowance	Total Recorded Investment				
Commercial real estate	\$21,477	\$ 19,081	\$ 2,367	\$ 21,448	\$ 601	\$ 21,786	\$ 774	
Residential first mortgages	4,226	3,730	495	4,225	27	4,276	141	
Residential rentals	4,473	3,893	181	4,074	40	4,400	170	
Construction and land dev.	4,283	3,780	504	4,284	471	4,302	13	
Home equity and second mtg.	154	154	-	154	-	163	8	
Commercial loans	4,775	4,195	380	4,575	330	4,524	251	
Commercial equipment	518	338	139	477	139	491	9	
<b>Total</b>	<b>\$39,906</b>	<b>\$ 35,171</b>	<b>\$ 4,066</b>	<b>\$ 39,237</b>	<b>\$ 1,608</b>	<b>\$ 39,942</b>	<b>\$ 1,366</b>	

		September 30, 2015				Quarter	Quarter	YTD	YTD
(dollars in thousands)		Unpaid	Recorded	Total	Related	Average	Interest	Average	Interest
		Recorded	Investment	Recorded	Allowance	Recorded	Income	Recorded	Income
		Contractual	With	Investment		Investment	Recognized	Investment	Recognized
		Principal	Allowance	Investment		Recognized	Investment	Recognized	Investment
		No Allowance	With	Investment		Recognized	Investment	Recognized	Investment
		Balance	Allowance	Investment		Recognized	Investment	Recognized	Investment
Commercial real estate									