

FIRST BANCORP /NC/
Form 10-K
March 17, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2013

Commission File Number 0-15572

FIRST BANCORP

(Exact Name of Registrant as Specified in its Charter)

North Carolina
(State of Incorporation) 56-1421916
(I.R.S. Employer Identification Number)

300 SW Broad Street, Southern Pines, North Carolina 28387
(Address of Principal Executive Offices) (Zip Code)
Registrant's telephone number, including area code: (910) 246-2500

Securities Registered Pursuant to Section 12(b) of the Act:

Title of each class Name of each exchange on which registered

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Common Stock, No Par Value The Nasdaq Global Select Market

Securities Registered Pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. YES NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934. YES NO

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 Website, 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to the Form 10-K.

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer 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

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The aggregate market value of the Common Stock, no par value, held by non-affiliates of the registrant, based on the closing price of the Common Stock as of June 30, 2013 as reported by The NASDAQ Global Select Market, was approximately \$253,572,158.

The number of shares of the registrant's Common Stock outstanding on February 28, 2014 was 19,679,659.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement to be filed pursuant to Regulation 14A are incorporated herein by reference into Part III.

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*definitive Proxy Statement for the 2014 Annual Meeting of Shareholders to be filed with the Securities and
Exchange Commission on or before April 30, 2014.

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FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995, which statements are inherently subject to risks and uncertainties. Forward-looking statements are statements that include projections, predictions, expectations or beliefs about future events or results or otherwise are not statements of historical fact. Further, forward-looking statements are intended to speak only as of the date made. Such statements are often characterized by the use of qualifying words (and their derivatives) such as “expect,” “believe,” “estimate,” “plan,” “project,” or other statements concerning our opinions or judgment about future events. Our actual results may differ materially from those anticipated in any forward-looking statements, as they will depend on many factors about which we are unsure, including many factors which are beyond our control. Factors that could influence the accuracy of such forward-looking statements include, but are not limited to, the financial success or changing strategies of our customers, our level of success in integrating acquisitions, actions of government regulators, the level of market interest rates, and general economic conditions. For additional information about factors that could affect the matters discussed in this paragraph, see the “Risk Factors” section in Item 1A of this report.

PART I

Item 1. Business

General Description

First Bancorp (the “Company”) is a bank holding company. Our principal activity is the ownership and operation of First Bank (the “Bank”), a state-chartered bank with its main office in Southern Pines, North Carolina. The Company is also the parent to a series of statutory business trusts organized under the laws of the State of Delaware that were created for the purpose of issuing trust preferred debt securities. Our outstanding debt associated with these trusts was \$46.4 million at December 31, 2013 and 2012.

The Company was incorporated in North Carolina on December 8, 1983, as Montgomery Bancorp, for the purpose of acquiring 100% of the outstanding common stock of the Bank through a stock-for-stock exchange. On December 31, 1986, the Company changed its name to First Bancorp to conform its name to the name of the Bank, which had changed its name from Bank of Montgomery to First Bank in 1985.

The Bank was organized in 1934 and began banking operations in 1935 as the Bank of Montgomery, named for the county in which it operated. Until September 2013, the Bank’s main office was in Troy, North Carolina, located in the

center of Montgomery County. In September 2013, the Company and the Bank moved their main offices approximately 45 miles to Southern Pines, North Carolina, in Moore County. As of December 31, 2013, we conducted business from 96 branches covering a geographical area from Florence, South Carolina to the southeast, to Wilmington, North Carolina to the east, to Kill Devil Hills, North Carolina to the northeast, to Salem, Virginia to the north, to Abingdon, Virginia to the northwest, and to Asheville, North Carolina to the west. We also have loan production offices in Charlotte, Greenville, and Fayetteville, all in North Carolina. Of the Bank's 96 branches, 81 branches are in North Carolina, seven branches are in South Carolina and eight branches are in Virginia (where we operate under the name "First Bank of Virginia"). Ranked by assets, the Bank was the fifth largest bank headquartered in North Carolina as of December 31, 2013.

On June 19, 2009, we acquired substantially all of the assets and liabilities of Cooperative Bank, which had been closed earlier that day by regulatory authorities. Cooperative Bank operated through twenty-four branches located primarily in the coastal region of North Carolina. In connection with the acquisition, we assumed assets with a book value of \$959 million, including \$829 million in loans and \$706 million in deposits. The loans and foreclosed real estate purchased in the acquisition are covered by loss share agreements between the Federal Deposit Insurance Corporation (FDIC) and First Bank which affords the Bank significant loss protection. We recorded a gain of \$67.9 million as a result of this acquisition. Additional information regarding this transaction is contained in the Company's 2009 Annual Report on Form 10-K.

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On January 21, 2011, we acquired substantially all of the assets and liabilities of The Bank of Asheville, which had been closed earlier that day by regulatory authorities. The Bank of Asheville operated through five branches located in or near Asheville, North Carolina. In connection with the acquisition, we assumed assets with a book value of \$190 million, including \$154 million in loans and \$192 million in deposits. Substantially all of the acquired loans and foreclosed real estate purchased in the acquisition are covered by loss share agreements with the FDIC, which affords the Bank significant loss protection. We recorded a gain of \$10.2 million as a result of this acquisition. Additional information regarding this transaction is also contained in Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 2 to the consolidated financial statements.

As of December 31, 2013, the Bank had two wholly owned subsidiaries, First Bank Insurance Services, Inc. ("First Bank Insurance") and First Troy SPE, LLC. First Bank Insurance's primary business activity is the placement of property and casualty insurance coverage. First Troy SPE, LLC, which was organized in December 2009, is a holding entity for certain foreclosed properties.

Our principal executive offices are located at 300 SW Broad Street, Southern Pines, North Carolina, 28387, and our telephone number is (910) 246-2500. Unless the context requires otherwise, references to the "Company," "we," "our," or "us" in this annual report on Form 10-K shall mean collectively First Bancorp and its consolidated subsidiaries.

General Business

We engage in a full range of banking activities, with the acceptance of deposits and the making of loans being our most basic activities. We offer deposit products such as checking, savings, and money market accounts, as well as time deposits, including various types of certificates of deposits (CDs) and individual retirement accounts (IRAs). We provide loans for a wide range of consumer and commercial purposes, including loans for business, agriculture, real estate, personal uses, home improvement and automobiles. We also offer credit cards, debit cards, letters of credit, safe deposit box rentals and electronic funds transfer services, including wire transfers. In addition, we offer internet banking, mobile banking, cash management and bank-by-phone capabilities to our customers, and are affiliated with ATM networks that give our customers access to 67,000 ATMs, with no surcharge fee. For our business customers, we offer remote deposit capture, which provides them with a method to electronically transmit checks received from customers into their bank account without having to visit a branch. We are a member of the Certificate of Deposit Account Registry Service (CDARS), which gives our customers the ability to obtain FDIC insurance on deposits of up to \$50 million, while continuing to work directly with their local First Bank branch.

Because the majority of our customers are individuals and small to medium-sized businesses located in the counties we serve, management does not believe that the loss of a single customer or group of customers would have a material adverse impact on the Bank. There are no seasonal factors that tend to have any material effect on the Bank's business, and we do not rely on foreign sources of funds or income. Because we operate primarily within North Carolina, southwestern Virginia and northeastern South Carolina, the economic conditions of these areas could have a material impact on the Company. See additional discussion below in the section entitled "Territory Served and Competition."

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Beginning in 1999, First Bank Insurance began offering non-FDIC insured investment and insurance products, including mutual funds, annuities, long-term care insurance, life insurance, and company retirement plans, as well as financial planning services (the “investments division”). In May 2001, First Bank Insurance added to its product line when it acquired two insurance agencies that specialized in the placement of property and casualty insurance. In October 2003, the “investments division” of First Bank Insurance became a part of the Bank. The primary activity of First Bank Insurance is now the placement of property and casualty insurance products. In February 2010, First Bank Insurance acquired The Insurance Center, Inc., a Troy-based property and casualty insurance agency with approximately 500 customers.

First Bancorp Capital Trust II and First Bancorp Capital Trust III were organized in December 2003 for the purpose of issuing \$20.6 million in debt securities (\$10.3 million was issued from each trust). These borrowings are due on January 23, 2034 and are also structured as trust preferred capital securities in order to qualify as regulatory capital. These debt securities are callable by the Company at par on any quarterly interest payment date beginning on January 23, 2009. The interest rate on these debt securities adjusts on a quarterly basis at a weighted average rate of three-month LIBOR plus 2.70%.

First Bancorp Capital Trust IV was organized in April 2006 for the purpose of issuing \$25.8 million in debt securities. These borrowings are due on June 15, 2036 and are also structured as trust preferred capital securities that qualify as regulatory capital. These debt securities are callable by the Company at par on any quarterly interest payment date beginning on June 15, 2011. The interest rate on these debt securities adjusts on a quarterly basis at a rate of three-month LIBOR plus 1.39%.

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Our headquarters are located in Southern Pines, Moore County, North Carolina, where we also have our highest concentration of deposits. At the end of 2013, we served primarily the south central region (sometimes called the Piedmont region), the central mountain region and the eastern coastal region of North Carolina, with additional operations in northeastern South Carolina and southwestern Virginia. The following table presents, for each county where we operated as of December 31, 2013, the number of bank branches operated by the Company within the county, the approximate amount of deposits with the Company in the county as of December 31, 2013, our approximate deposit market share at June 30, 2013, and the number of bank competitors located in the county at June 30, 2013.

County	Number of Branches	Deposits (in millions)	Market Share	Number of Competitors
Anson, NC	1	\$ 12	4.8%	4
Beaufort, NC	3	39	3.4%	7
Bladen, NC	1	23	8.6%	5
Brunswick, NC	4	94	6.0%	11
Buncombe, NC	4	81	2.2%	18
Cabarrus, NC	2	39	2.1%	11
Carteret, NC	2	24	2.3%	8
Chatham, NC	2	71	10.3%	10
Chesterfield, SC	2	45	14.4%	6
Columbus, NC	2	31	4.9%	5
Dare, NC	1	14	1.9%	10
Davidson, NC	3	91	3.8%	10
Dillon, SC	3	67	24.4%	3
Duplin, NC	3	117	23.0%	7
Florence, SC	2	32	1.6%	13
Guilford, NC	1	68	0.7%	20
Harnett, NC	3	109	12.9%	9
Iredell, NC	2	31	1.4%	20
Lee, NC	3	188	24.1%	9
Montgomery, NC	5	101	38.1%	4
Montgomery, VA	3	55	3.3%	13
Moore, NC	11	434	26.9%	10
New Hanover, NC	5	148	3.9%	17
Onslow, NC	2	44	4.1%	10
Pulaski, VA	1	26	6.6%	8
Randolph, NC	4	69	4.9%	13
Richmond, NC	2	43	10.5%	5
Roanoke, VA	1	5	0.3%	13
Robeson, NC	5	181	19.6%	9
Rockingham, NC	1	28	2.8%	11
Rowan, NC	2	52	3.6%	13
Scotland, NC	2	61	18.1%	6

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Stanly, NC	4	89	10.1%	6
Wake, NC	1	20	0.1%	29
Washington, VA	1	27	2.5%	16
Wythe, VA	2	75	13.4%	11
Brokered & Internet Deposits	—	117		
Total	96	\$ 2,751		

Our branches and facilities are primarily located in small communities whose economies are based primarily on services, manufacturing and light industry. Although our market is predominantly small communities and rural areas, the market area is not dependent on agriculture. Textiles, furniture, mobile homes, electronics, plastic and metal fabrication, forest products, food products, and chicken hatcheries are among the leading manufacturing industries in the trade area. Leading producers of lumber and rugs are located in Montgomery County, North Carolina. The Pinehurst area within Moore County, North Carolina, is a widely known golf resort and retirement area. The High Point, North Carolina, area is widely known for its furniture market. New Hanover and Brunswick Counties, located in the southeastern coastal region of North Carolina, are popular with tourists and have significant retirement populations. Buncombe County, located in the western region of North Carolina, is a highly diverse area with industries in manufacturing, service, and tourism. Additionally, several of the communities served by the Company are “bedroom” communities of large cities like Charlotte, Raleigh and Greensboro, while several branches are located in medium-sized cities such as Albemarle, Asheboro, High Point, Southern Pines and Sanford. We also have branches in small communities such as Bennett, Polkton, Vass, and Harmony.

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In addition to the branches shown above, in the second half of 2013, we established loan production offices in the markets of Charlotte, Greenville and Fayetteville, all in North Carolina. These are new, yet contiguous, markets to our branch footprint. We have experienced lenders working out of these offices and are expecting to achieve loan growth from these offices in 2014.

Approximately 16% of our deposit base is in Moore County. Accordingly, material changes in competition, the economy or population of Moore County could materially impact the Company. No other county comprises more than 10% of our deposit base.

We compete in our various market areas with, among others, several large interstate bank holding companies. These large competitors have substantially greater resources than us, including broader geographic markets, higher lending limits and the ability to make greater use of large-scale advertising and promotions. A significant number of interstate banking acquisitions have taken place in the past decade, thus further increasing the size and financial resources of some of our competitors, some of which are among the largest bank holding companies in the nation. In many of our markets, we also compete against smaller, local banks, many of which were formed within the past ten to fifteen years. Until recently, these new banks often focused on loan and deposit balance sheet growth, and not necessarily on earnings profitability, which often resulted in them offering more attractive terms on loans and deposits than we were willing to offer in light of our profitability goals. Due to capital considerations and increased regulatory costs, many of these banks are no longer seeking high balance sheet growth and are now seeking higher profitability. This has increased our ability to compete for loans. The pricing competition for deposits has also lessened. However, at any given time in many of our markets, there are smaller banks offering higher rates on deposits than we are willing to match. This has resulted in our bank losing the deposits of some price-sensitive customers, which has been primarily responsible for the declines in our time deposit accounts that are discussed below in Management's Discussion and Analysis of Financial Condition and Results of Operation. Moore County, which as noted above comprises a disproportionate share of our deposits, is a particularly competitive market, with at least ten other financial institutions having a physical presence within the county.

We compete not only against banking organizations, but also against a wide range of financial service providers, including federally and state-chartered savings and loan institutions, credit unions, investment and brokerage firms and small-loan or consumer finance companies. One of the credit unions in our market area is among the largest in the nation. Competition among financial institutions of all types is virtually unlimited with respect to legal ability and authority to provide most financial services. We also experience competition from internet banks, particularly in the area of time deposits.

Despite the competitive market, we believe we have certain advantages over our competition in the areas we serve. We are large enough to be able to more easily absorb higher costs being experienced in the banking industry, particularly regulatory costs and technology costs, than the smaller banks we compete with. But we attempt to maintain a banking culture associated with smaller banks – a culture that has a personal and local flavor that appeals to many retail and small business customers. Specifically, we seek to maintain a distinct local identity in each of the communities we serve and we actively sponsor and participate in local civic affairs. Most lending and other customer-related business decisions can be made without the delays often associated with larger institutions.

Additionally, employment of local managers and personnel in various offices and low turnover of personnel enable us to establish and maintain long-term relationships with individual and corporate customers.

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Lending Policy and Procedures

Conservative lending policies and procedures and appropriate underwriting standards are high priorities of the Bank. Loans are approved under our written loan policy, which provides that lending officers, principally branch managers, have authority to approve loans of various amounts up to \$350,000, with lending limits varying depending upon the experience of the lending officer and whether the loan is secured or unsecured. Each of our regional senior lending officers has discretion to approve secured loans of various principal amounts up to \$500,000. Loans up to \$4,000,000 are approved by a committee of the bank's regional credit officers. Loans above \$4,000,000 must be approved by the Executive Committee of the Company's board of directors.

A committee of our board of directors reviews and approves loans that exceed management's lending authority, loans to executive officers, directors, and their affiliates and, in certain instances, other types of loans. New credit extensions are reviewed daily by our senior management and at least monthly by our board committee.

We continually monitor our loan portfolio to identify areas of concern and to enable us to take corrective action. Lending officers and the board of directors meet periodically to review past due loans and portfolio quality, while assuring that the Bank is appropriately meeting the credit needs of the communities it serves. Individual lending officers are responsible for monitoring any changes in the financial status of borrowers and pursuing collection of early-stage past due amounts. For certain types of loans that exceed our established parameters of past due status, we engage a third-party firm to assist in collection efforts.

We also contract with an independent consulting firm to review new loan originations meeting certain criteria, as well as to assign risk grades to existing credits meeting certain thresholds. The consulting firm's observations, comments, and risk grades, including variances with the Bank's risk grades, are shared with the audit committee of the Company's board of directors and are considered by management in setting Bank policy, as well as in evaluating the adequacy of our allowance for loan losses. The consulting firm also provides training on a periodic basis to our lending officers to keep them updated on current developments in the marketplace. For additional information, see "Allowance for Loan Losses and Loan Loss Experience" under Item 7 below.

Investment Policy and Procedures

We have adopted an investment policy designed to maximize our income from funds not needed to meet loan demand, in a manner consistent with appropriate liquidity and risk objectives. Pursuant to this policy, we may invest in federal, state and municipal obligations, federal agency obligations, public housing authority bonds, industrial development revenue bonds, Federal Home Loan Bank bonds, Fannie Mae bonds, Government National Mortgage Association bonds, Freddie Mac bonds, Small Business Administration bonds, and, to a limited extent, corporate bonds. In making investment decisions, we do not solely rely on credit ratings to determine the credit-worthiness of an issuer of

securities, but we use credit ratings in conjunction with other information when performing due diligence prior to the purchase of a security. Securities rated below Moody's BAA or Standard and Poor's BBB generally will not be purchased. Securities rated below A are periodically reviewed for credit-worthiness. We may purchase non-rated municipal bonds only if such bonds are in our general market area and we determine these bonds have a credit risk no greater than the minimum ratings referred to above. Industrial development authority bonds, which normally are not rated, are purchased only if they are judged to possess a high degree of credit soundness to assure reasonably prompt sale at a fair value. We are also authorized by our board of directors to invest a portion of our securities portfolio in high quality corporate bonds, with the amount of such bonds not to exceed 15% of the entire securities portfolio. Prior to purchasing a corporate bond, the Company's management performs due diligence on the issuer of the bond, and the purchase is not made unless we believe that the purchase of the bond bears no more risk to the Company than would an unsecured loan to the same company.

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Our Chief Investment Officer implements the investment policy, monitors the investment portfolio, recommends portfolio strategies and reports to the Company's Investment Committee. The Investment Committee generally meets on a quarterly basis to review investment activity and to assess the overall position of the securities portfolio. The Investment Committee compares our securities portfolio with portfolios of other companies of comparable size. In addition, reports of all purchases, sales, issuer calls, net profits or losses and market appreciation or depreciation of the securities portfolio are reviewed by our board of directors. Once a quarter, our interest rate risk exposure is evaluated by our board of directors. Each year, the written investment policy is approved by the board of directors.

Mergers and Acquisitions

As part of our operations, we have pursued an acquisition strategy over the years to augment our internal growth. We regularly evaluate the potential acquisition of, or merger with, various financial institutions. Our acquisitions have generally fallen into one of three categories - 1) an acquisition of a financial institution or branch thereof within a market in which we operate, 2) an acquisition of a financial institution or branch thereof in a market contiguous or nearly contiguous to a market in which we operate, or 3) an acquisition of a company that has products or services that we do not currently offer. Historically, we have paid for our acquisitions with cash and/or common stock and any operating income or loss has been fully borne by the Company beginning on the closing date of the acquisition.

In 2009, FDIC-assisted acquisitions began to occur frequently as banking regulators closed problem banks. In FDIC-assisted transactions, the acquiring bank often does not pay any consideration for the failed bank, and in some cases receives cash from the FDIC as part of the transaction. In addition, the acquiring bank usually enters into one or more loss share agreements with the FDIC, which affords the acquiring bank significant loss protection. As discussed below, we completed FDIC-assisted transactions in 2009 and 2011.

We believe that we can enhance our earnings by pursuing these types of acquisition opportunities through any combination or all of the following: 1) achieving cost efficiencies, 2) enhancing the acquiree's earnings or gaining new customers by introducing a more successful banking model with more products and services to the acquiree's market base, 3) increasing customer satisfaction or gaining new customers by providing more locations for the convenience of customers, and 4) leveraging the customer base by offering new products and services. There is also the possibility, especially in a FDIC-assisted transaction, to record a gain on the acquisition date arising from the difference between the purchase price and the acquisition date fair value of the acquired assets and liabilities.

Since becoming a public company in 1987, we have completed numerous acquisitions in each of the three categories described above. We have completed several whole-bank traditional acquisitions in our existing and contiguous markets; we have purchased numerous bank branches from other banks (both in existing market areas and in contiguous/nearly contiguous markets) and we have acquired several insurance agencies, which has provided us with the ability to offer property and casualty insurance coverage.

In addition to the traditional acquisitions discussed above, in both 2009 and 2011 we acquired the operations of failed banks in FDIC-assisted transactions. On June 19, 2009, we acquired substantially all of the assets and liabilities of Cooperative Bank in a FDIC-assisted transaction. Cooperative Bank operated through twenty-one branches in North Carolina and three branches in South Carolina in the same markets in which the Bank was already operating, as well as in several new, mostly contiguous markets. In connection with the acquisition, the Bank assumed assets with a book value of \$959 million, including \$829 million in loans and \$706 million in deposits. See the Company's 2009 Annual Report on Form 10-K for more information on this acquisition.

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On January 21, 2011, we acquired substantially all of the assets and liabilities of The Bank of Asheville in a FDIC-assisted transaction. The Bank of Asheville operated through five branches in or near Asheville, North Carolina. This market was a new market for the Bank. In connection with the acquisition, the Bank assumed assets with a book value of \$190 million, including \$154 million in loans and \$192 million in deposits. See Note 2 to the consolidated financial statements for more information on this acquisition.

The following paragraphs describe the other acquisitions that we have completed in the past three years.

On August 24, 2012, we completed the purchase of a branch of Gateway Bank & Trust Co. located in Wilmington, North Carolina. We assumed the branch's \$9 million in deposits. No loans were acquired in this transaction. We also did not purchase the branch building, but instead transferred the acquired accounts to one of our nearby existing branches.

On March 22, 2013, we completed the purchase of two branches from Four Oaks Bank & Trust Company located in Southern Pines and Rockingham, North Carolina. We acquired \$57 million in deposits and \$16 million in loans in the acquisition. We purchased the Rockingham branch building, but did not purchase the Southern Pines branch building and instead transferred the acquired accounts to one of the Company's nearby existing branches.

There are many factors that we consider when evaluating how much to offer for potential acquisition candidates (including FDIC-assisted transactions) with a few of the more significant factors being projected impact on earnings per share, projected impact on capital, and projected impact on book value and tangible book value. Significant assumptions that affect this analysis include the estimated future earnings stream of the acquisition candidate, estimated credit and other losses to be incurred, the amount of cost efficiencies that can be realized, and the interest rate earned/lost on the cash received/paid. In addition to these primary factors, we also consider other factors including (but not limited to) marketplace acquisition statistics, location of the candidate in relation to our expansion strategy, market growth potential, management of the candidate, potential integration issues (including corporate culture), and the size of the acquisition candidate.

We plan to continue to evaluate acquisition opportunities that could potentially benefit the Company and its shareholders. These opportunities may include acquisitions that do not fit the categories discussed above.

For a further discussion of recent acquisition activity, see "Merger and Acquisition Activity" under Item 7 below.

Employees

As of December 31, 2013, we had 837 full-time and 36 part-time employees. We are not a party to any collective bargaining agreements, and we consider our employee relations to be good.

Supervision and Regulation

As a bank holding company, we are subject to supervision, examination and regulation by the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”) and the North Carolina Office of the Commissioner of Banks (the “Commissioner”). The Bank is subject to supervision and examination by the FDIC and the Commissioner. For additional information, see Note 16 to the consolidated financial statements.

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Supervision and Regulation of the Company

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended. The Company is also regulated by the Commissioner under the North Carolina Bank Holding Company Act of 1984.

A bank holding company is required to file quarterly reports and other information regarding its business operations and those of its subsidiaries with the Federal Reserve Board. It is also subject to examination by the Federal Reserve Board and is required to obtain Federal Reserve Board approval prior to making certain acquisitions of other institutions or voting securities. The Federal Reserve Board requires the Company to maintain certain levels of capital - see "Capital Resources and Shareholders' Equity" under Item 7 below. The Federal Reserve Board also has the authority to take enforcement action against any bank holding company that commits any unsafe or unsound practice, or violates certain laws, regulations or conditions imposed in writing by the Federal Reserve Board. The Federal Reserve Board generally prohibits a bank holding company from declaring or paying a cash dividend that would impose undue pressure on the capital of subsidiary banks or would be funded only through borrowing or other arrangements which might adversely affect a bank holding company's financial position. Under the Federal Reserve Board policy, a bank holding company is not permitted to continue its existing rate of cash dividends on its common stock unless its net income is sufficient to fully fund each dividend and its prospective rate of earnings retention appears consistent with its capital needs, asset quality and overall financial condition.

The Commissioner is empowered to regulate certain acquisitions of North Carolina banks and bank holding companies, issue cease and desist orders for violations of North Carolina banking laws, and promulgate rules necessary to effectuate the purposes of the North Carolina Bank Holding Company Act of 1984.

Regulatory authorities have cease and desist powers over bank holding companies and their nonbank subsidiaries where their actions would constitute a serious threat to the safety, soundness or stability of a subsidiary bank. Those authorities may compel holding companies to invest additional capital into banking subsidiaries upon acquisitions or in the event of significant loan losses or rapid growth of loans or deposits.

The United States Congress and the North Carolina General Assembly have periodically considered and adopted legislation that has impacted the Company.

Supervision and Regulation of the Bank

Federal banking regulations applicable to all depository financial institutions, among other things: (i) provide federal bank regulatory agencies with powers to prevent unsafe and unsound banking practices; (ii) restrict preferential loans by banks to “insiders” of banks; (iii) require banks to keep information on loans to major shareholders and executive officers and (iv) bar certain director and officer interlocks between financial institutions.

As a state-chartered bank, the Bank is subject to the provisions of the North Carolina banking statutes and to regulation by the Commissioner. The Commissioner has a wide range of regulatory authority over the activities and operations of the Bank, and the Commissioner’s staff conducts periodic examinations of the Bank and its affiliates to ensure compliance with state banking regulations and to assess the safety and soundness of the Bank. Among other things, the Commissioner regulates the merger and consolidation of state-chartered banks, the payment of dividends, loans to officers and directors, recordkeeping, types and amounts of loans and investments, and the establishment of branches. The Commissioner also has cease and desist powers over state-chartered banks for violations of state banking laws or regulations and for unsafe or unsound conduct that is likely to jeopardize the interest of depositors.

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The dividends that may be paid by the Bank to the Company are subject to legal limitations under North Carolina law. In addition, regulatory authorities may restrict dividends that may be paid by the Bank or the Company's other subsidiaries. The ability of the Company to pay dividends to its shareholders is largely dependent on the dividends paid to the Company by the Bank.

The FDIC is authorized to approve conversions, mergers, consolidations and assumptions of deposit liability transactions between insured banks and uninsured banks or institutions, and to prevent capital or surplus diminution in such transactions if the resulting, continuing, or assumed bank is an insured nonmember bank. In addition, the FDIC monitors the Bank's compliance with several banking statutes, such as the Depository Institution Management Interlocks Act and the Community Reinvestment Act of 1977. The FDIC also conducts periodic examinations of the Bank to assess its safety and soundness and its compliance with banking laws and regulations, and it has the power to implement changes to, or restrictions on, the Bank's operations if it finds that a violation is occurring or is threatened.

U.S. Treasury Capital Purchase Program (TARP)

On October 3, 2008, in response to the financial crises affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, the Emergency Economic Stabilization Act of 2008 (the "EESA") was signed into law. Pursuant to the EESA, the U.S. Treasury was given the authority to, among other things, purchase up to \$700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets.

On October 14, 2008, the Secretary of the U.S. Department of the Treasury announced that the Treasury would purchase equity stakes in a wide variety of banks and thrifts. Under the program, known as the Capital Purchase Program (also known as "TARP"), the Treasury made \$250 billion of capital available from EESA to U.S. financial institutions in the form of purchases of preferred stock. In addition to the preferred stock, the Treasury received, from participating financial institutions, warrants to purchase common stock with an aggregate market price equal to 15% of the preferred investment. Participating financial institutions were required to adopt the Treasury's standards for executive compensation and corporate governance for the period during which the Treasury holds equity issued under the Capital Purchase Program.

Although we believed that our capital position was sound, we concluded that the Capital Purchase Program would allow us to raise additional capital on favorable terms in comparison with other available alternatives. Accordingly, we applied to participate in the Capital Purchase Program. The Treasury approved our application in December 2008, and we received \$65 million in proceeds from the sale of 65,000 shares of Series A Cumulative Perpetual Preferred Stock with a liquidation value of \$1,000 per share to the Treasury on January 9, 2009. The terms of the preferred stock issued to the Treasury required a dividend of 5% for the first five years and 9% thereafter. As part of the transaction, we also granted the Treasury a ten-year warrant to purchase up to 616,308 shares of our common stock at an exercise price of \$15.82 per share.

On September 1, 2011, we redeemed the 65,000 shares of outstanding Series A Preferred Stock from the Treasury for a redemption price of \$65 million, plus unpaid dividends. We funded the majority of this transaction by simultaneously issuing Series B Preferred Stock to the Treasury in connection with our participation in the Small Business Lending Fund (see below). In November 2011, we repurchased the outstanding common stock warrant from the Treasury at a price of \$1.50 per common share for a total of \$924,000. See Note 19 to the consolidated financial statements for more information on these transactions.

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Small Business Lending Fund

In December 2010, the U.S. Treasury announced the creation of the Small Business Lending Fund (SBLF) program, which was established under the Small Business Jobs Act of 2010. The SBLF was created to encourage lending to small businesses by providing capital to qualified community banks at favorable rates.

Interested financial institutions were required to submit an application and a small business lending plan. Less than half of the financial institutions that applied for the SBLF were approved. We were one of the institutions approved, and on September 1, 2011, we completed the sale of \$63.5 million of Series B Preferred Stock to the Treasury under the SBLF. Under the terms of the stock purchase agreement, the Treasury received 63,500 shares of Series B non-cumulative perpetual preferred stock with a liquidation value of \$1,000 per share, in exchange for \$63.5 million. As noted above, we used the \$63.5 million received from this issuance along with \$1.5 million of existing Company funds to redeem the \$65 million of cumulative preferred stock issued to the Treasury as part of the Capital Purchase Program. The initial dividend rate on SBLF preferred stock was 5%. The terms of the stock provided that our dividend rate could decrease to as low as 1% for a period of time depending on our success in meeting certain loan growth targets to small businesses. Based on our increases in small business lending, we achieved the minimal dividend rate of 1% as of March 31, 2013. The increase in the amount of small business loans remained at a level corresponding to a 1% dividend rate at September 30, 2013, at which point the terms of the preferred stock provide that the dividend rate remains fixed until December 31, 2015. Accordingly, we expect that our dividend rate will remain at an annualized rate of 1% until January 1, 2016 unless the Series B Preferred Stock is redeemed at an earlier date. If this stock remains outstanding beyond January 1, 2016, the dividend rate increases to 9% thereafter. See Note 19 to the consolidated financial statements for more information.

FDIC Insurance

As a member of the FDIC, the Bank's deposits are insured by the FDIC. For this protection, each member bank pays a quarterly statutory assessment (which is based on average total assets less average tangible equity) and is subject to the rules and regulations of the FDIC.

We recognized approximately \$2.6 million, \$2.7 million, and \$3.0 million in FDIC insurance expense in 2013, 2012, and 2011, respectively.

Legislative and Regulatory Developments

Given the ongoing financial crisis and the current presidential administration, legislation that would affect regulation in the banking industry is introduced in most legislative sessions. The most significant recent legislative and regulatory developments impacting the Company are 1) the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, 2) Automated Overdraft Payment Regulation, and 3) Basel III, each of which is discussed below.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

On July 21, 2010, the Dodd-Frank Act became law. The Dodd-Frank Act has had and will continue to have a broad impact on the financial services industry, including significant regulatory and compliance changes including, among other things,

- enhanced authority over troubled and failing banks and their holding companies;
- increased capital and liquidity requirements;
- increased regulatory examination fees;

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specific provisions designed to improve supervision and safety and soundness by imposing restrictions and limitations on the scope and type of banking and financial activities.

In addition, the Dodd-Frank Act establishes a new framework for systemic risk oversight within the financial system that will be enforced by new and existing federal regulatory agencies, including the Financial Stability Oversight Council (FSOC), the Federal Reserve Bank (FRB), the Office of Comptroller of the Currency, the FDIC, and the Consumer Financial Protection Bureau (CFPB). The following description briefly summarizes aspects of the Dodd-Frank Act that could impact the Company, both currently and prospectively.

Deposit Insurance. The Dodd-Frank Act made permanent the \$250,000 deposit insurance limit for insured deposits, which was an increase from the previous limit of \$100,000. Amendments to the Federal Deposit Insurance Act also revised the assessment base against which an insured depository institution's deposit insurance premiums paid to the FDIC's Deposit Insurance Fund (DIF) will be calculated. Under the amendments, which became effective on April 1, 2011, the FDIC assessment base is no longer the institution's deposit base, but rather its average consolidated total assets less its average tangible equity. The Dodd-Frank Act also changed the minimum designated reserve ratio of the DIF, increasing the minimum from 1.15% to 1.35% of the estimated amount of total insured deposits, and eliminating the requirement that the FDIC pay dividends to depository institutions when the reserve ratio exceeds certain thresholds by September 30, 2020.

Interest on Demand Deposits. The Dodd-Frank Act provided that beginning July 21, 2011 depository institutions were permitted to pay interest on business demand deposits with no limit on the number of monthly withdrawals. Prior to July 21, 2011, we entered into securities repurchase agreements with business customers in order to allow them to earn interest on their excess funds. With the prohibition of paying interest now removed, we have been able to pay interest on our customers' deposits without the need to enter into a securities repurchase agreement. During 2011, approximately \$38 million in liabilities previously classified as "securities sold under agreements to repurchase" were moved to the "interest-bearing checking accounts" category. The remaining \$17 million were moved during 2012. We did not experience a material increase in total interest expense, but rather only an insignificant amount of reclassification among interest expense categories as a result of these changes.

Trust Preferred Securities. The Dodd-Frank Act prohibits bank holding companies from including in their regulatory Tier I capital hybrid debt and equity securities issued on or after May 19, 2010. Among the hybrid debt and equity securities included in this prohibition are trust preferred securities, which we have issued in the past in order to raise additional Tier I capital and otherwise improve our regulatory capital ratios. Although we may continue to include our existing trust preferred securities as Tier I capital, the prohibition on the use of these securities as Tier I capital may limit our ability to raise capital in the future.

The Consumer Financial Protection Bureau. The Dodd-Frank Act creates a new, independent federal agency called the Consumer Financial Protection Bureau ("CFPB"), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the

Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB will have examination and primary enforcement authority with respect to depository institutions with \$10 billion or more in assets. Depository institutions with less than \$10 billion in assets, such as the Bank, will be subject to rules promulgated by the CFPB but will continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB will have authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products.

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The Dodd-Frank Act also authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages, including a determination of the borrower's ability to repay. Under the Dodd-Frank Act, financial institutions may not make a residential mortgage loan unless they make a "reasonable and good faith determination" that the consumer has a "reasonable ability" to repay the loan. In addition, the Dodd-Frank Act will allow borrowers to raise certain defenses to foreclosure if they receive any loan other than a "qualified mortgage" as defined by the CFPB. On January 10, 2013, the CFPB published final rules to, among other things, define "qualified mortgage" and specify the types of income and assets that may be considered in the ability-to-repay determination, the permissible sources for verification, and the required methods of calculating the loan's monthly payments. For example, the rules extend the requirement that creditors verify and document a borrower's "income and assets" to include all "information" that creditors rely on in determining repayment ability. The rules also provide further examples of third-party documents that may be relied on for such verification, such as government records and check-cashing or funds-transfer service receipts. The new rules took effect on January 10, 2014. In response to these new rules, we centralized all residential loan origination to our mortgage banking department. The employees in this department are well-trained in the new rules. In addition, on November 20, 2013, the CFPB issued its final rule on integrated mortgage disclosures under the Truth in Lending Act and the Real Estate Settlement Procedures Act, for which compliance is required by August 1, 2015. We are evaluating these integrated mortgage disclosure rules to determine their impact on the Company.

The Dodd-Frank Act also permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations. Compliance with any such new regulations established by the CFPB and/or states could reduce our revenue, increase our cost of operations, and limit our ability to expand into certain products and services.

Debit Card Interchange Fees. The Dodd-Frank Act gives the FRB the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over \$10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer. While we are not directly subject to these rules for so long as our assets do not exceed \$10 billion, our activities as a debit card issuer may nevertheless be indirectly impacted by the change in the applicable debit card market caused by these regulations, which may require us to match any new lower fee structure implemented by larger financial institutions in order to remain competitive in the future. The new caps on interchange fees for banks with assets greater than \$10 billion became effective October 1, 2011. To date, the Company has not noted any significant indirect negative effects of the interchange fee caps that are applicable to the larger financial institutions.

Increased Capital Standards and Enhanced Supervision. The Dodd-Frank Act requires the federal banking agencies to establish minimum leverage and risk-based capital requirements for banks and bank holding companies. These new standards will be no less strict than existing regulatory capital and leverage standards applicable to insured depository institutions and may, in fact, become higher once the agencies promulgate the new standards. Compliance with heightened capital standards may reduce our ability to generate or originate revenue-producing assets and thereby restrict revenue generation from banking and non-banking operations.

Transactions with Affiliates. The Dodd-Frank Act enhances the requirements for certain transactions with affiliates under Section 23A and 23B of the Federal Reserve Act, including an expansion of the definition of “covered transactions,” and an increase in the amount of time for which collateral requirements regarding covered transactions must be maintained.

Transactions with Insiders. The Dodd-Frank Act expands insider transaction limitations through the strengthening of loan restrictions to insiders and the expansion of the types of transactions subject to the various limits, including derivative transactions, repurchase agreements, reverse repurchase agreements and securities lending and borrowing transactions. The Dodd-Frank Act also places restrictions on certain asset sales to and from an insider of an institution, including requirements that such sales be on market terms and, in certain circumstances, receive the approval of the institution’s board of directors.

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Enhanced Lending Limits. The Dodd-Frank Act strengthens the existing limits on a depository institution's credit exposure to one borrower. Federal banking law currently limits a national bank's ability to extend credit to one person or group of related persons to an amount that does not exceed certain thresholds. The Dodd-Frank Act expands the scope of these restrictions to include credit exposure arising from derivative transactions, repurchase agreements and securities lending and borrowing transactions. It also will eventually prohibit state-chartered banks from engaging in derivative transactions unless the state lending limit laws take into account credit exposure to such transactions.

Corporate Governance. The Dodd-Frank Act addresses many corporate governance and executive compensation matters that will affect most U.S. publicly traded companies, including the Company. The Dodd-Frank Act:

- grants shareholders of U.S. publicly traded companies an advisory vote on executive compensation;
- enhances independence requirements for compensation committee members;
- requires companies listed on national securities exchanges to adopt clawback policies for incentive-based compensation plans applicable to executive officers; and
- provides the SEC with authority to adopt proxy access rules that would allow shareholders of publicly traded companies to nominate candidates for election as directors and require such companies to include such nominees in its proxy materials.

Many of the requirements of the Dodd-Frank Act will be subject to implementation over the course of several years. While we do not currently expect the final requirements of the Dodd-Frank Act to have a material adverse impact on the Company, we do expect them to negatively impact our profitability, require changes to certain of our business practices, including limitations on fee income opportunities, and impose more stringent capital, liquidity and leverage requirements upon the Company. These changes may also require us to invest significant management attention and resources to evaluate and make any changes necessary to comply with the new statutory and regulatory requirements.

Automated Overdraft Payment Regulation

In recent years, the Federal Reserve and FDIC have enacted consumer protection regulations related to automated overdraft payment programs offered by financial institutions. In November 2009, the Federal Reserve amended its Regulation E to prohibit financial institutions, including the Company, from charging consumers fees for paying overdrafts on automated teller machine and one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions. The Regulation E amendments also require financial institutions to provide consumers with a notice that explains the financial institution's overdraft services, including the fees associated with the service and the consumer's choices. We have completed implementation of the changes as required by the Regulation E amendments, which resulted in reductions to overdraft fees that we were able to collect beginning in the second half of 2010.

In November 2010, the FDIC supplemented the Regulation E amendments by requiring FDIC-supervised institutions, including the Bank, to implement additional changes relating to automated overdraft payment programs by July 1, 2011. The most significant of these changes require financial institutions to monitor overdraft payment programs for

“excessive or chronic” customer use and undertake “meaningful and effective” follow-up action with customers that overdraw their accounts more than six times during a rolling 12-month period. The additional guidance also imposes daily limits on overdraft charges, requires institutions to review and modify check-clearing procedures, prominently distinguish account balances from available overdraft coverage amounts and requires increased board and management oversight regarding overdraft payment programs. We have now implemented the supplemental requirements of the Regulation E amendments, which resulted in further reductions to the amount of overdraft fees we were able to collect beginning in July 2011.

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Recent Amendments to Regulatory Capital Requirement under Basel III

In July 2013, the federal banking agencies approved amendments to their regulatory capital rules to conform U.S. regulatory capital rules with the international regulatory standards agreed to by the Basel Committee on Banking Supervision in the accord referred to as “Basel III.” The revisions establish new higher capital ratio requirements, narrow the definitions of capital, impose new operating restrictions on banking organizations with insufficient capital buffers and increase the risk weighting of certain assets. The new capital requirements apply to all banks, savings associations, bank holding companies with more than \$500 million in assets and all savings and loan holding companies regardless of asset size. The rules will become effective for institutions with assets over \$250 billion and internationally active institutions starting in January 2014 and will become effective for all other institutions beginning in January 2015. The following discussion summarizes the changes we believe are most likely to affect the Company and the Bank.

New and Increased Capital Requirements. The regulations establish a new capital measure called “Common Equity Tier I Capital” consisting of common stock and related surplus, retained earnings, accumulated other comprehensive income and, subject to certain adjustments, minority common equity interests in subsidiaries. Unlike the current rules which exclude unrealized gains and losses on available-for-sale debt securities from regulatory capital, the amended rules generally require accumulated other comprehensive income to flow through to regulatory capital unless a one-time, irrevocable opt-out election is made in the first regulatory reporting period under the new rule. Depository institutions and their holding companies will be required to maintain Common Equity Tier I Capital equal to 4.5% of risk-weighted assets by 2015.

The regulations also increase the required ratio of Tier I Capital to risk-weighted assets from the current 4% to 6% by 2015. Tier I Capital will consist of Common Equity Tier I Capital plus Additional Tier I Capital which will include non-cumulative perpetual preferred stock. Cumulative preferred stock (other than cumulative preferred stock issued to the U.S. Treasury under the TARP Capital Purchase Program or the Small Business Lending Fund) will no longer qualify as Additional Tier I Capital. Trust preferred securities and other non-qualifying capital instruments issued prior to May 19, 2010 by bank and savings and loan holding companies with less than \$15 billion in assets as of December 31, 2009, may continue to be included in Tier I Capital, but these instruments will be phased out over 10 years beginning in 2016 for all other banking organizations. These non-qualified capital instruments, however, may be included in Tier II Capital which could also include qualifying subordinated debt. The amended regulations also require a minimum Tier I leverage ratio of 4% for all institutions, eliminating the 3% option for institutions with the highest supervisory ratings. The minimum required ratio of total capital to risk-weighted assets will remain at 8%.

Capital Buffer Requirement. In addition to increased capital requirements, depository institutions and their holding companies will be required to maintain a capital buffer of at least 2.5% of risk-weighted assets over and above the minimum risk-based capital requirements. Institutions that do not maintain the required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement will be phased in over a four-year period beginning in 2016. The capital buffer requirement effectively raises the minimum required risk-based capital ratios to 7% Common Equity Tier I Capital, 8.5% Tier I Capital and 10.5% Total Capital on a fully phased-in basis.

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Changes to Prompt Corrective Action Capital Categories. The Prompt Corrective Action rules will be amended effective January 1, 2015 to incorporate a Common Equity Tier I Capital requirement and to raise the capital requirements for certain capital categories. In order to be adequately capitalized for purposes of the prompt corrective action rules, a banking organization will be required to have at least an 8% Total Risk-Based Capital Ratio, a 6% Tier I Risk-Based Capital Ratio, a 4.5% Common Equity Tier I Risk Based Capital Ratio and a 4% Tier I Leverage Ratio. To be well capitalized, a banking organization will be required to have at least a 10% Total Risk-Based Capital Ratio, an 8% Tier I Risk-Based Capital Ratio, a 6.5% Common Equity Tier I Risk-Based Capital Ratio and a 5% Tier I Leverage Ratio.

Additional Deductions from Capital. Banking organizations will be required to deduct goodwill and certain other intangible assets, net of associated deferred tax liabilities, from Common Equity Tier I Capital. Deferred tax assets arising from temporary timing differences that cannot be realized through net operating loss (“NOL”) carrybacks will continue to be deducted. Deferred tax assets that can be realized through NOL carrybacks will not be deducted but will be subject to 100% risk weighting. Defined benefit pension fund assets, net of any associated deferred tax liability, will be deducted from Common Equity Tier I Capital unless the banking organization has unrestricted and unfettered access to such assets. Reciprocal cross-holdings of capital instruments in any other financial institutions will now be deducted from capital, not just holdings in other depository institutions. For this purpose, financial institutions are broadly defined to include securities and commodities firms, hedge and private equity funds and non-depository lenders. Banking organizations will also be required to deduct non-significant investments (less than 10% of outstanding stock) in other financial institutions to the extent these exceed 10% of Common Equity Tier I Capital subject to a 15% of Common Equity Tier I Capital cap. Greater than 10% investments must be deducted if they exceed 10% of Common Equity Tier I Capital. If the aggregate amount of certain items excluded from capital deduction due to a 10% threshold exceeds 17.65% of Common Equity Tier I Capital, the excess must be deducted.

Changes in Risk-Weightings. The amended regulations will continue to follow the current capital rules which assign a 50% risk-weighting to “qualifying mortgage loans” which generally consist of residential first mortgages with an 80% loan-to-value ratio (or which carry mortgage insurance that reduces the bank’s exposure to 80%) that are not more than 90 days past due. All other mortgage loans will have a 100% risk weight. The revised regulations apply a 250% risk-weighting to mortgage servicing rights, deferred tax assets that cannot be realized through NOL carrybacks and investments in the capital instruments of other financial institutions that are not deducted from capital. The revised regulations also create a new 150% risk-weighting category for “high volatility commercial real estate loans” which are credit facilities for the acquisition, construction or development of real property other than for certain community development projects, agricultural land and one- to four-family residential properties or commercial real projects where: (i) the loan-to-value ratio is not in excess of interagency real estate lending standards; and (ii) the borrower has contributed capital equal to not less than 15% of the real estate’s “as completed” value before the loan was made.

The final rules become effective January 1, 2015 for the Company. The capital conservation buffer requirement will be phased in beginning January 1, 2016, at 0.625% of risk-weighted assets, increasing each year until fully implemented at 2.5% on January 1, 2019.

We are currently evaluating the impact of these rules on both the Company and the Bank; however, based on our current analyses, we believe that both the Company and the Bank would meet all capital adequacy requirements under the final rules.

Neither the Company nor the Bank can predict what other legislation might be enacted or what other regulations or assessments might be adopted.

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See “Capital Resources and Shareholders’ Equity” under Item 7 below for a discussion of regulatory capital requirements.

Available Information

We maintain a corporate Internet site at www.LocalFirstBank.com, which contains a link within the “Investor Relations” section of the site to each of our filings with the Securities and Exchange Commission, including our annual reports on Form 10-K, our quarterly reports on Form 10-Q, our current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934. These filings are available, free of charge, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. These filings can also be accessed at the Securities and Exchange Commission’s website located at www.sec.gov. Information included on our Internet site is not incorporated by reference into this annual report.

Item 1A. Risk Factors

An investment in our common stock involves certain risks. Before you invest in our common stock, you should be aware that there are various risks, including those described below, which could affect the value of your investment in the future. The trading price of our common stock could decline due to any of these risks, and you may lose all or part of your investment. The risk factors described in this section, as well as any cautionary language in this report, provide examples of risks, uncertainties and events that could have a material adverse effect on our business, including our operating results and financial condition. In addition to the risks and uncertainties described below, other risks and uncertainties not currently known to us, or that we currently deem to be immaterial, also may materially or adversely affect our business, financial condition, and results of operations. The value or market price of our common stock could decline due to any of these identified or other unidentified risks.

Difficult market conditions and economic trends have adversely affected our industry and our business.

A general economic downturn began in the latter half of 2007. Dramatic declines in the housing market, with decreasing home prices and increasing delinquencies and foreclosures, negatively impacted the credit performance of mortgage loans, especially land development loans, and resulted in significant write-downs of assets by many financial institutions. In addition, the value of real estate collateral supporting many loans declined and may continue to decline. General downward economic trends, reduced availability of commercial credit and high unemployment rates negatively impacted the credit performance of commercial and consumer credit, resulting in additional write-downs. Although the U.S. economy has emerged from the most severe aspects of the recession that occurred in 2008 and 2009, the economy remains fragile, with economic growth slow and uneven, and unemployment levels remaining high. And while there have been recent signs of recovery in the national economy, the economic conditions

in our market area do not seem to have improved at the same rate. The unemployment rates in most of our markets exceed the national average. We believe that the economic downtrends are largely responsible for the deterioration in loan quality that we have experienced over the past five years, including higher levels of loan charge-offs, higher levels of nonperforming assets, and higher provisions for loan losses. The market turmoil led to increased commercial and consumer delinquencies, lack of confidence, increased market volatility and widespread reduction in general business activity. Financial institutions, including us, have experienced a decrease in access to borrowings. The resulting economic pressure on consumers and businesses and the lack of confidence in the financial markets have adversely affected, and may continue to adversely affect, our business, financial condition, results of operations and stock price.

As a result of the foregoing factors, there have been numerous new or proposed federal or state laws and regulations regarding lending and funding practices and liquidity standards, and bank regulatory agencies are expected to be very aggressive in responding to concerns and trends identified in examinations. This increased governmental action may increase our costs and limit our ability to pursue certain business opportunities.

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Our ability to assess the creditworthiness of customers and to estimate the losses inherent in our credit exposure is made more complex by these prolonged difficult market and economic conditions. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market and economic conditions on us, our customers and the other financial institutions in our market. As a result, we may experience additional increases in foreclosures, delinquencies and customer bankruptcies, as well as more restricted access to funds.

We are vulnerable to the economic conditions within the fairly small geographic region in which we operate.

Like many businesses, our overall success is partially dependent on the economic conditions in the marketplace where we operate. Our marketplace is concentrated in the central Piedmont and coastal regions of North Carolina. Although some improvement has been noted, these regions continue to experience challenging economic conditions, which we believe is a factor in the elevated amounts of borrower delinquencies, nonperforming assets, and loan losses we have experienced during the past few years. If economic conditions in our marketplace worsen, it would likely have an adverse impact on us. In particular, if economic conditions related to real estate values in our marketplace were to worsen, our loan losses would likely increase. At December 31, 2013, approximately 90% of our loans were secured by real estate collateral, which means that additional decreases in real estate values would have an adverse impact on our operations.

If our goodwill becomes impaired, we may be required to record a significant charge to earnings.

We have goodwill recorded on our balance sheet as an asset with a carrying value as of December 31, 2013 of \$65.8 million. Under generally accepted accounting principles, goodwill is required to be tested for impairment at least annually and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The test for goodwill impairment involves comparing the fair value of a company's reporting units to their respective carrying values. For our company, our community banking operation is our only material reporting unit. The price of our common stock is one of several measures available for estimating the fair value of our community banking operations. Although the price of our common stock has recently traded above the book value, for most of the last several years, it has traded below the book value of our company. Subject to the results of other valuation techniques, if this situation were to return and persist, it could indicate that our goodwill is impaired. Accordingly, we may be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill is determined, which could have a negative impact on our results of operations.

We may be subject to more stringent capital requirements.

We are subject to capital adequacy guidelines and other regulatory requirements specifying minimum amounts and types of capital which we must maintain. From time to time, the regulators implement changes to these regulatory

capital adequacy guidelines. If we fail to meet these minimum capital guidelines and other regulatory requirements, our financial condition would be materially and adversely affected. Based on recent regulatory capital requirements contained in the Dodd-Frank Act and the regulatory accords on international banking institutions formulated by the Basel Committee and implemented by the Federal Reserve, we will be required to satisfy additional, more stringent, capital adequacy standards. These requirements and any other new regulations, could adversely affect our ability to pay dividends, or could require us to reduce business levels or raise capital, including in ways that may adversely affect our financial condition or results of operations.

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We might be required to raise additional capital in the future, but that capital may not be available or may not be available on terms acceptable to us when it is needed.

We are required to maintain adequate capital levels to support our operations. In the future, we might need to raise additional capital to support growth, absorb loan losses, or meet more stringent capital requirements. Our ability to raise additional capital will depend on conditions in the capital markets at that time, which are outside our control, and on our financial performance. Accordingly, we cannot be certain of our ability to raise additional capital in the future if needed or on terms acceptable to us. If we cannot raise additional capital when needed, our ability to conduct our business could be materially impaired.

The soundness of other financial institutions could adversely affect us.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services companies are interrelated as a result of trading, clearing, counterparty or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial services industry, including brokers and dealers, commercial banks, and investment banks. Defaults by, or even rumors or questions about, one or more financial services companies, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by us or by other institutions. We can make no assurance that any such losses would not materially and adversely affect our business, financial condition or results of operations.

We are subject to extensive regulation, which could have an adverse effect on our operations.

We are subject to extensive regulation and supervision from the North Carolina Commissioner of Banks, the FDIC, and the Federal Reserve Board. This regulation and supervision is intended primarily for the protection of the FDIC insurance fund and our depositors and borrowers, rather than for holders of our equity securities. In the past, our business has been materially affected by these regulations. This trend is likely to continue in the future.

Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on operations, the classification of our assets and the determination of the level of allowance for loan losses. Changes in the regulations that apply to us, or changes in our compliance with regulations, could have a material impact on our operations.

Financial reform legislation enacted by the U.S. Congress, and further changes in regulation to which we are exposed, will result in additional new laws and regulations that are expected to increase our costs of operations.

The Dodd-Frank Act has and will continue to significantly change bank regulatory structure and affect lending, deposit, investment, and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting and implementing the rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years. See “Legislative and Regulatory Developments – Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010” above for additional information regarding the Dodd-Frank Act.

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The Dodd-Frank Act also created the Consumer Financial Protection Bureau and gave it broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit “unfair, deceptive or abusive” acts and practices. Additionally, the Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than \$10 billion in assets.

Proposals for further regulation of the financial services industry are continually being introduced in the United States Congress. The agencies regulating the financial services industry also periodically adopt changes to their regulations. It is possible that additional legislative proposals may be adopted or regulatory changes may be made that would have an adverse effect on our business. In addition, it is expected that such regulatory changes will increase our operating and compliance cost. We can provide no assurance regarding the manner in which new laws and regulations will affect us.

We are subject to interest rate risk, which could negatively impact earnings.

Net interest income is the most significant component of our earnings. Our net interest income results from the difference between the yields we earn on our interest-earning assets, primarily loans and investments, and the rates that we pay on our interest-bearing liabilities, primarily deposits and borrowings. When interest rates change, the yields we earn on our interest-earning assets and the rates we pay on our interest-bearing liabilities do not necessarily move in tandem with each other because of the difference between their maturities and repricing characteristics. This mismatch can negatively impact net interest income if the margin between yields earned and rates paid narrows. Interest rate environment changes can occur at any time and are affected by many factors that are outside our control, including inflation, recession, unemployment trends, the Federal Reserve’s monetary policy, domestic and international disorder and instability in domestic and foreign financial markets.

Our allowance for loan losses may not be adequate to cover actual losses.

Like all financial institutions, we maintain an allowance for loan losses to provide for probable losses caused by customer loan defaults. The allowance for loan losses may not be adequate to cover actual loan losses, and in this case additional and larger provisions for loan losses would be required to replenish the allowance. Provisions for loan losses are a direct charge against income.

We establish the amount of the allowance for loan losses based on historical loss rates, as well as estimates and assumptions about future events. Because of the extensive use of estimates and assumptions, our actual loan losses could differ, possibly significantly, from our estimate. We believe that our allowance for loan losses is adequate to provide for probable losses, but it is possible that the allowance for loan losses will need to be increased for credit reasons or that regulators will require us to increase this allowance. Either of these occurrences could materially and adversely affect our earnings and profitability.

In the normal course of business, we process large volumes of transactions involving millions of dollars. If our internal controls fail to work as expected, if our systems are used in an unauthorized manner, or if our employees subvert our internal controls, we could experience significant losses.

We process large volumes of transactions on a daily basis and are exposed to numerous types of operational risk. Operational risk includes the risk of fraud by persons inside or outside the Company, the execution of unauthorized transactions by employees, errors relating to transaction processing and systems and breaches of the internal control system and compliance requirements. This risk also includes potential legal actions that could arise as a result of an operational deficiency or as a result of noncompliance with applicable regulatory standards.

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We establish and maintain systems of internal operational controls that provide us with timely and accurate information about our level of operational risk. Although not foolproof, these systems have been designed to manage operational risk at appropriate, cost-effective levels. Procedures exist that are designed to ensure that policies relating to conduct, ethics, and business practices are followed. From time to time, losses from operational risk may occur, including the effects of operational errors. We continually monitor and improve our internal controls, data processing systems, and corporate-wide processes and procedures, but there can be no assurance that future losses will not occur.

Negative public opinion regarding our company and the financial services industry in general, could damage our reputation and adversely impact our earnings.

Reputation risk, or the risk to our business, earnings and capital from negative public opinion regarding our company and the financial services industry in general, is inherent in our business. Negative public opinion can result from actual or alleged conduct in any number of activities, including lending practices, corporate governance and acquisitions, and from actions taken by government regulators and community organizations in response to those activities. Negative public opinion can adversely affect our ability to keep and attract clients and employees and can expose us to litigation and regulatory action. Although we have taken steps to minimize reputation risk in dealing with our clients and communities, this risk will always be present given the nature of our business.

Our reported financial results are impacted by management's selection of accounting methods and certain assumptions and estimates.

Our accounting policies and methods are fundamental to the way we record and report our financial condition and results of operations. Our management must exercise judgment in selecting and applying many of these accounting policies and methods so they comply with generally accepted accounting principles and reflect management's judgment of the most appropriate manner to report our financial condition and results. In some cases, management must select the accounting policy or method to apply from two or more alternatives, any of which may be reasonable under the circumstances, yet may result in reporting materially different results than would have been reported under a different alternative.

Certain accounting policies are critical to presenting our financial condition and results. They require management to make difficult, subjective or complex judgments about matters that are uncertain. Materially different amounts could be reported under different conditions or using different assumptions or estimates. These critical accounting policies include: the allowance for loan losses; intangible assets; and the fair value and discount accretion of loans acquired in FDIC-assisted transactions.

There can be no assurance that we will continue to pay cash dividends.

Although we have historically paid cash dividends, there is no assurance that we will continue to pay cash dividends. Future payment of cash dividends, if any, will be at the discretion of our board of directors and will be dependent upon our financial condition, results of operations, capital requirements, economic conditions, and such other factors as the board may deem relevant.

Our business continuity plans or data security systems could prove to be inadequate, resulting in a material interruption in, or disruption to, our business and a negative impact on our results of operations.

We rely heavily on communications and information systems to conduct our business. Our daily operations depend on the operational effectiveness of our technology. We rely on our systems to accurately track and record our assets and liabilities. Any failure, interruption or breach in security of our computer systems or outside technology, whether due to severe weather, natural disasters, acts of war or terrorism, criminal activity or other factors, could result in failures or disruptions in general ledger, deposit, loan, customer relationship management, and other systems leading to inaccurate financial records. This could materially affect our business operations and financial condition. While we have disaster recovery and other policies and procedures designed to prevent or limit the effect of any failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions, or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our results of operations.

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In addition, the Bank provides its customers the ability to bank online. The secure transmission of confidential information over the Internet is a critical element of online banking. While we use qualified third party vendors to test and audit our network, our network could become vulnerable to unauthorized access, computer viruses, phishing schemes and other security issues. The Bank may be required to spend significant capital and other resources to alleviate problems caused by security breaches or computer viruses. To the extent that the Bank activities or the activities of its customers involve the storage and transmission of confidential information, security breaches and viruses could expose the Bank to claims, litigation, and other potential liabilities. Any inability to prevent security breaches or computer viruses could also cause existing customers to lose confidence in the Bank's systems and could adversely affect its reputation and its ability to generate deposits.

Additionally, we outsource the processing of our core data system, as well as other systems such as online banking, to third party vendors. Prior to establishing an outsourcing relationship, and on an ongoing basis thereafter, management monitors key vendor controls and procedures related to information technology, which includes reviewing reports of service auditor's examinations. If our third party provider encounters difficulties or if we have difficulty in communicating with such third party, it will significantly affect our ability to adequately process and account for customer transactions, which would significantly affect our business operations.

We rely on certain external vendors.

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

Our potential inability to integrate companies we may acquire in the future could expose us to financial, execution, and operational risks that could negatively affect our financial condition and results of operations. Acquisitions may be dilutive to common shareholders and FDIC-assisted transactions have additional compliance risk that other acquisitions do not have.

On occasion, we may engage in a strategic acquisition when we believe there is an opportunity to strengthen and expand our business. In addition, such acquisitions may involve the issuance of stock, which may have a dilutive effect on earnings per share. To fully benefit from such acquisition, however, we must integrate the administrative, financial, sales, lending, collections, and marketing functions of the acquired company. If we are unable to successfully integrate an acquired company, we may not realize the benefits of the acquisition, and our financial results may be negatively affected. A completed acquisition may adversely affect our financial condition and results of operations, including our capital requirements and the accounting treatment of the acquisition. Completed acquisitions

may also lead to exposure from potential asset quality issues, losses of key employees or customers, difficulty and expense of integrating operations and systems, and significant unexpected liabilities after the consummation of these acquisitions. In addition, if we were to conclude that the value of an acquired business had decreased and that the related goodwill had been impaired, that conclusion would result in a goodwill impairment charge, which would adversely affect our results of operations.

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We may have opportunities to acquire the assets and liabilities of failed banks in FDIC-assisted transactions. Although these transactions typically provide for FDIC assistance to an acquirer to mitigate certain risks, such as sharing exposure to loan losses and providing indemnification against certain liabilities of the failed institution, we are (and would be in future transactions) subject to many of the same risks we would face in acquiring another bank in a negotiated transaction, including risks associated with maintaining customer relationships and failure to realize the anticipated acquisition benefits in the amounts and within the time frames we expect. In addition, ongoing compliance risk under the loss-share agreement with the FDIC is considerable and the event of noncompliance could result in coverage under the loss-share being disallowed, thus increasing the actual losses to the Bank. Our inability to overcome these risks could have a material adverse effect on our business, financial condition and results of operations.

Our FDIC loss share agreement related to a high risk loan portfolio acquired in a failed-bank acquisition expires on June 19, 2014, and therefore we will bear the full risk of losses for assets currently under that agreement subsequent to that date.

On June 19, 2009, we acquired Cooperative Bank in a FDIC failed-bank acquisition. As part of the terms of the acquisition, we entered into two loss share agreements with the FDIC – 1) a loss share agreement related to single-family home loans, which has a ten year term, and 2) a loss share agreement for all non-single family loans, which has a five year term. The loss share agreements generally provide us with an 80% reimbursement for all losses incurred and thus they limit our risk. The non-single family loss share agreement related to Cooperative Bank expires on June 19, 2014. The assets covered by the non-single family portfolio include a high percentage of commercial real estate and land development loans, loan types which experienced high loss rates during the economic downturn.

At December 31, 2013, the carrying value of the assets covered by the Cooperative Bank non-single family loss-share agreement was approximately \$79 million in loans, of which \$24 million were on nonaccrual status because of collection problems, and \$12 million in foreclosed properties. Accounting regulations require us to record losses as they occur, and thus we believe that we have recorded all probable losses associated with that portfolio as of each period end. However, the value of the underlying collateral for many of the loans, as well as the foreclosed properties, is volatile and has experienced significant declines in recent years. Beginning June 20, 2014, we will incur 100% of the loss related to further deterioration of the Cooperative Bank non-single family assets.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

The main offices of the Company and the Bank are owned by the Bank and are located in a three-story building in the central business district of Southern Pines, North Carolina. The building houses administrative facilities. The Bank's Operations Division, including customer accounting functions, offices for information technology operations, and offices for loan operations, are housed in two one-story steel frame buildings in Troy, North Carolina. Both of these

buildings are owned by the Bank. The Company operates 96 bank branches. The Company owns all of its bank branch premises except eight branch offices for which the land and buildings are leased and ten branch offices for which the land is leased but the building is owned. The Company also leases three loan production offices. There are no options to purchase or lease additional properties. The Company considers its facilities adequate to meet current needs and believes that lease renewals or replacement properties can be acquired as necessary to meet future needs.

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Item 3. Legal Proceedings

Various legal proceedings may arise in the ordinary course of business and may be pending or threatened against the Company and its subsidiaries. However, neither the Company nor any of its subsidiaries is involved in any pending legal proceedings that management believes are material to the Company or its consolidated financial position. If an exposure were to be identified, it is the Company's policy to establish and accrue appropriate reserves during the accounting period in which a loss is deemed to be probable and the amount is determinable.

There were no tax shelter penalties assessed by the Internal Revenue Service against the Company during the year ended December 31, 2013.

Item 4. Mine Safety Disclosure

Not applicable.

Table of Contents**PART II****Item 5. Market for the Registrant's Common Stock, Related Shareholder Matters, and Issuer Purchases of Equity Securities**

Our common stock trades on The NASDAQ Global Select Market under the symbol FBNC. Table 22, included in "Management's Discussion and Analysis" below, sets forth the high and low market prices of our common stock as traded by the brokerage firms that maintain a market in our common stock and the dividends declared for the periods indicated. We paid a cash dividend of \$0.08 per share for each quarter of 2013. For the foreseeable future, it is our current intention to continue to pay cash dividends of \$0.08 per share on a quarterly basis. See "Business - Supervision and Regulation" above and Note 16 to the consolidated financial statements for a discussion of other regulatory restrictions on the Company's payment of dividends. As of December 31, 2013, there were approximately 2,400 shareholders of record and another 3,200 shareholders whose stock is held in "street name."

There were no sales of unregistered securities during the year ended December 31, 2013.

Additional Information Regarding the Registrant's Equity Compensation Plans

At December 31, 2013, the Company had three equity-based compensation plans. The Company's 2007 Equity Plan is the only one of three plans under which new grants of equity-based awards are possible.

The following table presents information as of December 31, 2013 regarding shares of the Company's stock that may be issued pursuant to the Company's equity based compensation plans. At December 31, 2013, the Company had no warrants or stock appreciation rights outstanding under any compensation plans.

	As of December 31, 2013		
	(a)	(b)	(c)
Plan category	Number of securities to be issued upon exercise	Weighted-average exercise price of options, warrants and rights	Number of securities available for future issuance under equity compensation plans (excluding securities reflected in column (a))

	of outstanding options, warrants and rights		
Equity compensation plans approved by security holders (1)	463,813	\$ 17.92	761,538
Equity compensation plans not approved by security holders	—	—	—
Total	463,813	\$ 17.92	761,538

(1) Consists of (A) the Company's 2007 Equity Plan, which is currently in effect; (B) the Company's 2004 Stock Option Plan; and (C) the Company's 1994 Stock Option Plan, each of which was approved by our shareholders.

Table of Contents**Performance Graph**

The performance graph shown below compares the Company's cumulative total return to shareholders for the five-year period commencing December 31, 2008 and ending December 31, 2013, with the cumulative total return of the Russell 2000 Index (reflecting overall stock market performance of small-capitalization companies), and an index of banks with between \$1 billion and \$5 billion in assets, as constructed by SNL Securities, LP (reflecting changes in banking industry stocks). The graph and table assume that \$100 was invested on December 31, 2008 in each of the Company's common stock, the Russell 2000 Index, and the SNL Bank Index, and that all dividends were reinvested.

First Bancorp

Comparison of Five-Year Total Return Performances (1)

Five Years Ending December 31, 2013

	Total Return Index Values (1)					
	December 31,					
	2008	2009	2010	2011	2012	2013
First Bancorp	\$ 100.00	77.81	87.20	65.39	77.41	102.58
Russell 2000	100.00	127.17	161.32	154.59	179.86	249.69
SNL Index-Banks between \$1 billion and \$5 billion	100.00	71.68	81.25	74.10	91.37	132.87

Notes:

Total return indices were provided from an independent source, SNL Securities LP, Charlottesville, Virginia, and (1) assume initial investment of \$100 on December 31, 2008, reinvestment of dividends, and changes in market values.

Total return index numerical values used in this example are for illustrative purposes only.

Table of Contents**Issuer Purchases of Equity Securities**

Pursuant to authorizations by the Company's board of directors, the Company has from time to time repurchased shares of common stock in private transactions and in open-market purchases. The most recent board authorization was announced on July 30, 2004 and authorized the repurchase of 375,000 shares of the Company's stock. The Company did not repurchase any shares of its common stock during the quarter ended December 31, 2013.

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased (2)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs (1)
Month #1 (October 1, 2013 to October 31, 2013)	—	\$ —	—	214,241
Month #2 (November 1, 2013 to November 30, 2013)	—	—	—	214,241
Month #3 (December 1, 2013 to December 31, 2013)	—	—	—	214,241
Total	—	\$ —	—	214,241

Footnotes to the Above Table

All shares available for repurchase are pursuant to publicly announced share repurchase authorizations. On July 30, 2004, the Company announced that its board of directors had approved the repurchase of 375,000 shares of the (1) Company's common stock. The repurchase authorization does not have an expiration date. There are no plans or programs the Company has determined to terminate prior to expiration, or under which the Company does not intend to make further purchases.

The table above does not include shares that were used by option holders to satisfy the exercise price of the call (2) options issued by the Company to its employees and directors pursuant to the Company's stock option plans. There were no such exercises during the three months ended December 31, 2013.

Item 6. Selected Consolidated Financial Data

Table 1 on page 72 of this report sets forth the selected consolidated financial data for the Company.

Table of Contents**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

Management's Discussion and Analysis is intended to assist readers in understanding our results of operations and changes in financial position for the past three years. This review should be read in conjunction with the consolidated financial statements and accompanying notes beginning on page 91 of this report and the supplemental financial data contained in Tables 1 through 22 included with this discussion and analysis.

Overview - 2013 Compared to 2012

We returned to profitability in 2013 after a loss in 2012. Earnings for 2012 were significantly impacted by charges associated with a loan disposition and foreclosed property write-down that occurred in the fourth quarter of 2012.

Financial Highlights

<i>(\$ in thousands except per share data)</i>	2013	2012	Change
Earnings			
Net interest income	\$136,526	135,200	1.0%
Provision for loan losses - non-covered	18,266	69,993	-73.9%
Provision for loan losses - covered	12,350	9,679	27.6%
Noninterest income	23,489	1,389	1591.1%
Noninterest expenses	96,619	97,275	-0.7%
Income (loss) before income taxes	32,780	(40,358)	n/m
Income tax (benefit) expense	12,081	(16,952)	n/m
Net income (loss)	20,699	(23,406)	n/m
Preferred stock dividends	(895)	(2,809)	
Net income (loss) available to common shareholders	\$19,804	(26,215)	n/m
Net income (loss) per common share			
Basic	\$1.01	(1.54)	n/m
Diluted	0.98	(1.54)	n/m
Balances At Year End			
Assets	\$3,185,070	3,244,910	-1.8%
Loans	2,463,194	2,376,457	3.6%
Deposits	2,751,019	2,821,360	-2.5%
Ratios			
Return on average assets	0.62%	(0.79%)	
Return on average common equity	6.78%	(9.29%)	
Net interest margin (taxable-equivalent)	4.92%	4.78%	

The following is a more detailed discussion of our results for 2013 compared to 2012:

For the year ended December 31, 2013, we reported net income available to common shareholder of \$19.8 million, or \$0.98 per diluted common share, compared to a net loss of \$26.2 million, or (\$1.54) per diluted common share, for the year ended December 31, 2012.

The following significant factors occurred in 2012 that impacted comparability between 2012 and 2013:

- In the fourth quarter of 2012, we reported the completion of a capital raise totaling \$33.8 million. A combination of common and preferred stock was issued, including 2,656,294 shares of common stock and 728,706 shares of non-voting preferred stock, each at the same price of \$10.00 per share.

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Also in the fourth quarter of 2012, we identified a \$68 million pool of non-covered higher-risk loans that were targeted for sale to a third-party investor. Based on an offer to purchase these loans that was received in December 2012, we wrote the loans down by approximately \$38 million in the fourth quarter of 2012, which required an incremental provision for loan losses of \$33.6 million. The loans had a remaining carrying value of approximately \$30 million and were reclassified as “loans held for sale.” Of the \$68 million in loans targeted for sale, approximately \$38.2 million had been classified as nonaccrual loans, and \$10.5 million had been classified as accruing troubled-debt-restructurings. The sale of substantially all of these loans was completed on January 23, 2013.

In the fourth quarter of 2012, we recorded write-downs totaling \$10.6 million on substantially all of our non-covered foreclosed properties in connection with efforts to accelerate the sale of these assets.

In the first quarter of 2012, we recorded a provision for loan loss on non-covered loans of \$18.6 million, which was significantly higher than any prior quarterly provision for loan loss for non-covered loans. This higher provision was the result of an internal review of non-covered loans that occurred in the first quarter of 2012 that applied more conservative assumptions to estimate the probable losses associated with some of our nonperforming loan relationships, which we believed could lead to a more timely resolution of the related credits. Many of these same loans were included in the loans transferred to the held-for-sale category in the fourth quarter of 2012.

We note that our results of operation are significantly affected by the on-going accounting for two FDIC-assisted failed bank acquisitions. In the discussion in this document, the term “covered” is used to describe assets included as part of FDIC loss share agreements, which generally result in the FDIC reimbursing the Company for 80% of losses incurred on those assets during the terms of the agreements. The term “non-covered” refers to our legacy assets, which are not included in any type of loss share arrangement.

For covered loans that deteriorate in terms of repayment expectations, we record immediate allowances through the provision for loan losses. For covered loans that experience favorable changes in credit quality compared to what was expected at the acquisition date, including loans that payoff, we record positive adjustments to interest income over the life of the respective loan – also referred to as loan discount accretion. For covered foreclosed properties that are sold at gains or losses or that are written down to lower values, we record the gains/losses within noninterest income.

The adjustments discussed above are recorded within the income statement line items noted without consideration of the FDIC loss share agreements. Because favorable changes in covered assets result in lower expected FDIC claims, and unfavorable changes in covered assets result in higher expected FDIC claims, the FDIC indemnification asset is adjusted to reflect those expectations. The net increase or decrease in the indemnification asset is reflected within noninterest income.

The adjustments noted above can result in volatility within individual income statement line items. Because of the FDIC loss share agreements and the associated indemnification asset, pretax income resulting from amounts recorded as provisions for loan losses on covered loans, discount accretion, and losses from covered foreclosed properties is generally only impacted by 20% of these amounts due to the corresponding adjustments made to the indemnification

asset.

Total assets at December 31, 2013 amounted to \$3.2 billion, a 1.8% decrease from a year earlier. Total loans at December 31, 2013 amounted to \$2.5 billion, a 3.6% increase from a year earlier, and total deposits amounted to \$2.8 billion at December 31, 2013, a 2.5% decrease from a year earlier.

Total loans increased in 2013, as growth in non-covered loans exceeded the steady decline in covered loans. Excluding acquired loans of \$16 million that were added in a March 2013 branch acquisition, our non-covered loans increased by \$142 million in 2013, representing growth of 6.8%. We are seeing improved loan demand as the economy in our market areas improves.

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Total deposit balances decreased 2.5% in 2013 as a result of declines in all categories of time deposits. Strong growth in transaction deposit accounts offset a majority of the time deposit declines. In 2013, total transaction deposit accounts increased \$113 million or 6.8%, while time deposits declined by \$183 million or 15.6%. We generally pay lower interest rates on transaction accounts compared to time deposits, and thus the favorable change in the mix of deposits played a factor in our overall cost of funds declining from 0.59% in 2012 to 0.39% in 2013.

A portion of our loan and deposit growth during 2013 was the result of the acquisition of two branches from a competitor bank, which resulted in the addition of \$16 million in loans and \$57 million in deposits.

Net interest income for the year ended December 31, 2013 amounted to \$136.5 million, a 1.0% increase from the \$135.2 million recorded in 2012. The higher net interest income in 2013 was primarily caused by an increase in the amount of discount accretion on loans purchased in failed bank acquisitions. Loan discount accretion amounted to \$20.2 million for 2013 compared to \$16.5 million in 2012, an increase of \$3.7 million. As previously discussed, the impact of the changes in discount accretion on pretax income is only 20% of the gross amount of the change. The higher amount of discount accretion was due to increased expectations regarding the collectability of the loans. See “Net Interest Income” below for additional information.

Our net interest margin (tax-equivalent net interest income divided by average earning assets) was 4.92% for 2013 compared to 4.78% for 2012. The higher margin was primarily a result of a higher amount of discount accretion as noted above, as well as lower overall funding costs. As noted previously, our cost of funds has steadily declined from 0.59% in 2012 to 0.39% in 2013.

We recorded total provisions for loan losses on our covered and non-covered loans of \$30.6 million in 2013 compared to \$79.7 million for 2012. The provision for loan losses on non-covered loans amounted to \$18.3 million in 2013 compared to \$70.0 million for 2012. The decrease in 2013 was primarily due to the incremental provision for loan losses in December 2012 of \$33.6 million recorded in connection with the aforementioned loan sale. For the year ended December 31, 2013, the provision for loan losses on covered loans amounted to \$12.4 million compared to \$9.7 million for 2012. The increase in 2013 was primarily caused by several large credits that deteriorated during the first quarter of 2013.

Our non-covered nonperforming assets amounted to \$82.0 million at December 31, 2013 (2.78% of total non-covered assets) compared to \$106.1 million at December 31, 2012. The decrease in 2013 compared to 2012 was primarily due to the loan sale that was completed in the first quarter of 2013, as discussed above, which resulted in the disposition of \$21.9 million in nonperforming loans.

Total covered nonperforming assets steadily declined in 2013, amounting to \$70.6 million at December 31, 2013 compared to \$96.2 million at December 31, 2012, a decline of 26.6%, which was primarily the result of a combination

of loan paydowns, loan charge-offs, and sales of foreclosed properties.

For the year ended December 31, 2013, noninterest income amounted to \$23.5 million compared to \$1.4 million for the year ended December 31, 2012. The significant increase in 2013 is primarily the result of a high level of covered and non-covered foreclosed property losses that occurred in 2012 that reduced noninterest income compared to gains in both categories in 2013.

Noninterest expenses for the year ended December 31, 2013 amounted to \$96.6 million, which was relatively unchanged from the \$97.3 million recorded in 2012.

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Preferred stock dividends amounted to \$0.9 million for 2013 compared to \$2.8 million for 2012. The decrease in 2013 is the result of an increase in our small business lending which resulted in a favorable dividend rate change related to preferred stock that was issued in September 2011 to the US Treasury as part of the Company's participation in the Treasury's Small Business Lending Fund.

Overview - 2012 Compared to 2011

Earnings for 2012 were significantly impacted by charges associated with a loan disposition and foreclosed property write-down that occurred in the fourth quarter of 2012, as previously discussed. Additionally, in the first quarter of 2012, we recorded a significant provision for loan losses resulting from an internal review of certain nonperforming loan relationships (see discussion below). Our 2011 results were impacted by a bargain purchase gain and accelerated accretion on our preferred stock discount (see discussion below).

Financial Highlights

<i>(\$ in thousands except per share data)</i>	2012	2011	Change
Earnings			
Net interest income	\$ 135,200	132,203	2.3%
Provision for loan losses - non-covered	69,993	28,525	145.4%
Provision for loan losses - covered	9,679	12,776	-24.2%
Noninterest income	1,389	26,216	-94.7%
Noninterest expenses	97,275	96,106	1.2%
Income (loss) before income taxes	(40,358)	21,012	n/m
Income tax (benefit) expense	(16,952)	7,370	n/m
Net income (loss)	(23,406)	13,642	n/m
Preferred stock dividends	(2,809)	(3,234)	
Accretion of preferred stock discount	—	(2,932)	
Net income (loss) available to common shareholders	\$(26,215)	7,476	n/m
Net income (loss) per common share			
Basic	\$(1.54)	0.44	n/m
Diluted	(1.54)	0.44	n/m
Balances At Year End			
Assets	\$3,244,910	3,290,474	-1.4%
Loans	2,376,457	2,430,386	-2.2%
Deposits	2,821,360	2,755,037	2.4%
Ratios			
Return on average assets	(0.79%)	0.23%	
Return on average common equity	(9.29%)	2.59%	
Net interest margin (taxable-equivalent)	4.78%	4.72%	

The following is a more detailed discussion of our results for 2012 compared to 2011:

For the year ended December 31, 2012, we reported a net loss available to common shareholders of \$26.2 million, or (\$1.54) per diluted common share, compared to net income of \$7.5 million, or \$0.44 per diluted common share, for the year ended December 31, 2011.

Our results for 2012 were significantly impacted by a capital raise and an asset disposition initiative (comprised of a loan sale and foreclosed property write-down) that both occurred in the fourth quarter of 2012, as previously discussed.

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Other significant factors that affect the comparability of the full year 2012 and 2011 results are:

In the first quarter of 2012, we recorded a provision for loan loss on non-covered loans of \$18.6 million, which was significantly higher than any prior quarterly provision for loan loss for non-covered loans. This higher provision was the result of an internal review of non-covered loans that occurred in the first quarter of 2012 that applied more conservative assumptions to estimate the probable losses associated with some of our nonperforming loan relationships, which we believed could lead to a more timely resolution of the related credits. Many of these same loans were included in the loans transferred to the held-for-sale category in the fourth quarter of 2012.

In the third quarter of 2011, we recorded \$2.3 million in accelerated accretion of the discount remaining on preferred stock that was redeemed that quarter. Total discount accretion of the preferred stock in 2011 was \$2.9 million. There was no remaining preferred stock discount after the redemption transaction in September 2011, and therefore we did not record any discount accretion on preferred stock in 2012.

In the first quarter of 2011, we realized a \$10.2 million bargain purchase gain related to the acquisition of The Bank of Asheville in Asheville, North Carolina.

Total assets at December 31, 2012 amounted to \$3.2 billion, a 1.4% decrease from a year earlier. Total loans at December 31, 2012 amounted to \$2.4 billion, a 2.2% decrease from a year earlier, and total deposits amounted to \$2.8 billion at December 31, 2012, a 2.4% increase from a year earlier.

During 2012, we continued to originate new loans within our non-covered loan portfolio. However, due to the aforementioned loan sale, we wrote-down and transferred a total of \$68 million from this category in the fourth quarter of 2012. Even with the transfer, our non-covered loans increased by \$25.0 million, or 1.2%, for the year and amounted to \$2.1 billion at December 31, 2012.

While our total deposit increase was 2.4% for the year, there was a significant shift in the mix of our deposits. Our level of non-interest bearing checking accounts amounted to \$413.2 million at December 31, 2012, a 23.0% increase from a year earlier, while interest-bearing checking accounts amounted to \$519.6 million, an increase of 22.7% from a year earlier. The overall growth in checking and other transaction accounts allowed us to reduce our reliance on higher cost time deposits and borrowings. Time deposits declined by 12% and borrowings declined by 65%.

Net interest income for the year ended December 31, 2012 amounted to \$135.2 million, a 2.3% increase from the \$132.2 million recorded 2011. The higher net interest income was primarily caused by an increase in 2012 in the amount of discount accretion on loans purchased in failed bank acquisitions. Loan discount accretion amounted to \$16.5 million for 2012 compared to \$11.6 million in 2011, an increase of \$4.9 million. As previously discussed, the impact of changes in discount accretion on pretax income is only 20% of the gross amount of the change. See "Net Interest Income" below for additional information.

Our net interest margin (tax-equivalent net interest income divided by average earning assets) for 2012 was 4.78% compared to 4.72% for 2011. The higher margin was primarily a result of a higher amount of discount accretion as noted above, as well as lower overall funding costs. The higher amount of discount accretion was due to increased expectations regarding the collectability of the loans. Our cost of funds declined from 0.80% for 2011 to 0.59% in 2012.

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Our total provisions for loan losses amounted to \$79.7 million compared to \$41.3 million for 2011. For 2012, the provision for loan losses on non-covered loans amounted to \$70.0 million compared to \$28.5 million for 2011. The higher provision was primarily a result of the loan sale initiative and an elevated provision for loan losses we recorded in the first quarter of 2012, both of which were described above.

We recorded provisions for loan losses for covered loans amounting to \$9.7 million and \$12.8 million for the years ended December 31, 2012 and 2011, respectively. The lower provision for the year ended 2012 was due to stabilization in our assessment of the losses associated with our nonperforming covered loans.

Our non-covered nonperforming assets amounted to \$106.1 million at December 31, 2012 (3.64% of non-covered total assets) a decrease of \$16.2 million from the \$122.3 million recorded at December 31, 2011. The decrease was due to the write-downs associated with the loan sale, as well as the foreclosed property write-downs previously discussed. Upon the January 23, 2013 completion of the loan sale, nonperforming assets declined by an additional \$21.9 million, which was the amount of nonperforming loans held for sale at December 31, 2012.

Total covered nonperforming assets steadily declined during 2012, amounting to \$96.2 million at December 31, 2012 compared to \$141.0 million at December 31, 2011, a decline of 31.7%.

For the years ended December 31, 2012 and 2011, we recorded noninterest income of \$1.4 million and \$26.2 million, respectively. The significant decrease in noninterest income for 2012 compared to 2011 is primarily the result of covered and non-covered foreclosed property write-downs recorded in 2012 and the \$10.2 million bargain purchase gain recorded in the 2011 acquisition of The Bank of Asheville.

Noninterest expenses for the twelve months ended December 31, 2012 amounted to \$97.3 million, a 1.2% increase from the \$96.1 million recorded in 2011. The increase primarily relates to an increase in personnel expense, as we hired additional employees in order to build our infrastructure, expand wealth management capabilities, and prepare the Company for future growth.

Outlook for 2014

We have begun to see signs of a recovering economy in most of our market area. However, the recovery in our market area appears to be lagging and less robust than that of the national economy. Unemployment rates in our market area continue to be above the national average, and our local economic conditions remain challenging. We continue to have an elevated level of past due and adversely classified assets compared to historic averages. In fact, over the past year, we have experienced a steady increase in our non-covered nonperforming and adversely classified assets.

Despite the higher levels of these problem assets, based on our analysis, we believe the severity of the loss rate inherent in our classified loans is less than in recent years. In addition, we believe that our allowance for loan losses is sufficient to absorb the probable losses inherent in our portfolio at December 31, 2013. Accordingly, at the present time and based on current conditions, we do not expect our 2014 provision for loan losses related to non-covered assets to be materially greater than the amount recorded in 2013.

Because interest rates have progressively declined to historic lows, the rates we have realized on newly originated loans and newly purchased investment securities have generally decreased. As it relates to our funding costs, the yields on many of our deposits are already very low and the ability to lower them further is limited. Accordingly, we believe that compression of our net interest margin is likely.

We believe that regulatory reform will negatively impact our earnings. The regulatory climate is not favorable for banks. We expect additional overhead costs will be necessary to comply with the new regulations expected to arise directly or indirectly from the Dodd-Frank Act (see additional discussion in the “Legislative and Regulatory Developments” section).

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In 2009 and 2011 we acquired failed banks with approximately \$959 and \$193 million in assets, respectively. These acquisitions resulted in significant volatility to our earnings subsequent to the acquisitions, primarily as a result of the bargain purchase gains recorded on the acquisition dates that increased earnings and write-downs of foreclosed properties that negatively impacted earnings. While the volatility caused by these acquisitions on our earnings has generally lessened over the years, they may continue to add volatility to our reported earnings in 2014. The volatility may be positive to earnings, which would most likely occur if the credit quality of the acquired loans continues to stabilize or improves, or negative to earnings, which would most likely occur if the credit quality of the acquired loans deteriorates or if the properties we have foreclosed on continue to decline in value.

As discussed in the Risk Factors section above, one of our non-single family loss share agreements with the FDIC expires in June 2014, which will result in our company absorbing 100% of all losses related to those assets that occur subsequent to the expiration date. We are working diligently to resolve that portfolio of assets as prudently as possible. In addition, property values for most types of real estate appear to have generally stabilized. Accordingly, while concern remains, we do not currently expect that the expiration of the loss share agreement will have a material impact on our financial results for 2014.

We are expecting solid loan growth in 2014 as a result of a recovering economy in many of our market areas, enhanced credit processes that we recently implemented that allow us to be more responsive to our customers, and the growth we expect from our three newly establish loan production offices in Charlotte, Greenville and Fayetteville, which we believe are attractive markets in North Carolina.

In December 2013, we introduced a new deposit product line-up. In addition to simplifying our product offering, which was a primary goal, other significant changes included the elimination of our free checking account for customers maintaining low account balances and the elimination of paper statement fees and certain overdraft fees. As a result of these changes, we expect a significant net increase in our service charges on deposit accounts in 2014 over 2013.

Due to increases in our level of lending to small businesses, we expect that the dividend rate on the \$63.5 million of preferred stock that was issued to the US Treasury in connection with our participation in the Small Business Lending Fund will be 1.0% until 2016, unless the preferred stock is redeemed at an earlier date.

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Critical Accounting Policies

The accounting principles we follow and our methods of applying these principles conform with accounting principles generally accepted in the United States of America and with general practices followed by the banking industry. Certain of these principles involve a significant amount of judgment and may involve the use of estimates based on our best assumptions at the time of the estimation. The allowance for loan losses, intangible assets, and the fair value and discount accretion of loans acquired in FDIC-assisted transactions

are three policies we have identified as being more sensitive in terms of judgments and estimates, taking into account their overall potential impact to our consolidated financial statements.

Allowance for Loan Losses

Due to the estimation process and the potential materiality of the amounts involved, we have identified the accounting for the allowance for loan losses and the related provision for loan losses as an accounting policy critical to our consolidated financial statements. The provision for loan losses charged to operations is an amount sufficient to bring the allowance for loan losses to an estimated balance considered adequate to absorb losses inherent in the portfolio.

Our determination of the adequacy of the allowance is based primarily on a mathematical model that estimates the appropriate allowance for loan losses. This model has three components. The first component involves the estimation of losses on individually significant “impaired loans”. A loan is considered to be impaired when, based on current information and events, it is probable we will be unable to collect all amounts due according to the contractual terms of the loan agreement. A loan is specifically evaluated for an appropriate valuation allowance if the loan balance is above a prescribed evaluation threshold (which varies based on credit quality, accruing status, and type of collateral) and the loan is determined to be impaired. The estimated valuation allowance is the difference, if any, between the loan balance outstanding and the value of the impaired loan as determined by either 1) an estimate of the cash flows that we expect to receive from the borrower discounted at the loan’s effective rate, or 2) in the case of a collateral-dependent loan, the fair value of the collateral.

The second component of the allowance model is the estimation of losses for impaired loans that have common risk characteristics and are aggregated to measure impairment. These impaired loans generally have loan balances below the thresholds that result in an individual review discussed above. For these impaired loans, we aggregate loans among similar loan types and apply loss rates that are derived from historical statistics.

The third component of the allowance model is the estimation of losses for loans that are not considered to be impaired loans. Loans not considered to be impaired are segregated by loan type, and estimated loss percentages are assigned to each loan type, based on historical losses, current economic conditions, and operational conditions specific to each loan type. For loans with more than standard risk, loss percentages are based on a multiple of the estimated

loss rate for loans of a similar loan type with normal risk. The multiples assigned vary by type of loan, depending on risk, and we have consulted with an external credit review firm in assigning those multiples.

The reserves estimated for impaired loans (specifically reviewed and aggregate) are then added to the reserve estimated for all other loans. This becomes our “allocated allowance.” In addition to the allocated allowance derived from the model, we also evaluate other data such as the ratio of the allowance for loan losses to total loans, net loan growth information, nonperforming asset levels and trends in such data. Based on this additional analysis, we may determine that an additional amount of allowance for loan losses is necessary to reserve for probable losses. This additional amount, if any, is our “unallocated allowance.” The sum of the allocated allowance and the unallocated allowance is compared to the actual allowance for loan losses recorded on our books and any adjustment necessary for the recorded allowance to equal the computed allowance is recorded as a provision for loan losses. The provision for loan losses is a direct charge to earnings in the period recorded.

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Loans covered under loss share agreements (referred to as “covered loans”) are recorded at fair value at acquisition date. Therefore, amounts deemed uncollectible at acquisition date become a part of the fair value calculation and are excluded from the allowance for loan losses. Subsequent decreases in the amount expected to be collected result in a provision for loan losses with a corresponding increase in the allowance for loan losses. Subsequent increases in the amount expected to be collected are accreted into income over the life of the loan. Proportional adjustments are also recorded to the FDIC indemnification asset.

Although we use the best information available to make evaluations, future material adjustments may be necessary if economic, operational, or other conditions change. In addition, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses. Such agencies may require us to recognize additions to the allowance based on the examiners’ judgment about information available to them at the time of their examinations.

For further discussion, see “Nonperforming Assets” and “Summary of Loan Loss Experience” below.

Intangible Assets

Due to the estimation process and the potential materiality of the amounts involved, we have also identified the accounting for intangible assets as an accounting policy critical to our consolidated financial statements.

When we complete an acquisition transaction, the excess of the purchase price over the amount by which the fair market value of assets acquired exceeds the fair market value of liabilities assumed represents an intangible asset. We must then determine the identifiable portions of the intangible asset, with any remaining amount classified as goodwill. Identifiable intangible assets associated with these acquisitions are generally amortized over the estimated life of the related asset, whereas goodwill is tested annually for impairment, but not systematically amortized. Assuming no goodwill impairment, it is beneficial to our future earnings to have a lower amount assigned to identifiable intangible assets and higher amount of goodwill as opposed to having a higher amount considered to be identifiable intangible assets and a lower amount classified as goodwill.

The primary identifiable intangible asset we typically record in connection with a whole bank or bank branch acquisition is the value of the core deposit intangible, whereas when we acquire an insurance agency, the primary identifiable intangible asset is the value of the acquired customer list. Determining the amount of identifiable intangible assets and their average lives involves multiple assumptions and estimates and is typically determined by performing a discounted cash flow analysis, which involves a combination of any or all of the following assumptions: customer attrition/runoff, alternative funding costs, deposit servicing costs, and discount rates. We typically engage a third party consultant to assist in each analysis. For the whole bank and bank branch transactions recorded to date, the core deposit intangibles have generally been estimated to have a life ranging from seven to ten years, with an

accelerated rate of amortization. For insurance agency acquisitions, the identifiable intangible assets related to the customer lists were determined to have a life of ten to fifteen years, with amortization occurring on a straight-line basis.

Subsequent to the initial recording of the identifiable intangible assets and goodwill, we amortize the identifiable intangible assets over their estimated average lives, as discussed above. In addition, on at least an annual basis, goodwill is evaluated for impairment by comparing the fair value of our reporting units to their related carrying value, including goodwill (our community banking operation is our only material reporting unit). If the carrying value of a reporting unit were ever to exceed its fair value, we would determine whether the implied fair value of the goodwill, using a discounted cash flow analysis, exceeded the carrying value of the goodwill. If the carrying value of the goodwill exceeded the implied fair value of the goodwill, an impairment loss would be recorded in an amount equal to that excess. Performing such a discounted cash flow analysis would involve the significant use of estimates and assumptions.

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In our 2013 goodwill impairment evaluation, we engaged a consulting firm that used various valuation techniques to assist us in concluding that our goodwill was not impaired.

We review identifiable intangible assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Our policy is that an impairment loss is recognized, equal to the difference between the asset's carrying amount and its fair value, if the sum of the expected undiscounted future cash flows is less than the carrying amount of the asset. Estimating future cash flows involves the use of multiple estimates and assumptions, such as those listed above.

Fair Value and Discount Accretion of Loans Acquired in FDIC-Assisted Transactions

We consider the determination of the initial fair value of loans acquired in FDIC-assisted transactions, the initial fair value of the related FDIC indemnification asset, and the subsequent discount accretion of the purchased loans to involve a high degree of judgment and complexity. We determine fair value accounting estimates of newly assumed assets and liabilities in accordance with relevant accounting guidance. However, the amount that we realize on these assets could differ materially from the carrying value reflected in our financial statements, based upon the timing of collections on the acquired loans in future periods. To the extent the actual values realized for the acquired loans are different from the estimates, the FDIC indemnification asset will generally be impacted in an offsetting manner due to the loss-sharing support from the FDIC.

Because of the inherent credit losses associated with the acquired loans in a failed bank acquisition, the amount that we record as the fair values for the loans is generally less than the contractual unpaid principal balance due from the borrowers, with the difference being referred to as the "discount" on the acquired loans. We have applied the cost recovery method of accounting to all purchased impaired loans due to the uncertainty as to the timing of expected cash flows. This will generally result in the recognition of interest income on these impaired loans only when the cash payments received from the borrower exceed the recorded net book value of the related loans.

For nonimpaired purchased loans, we accrete the discount over the lives of the loans in a manner consistent with the guidance for accounting for loan origination fees and costs.

Merger and Acquisition Activity

In 2011, we completed the acquisition of The Bank of Asheville, an FDIC-assisted transaction previously discussed. In 2012, we completed a small branch acquisition, consisting of approximately \$9 million in deposits, which were transferred to a First Bank branch located nearby. In 2013, we completed an acquisition of two branches with \$57

million in deposits and \$16 million in loans. In the 2013 acquisition, we purchased one of the branch buildings, while transferring the accounts of the other branch to an existing branch located nearby. The results of each acquired company/branch are included in our financial statements beginning on their respective acquisition dates. See Note 2 to the consolidated financial statements for additional information regarding these acquisitions.

FDIC Indemnification Asset

As previously discussed, on June 19, 2009 and January 21, 2011, we acquired substantially all of the assets and liabilities of Cooperative Bank and The Bank of Asheville, respectively, in FDIC-assisted transactions. For each transaction, the loans and foreclosed real estate purchased are covered by two loss share agreements with the FDIC, which afford First Bank significant loss protection. Under the Cooperative Bank loss share agreements, the FDIC will cover 80% of covered loan and foreclosed real estate losses up to \$303 million, and 95% of losses in excess of that amount. Under The Bank of Asheville loss share agreements, the FDIC will cover 80% of all covered loan and foreclosed real estate losses. For both transactions, the loss share reimbursements are applicable for ten years for single family home loans and five years for all other loans.

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We have recorded a FDIC indemnification asset related to the two transactions to account for payments that we expect to receive from the FDIC related to the loss share agreements. The carrying value of this receivable at each period end is the sum of: 1) actual claims that have been incurred and are in the process of submission to the FDIC for reimbursement, but have not yet been received and 2) our estimated amount of claimable loan and other real estate losses covered by the agreements multiplied by the FDIC reimbursement percentage.

At December 31, 2013 and 2012, the FDIC indemnification asset was comprised of the following components:

(\$ in thousands)	2013	2012
Receivable related to claims incurred, not yet received	\$12,649	33,040
Receivable related to estimated future claims on loans	33,398	62,044
Receivable related to estimated future claims on other real estate owned	2,575	7,475
FDIC indemnification asset	\$48,622	102,559

As of each acquisition date, based on the losses inherent in the covered assets and what we estimated we would receive as payments from the FDIC, we recorded a “FDIC Indemnification Asset.” Since that time, we have recorded adjustments to the indemnification asset as discussed below.

The FDIC indemnification asset has generally been adjusted upwards in the following circumstances:

1) Deterioration of credit quality of covered loans – As of the acquisition dates, we recorded the loans acquired from Cooperative Bank and The Bank of Asheville on our books at a fair value that was \$227.9 million and \$51.7 million, respectively, less than the contractual amounts due from the borrowers, which was our estimate of the loan losses inherent in the portfolio. As the credit quality of these portfolios change and better information is obtained about likely losses, some loans have better repayment expectations than we originally projected and some loans have worse repayment expectations than originally projected. For loans with worse repayment expectations, we generally record provisions for loan losses with corresponding increases to the FDIC indemnification asset by recording noninterest income in proportion to the reimbursement percentage. However, beginning in the fourth quarter of 2012, we began recording some provisions for loan losses without corresponding increases to the indemnification asset because we believe certain loan losses will occur after the June 2014 expiration of the Cooperative Bank non-single family share agreement and after the January 2016 expiration of the Bank of Asheville non-single family share agreement. In 2013, 2012 and 2011, we recorded total provisions for loan losses on covered loans amounting to \$12.4 million, \$9.7 million and \$12.8 million, respectively, which resulted in upward adjustments to the FDIC indemnification asset of \$9.6 million, \$6.6 million and \$10.2 million, respectively. In 2013 and 2012, we recorded provisions for loan losses on covered loans without a corresponding increase to the indemnification asset of \$0.3 million and \$1.5 million, respectively.

2) Write-downs and losses on foreclosed properties – When we foreclose on delinquent borrowers, we initially record the foreclosed property at the lower of book or fair value (based on current appraisals), with any deficiency recorded as a loan charge-off. Subsequent to the foreclosure, we periodically order updated appraisals and if the appraisal indicates a fair value lower than our carrying value, we must write the property down. We also sell foreclosed properties that frequently result in losses. Each of these situations results in the Company recording losses on other real estate owned with a corresponding increase to the FDIC indemnification asset by recording noninterest income in proportion to the reimbursement percentage. If we sell foreclosed properties that result in gains, then we record a corresponding decrease to the FDIC indemnification asset to reflect the fact that reimbursements from loss claims will be reduced by the gains. In 2013, we recorded net gains on covered foreclosed properties amounting to \$0.4 million, which resulted in a downward adjustment to the FDIC indemnification asset of \$0.3 million. In 2012 and 2011, we recorded net losses and write downs on covered foreclosed properties amounting to \$13.0 million and \$24.5 million, respectively, which resulted in upward adjustments to the FDIC indemnification asset of \$10.4 million and \$19.6 million, respectively.

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3) Expenses incurred related to collection activities on covered assets – As a result of our collection efforts, we incur expenses such as legal fees, property taxes and appraisal costs. Many of these expenses are reimbursable by the FDIC. These expenses are recorded as “other” noninterest expenses and a corresponding increase is made to increase the FDIC indemnification asset by reducing the gross collection expenses by the amount expected to be reimbursed by the FDIC for eligible expenses. In 2013, 2012, and 2011, we incurred \$6.5 million, \$9.5 million, and \$8.5 million, in gross collection expenses related to covered assets, respectively, and reduced that amount by \$5.4 million, \$6.9 million, and \$5.7 million in FDIC reimbursements, respectively.

The FDIC indemnification asset has generally been adjusted downwards in the following circumstances:

1) Receipt of cash from the FDIC related to claims submitted – On at least a quarterly basis, we submit eligible loss share claims to the FDIC. After reviewing and approving the claims, the FDIC wires us cash, which reduces the amount of the FDIC indemnification asset. In 2013, 2012, and 2011, we received \$49.6 million, \$29.8 million, and \$69.3 million, in FDIC reimbursements, respectively.

2) Accretion of discount on acquired loans – As noted above, we recorded the acquired loans of the two transactions on our books at a fair value that was \$280 million (in total) less than the contractual amounts due from the borrowers (the “discount”), which was our estimate of the loan losses inherent in the portfolio. As the credit quality of this portfolio changes and better information is obtained about likely losses, some loans have better repayment expectations than we originally projected and some loans have worse repayment expectations than originally projected (discussed above). For loans with improved repayment expectations, we are systematically reducing the discount over the life of the loan. For some loans, we have received complete payoffs at the contractual balance and the discount must be reduced to zero. When we reduce/accrete the discount, we do so by recognizing interest income in that same amount. When the expected losses on loans with improved repayment expectations becomes less than the original estimate, our expected reimbursement from the FDIC declines as well. Accordingly, we reduce the FDIC indemnification asset by the corresponding reimbursement percentage. In 2013, 2012, and 2011, we recorded discount accretion of \$20.2 million, \$16.5 million, and \$11.6 million, respectively, which resulted in a reduction of FDIC indemnification asset and indemnification expense of \$16.2 million, \$13.2 million, and \$9.3 million, respectively.

In summary, circumstances that result in adjustments to the FDIC indemnification asset are recorded within the income statement line items noted without consideration of the FDIC loss share agreements. Because favorable changes in covered assets result in lower expected FDIC claims, and unfavorable changes in covered assets generally result in higher expected FDIC claims, the FDIC indemnification asset is adjusted to reflect those expectations. The net increase or decrease in the indemnification asset is reflected within noninterest income.

The adjustments can result in volatility within individual income statement line items. Because of the FDIC loss share agreements and the associated indemnification asset, amounts recorded as provisions for loan losses, discount accretion, and losses from foreclosed properties generally only impact pretax income by 20% of those amounts, due to the corresponding adjustments made to the indemnification asset.

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The following presents a rollforward of the FDIC indemnification asset since the date of the Cooperative Bank acquisition on June 19, 2009.

(\$ in thousands)	
Balance at June 19, 2009	\$ 185,112
Decrease related to favorable change in loss estimates	(1,516)
Increase related to reimbursable expenses	1,300
Cash received	(40,500)
Accretion of loan discount	(1,175)
Balance at December 31, 2009	143,221
Increase related to unfavorable change in loss estimates	30,419
Increase related to reimbursable expenses	2,900
Cash received	(46,721)
Accretion of loan discount	(6,100)
Balance at December 31, 2010	123,719
Increase related to acquisition of The Bank of Asheville	42,218
Increase related to unfavorable change in loss estimates	29,814
Increase related to reimbursable expenses	5,725
Cash received	(69,339)
Accretion of loan discount	(9,278)
Other	(1,182)
Balance at December 31, 2011	121,677
Increase related to unfavorable change in loss estimates	16,984
Increase related to reimbursable expenses	6,947
Cash received	(29,796)
Accretion of loan discount	(13,173)
Other	(80)
Balance at December 31, 2012	102,559
Increase related to unfavorable change in loss estimates	9,312
Increase related to reimbursable expenses	5,352
Cash received	(49,572)
Accretion of loan discount	(16,160)
Other	(2,869)
Balance at December 31, 2013	\$48,622

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The following table presents additional information regarding our covered loans, loan discounts, allowances for loan losses and the corresponding FDIC indemnification asset:

(\$ in thousands)

	Cooperative Single Family Loss Share Loans	Cooperative Non-Single Family Loss Share Loans	Bank of Asheville Single Family Loss Share Loans	Bank of Asheville Non- Single Family Loss Share Loans	Total
<u>At December 31, 2013</u>					
Expiration of loss share agreement	6/19/2019	6/19/2014	1/21/2021	1/21/2016	
Nonaccrual covered loans					
Unpaid principal balance	12,342	40,473	518	7,061	60,394
Carrying value prior to loan discount*	12,192	26,998	403	5,661	45,254
Loan discount	2,564	3,030	279	2,165	8,038
Net carrying value	9,628	23,968	124	3,496	37,216
Allowance for loan losses	764	942		208	1,914
Indemnification asset recorded	2,662	3,042	223	1,898	7,825
All other covered loans					
Unpaid principal balance	118,353	38,504	12,052	36,410	205,319
Carrying value prior to loan discount*	118,269	38,032	11,971	36,390	204,662
Loan discount	16,046	2,504	3,528	9,491	31,569
Net carrying value	102,223	35,528	8,443	26,899	173,093
Allowance for loan losses	129	1,905	22	272	2,328
Indemnification asset recorded	12,940	2,418	2,840	7,593	25,791
All covered loans					
Unpaid principal balance	130,695	78,977	12,570	43,471	265,713