

COMMUNITY FINANCIAL CORP /MD/
Form 10-Q
August 08, 2017

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 June 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)

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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 x

As of July 28, 2017, the registrant had 4,649,302 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**

	June 30, 2017 (Unaudited)	December 31, 2016
(dollars in thousands, except per share amounts)		
Assets		
Cash and due from banks	\$ 14,982	\$ 9,948
Interest-bearing deposits with banks	1,338	1,315
Securities available for sale (AFS), at fair value	54,288	53,033
Securities held to maturity (HTM), at amortized cost	106,842	109,247
Federal Home Loan Bank (FHLB) stock - at cost	7,745	7,235
Loans receivable - net of allowance for loan losses of \$10,434 and \$9,860	1,132,429	1,079,519
Premises and equipment, net	22,042	22,205
Premises and equipment held for sale	-	345
Other real estate owned (OREO)	9,154	7,763
Accrued interest receivable	4,212	3,979
Investment in bank owned life insurance	29,011	28,625
Other assets	10,645	11,043
Total Assets	\$ 1,392,688	\$ 1,334,257
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Non-interest-bearing deposits	\$ 154,962	\$ 144,877
Interest-bearing deposits	932,844	893,948
Total deposits	1,087,806	1,038,825
Short-term borrowings	88,500	79,000
Long-term debt	65,529	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	6,560	11,447
Total Liabilities	1,283,395	1,229,831
Stockholders' Equity		
Common stock - par value \$.01; authorized - 15,000,000 shares; issued 4,648,199 and 4,633,868 shares, respectively	46	46
Additional paid in capital	47,847	47,377
Retained earnings	62,058	58,100

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Accumulated other comprehensive loss	(489)	(928)
Unearned ESOP shares	(169)	(169)
Total Stockholders' Equity	109,293		104,426	
Total Liabilities and Stockholders' Equity	\$ 1,392,688		\$ 1,334,257	

See notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

(dollars in thousands, except per share amounts)	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Interest and Dividend Income				
Loans, including fees	\$ 12,410	\$ 11,170	\$ 24,380	\$ 21,715
Interest and dividends on investment securities	973	752	1,919	1,515
Interest on deposits with banks	12	6	18	10
Total Interest and Dividend Income	13,395	11,928	26,317	23,240
Interest Expense				
Deposits	1,403	1,182	2,671	2,277
Short-term borrowings	283	49	430	87
Long-term debt	776	802	1,609	1,588
Total Interest Expense	2,462	2,033	4,710	3,952
Net Interest Income	10,933	9,895	21,607	19,288
Provision for loan losses	376	564	756	991
Net Interest Income After Provision For Loan Losses	10,557	9,331	20,851	18,297
Noninterest Income				
Loan appraisal, credit, and miscellaneous charges	9	102	56	163
Gain on sale of asset	47	4	47	4
Net gains (losses) on sale of OREO	9	(448)	36	(443)
Net gains on sale of investment securities	133	39	133	39
Income from bank owned life insurance	194	198	385	394
Service charges	660	882	1,270	1,470
Total Noninterest Income	1,052	777	1,927	1,627
Noninterest Expense				
Salary and employee benefits	4,198	4,197	8,511	8,349
Occupancy expense	658	636	1,311	1,225
Advertising	140	156	248	219
Data processing expense	634	580	1,211	1,134
Professional fees	598	380	935	805
Depreciation of furniture, fixtures, and equipment	204	206	403	402
Telephone communications	45	46	96	90
Office supplies	28	29	60	72
FDIC Insurance	161	184	327	427
OREO valuation allowance and expenses	145	105	340	406
Other	719	773	1,467	1,403
Total Noninterest Expense	7,530	7,292	14,909	14,532
Income before income taxes	4,079	2,816	7,869	5,392
Income tax expense	1,536	1,078	2,984	2,046

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Net Income	\$ 2,543	\$ 1,738	\$ 4,885	\$ 3,346
Earnings Per Common Share				
Basic	\$ 0.55	\$ 0.38	\$ 1.05	\$ 0.73
Diluted	\$ 0.55	\$ 0.38	\$ 1.05	\$ 0.72
Cash dividends paid per common share	\$ 0.10	\$ 0.10	\$ 0.20	\$ 0.20

See notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

(dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Net Income	\$ 2,543	\$ 1,738	\$ 4,885	\$ 3,346
Net unrealized holding gains arising during period, net of tax expense of \$206 and \$55, and \$289 and \$210, respectively.	318	86	445	325
Reclassification adjustment for gains included in net income, net of tax benefit of \$(3) and \$(10), and \$(3) and \$(10), respectively.	(6)	(20)	(6)	(20)
Comprehensive Income	\$ 2,855	\$ 1,804	\$ 5,324	\$ 3,651

See notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(dollars in thousands)	Six Months Ended June 30,	
	2017	2016
Cash Flows from Operating Activities		
Net income	\$ 4,885	\$ 3,346
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan losses	756	991
Depreciation and amortization	806	746
Net (gains) loss on the sale of OREO	(36)	) 443
Gains on sales of investment securities	(133)	) (39)
Gain on sale of asset	(47)	) (4)
Net amortization of premium/discount on investment securities	199	268
Increase in OREO valuation allowance	313	262
Increase in cash surrender of bank owned life insurance	(386)	) (394)
Increase in deferred income tax benefit	(616)	) (115)
Increase in accrued interest receivable	(233)	) (268)
Stock based compensation	284	160
Increase (decrease) in net deferred loan premiums	(456)	) 705
Decrease in accrued expenses and other liabilities	(4,887)	) (1,061)
Decrease (increase) in other assets	751	(467)
Net Cash Provided by Operating Activities	1,200	4,573
Cash Flows from Investing Activities		
Purchase of AFS investment securities	(7,653)	) (9,611)
Proceeds from redemption or principal payments of AFS investment securities	3,369	2,912
Purchase of HTM investment securities	(10,082)	) (9,963)
Proceeds from maturities or principal payments of HTM investment securities	8,905	10,688
Net (decrease) increase of FHLB and FRB stock	(510)	) 1,927
Loans originated or acquired	(182,660)	) (193,983)
Principal collected on loans	126,878	103,627
Purchase of premises and equipment	(638)	) (3,408)
Proceeds from sale of OREO	903	2,630
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
Net Cash Used in Investing Activities	(53,830)	) (89,992)

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

(dollars in thousands)	Six Months Ended June 30,	
	2017	2016
Cash Flows from Financing Activities		
Net increase in deposits	\$ 48,981	\$ 86,576
Proceeds from long-term debt	10,000	15,000
Payments of long-term debt	(10,030)	(5,029)
Net increase (decrease) in short term borrowings	9,500	(8,000)
Exercise of stock options	137	-
Dividends paid	(901)	(908)
Repurchase of common stock	-	(336)
Net Cash Provided by Financing Activities	57,687	87,303
Increase in Cash and Cash Equivalents	\$ 5,057	\$ 1,884
Cash and Cash Equivalents - January 1	11,263	11,139
Cash and Cash Equivalents - June 30	\$ 16,320	\$ 13,023
Supplemental Disclosures of Cash Flow Information		
Cash paid during the period for		
Interest	\$ 4,700	\$ 3,920
Income taxes	\$ 3,450	\$ 2,175
Supplemental Schedule of Non-Cash Operating Activities		
Issuance of common stock for payment of compensation	\$ 203	\$ 464
Transfer from loans to OREO	\$ 2,772	\$ 2,718
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 six months ended June 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.

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 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.

During the second quarter of 2017, the Company announced the closing of its Central Park Fredericksburg branch. The branch is expected to close in the third quarter of 2017. This location will continue to serve as a loan production office and the branch closure will not have a material effect on operations. Current branch employees will fill open positions in the Company.

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 six months ended June 30, 2017 and 2016. The Company's "other comprehensive" income was solely related to securities for the three and six months ended June 30, 2017 and 2016.

(dollars in thousands)	Three Months Ended June 30, 2017			Three Months Ended June 30, 2016		
	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
Net unrealized holding gains arising during period	\$ 524	\$ 206	\$ 318	\$ 141	\$ 55	\$ 86
Reclassification adjustments	(9)	(3)	(6)	(30)	(10)	(20)
Other comprehensive income	\$ 515	\$ 203	\$ 312	\$ 111	\$ 45	\$ 66

(dollars in thousands)	Six Months Ended June 30, 2017			Six Months Ended June, 2016		
	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
Net unrealized holding gains arising during period	\$ 734	\$ 289	\$ 445	\$ 535	\$ 210	\$ 325
Reclassification adjustments	(9)	(3)	(6)	(30)	(10)	(20)
Other comprehensive income	\$ 725	\$ 286	\$ 439	\$ 505	\$ 200	\$ 305

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

(dollars in thousands)	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses
Beginning of period	\$ (801)	\$ (12)	\$ (928)	\$ (251)
Other comprehensive gains, net of tax before reclassifications	318	86	445	325
Amounts reclassified from accumulated other comprehensive loss	(6)	(20)	(6)	(20)

Net other comprehensive income	312	66	439	305
End of period	\$ (489	) \$ 54	\$ (489	) \$ 54

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 June 30, 2017 and 2016, there were 0 and 21,111 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.

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 June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Net Income	\$2,543	\$1,738	\$4,885	\$3,346
Average number of common shares outstanding	4,632,911	4,590,444	4,630,647	4,592,563
Dilutive effect of common stock equivalents	2,572	27,350	3,073	28,636
Average number of shares used to calculate diluted EPS	4,635,483	4,617,794	4,633,720	4,621,199
Earnings Per Common Share				
Basic	\$0.55	\$0.38	\$1.05	\$0.73
Diluted	0.55	0.38	1.05	0.72

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 \$171,000 and \$284,000, respectively, for the three and six months ended June 30, 2017 and \$79,000 and \$160,000, respectively, for the three and six months ended June 30, 2016. 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 June 30, 2017 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 June 30, 2017 and 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	(13,181)	27.70	123	
Forfeited	(500)	27.70	-	
Outstanding at June 30, 2017	1,400	\$ 27.70	\$ 15	0.3
Exercisable at June 30, 2017	1,400	\$ 27.70	\$ 15	0.3

(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

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

Shares Outstanding June 30, 2017	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
1,400	less than 1 year	\$ 27.70

The aggregate intrinsic value of outstanding stock options and exercisable stock options was \$15,000 at June 30, 2017 and \$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 \$38.50 and \$29.00 per share at June 30, 2017 and December 31, 2016, respectively, and the exercise price multiplied by the number of options outstanding.

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 June 30, 2017 and December 31, 2016, unrecognized stock compensation expense was \$751,000 and \$810,000, respectively. The following tables summarize the unvested restricted stock awards outstanding at June 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	(20,271)	20.09
Cancelled	(86)	20.75
Nonvested at June 30, 2017	34,276	\$ 22.53

	Restricted Stock	
	Number	Weighted
	of	Average Grant
	Shares	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.

	Six Months Ended June 30,		Years Ended December 31,
(dollars in thousands)	2017	2016	2016
Balance at beginning of year	\$ 7,763	\$ 9,449	\$ 9,449
Additions of underlying property	2,772	2,718	3,120
Disposals of underlying property	(1,068)	(3,445)	(3,860)
Transfers to premises and equipment	-	-	(372)
Valuation allowance	(313)	(262)	(574)
Balance at end of period	\$ 9,154	\$ 8,460	\$ 7,763

During the six months ended June 30, 2017, additions of \$2.8 million to OREO were related to the foreclosure of a stalled residential development project. The Bank is working with a construction manager to stabilize and market the project. 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 six months ended June 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 six months ended June 30, 2016, additions of \$2.7 million consisted of \$577,000 for a residential property 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 \$443,000 for the six months ended June 30, 2016. Disposals for the six months ended June 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 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 \$742,000 and \$353,000 of impaired loans secured by residential real estate for which formal foreclosure proceedings were in process as of June 30, 2017 and December 31, 2016, respectively.

Additions to the valuation allowances of \$313,000 and \$262,000 were taken to adjust properties to current appraised values for the six months ended June 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 June 30,		Six Months Ended June 30,	
(dollars in thousands)	2017	2016	2017	2016
Valuation allowance	\$ 117	\$ 7	\$ 313	\$ 262
Operating expenses	28	98	27	144
	\$ 145	\$ 105	\$ 340	\$ 406

NOTE 10 – SECURITIES

	June 30, 2017			
	Amortized	Gross	Gross	Estimated
(dollars in thousands)	Cost	Unrealized	Unrealized	Fair Value
		Gains	Losses	
Securities available for sale (AFS)				
Asset-backed securities issued by GSEs and U.S. Agencies				
Residential Mortgage Backed Securities ("MBS")	\$6,229	\$ -	\$ 83	\$ 6,146
Residential Collateralized Mortgage Obligations ("CMOs")	34,185	16	595	33,606
U.S. Agency	10,213	-	198	10,015
Corporate equity securities	37	-	-	37
Bond mutual funds	4,432	52	-	4,484
Total securities available for sale	\$55,096	\$ 68	\$ 876	\$ 54,288

Securities held to maturity (HTM)				
Asset-backed securities issued by GSEs and U.S. Agencies				
Residential MBS	\$30,612	\$ 413	\$ 74	\$ 30,951
Residential CMOs	60,500	190	449	60,241
U.S. Agency	8,970	7	102	8,875
Asset-backed securities issued by Others:				
Residential CMOs	740	-	62	678
Callable GSE Agency Bonds	5,020	10	-	5,030
U.S. government obligations	1,000	-	-	1,000
Total securities held to maturity	\$106,842	\$ 620	\$ 687	\$ 106,775

	December 31, 2016			
	Amortized	Gross	Gross	Estimated
(dollars in thousands)	Cost	Unrealized	Unrealized	Fair Value
		Gains	Losses	
Securities available for sale (AFS)				
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
Total securities available for sale	\$54,565	\$ 45	\$ 1,577	\$ 53,033

Securities held to maturity (HTM)				
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 June 30, 2017, securities with an amortized cost of \$25.4 million were pledged to secure certain customer deposits. At June 30, 2017, securities with an amortized cost of \$4.3 million were pledged as collateral for advances from the Federal Home Loan Bank ("FHLB") of Atlanta.

At June 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 4.57 years and average duration of 4.11 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 4.69 years and average duration of 4.20 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. We believe 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.

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 six months ended June 30, 2017 and the year ended December 31, 2016.

During the six months ended June 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 six months ended June 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 June 30, 2017 were as follows:

June 30, 2017	Less Than 12 Months		More Than 12 Months		Total	
(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	\$33,710	\$ 536	\$13,314	\$ 340	\$47,024	\$ 876

At June 30, 2017, the AFS investment portfolio had an estimated fair value of \$54.3 million, of which \$47.0 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 \$876,000 of the portfolio amortized cost of \$50.6 million. AFS asset-backed securities issued by GSEs and U.S. Agencies with unrealized losses had an average life of 4.60 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:

December 31, 2016	Less Than 12 Months		More Than 12 Months		Total	
(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 June 30, 2017 were as follows:

June 30, 2017 (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	55,262	504	6,003	121	61,265	625
Asset-backed securities issued by Others	-	-	678	62	678	62
	\$55,262	\$ 504	\$6,681	\$ 183	\$61,943	\$ 687

At June 30, 2017, the HTM investment portfolio had an estimated fair value of \$106.8 million, of which \$61.9 million of the securities had some unrealized losses from their amortized cost. Of these securities, \$61.3 million were asset-backed securities issued by GSEs and U.S. Agencies and \$678,000 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 \$625,000 of the portfolio amortized cost of \$100.1 million. The securities with unrealized losses had an average life of 4.56 years and an average duration of 4.11 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 \$62,000 of the portfolio amortized cost of \$740,000. HTM asset-backed securities issued by others with unrealized losses had an average life of 2.96 years and an average duration of 2.44 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	Less Than 12 Months		More Than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
(dollars in thousands)						
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 June 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.

June 30, 2017		December 31, 2016	
Credit Rating	Amount	Credit Rating	Amount
(dollars in thousands)			
AAA	\$155,869	AAA	\$156,947
BB	740	BB	411
B+	-	B+	472
Total	\$156,609	Total	\$157,830

NOTE 11 – LOANS

Loans consist of the following:

(dollars in thousands)	June 30, 2017	%		December 31, 2016	%
Commercial real estate	\$ 713,789	62.50 %	\$	667,105	61.25 %
Residential first mortgages	181,386	15.88 %		171,004	15.70 %
Residential rentals	103,361	9.05 %		101,897	9.36 %
Construction and land development	32,603	2.85 %		36,934	3.39 %
Home equity and second mortgages	20,847	1.83 %		21,399	1.97 %
Commercial loans	55,023	4.82 %		50,484	4.64 %
Consumer loans	412	0.04 %		422	0.04 %
Commercial equipment	34,589	3.03 %		39,737	3.65 %
	1,142,010	100.00 %		1,088,982	100.00 %
Less:					
Deferred loan fees and premiums	(853	) -0.07 %	(397	) -0.04 %	
Allowance for loan losses	10,434	0.91 %	9,860	0.91 %	
	9,581		9,463		
	\$ 1,132,429		\$	1,079,519	

At June 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 June 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 \$3.6 million and \$3.1 million, respectively, at June 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 5.9% and 9.3% of the CRE portfolio at June 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 six months ended June 30, 2017 and the years ended December 31, 2016, the Bank purchased residential first mortgages of \$19.0 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 \$59.6 million or 5.2% of total gross loans of \$1.14 billion at June 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 June 30, 2017 and December 31, 2016, \$85.8 million and \$84.9 million, respectively, were 1-4 family units and \$17.6 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 \$85.5 million or 7.5% of total gross loans of \$1.14 billion at June 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 June 30, 2017 and December 31, 2016 were as follows:

(dollars in thousands)	June 30, 2017		Non-accrual Only Loans	Number of Loans	Total Non-accrual Loans	Total Number of Loans
	90 or Greater Days Delinquent	Number of Loans				
Commercial real estate	\$2,015	7	\$ -	-	\$ 2,015	7
Residential first mortgages	288	3	-	-	288	3
Residential rentals	332	3	-	-	332	3
Construction and land development	252	1	-	-	252	1
Home equity and second mortgages	52	2	-	-	52	2
Commercial loans	376	3	660	2	1,036	5
Commercial equipment	467	3	-	-	467	3
	\$3,782	22	\$ 660	2	\$ 4,442	24

(dollars in thousands)	December 31, 2016		Non-accrual Only Loans	Number of Loans	Total Non-accrual Loans	Total Number of Loans
	90 or Greater Days Delinquent	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 \$3.9 million from \$8.4 million or 0.77% of total loans at December 31, 2016 to \$4.4 million or 0.39% of total loans at June 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.

Non-accrual loans at June 30, 2017 included \$3.1 million, or 71% of non-accrual loans, attributed to 11 loans representing five customer relationships. During the six months ended June 30, 2017 non-accrual loans decreased \$2.8

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. Non-accrual loans at December 31, 2016 included \$6.4 million, or 77% of non-accrual loans, attributed to 15 loans representing six customer relationships. Non-accrual loans included four troubled debt restructures (“TDRs”) totaling \$1.8 million at June 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.

Non-accrual loans on which the recognition of interest has been discontinued, which did not have a specific allowance for impairment, amounted to \$3.8 million and \$7.8 million at June 30, 2017 and December 31, 2016, respectively. Interest due but not recognized on these balances at June 30, 2017 and December 31, 2016 was \$183,000 and \$947,000, respectively. Non-accrual loans with a specific allowance for impairment on which the recognition of interest has been discontinued amounted to \$689,000 and \$575,000 at June 30, 2017 and December 31, 2016, respectively. Interest due but not recognized on these balances at June 30, 2017 and December 31, 2016 was \$80,000 and \$156,000, respectively.

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

(dollars in thousands)	June 30, 2017						
	Current	31-60 Days	61-89 Days	90 or Greater Days	Total Past Due	Total Loan Receivables	Loans > 90 Days and Accruing
Commercial real estate	\$711,317	\$ -	\$457	\$ 2,015	\$ 2,472	\$713,789	\$ -
Residential first mortgages	180,762	-	336	288	624	181,386	-
Residential rentals	102,945	-	84	332	416	103,361	-
Construction and land dev.	32,351	-	-	252	252	32,603	-
Home equity and second mtg.	20,657	-	138	52	190	20,847	-
Commercial loans	54,647	-	-	376	376	55,023	-
Consumer loans	412	-	-	-	-	412	-
Commercial equipment	34,056	39	27	467	533	34,589	-
Total	\$1,137,147	\$ 39	\$1,042	\$ 3,782	\$ 4,863	\$1,142,010	\$ -

(dollars in thousands)	December 31, 2016						
	Current	31-60 Days	61-89 Days	90 or Greater Days	Total Past Due	Total Loan Receivables	Loans > 90 Days and Accruing
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 June 30, 2017 and 2016 and at December 31, 2016 were as follows:

(dollars in thousands)	June 30, 2017								
	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Quarter Average Recorded Investment	Quarter Interest Income Recognized	YTD Average Recorded Investment	YTD Interest Income Recognized
Commercial real estate	\$20,277	\$ 13,079	\$ 6,987	\$ 20,066	\$ 693	\$ 20,186	\$ 198	\$ 20,274	\$ 417
Residential first mortgages	2,294	1,823	468	2,291	11	2,299	21	2,311	49
Residential rentals	2,758	2,286	400	2,686	23	2,693	27	2,731	56
Construction and land dev.	981	252	729	981	163	980	4	980	7
Home equity and second mtg.	109	109	-	109	-	110	1	111	2
Commercial loans	3,063	2,804	169	2,973	169	2,974	23	2,986	46
Commercial equipment	638	108	491	599	417	617	6	625	11
Total	\$30,120	\$ 20,461	\$ 9,244	\$ 29,705	\$ 1,476	\$ 29,859	\$ 280	\$ 30,018	\$ 588

(dollars in thousands)	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
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
Total	\$ 36,685	\$ 26,436	\$ 8,924	\$ 35,360	\$ 1,289	\$ 36,534	\$ 1,309

(dollars in thousands)	June 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	\$22,444	\$ 20,010	\$ 2,404	\$ 22,414	\$ 582	\$ 22,503	\$ 243	\$ 22,724	\$ 420
Residential first mortgages	2,957	2,472	485	2,957	20	2,982	23	2,990	51
Residential rentals	3,987	3,352	239	3,591	53	3,747	42	3,798	67
Construction and land dev.	4,443	3,939	431	4,370	398	4,317	4	4,264	7
Home equity and second mtg.	109	109	-	109	-	109	1	108	2
Commercial loans	4,551	4,222	5	4,227	5	4,237	36	4,238	69
Commercial equipment	839	623	193	816	165	828	5	840	11
Total	\$39,330	\$ 34,727	\$ 3,757	\$ 38,484	\$ 1,223	\$ 38,723	\$ 354	\$ 38,962	\$ 627

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

(dollars in thousands)	June 30, 2017		December 31, 2016	
	Dollars	Number of Loans	Dollars	Number of Loans
Commercial real estate	\$9,466	9	\$ 9,587	8
Residential first mortgages	537	2	545	2
Residential rentals	224	1	227	1
Construction and land development	981	3	3,777	4
Commercial loans	665	3	872	5
Commercial equipment	108	2	113	2
Total TDRs	\$11,981	20	\$ 15,121	22
Less: TDRs included in non-accrual loans	(1,753)	(4)	(4,673)	(6)
Total accrual TDR loans	\$10,228	16	\$ 10,448	16

TDRs decreased \$3.1 million from \$15.1 million at December 31, 2016 to \$12.0 million at June 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 \$728,000 on nine TDRs totaling \$5.8 million at June 30, 2017 and \$844,000 on nine TDRs totaling \$5.7 million at December 31, 2016. Interest income in the amount of \$181,000 and \$357,000 was recognized on outstanding TDR loans for the six months ended June 30, 2017 and the year ended December 31, 2016, respectively.

During the six months ended June 30, 2017, TDR disposals, which included payoffs and refinancing decreased by one loan of \$167,000 and TDR loan principal curtailment was \$177,000. In addition, TDRs declined by \$2.8 million in the three months ended June 30, 2017, due to the foreclosure of a stalled residential development project. There were no TDRs added during the six months ended June 30, 2017. One TDR loan was refinanced during the six months ended June 30, 2017 from a commercial loan to a commercial mortgage. This loan remains a TDR as of June 30, 2017. 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 six months ended June 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.

	June 30, 2017				
(dollars in thousands)	Beginning Balance	Charge-offs	Recoveries	Provisions	Ending Balance
Three Months Ended					
Commercial real estate	\$5,179	\$ -	\$ 4	\$ 902	\$6,085
Residential first mortgages	1,428	-	-	(128)	1,300
Residential rentals	354	(42)	-	23	335
Construction and land development	891	(25)	-	(146)	720
Home equity and second mortgages	76	(1)	-	37	112
Commercial loans	789	-	-	25	814
Consumer loans	5	-	-	-	5
Commercial equipment	1,387	-	13	(337)	1,063
	\$10,109	\$ (68)	\$ 17	\$ 376	\$10,434
Six Months Ended					
Commercial real estate	\$5,212	\$ -	\$ 9	\$ 864	\$6,085
Residential first mortgages	1,406	-	-	(106)	1,300
Residential rentals	362	(42)	-	15	335
Construction and land development	941	(25)	-	(196)	720
Home equity and second mortgages	138	(1)	-	(25)	112
Commercial loans	794	-	1	19	814
Consumer loans	3	(2)	-	4	5
Commercial equipment	1,004	(146)	24	181	1,063
	\$9,860	\$ (216)	\$ 34	\$ 756	\$10,434

(dollars in thousands)	June 30, 2016				
	Beginning Balance	Charge-offs	Recoveries	Provisions	Ending Balance
Three Months Ended					
Commercial real estate	\$3,838	\$ -	\$ 3	\$ 539	\$ 4,380
Residential first mortgages	591	-	-	344	935
Residential rentals	590	-	-	23	613
Construction and land development	1,129	-	-	(85)	1,044
Home equity and second mortgages	134	-	-	7	141
Commercial loans	1,046	(69)	8	(276)	709
Consumer loans	1	-	-	1	2
Commercial equipment	1,262	-	9	11	1,282
	\$8,591	\$ (69)	\$ 20	\$ 564	\$ 9,106
Six Months Ended					
Commercial real estate	\$3,465	\$ -	\$ 5	\$ 910	\$ 4,380
Residential first mortgages	584	-	-	351	935
Residential rentals	538	-	-	75	613
Construction and land development	1,103	(73)	1	13	1,044
Home equity and second mortgages	142	-	5	(6)	141
Commercial loans	1,477	(394)	11	(385)	709
Consumer loans	2	(1)	-	1	2
Commercial equipment	1,229	-	21	32	1,282
	\$8,540	\$ (468)	\$ 43	\$ 991	\$ 9,106

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

(dollars in thousands)	June 30, 2017			December 31, 2016			June 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
Loan Receivables:									
Commercial real estate	\$20,066	\$693,723	\$713,789	\$21,977	\$645,128	\$667,105	\$22,414	\$585,966	\$608,380
Residential first mortgages	2,291	179,095	181,386	2,413	168,591	171,004	2,957	145,181	148,138
Residential rentals	2,686	100,675	103,361	3,028	98,869	101,897	3,591	96,611	100,202
Construction and land development	981	31,622	32,603	3,777	33,157	36,934	4,370	31,190	35,560
Home equity and second mortgages	109	20,738	20,847	170	21,229	21,399	109	21,995	22,104
Commercial loans	2,973	52,050	55,023	3,204	47,280	50,484	4,227	52,940	57,167
Consumer loans	-	412	412	-	422	422	-	332	332
Commercial equipment	599	33,990	34,589	791	38,946	39,737	816	32,369	33,185
	\$29,705	\$1,112,305	\$1,142,010	\$35,360	\$1,053,622	\$1,088,982	\$38,484	\$966,584	\$1,005,068
Allowance for loan losses:									
Commercial real estate	\$693	\$5,392	\$6,085	\$806	\$4,406	\$5,212	\$582	\$3,798	\$4,380
Residential first mortgages	11	1,289	1,300	7	1,399	1,406	20	915	935
Residential rentals	23	312	335	36	326	362	53	560	613
Construction and land development	163	557	720	178	763	941	398	646	1,044
Home equity and second mortgages	-	112	112	-	138	138	-	141	141
Commercial loans	169	645	814	123	671	794	5	704	709
Consumer loans	-	5	5	-	3	3	-	2	2
Commercial equipment	417	646	1,063	139	865	1,004	165	1,117	1,282
	\$1,476	\$8,958	\$10,434	\$1,289	\$8,571	\$9,860	\$1,223	\$7,883	\$9,106

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 June 30, 2017 and December 31, 2016 were as follows:

Credit Risk Profile by Internally Assigned Grade

	Commercial Real Estate		Construction and Land Dev.		Residential Rentals	
(dollars in thousands)	6/30/2017	12/31/2016	6/30/2017	12/31/2016	6/30/2017	12/31/2016
Unrated	\$ 53,423	\$ 51,503	\$ 1,820	\$ 1,632	\$ 26,256	\$ 25,563
Pass	639,970	594,768	29,801	31,525	76,063	74,989
Special mention	1,019	-	-	-	-	-
Substandard	19,377	20,834	982	3,777	1,042	1,345
Doubtful	-	-	-	-	-	-
Loss	-	-	-	-	-	-
Total	\$ 713,789	\$ 667,105	\$ 32,603	\$ 36,934	\$ 103,361	\$ 101,897

	Commercial Loans		Commercial Equipment		Total	Commercial Portfolios
(dollars in thousands)	6/30/2017	12/31/2016	6/30/2017	12/31/2016	6/30/2017	12/31/2016
Unrated	\$ 11,586	\$ 11,266	\$ 10,068	\$ 11,769	\$ 103,153	\$ 101,733
Pass	40,503	36,221	24,030	27,290	810,367	764,793
Special mention	-	-	-	-	1,019	-
Substandard	2,934	2,997	491	541	24,826	29,494
Doubtful	-	-	-	137	-	137
Loss	-	-	-	-	-	-
Total	\$ 55,023	\$ 50,484	\$ 34,589	\$ 39,737	\$ 939,365	\$ 896,157

Credit Risk Profile Based on Payment Activity

	Residential First Mortgages		Home Equity and Second Mtg.		Consumer Loans	
(dollars in thousands)	6/30/2017	12/31/2016	6/30/2017	12/31/2016	6/30/2017	12/31/2016
Performing	\$ 181,098	\$ 170,381	\$ 20,795	\$ 21,338	\$ 412	\$ 422
Nonperforming	288	623	52	61	-	-
Total	\$ 181,386	\$ 171,004	\$ 20,847	\$ 21,399	\$ 412	\$ 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 June 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.

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	
	June 30, 2017	December 31, 2016	June 30, 2017	December 31, 2016
Common Equity	\$ 109,293	\$ 104,426	\$ 138,385	\$ 136,109
AOCI Losses	489	928	489	928
Common Equity Tier 1 C				