

COMMUNITY FINANCIAL CORP /MD/  
Form 10-K  
March 10, 2016

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, DC 20549**

**FORM 10-K**

**(Mark One)**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF**  
**<sup>x</sup>1934**

For the fiscal year ended December 31, 2015

**OR**

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

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

Commission File No. **0-18279**

**The Community Financial Corporation**

(Exact name of registrant as specified in its charter)

**Maryland** **52-1652138**

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

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

Registrant's telephone number, including area code: (301) 645-5601

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

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Common Stock, par value \$.01 per share	The NASDAQ Stock Market, LLC

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

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. 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 Act. 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 Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Yes  No

Indicate by check mark 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 registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer  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

The aggregate market value of voting stock held by non-affiliates of the registrant was approximately \$84.2 million based on the closing price \$21.50 per share at which the common stock was sold on the last business day of the Company's most recently completed second fiscal quarter. For purposes of this calculation only, the shares held by directors, executive officers and the Company's Employee Stock Ownership Plan of the registrant are deemed to be shares held by affiliates.

Number of shares of common stock outstanding as of March 3, 2016: 4,652,292

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for the 2016 Annual Meeting of Stockholders. (Part III)

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## **PART I**

*This report contains certain “forward-looking statements” within the meaning of the federal securities laws. These statements are not historical facts, rather statements based on The Community Financial Corporation’s current expectations regarding its business strategies, intended results and future performance. Forward-looking statements are preceded by terms such as “expects,” “believes,” “anticipates,” “intends” and similar expressions.*

Management’s ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors that could affect actual results include interest rate trends, the general economic climate in the market area in which The Community Financial Corporation operates, as well as nationwide, The Community Financial Corporation’s ability to control costs and expenses, competitive products and pricing, changes in accounting principles, loan demand, loan delinquency rates, charge-offs, changes in federal and state legislation and regulation and effectively manage the risks the Company faces, including credit, operational and cyber security risks. These factors should be considered in evaluating the forward-looking statements and undue reliance should not be placed on such statements. The Community Financial Corporation assumes no obligation to update any forward-looking statement after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

### Item 1. Business

#### **Business**

The Community Financial Corporation (the “Company”) is a bank holding company organized in 1989 under the laws of the State of Maryland. It owns all the outstanding shares of capital stock of Community Bank of the Chesapeake (the “Bank”), a Maryland-chartered commercial bank. The Bank was organized in 1950 as Tri-County Building and Loan Association of Waldorf, a mutual savings and loan association, and in 1986 converted to a federal stock savings bank and adopted the name Tri-County Federal Savings Bank. In 1997, the Bank converted to a Maryland-chartered commercial bank and adopted the name Community Bank of Tri-County. Effective October 18, 2013, Community Bank changed its name to become Community Bank of the Chesapeake.

The Company engages in no significant activity other than holding the stock of the Bank and operating the business of the Bank. Accordingly, the information set forth in this 10-K, including financial statements and related data, relates primarily to the Bank and its subsidiaries.

The Bank maintains its main office and operations center in Waldorf, Maryland, in addition to its branch offices in Lexington Park, Leonardtown, La Plata, Dunkirk, Bryans Road, Waldorf, Charlotte Hall, Prince Frederick and Lusby, Maryland and Fredericksburg and King George, Virginia. The Company's second branch in Fredericksburg is scheduled to open in downtown during the first quarter of 2016. During the third quarter of 2015, the Company agreed to sell its King George, Virginia branch building and equipment and the transaction closed on January 28, 2016. In addition, the Bank maintains five loan production offices ("LPOs") in La Plata, Prince Frederick, Leonardtown and Annapolis, Maryland and Fredericksburg, Virginia. The Leonardtown and Fredericksburg LPOs are co-located with branches. The Annapolis LPO opened in October 2014.

The Bank operates 16 automated teller machines including four stand-alone locations. The Bank offers telephone and internet banking services. The Bank is engaged in the commercial and retail banking business as authorized by the banking statutes of the States of Maryland and Virginia and applicable federal regulations, including the acceptance of deposits, and the origination of loans to individuals, associations, partnerships and corporations. The Bank's real estate portfolio consists of commercial mortgage loans, residential first and second mortgage loans and home equity lines of credit. Commercial lending consists of both secured and unsecured loans. The Bank is a member of the Federal Reserve and Federal Home Loan Bank (the "FHLB") system and its deposits are insured up to applicable limits by the Deposit Insurance Fund administered by the Federal Deposit Insurance Corporation ("FDIC").

### **Market Area**

The Bank considers its principal lending and deposit market area to consist of the tri-county area in Southern Maryland and the greater Fredericksburg market in Virginia. As a result of the Bank's expansion into the greater Fredericksburg market in 2013, Stafford County has become part of the Bank's principal lending and deposit market area. The Annapolis LPO opening in October 2014 provided additional growth in 2015. Our market area is one of the fastest growing regions in the country and is home to a mix of federal facilities, industrial and high-tech businesses.

The presence of several major federal facilities located within the Bank's footprint and in adjoining counties contribute to economic growth. Major federal facilities include the Patuxent River Naval Air Station in St. Mary's County, the Indian Head Division, Naval Surface Warfare Center in Charles County and the Naval Surface Warfare –Naval Support Facility in King George County. In addition, there are several major federal facilities located in adjoining markets including Andrews Air Force Base and Defense Intelligence Agency & Defense Intelligence Analysis Center in Prince Georges County, Maryland and the U.S. Marine Base Quantico, Drug Enforcement Administration Quantico facility and Federal Bureau of Investigation Quantico facility in Prince William County, Virginia. These facilities directly employ thousands of local employees and serve as an important player in the region's overall economic health.

The economic health of the region, while stabilized by the influence of the federal government, is not solely dependent on this sector. Calvert County is home to the Dominion Power Cove Point Liquid Natural Gas Terminal, which is one of the nation's largest liquefied natural gas terminals and Dominion Power is currently constructing liquefaction facilities for exporting liquefied natural gas. Based on information from the U.S. Bureau of Labor Statistics, unemployment rates in the Company's footprint have historically remained well below the national average.

Southern Maryland is generally considered to have more affordable housing than many other Washington and Baltimore area suburbs. During the recession, growth in the Bank's market area was slowed as the demand for new housing in the tri-county area fell with the overall housing market. According to the Maryland Department of Planning, new housing unit starts fell from 2006 through 2010. However, after 2010, real estate values stabilized and there were positive trends in housing beginning in 2012.

The Bank expanded into the greater Fredericksburg, Virginia market in August 2013. According to the Fredericksburg Regional Alliance, the Fredericksburg Region, including the City of Fredericksburg and the counties of Caroline, King George, Spotsylvania, and Stafford, Virginia, has been one of the the fastest growing region in the Commonwealth of Virginia for greater than the past eight years.

The Bank's primary market area also boasts a strong median household income. According to SNL Financial, the median household income in 2014 was greater than \$94,000 and \$92,000, respectively, for our legacy Southern Maryland market and for our new markets of Fredericksburg and Annapolis compared to slightly more than \$51,000 for the United States.

## **Competition**

The Bank faces strong competition in the attraction of deposits and in the origination of loans. Its most direct competition for deposits and loans comes from other banks, savings and loan associations and federal and state credit unions located in its primary market area. There are more than 25 FDIC-insured depository institutions operating in the Bank's footprint including subsidiaries of several large, regional and national bank holding companies. The Bank



also faces additional significant competition for customers' funds from mutual funds, brokerage firms, and other financial service companies. The Bank competes for loans by providing competitive rates and flexibility of terms and service, including customer access to senior decision makers. It competes for deposits by offering depositors a wide variety of account types, convenient office locations and competitive rates. Other services offered include tax deferred retirement programs, brokerage services through an affiliation with Community Wealth Advisors, cash management services and safe deposit boxes. The Bank has used targeted direct mail, print and online advertising and community outreach to increase its market share of deposits, loans and other services in its market area. It provides ongoing training for its staff in an attempt to ensure high-quality service.

## **Lending Activities**

### ***General***

The Bank offers a wide variety of real estate and commercial loans. The Bank's lending activities include commercial real estate loans, construction loans, land acquisition and development loans, equipment financing, commercial and consumer loans. The Company exited the residential mortgage origination line of business in April 2015 and has established third party sources to supply its residential whole loan portfolio. Most of the Bank's customers are residents of, or businesses located in the Bank's market area. The Bank's primary targets for commercial loans consist of small and medium-sized businesses with revenues of \$5.0 million to \$35.0 million as well as local municipal agencies and not-for-profits in Southern Maryland, the Annapolis area of Maryland, the Northern Neck region, and the greater Fredericksburg area of Virginia.

### ***Commercial Real Estate (CRE) and Other Non-Residential Real Estate Loans***

The permanent financing of commercial and other improved real estate projects, including office buildings, retail locations, churches, and other special purpose buildings, is the largest component of the Bank's loan portfolio. Commercial real estate loans amounted to \$613.5 million or 66.8% of the loan portfolio and \$561.1 million or 64.3% of the loan portfolio, respectively at December 31, 2015 and 2014. This portfolio has increased in both absolute size and as a percentage of the loan portfolio in each of the last five years. The CRE portfolio includes commercial construction balances. At December 31, 2015 and 2014, commercial construction balances were 5.3% and 4.4% of the CRE portfolio.

The primary security on a commercial real estate loan is the real property and the leases or businesses that produce income for the real property. The Bank generally limits its exposure to a single borrower to 15% of the Bank's capital and participates with other lenders on larger projects. Loans secured by commercial real estate are generally limited to 80% of the lower of the appraised value or sales price and have an initial contractual loan amortization period ranging from three to 20 years. Interest rates and payments on these loans typically adjust after an initial fixed-rate period, which is generally between three and ten years. Interest rates and payments on adjustable-rate loans are adjusted to a rate based on the United States Treasury Bill Index. Almost all of the Bank's commercial real estate loans are secured by real estate located in the Bank's primary market area. At December 31, 2015 and 2014, the largest outstanding commercial real estate loan was \$9.7 million and \$9.9 million, respectively, which is secured by commercial real estate and was performing according to its terms at December 31, 2015 and 2014.

Loans secured by commercial real estate are larger and involve greater risks than one- to four-family residential mortgage loans. Because payments on loans secured by such properties are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to a greater extent to adverse conditions in the real estate market or the economy. As a result of the greater emphasis that the Bank places on increasing its portfolio of commercial real estate loans, the Bank is increasingly exposed to the risks posed by this type of lending. To monitor cash flows on income properties, the Bank requires borrowers and loan guarantors, if any, to provide annual financial statements on multi-family or commercial real estate loans. In reaching a decision on whether to make a multi-family or commercial real estate loan, the Bank considers the net operating income of the property, the borrower's expertise, credit history and profitability, and the value of the underlying property, as well as the borrower's global cash flows. Environmental surveys are generally required for commercial real estate loans over \$250,000.

### ***Residential First Mortgage Loans***

Residential first mortgage loans are generally long-term loans, amortized on a monthly or bi-weekly basis, with principal and interest due each payment. The initial contractual loan payment period for residential loans typically ranges from ten to 30 years. The Bank's experience indicates that residential real estate loans remain outstanding for significantly shorter time periods than their contractual terms. Borrowers may refinance or prepay loans at their option, without penalty. The Bank originates both fixed-rate and adjustable-rate residential first mortgages.

The Company exited the residential mortgage origination line of business in April 2015 and has established third party sources to fund its residential whole loan portfolio. The third party sources will allow the Company to maintain a well-diversified residential portfolio while addressing the credit needs of the communities in its footprint. The Bank's practice has been to purchase the right to service the loans acquired.

Fixed-rate residential first mortgages include loan periods from ten to 30 years and bi-weekly payment loans. Total fixed-rate loans in our residential first mortgage portfolio amounted to \$116.4 million and \$125.5 million, respectively, as of December 31, 2015 and 2014. Fixed-rate loans may be packaged and sold to investors or retained in the Bank's loan portfolio. The Bank generally retains the right to service loans sold for a payment based upon a percentage (generally 0.25% of the outstanding loan balance). As of December 31, 2015 and 2014, the Bank serviced \$63.0 million and \$68.7 million, respectively, in residential mortgage loans for others.

Adjustable mortgages are generally adjustable on a one-, three- and five-year basis with limitations on upward adjustments per re-pricing period and a upward cap over the life of the loan. As of December 31, 2015 and 2014, the Bank had \$33.6 million and \$27.4 million, respectively, in adjustable-rate residential mortgage loans. At December 31, 2015, the largest outstanding residential first mortgage loan was \$10.8 million, which was secured by over 120 single family homes located in the Bank's market area. The loan was performing according to its terms at December 31, 2015. At December 31, 2014, the largest outstanding residential first mortgage loan was \$2.2 million, which was secured by a residence located in the Bank's market area. The loan was performing according to its terms at December 31, 2014.

The Bank's practice has been to purchase individual residential first mortgage loans secured by owner-occupied single-family homes from the Bank's third party partners. The Bank underwrites non-owner occupied one- to four-family loans up to a maximum 80% loan-to-value of the appraised value depending on the overall strength of the application. Residential first mortgage loans with loan-to-value ratios in excess of 80% generally carry private mortgage insurance to lower the Bank's exposure to approximately 80% of the value of the property. The Bank had fewer than 10 loans with private mortgage insurance at December 31, 2015 and 2014.

All improved real estate that serves as security for a loan made by the Bank must be insured, in the amount and by such companies as may be approved by the Bank, against fire, vandalism, malicious mischief and other hazards. Such insurance must be maintained through the entire term of the loan and in an amount not less than that amount necessary to pay the Bank's indebtedness in full.

### ***Construction and Land Development Loans***

The Bank offers construction loans for the construction of one- to four-family dwellings to home builders. Construction loans totaled \$14.1 million and \$14.5 million, respectively, at December 31, 2015 and 2014. Generally, these loans are secured by the real estate under construction as well as by guarantees of the principals involved. Draws are made upon satisfactory completion of predefined stages of construction. The Bank will typically lend up to the lower of 80% of the appraised value or the contract purchase price of the homes to be constructed. In addition, the Bank offers loans to acquire and develop land, as well as loans on undeveloped, subdivided lots for home building by individuals. Land acquisition and development loans totaled \$22.0 million and \$21.9 million, respectively, at December 31, 2015 and 2014. Bank policy requires that zoning and permits must be in place prior to making development loans. The Bank will typically lend up to the lower of 75% of the appraised value or cost. At December 31, 2015 and 2014, the largest outstanding construction and land development loan was \$4.9 million, which was secured by land in the Bank's market area.

The Bank's ability to originate residential construction and development loans is heavily dependent on the continued demand for single-family housing construction in the Bank's market area. The Bank's investment in these loans has declined in recent years. Construction and land development loans as a percentage of the total loan portfolio have been decreasing since 2008 from greater than 10% as of December 31, 2008 to 3.9% at December 31, 2015. If the demand for new houses being built from smaller builders in the Bank's market areas continues to decline, this portion of the loan portfolio may continue to decline. In addition, a decline in demand for new housing might adversely affect the ability of borrowers to repay these loans.

Construction and land development loans are inherently riskier than providing financing on owner-occupied real estate. The Bank's risk of loss is affected by the accuracy of the initial estimate of the market value of the completed project as well as the accuracy of the cost estimates made to complete the project. In addition, the volatility of the real estate market has made it increasingly difficult to ensure that the valuation of land associated with these loans is accurate. During the construction phase, a number of factors could result in delays and cost overruns. If the estimate of

construction costs proves to be inaccurate, the Bank may be required to advance funds beyond the amount originally committed to permit completion of the development. If the estimate of value proves to be inaccurate, the Bank may be confronted, at or before the maturity of the loan, with a project having a value that is insufficient to assure full repayment. As a result of these factors, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the project rather than the ability of the borrower or guarantor to repay principal and interest. If the Bank forecloses on a project, the Bank may not be able to recover all of the unpaid balance of, and accrued interest on, the loan as well as related foreclosure and holding costs.

### *Home Equity and Second Mortgage Loans*

The Bank maintains a portfolio of home equity and second mortgage loans. Home equity loans, which totaled \$19.5 million and \$18.7 million, respectively at December 31, 2015 and 2014, are generally made in the form of lines of credit with minimum amounts of \$5,000, have terms of up to 20 years, variable rates priced at the then current Wall Street Journal prime rate plus a margin, and require an 80% or 90% loan-to-value ratio (including any prior liens), depending on the specific loan program. Second mortgage loans, which totaled \$2.2 million and \$2.8 million, respectively at December 31, 2015 and 2014, are fixed or variable-rate loans that have original terms between five and 15 years. Loan-to-value ratios of up to 95% are allowed depending on the specific loan program.

These products contain a higher risk of default than residential first mortgages as in the event of foreclosure, the first mortgage would need to be paid off prior to collection of the second mortgage. This risk has been heightened as the market value of residential property has declined. The Bank monitors the property values of the properties that secure its second mortgages and is lowering credit availability where prudent. The Bank believes that its policies and procedures are sufficient to mitigate the additional risk posed by these loans at the current time.

### ***Commercial Loans***

The Bank offers commercial loans to its business customers. The Bank offers a variety of commercial loan products including term loans and lines of credit. The portfolio consists primarily of demand loans and lines of credit. Such loans can be made for terms of up to five years. However, most of the loans are originated for a term of two years or less. The Bank offers both fixed-rate and adjustable-rate loans (typically tied to the then current Wall Street Journal prime rate plus a margin with a floor) under these product lines. Commercial loans remain an important class of the Bank's loan portfolio, but have decreased as a percentage of total loans and in total dollars over the last few years. At \$67.2 million and 7.3% of total loans and \$73.6 million and 8.4% of total loans at December 31, 2015 and 2014, respectively, the commercial loan portfolio decreased by \$6.4 million and \$20.6 million compared to the prior year end balance.

When making commercial business loans, the Bank considers the financial condition of the borrower, the borrower's payment history of both corporate and personal debt, the projected cash flows of the business as well the borrower's global cash flows, the viability of the industry in which the borrower operates, the value of the collateral, and the borrower's ability to service the debt. These loans are primarily secured by equipment, real property, accounts receivable or other security as determined by the Bank. The higher interest rates and shorter loan terms available on commercial lending make these products attractive to the Bank.

Commercial business loans, however, entail greater risk than residential mortgage loans. Unlike residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income and which are secured by real property whose value tends to be more easily ascertainable, commercial loans are made on the basis of the borrower's ability to make repayment from the cash flows of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. In the case of business failure, collateral would need to be liquidated to provide repayment for the loan. In many cases, the highly specialized nature of collateral would make full recovery from the sale of collateral problematic. The Bank attempts to control these risks by establishing guidelines that provide for loans with low loan-to-value ratios. At December 31, 2015 and 2014, the largest outstanding commercial loan was \$12.0 million, which was secured by commercial real estate (all of which was located in the Bank's market area), cash and investments. This loan was performing according to its terms at December 31, 2015 and 2014. This operating line of credit was paid off subsequent to December 31, 2015.

### ***Consumer Loans***

The Bank has consumer loans secured by automobiles, boats, recreational vehicles and trucks. The Bank also makes home improvement loans and offers both secured and unsecured personal lines of credit. Consumer loans totaled \$366,000 and \$613,000, respectively, at December 31, 2015 and 2014. Consumer loans entail greater risk than residential mortgage loans, particularly in the case of consumer loans, which are unsecured or secured by rapidly depreciating assets such as automobiles. In such cases, any repossessed collateral may not provide an adequate source of repayment of the outstanding loan balance. Further collection efforts may be hampered by the borrower's lack of current income or other assets. In addition, consumer loan collections are dependent on the borrower's continuing

financial stability and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws including federal and state bankruptcy and insolvency laws, may limit the amount that can be recovered on such loans. Such loans may also give rise to claims and defenses by a consumer loan borrower against an assignee such as the Bank, and a borrower may be able to assert against such assignee claims and defenses that it has against the seller of the underlying collateral.

### ***Commercial Equipment Loans***

The Bank also maintains an amortizing commercial portfolio consisting primarily of commercial equipment loans. Commercial equipment loans totaled \$29.9 million and \$26.2 million, or 3.3% and 3.0% of the total loan portfolio, respectively, at December 31, 2015 and 2014. These loans consist primarily of fixed-rate, short-term loans collateralized by customers' equipment including trucks, cars, construction and other more specialized equipment. When making commercial equipment loans, the Bank considers the same factors it considers when underwriting a commercial business loan. The higher interest rates and shorter loan terms available on commercial equipment lending make these products attractive to the Bank. These loans entail greater risk than loans such as residential mortgage loans. Unlike residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income and which are secured by real property whose value tends to be more easily ascertainable, commercial loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flows of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. In the case of business failure, collateral would need to be liquidated to provide repayment for the loan. In many cases, the highly specialized nature of collateral equipment would make full recovery from the sale of collateral problematic. The Bank assesses the amount of collateral required for a loan based upon the credit worthiness of the borrowers.

**Loan Portfolio Analysis**

Set forth below is selected data relating to the composition of the Bank's loan portfolio by type of loan on the dates indicated.

(dollars in thousands)	At December 31, 2015		2014		2013		2012		2011	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Commercial real estate	\$613,479	66.76 %	\$561,080	64.34 %	\$476,648	58.97 %	\$419,667	55.47 %	\$370,384	55.47 %
Residential first mtgs.	149,967	16.32 %	152,837	17.52 %	159,147	19.69 %	177,663	23.48 %	164,543	23.48 %
Construction and land dev.	36,189	3.94 %	36,370	4.17 %	32,001	3.96 %	31,819	4.21 %	36,745	5.14 %
Home equity and second mtgs.	21,716	2.36 %	21,452	2.46 %	21,692	2.68 %	21,982	2.91 %	24,138	3.31 %
Commercial loans	67,246	7.32 %	73,625	8.44 %	94,176	11.65 %	88,158	11.65 %	101,968	13.98 %
Consumer loans	366	0.04 %	613	0.07 %	838	0.10 %	995	0.13 %	1,001	0.13 %
Commercial equipment	29,931	3.26 %	26,152	3.00 %	23,738	2.94 %	16,268	2.15 %	19,761	2.71 %
Total Loans	918,894	100.00 %	872,129	100.00 %	808,240	100.00 %	756,552	100.00 %	718,540	100.00 %
Deferred loan fees	1,154		1,239		972		664		796	
Allowance for loan losses	8,540		8,481		8,138		8,247		7,655	
Loans receivable, net	\$909,200		\$862,409		\$799,130		\$747,641		\$710,889	

The following table sets forth for the periods indicated the average balances outstanding and average interest rates for each major category of loans.

dollars in thousands	For the Years Ended December 31,									
	2015		2014		2013		2012		2011	
	Average Balance	Average Yield/Cost	Average Balance	Average Yield/Cost	Average Balance	Average Yield/Cost	Average Balance	Average Yield/Cost	Average Balance	Average Yield/Cost
Commercial real estate	597,034	4.65 %	523,796	4.82 %	434,889	5.08 %	395,276	5.40 %	357,272	5.72 %
Residential first mortgages	147,606	4.36 %	159,689	4.42 %	169,671	4.68 %	177,401	4.68 %	153,249	4.94 %
Construction and land development	34,333	4.81 %	29,921	4.68 %	27,065	4.75 %	31,499	4.94 %	33,108	4.90 %
Home equity and second mortgages	21,332	4.09 %	21,426	4.21 %	21,647	4.33 %	22,703	4.33 %	24,201	4.36 %



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Commercial and equipment loans <sup>(1)</sup>	81,957	5.61%	92,199	5.21%	95,316	5.11%	99,735	4.88%	109,618	5.12%
Consumer loans	465	8.82%	701	7.99%	954	7.23%	1,002	7.98%	1,143	8.05%
Allowance for loan losses	(8,541 )	n/a	(8,351 )	n/a	(8,173 )	n/a	(7,818 )	n/a	(7,349 )	n/a
Net Average Loans	874,186	4.73%	819,381	4.82%	741,369	5.02%	719,798	5.16%	671,242	5.42%

<sup>(1)</sup> Includes both commercial loans and commercial equipment loans.

### ***Loan Originations, Purchases and Sales***

The Bank solicits loan applications through marketing by commercial loan officers, its branch network, and referrals from customers. Loans are processed and approved according to guidelines established by the Bank. Loan requirements such as income verification, collateral appraisal, and credit reports vary by loan type. Additionally, residential mortgages are purchased from third party providers after reviewing loan documents, underwriting support, and completing other procedures, as necessary. Loan processing functions are generally centralized except for small consumer loans. Depending on market conditions, residential mortgage loans may be classified with the intent to sell to third parties such as FHLMC. Residential mortgage loans in the amounts of \$4.2 million, \$13.6 million and \$23.3 million were sold by the Bank for the years ended December 31, 2015, 2014 and 2013, respectively.

To comply with internal and regulatory limits on loans to one borrower, the Bank may sell portions of commercial and commercial real estate loans to other lenders. The Bank sold CRE participations of \$1.5 million in 2015 and \$482,000 in 2014. The Bank may also buy loans, portions of loans, or participation certificates from other lenders. The Bank only purchases loans or portions of loans after reviewing loan documents, underwriting support, and completing other procedures, as necessary. The Bank purchased no commercial real estate or commercial loans during 2015 and 2014. Purchased participation loans are subject to the same regulatory and internal policy requirements as other loans in the Bank's portfolio as described below.

### ***Loan Approvals, Procedures and Authority***

Loan approval authority is established by Board policy. Loan approval authorities vary by individual with the Chief Executive Officer having approval authority up to \$1.25 million, the Chief Lending Officer up to \$1.0 million, the Chief Risk Officer up to \$1.0 million and the Chief Operating Officer up to \$1.0 million. The individual lending authority of the other lenders is set by management and based on their individual abilities. The loan approval authorities of the Chief Executive Officer, the Chief Lending Officer, the Chief Risk Officer, the Chief Operating Officer, the Senior Credit Officer and the regional senior loan officers may be combined and a minimum of at least three other individuals (two-thirds of which must be executive level) need to be present in an officers' loan committee. The officers' loan committee approves loans up to the Bank's legal lending limit. The in-house lending guideline is approved by the Credit Risk Committee on an annual basis or as needed if more frequently and is less than the Bank's legal lending limit. Relationships in excess of the Bank's in-house lending guideline are reported to the Board of Directors. The Board of Directors approves all loans required to be approved by regulation, such as Regulation O loans.

The Credit Risk Committee of the Board, consisting of three or more directors, has been delegated by the Board of Directors of the Bank to assist the Board in its oversight responsibilities. The committee reviews the Bank's credit risk management, including the significant policies, procedures and practices employed to manage credit risk, and provides recommendations to the Board on strategic guidance to management on the assumption, management and mitigation of credit risk.

Depending on the loan and collateral type, conditions for protecting the Bank's collateral are specified in the loan documents. Typically these conditions might include requirements to maintain hazard and title insurance and to pay property taxes.

### ***Loans to One Borrower***

Under Maryland law, the maximum amount that the Bank is permitted to lend to any one borrower and his or her related interests may generally not exceed 10% of the Bank's unimpaired capital and surplus, which is defined to include the Bank's capital, surplus, retained earnings and 50% of its reserve for possible loan losses. Under this authority, the Bank would have been permitted to lend up to \$13.7 million and \$13.1 million, respectively, to any one borrower at December 31, 2015 and 2014. By interpretive ruling of the Maryland Commissioner, Maryland banks have the option of lending up to the amount that would be permissible for a national bank, which is generally 15% of unimpaired capital and surplus (defined to include a bank's total capital for regulatory capital purposes plus any loan loss allowances not included in regulatory capital). Under this formula, the Bank would have been permitted to lend up to \$21.2 million and \$20.3 million, respectively, to any one borrower at December 31, 2015 and 2014. At December 31, 2015 and 2014, the largest amount outstanding to any one borrower and his or her related interests was \$12.0 million. This borrower is a AAA-rated university hospital system located within the our market area.

### ***Loan Commitments***

The Bank does not normally negotiate standby commitments for the construction and purchase of real estate. Most loan commitments are granted for a one-month period. The Bank's outstanding commitments to originate loans at December 31, 2015 and 2014 were approximately \$73.5 million and \$36.3 million, respectively, excluding undisbursed portions of loans in process. It has been the Bank's experience that few commitments expire unfunded.

***Maturity of Loan Portfolio***

See Note 6 of the Consolidated Financial Statements for regarding the dollar amount of loans maturing in the Bank's portfolio based on their contractual terms to maturity as of December 31, 2015 and 2014. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less.

***Asset Classification***

Federal regulations and our policies require that we utilize an internal asset classification system as a means of reporting on asset quality. We use an internal asset classification system, substantially consistent with Federal banking regulations, as a part of our credit monitoring system. Federal banking regulations set forth a classification scheme for problem and potential problem assets as "substandard," "doubtful" or "loss" assets. An asset is considered "substandard" if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. "Substandard" assets include those characterized by the "distinct possibility" that the insured institution will sustain "some loss" if the deficiencies are not corrected. Assets classified as "doubtful" have all of the weaknesses inherent in those classified "substandard" with the added characteristic that the weaknesses present make "collection or liquidation in full," on the basis of currently existing facts, conditions, and values, "highly questionable and improbable." Assets classified as "loss" are those considered "uncollectible" and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. Assets that do not currently expose the insured institution to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are required to be designated "special mention."

When an insured institution classifies one or more assets, or portions thereof, as "substandard" or "doubtful," it is required that a general valuation allowance for loan losses be established in an amount deemed prudent by management. General valuation allowances represent loss allowances that have been established to recognize the inherent losses associated with lending activities, but that, unlike specific allowances, have not been allocated to particular problem assets. When an insured institution classifies one or more assets, or portions thereof, as "loss," it is required either to establish a specific allowance for losses equal to 100% of the amount of the asset so classified or to charge off such amount.

The table below sets forth information on our classified assets and assets designated special mention at the dates indicated. Classified and special mention assets include loans, securities and other real estate owned.

(dollars in thousands)	December 31, 2015	December 31, 2014	December 31, 2013	December 31, 2012	December 31, 2011
Classified assets					
Substandard	\$ 42,485	\$ 54,022	\$ 56,880	\$ 58,595	\$ 79,601
Doubtful	861	-	-	-	-
Loss	-	-	-	-	37

Total classified assets	43,346	54,022	56,880	58,595	79,638
Special mention assets	1,642	5,460	9,246	6,092	-
	\$ 44,988	\$ 59,482	\$ 66,126	\$ 64,687	\$ 79,638

### ***Delinquencies***

The Bank's collection procedures provide that when a loan is 15 days delinquent, the borrower is contacted by mail and payment is requested. If the delinquency continues, subsequent efforts will be made to contact the delinquent borrower and obtain payment. If these efforts prove unsuccessful, the Bank will pursue appropriate legal action including repossession of the collateral and other actions as deemed necessary. In certain instances, the Bank will attempt to modify the loan or grant a limited moratorium on loan payments to enable the borrower to reorganize his financial affairs. For an analysis of past due loans as of December 31, 2015 and 2014, respectively, refer to Note 6 in the Consolidated Financial Statements.

### ***Impaired Loans***

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The Bank evaluates substandard and doubtful classified loans, loans delinquent 90 days or greater, non-accrual loans and troubled debt restructures ("TDRs") on an individualized basis to determine whether a loan is impaired (See Notes 1 and 6 of the Consolidated Financial Statements).

Factors considered by management in determining impaired status include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and shortfalls on a case-by-case basis, taking into consideration the circumstances surrounding the loan. These circumstances include the length of the delay, the reasons for the delay, the borrower's payment record and the amount of the shortfall in relation to the principal and interest owed. Loans not impaired are included in the pool of loans evaluated in the general component of the allowance.

If a specific loan is deemed to be impaired it is evaluated for impairment. Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral, if the loan is collateral dependent. For loans that have an impairment, a specific allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than carrying value of that loan.

The Bank considers all TDRs to be impaired and defines TDRs as loans whose terms have been modified to provide for a reduction or a delay in the payment of either interest or principal because of deterioration in the financial condition of the borrower. A loan extended or renewed at a stated interest rate equal to the current interest rate for new debt with similar risk is not considered a TDR. Once an obligation has been classified as a TDR it continues to be considered a TDR until paid in full or until the debt is refinanced at market rates with no debt forgiveness. TDRs are evaluated for impairment on a loan-by-loan basis in accordance with the Bank's impairment methodology. The Bank does not participate in any specific government or Bank-sponsored loan modification programs. All restructured loan agreements are individual contracts negotiated with a borrower.

Specific loan loss reserves of \$1.6 million and \$451,000, respectively, related to impaired loans at December 31, 2015 and 2014. The following table sets forth information with respect to the Bank's impaired loans at the dates indicated. The table includes a breakdown between impaired loans with and without an allowance:

(dollars in thousands)	December 31,				
	2015	2014	2013	2012	2011
Recorded investment with no allowance	\$35,171	\$45,587	\$28,220	\$34,717	\$10,621
Recorded investment with allowance	4,066	4,122	9,786	4,273	10,096
Total impaired loans	\$39,237	\$49,709	\$38,006	\$38,990	\$20,717
Specific allocations of allowance	\$1,608	\$451	\$985	\$1,548	\$1,997
Interest income recognized	\$1,366	\$1,841	\$1,608	\$1,850	\$793

For additional information regarding impaired loans by class at December 31, 2015 and 2014, respectively, refer to Note 6 in the Consolidated Financial Statements.

The Bank closely monitors the payment activity of all its loans. The Bank periodically reviews the adequacy of the allowance for loan losses based on an analysis of the size of and composition of the loan portfolio, the Bank's historical loss experience, including trends in delinquency, non-performing and classified loans and charge-offs, economic conditions in the Bank's market area, and a review of selected individual loans. Loan losses are charged off against the allowance when individual loans are deemed uncollectible. Subsequent recoveries, if any, are credited to the allowance. The Bank believes it has established its existing allowance for loan losses in accordance with accounting principles generally accepted in the United States of America and is in compliance with appropriate regulatory guidelines. However, the establishment of the level of the allowance for loan losses is highly subjective and dependent on incomplete information as to the ultimate disposition of loans. Accordingly, actual losses may vary from the amounts estimated. Additionally, our regulators as an integral part of their examination process, periodically review our allowance for loan losses and may require us to increase or decrease the allowance for loan losses, thereby affecting the Bank's financial condition and earnings. For a more complete discussion of the allowance for loan losses, see the section captioned "*Management's Discussion and Analysis of Financial Condition and Results of Operations-Critical Accounting Policies*" and Notes 1 and 6 of the Consolidated Financial Statements.

The following table allocates the allowance for loan losses by loan category at the dates indicated. The allocation of the allowance to each category is not necessarily indicative of future losses and does not restrict the use of the allowance to absorb losses in any category.

(dollars in thousands)	At December 31,		2014		2013		2012		2011	
	2015		Amount	% <sup>(1)</sup>	Amount	% <sup>(1)</sup>	Amount	% <sup>(1)</sup>	Amount	% <sup>(1)</sup>
Commercial real estate	\$3,882	66.76 %	\$4,076	64.34 %	\$3,525	58.97 %	\$4,092	55.47 %	\$2,526	51.55 %
Residential first mtgs.	705	16.32 %	1,092	17.52 %	1,401	19.69 %	1,083	23.48 %	539	22.90 %
Construction and land dev.	1,103	3.94 %	1,071	4.17 %	584	3.96 %	533	4.21 %	354	5.11 %
Home equity and second mtgs.	142	2.36 %	173	2.46 %	249	2.68 %	280	2.91 %	144	3.36 %
Commercial loans	1,477	7.32 %	1,677	8.44 %	1,916	11.65 %	1,948	11.65 %	3,850	14.19 %
Consumer loans	2	0.04 %	3	0.07 %	10	0.10 %	19	0.13 %	19	0.14 %
Commercial equipment	1,229	3.26 %	389	3.00 %	453	2.94 %	292	2.15 %	223	2.75 %
Total allowance for loan losses	\$8,540	100.00 %	\$8,481	100.00 %	\$8,138	100.00 %	\$8,247	100.00 %	\$7,655	100.00 %

<sup>(1)</sup> Percent of loans in each category to total loans



The following table sets forth an analysis of activity in the Bank's allowance for loan losses for the periods indicated.

(dollars in thousands)	At December 31,				
	2015	2014	2013	2012	2011
Balance at beginning of period	\$8,481	\$8,138	\$8,247	\$7,655	\$7,669
Charge-offs:					
Commercial real estate	78	350	140	486	1,249
Residential first mtgs.	30	94	348	11	49
Construction and land dev.	-	992	36	141	213
Home equity and second mtgs.	100	59	111	211	-
Commercial loans	432	1,134	480	1,004	2,441
Consumer loans	-	3	12	5	3
Commercial equipment	818	10	35	169	150
Total Charge-offs	1,458	2,642	1,162	2,027	4,105
Recoveries:					
Commercial real estate	17	11	-	-	-
Residential first mtgs.	1	186	11	38	1
Construction and land dev.	32	84	1	-	-
Home equity and second mtgs.	-	10	17	-	-
Commercial loans	11	5	23	51	-
Consumer loans	-	11	3	1	1
Commercial equipment	23	25	58	-	2
Total Recoveries	84	332	113	90	4
Net Charge-offs	1,374	2,310	1,049	1,937	4,101
Provision for Loan Losses	1,433	2,653	940	2,529	4,087
Balance at end of period	\$8,540	\$8,481	\$8,138	\$8,247	\$7,655
Allowance for loan losses to total loans	0.93 %	0.97 %	1.01 %	1.09 %	1.07 %
Net charge-offs to average loans	0.16 %	0.28 %	0.14 %	0.27 %	0.61 %

### ***Non-performing Assets***

The Bank's non-performing assets include other real estate owned, non-accrual loans and TDRs. Both non-accrual and TDR loans include loans that are paid current and are performing in accordance with the term of their original or modified contract terms. For a detailed discussion on asset quality see the section captioned "*Management's Discussion and Analysis of Financial Condition and Results of Operations-Asset Quality.*"

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

Real estate acquired by the Bank as a result of foreclosure or by deed in lieu of foreclosure is classified as foreclosed real estate until such time as it is sold. When such property is acquired, it is recorded at its fair market value.

Subsequent to foreclosure, the property is carried at the lower of cost or fair value less selling costs. Additional write-downs as well as carrying expenses of the foreclosed properties are charged to expenses in the current period. The Bank had foreclosed real estate with a carrying value of approximately \$9.4 million and \$5.9 million, respectively at December 31, 2015 and 2014. For a discussion of the accounting for foreclosed real estate, see “*Management’s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies - Other Real Estate Owned*” and Notes 1 and 8 in the Consolidated Financial Statements.

#### *Non-accrual Loans*

Loans are reviewed on a regular basis and are placed on non-accrual status when, in the opinion of management, the collection of additional interest is doubtful. The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in the process of collection. Consumer loans are typically charged-off no later than 90 days past due. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Non-accrual loans are evaluated for impaired status on a loan by loan basis in accordance with the Company’s impairment methodology.

All interest accrued but not collected from loans that are placed on non-accrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. Non-accrual loans include certain loans that are current with all loan payments and are placed on non-accrual status due to customer operating results and cash flows. Interest is recognized on non-accrual loans on a cash-basis if the loans are not impaired or there is no impairment. For a discussion of the accounting for non-accrual loans, see “*Management’s Discussion and Analysis of Financial Condition and Results of Operations-Asset Quality*” and Notes 1 and 6 in the Consolidated Financial Statements. The following table sets forth information with respect to the Bank’s non-performing assets. There were no loans 90 days or more past due that were still accruing interest at the dates indicated.

(dollars in thousands)	December 31,				
	2015	2014	2013	2012	2011
Non-accrual loans:					
Commercial real estate	\$3,480	\$3,824	\$7,930	\$5,331	\$2,866
Residential first mtgs.	1,948	533	2,245	3,739	2,439
Construction and land dev.	3,555	3,634	2,968	-	1,414
Home equity and second mtgs.	48	399	115	71	291
Commercial loans	2,054	1,587	1,935	3,732	2,264
Consumer loans	-	-	24	52	1
Commercial equipment	348	286	234	216	236
<b>Total non-accrual loans</b> <sup>(1)</sup>	<b>11,433</b>	<b>10,263</b>	<b>15,451</b>	<b>13,141</b>	<b>9,511</b>
OREO	9,449	5,883	6,797	6,891	5,029
<b>TDRs:</b> <sup>(2)</sup>					
Commercial real estate	11,897	10,438	3,141	3,097	7,697
Residential first mtgs.	881	906	1,485	1,418	-
Construction and land dev.	4,283	4,376	-	-	1,717
Commercial loans	1,384	2,262	-	-	2,369
Commercial equipment	123	154	67	-	130
Total TDRs	18,568	18,136	4,693	4,515	11,913
Total Accrual TDRs	13,133	13,249	4,364	4,515	11,113
Total non-accrual loans, OREO and Accrual TDRs	\$34,015	\$29,395	\$26,612	\$24,547	\$25,653
Interest due at stated rates, but not recognized	\$987	\$845	\$599	\$626	\$415
Non-accrual loans to total loans	1.24 %	1.18 %	1.91 %	1.74 %	1.32 %
Non-accrual loans and Accrual TDRs to total loans <sup>(2)</sup>	2.67 %	2.70 %	2.45 %	2.33 %	2.87 %
Non-accrual loans, OREO and Accrual TDRs to total assets <sup>(2)</sup>	2.98 %	2.71 %	2.60 %	2.50 %	2.61 %

<sup>(1)</sup> Non-accrual loans include all loans that are 90 days or more delinquent and loans that are non-accrual due to the operating results or cash flows of a customer.

(2) TDR loans include both non-accrual and accruing performing loans. All TDR loans are included in the calculation of asset quality financial ratios. Non-accrual TDR loans are included in the non-accrual balance and accruing TDR loans are included in the accruing TDR balance.

***Investment Activities***

The Bank maintains a portfolio of investment securities to provide liquidity as well as a source of earnings. The Bank's investment securities portfolio consists primarily of asset-backed mortgage-backed ("MBS") and collateralized mortgage obligations ("CMOs") and other securities issued by U.S. government-sponsored enterprises ("GSEs"), including FNMA and FHLMC. The Bank also has smaller holdings of privately issued mortgage-backed securities, U.S. Treasury obligations, and other equity and debt securities. As a member of the Federal Reserve and FHLB system, the Bank is required to maintain investments in the Federal Reserve Bank as a condition of membership and the Federal Home Loan Bank based upon levels of borrowings.

The following table sets forth the carrying value of the Company's investment securities portfolio and FHLB of Atlanta and Federal Reserve Bank stock at the dates indicated. HTM securities and FHLB of Atlanta and Federal Reserve Bank stock are carried at amortized cost and AFS securities are carried at fair value. At December 31, 2015, 2014, 2013, 2012 and 2011, their estimated fair value was \$151.4 million, \$133.3 million, \$139.9 million, \$166.9 million and \$201.5 million, respectively.

(dollars in thousands)	At December 31,				
	2015	2014	2013	2012	2011
Asset-backed securities:					
Freddie Mac and Fannie Mae	\$ 138,267	\$ 119,762	\$ 126,607	\$ 150,318	\$ 180,638
Other	1,093	1,472	3,120	4,439	9,839
Total asset-backed securities	139,360	121,234	129,727	154,757	190,477
Corporate equity securities	39	40	41	37	37
Bond mutual funds	4,387	4,321	4,130	4,281	4,080
Treasury bills	750	850	750	750	750
Total investment securities	144,536	126,445	134,648	159,825	195,344
FHLB and Federal Reserve Bank stock	6,931	6,434	5,593	5,476	5,587
Total investment securities	\$ 151,467	\$ 132,879	\$ 140,241	\$ 165,301	\$ 200,931

The maturities and weighted average yields for investment securities available for sale ("AFS") and held to maturity ("HTM") at December 31, 2015 and 2014 are shown below.

December 31, 2015 (dollars in thousands)	One Year or Less		After One Through Five Years		After Five Through Ten Years		After Ten Years	
	Amortized Cost	Average Yield	Amortized Cost	Average Yield	Amortized Cost	Average Yield	Amortized Cost	Average Yield
AFS Investment securities:								
Asset-backed securities	\$ 6,075	1.86 %	\$ 15,355	1.86 %	\$ 7,727	1.87 %	\$ 2,048	1.86 %
Mutual funds	4,288	2.02 %	-	0.00 %	-	0.00 %	-	0.00 %
Total AFS investment securities	\$ 10,363	1.93 %	\$ 15,355	1.86 %	\$ 7,727	1.87 %	\$ 2,048	1.86 %
HTM Investment securities:								
Asset-backed securities	\$ 21,850	2.31 %	\$ 50,895	2.32 %	\$ 23,259	2.32 %	\$ 12,666	2.25 %
U.S. government obligations	750	0.00 %	-	0.00 %	-	0.00 %	-	0.00 %
Total HTM investment securities	\$ 22,600	2.23 %	\$ 50,895	2.32 %	\$ 23,259	2.32 %	\$ 12,666	2.25 %

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December 31, 2014 (dollars in thousands)	One Year or Less		After One Through Five Years		After Five Through Ten Years		After Ten Years	
	Amortized Cost	Average Yield	Amortized Cost	Average Yield	Amortized Cost	Average Yield	Amortized Cost	Average Yield
AFS Investment securities:								
Asset-backed securities	\$ 8,084	1.81 %	\$ 19,708	1.82 %	\$ 8,671	1.76 %	\$ 1,865	1.69 %
Mutual funds	4,198	2.05 %	-	0.00 %	-	0.00 %	-	0.00 %
Total AFS investment securities	\$ 12,282	1.89 %	\$ 19,708	1.82 %	\$ 8,671	1.76 %	\$ 1,865	1.69 %
HTM Investment securities:								
Asset-backed securities	\$ 20,647	2.02 %	\$ 44,575	2.00 %	\$ 14,299	1.88 %	\$ 4,135	1.57 %
U.S. government obligations	850	0.00 %	-	0.00 %	-	0.00 %	-	0.00 %
Total HTM investment securities	\$ 21,497	1.94 %	\$ 44,575	2.00 %	\$ 14,299	1.88 %	\$ 4,135	1.57 %

The Bank's investment policy provides that securities that will be held for indefinite periods of time, including securities that will be used as part of the Bank's asset/liability management strategy and that may be sold in response to changes in interest rates, prepayments and similar factors are classified as available for sale and accounted for at fair value. Management's intent is to hold securities reported at amortized cost to maturity. Certain of the Company's asset-backed securities are issued by private issuers (defined as an issuer that is not a government or a government-sponsored entity). The Company had no investments in any private issuer's securities that aggregate to more than 10% of the Company's equity. For a discussion of investments see "*Management's Discussion and Analysis of Financial Condition and Results of Operations-Asset Quality*" and Notes 1 and 5 in the Consolidated Financial Statements.

### ***Deposits and Other Sources of Funds***

#### ***General***

The funds needed by the Bank to make loans are primarily generated by deposit accounts solicited from the communities surrounding its ten branches in the tri-county area and its branch in the Fredericksburg area of Virginia. Total deposits were \$906.9 million and \$869.4 million, respectively, as of December 31, 2015 and 2014. The Company uses both traditional brokered deposits and reciprocal brokered deposits. Traditional brokered deposits at December 31, 2015 and December 31, 2014 were \$49.1 million and \$41.7 million, respectively. Reciprocal brokered deposits at December 31, 2015 and December 31, 2014 were \$61.1 million and \$41.6 million, respectively. The reciprocal brokered deposits have many characteristics of core deposits and are used to maximize FDIC insurance available to our customers.

#### ***Deposits***

The Bank's deposit products include savings, money market, demand deposit, IRA, SEP, and time deposit accounts. Variations in service charges, terms and interest rates are used to target specific markets. Ancillary products and services for deposit customers include safe deposit boxes, night depositories, automated clearinghouse transactions, wire transfers, ATMs, online and telephone banking, remote deposit capture, merchant card services, investment services, positive pay, payroll services and lockbox. The Bank is a member of ACCEL, Master Card, Allpoint and Star ATM networks.

The following table sets forth for the periods indicated the average balances outstanding and average interest rates for each major category of deposits.

For the Years Ended December 31,					
2015	2014	2013	2012	2011	

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(dollars in thousands)	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Savings	\$44,963	0.10%	\$40,104	0.10%	\$37,540	0.10%	\$32,577	0.17%	\$31,446	0.35%
Interest-bearing demand and money market accounts	322,717	0.28%	281,960	0.27%	268,832	0.33%	262,331	0.56%	217,183	1.00%
Certificates of deposit	378,179	0.85%	389,641	0.97%	392,675	1.19%	432,487	1.60%	434,811	1.94%
Total interest-bearing deposits	745,859	0.56%	711,705	0.64%	699,047	0.80%	727,395	1.16%	683,440	1.57%
Noninterest-bearing demand deposits	120,527		100,783		87,649		74,161		66,105	
	\$866,386	0.48%	\$812,488	0.56%	\$786,696	0.71%	\$801,556	1.05%	\$749,545	1.43%



The following table indicates the amount of the Bank's certificates of deposit and other time deposits of \$100,000 or more and \$250,000 or more by time remaining until maturity as of December 31, 2015 and 2014.

Time Deposit Maturity Period (dollars in thousands)	At December 31, 2015	
	\$100,000 or More	\$250,000 or More
Three months or less	\$ 33,873	\$ 14,071
Three through six months	42,091	24,860
Six through twelve months	65,299	26,778
Over twelve months	81,031	32,903
Total	\$ 222,294	\$ 98,612

Time Deposit Maturity Period (dollars in thousands)	At December 31, 2014	
	\$100,000 or More	\$250,000 or More
Three months or less	\$ 57,152	\$ 24,445
Three through six months	35,288	13,087
Six through twelve months	51,151	24,790
Over twelve months	72,637	21,610
Total	\$ 216,228	\$ 83,932

For a discussion of deposits, see "*Management's Discussion and Analysis of Financial Condition and Results of Operations-Liabilities*" and Notes 1 and 10 in the Consolidated Financial Statements. Note 10 includes the scheduled contractual maturities of total certificates of deposits of \$375.6 million and \$385.4 million, respectively at December 31, 2015 and 2014.

### ***Borrowings***

Deposits are the primary source of funds for the Bank's lending and investment activities and for its general business purposes. The Bank uses advances from the FHLB of Atlanta to supplement the supply of funds it may lend and to meet deposit withdrawal requirements. Advances from the FHLB are secured by the Bank's stock in the FHLB, a portion of the Bank's loan portfolio and certain investments. Generally, the Bank's ability to borrow from the FHLB of Atlanta is limited by its available collateral and also by an overall limitation of 30% of assets. Further, short-term credit facilities are available at the Federal Reserve Bank of Richmond and other commercial banks. Long-term debt consists of adjustable-rate advances with rates based upon LIBOR, fixed-rate advances, and convertible advances. For a discussion of borrowing, see "*Management's Discussion and Analysis of Financial Condition and Results of Operations-Liabilities*" and Notes 1, 11, 16 and 17 in the Consolidated Financial Statements.

### **Subsidiary Activities**

In April 1997, the Bank formed a wholly owned subsidiary, Community Mortgage Corporation of Tri-County, to offer mortgage banking, brokerage, and other services to the public. This corporation is currently inactive. The Company has two direct subsidiaries other than the Bank. In July 2004, Tri-County Capital Trust I was established as a statutory trust under Delaware law as a wholly-owned subsidiary of the Company to issue trust preferred securities. Tri-County Capital Trust I issued \$7.0 million of trust preferred securities on July 22, 2004. In June 2005, Tri-County Capital Trust II was also established as a statutory trust under Delaware law as a wholly owned subsidiary of the Company to issue trust preferred securities. Tri-County Capital Trust II issued \$5.0 million of trust preferred securities on June 15, 2005. For more information regarding these entities, see Note 16 in the Consolidated Financial Statements.

## Supervision and Regulation

### **Regulation of the Company**

#### ***General***

As a bank holding company, the Company is subject to comprehensive regulation, examination and supervision by the Federal Reserve Board under the Bank Holding Company Act of 1956, as amended (the “BHCA”), and the regulations of the Federal Reserve Board. The Federal Reserve Board also has extensive enforcement authority over bank holding companies, including, among other things, the ability to assess civil money penalties, to issue cease and desist or removal orders, and to require that a holding company divest subsidiaries (including its bank subsidiaries). In general, enforcement actions may be initiated for violations of law and regulations and unsafe or unsound practices.

The following discussion summarizes certain of the regulations applicable to the Company but does not purport to be a complete description of such regulations and is qualified in its entirety by reference to the actual laws and regulations involved.

#### ***Acquisition of Control***

A bank holding company, with certain exceptions, must obtain Federal Reserve Board approval before (1) acquiring ownership or control of another bank or bank holding company if it would own or control more than 5% of such shares or (2) acquiring all or substantially all of the assets of another bank or bank holding company; or (3) merging with another bank holding company. In evaluating such application, the Federal Reserve Board considers factors such as the financial condition and managerial resources of the companies involved, the convenience and needs of the communities to be served and competitive factors. Federal law provides that no person may acquire “control” of a bank holding company or insured bank without the approval of the appropriate federal regulator. Control is defined to mean direct or indirect ownership, control of 25% or more of any class of voting stock, control of the election of a majority of the bank’s directors or a determination by the Federal Reserve Board that the acquirer has or would have the power to exercise a controlling influence over the management or policies of the institution.

#### ***Permissible Activities***

A bank holding company is limited in its activities to banking, managing or controlling banks, or providing services for its subsidiaries. Other permitted non-bank activities have been identified as closely related to banking. Bank holding companies that are “well capitalized” and “well managed” and whose financial institution subsidiaries have satisfactory Community Reinvestment Act records can elect to become “financial holding companies,” which are permitted to engage in a broader range of financial activities than are permitted to bank holding companies. The

Company has not opted to become a financial holding company.

The Federal Reserve Board has the power to order a holding company or its subsidiaries to terminate any activity, or to terminate its ownership or control of any subsidiary, when it has reasonable cause to believe that the continuation of such activity or such ownership or control constitutes a serious risk to the financial safety, soundness or stability of any bank subsidiary of that holding company.

The Maryland Financial Institutions Code prohibits a bank holding company from acquiring more than 5% of any class of voting stock of a bank or bank holding company without the approval of the Commissioner of Financial Regulation. The Maryland Financial Institutions Code additionally prohibits any person from acquiring voting stock in a bank or bank holding company without 60 days prior notice to the Commissioner if such acquisition will give the person control of 25% or more of the voting stock of the bank or bank holding company. The Commissioner may deny approval of the acquisition if the Commissioner determines it to be anti-competitive or to threaten the safety or soundness of a banking institution.

### ***Dividend***

The Federal Reserve Board has the power to prohibit dividends by bank holding companies if their actions constitute unsafe or unsound practices. The Federal Reserve Board has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses the Federal Reserve Board's view that a bank holding company should pay cash dividends only to the extent that the company's net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the company's capital needs, asset quality and overall financial condition. The Federal Reserve Board also indicated that it would be inappropriate for a bank holding company experiencing serious financial problems to borrow funds to pay dividends. Under the prompt corrective action regulations adopted by the Federal Reserve Board, the Federal Reserve Board may prohibit a bank holding company from paying any dividends if the holding company's bank subsidiary is classified as "undercapitalized." See "Regulation of the Bank – Capital Adequacy."

### ***Sources of Strength***

The Dodd-Frank Act codified the source of strength doctrine requiring bank holding companies to serve as a source of strength for their depository subsidiaries, by providing capital, liquidity and other support in times of financial stress. The regulatory agencies are required, under the Act, to issue implementing regulations.

### ***Stock Repurchases***

The Company is required to give the Federal Reserve Board prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the Company's consolidated net worth. The Federal Reserve Board may disapprove such a purchase or redemption. This requirement does not apply to bank holding companies that are "well capitalized," "well-managed" and are not the subject of any unresolved supervisory issues.

### ***Capital Requirement***

Bank holding companies are required to maintain on a consolidated basis, specified minimum ratios of capital to total assets and capital to risk-weighted assets. These requirements, which generally apply to bank holding companies with consolidated assets of \$500 million or more, are substantially similar to, but somewhat more generous than, those applicable to the Bank. See "– Regulation of the Bank – Capital Adequacy." The Dodd-Frank Act required the Federal Reserve Board to adopt consolidated capital requirements for holding companies that are equally as stringent as those applicable to the depository institution subsidiaries. That means that certain instruments that had previously been includable in Tier 1 capital for bank holding companies, such as trust preferred securities, will no longer be eligible for inclusion. The revised capital requirements are subject to certain grandfathering and transition rules. The Company is currently considered a grandfathered institution under these rules.

### **Regulation of the Bank**

#### ***General***

The Bank is a Maryland commercial bank and its deposit accounts are insured by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation. The Bank is a member of the Federal Reserve and FHLB systems. The Bank is subject to supervision, examination and regulation by Commissioner of Financial Regulation of the State of Maryland (the "Commissioner") and the Federal Reserve Board.

The Dodd-Frank Act established the Consumer Financial Protection Bureau as an independent bureau of the Federal Reserve Board. The Consumer Financial Protection Bureau assumed responsibility for implementing federal consumer financial protection and fair lending laws and regulations, a function currently handled by federal bank regulatory agencies. However, institutions of less than \$10 billion, such as the Bank, will continue to be examined for compliance with consumer protection or fair lending laws and regulations by, and be subject to enforcement authority of their potential regulators.

The following discussion summarizes certain regulations applicable to the Bank but does not purport to be a complete description of such regulations and is qualified in its entirety by reference to the actual laws and regulations involved.

### *Capital Adequacy*

On July 9, 2013, the federal bank regulatory agencies issued a final rule that revised their risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision (“Basel III”) and certain provisions of the Dodd-Frank Act.

The rule established a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increased the minimum Tier 1 capital to risk-based assets requirement (from 4.0% to 6.0% of risk-weighted assets) and assigned a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property.

The rule also includes changes in what constitutes regulatory capital, some of which are subject to a two-year transition period. These changes include the phasing-out of certain instruments as qualifying capital. In addition, Tier 2 capital is no longer limited to the amount of Tier 1 capital included in total capital. Mortgage servicing rights, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of common stock will be required to be deducted from capital, subject to a two-year transition period. Finally, Tier 1 capital will include accumulated other comprehensive income (which includes all unrealized gains and losses on available for sale debt and equity securities), subject to a two-year transition period.

Finally, the rule limits capital distributions and certain discretionary bonus payments if the banking organization does not hold a “capital conservation buffer” consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements.

The final rule became effective on January 1, 2015. 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.

### ***Prompt Corrective Regulatory Action***

Federal law requires, among other things, that federal bank regulatory authorities take “prompt corrective action” with respect to institutions that do not meet minimum capital requirements. For such purposes, the law establishes five capital tiers: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.

As a result of Basel III (discussed further above), effective January 1, 2015, an institution is deemed to be “well capitalized” if it has a total risk-based capital ratio of 10% or greater, a Tier 1 risk-based capital ratio of 8% or greater, a common equity Tier 1 risk-based capital ratio of 6.5% or greater, and a leverage capital ratio of 5% or greater, and is not subject to a regulatory order, agreement, or directive to meet and maintain a specific capital level for any capital measure. An institution is deemed to be “adequately capitalized” if it has a total risk-based capital ratio of 8% or greater, a Tier 1 risk-based capital ratio of 6% or greater, a common equity Tier 1 risk-based capital ratio of 4.5% or greater and generally a leverage capital ratio of 4% or greater. An institution is deemed to be “undercapitalized” if it has a total risk-based capital ratio of less than 8%, a Tier 1 risk-based capital ratio of less than 6%, a common equity Tier 1 risk-based capital ratio of less than 4.5% or generally a leverage capital ratio of less than 4%. An institution is deemed to be “significantly undercapitalized” if it has a total risk-based capital ratio of less than 6%, a Tier 1 risk-based capital ratio of less than 4%, a common equity Tier 1 risk-based capital ratio of less than 3% or a leverage capital ratio of less than 3%. An institution is deemed to be “critically undercapitalized” if it has a ratio of tangible equity (as defined in the regulations) to total assets that is equal to or less than 2%.

“Undercapitalized” institutions are subject to growth, capital distribution (including dividend), and other limitations, and are required to submit a capital restoration plan. An institution’s compliance with such a plan is required to be guaranteed by any company that controls the undercapitalized institution in an amount equal to the lesser of 5% of the bank’s total assets when deemed undercapitalized or the amount necessary to achieve the status of adequately capitalized. If an undercapitalized institution fails to submit an acceptable plan, it is treated as if it is “significantly undercapitalized.” Significantly undercapitalized institutions are subject to one or more additional restrictions including, but not limited to, a regulatory order requiring them to sell sufficient voting stock to become adequately capitalized; requirements to reduce total assets, cease receipt of deposits from correspondent banks, or dismiss directors or officers; and restrictions on interest rates paid on deposits, compensation of executive officers, and capital distributions by the parent holding company.

Beginning 60 days after becoming “critically undercapitalized,” critically undercapitalized institutions also may not make any payment of principal or interest on certain subordinated debt, extend credit for a highly leveraged transaction, or enter into any material transaction outside the ordinary course of business. In addition, subject to a narrow exception, the appointment of a receiver is required for a critically undercapitalized institution within 270 days after it obtains such status.

***Branching***

Maryland law provides that, with the approval of the Commissioner, Maryland banks may establish branches within Maryland and may establish branches in other states by any means permitted by the laws of such state or by federal law. The Federal Reserve Board may approve interstate branching by merger by state member banks in any state that did not opt out and *de novo* in states that specifically allow for such branching.

***Dividend Limitations***

Maryland banks may only pay dividends from undivided profits or, with the prior approval of the Commissioner, their surplus in excess of 100% of required capital stock. Maryland banks are further prohibited from declaring a dividend on its shares of common stock until its surplus fund equals the amount of required capital stock or, if the surplus fund does not equal the amount of capital stock, in an amount in excess of 90% of net earnings.



Without the approval of the Federal Reserve Board, a state member bank may not declare or pay a dividend if the total of all dividends declared during the year exceeds its net income during the current calendar year and retained net income for the prior two years. The Bank is further prohibited from making a capital distribution if it would be undercapitalized after payment of the dividend within the meaning of the prompt corrective action regulations discussed above.

### ***Insurance of Deposit Accounts***

Under the Federal Deposit Insurance Corporation's risk-based assessment system, insured institutions are assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors, with less risky institutions paying lower assessments. An institution's assessment rate depends upon the category to which it is assigned. The initial base assessment rate ranges from five to 35 basis points. The rate schedules will automatically adjust in the future when the Deposit Insurance Fund reaches certain milestones. No institution may pay a dividend if in default of the federal deposit insurance assessment.

Insurance of deposits may be terminated by the Federal Deposit Insurance Corporation upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the Federal Deposit Insurance Corporation or its prudential banking regulator. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

### ***Reserve Requirements***

Under Federal Reserve Board regulations, the Bank is required to maintain non-interest earning reserves against their transaction accounts (primarily Negotiable Order of Withdrawal (NOW) and regular checking accounts). The regulations generally provide that reserves be maintained against aggregate transaction accounts as follows for 2015: a 3% reserve ratio was assessed on net transaction accounts up to and including \$103.6 million; a 10% reserve ratio is applied above \$103.6 million. The first \$14.5 million of otherwise reservable balances (subject to adjustments by the Federal Reserve Board) are exempted from the reserve requirements. The amounts are adjusted annually and, for 2016, will require a 3% ratio for up to \$110.2 million and an exemption of \$15.2 million. At December 31, 2015, the Bank met applicable Federal Reserve Board reserve requirements.

### ***Transactions with Affiliate***

A state member bank is limited in the amount of "covered transactions" with any affiliate. All such transactions must also be on terms substantially the same, or at least as favorable, to the Bank or subsidiary as those provided to a non-affiliate. The term "covered transaction" includes the making of loans, purchase of assets, issuance of a guarantee and similar types of transactions. Certain covered transactions, such as loans to affiliates, must meet collateral requirements. At December 31, 2015, we had no transactions with affiliates.

Loans to directors, executive officers and principal stockholders of a state member bank must be made on substantially the same terms as those prevailing for comparable transactions with persons who are not executive officers, directors, principal stockholders or employees of the bank. Loans to any executive officer, director and principal stockholder together with all other outstanding loans to such person and affiliated interests generally may not exceed 15% of the Bank's unimpaired capital and surplus and all loans to such persons may not exceed the institution's unimpaired capital and unimpaired surplus. Loans to directors, executive officers and principal stockholders, and their respective affiliates, in excess of the greater of \$25,000 or 5% of capital and surplus, or any loans cumulatively aggregating \$500,000 or more, must be approved in advance by a majority of the board of directors of the bank with any "interested" director not participating in the voting. State member banks are prohibited from paying the overdrafts of any of their executive officers or directors unless payment is made pursuant to a written, pre-authorized interest-bearing extension of credit plan that specifies a method of repayment or transfer of funds from another account at the bank. In addition, loans to executive officers may not be made on terms more favorable than those afforded other borrowers and are restricted as to type, amount and terms of credit.

### ***Enforcement***

The Commissioner has extensive enforcement authority over Maryland banks. Such authority includes the ability to issue cease and desist orders and civil money penalties and to remove directors or officers. The Commissioner may also take possession of a Maryland bank whose capital is impaired and seek to have a receiver appointed by a court.

The Federal Reserve Board has primary federal enforcement responsibility over state banks under its jurisdiction, including the authority to bring enforcement action against all “institution-related parties,” including stockholders, and any attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an institution. Formal enforcement action may range from the issuance of capital directive or a cease and desist order for the removal of officers and/or directors, receivership, conservatorship or termination of deposit insurance. Civil money penalties cover a wide range of violations and actions, and range up to \$25,000 per day or even up to \$1 million per day (in the most egregious cases). Criminal penalties for most financial institution crimes include fines of up to \$1 million and imprisonment for up to 30 years.

### ***Other Regulations***

The Bank’s operations are also subject to federal laws applicable to credit transactions, including the:

- Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;

- Home Mortgage Disclosure Act of 1975, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;

- Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;

- Fair Credit Reporting Act of 1978, governing the use and provision of information to credit reporting agencies; and

- Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies; and rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

The operations of the Bank also are subject to laws such as the:

- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;

- Electronic Funds Transfer Act and Regulation E promulgated thereunder, which govern automatic deposits to and withdrawals from deposit accounts and customers’ rights and liabilities arising from the use of automated teller

machines and other electronic banking services; and

Check Clearing for the 21st Century Act (also known as “Check 21”), which gives “substitute checks,” such as digital check images and copies made from that image, the same legal standing as the original paper check.

## Management

### Chief Officers

Our executive officers are elected by the Board of Directors and serve at the Board's discretion. Executive officers of the Bank also serve as executive officers of the Company. The executive officers of the Company are as follows:

**Michael L. Middleton, 68**, is Executive Chairman of the Company and the Bank. Mr. Middleton joined the Bank in 1973 and served in various management positions until 1979 when he became President of the Bank, which he served as until 2010. He remained President of the Company until May 2012. Mr. Middleton has over 40 years of banking experience. Before joining the Bank, Mr. Middleton was employed by KMPG-Peat Marwick. Mr. Middleton is a member of the Maryland Association of Certified Public Accountants and holds a Masters of Business Administration from the University of Maryland. He also attended the Harvard Business School Program on Negotiation. From 1996 to 2004, Mr. Middleton served on the Board of Directors of the FHLB of Atlanta, serving as Chairman of the Board in 2004. Mr. Middleton served on the Board of Directors of the Federal Reserve Bank, Baltimore Branch, from 2004 to 2009. He completed his term as Chairman of the Maryland Bankers Association in June 2013 and is a trustee and former Chairman of the Board for the College of Southern Maryland, serves on the Advisory Board of the Robert H. Smith School of Business Center for Financial Policy and he completed his term as Vice Chairman of the Federal Reserve's Community Depository Advisory Council (CDIAC) in October 2015. He also serves on several philanthropic and civic boards.

**William J. Pasenelli, 57**, is a Director and President and Chief Executive of the Company and Bank. Mr. Pasenelli joined the Bank as Chief Financial Officer in 2000 and was named President of the Bank in 2010 and President of the Company in May 2012. He relinquished the position of Chief Financial Officer of the Bank in March 2013. Before joining the Bank, Mr. Pasenelli had been Chief Financial Officer of Acacia Federal Savings Bank, Annandale, Virginia, since 1987. Mr. Pasenelli has over 20 years of banking experience. Mr. Pasenelli is a member of the American Institute of Certified Public Accountants, the Greater Washington Society of Certified Public Accountants and other civic groups. Mr. Pasenelli is a graduate of the National School of Banking and holds a Bachelor of Arts from Duke University. He also attended the Harvard Business School Program on Negotiation.

**Gregory C. Cockerham, 61**, joined the Bank in 1988. He serves as the Bank's Executive Vice President—Chief Lending Officer of the Company and the Bank. Before joining the Bank, he was Vice President of Maryland National Bank. Mr. Cockerham has over 35 years of banking experience. Mr. Cockerham serves as former Chairman of the College of Southern Maryland Foundation and is the past Chairman of the Maryland Title Center. He presently serves as the Potomac Baptist Associate Finance Chair, is a Paul Harris Fellow and Foundation Chair with the Rotary Club of Charles County and serves on various civic boards. Mr. Cockerham is a Maryland Bankers School graduate and holds a Bachelor of Science from West Virginia University. He also attended the Harvard Business School Program on Negotiation.

**James M. Burke, 47**, joined the Bank in 2006. He serves as the Bank's Executive Vice President—Chief Risk Officer of the Company and the Bank. Before his appointment as Executive Vice President in 2007, he served as the Bank's Senior Credit Officer. Before joining the Bank, Mr. Burke served as Executive Vice President and Senior Loan Officer of Mercantile Southern Maryland Bank. Mr. Burke has over 20 years of banking experience. Mr. Burke is the former Chairman of the Board of Directors of University of Maryland Charles Regional Medical Center and is active in other civic groups. Mr. Burke is a Maryland Bankers School graduate and holds a Bachelor of Arts from High Point College. He is also a graduate of the East Carolina Advanced School of Commercial Lending and attended the Harvard Business School Program on Negotiation.

**James F. Di Misa, 56**, joined the Bank in 2006. He serves as Executive Vice President—Chief Operating Officer of the Company and the Bank. Before joining the Bank, Mr. Di Misa served as Executive Vice President of Mercantile Southern Maryland Bank. Mr. Di Misa has over 30 years of banking experience. Mr. Di Misa is Chairman of the Board of Trustees for the Maryland Bankers School and a member of several other civic and professional groups. Mr. Di Misa is a Stonier Graduate School of Banking graduate and holds a Masters of Business Administration from Mount St. Mary's College and a Bachelor of Science from George Mason University. He also attended the Harvard Business School Program on Negotiation.

**Todd L. Capitani, 49**, joined the Bank in 2009. He serves as Executive Vice President—Chief Financial Officer of the Company and the Bank. Before joining the Bank, Mr. Capitani served as a Senior Finance Manager at Deloitte Consulting and as Chief Financial Officer at Ruesch International, Inc. Mr. Capitani has over 25 years of experience in corporate finance, controllership and external audit. Mr. Capitani is a member of the American Institute of Certified Public Accountants and other civic groups. Mr. Capitani is a Certified Public Accountant and holds a Bachelor of Arts from the University of California at Santa Barbara. He also attended the Harvard Business School Program on Negotiation and the Yale School of Management Strategic Leadership Conference.

**Christy M Lombardi, 39**, joined the Bank in 1998. She serves as Executive Vice President—Chief Administrative Officer of the Company and the Bank. Ms. Lombardi is responsible for administrative and corporate governance matters for the Company, and oversees human resources and shareholder relations. Ms. Lombardi has 20 years of banking experience. She serves as Chair for the Calvert County Chamber of Commerce Board of Directors, the Advisory Board of the Maryland Banker’s Association Council of Professional Women in Banking and Finance and on the Southern Maryland Workforce Development Board. She is a Maryland Bankers School graduate and holds a Masters in Management from University of Maryland University College as well as a Masters in Business Administration. Ms. Lombardi also attended the Harvard Business School Program on Negotiation.

Item 1A. Risk Factors

***Risks***

*An investment in shares of our common stock involves various risks. Our business, financial condition and results of operations could be harmed by any of the following risks or by other risks that have not been identified or that we may believe are immaterial or unlikely. The value or market price of our common stock could decline due to any of these risks, and you may lose all or part of your investment. The risks discussed below also include forward-looking statements, and our actual results may differ substantially from those discussed in these forward-looking statements.*

**Our increased emphasis on commercial lending may expose us to increased lending risks.**

At December 31, 2015 and 2014, our loan portfolio consisted of \$613.5 million, or 66.8%, and \$561.1 million, or 64.3%, respectively, of commercial real estate loans, \$67.2 million, or 7.3% and \$73.6 million, or 8.4%, respectively of commercial business loans and \$29.9 million, or 3.3% and \$26.2 million, or 3.0%, respectively, of commercial equipment loans. We intend to maintain our emphasis on these types of loans. These types of loans generally expose a lender to greater risk of non-payment and loss and require a commensurately higher loan loss allowance than one- to four-family residential mortgage loans because repayment of the loans often depends on the successful operation of the property and the income stream of the borrowers. Such loans typically involve larger loan balances compared to one- to four-family residential mortgage loans. Commercial business and equipment loans expose us to additional risks since they typically are made on the basis of the borrower's ability to make repayments from the cash flows of the borrower's business and are secured by non-real estate collateral that may depreciate over time. Also, many of our commercial borrowers have more than one loan outstanding with us. Consequently, an adverse development with respect to one loan or one credit relationship can expose us to a significantly greater risk of loss compared to an adverse development with respect to a one- to four-family residential mortgage loan. At December 31, 2015 and 2014, \$5.8 million, or 51.4% and \$5.7 million, or 55.5%, respectively, of our non-accrual loans of \$11.4 million and \$10.3 million, respectively, consisted of commercial loans.

**Our provision for loan losses has been elevated during the last five years and we may be required to make further increases in our provision for loan losses and to charge-off additional loans in the future. Further, our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio.**

For the years ended December 31, 2015 and 2014, we recorded a provision for loan losses of \$1.4 million and \$2.7 million, respectively. We also recorded net loan charge-offs of \$1.4 million and \$2.3 million for the years ended December 31, 2015 and 2014, respectively. Our non-accrual loans, OREO and accruing TDRs aggregated \$34.0



million, or 2.98% of total assets and \$29.4 million, or 2.71% of total assets, respectively, at December 31, 2015 and 2014. Additionally, loans that were classified as either special mention and substandard were \$33.6 million and \$52.2 million, respectively, at December 31, 2015 and 2014. We had \$861,000 in loans classified as doubtful and no loans classified as loss at December 31, 2015. We had no loans classified as doubtful or loss at December 31, 2014. If the economy and/or the real estate market weakens, more of our classified loans may become non-performing and we may be required to take additional provisions to increase our allowance for loan losses for these assets as the value of the collateral may be insufficient to pay any remaining net loan balance, which could have a negative effect on our results of operations. We maintain an allowance for loan losses to provide for loans in our portfolio that may not be repaid in their entirety. We believe that our allowance for loan losses is maintained at a level adequate to absorb probable losses inherent in our loan portfolio as of the corresponding balance sheet date. However, our allowance for loan losses may not be sufficient to cover actual loan losses, and future provisions for loan losses could materially adversely affect our operating results.

In evaluating the adequacy of our allowance for loan losses, we consider numerous quantitative factors, including our historical charge-off experience, growth of our loan portfolio, changes in the composition of our loan portfolio and the volume of delinquent, non-accrual and classified loans, TDRs and foreclosed real estate. In addition, we use information about specific borrower situations, including their financial position and estimated collateral values, to estimate the risk and amount of loss for those borrowers. Finally, we also consider many qualitative factors, including general and economic business conditions, anticipated duration of the current business cycle, current general market collateral valuations, trends apparent in any of the factors we take into account and other matters, which are, by nature, more subjective and fluid. Our estimates of the risk of loss and amount of loss on any loan are complicated by the significant uncertainties surrounding our borrowers' abilities to successfully execute their business models through changing economic environments, competitive challenges and other factors. Because of the degree of uncertainty and susceptibility of these factors to change, our actual losses may vary from our current estimates.

Our regulators, as an integral part of their examination process, periodically review our allowance for loan losses and may require us to increase our allowance for loan losses by recognizing additional provisions for loan losses charged to expense, or to decrease our allowance for loan losses by recognizing loan charge-offs. Any such additional provisions for loan losses or charge-offs, as required by our regulators, could have a material adverse effect on our financial condition and results of operations.

**If we do not effectively manage our credit risk, we may experience increased levels of non-performing loans, charge-offs and delinquencies, which would require additional increases in our provision for loan losses.**

There are risks inherent in making any loan, including risks inherent in dealing with individual borrowers, risks of non-payment, risks resulting from uncertainties as to the future value of collateral and cash flows available to service debt and risks resulting from changes in economic and market conditions. Our credit risk approval and monitoring procedures may not reduce these credit risks, and they cannot be expected to completely eliminate our credit risks. If the overall economic climate in the United States, generally, or our market areas, specifically, fails to improve, or even if it does improve, our borrowers may experience difficulties in repaying their loans, and the level of non-performing loans, charge-offs and delinquencies could rise and require further increases in the provision for loan losses, which would cause our net income and return on equity to decrease.

**Non-performing and classified assets take significant time to resolve and adversely affect our results of operations and financial condition, and could result in further losses in the future.**

At December 31, 2015 and 2014, our non-accrual loans totaled \$11.4 million, or 1.24% of our loan portfolio and \$10.3 million, or 1.18% of our loan portfolio, respectively. At December 31, 2015 and 2014, our non-accrual loans, OREO and accruing TDRs totaled \$34.0 million, or 2.98% of total assets and \$29.4 million, or 2.71% of total assets, respectively. Our non-performing assets adversely affect our net income in various ways. We do not accrue interest income on non-accrual loans or foreclosed properties, thereby adversely affecting our net income and returns on assets and equity, increasing our loan administration costs and adversely affecting our efficiency ratio. When we take collateral in foreclosure and similar proceedings, we are required to mark the collateral to its then fair market value, less estimated selling costs, which may result in a loss. These non-performing loans and foreclosed properties also increase our risk profile and the amount of capital our regulators believe is appropriate to maintain in light of such risks. The resolution of non-performing assets requires significant time commitments from management and can be detrimental to the performance of their other responsibilities. If we experience increases in non-performing loans and non-performing assets, our net interest income will be negatively impacted and our loan administration costs could increase, each of which could have an adverse effect on our net income and related ratios, such as return on assets and equity.

At December 31, 2015 and 2014 our total classified assets were \$43.3 million and \$54.0 million, respectively. While we continue to accrue interest income on classified loans that are performing, classified loans and other classified assets may negatively impact profitability by requiring additional management attention and regular monitoring. Increased monitoring of these assets by management may impact our management's ability to focus on opportunistic growth, potentially adversely impacting future profitability.

**Our residential mortgage loans and home equity loans expose us to a risk of loss due to declining real estate values.**

At December 31, 2015 and 2014, \$150.0 million, or 16.3%, of our total loan portfolio, and \$152.8 million, or 17.5%, of our total loan portfolio, respectively, consisted of one- to four-family residential mortgage loans. At December 31, 2015 and 2014, \$21.7 million, or 2.4%, of our total loan portfolio and \$21.5 million, or 2.5%, of our total loan portfolio, respectively, consisted of home equity loans and lines of credit. Declines in the housing market could result in declines in real estate values in our market area. A decline in real estate values could cause some of our mortgage and home equity loans to be inadequately collateralized, which would expose us to a greater risk of loss if we seek to recover on defaulted loans by selling the real estate collateral.

**Negative developments in the financial industry, the domestic and international credit markets, and the economy in general pose significant challenges for our industry and us and could adversely affect our business, financial condition and results of operations.**

Negative developments that began in the latter half of 2007 and that have continued since then in the global credit and securitization markets have resulted in unprecedented volatility and disruption in the financial markets, a general economic downturn and a tepid economic recovery, both nationally and in our primary markets. As a result, commercial as well as consumer loan portfolio performances deteriorated at many institutions and have not fully recovered, and the competition for deposits and quality loans has increased significantly. In addition, the values of real estate collateral supporting many commercial loans and home mortgages have declined and may continue to decline. As a result, we may face the following risks:

- Economic conditions that negatively affect housing prices and the job market may cause the credit quality of our loan portfolios to deteriorate;
- Market developments that affect consumer confidence may cause adverse changes in payment patterns by our customers, causing increases in delinquencies and default rates on loans and other credit facilities;
- The processes that we use to estimate our allowance for loan losses and reserves may no longer be reliable because they rely on judgments, such as forecasts of economic conditions, that may no longer be capable of accurate estimation;
- The value of our securities portfolio may decline; and
- We face increased regulation of our industry, and the costs of compliance with such regulation may increase.

These conditions or similar ones may continue to persist or worsen, causing us to experience continuing or increased adverse effects on our business, financial condition, results of operations and the price of our common stock.

**Changes in interest rates could reduce our net interest income and earnings.**

Our largest component of earnings is net interest income, which could be negatively affected by changes in interest rates. Changing interest rates impact customer actions and may limit the options available to the Company to maximize earnings or increase the costs to minimize risk. We do not have control over market interest rates and the Company's focus to mitigate potential earnings risk centers on controlling the composition of our assets and liabilities.

Our net interest income is the interest we earn on loans and investments less the interest we pay on our deposits and borrowings. Our net interest margin is net interest income divided by average interest-earning assets. Changes in interest rates could adversely affect our net interest margin and, as a result, our net interest income. Although the yield we earn on our assets and our funding costs tend to move in the same direction in response to changes in interest rates, one can rise or fall faster than the other, causing our net interest margin to increase or decrease. Our liabilities tend to be shorter in duration than our assets, so they may adjust faster in response to changes in interest rates. As a result, when interest rates rise, our funding costs may rise faster than the yield we earn on our assets, causing our net interest margin to contract until the yield catches up. Changes in the slope of the "yield curve"—or the spread between short-term and long-term interest rates—could also reduce our net interest margin. Normally, the yield curve is upward sloping, meaning short-term rates are lower than long-term rates. Because our liabilities tend to be shorter in duration than our assets, when the yield curve flattens or inverts, we could experience pressure on our net interest margin as our cost of funds increases relative to the yield we can earn on our assets. Our procedures for managing exposure to falling net interest income involve modeling possible scenarios of interest rate increases and decreases to interest-earning assets and interest-bearing liabilities.

Changes in interest rates also can affect: (1) our ability to originate loans; (2) the value of our interest-earning assets; (3) our ability to obtain and retain deposits in competition with other available investment alternatives; and (4) the ability of our borrowers to repay their loans, particularly adjustable or variable rate loans.

**Monetary policies and regulations of the Federal Reserve could adversely affect our business, financial condition and results of operations.**

In addition to being affected by general economic conditions, our earnings and growth are affected by the policies of the Federal Reserve. An important function of the Federal Reserve is to regulate the money supply and credit conditions. Among the instruments used by the Federal Reserve to implement these objectives are open market operations in U.S. government securities, adjustments of the discount rate and changes in reserve requirements against bank deposits. These instruments are used in varying combinations to influence overall economic growth and the distribution of credit, bank loans, investments and deposits. Their use also affects interest rates charged on loans or paid on deposits. The monetary policies and regulations of the Federal Reserve have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future. The effects of such policies upon our business, financial condition and results of operations cannot be predicted.

**Our financial condition and results of operations could be negatively affected if we fail to effectively execute our strategic plan or manage the growth called for in our strategic plan.**

Among other things, our strategic plan currently calls for reducing the amount of our non-performing assets, growing assets through commercial lending and generating transaction deposit accounts to reduce our funding costs and improve our net interest margin. Our ability to increase profitability in accordance with this plan will depend on a variety of factors including the identification of desirable business opportunities, competitive responses from financial institutions in our market area and our ability to manage liquidity and funding sources. While we believe we have the management resources and internal systems in place to successfully manage our strategic plan, opportunities may not be available and that the strategic plan may not be successful or effectively managed.

Although we do not have any current definitive plans to do so, other than what we have already disclosed regarding a planned new bank in Fredericksburg in early 2016, in implementing our strategic plan we may expand into additional communities or attempt to strengthen our position in our current markets through opportunistic acquisitions of whole banks or branch locations. To the extent that we undertake acquisitions, we are likely to experience the effects of higher operating expenses relative to operating income from the new operations, which may have an adverse effect on our levels of reported net income, return on average equity and return on average assets. Other effects of engaging in such growth strategies may include potential diversion of our management's time and attention and general disruption to our business. We may be able to adequately and profitably manage anticipated growth.

**We are a community bank and our ability to maintain our reputation is critical to the success of our business and the failure to do so may materially adversely affect our performance.**

We are a community bank, and our reputation is one of the most valuable components of our business. As such, we strive to conduct our business in a manner that enhances our reputation. This is done, in part, by recruiting, hiring and retaining employees who share our core values of being an integral part of the communities we serve, delivering superior service to our customers and caring about our customers and associates. If our reputation is negatively affected, by the actions of our employees or otherwise, our business and, therefore, our operating results may be adversely affected.

**Our asset valuation may include methodologies, estimations and assumptions that are subject to differing interpretations and could result in changes to asset valuations that may materially adversely affect our results of operations or financial condition.**

We must use estimates, assumptions, and judgments when financial assets and liabilities are measured and reported at fair value. Assets and liabilities carried at fair value inherently result in a higher degree of financial statement volatility. Fair values and the information used to record valuation adjustments for certain assets and liabilities are based on quoted market prices and/or other observable inputs provided by independent third-party sources, when available. When such third-party information is not available, we estimate fair value primarily by using cash flows and other financial modeling techniques utilizing assumptions such as credit quality, liquidity, interest rates and other relevant inputs. Changes in underlying factors, assumptions, or estimates in any of these areas could materially impact our future financial condition and results of operations.

During periods of market disruption, including periods of significantly rising or high interest rates, rapidly widening credit spreads or illiquidity, it may be difficult to value certain of our assets if trading becomes less frequent and market data becomes less observable. There may be certain asset classes that were in active markets with significant observable data that become illiquid due to the current financial environment. In such cases, certain asset valuations may require more subjectivity and management judgment. As such, valuations may include inputs and assumptions that are less observable or require greater estimation.

**Strong competition within our market area could hurt our profits and slow growth.**

We face intense competition both in making loans and attracting deposits. Our competition for loans and deposits includes banks, savings institutions, mortgage banking companies, credit unions and non-banking financial institutions. We compete with regional and national financial institutions that have a substantial presence in our market area, many of which have greater liquidity, higher lending limits, greater access to capital, more established market recognition and more resources and collective experience than us. Furthermore, tax-exempt credit unions operate in our market area and aggressively price their products and services to a large portion of the market. This competition may make it more difficult for us to originate new loans and may force us to offer higher deposit rates than we currently offer. Price competition for loans and deposits might result in lower interest rates earned on our loans and higher interest rates paid on our deposits, which would reduce net interest income. Our profitability depends upon our continued ability to compete successfully in our market area.

**If the value of real estate in our market area were to decline, a significant portion of our loan portfolio could become under-collateralized, which could have a material adverse effect on us.**

Declines in local economic conditions could adversely affect the value of the real estate collateral securing our loans. A decline in property values would diminish our ability to recover on defaulted loans by selling the real estate collateral, making it more likely that we would suffer losses on defaulted loans. Additionally, a decrease in asset quality could require additions to our allowance for loan losses through increased provisions for loan losses, which would hurt our profits. Real estate values are affected by various factors in addition to local economic conditions, including, among other things, changes in general or regional economic conditions, governmental rules or policies and natural disasters.

**We may be adversely affected by economic conditions in our market area, which is significantly dependent on federal government and military employment, as well as national and international economic conditions.**

Our marketplace is primarily in the counties of Charles, Calvert, St. Mary's and Anne Arundel, Maryland and neighboring communities, and the Fredericksburg area of Virginia. Many, if not most, of our customers live and/or work in those counties or in the greater Washington, DC metropolitan area. Because our services are concentrated in this market, we are affected by the general economic conditions in the greater Washington, DC area. Changes in the economy may influence the growth rate of our loans and deposits, the quality of the loan portfolio and loan and deposit pricing. A significant decline in economic conditions caused by inflation, recession, unemployment or other factors beyond our control could decrease the demand for banking products and services generally and/or impair the ability of existing borrowers to repay their loans, which could negatively affect our financial condition and performance.



A significant portion of the population in our market area is affiliated with or employed by the federal government or at military facilities located in the area. As a result, a downturn in federal government or military employment could have a negative impact on local economic conditions and real estate collateral values, and could also negatively affect the Company's profitability. The impact on the economy has been moderated by the presence of federal government agencies and defense facilities. However, the possibility of large cuts to the defense budget hampered economic expansion in recent years and the effect of the sequestration negatively impacted employment.

**We operate in a highly regulated environment and we may be adversely affected by changes in laws and regulations.**

The Company and the Bank are subject to extensive regulation, supervision and examination as noted in the “*Supervision and Regulation*” section of this report. The regulation and supervision by the Maryland Commissioner, the Federal Reserve and the FDIC are not intended to protect the interests of investors in The Community Financial Corporation common stock. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on our operations, the classification of our assets and determination of the level of our allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, legislation or supervisory action, may have a material impact on our operations.

**Regulation of the financial services industry is undergoing major changes and future legislation could increase our cost of doing business or harm our competitive position.**

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) has created a significant shift in the way financial institutions operate. The key effects of the Dodd-Frank Act on our business are:

- Changes to regulatory capital requirements;
  
- Creation of new government regulatory agencies (such as the Financial Stability Oversight Council, which oversees systemic risk, and the Consumer Financial Protection Bureau, which develops and enforces rules for bank and non-bank providers of consumer financial products);
  
- Potential limitations on federal preemption;
  
- Changes to deposit insurance assessments;
  
- Regulation of debit interchange fees we earn;

- Changes in retail banking regulations, including potential limitations on certain fees we may charge; and
- Changes in regulation of consumer mortgage loan origination and risk retention.

In addition, the Dodd-Frank Act restricts the ability of banks to engage in certain proprietary trading or to sponsor or invest in private equity or hedge funds. The Dodd-Frank Act also contains provisions designed to limit the ability of insured depository institutions, their holding companies and their affiliates to conduct certain swaps and derivatives activities and to take certain principal positions in financial instruments.

Certain changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage requirements or otherwise adversely affect our business. These changes may also require us to invest significant management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements. Failure to comply with the requirements may negatively impact our results of operations and financial condition.

Any future legislative changes could have a material impact on our profitability, the value of assets held for investment or collateral for loans. Future legislative changes could require changes to business practices or force us to discontinue businesses and potentially expose us to additional costs, liabilities, enforcement action and reputational risk.

**New capital rules generally require insured depository institutions and their holding companies to hold more capital. The impact of the new rules on our financial condition and operations is uncertain but could be materially adverse.**

New capital rules adopted by the Federal Reserve substantially amended the regulatory risk-based capital rules applicable to us. The rules phase in over several years between 2015 and 2019. The rules apply to the Company as well as to the Bank. Beginning in the first quarter of 2015, our minimum capital requirements were (i) a common Tier 1 equity ratio of 4.5%, (ii) a Tier 1 capital (common Tier 1 capital plus Additional Tier 1 capital) of 6% (up from 4%) and (iii) a total capital ratio of 8% (the current requirement). Our leverage ratio requirement will remain at the 4% level. Beginning in 2016, a capital conservation buffer will phase in over three years, ultimately resulting in a requirement of 2.5% on top of the common Tier 1, Tier 1 and total capital requirements, resulting in a required common Tier 1 equity ratio of 7%, a Tier 1 ratio of 8.5%, and a total capital ratio of 10.5%. Failure to satisfy any of these three capital requirements will result in limits on paying dividends, engaging in share repurchases and paying discretionary bonuses. These limitations will establish a maximum percentage of eligible retained income that could be utilized for such actions.



**We are periodically subject to examination and scrutiny by a number of banking agencies and, depending upon the findings and determinations of these agencies, we may be required to make adjustments to our business that could adversely affect us.**

Federal and state banking agencies periodically conduct examinations of our business, including compliance with applicable laws and regulations. If, as a result of an examination, a federal banking agency was to determine that the financial condition, capital resources, asset quality, asset concentration, earnings prospects, management, liquidity, sensitivity to market risk or other aspects of any of our operations has become unsatisfactory, or that we or our management is in violation of any law or regulation, it could take a number of different remedial actions as it deems appropriate. These actions include the power to enjoin “unsafe or unsound” practices, to require affirmative actions to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in our capital, to restrict our growth, to change the asset composition of our portfolio or balance sheet, to assess civil monetary penalties against our officers or directors, to remove officers and directors and, if it is concluded that such conditions cannot be corrected or there is an imminent risk of loss to depositors, to terminate our deposit insurance. If we become subject to such regulatory actions, our business, results of operations and reputation may be negatively impacted.

**The Company is a bank holding company and its sources of funds necessary to meet its obligations are limited.**

The Company is a bank holding company, and its operations are primarily conducted by the Bank, which is subject to significant federal and state regulation. Cash available to pay dividends to our common and preferred stockholders, pay our obligations and meet our debt service requirements is derived primarily from our existing cash flow sources, dividends received from the Bank, or a combination thereof. Future dividend payments by the Bank to us will require generation of future earnings by the Bank and are subject to certain regulatory guidelines. If the Bank is unable to pay dividends to us, we may not have the resources or cash flow to pay or meet all of our obligations.

**The Bank became subject to increased internal control reporting under FDIC regulations in 2014. If it cannot favorably assess the effectiveness of its internal controls over financial reporting or if its independent registered public accounting firm is unable to provide an unqualified attestation report on the Bank’s internal controls, we may be subject to additional regulatory scrutiny.**

The Bank’s total assets exceeded \$1.0 billion at December 31, 2014 and it became subject to further reporting requirements under the rules of the FDIC for fiscal year 2014. Pursuant to these rules, management was required to prepare a report that contained an assessment by management of the Bank’s effectiveness of internal control structure and procedures for financial reporting as of the end of such fiscal year. The Bank was also required to obtain an

independent public accountant's attestation report concerning its internal control structure over financial reporting. The rules that must be met for management to assess the Bank's internal controls over financial reporting are complex, and require significant documentation, testing and possible remediation. The effort to comply with regulatory requirements relating to internal controls will likely cause us to incur increased expenses. We also may encounter problems or delays in completing the implementation of any changes necessary to make a favorable assessment of the Bank's internal controls over financial reporting. In addition, in connection with the attestation process, the Bank may encounter problems or delays in completing the implementation of any requested improvements or receiving a favorable attestation from its independent registered public accounting firm. If the Bank cannot favorably assess the effectiveness of its internal controls over financial reporting, or if its independent registered public accounting firm is unable to provide an unqualified attestation report on the Bank's internal controls, investor confidence and the price of our common stock could be adversely affected and we may be subject to additional regulatory scrutiny.

**Provisions of our articles of incorporation, bylaws and Maryland law, as well as state and federal banking regulations, could delay or prevent a takeover of us by a third party.**

Provisions in our articles of incorporation and bylaws and Maryland corporate law could delay, defer or prevent a third party from acquiring us, despite the possible benefit to our shareholders, or otherwise adversely affect the price of our common stock. These provisions include: supermajority voting requirements for certain business combinations; the election of directors to staggered terms of three years; and advance notice requirements for nominations for election to our board of directors and for proposing matters that shareholders may act on at shareholder meetings. In addition, we are subject to Maryland laws, including one that prohibits us from engaging in a business combination with any interested shareholder for a period of five years from the date the person became an interested shareholder unless certain conditions are met. These provisions may discourage potential takeover attempts, discourage bids for our common stock at a premium over market price or adversely affect the market price of, and the voting and other rights of the holders of, our common stock. These provisions could also discourage proxy contests and make it more difficult for shareholders to elect directors other than the candidates nominated by our Board.

**We rely on other companies to provide key components of our business infrastructure.**

Third party vendors provide key components of our business infrastructure such as core data processing systems, internet connections, network access and fund distribution. While we have selected these third party vendors carefully, we cannot control their actions. Any problems caused by these third parties, including those which result from their failure to provide services for any reason or their poor performance of services, could adversely affect our ability to deliver products and services to its customers and otherwise to conduct its business. Replacing these third party vendors could also entail significant delay and expense.

**We are dependent on our information technology and telecommunications systems and third-party servicers, and systems failures, interruptions or breaches of security could have a material adverse effect on us.**

Our business is dependent on the successful and uninterrupted functioning of our information technology and telecommunications systems and third-party servicers. The failure of these systems, or the termination of a third-party software license or service agreement on which any of these systems is based, could interrupt our operations. Because our information technology and telecommunications systems interface with and depend on third-party systems, we could experience service denials if demand for such services exceeds capacity or such third-party systems fail or experience interruptions. If significant, sustained or repeated, a system failure or service denial could compromise our ability to operate effectively, damage our reputation, result in a loss of customer business, and/or subject us to additional regulatory scrutiny and possible financial liability, any of which could have a material adverse effect on us.

In addition, we provide our customers with the ability to bank remotely, including over the Internet and the telephone. The secure transmission of confidential information over the Internet and other remote channels is a critical element of remote banking. Despite instituted safeguards and monitoring, our network could be vulnerable to unauthorized access, computer viruses, phishing schemes and other security breaches. We may be required to spend significant capital and other resources to protect against the threat of security breaches and computer viruses, or to alleviate problems caused by security breaches or viruses. To the extent that our activities or the activities of our customers involve the storage and transmission of confidential information, physical and cyber security breaches and viruses could expose us to claims, regulatory scrutiny, litigation and other possible liabilities. Any inability to prevent security breaches or computer viruses could also cause existing customers to lose confidence in our systems and could materially and adversely affect us.

**The laws that regulate our operations are designed for the protection of depositors and the public, not our shareholders.**

The federal and state laws and regulations applicable to our operations give regulatory authorities extensive discretion in connection with their supervisory and enforcement responsibilities, and generally have been promulgated to protect

depositors and the Deposit Insurance Fund and not for the purpose of protecting shareholders. These laws and regulations can materially affect our future business. Laws and regulations now affecting us may be changed at any time, and the interpretation of such laws and regulations by bank regulatory authorities is also subject to change. We can give no assurance that future changes in laws and regulations or changes in their interpretation will not adversely affect our business. Legislative and regulatory changes may increase our cost of doing business or otherwise adversely affect us and create competitive advantages for non-bank competitors.

**We are subject to a variety of operational risks, environmental, legal and compliance risks, and the risk of fraud or theft by employees or outsiders, which may adversely affect our business and results of operations.**

We are exposed to many types of operational risks, including reputational risk, legal and compliance risk, the risk of fraud or theft by employees or outsiders, and unauthorized transactions by employees or operational errors, including clerical or record-keeping errors or those resulting from faulty or disabled computer, telecommunications systems, cyber security breaches and other disruptive problems caused by the Internet or other users. Negative public opinion can result from our 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 attract and keep customers and can expose us to litigation and regulatory action. Actual or alleged conduct by the Bank can also result in negative public opinion about our other businesses.



If personal, non-public, confidential or proprietary information of customers in our possession were to be misappropriated, mishandled or misused, we could suffer significant regulatory consequences, reputational damage and financial loss. Such mishandling or misuse could include, for example, erroneously providing such information to parties who are not permitted to have the information, either by fault of our systems, employees, or counterparties, or the interception or inappropriate acquisition of such information by third parties.

Because the nature of the financial services business involves a high volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully rectified. Our necessary dependence upon automated systems to record and process transactions and our large transaction volume may further increase the risk that technical flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. We also may be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control (for example, computer viruses or electrical or telecommunications outages, or natural disasters, disease pandemics or other damage to property or physical assets) which may give rise to disruption of service to customers and to financial loss or liability. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as we are) and to the risk that our (or our vendors') business continuity and data security systems prove to be inadequate. The occurrence of any of these risks could result in our diminished ability to operate our business (for example, by requiring us to expend significant resources to correct the defect), as well as potential liability to clients, reputational damage and regulatory intervention, which could adversely affect our business, financial condition or results of operations, perhaps materially.

**We face a risk of noncompliance and enforcement action with the Bank Secrecy Act and other anti-money laundering statutes and regulations.**

The federal Bank Secrecy Act, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "PATRIOT Act") and other laws and regulations require financial institutions, among other duties, to institute and maintain effective anti-money laundering programs and file suspicious activity and currency transaction reports as appropriate. The federal Financial Crimes Enforcement Network, established by the U.S. Treasury Department to administer the Bank Secrecy Act, is authorized to impose significant civil money penalties for violations of those requirements and has recently engaged in coordinated enforcement efforts with the individual federal banking regulators, as well as the U.S. Department of Justice, Drug Enforcement Administration and Internal Revenue Service. Federal and state bank regulators also have begun to focus on compliance with Bank Secrecy Act and anti-money laundering regulations. If our policies, procedures and systems are deemed deficient or the policies, procedures and systems of the financial institutions that we may acquire in the future are deficient, we would be subject to liability, including fines and regulatory actions such as restrictions on our ability to pay dividends and the necessity to obtain regulatory approvals to proceed with certain aspects of our business plan, including our acquisition plans, which would negatively impact our business, financial condition and results of operations. Failure to maintain and implement adequate programs to combat money laundering and terrorist financing could also have serious reputational consequences for us.

**Security breaches and other disruptions could compromise our information and expose us to liability, which would cause our business and reputation to suffer.**

In the ordinary course of our business, we collect and store sensitive data, including our proprietary business information and that of our customers, suppliers and business partners; and personally identifiable information of our customers and employees. The secure processing, maintenance and transmission of this information is critical to our operations and business strategy. We, our customers, and other financial institutions with which we interact, are subject to ongoing, continuous attempts to penetrate key systems by individual hackers, organized criminals, and in some cases, state-sponsored organizations. Information security risks for financial institutions have generally increased in recent years in part because of the proliferation of new technologies, the use of the Internet and telecommunications technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, terrorists, activists, and other external parties. Despite our security measures and monitoring, our information technology and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance or other disruptions. Any such breach could compromise our networks and the information stored there could be accessed, publicly disclosed, lost or stolen. Any such unauthorized access, disclosure or other loss of information could result in significant costs to us, which may include fines and penalties, potential liabilities from governmental or third party investigations, proceedings or litigation, legal, forensic and consulting fees and expenses, costs and diversion of management attention required for investigation and remediation actions, and the negative impact on our reputation and loss of confidence of our customers and others, any of which could have a material adverse impact on our business, revenues, financial condition and competitive position. As cyber threats continue to evolve, we may be required to spend significant capital and other resources to protect against the threat of security breaches and computer viruses, or to alleviate problems caused by security breaches or viruses.

**Exiting or entering new lines of business or new products and services may subject us to additional risk.**

From time to time, we may exit an existing line of business or implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts. When exiting a line of business or product we may have difficulty replacing the revenue stream and may have to take certain actions to make up for the line of business or product. For example, we recently discontinued the origination of residential mortgage loans and instead now purchase residential mortgage loans for our loan portfolio from other sources. If those sources are not available or the cost for such purchases increases our results of operations may be adversely affected. We also may face increased credit risk with respect to purchased loans relative to the credit risks we faced in connection with the origination of loans. In developing and marketing new lines of business and/or new products and services, we may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business and/or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of our system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business and/or new products or services could have a material adverse effect on our business and, in turn, our financial condition and results of operations.

**To remain competitive, we must keep pace with technological change.**

Financial products and services have become increasingly technology-driven. Our ability to meet the needs of our customers competitively, and in a cost-efficient manner, is dependent on the ability to keep pace with technological advances and to invest in new technology as it becomes available. Many of our competitors have greater resources to invest in technology than we do and may be better equipped to market new technology-driven products and services. The ability to keep pace with technological change is important, and the failure to do so could have a material adverse impact on our business and therefore on our financial condition and results of operations.

**The amount of interest payable on our 6.25% Fixed to Floating Rate Subordinated Notes due 2025 will vary after February 15, 2020.**

The interest rate on our 6.25% Fixed to Floating Rate Subordinated Notes due 2025 will vary after February 15, 2020. From and including the issue date of such notes but excluding February 15, 2020, the notes will bear interest at a fixed rate of 6.25% per year. From and including February 15, 2020, to but excluding the maturity date, the notes will bear interest at an annual floating rate equal to the three-month LIBOR plus 479 basis points for any interest period. If interest rates rise, the cost of our subordinated notes may increase thereby negatively affecting our net income.



Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

The Bank maintains its main office and operations center in Waldorf, Maryland, in addition to its branch offices in Lexington Park, Leonardtown, La Plata, Dunkirk, Bryans Road, Waldorf, Charlotte Hall, Prince Frederick and Lusby, Maryland and one branch in Fredericksburg, Virginia. The Bank is expected to open a second branch in downtown Fredericksburg, Virginia during the first quarter of 2016. The Bank owns all of its branches except for the Dunkirk, Maryland branch, the Fredericksburg Central Park, Virginia branch and the land on which the Waldorf, Charlotte Hall, Prince Frederick and Lusby, Maryland branches are located. In addition, the Bank maintains five loan production offices (“LPOs”) in La Plata, Prince Frederick, Leonardtown and Annapolis, Maryland; and Fredericksburg, Virginia. The Leonardtown and Fredericksburg LPOs are co-located with branches. Lease expiration dates range from 2017 to 2035 with renewal options of 5 to 10 years. The total net book value of the properties at December 31, 2015 and 2014 was \$17.3 million and \$17.8 million, respectively, which included \$13.1 million and \$12.2 million, respectively, related to buildings and improvements.

Item 3. Legal Proceedings

Neither the Company, the Bank, nor any subsidiary is engaged in any legal proceedings of a material nature at the present time. From time to time, the Bank is a party to legal proceedings in the ordinary course of business.

Item 4. Mine Safety Disclosures

Not applicable.

**PART II****Item 5 - Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities****Market Price and Dividends on Registrant's and Related Stockholder Matters.***Market Information*

The following table sets forth high and low bid quotations reported for the Company's common stock for each quarter during 2015 and 2014 and the dividends declared per share for common stock. These quotes reflect inter-dealer prices without retail mark-up, mark-down or commission and may not necessarily reflect actual transactions.

Quarter Ended	High	Low	Dividends Per Share
December 31, 2015	\$24.00	\$20.25	\$ 0.10
September 30, 2015	24.60	19.18	0.10
June 30, 2015	23.77	19.75	0.10
March 31, 2015	20.35	18.41	0.10
December 31, 2014	21.50	19.56	0.10
September 30, 2014	23.75	20.21	0.10
June 30, 2014	23.96	20.55	0.10
March 31, 2014	24.80	19.38	0.10

*Holder*s

The common stock of the Company is traded on the NASDAQ Stock Exchange (Symbol: TCFC). The number of stockholders of record of the Company at March 3, 2016 was 518.

*Dividends*

During 2015 and 2014, the Company declared and paid four quarters of dividends at \$0.10 per share. The Board of Directors considers on a quarterly basis the feasibility of paying a cash dividend to its stockholders. Under the Company's general practice, dividends, if declared during the quarter, are paid prior to the end of the subsequent quarter.

The Company's ability to pay dividends is governed by the policies and regulations of the Federal Reserve Board (the "FRB"), which prohibits the payment of dividends under certain circumstances dependent on the Company's financial condition and capital adequacy. The Company's ability to pay dividends is also dependent on the receipt of dividends from the Bank.

Federal regulations impose certain limitations on the payment of dividends and other capital distributions by the Bank. The Bank's ability to pay dividends is governed by the Maryland Financial Institutions Code and the regulations of the FRB. Under the Maryland Financial Institutions Code, a Maryland bank (1) may only pay dividends from undivided profits or, with prior regulatory approval, its surplus in excess of 100% of required capital stock and, (2) may not declare dividends on its common stock until its surplus funds equals the amount of required capital stock, or if the surplus fund does not equal the amount of capital stock, in an amount in excess of 90% of net earnings.

Without the approval of the FRB, a state member bank may not declare or pay a dividend if the total of all dividends declared during the year exceeds its net income during the current calendar year and retained net income for the prior two years. The Bank is further prohibited from making a capital distribution if it would not be adequately capitalized thereafter. In addition, the Bank may not make a capital distribution that would reduce its net worth below the amount required to maintain the liquidation account established for the benefit of its depositors at the time of its conversion to stock form.

On September 22, 2011, the U.S. Department of Treasury purchased \$20.0 million of the Company's Series C Preferred Stock under the Small Business Lending Fund. On February 13, 2015, the Company's federal banking regulator approved the repayment of SBLF by the Company. The Company used proceeds from a \$23 million dollar subordinated debt offering closed on February 6, 2015 to redeem all \$20 million of the Company's outstanding preferred stock issued under the SBLF program. The Company paid \$23,000 and \$200,000, respectively, in preferred dividends for the years ended December 31, 2015 and 2014.

### **Stock Performance Graph**

The following graph and table show the cumulative total return on the common stock of the Company over the last five years, compared with the cumulative total return of a broad stock market index (the NASDAQ Capital Market Composite), and a narrower index of the NASDAQ Bank Index. Cumulative total return on the stock or the index equals the total increase in value since December 31, 2010, assuming reinvestment of all dividends paid into the stock or the index.

The graph and table were prepared assuming that \$100 was invested on December 31, 2010, in the common stock and the securities included in the indexes

Source: Bloomberg Index	Year Ended					
	12/31/2010	12/30/2011	12/31/2012	12/31/2013	12/31/2014	12/31/2015
The Community Financial Corporation	100.00	95.65	104.45	138.63	137.03	145.16
NASDAQ Bank Index	100.00	89.54	106.15	149.99	157.21	170.98
NASDAQ Capital Market Composite	100.00	77.02	87.44	119.44	112.75	93.63



**Recent Sales of Unregistered Securities**

Not applicable.

**Purchases of Equity Securities by the Issuer**

On September 25, 2008, the Company announced a repurchase program (“2008 repurchase plan”) under which it would repurchase up to 5% of its outstanding common stock or approximately 147,435 shares. The program will continue until it is completed. On May 4, 2015, the Board of Directors approved a successor repurchase plan (“2015 repurchase plan”) that will commence upon the completion of the 2008 repurchase plan. The 2015 repurchase plan authorizes the repurchase of up to 250,000 shares of outstanding common stock. The 2015 repurchase plan will continue until it is completed or terminated by the Company’s Board of Directors. During the quarter ended December 31, 2015, the remaining 43,923 shares were repurchased under the 2008 repurchase program. As of December 31, 2015, 228,940 shares were available to be repurchased under the 2015 repurchase program

The following schedules show the repurchases during the three months ended December 31, 2015.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
2008 Repurchase Plan				43,923
October 1-31, 2015	25,000	\$ 21.20	25,000	18,923
November 1-30, 2015	18,923	21.24	18,923	-
December 1-31, 2015	-	-	-	-
Total	43,923	\$ 21.22	43,923	-
2015 Repurchase Plan				250,000
October 1-31, 2015	-	\$ -	-	250,000
November 1-30, 2015	-	-	-	250,000
December 1-31, 2015	21,060	21.24	21,060	228,940
Total	21,060	\$ 21.24	21,060	228,940

Item 6 - Selected Financial Data**SUMMARY OF SELECTED FINANCIAL DATA**

The following table shows selected historical consolidated financial data for the Company as of and for each of the five years ended December 31, 2015, which has been derived from our audited consolidated financial statements. You should read this table together with our consolidated financial statements and related notes included elsewhere in this Annual 10-K report.

	At or for the Years Ended December 31,				
(dollars in thousands, except per share amounts)	2015	2014	2013	2012	2011
<b>FINANCIAL CONDITION DATA</b>					
Total assets	\$1,143,332	\$1,082,878	\$1,023,824	\$981,639	\$983,480
Loans receivable, net	909,200	862,409	799,130	747,641	710,089
Investment securities	144,536	126,445	134,648	159,825	195,344
Deposits	906,899	869,384	821,295	820,231	827,253
Borrowings	91,617	76,672	70,476	61,527	60,577
Junior subordinated debentures	12,000	12,000	12,000	12,000	12,000
Subordinated notes - 6.25%	23,000	-	-	-	-
Stockholders' equity—preferred	-	20,000	20,000	20,000	20,000
Stockholders' equity—common	99,783	96,559	90,730	59,047	55,454
<b>OPERATING DATA</b>					
Interest and dividend income	\$43,873	\$41,759	\$39,678	\$40,293	\$39,959
Interest expenses	7,345	6,698	7,646	10,604	13,121
Net interest income (NII)	36,528	35,061	32,032	29,689	26,838
Provision for loan losses	1,433	2,653	940	2,529	4,087
NII after provision for loan losses	35,095	32,408	31,092	27,160	22,751
Noninterest income	3,299	4,093	4,174	4,410	4,193
Noninterest expenses	28,418	26,235	24,844	23,804	22,249
Income before income taxes	9,976	10,266	10,422	7,766	4,695
Income taxes	3,633	3,776	3,771	2,776	1,534
Net income	6,343	6,490	6,651	4,990	3,161
Preferred stock dividends declared	23	200	200	200	672
Income available to common shares	\$6,320	\$6,290	\$6,451	\$4,790	\$2,489
<b>COMMON SHARE DATA</b>					
Basic earnings per common share	\$1.36	\$1.35	\$1.90	\$1.57	\$0.83
Diluted earnings per common share	1.35	1.35	1.88	1.57	0.82
Dividends declared per common share	0.40	0.40	0.40	0.40	0.40
Book value per common share <sup>(1)</sup>	21.48	20.53	19.52	19.34	18.32
Common shares outstanding at end of period	4,645,429	4,702,715	4,647,407	3,052,416	3,026,557

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Basic weighted average common shares	4,639,700	4,646,424	3,402,432	3,043,039	3,016,286
Diluted weighted average common shares	4,676,748	4,655,127	3,426,793	3,055,362	3,052,810

(dollars in thousands, except per share amounts)	At or for the Years Ended December 31,									
	2015	2014	2013	2012	2011					
<b>KEY OPERATING RATIOS</b>										
Return on average assets	0.58	%	0.63	%	0.69	%	0.52	%	0.35	%
Return on average total equity	6.21		5.69		7.49		6.42		4.33	
Return on average common equity	6.33		6.69		9.38		8.29		4.47	
Interest rate spread	3.48		3.55		3.45		3.18		3.05	
Net interest margin	3.60		3.68		3.56		3.31		3.21	
Efficiency ratio <sup>(2)</sup>	71.35		67.00		68.62		69.81		71.70	
Common dividend payout ratio	29.41		29.63		21.05		25.48		48.78	
Non-interest expense to average assets	2.60		2.56		2.56		2.47		2.46	
Avg. int-earning assets to avg. int-bearing liabilities	117.71		118.83		114.57		111.56		110.11	
<b>SELECTED ASSET QUALITY DATA</b>										
Gross loans	\$918,894		\$872,129		\$808,240		\$756,552		\$718,540	
Classified assets	43,346		54,022		56,880		58,595		79,638	
Allowance for loan losses	8,540		8,481		8,138		8,247		7,655	
Nonperforming loans (>=90 Days) <sup>(3)</sup>	10,740		10,263		11,170		8,717		9,511	
Non-accrual loans <sup>(4)</sup>	11,433		10,263		15,451		13,141		9,511	
Accruing troubled debt restructures (TDRs) <sup>(5)</sup>	13,133		13,249		4,364		4,515		11,113	
Other Real Estate Owned (OREO)	9,449		5,883		6,797		6,891		5,029	
<b>SELECTED ASSET QUALITY RATIOS</b>										
Average total equity to average total assets	9.35	%	11.11	%	9.16	%	8.07	%	8.06	%
Classified assets to total assets	3.79		4.99		5.56		5.97		8.10	
Classified assets to risk-based capital	30.19		39.30		43.11		59.02		83.89	
Allowance for loan losses to total loans	0.93		0.97		1.01		1.09		1.07	
Allowance for loan losses to nonperforming loans	79.52		82.64		72.86		94.78		80.49	
Net charge-offs to avg. outstanding loans	0.16		0.28		0.14		0.27		0.61	
Nonperforming loans to total loans	1.17		1.18		1.38		1.15		1.32	
Non-accrual loans to total loans	1.24		1.18		1.91		1.74		1.32	
Non-accrual loans and TDRs to total loans	2.67		2.70		2.45		2.33		2.87	
Non-accrual loans and OREO to total assets	1.83		1.49		2.17		2.04		1.48	
Non-accrual loans, OREO and TDRs to total assets	2.98		2.71		2.60		2.50		2.61	
<b>OTHER DATA</b>										
Number of:										
Full-time equivalent employees	171		172		165		160		143	
Full-service offices	12		12		11		11		10	
Loan Production Offices	5		5		4		n/a		n/a	
<b>REGULATORY CAPITAL RATIOS (consolidated)</b>										
Tier 1 capital to average assets	10.01	%	12.24	%	12.50	%	9.39	%	9.17	%
Tier 1 common capital to risk-weighted assets	10.16		n/a		n/a		n/a		n/a	
Tier 1 capital to risk-weighted assets	11.38		14.26		14.66		11.76		11.65	
Total risk-based capital to risk-weighted assets	14.58		15.21		15.62		12.84		12.69	

(1) The Company had no intangible assets as of the dates indicated. Thus, tangible book value per share is the same as book value per share for each of the periods indicated.

(2) Efficiency ratio is noninterest expense divided by the sum of net interest income and noninterest income.

(3) Nonperforming loans include all loans that are 90 days or more delinquent.

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

(5) TDR loans include both non-accrual and accruing performing loans. All TDR loans are included in the calculation of asset quality financial ratios. Non-accrual TDR loans are included in the non-accrual balance and accruing TDR loans are included in the accruing TDR balance.

Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations

**FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements that are based on assumptions and may describe future plans, strategies and expectations of The Community Financial Corporation (the “Company”) and Community Bank of the Chesapeake (the “Bank”). These forward-looking statements are generally identified by use of the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “project” or similar expressions.

The Company and the Bank’s ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors that could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, national and regional economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Company and the Bank’s market area, changes in real estate market values in the Company and the Bank’s market area, changes in relevant accounting principles and guidelines and cyber security risks. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, the Company does not undertake, and specifically disclaims any obligation, to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

**Critical Accounting Policies**

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

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

Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established or when an asset or liability needs to be recorded

contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When these sources are not available, management makes estimates based upon what it considers to be the best available information.

### *Allowance for Loan Losses*

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

The allowance for loan loss balance is an estimate based upon management’s evaluation of the loan portfolio. The allowance is comprised of a specific and a general component. The specific component consists of management’s evaluation of certain classified and non-accrual loans and their underlying collateral. Management assesses the ability of the borrower to repay the loan based upon all information available. Loans are examined to determine a specific allowance based upon the borrower’s payment history, economic conditions specific to the loan or borrower and other factors that would impact the borrower’s ability to repay the loan on its contractual basis. Depending on the assessment of the borrower’s ability to pay and the type, condition and value of collateral, management will establish an allowance amount specific to the loan.

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

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

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

Management has significant discretion in making the judgments inherent in the determination of the allowance for loan losses, including the valuation of collateral, assessing a borrower's prospects of repayment and in establishing loss factors on the general component of the allowance. Changes in loss factors have a direct impact on the amount of the provision and on net income. Errors in management's assessment of the global factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions. At December 31, 2015, the allowance for loan losses was \$8.5 million or 0.93% of total loans. An increase or decrease in the allowance could result in a charge or credit to income before income taxes that materially impacts earnings. For additional information regarding the allowance for loan losses, refer to Notes 1 and 6 of the Consolidated Financial Statements and the discussion under the caption "Provision for Loan Losses" below.

#### ***Other-Than-Temporary-Impairment ("OTTI")***

Debt securities are evaluated quarterly to determine whether a decline in their value is other-than-temporary. The term "other-than-temporary" is not necessarily intended to indicate a permanent decline in value. It means that the prospects for near-term recovery of value are not necessarily favorable, or that there is a lack of evidence to support fair values equal to, or greater than, the carrying value of the investment. Accounting guidance indicates that the amount of other-than-temporary impairment that is recognized through earnings for debt securities is determined by comparing the present value of the expected cash flows to the amortized cost of the security. The discount rate used to determine the credit loss is the expected book yield on the security. The Company does not evaluate declines in the value of securities of Government Sponsored Enterprises ("GSEs") or investments backed by the full faith and credit of the United States government (e.g. US Treasury Bills), for other-than-temporary impairment. For additional information regarding OTTI, refer to Notes 1 and 5 of the Consolidated Financial Statements.



***Other Real Estate Owned (“OREO”)***

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

In estimating the cash flows from the sale of OREO, management must make significant assumptions regarding the timing and amount of cash flows. For example, in cases where the real estate acquired is undeveloped land, management must gather the best available evidence regarding the market value of the property, including appraisals, cost estimates of development and broker opinions. Due to the highly subjective nature of this evidence, as well as the limited market, long time periods involved and substantial risks, cash flow estimates are highly subjective and subject to change. Errors regarding any aspect of the costs or proceeds of developing, selling or otherwise disposing of foreclosed real estate could result in the allowance being inadequate to reduce carrying costs to fair value and may require an additional provision for valuation allowances. For additional information regarding OREO, refer to Notes 1 and 8 of the Consolidated Financial Statements.

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

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

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

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

The Company's provision for income taxes and the determination of the resulting deferred tax assets and liabilities involve a significant amount of management judgment and are based on the best information available at the time. The Company operates within federal and state taxing jurisdictions and is subject to audit in these jurisdictions. For additional information regarding income taxes and deferred tax assets, refer to Notes 1 and 12 of the Consolidated Financial Statements.

### **OVERVIEW**

Community Bank of the Chesapeake (the "Bank") is headquartered in Southern Maryland with branches located in Maryland and Virginia. The Bank is a wholly owned subsidiary of The Community Financial Corporation. The Bank conducts business through its main office in Waldorf, Maryland, and 11 branch offices in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick, Lusby, California, Maryland; and King George and Fredericksburg, Virginia. The Company opened a branch in Fredericksburg, Virginia in July 2014. The Company's second branch in Fredericksburg is scheduled to open in downtown during the first quarter of 2016. In addition, the Company maintains five loan production offices ("LPOs") in La Plata, Prince Frederick, Leonardtown and Annapolis, Maryland; and Fredericksburg, Virginia. The Leonardtown and Fredericksburg LPOs are co-located with branches.

The Bank opened its LPO in Fredericksburg, Virginia during August 2013. The Fredericksburg Virginia area market is comparable in size to our legacy Southern Maryland footprint. During the second quarter of 2014, we continued to

execute the Bank's growth strategy and added seasoned lenders and support staff to expand into the city of Annapolis and surrounding Anne Arundel County. We opened the Annapolis LPO in October 2014. We are optimistic that our returns on these investments will continue to increase shareholder value.

In October 2013, the Company issued 1,591,300 shares of common stock at a price of \$18.75 per share resulting in net proceeds of \$27.4 million after commissions and related offering expenses. In addition, the Company listed its stock on the NASDAQ Stock Exchange and began trading on the exchange September 27, 2013 under the ticker symbol "TCFC."

The Bank has increased assets through loan production. The Bank believes that its ability to offer fast, flexible, local decision-making will continue to attract significant new business relationships. The Bank focuses its business generation efforts on targeting small and medium sized commercial businesses with revenues between \$5.0 million and \$35.0 million as well as local municipal agencies and not-for-profits. The Bank's marketing is also directed towards increasing its balances of transaction deposit accounts, which are all deposit accounts other than certificates of deposit. The Bank believes that increases in these account types will lessen the Bank's dependence on higher-cost funding, such as certificates of deposit and borrowings. Although management believes that this strategy will increase financial performance over time, increasing the balances of certain products, such as commercial lending and transaction accounts, may also increase the Bank's noninterest expense. The Bank recognizes that certain lending and deposit products increase the possibility of losses from credit and other risks. During 2015, the Company made a number of strategic decisions to meet our longer-term objectives of increased profitability and increase shareholder value. The Company continued to execute its plans to improve asset quality and to increase transaction deposits. The following is a summary of progress made during 2015:

**Improved asset quality** – The Company has been working in an increasingly assertive manner to reduce its classified assets and will continue to move non-performing or substandard credits that are not likely to become performing or passing credits in a reasonable timeframe off the balance sheet. The Company is encouraging existing classified customers to obtain financing with other lenders or enforcing its contractual rights. Management believes this strategy is in the best long-term interest of the Company.

As of December 31, 2015 total loan delinquency at 1.27% of loans was in line with the Company's peers. In addition, total classified assets, consisting primarily of classified loans and OREO, were \$43.3 million at December 31, 2015, a reduction of \$10.7 million, or approximately 19.8% from \$54.0 million as of December 31, 2014. Total classified assets as a percentage of assets and risk-based capital decreased from 5.0% and 39.3%, respectively, at December 31, 2014 to 3.8% and 30.2%, respectively, at December 31, 2015. During the fourth quarter of 2015, the Company reduced its classified loans by \$3.5 million. The majority of the fourth quarter reduction in classified loans resulted in a transfer to OREO of \$2.7 million of developed real estate. The Company is optimistic that these properties will be sold in the near term based on the current valuation, the existing market and tenant occupancy.

**Increased transaction deposits** – The Company continued to increase transaction deposits to compliment interest-earning asset growth. Our efforts center on providing products and services that serve small and midsize businesses and municipal customers. This has been the primary reason for the decrease in the Company's funding costs. Since 2011, our deposit costs have decreased 96 basis points from 1.43% for the year ended December 31, 2011 to 0.47% for the three months ended December 31, 2015. Average transaction deposits for the year ended December 31, 2015 increased \$65.4 million, or 15.5%, to \$488.2 million compared to the prior year. Transaction deposits have increased from 44.9% of total deposits at December 31, 2011 to 58.6% of total deposits at December 31, 2015. The Company will use time deposits and wholesale funding to supplement interest-earning asset growth as needed.

**Controlled the growth of expenses** – The Company's noninterest expenses for 2015, excluding OREO charges and an insurance settlement claim adjustment, were \$27.2 million which represents a \$1.3 million, or 5.1%, increase over the comparable \$25.9 million for the year ended December 31, 2014. With these adjustments, noninterest expense as a percentage of average assets decreased three basis points from 2.52% for the year ended December 31, 2014 to 2.49% for the year ended December 31, 2015.

Employee compensation and other operating expenses have grown over the last several years due to the Company's expanding footprint and the increased cost of compliance and regulation. The Company controlled the growth of salary and benefit costs in 2015 with the remodeling of our retail centers and the restructuring of our branch organization. Additionally, management realigned incentives to more closely correlate with Company performance.

**Invested in infrastructure** – During 2015, the Company invested in software and professional services to support the Company's continued growth. These investments included capabilities to manage enterprise risks, interest rate risks, vendor risk management, customer information risks and cyber security risks.

**Exited underwriting residential mortgages and established third-party relationships to purchase residential mortgages** - The Company exited the residential mortgage origination line of business in April 2015 and has established third party sources to fund its residential whole loan portfolio. The third party sources will allow the Company to maintain a well-diversified residential portfolio while addressing the credit needs of the communities in its footprint. The Company continues to underwrite non-owner occupied residential mortgages.

**Sold an unprofitable branch** - The Company agreed to sell its King George, Virginia branch building and equipment to InFirst Federal Credit Union. The transaction closed on January 28, 2016. Operating results for the year ended December 31, 2015 reflect a one-time \$426,000 pre-tax provision for the loss on the transaction with a \$0.05 impact to earnings per share. The elimination of the estimated direct annual operating costs of the King George branch will have an immediate accretive impact on earnings per share in 2016 with the earn back period of less than 10 months.

**Executed plans to open a branch in downtown Fredericksburg in early 2016** - The Company's second branch in Fredericksburg is scheduled to open in downtown during the first quarter of 2016. The Company believes that this second branch will enhance its deposit gathering in this market and complement the strong loan growth experienced in the Fredericksburg market during 2014 and 2015.

**The Company proactively refinanced preferred stock issued under the Small Business Lending Fund ("SBLF") program** - On February 6, 2015 the Company issued \$23.0 million of unsecured 6.25% fixed to floating rate subordinated notes due 2025 ("subordinated notes"). On February 13, 2015, the Company used proceeds of the offering to redeem all \$20 million of the Company's outstanding preferred stock issued under the Small Business Lending Fund ("SBLF") program. The subordinated notes qualified as tier 2 regulatory capital and replaced SBLF tier 1 capital. The Company decided to issue the subordinated notes during 2015 because of the scheduled increase in the after-tax SBLF dividend rate to 9% in March 2016. The short-term impact for 2016 was increased interest expense of \$1.3 million; however, the Company believed it was prudent to issue the subordinated notes before the SBLF dividends were scheduled to increase.

### *Economy*

The U.S. economy continued to grow slowly throughout 2015 and 2014. Gross domestic product grew at an annual rate of one percent during the fourth quarter of 2015, which was half of the growth posted during the third quarter of 2015. It appears that an economic slowdown is a distinct possibility during 2016. The Federal Reserve has indicated through its survey of the Board of Governors that up to four rate increases are planned for 2016. This may depend on whether a further softening in the economy continues. The Federal Reserve is more likely to implement its estimated rate rises if inflationary factors present themselves, which appears less likely at this point. During the beginning of 2016, due to a number world events and market disruptions, many economists reduced their forecasts for 2016 rate hikes from four down to two.

Medium-term interest rates have fallen since the fourth quarter of 2015, with the ten year U.S. Treasury rate as of February 25, 2016 ending at 1.71%. This is down from 2.27% at December 31, 2015 and 2.17% at December 31, 2014. The five year U.S. Treasury rate as of February 25, 2016 was 1.16%. This is down from 1.76% at December 31, 2015 and 1.65% at December 31, 2014. These lower medium-term interest rates were due to market adjustments at the beginning of 2016 and a flight to quality in U.S. Treasury securities, as economic weaknesses have continued in Europe and the Far East. In addition, depressed prices for commodities have impacted economies globally. The main issue for the Company with regard to depressed medium-term interest rates is the potential impact on loan pricing as loans reprice in our portfolio.

The impact of slower economic growth on the Southern Maryland, Annapolis, Maryland and Fredericksburg, Virginia areas has been moderated by the presence of federal government agencies and defense facilities. Further, the private sector that supports our footprint has continued to grow at a pace faster than other parts of the country. In addition, the Bank's market expansion has enabled the Company to grow the loan portfolio in the present environment and was able to produce good organic growth in deposits during 2014 and 2015. Even through the difficult economic environment, the Bank's capital levels and asset quality have remained strong



**COMPARISON OF RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2015 AND 2014**

*Earnings Summary*

Net income available to common shareholders for 2015 was stable compared to the prior year increasing \$30,000 to \$6.3 million, or 0.5%, compared to 2014. Diluted earnings per share (“EPS”) were \$1.36 in 2015, an increase of \$0.01 compared to 2014. The Company’s return on average assets was 0.58% in 2015, a decrease of five basis points from 2014. The Company’s return on average common stockholders' equity was 6.33% in 2015, a decrease of 36 basis points from 2014.

Pretax operating income decreased \$290,000 to \$10.0 million in 2015 compared to \$10.3 million in 2014.

The small decrease in operating income in 2015 was primarily due to the following:

Noninterest income decreased \$794,000 to \$3.3 million for 2015 compared to 2014. The sale of the King George, Virginia branch, lower gains on mortgage loan sales due to the Bank exiting the residential mortgage origination line of business and a reduction on gains on the sale of OREO. These reductions in noninterest income were partially offset by increased service charge and BOLI income

Noninterest expense increased \$2.2 million, or 8.3%, to \$28.4 million for 2015 compared to 2014. The largest impact on the growth of expenses was an increase in OREO charges and an insurance settlement claim adjustment. Employee compensation, data processing and professional fees increased to support the growth of the Bank and increased compliance costs. Specifically, professional fees increased to support the February 2015 subordinated notes issuance and infrastructure investments in enterprise risks, interest rate risks, vendor risk management, customer information risks and cyber security risks.

The Company’s noninterest expenses for 2015, excluding OREO charges and the title insurance settlement claim adjustment, were \$27.2 million which represents a \$1.3 million, or 5.1%, increase over the comparable \$25.9 million for the year ended December 31, 2014. With these adjustments, noninterest expense as a percentage of average assets decreased three basis points from 2.52% for the year ended December 31, 2014 to 2.49% for the year ended December 31, 2015.

The increased expenses were partially offset by the following positive increases to revenues:



- Net interest income was \$36.5 million in 2015 an increase of \$1.5 million, or 4.2%, compared to 2014.

Interest income increased \$2.1 million. The increase was driven by increased loan average balances. The Bank increased average net loan balances \$54.8 million to \$874.2 million in 2015 from \$819.4 million in 2014. Loan volume was partially offset by yield declines.

Interest expense increased \$647,000 which partially offset increased interest income. The primary reason for the increase related to the \$23.0 million 6.25% subordinated notes issued during the first quarter of 2015. Continued progress in continuing to add transaction deposits mitigated some of the impact of the increased interest expense associated with the subordinated notes. Overall deposit cost decreased by eight basis points to 0.48% compared to the prior year.

The provision for loan losses decreased \$1.2 million to \$1.4 million in 2015 due primarily to improvements to baseline charge-off factors for the periods used to evaluate the adequacy of the allowance as well as improvements in other qualitative factors, such as reductions in classified assets.

A more detailed analysis comparing the results of operations for the years ended December 31, 2015 and 2014 follows.

**Net Interest Income**

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

Net interest income increased to \$36.5 million for the year ended December 31, 2015 compared to \$35.1 million for the year ended December 31, 2014. The net interest margin was 3.60% for the year ended December 31, 2015, an eight basis point decrease from 3.68% for the year ended December 31, 2014. The decrease in net interest margin was largely the result of additional interest expense related to the subordinated notes issued during the first quarter of 2015.

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

(dollars in thousands )	Years Ended December 31,		\$ Change	% Change	
	2015	2014			
Interest and Dividend Income					
Loans, including fees	\$ 41,386	\$ 39,475	\$ 1,911	4.8	%
Taxable interest and dividends on investment securities	2,473	2,270	203	8.9	%
Interest on deposits with banks	14	14	-	0.0	%
Total Interest and Dividend Income	43,873	41,759	2,114	5.1	%
Interest Expenses					
Deposits	4,152	4,586	(434 )	(9.5 )	%
Short-term borrowings	37	12	25	208.3	%
Long-term debt	3,156	2,100	1,056	50.3	%
Total Interest Expenses	7,345	6,698	647	9.7	%
Net Interest Income (NII)	\$ 36,528	\$ 35,061	\$ 1,467	4.2	%

Interest and dividend income increased by \$2.1 million to \$43.9 million for the year ended December 31, 2015 compared to \$41.8 million for the year ended December 31, 2014, primarily due to increased income from the growth in the average balance of loans. Interest and dividend income on loans increased \$2.6 million due to growth of \$54.8 million in the average balance of loans from \$819.4 million for the year ended December 31, 2014 to \$874.2 million for the year ended December 31, 2015. Interest and dividend income on investments increased \$203,000 during 2015 compared to the prior year as average interest-earning investment balances increased \$4.7 million and average yields increased from 1.70% to 1.79%. These increases to interest income were partially offset by decreased income from reduced yields on loans. Average loan yields declined nine basis points from 4.82% for the year ended December 31, 2014 to 4.73% for the year ended December 31, 2015, which resulted in a decrease in interest income of \$684,000.

Interest expense increased \$647,000 to \$7.3 million for the year ended December 31, 2015 compared to the year ended December 31, 2014 due primarily to an increase in interest expense related to the subordinated notes issued during the first quarter of 2015. The average cost of total interest-bearing liabilities was 0.85% for the year ended December 31, 2015 compared to 0.83% for the year ended December 31, 2014. During the year ended December 31, 2015, interest expense increased \$1.3 million due to the subordinated note issuance and larger short-term debt balances and \$119,000 due to increased average balances of interest-bearing transaction deposit accounts compared to the same twelve months of 2014. Additionally, interest expense increased \$35,000 on money market accounts, as rates increased modestly from 0.27% to 0.28%. The increases to interest expense were partially offset by reductions of \$228,000 due to lower average balances of long-term debt and time deposits and \$594,000 due to net decreases in rates paid on time deposits and long-term debt. The average rate paid on debt, which includes long-term debt, TRUPS, subordinated notes, and short-term borrowings, increased from 2.32% for the year ended December 31, 2014 to 2.77% for the year ended December 31, 2015.

The Company continued to make progress in reducing overall deposit costs by increasing transaction deposits as a percentage of overall deposits. Average transaction accounts as a percentage of average deposits increased from 52.0% for the year ended December 31, 2014 to 56.4% for the year ended December 31, 2015. Deposit costs declined eight basis points from 0.56% for the year ended December 31, 2014 to 0.48% for the year ended December 31, 2015. Average transaction deposits for the year ended December 31, 2015 increased \$65.4 million, or 15.5%, to \$488.2 million compared to \$422.9 million for the comparable period in 2014. The increase in average transaction deposits included growth in average noninterest bearing demand deposits of \$19.7 million, or 19.6%, from \$100.8 million for the year ended December 31, 2014 to \$120.5 million for the year ended December 31, 2015. The Company is less dependent on time deposits for funding. In the current year, the progress in continuing to add transaction deposits has mitigated some of the impact of the increased interest expense associated with the subordinated notes.

Changes in the components of net interest income due to changes in average balances of assets and liabilities and to changes caused by changes in interest rates are presented in the rate volume analysis included below. The table below presents information on average balances and rates for deposits.

(dollars in thousands)	For the Years Ended December 31,					
	2015		2014			
	Average Balance	Average Rate	Average Balance	Average Rate		
Savings	\$ 44,963	0.10 %	\$ 40,104	0.10 %		
Interest-bearing demand and money market accounts	322,717	0.28 %	281,960	0.27 %		
Certificates of deposit	378,179	0.85 %	389,641	0.97 %		
Total interest-bearing deposits	745,859	0.56 %	711,705	0.64 %		
Noninterest-bearing demand deposits	120,527		100,783			
	\$ 866,386	0.48 %	\$ 812,488	0.56 %		

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

dollars in thousands	Year Ended December, 2015 compared to Year Ended December 31, 2014		
	Volume	Rate	Total
Interest income:			
Loan portfolio (1)	\$ 2,595	\$(684 )	\$ 1,911
Investment securities, federal funds sold and interest bearing deposits	84	119	203

Total interest-earning assets	\$ 2,679	\$ (565 )	\$ 2,114
Interest-bearing liabilities:			
Savings	5	-	5
Interest-bearing demand and money market accounts	114	35	149
Certificates of deposit	(97 )	(491 )	(588 )
Long-term debt	(131 )	(100 )	(231 )
Short-term debt	25	-	25
Subordinated notes	1,290	-	1,290
Guaranteed preferred beneficial interest in junior subordinated debentures	-	(3 )	(3 )
Total interest-bearing liabilities	\$ 1,206	\$ (559 )	\$ 647
Net change in net interest income	\$ 1,473	\$ (6 )	\$ 1,467

(1) Average balance includes non-accrual loans

The following table presents information on the average balances of the Company's interest-earning assets and interest-bearing liabilities and interest earned or paid thereon for the past two fiscal years. There are no tax equivalency adjustments.

	For the Years Ended December 31,							
	2015		Average		2014		Average	
dollars in thousands	Average	Interest	Yield/ Cost	Average	Average	Interest	Yield/ Cost	
	Balance			Balance				
<b>Assets</b>								
<b>Interest-earning assets:</b>								
Loan portfolio (1)	\$874,186	\$41,386	4.73 %	\$819,381	\$39,475	4.82 %		
Investment securities, federal funds sold and interest-bearing deposits	139,256	2,487	1.79 %	134,552	2,284	1.70 %		
<b>Total Interest-Earning Assets</b>	<b>1,013,442</b>	<b>43,873</b>	<b>4.33 %</b>	<b>953,933</b>	<b>41,759</b>	<b>4.38 %</b>		
Cash and cash equivalents	12,192			11,979				
Other assets	67,272			60,530				
<b>Total Assets</b>	<b>\$1,092,906</b>			<b>\$1,026,442</b>				
<b>Liabilities and Stockholders' Equity</b>								
<b>Interest-bearing liabilities:</b>								
Savings	\$44,963	\$45	0.10 %	\$40,104	\$40	0.10 %		
Interest-bearing demand and money market accounts	322,717	904	0.28 %	281,960	755	0.27 %		
Certificates of deposit	378,179	3,203	0.85 %	389,641	3,791	0.97 %		
Long-term debt	68,924	1,557	2.26 %	74,714	1,788	2.39 %		
Short-term debt	13,463	37	0.27 %	4,344	12	0.28 %		
Subordinated Notes	20,732	1,290	6.22 %	-	-	0.00 %		
Guaranteed preferred beneficial interest in junior subordinated debentures	12,000	309	2.58 %	12,000	312	2.60 %		
<b>Total Interest-Bearing Liabilities</b>	<b>860,978</b>	<b>7,345</b>	<b>0.85 %</b>	<b>802,763</b>	<b>6,698</b>	<b>0.83 %</b>		
Noninterest-bearing demand deposits	120,527			100,783				
Other liabilities	9,244			8,898				
Stockholders' equity	102,157			113,997				
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$1,092,906</b>			<b>\$1,026,441</b>				
<b>Net interest income</b>		<b>\$36,528</b>			<b>\$35,061</b>			
Interest rate spread			3.48 %			3.55 %		
Net yield on interest-earning assets			3.60 %			3.68 %		
Ratio of average interest-earning assets to average interest bearing liabilities			117.71 %			118.83 %		

Cost of funds	0.75	%	0.74	%
Cost of deposits	0.48	%	0.56	%
Cost of debt	2.77	%	2.32	%

(1) Average balance includes non-accrual loans

***Provision for Loan Losses***

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

	Years Ended December 31,			
(dollars in thousands )	2015	2014	\$ Change	% Change
Provision for loan losses	\$ 1,433	\$ 2,653	\$ (1,220 )	(46.0 )%

The provision for loan losses decreased \$1.2 million to \$1.4 million for the year ended December 31, 2015 compared to \$2.6 million for the year ended December 31, 2014. Net charge-offs decreased \$936,000 from \$2.3 million for the year ended December 31, 2014 to \$1.4 million for the year ended December 31, 2015. The effects of these charge-offs were mitigated by improvements to baseline charge-off factors for the periods used to evaluate the adequacy of the allowance as well as improvements in other qualitative factors, such as reductions in classified assets.

In 2014 greater than 50% of net charge-offs were the result of concessions granted on two loan relationships during the fourth quarter of 2014. As a result of these concessions, the Bank determined that the loans were TDRs. As such, the loans became impaired and were evaluated for impairment in accordance with Bank policy. The first loan relationship, which totaled \$8.6 million, consisted of commercial real estate and construction loans. The borrower agreed to provide additional collateral to cover most of the deficiency determined as a result of the impairment analysis and the Bank charged-off \$500,000 in principal. The carrying value of the loans at December 31, 2015 and 2014 were \$8.1 million and \$8.2 million, respectively. The second loan relationship, which totaled approximately \$3.8 million, consisted of construction and land development and commercial loans. As a result of the concessions granted and the impairment analysis, the Bank charged-off \$843,000 and took 11 finished residential lots into other real estate owned (“OREO”). At December 31, 2015 and 2014, the carrying value of the loans and the OREO were \$1.4 million and \$1.9 million, respectively and \$486,000 and \$757,000, respectively.

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

***Noninterest Income***

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

Years Ended December 31,



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(dollars in thousands )	2015	2014	\$ Change	% Change
Noninterest Income				
Loan appraisal, credit, and miscellaneous charges	\$ 315	\$ 368	\$ (53 )	(14.4 )%
Gain on sale of asset	19	7	12	171.4 %
Net (losses) gains on sale of OREO	(20 )	322	(342 )	(106.2 )%
Net (losses) gains on sale of investment securities	4	19	(15 )	(78.9 )%
Loss on premises and equipment held for sale	(426 )	-	(426 )	n/a
Income from bank owned life insurance	815	671	144	21.5 %
Service charges	2,488	2,213	275	12.4 %
Gain on sale of loans held for sale	104	493	(389 )	(78.9 )%
Total Noninterest Income	\$ 3,299	\$ 4,093	\$ (794 )	(19.4 )%

Noninterest income decreased by \$794,000 for the year ended December 31, 2015 compared to the year ended December 31, 2014 primarily due to a decrease in income from residential loan sales, a reduction in OREO gains on disposals, and the one-time expense to record a provision for the loss on the sale of the King George, Virginia branch building and equipment. The reduction in loans held for sale reflected the Company's exit from residential loan origination line of business during the second quarter of 2015 and there were no loans sales during the last six months of 2015.

During the year ended December 31, 2015, the Bank recognized \$20,000 in losses on the sale of OREO which consisted of the sale of eight properties for net proceeds of \$1.2 million. During the year ended December 31, 2014, the Bank recognized \$322,000 in gains on the sale of OREO which consisted of the sale of eight properties for net proceeds of \$3.7 million, which included the financing of \$1.0 million on a residential subdivision that was transferred from OREO to loans during the fourth quarter of 2014. The contracted sale price of \$1.4 million on the residential subdivision qualified for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition".

The Company agreed to sell its King George, Virginia branch building and equipment to InFirst Federal Credit Union. The transaction closed on January 28, 2016. Operating results for the year ended December 31, 2015 reflect a one-time \$426,000 pre-tax provision for the loss on the transaction with a \$0.05 impact to earnings per share. The elimination of the estimated direct annual operating costs of the King George branch will have an immediate accretive impact on earnings per share in 2016 with the earn back period of less than 10 months.

These reductions in noninterest income were partially offset by increased service charges and BOLI income for the year ended December 31, 2015 compared to the prior year. Service charges increased \$275,000 compared to the prior year primarily due to additional product offerings offered to the Bank's commercial customers. BOLI increased \$144,000 for the comparable period because the Company made an additional investment of \$7.0 million in BOLI during the third quarter of 2014.

### *Noninterest Expense*

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

(dollars in thousands )	Years Ended December 31,			
	2015	2014	\$ Change	% Change
Noninterest Expense				
Salary and employee benefits	\$ 16,366	\$ 15,851	\$ 515	3.2 %
Occupancy expense	2,427	2,371	56	2.4 %
Advertising	583	545	38	7.0 %
Data processing expense	2,044	1,556	488	31.4 %
Professional fees	1,323	1,129	194	17.2 %
Depreciation of furniture, fixtures, and equipment	810	753	57	7.6 %
Telephone communications	188	185	3	1.6 %
Office supplies	157	204	(47 )	(23.0 )%
FDIC Insurance	799	709	90	12.7 %
OREO valuation allowance and expenses	1,059	386	673	174.4 %
Other	2,662	2,546	116	4.6 %
Total Noninterest Expense	\$ 28,418	\$ 26,235	\$ 2,183	8.3 %

(dollars in thousands)	Years Ended December 31,			
	2015	2014	\$ Change	% Change
Compensation and Benefits	\$ 16,366	\$ 15,851	\$ 515	3.2 %
OREO Valuation Allowance and Expenses	1,059	386	673	174.4 %
Operating Expenses	10,993	9,998	995	10.0 %
Total Noninterest Expense	\$ 28,418	\$ 26,235	\$ 2,183	8.3 %

For the year ended December 31, 2015, noninterest expense increased 8.3%, or \$2.2 million, to \$28.4 million from \$26.2 million for the year ended December 31, 2014. The Company's noninterest expense of \$28.4 million for the year ended December 31, 2015 included OREO expenses of \$1.1 million and a \$200,000 reduction in an insurance settlement claim receivable. The Company's noninterest expense for 2015, excluding OREO charges and the insurance settlement claim, was \$27.2 million which represents a \$1.3 million, or 5.1%, increase over the comparable \$25.9 million for the year end December 31, 2014.

Noninterest expense as a percentage of average assets for the year ended December 31, 2015 was 2.60% compared to 2.56% for the year ended December 31, 2014. The Company's ratio decreased three basis points during 2015, excluding OREO charges and the insurance settlement claim adjustment, to 2.49% for the year ended December 31, 2015 compared to 2.52% for the year ended December 31, 2014. Compensation and benefits increased 3.2% or \$515,000 compared to the same period in the prior year. The Company has controlled the growth of salary and benefit costs by restructuring our branch organization and better aligning incentives with Company performance. The Company is continuing to work to slow the growth of noninterest expenses as a percentage of average assets based on current expansion plans and a greater ability to increase efficiencies as a result of our larger asset size.

The Company's efficiency ratio for the year ended December 31, 2015 was 71.35% compared to 67.00% for the year ended December 31, 2014. Excluding the impact of the one-time loss provision on the sale of the King George branch, OREO expenses, OREO gains and losses and the insurance claim, the adjusted efficiency ratio for the years ended December 31, 2015 and 2014 was 67.44% and 66.57%, respectively.

***Income Tax Expense***

For the years ended December 31, 2015 and 2014, the Company recorded income tax expense of \$3.6 million and \$3.8 million, respectively. The Company's effective tax rates for the years ended December 31, 2015 and 2014 were 36.42% and 36.78%, respectively. The decrease in the effective tax rate was the result of tax-exempt income being relatively higher to total income for 2015 compared to 2014.

**COMPARISON OF RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013**

*Earnings Summary*

Net income available to common shareholders for 2014 was stable compared to the prior year decreasing \$161,000 to \$6.3 million, or 2.5%, compared to 2013. Diluted earnings per share ("EPS") were \$1.35 in 2014, a decrease of \$0.53 compared to 2013. The decrease in EPS was the result of the fourth quarter 2013 capital raise previously discussed. The Company's return on average assets was 0.63% in 2014, a decrease of six basis points from 2013. The Company's return on average common stockholders' equity was 6.69% in 2014, a decrease of 269 basis points from 2013.

Pretax operating income decreased \$156,000 to \$10.3 million in 2014 compared to 2013.

The decreased income in 2014 was primarily due to the following:

The provision for loan losses increased \$1.7 million to \$2.7 million in 2014 due primarily to increases related to specific credits and increased average loan balances. The overall credit quality of our loan portfolio improved after charge-offs were taken and other workout strategies were exercised for challenging credits. At year end, this resulted in lower levels of classified loans and assets compared to the prior year. The general allowance as a percentage of gross loans increased in 2014 to 0.92% from 0.89% in 2013. During the same time frame the specific allowance decreased 7 basis point to 0.05% as a result of charge-offs and specific work out strategies.

Noninterest income decreased \$81,000 to \$4.1 million for 2014 compared to 2013. Lower gains on mortgage loans sales and service charge income were partially offset by increases in gains on the sale of OREO.

Noninterest expense increased \$1.4 million, or 5.6%, to \$26.2 million for 2014 compared to 2013. Employee compensation, occupancy expense and data processing increased to support the growth of the Bank and increased compliance costs. These increases were partially offset by a decrease in costs for FDIC insurance and OREO. The Company's efficiency ratio improved from 68.62% for 2013 to 67.00% for 2014 and non-interest expense as a percentage of average assets remained flat at 2.56% for both years.

The increased expenses were partially offset by the following positive trends:

- Net interest income was \$35.1 million in 2014, an increase of \$3.0 million, or 9.5%, compared to 2013.

Interest income increased \$2.1 million. The increase was driven by increased loan average balances. The Bank increased average net loan balances \$72.7 million to \$838.1 million for the fourth quarter of 2014 from \$765.4 million for the fourth quarter of 2013. Increased loan volume was partially offset by yield declines. Average loan yields decreased 20 basis points from 5.02% for 2013 to 4.82% for 2014.

Interest expense decreased \$948,000. This was primarily due to a decrease in the cost of funds compared to the prior year. The Bank continued to develop core deposit relationships and increased transaction deposits as it re-priced maturing time deposits. Higher cost time deposits were partially replaced with lower cost transaction and time deposits. In addition, the Bank continued to decrease its deposit costs on transaction accounts. The Bank completed the year with a \$48.1 million increase in total deposits to \$869.4 million. Transaction accounts increased to 56% at December 2014 from 53% and 51% at December 31, 2013 and 2012, respectively.

A more detailed analysis comparing the results of operations for the years ended December 31, 2014 and 2013 follows.

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

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

Net interest income increased to \$35.1 million for the year ended December 31, 2014 compared to \$32.0 million for the year ended December 31, 2013. The net interest margin was 3.68% for the year ended December 31, 2014, a 12 basis point increase from 3.56% for the year ended December 31, 2013. The increase was largely the result of an increase in loan average balances during 2014 compared to 2013. The growth in loan balances is directly attributable to the Bank continuing to be an important commercial lender in our legacy Southern Maryland footprint while adding greater than \$80 million in new loans in the newer Fredericksburg, Virginia market. In addition, the Company's cost of funds decreased in 2014. This decrease began during 2012 as certificates of deposit re-priced and rates declined on money market accounts. The average cost of total interest-bearing liabilities decreased 14 basis points from 0.97% for 2013 to 0.83% for 2014. Lastly, cost of deposits has decreased over the last several years because the composition of deposits has changed from reliance upon time deposits to lower cost transaction, both interest-bearing and noninterest bearing, demand deposits. Changes in the components of net interest income due to changes in average balances of assets and liabilities and to changes caused by changes in interest rates are presented in the rate volume analysis included below.

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

(dollars in thousands )	Years Ended December 31,				
	2014	2013	\$ Change	% Change	
Interest and Dividend Income					
Loans, including fees	\$ 39,475	\$ 37,196	\$ 2,279	6.1	%
Taxable interest and dividends on investment securities	2,270	2,466	(196 )	(7.9	)%
Interest on deposits with banks	14	16	(2 )	(12.5	)%
Total Interest and Dividend Income	41,759	39,678	2,081	5.2	%
Interest Expenses					
Deposits	4,586	5,581	(995 )	(17.8	)%
Short-term borrowings	12	14	(2 )	(14.3	)%
Long-term debt	2,100	2,051	49	2.4	%
Total Interest Expenses	6,698	7,646	(948 )	(12.4	)%
Net Interest Income (NII)	\$ 35,061	\$ 32,032	\$ 3,029	9.5	%

Interest and dividend income increased by \$2.1 million to \$41.8 million for the year ended December 31, 2014, compared to \$39.7 million for the year ended December 31, 2013. Growth in the average balance of loans and, to a lesser extent, investment yields were partially offset by decreases in yields on loans and average investment balances. Interest and dividend income increased \$3.8 million due to growth of \$78.0 million in the average balance of loans from \$741.4 million to \$819.4 million and \$187,000 due to higher investment yields. This increase was partially offset by a decrease of \$1.5 million in interest income from a reduction in loan yields. Average loan yields declined 20 basis points from 5.02% for the year ended December 31, 2013 to 4.82% for the year ended December 31, 2014. Interest and dividend income was further reduced \$385,000 as average interest-earning investment balances decreased \$22.6 million from \$157.2 million for the year ended December 31, 2013 to \$134.6 million for the year ended December 31, 2014.

The cost of funds continued to decrease as certificates of deposit re-price and lower rates are offered on money market accounts. The average cost of total interest-bearing liabilities decreased 14 basis points from 0.97% for year ended December 31, 2013 to 0.83% for the year ended December 31, 2014. Deposit costs decreased 15 basis points from 0.71% to 0.56% during the same timeframe. Additionally, the increase in average noninterest bearing demand deposits of \$13.2 million contributed to the decline in funding costs with average balances increasing from \$87.6 million for the year ended December 31, 2013 to \$100.8 million for the year ended December 31, 2014.

Interest expense decreased \$948,000 to \$6.7 million for the year ended December 31, 2014 compared to \$7.6 million for the year ended December 31, 2013 due primarily to a reduction in the cost of funds on interest-bearing liabilities; as interest expense decreased \$1.1 million due to a decrease in rates. This was principally achieved by a decrease in the average rates paid on certificates of deposits and money market accounts, which declined from 1.19% and 0.33%, respectively, for the year ended December 31, 2013 to 0.97% and 0.27%, respectively, for the year ended December 31, 2014. The Company has been successful in increasing its core deposits and reducing its cost of funds in the low interest rate environment over the last several years. In addition, the average rate paid on debt, which includes long-term debt, subordinated debentures and short-term borrowings, decreased from 2.42% to 2.32% for the comparable period. Interest expense was also reduced \$30,000 due to a decline in average certificate of deposit balances of \$3.1 million from \$392.7 million for the year ended December 31, 2013 to \$389.6 million for the year ended December 31, 2014. These reductions were partially offset by increases in interest expense due to larger average balances for interest-bearing transaction accounts and debt. Interest expense increased \$38,000 due to a \$15.7 million increase in average interest-bearing transaction accounts from \$306.4 million for the year ended December 31, 2013 to \$322.1 million for the year ended December 31, 2014. Interest expense increased \$137,000 due to a \$5.8 million increase in average debt balances from \$85.3 million for the year ended December 31, 2013 to \$91.1 million for the year ended December 31, 2014.



The table below presents information on average balances and rates for deposits

(dollars in thousands)	For the Years Ended December 31,					
	2014		2013			
	Average Balance	Average Rate	Average Balance	Average Rate		
Savings	\$40,104	0.10	% \$37,540	0.10	%	
Interest-bearing demand and money market accounts	281,960	0.27	% 268,832	0.33	%	
Certificates of deposit	389,641	0.97	% 392,675	1.19	%	
Total interest-bearing deposits	711,705	0.64	% 699,047	0.80	%	
Noninterest-bearing demand deposits	100,783		87,649			
	\$812,488	0.56	% \$786,696	0.71	%	

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

dollars in thousands	Year Ended December 31, 2014 compared to Year Ended December 31, 2013		
	Due to Volume	Rate	Total
Interest income:			
Loan portfolio (1)	\$ 3,758	\$ (1,479 )	\$ 2,279
Investment securities, federal funds sold and interest bearing deposits	(385 )	187	(198 )
Total interest-earning assets	\$ 3,373	\$ (1,292 )	\$ 2,081
Interest-bearing liabilities:			
Savings	3	(1 )	2
Interest-bearing demand and money market accounts	35	(166 )	(131 )
Certificates of deposit	(30 )	(836 )	(866 )
Long-term debt	137	(95 )	42
Short-term debt	-	(2 )	(2 )
Guaranteed preferred beneficial interest in junior subordinated debentures	-	7	7
Total interest-bearing liabilities	\$ 145	\$ (1,093 )	\$ (948 )
Net change in net interest income	\$ 3,228	\$ (199 )	\$ 3,029

(1) Average balance includes non-accrual loans

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The following table presents information on the average balances of the Company's interest-earning assets and interest-bearing liabilities and interest earned or paid thereon for the past two fiscal years. There are no tax equivalency adjustments.

	For the Years Ended December 31,							
	2014		Average		2013		Average	
dollars in thousands	Average	Interest	Yield/ Cost	%	Average	Interest	Yield/ Cost	%
<b>Assets</b>								
Interest-earning assets:								
Loan portfolio (1)	\$819,381	\$39,475	4.82	%	\$741,369	\$37,196	5.02	%
Investment securities, federal funds sold and interest-bearing deposits	134,552	2,284	1.70	%	157,211	2,482	1.58	%
<b>Total Interest-Earning Assets</b>	<b>953,933</b>	<b>41,759</b>	<b>4.38</b>	<b>%</b>	<b>898,580</b>	<b>39,678</b>	<b>4.42</b>	<b>%</b>
Cash and cash equivalents	11,979				13,028			
Other assets	60,530				57,455			
<b>Total Assets</b>	<b>\$1,026,442</b>				<b>\$969,063</b>			
<b>Liabilities and Stockholders' Equity</b>								
Interest-bearing liabilities:								
Savings	\$40,104	\$40	0.10	%	\$37,540	\$38	0.10	%
Interest-bearing demand and money market accounts	281,960	755	0.27	%	268,832	886	0.33	%
Certificates of deposit	389,641	3,791	0.97	%	392,675	4,657	1.19	%
Long-term debt	74,714	1,788	2.39	%	68,996	1,746	2.53	%
Short-term debt	4,344	12	0.28	%	4,278	14	0.33	%
Guaranteed preferred beneficial interest in junior subordinated debentures	12,000	312	2.60	%	12,000	305	2.54	%
<b>Total Interest-Bearing Liabilities</b>	<b>802,763</b>	<b>6,698</b>	<b>0.83</b>	<b>%</b>	<b>784,321</b>	<b>7,646</b>	<b>0.97</b>	<b>%</b>
Noninterest-bearing demand deposits	100,783				87,649			
Other liabilities	8,898				8,318			
Stockholders' equity	113,998				88,775			
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$1,026,442</b>				<b>\$969,063</b>			
<b>Net interest income</b>		<b>\$35,061</b>				<b>\$32,032</b>		
Interest rate spread			3.55	%			3.45	%
Net yield on interest-earning assets			3.68	%			3.56	%
Ratio of average interest-earning assets to average interest bearing liabilities			118.83	%			114.57	%
Cost of funds			0.74	%			0.88	%

Cost of deposits	0.56 %	0.71 %
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(1) Average balance includes non-accrual loans

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***Provision for Loan Losses***

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

	Years Ended December 31,				
(dollars in thousands )	2014	2013	\$ Change	% Change	
Provision for loan losses	\$ 2,653	\$ 940	\$ 1,713	182.2	%

The provision for loan losses increased \$1.7 million from the comparable period in 2013 to \$2.7 million for the year ended December 31, 2014 and reflected an increase in net-charge-offs offset by a decrease in the specific allowance of nonperforming loans. The provision for loan losses increased in 2014 due primarily to increases related to specific credits and increased average loan balances. The specific allowance is based on management's estimate of realizable value for particular loans and has decreased as specific credits have been resolved through a return to performance, charge-offs, additions to other real estate owned, or the sale of non-performing and classified loans. Net charge-offs increased \$1.3 million from \$1.0 million for the year ended December 31, 2013 to \$2.3 million for the year ended December 31, 2014, primarily due to the two loan relationships discussed below.

In the fourth quarter of 2014, the Bank granted concessions on two loan relationships, each of which was classified as substandard. As a result of these concessions, the Bank determined that the loans were TDRs. As such, the loans became impaired and were evaluated for impairment in accordance with Bank policy. The first loan relationship, which totaled \$8.6 million, consisted of commercial real estate and construction loans. The borrower agreed to provide additional collateral to cover most of the deficiency determined as a result of the impairment analysis and the Bank charged-off \$500,000 in principal. The carrying value of the loans at December 31, 2014 was \$8.2 million. The second loan relationship, which totaled approximately \$3.8 million, consisted of construction and land development and commercial loans. As a result of the concessions granted and the impairment analysis, the Bank charged-off \$843,000 and took 11 finished residential lots into other real estate owned ("OREO"). At December 31, 2014, the carrying value of the loans and the OREO was \$1.9 million and \$757,000, respectively. Both loan relationships were current and making payments in accordance with their original contract terms before the restructuring occurred. Accordingly, the two loan relationships remained on accrual status at December 31, 2014. As a result of these classifications, total accruing TDRs increased to \$13.2 million at December 31, 2014 from \$4.4 million at December 31, 2013. Total nonaccrual loans and OREO at December 31, 2014 were \$10.3 million and \$5.9 million, respectively, as compared to \$15.5 million and \$6.8 million, respectively, at December 31, 2013, representing a decrease of \$5.2 million and \$0.9 million, respectively. Additionally, total classified assets declined \$2.9 million from \$56.9 million at December 31, 2013 to \$54.0 million at December 31, 2014.

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

**Noninterest Income**

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

(dollars in thousands )	Years Ended December 31,			
	2014	2013	\$ Change	% Change
Noninterest Income				
Loan appraisal, credit, and miscellaneous charges	\$ 368	\$ 391	\$ (23 )	(5.9 )%
Gain on sale of asset	7	11	(4 )	(36.4 )%
Net gains on sale of OREO	322	179	143	79.9 %
Net gains on sale of investment securities	19	-	19	n/a
Income from bank owned life insurance	671	620	51	8.2 %
Service charges	2,213	2,346	(133 )	(5.7 )%
Gain on sale of loans held for sale	493	627	(134 )	(21.4 )%
Total Noninterest Income	\$ 4,093	\$ 4,174	\$ (81 )	(1.9 )%

Noninterest income decreased slightly during 2014 compared to the prior year as reductions in gains on the sale of loans held for sale and service charge income were partially offset by increased gains on sales of other real owned.

Service charge income decreased due to the Bank's focus on transaction account acquisition. The Bank is providing more products and services to attract and retain commercial customers. In addition, the Bank continued to see a reduction in service fees due to increased regulation.

During the year ended December 31, 2014, the Bank recognized \$322,000 in gains on the sale of OREO which consisted of the sale of eight properties for net proceeds of \$3.7 million, which included the financing of \$1.0 million dollars on a residential subdivision that was transferred from OREO to loans during the fourth quarter of 2014. The contracted sales price of \$1.4 million on the residential subdivision qualified for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition".

During the year ended December 31, 2013, the Bank recognized \$179,000 in gains on the sale of OREO which consisted of the sale of six properties for net proceeds of \$1.3 million and net losses of \$46,000 and the recognition of \$225,000 of previously deferred gain from an OREO property that the Bank financed during 2011 that did not initially qualify for full accrual sales treatment. The Bank utilized the cost recovery method (ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition") to account for the sale.

Gains on loans originated for sale in the secondary market decreased in 2014 compared to the prior year. Secondary market sales slowed during the third quarter of 2013 as a result of rising residential mortgage interest rates. The refinance market rebounded slightly during the second half of 2014 due a decrease in rates. The Bank recognized \$349,000, or 70.8% of 2014 gains on loan sales, in the last six months of 2014. In 2013, secondary market sales were concentrated during the first six months of 2013, as residential mortgage refinancing slowed during the third and fourth quarters of 2013 due to rising market interest rates. The Bank recognized \$516,000, or 82.3% of 2013 gains on loan sales, in the six months ended June 30, 2013.

### *Noninterest Expense*

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

(dollars in thousands )	Years Ended December 31,			
	2014	2013	\$ Change	% Change
Noninterest Expense				
Salary and employee benefits	\$ 15,851	\$ 14,521	\$ 1,330	9.2 %
Occupancy expense	2,371	2,139	232	10.8 %
Advertising	545	477	68	14.3 %
Data processing expense	1,556	1,289	267	20.7 %
Professional fees	1,129	1,095	34	3.1 %

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Depreciation of furniture, fixtures, and equipment	753	765	(12 )	(1.6 )%
Telephone communications	185	200	(15 )	(7.5 )%
Office supplies	204	226	(22 )	(9.7 )%
FDIC Insurance	709	1,115	(406 )	(36.4 )%
OREO valuation allowance and expenses	386	787	(401 )	(51.0 )%
Other	2,546	2,230	316	14.2 %
Total Noninterest Expense	\$ 26,235	\$ 24,844	\$ 1,391	5.6 %

(dollars in thousands)	Years Ended December 31,			
	2014	2013	\$ Change	% Change
Compensation and Benefits	\$ 15,851	\$ 14,521	\$ 1,330	9.2 %
OREO Valuation Allowance and Expenses	386	787	(401 )	(51.0 )%
Operating Expenses	9,998	9,536	462	4.8 %
Total Noninterest Expense	\$ 26,235	\$ 24,844	\$ 1,391	5.6 %



For the year ended December 31, 2014, noninterest expense increased 5.6%, or \$1.4 million, to \$26.2 million from \$24.8 million for the comparable period in 2013. The increase was primarily due to growth in salary and employee benefits of \$1.3 million to \$15.9 million as the Bank added employees in 2014 to support its expansion in Fredericksburg, Virginia and Annapolis, Maryland and the surrounding markets. Occupancy and advertising expense increased compared to the same period of the prior year primarily as a result of the Company's entrance into new markets. Additionally, salary and benefits, data processing and other expenses were impacted by the increased cost of compliance and regulation. These increased costs were partially offset by a reduction in FDIC insurance premiums and OREO related expenses. The Company's efficiency ratio and noninterest expense as a percentage of average assets for the year ended December 31, 2014 were 67.00% and 2.56%, respectively, compared to 68.62% and 2.56%, respectively, for the year ended December 31, 2013.

### *Income Tax Expense*

For the years ended December 31, 2014 and 2013, the Company recorded income tax expense of \$3.8 million. The Company's effective tax rates for the years ended December 31, 2014 and 2013 were 36.78% and 36.18%, respectively. The increase in the effective tax rate was the result of tax exempt income being relatively lower to total income in 2014 than in 2013.

**COMPARISON OF FINANCIAL CONDITION AT DECEMBER 31, 2015 AND 2014*****Assets***

Total assets at December 31, 2015 of \$1.14 billion increased \$60.5 million compared to total assets of \$1.08 billion at December 31, 2014. The increase in total assets was primarily attributable to growth in securities and loans partially offset by declines in cash.

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

(dollars in thousands)	December 31, 2015	December 31, 2014	\$ Change	% Change	
Cash and due from banks	\$ 9,059	\$ 17,275	\$ (8,216 )	(47.6 )	%
Federal funds sold	225	965	(740 )	(76.7 )	%
Interest-bearing deposits with banks	1,855	3,133	(1,278 )	(40.8 )	%
Securities available for sale (AFS), at fair value	35,116	41,939	(6,823 )	(16.3 )	%
Securities held to maturity (HTM), at amortized cost	109,420	84,506	24,914	29.5	%
FHLB and FRB stock - at cost	6,931	6,434	497	7.7	%
Loans receivable - net of ALLL	909,200	862,409	46,791	5.4	%
Premises and equipment, net	20,156	20,586	(430 )	(2.1 )	%
Premises and equipment held for sale	2,000	-	2,000	n/a	
Other real estate owned (OREO)	9,449	5,883	3,566	60.6	%
Accrued interest receivable	3,218	3,036	182	6.0	%
Investment in bank owned life insurance	27,836	27,021	815	3.0	%
Other assets	8,867	9,691	(824 )	(8.5 )	%
Total Assets	\$ 1,143,332	\$ 1,082,878	\$ 60,454	5.6	%

The differences in allocations between the cash and investment categories reflect operational needs. Net loans increased \$46.8 million from \$862.4 million at December 31, 2014 to \$909.2 million at December 31, 2015, due primarily to increases in loans for commercial real estate.

Details of the Company's loan portfolio are presented below:

(dollars in thousands)	December 31, 2015	%	December 31, 2014	%
Commercial real estate	\$ 613,479	66.76 %	\$ 561,080	64.34 %

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Residential first mortgages	149,967	16.32 %	152,837	17.52 %
Construction and land development	36,189	3.94 %	36,370	4.17 %
Home equity and second mortgages	21,716	2.36 %	21,452	2.46 %
Commercial loans	67,246	7.32 %	73,625	8.44 %
Consumer loans	366	0.04 %	613	0.07 %
Commercial equipment	29,931	3.26 %	26,152	3.00 %
	918,894	100.00 %	872,129	100.00 %
Less:				
Deferred loan fees	1,154	0.13 %	1,239	0.14 %
Allowance for loan losses	8,540	0.93 %	8,481	0.97 %
	9,694		9,720	
	\$ 909,200		\$ 862,409	

*Asset Quality*

(dollars in thousands, except per share amounts)	December 31, 2015	December 31, 2014	\$ Change	% Change	
<b>SELECTED ASSET QUALITY DATA</b>					
Gross loans	\$ 918,894	\$ 872,129	\$46,765	5.4	%
Classified assets	43,346	54,022	(10,676)	(19.8)	%
Allowance for loan losses	8,540	8,481	59	0.7	%
Nonperforming loans (>=90 Days) <sup>(1)</sup>	10,740	10,263	477	4.6	%
Non-accrual loans <sup>(2)</sup>	11,433	10,263	1,170	11.4	%
Accruing troubled debt restructures (TDRs) <sup>(3)</sup>	13,133	13,249	(116)	(0.9)	%
Other Real Estate Owned (OREO)	9,449	5,883	3,566	60.6	%
<b>SELECTED ASSET QUALITY RATIOS</b>					
Average total equity to average total assets	9.35	% 11.11		%	
Classified assets to total assets	3.79	4.99			
Classified assets to risk-based capital	30.19	39.30			
Allowance for loan losses to total loans at end of period	0.93	0.97			
Allowance for loan losses to nonperforming loans	79.52	82.64			
Net charge-offs to avg. outstanding loans	0.16	0.28			
Nonperforming loans to total loans	1.17	1.18			
Non-accrual loans to total loans	1.24	1.18			
Non-accrual loans and TDRs to total loans	2.67	2.70			
Non-accrual loans and OREO to total assets	1.83	1.49			
Non-accrual loans, OREO and TDRs to total assets	2.98	2.71			

<sup>(1)</sup> Nonperforming loans include all loans that are 90 days or more delinquent.

<sup>(2)</sup> Non-accrual loans include all loans that are 90 days or more delinquent and loans that are non-accrual due to the operating results or cash flows of a customer.

<sup>(3)</sup> TDR loans include both non-accrual and accruing performing loans. All TDR loans are included in the calculation of asset quality financial ratios. Non-accrual TDR loans are included in the non-accrual balance and accruing TDR loans are included in the accruing TDR balance.

The Company has been working in an increasingly assertive manner to reduce classified loans by using approaches that maximize the Company's contractual rights with each individual customer relationship. The objective is to move non-performing or substandard credits that are not likely to become performing or passing credits in a reasonable timeframe off the balance sheet. The Company is encouraging existing classified customers to obtain financing with other lenders or enforcing its contractual rights. Management believes this strategy is in the best long-term interest of the Company.

Management considers classified assets to be an important measure of asset quality. Classified assets declined as a percentage of total assets and risk-based regulatory capital and in total dollars from a high point of greater than \$81.9 million at September 30, 2011. Classified assets decreased \$10.7 million, or 19.8%, from \$54.0 million at December 31, 2014 to \$43.3 million at December 31, 2015. During the fourth quarter of 2015, the Company reduced classified loans \$3.5 million to \$32.8 million compared to \$36.3 million at September 30, 2015. Of the \$3.5 million reduction in classified loans, \$2.7 million was transferred to OREO. These properties include a 21 unit apartment building, 11 condo units and a commercial property. The Company is optimistic that these properties will be sold in the near term based on the current valuation, the existing market and tenant occupancy.

The following is a breakdown of the Company's classified and special mention assets at December 31, 2015, 2014, 2013, 2012 and 2011, respectively:

Classified Assets and Special Mention Assets

(dollars in thousands)	12/31/2015	12/31/2014	12/31/2013	12/31/2012	12/31/2011
Classified loans					
Substandard	\$ 31,943	\$ 46,735	\$ 47,645	\$ 48,676	\$ 68,515
Doubtful	861	-	-	-	-
Loss	-	-	-	-	37
Total classified loans	32,804	46,735	47,645	48,676	68,552
Special mention loans	1,642	5,460	9,246	6,092	-
Total classified and special mention loans	\$ 34,446	\$ 52,195	\$ 56,891	\$ 54,768	\$ 68,552
Classified loans	32,804	46,735	47,645	48,676	68,552
Classified securities	1,093	1,404	2,438	3,028	6,057
Other real estate owned	9,449	5,883	6,797	6,891	5,029
Total classified assets	\$ 43,346	\$ 54,022	\$ 56,880	\$ 58,595	\$ 79,638
Total classified assets as a percentage of total assets	3.79	% 4.99	% 5.56	% 5.97	% 8.10
Total classified assets as a percentage of Risk Based Capital	30.19	% 39.30	% 43.11	% 59.02	% 83.89

Non-accrual loans (90 days or greater delinquent and non-accrual only loans) increased \$1.1 million from \$10.3 million, or 1.18%, of total loans at December 31, 2014 to \$11.4 million, or 1.24%, of total loans at December 31, 2015. Non-accrual only loans are loans classified as non-accrual due to customer operating results or payment history. In accordance with the Company's policy, interest income is recognized on a cash basis for these loans. The Company had 38 non-accrual loans at December 31, 2015 compared to 31 non-accrual loans at December 31, 2014. Non-accrual loans at December 31, 2015 included \$8.1 million, or 71% of non-accrual loans, attributed to 19 loans representing six customer relationships classified as substandard. Non-accrual loans at December 31, 2014 included \$8.8 million, or 86% of nonperforming loans, attributed to 16 loans representing six customer relationships classified as substandard. Of these loans at December 31, 2015 and December 31, 2014, four loans totaling \$3.8 million and \$3.9 million, respectively, represented a stalled residential development project. During the second quarter of 2014, the Company deferred the collection of principal and interest to enable the project to use available funds to build units and complete the project. The stalled development project loans are considered both TDRs and non-accrual loans. At December 31, 2015, the Company had an additional three TDR loans totaling \$1.7 million classified as non-accrual. At December 31, 2014, the Company had one additional TDR loan totaling \$1.0 million that was non-accrual. These loans are classified solely as non-accrual loans for the calculation of financial ratios.

Loan delinquency (90 days or greater delinquent and 31-89 days delinquent) decreased \$395,000 from \$12.1 million, or 1.39% of loans, at December 31, 2014 to \$11.7 million, or 1.27% of loans, at December 31, 2015. Loans 31-89

days delinquent decreased \$872,000 from \$1.8 million, or 0.21% of total loans, at December 31, 2014 to \$948,000, or 0.10% of total loans, at December 31, 2015.

At December 31, 2015, the Company had 23 accruing TDRs totaling \$13.1 million compared to 19 accruing TDRs totaling \$13.2 million as of December 31, 2014. The Company had specific reserves of \$1.3 million on nine TDRs totaling \$3.6 million at December 31, 2015 and \$251,000 on five TDRs totaling \$2.5 million at December 31, 2014.

The following is a breakdown by loan classification of the Company's TDRs at December 31, 2015 and December 31, 2014:

(dollars in thousands)	December 31, 2015		December 31, 2014	
	Dollars	Number of Loans	Dollars	Number of Loans
Commercial real estate	\$ 11,897	13	\$ 10,438	9
Residential first mortgages	881	3	906	3
Construction and land development	4,283	5	4,376	4
Commercial loans	1,384	7	2,262	6
Commercial equipment	123	2	154	2
Total TDRs	\$ 18,568	30	\$ 18,136	24
Less: TDRs included in non-accrual loans	(5,435 )	(7 )	(4,887 )	(5 )
Total accrual TDR loans	\$ 13,133	23	\$ 13,249	19

The OREO balance was \$9.4 million at December 31, 2015, an increase of \$3.5 million compared to \$5.9 million at December 31, 2014. This increase consisted of additions of \$5.4 million offset by valuation allowances of \$664,000 to adjust properties to current appraised values and \$1.2 million in disposals. OREO carrying amounts reflect management's estimate of the realizable value of these properties incorporating current appraised values, local real estate market conditions and related costs.

Non-accrual loans and OREO to total assets increased 34 basis points from 1.49% at December 31, 2014 to 1.83% at December 31, 2015. Non-accrual loans, OREO and TDRs to total assets increased 37 basis points from 2.71% at December 31, 2014 to 2.98% at December 31, 2015.

The allowance for loan losses was 0.93% of gross loans at December 31, 2015 and 0.97% at December 31, 2014. There was a decrease in the general component of the allowance due to changes to general allowance factors that reflect changes in historical loss, delinquency rates and general economic conditions. Management's determination of the adequacy of the allowance is based on a periodic evaluation of the portfolio with consideration given to: overall loss experience; current economic conditions; size, growth and composition of the loan portfolio; financial condition of the borrowers; current appraised values of underlying collateral and other relevant factors that, in management's judgment, warrant recognition in determining an adequate allowance. The specific allowance is based on management's estimate of realizable value for particular loans. Management believes that the allowance is adequate. The Company decreased its general allowance as a percentage of gross loans 17 basis points from 0.92% at December 31, 2014 to 0.75% at December 31, 2015.



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The following is a breakdown of the Company's general and specific allowances as a percentage of gross loans at December 31, 2015 and December 31, 2014, respectively.

(dollar in thousands)	December 31, 2015	% of Gross Loans	December 31, 2014	% of Gross Loans
General Allowance	\$ 6,932	0.75	\$ 8,030	0.92
Specific Allowance	1,608	0.17	451	0.05
Total Allowance	\$ 8,540	0.93	\$ 8,481	0.97

The most important weighted factor in the Company's allowance for loan loss methodology is the charge-off history of the loan portfolio. The historical loss experience factor is tracked over various time horizons for each portfolio segment. It is weighted as the most important factor of the general component of the allowance and has decreased as the Company's charge-off history has improved.

The following table provides a six-year trend of net charge-offs as a percentage of average loans.

(dollars in thousands)	Years Ended December 31,											
	2015	2014	2013	2012	2011	2010						
Average loans	\$874,186	\$819,381	\$741,369	\$719,798	\$671,242	\$615,887						
Net charge-offs	1,374	2,309	1,049	1,937	4,101	3,736						
<b>Net charge-offs to average loans</b>	0.16	% 0.28	% 0.14	% 0.27	% 0.61	% 0.61						

At December 31, 2015, 99%, or \$138.3 million of the asset-backed securities and agency bond portfolio was rated AAA by Standard & Poor's or the equivalent credit rating from another major rating agency compared to 99%, or \$119.8 million, at December 31, 2014. Debt securities are evaluated quarterly to determine whether a decline in their value is OTTI. No OTTI charge was recorded for the year ended December 31, 2015 and the year ended December 31, 2014, respectively. Classified securities decreased \$311,000 from \$1.4 million at December 31, 2014 to \$1.1 million at December 31, 2015.

Gross unrealized losses on HTM and AFS securities decreased from \$1.6 million at December 31, 2014 to \$1.5 million at December 31, 2015 (see Note 5 in Consolidated Financial Statements). Gross unrealized losses at December 31, 2015 and 2014 for AFS securities were \$557,000 and \$830,000, respectively, of amortized cost of \$35.5 million and \$42.6 million, respectively. Gross unrealized losses at December 31, 2015 and 2014 for HTM securities were \$941,000 and \$737,000, respectively, of amortized cost of \$109.4 million and \$84.5 million, respectively. The change in unrealized losses was the result of changes in interest rates, while credit risks remained stable. The Bank holds over 95% of its AFS and HTM securities as asset-backed securities of GSEs, GSE agency bonds or U.S. government obligations. The Company intends to, and has the ability to, hold both AFS and HTM securities with unrealized losses until they mature, at which time the Company will receive full value for the securities. The Company believes that the AFS and HTM securities with unrealized losses will either recover in market value or be paid off as agreed.

### *Liabilities*

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

(dollars in thousands)	December 31, 2015	December 31, 2014	\$ Change	% Change	
Deposits					
Non-interest-bearing deposits	\$ 142,771	\$ 122,195	\$20,576	16.8	%
Interest-bearing deposits	764,128	747,189	16,939	2.3	%
Total deposits	906,899	869,384	37,515	4.3	%
Short-term borrowings	36,000	2,000	34,000	1700.0	%
Long-term debt	55,617	74,672	(19,055)	(25.5)	)%

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Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs)	12,000	12,000	-	0.0	%
Subordinated notes - 6.25%	23,000	-	23,000	n/a	
Accrued expenses and other liabilities	10,033	8,263	1,770	21.4	%
Total Liabilities	\$ 1,043,549	\$ 966,319	\$ 77,230	8.0	%

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Deposits

Deposits increased by 4.3%, or \$37.5 million to \$906.9 million at December 31, 2015 compared to \$869.4 million at December 31, 2014. Between 2012 and 2015, the Company increased transaction deposits, including noninterest bearing deposits, to lower its overall cost of funds. Average transaction deposits for the year ended December 31, 2015 increased \$65.4 million, or 15.5%, to \$488.2 million compared to \$422.9 million for the comparable period in 2014. The increase in average transaction deposits included growth in average noninterest bearing demand deposits of \$19.7 million, or 19.6%, from \$100.8 million for the year ended December 31, 2014 to \$120.5 million for the year ended December 31, 2015. Transaction deposits have increased from 44.9% of total deposits at December 31, 2011 to 58.6% of total deposits at December 31, 2015. Details of the Company's deposit portfolio at December 31, 2015 and December 31, 2014 are presented below:

(dollars in thousands)	December 31,		2014		
	2015		Balance	%	
Noninterest-bearing demand	\$ 142,771	15.74 %	\$ 122,195	14.06 %	
Interest-bearing:					
Demand	120,918	13.33 %	108,350	12.46 %	
Money market deposits	219,956	24.25 %	211,929	24.38 %	
Savings	47,703	5.26 %	41,499	4.77 %	
Certificates of deposit	375,551	41.41 %	385,411	44.33 %	
Total interest-bearing	764,128	84.26 %	747,189	85.94 %	
Total Deposits	\$906,899	100.00 %	\$869,384	100.00 %	
Transaction accounts	\$531,348	58.59 %	\$483,973	55.67 %	

The Company uses both traditional brokered deposits and reciprocal brokered deposits. Traditional brokered deposits at December 31, 2015 and December 31, 2014 were \$49.1 million and \$41.7 million, respectively. Reciprocal brokered deposits at December 31, 2015 and December 31, 2014 were \$61.1 million and \$41.6 million, respectively. The reciprocal brokered deposits have many characteristics of core deposits and are used to maximize FDIC insurance available to our customers.

Borrowings

Long-term debt and short-term borrowings increased \$14.9 million from \$76.7 million at December 31, 2014 to \$91.6 million at December 31, 2015. During the year ended December 31, 2015, the Company paid off a net of \$19.1 million in Federal Home Loan Bank ("FHLB") long-term debt reducing the balance to \$55.6 million at December 31, 2015. Short-term borrowings increased \$34.0 million to \$36.0 million at December 31, 2015. The Company uses brokered deposits and other wholesale funding to supplement funding when loan growth exceeds core deposit growth and for asset-liability management purposes.

The Bank uses advances from the FHLB of Atlanta to supplement the supply of funds it may lend and to meet deposit withdrawal requirements. Advances from the FHLB are secured by the Bank's stock in the FHLB, a portion of the Bank's loan portfolio and certain investments. Generally, the Bank's ability to borrow from the FHLB of Atlanta is limited by its available collateral and also by an overall limitation of 30% of assets. Further, short-term credit facilities are available at the Federal Reserve Bank of Richmond and other commercial banks. Long-term debt consists of adjustable-rate advances with rates based upon LIBOR, fixed-rate advances, and convertible advances. At December 31, 2015 and 2014, 100% of the Bank's long-term debt was fixed for rate and term, as the conversion optionality of the advances have either been exercised or expired.

The table below sets forth information about long-term debt and short-term borrowings for the years indicated. Junior subordinated debentures of \$12 million and subordinated notes of \$23.0 million are not included in the below table. For more information on borrowings, see Notes 11, 16 and 17 in the Consolidated Financial Statements.

(dollars in thousands)	At or for the Year Ended December 31,					
	2015		2014		2013	
<b>Long-term debt</b>						
Long-term debt outstanding at end of period	\$ 55,617		\$ 74,672		\$ 70,476	
Weighted average rate on outstanding long-term debt	2.47	%	2.35	%	2.49	%
Maximum outstanding long-term debt of any month end	74,668		75,471		70,519	
Average outstanding long-term debt	68,924		74,714		68,996	
Approximate average rate paid on long-term debt	2.26	%	2.39	%	2.53	%
<b>Short-term borrowings</b>						
Short-term borrowings outstanding at end of period	\$ 36,000		\$ 2,000		\$ -	
Weighted average rate on short-term borrowings	0.38	%	0.31	%	0.00	%
Maximum outstanding short-term borrowings at any month end	36,000		15,000		24,000	
Average outstanding short-term borrowings	13,463		4,344		4,278	
Approximate average rate paid on short-term borrowings	0.27	%	0.28	%	0.33	%

### ***Stockholders' Equity***

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

(dollars in thousands)	December 31, 2015	December 31, 2014	\$ Change	% Change
Preferred Stock at par of \$1,000	\$ -	\$ 20,000	\$(20,000)	(100.0)%
Common Stock at par of \$0.01	46	47	(1)	(2.1)%
Additional paid in capital	46,809	46,416	393	0.8%
Retained earnings	53,495	50,936	2,559	5.0%
Accumulated other comprehensive loss	(251)	(378)	127	(33.6)%
Unearned ESOP shares	(316)	(462)	146	(31.6)%
Total Stockholders' Equity	\$ 99,783	\$ 116,559	\$(16,776)	(14.4)%

During the year ended December 31, 2015, stockholders' equity decreased \$16.8 million to \$99.8 million. The decrease in stockholders' equity was due to the \$20.0 million payoff of SBLF preferred stock as described below, quarterly common dividends paid of \$1.8 million, quarterly preferred stock dividends paid of \$73,000 and repurchases of common stock of \$1.8 million. These decreases to capital were partially offset by increases to equity from net income of \$6.3 million, net stock related activities related to stock-based compensation and the exercise of options of \$497,000 and a current year decrease in accumulated other comprehensive loss of \$127,000. Common stockholders'

equity of \$99.8 million at December 31, 2015 resulted in a book value of \$21.48 per common share compared to \$20.53 at December 31, 2014. The Company remains well-capitalized at December 31, 2015 with a Tier 1 capital to average assets ratio of 10.01%.

On February 6, 2015, the Company issued \$23.0 million of unsecured 6.25% fixed to floating rate subordinated notes due 2025 (“subordinated notes”). On February 13, 2015, the Company used proceeds of the offering to redeem all \$20 million of the Company’s outstanding preferred stock issued under the Small Business Lending Fund (“SBLF”) program. The subordinated notes qualify as Tier 2 regulatory capital and replaced SBLF Tier 1 capital. The balance of the net proceeds will be used for general corporate purposes, including, but not limited to, contributing capital to Community Bank of the Chesapeake, supporting organic growth, possible acquisitions of branches or other financial institutions should attractive acquisition opportunities arise and the payment of dividends. The subordinated notes will increase the Company’s cost of funds during 2015. The Company’s decision to move forward with the transaction during 2015 was based on a scheduled increase in the after-tax SBLF dividend rate to 9% in March 2016.

## **LIQUIDITY AND CAPITAL RESOURCES**

### ***Capital Resources***

The Company has no business other than holding the stock of the Bank and does not currently have any material funding requirements, except for the payment of dividends on common stock, and the payment of interest on subordinated debentures and subordinated notes.

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

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

Federal banking regulations require the Company and the Bank to maintain specified levels of capital. As of December 31, 2015, the Company and Bank were well-capitalized under the regulatory framework for prompt corrective action under the new Basel III Capital Rules. Management believes, as of December 31, 2015 and 2014, that the Company and the Bank met all capital adequacy requirements to which they were subject. See Note 18 of the Consolidated Financial Statements.

### ***Liquidity***

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

Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. Liquid assets include cash, federal funds sold, and short-term investments in cash deposits with other banks. Liquidity



is also provided by access to funding sources, which include core depositors and brokered deposits. Other sources of funds include our ability to borrow, such as purchasing federal funds from correspondent banks, sales of securities under agreements to repurchase and advances from the FHLB.

At December 31, 2015 and 2014, the Bank had \$73.5 million and \$36.3 million, respectively, in loan commitments outstanding. Certificates of deposit due within one year of December 31, 2015 and 2014 totaled \$230.6 million or 61.4% and \$240.6 million or 62.4%, respectively, of total certificates of deposit outstanding. If maturing deposits do not remain, the Bank will be required to seek other sources of funds, including other certificates of deposit and borrowings. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposits. We believe, however, based on past experience that a significant portion of our certificates of deposit will remain with us. We have the ability to attract and retain deposits by adjusting the interest rates offered.

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

The Bank's principal sources of funds for investment and operations are net income, deposits, sales of loans, borrowings, principal and interest payments on loans, principal and interest received on investment securities and proceeds from the maturity and sale of investment securities. Its principal funding commitments are for the origination or purchase of loans, the purchase of securities and the payment of maturing deposits. Deposits are considered the primary source of funds supporting the Bank's lending and investment activities. The Bank also uses borrowings from the FHLB of Atlanta to supplement deposits. The amount of FHLB advances available to the Bank is limited to the lower of 30% of Bank assets or the amount supportable by eligible collateral including FHLB stock, loans and securities. In addition, the Bank has established lines of credit with the Federal Reserve Bank and commercial banks. For a discussion of these agreements including collateral see Note 11 in the Consolidated Financial Statements.

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

***Comparison for the Years Ending December 31, 2015 and 2014***

Cash and cash equivalents as of December 31, 2015 totaled \$11.1 million, a decrease of \$10.2 million, or 47.9%, from the December 31, 2014 total of \$21.4 million. The decrease in cash was primarily due to more cash used in investing activities in 2015 compared to 2014 partially offset by more cash provided by operating activities in 2015 compared to 2014. Changes to the level of cash and cash equivalents have minimal impact on operational needs as the Bank has substantial sources of funds available from other sources.

During the year ended December 31, 2015, all financing activities provided \$51.9 million in cash compared to \$52.7 million in cash provided for the same period in 2014. The Company provided \$794,000 less cash for financing activities in the year ended December 31, 2015 compared to the year ended December 31, 2014. The slight decrease in cash provided for the comparable periods was primarily the result of a decrease in the rate of deposit growth of \$10.6 million, a net reduction in long-term debt of \$23.3 million, partially offset by net increases in short-term borrowings of \$32.0 million and a net increase of \$3.0 million in proceeds due to the subordinated note raise of \$23.0 million offset by the SBLF payoff of \$20 million. Additionally, the Company used \$1.8 million in cash to repurchase common stock during 2015 and other financing activities decreased cash provided \$142,000.

The Bank's principal use of cash has been in investing activities including its investments in loans, investment securities and other assets. In 2015, the level of net cash used in investing increased to \$74.6 million from \$66.4 million in 2014. The increase in cash used in investing activity of \$8.2 million in 2015 was due to a reduction in net proceeds received on security transactions of \$26.6 million primarily due to more investment purchases for the year ended December 31, 2015 than the comparable period of 2014. Additionally, the Bank sold some securities during 2014. The result of these securities activities was that the Bank was a net purchaser of securities of \$18.6 million in 2015 compared to a net seller of securities of \$8.0 million in 2014. Additional cash of \$1.1 million was used to purchase premises and equipment in the year ended December 31, 2015 compared to 2014. During the same comparable period, net proceeds from the sale of OREO and other assets decreased \$2.5 million. These increases to cash used were partially offset by decreases to cash used of \$22.1 million due to \$7.0 million from BOLI purchased in 2014 that was not purchased in 2015 and a net increase in cash provided of \$15.1 million from loan activities. The principal collected on loans increased \$12.0 million from \$193.1 million for the year ended December 31, 2014 to \$205.1 million for the year ended December 31, 2015. Less cash was used to fund loans as loans originated or acquired decreased \$3.1 million from \$262.0 million for the year ended December 31, 2014 to \$258.9 million for the year ended December 31, 2015.

Operating activities provided cash of \$12.5 million for the year ended December 31, 2015 compared to \$10.6 million of cash provided for the same period of 2014. Cash increased by \$1.9 million primarily due to an increase in accrued

expenses and other liabilities, decreases in deferred income taxes and other assets partially offset by a decrease in the provision for loan losses.

***Comparison for the Years Ending December 31, 2014 and 2013***

Cash and cash equivalents as of December 31, 2014 totaled \$21.4 million, a decrease of \$3.1 million, or 12.8%, from the December 31, 2013 total of \$24.5 million. The decrease in cash was primarily due to more cash used in investing activities in 2014 compared to 2013 partially offset by more cash provided by financing activities in 2014 compared to 2013. Changes to the level of cash and cash equivalents have minimal impact on operational needs as the Bank has substantial sources of funds available from other sources.

During the year ended December 31, 2014, all financing activities provided \$52.7 million in cash compared to \$36.0 million in cash provided for the same period in 2013. The Company provided \$16.7 million more cash for financing activities in the year ended December 31, 2014 compared to the year ended December 31, 2013 primarily due to an increase in deposits of 47.0 million. These increases to cash were partially offset by \$27.4 million of net cash proceeds from the October 2013 capital raise, a decrease in net borrowings of \$2.8 million. Other financing activities decreased cash provided \$185,000.

The Bank's principal use of cash has been in investing activities including its investments in loans, investment securities and other assets. In 2014, the level of net cash used in investing increased to \$66.4 million from \$31.2 million in 2013. The increase in cash used in investing activity of \$35.2 million in 2014 was due to a decrease in the amount of principal collected on loans of \$27.7 million and a reduction in net proceeds received on security transactions of \$14.7 million compared to the prior year; security net purchases used less cash of \$5.7 million which was offset by a decrease in net proceeds from the sale or maturity of securities of \$20.4 million. The purchase of additional bank owned life insurance and equipment used cash of \$7.0 million and \$1.3 million, respectively. These uses of cash were partially offset by less cash used to fund additional loans as loans originated or acquired decreased \$13.0 million from \$275.0 million in 2013 to \$262.0 million in 2014. Additionally, additional proceeds of \$2.5 million were received on the sale of OREO and asset disposals.

Operating activities provided cash of \$10.6 million for the year ended December 31, 2014 compared to \$8.5 million of cash provided for the same period of 2013. Cash increased by \$2.1 million primarily due to an increase in the provision for loan losses and decreases in deferred income taxes and other assets partially offset by a decrease in accrued expenses and other liabilities.

## **QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

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

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

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

The Company's interest rate risk ("IRR") model uses assumptions which include factors such as call features, prepayment options and interest rate caps and floors included in investment and loan portfolio contracts. Additionally, the IRR model estimates the lives and interest rate sensitivity of the Company's non-maturity deposits. These assumptions have a significant effect on model results. The assumptions are developed primarily based upon historical behavior of Bank customers. The Company also considers industry and regional data in developing IRR model assumptions. There are inherent limitations in the Company's IRR model and underlying assumptions. When interest rates change, actual movements of interest-earning assets and interest-bearing liabilities, loan prepayments, and withdrawals of time and other deposits, may deviate significantly from assumptions used in the model.

The Company prepares a current base case and several alternative simulations at least quarterly. Current interest rates are shocked by +/- 100, 200, 300, and 400 basis points ("bp"). The Company may elect not to use particular scenarios that it determines are impractical in a current rate environment. It is management's goal to manage the portfolios of the Bank so that net interest income at risk over a twelve-month and twenty-four month period and the economic value of equity at risk do not exceed policy guidelines at the various interest rate shock levels. Measures of net interest income at risk produced by simulation analysis are indicators of an institution's short-term performance in alternative rate environments. The below schedule estimates the changes in net interest income over a twelve month period for

parallel rate shocks:

### Estimated Changes in Net Interest Income

Change in Interest Rates: Policy Limit	+ 400 bp	+ 300 bp	+ 200 bp	+ 100 bp	- 100 bp	- 200 bp	- 300 bp	- 400 bp
December 31, 2015	2.62 %	1.74 %	0.79 %	(0.20) %	1.11 %	(0.38) %	N/A	N/A

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

### Estimated Changes in Economic Value of Equity (EVE)

Change in Interest Rates: Policy Limit	+ 400 bp	+ 300 bp	+ 200 bp	+ 100 bp	- 100 bp	- 200 bp	- 300 bp	- 400 bp
December 31, 2015	(6.17) %	(3.71) %	(1.49) %	(0.03) %	(0.79) %	(4.32) %	N/A	N/A

**OFF-BALANCE SHEET ARRANGEMENTS**

In the normal course of operations, we engage in a variety of financial transactions that, in accordance with accounting principles generally accepted in the United States of America and to general practices within the banking industry, are not recorded in our financial statements. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are used primarily to manage customers' requests for funding and take the form of loan commitments, letters of credit and lines of credit. For a discussion of these agreements, including collateral and other arrangements, see Note 13 in the Consolidated Financial Statements.

For the years ended December 31, 2015 and 2014, the Company did not engage in any off-balance sheet transactions reasonably likely to have a material effect on its financial condition, results of operations or cash flows.

**CONTRACTUAL OBLIGATIONS**

In the normal course of its business, the Bank commits to make future payments to others to satisfy contractual obligations. These obligations include commitments to repay short and long-term borrowings and commitments incurred under operating lease agreements.

	Total	Payments due by period			
		Less than One Year	One to Three Years	Three to Five Years	More Than 5 Years
At December 31, 2015 (In thousands)					
Short-term debt obligations	\$36,000	\$36,000	\$ -	\$ -	\$ -
Long-term debt obligations	55,617	5,000	30,000	10,000	10,617
Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs)	12,000				12,000
Subordinated notes - 6.25%	23,000				23,000
Time deposits	375,551	230,559	129,073	15,919	-
Operating lease obligations <sup>(1)</sup>	6,263	705	1,305	823	3,430
Purchase Obligations <sup>(2)</sup>	7,364	1,886	3,937	1,541	-
Total	\$515,795	\$274,150	\$ 164,315	\$ 28,283	\$ 49,047

<sup>(1)</sup> Payments are for lease of real property.

<sup>(2)</sup> Represents payments for data processing under contract based on average monthly service charges for 2015.

**IMPACT OF INFLATION AND CHANGING PRICES**

The Consolidated Financial Statements and notes thereto presented herein have been prepared in accordance with accounting principles generally accepted in the United States of America and to general practices within the banking industry, which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, nearly all of the Company's assets and liabilities are monetary in nature. As a result, interest rates have a greater impact on the Company's performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.



Item 8 - Financial Statements and Supplementary Data

**MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The management of The Community Financial Corporation (the "Company") is responsible for the preparation, integrity and fair presentation of the financial statements included in this Annual Report. The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and reflect management's judgments and estimates concerning the effects of events and transactions that are accounted for or disclosed.

Management is also responsible for establishing and maintaining effective internal control over financial reporting. The Company's internal control over financial reporting includes those policies and procedures that pertain to the Company's ability to record, process, summarize and report reliable financial data. The internal control system contains monitoring mechanisms, and appropriate actions taken to correct identified deficiencies. Management believes that internal controls over financial reporting, which are subject to scrutiny by management and the Company's internal auditors, support the integrity and reliability of the financial statements. Management recognizes that there are inherent limitations in the effectiveness of any internal control system, including the possibility of human error and the circumvention or overriding of internal controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. In addition, because of changes in conditions and circumstances, the effectiveness of internal control over financial reporting may vary over time. The Audit Committee of the Board of Directors (the "Committee"), is comprised entirely of outside directors who are independent of management. The Committee is responsible for the appointment and compensation of the independent auditors and makes decisions regarding the appointment or removal of members of the internal audit function. The Committee meets periodically with management, the independent auditors, and the internal auditors to ensure that they are carrying out their responsibilities. The Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting, and auditing procedures of the Company in addition to reviewing the Company's financial reports. The independent auditors and the internal auditors have full and unlimited access to the Audit Committee, with or without the presence of management, to discuss the adequacy of internal control over financial reporting, and any other matters which they believe should be brought to the attention of the Audit Committee.

Management assessed the Company's system of internal control over financial reporting as of December 31, 2015. This assessment was conducted based on the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission "Internal Control — Integrated Framework (2013)." Based on this assessment, management believes that the Company maintained effective internal control over financial reporting as of December 31, 2015. Management's assessment concluded that there were no material weaknesses within the Company's internal control structure. There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15 under the Securities Act of 1934) during the quarter ended December 31, 2015 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

The 2015 financial statements have been audited by the independent registered public accounting firm of Stegman & Company ("Stegman"). Personnel from Stegman were given unrestricted access to all financial records and related data, including minutes of all meetings of the Board of Directors and committees thereof. Management believes that all representations made to all the independent auditors were valid and appropriate. The resulting report from Stegman accompanies the financial statements. Stegman has also issued a report on the effectiveness of internal control over financial reporting. That report has also been made a part of this Annual Report.

/s/ William J. Pasenelli

/s/ Todd L. Capitani

William J. Pasenelli  
President and Chief Executive Officer  
March 10, 2016

Todd L. Capitani  
Executive Vice President and Chief Financial Officer  
March 10, 2016

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

The Community Financial Corporation

Waldorf, Maryland

We have audited the accompanying consolidated balance sheets of The Community Financial Corporation (the “Company”) as of December 31, 2015 and 2014, and the related consolidated statements of income, comprehensive income, changes in stockholders’ equity, and cash flows for each of the years in the three-year period ended December 31, 2015. We also have audited the Company’s internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control—Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company’s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management’s Report on Internal Control over Financial Reporting*. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company’s internal control over financial reporting based on our audits.

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

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding

prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Community Financial Corporation as of December 31, 2015 and 2014, and the results of their consolidated operations and their cash flows for each of the years in the three-year period ended December 31, 2015, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, The Community Financial Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control—Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”).

/s/ Stegman and Company

Baltimore, Maryland  
March 10, 2016

**CONSOLIDATED BALANCE SHEETS**

(dollars in thousands)	December 31, 2015	December 31, 2014
<b>Assets</b>		
Cash and due from banks	\$ 9,059	\$ 17,275
Federal funds sold	225	965
Interest-bearing deposits with banks	1,855	3,133
Securities available for sale (AFS), at fair value	35,116	41,939
Securities held to maturity (HTM), at amortized cost	109,420	84,506
Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock - at cost	6,931	6,434
Loans receivable - net of allowance for loan losses of \$8,540 and \$8,481	909,200	862,409
Premises and equipment, net	20,156	20,586
Premises and equipment held for sale	2,000	-
Other real estate owned (OREO)	9,449	5,883
Accrued interest receivable	3,218	3,036
Investment in bank owned life insurance	27,836	27,021
Other assets	8,867	9,691
<b>Total Assets</b>	<b>\$ 1,143,332</b>	<b>\$ 1,082,878</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
<b>Deposits</b>		
Non-interest-bearing deposits	\$ 142,771	\$ 122,195
Interest-bearing deposits	764,128	747,189
<b>Total deposits</b>	<b>906,899</b>	<b>869,384</b>
Short-term borrowings	36,000	2,000
Long-term debt	55,617	74,672
Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs)	12,000	12,000
Subordinated notes - 6.25%	23,000	-
Accrued expenses and other liabilities	10,033	8,263
<b>Total Liabilities</b>	<b>1,043,549</b>	<b>966,319</b>
<b>Stockholders' Equity</b>		
Preferred Stock, Senior Non-Cumulative Perpetual, Series C - par value \$1,000; authorized and issued 20,000 at December 31, 2014 and none at December 31, 2015	-	20,000
Common stock - par value \$.01; authorized - 15,000,000 shares; issued 4,645,429 and 4,702,715 shares, respectively	46	47
Additional paid in capital	46,809	46,416
Retained earnings	53,495	50,936
Accumulated other comprehensive loss	(251	) (378
Unearned ESOP shares	(316	) (462

Total Stockholders' Equity	99,783	116,559
Total Liabilities and Stockholders' Equity	\$ 1,143,332	\$ 1,082,878

*See notes to Consolidated Financial Statements*

**CONSOLIDATED STATEMENTS OF INCOME**

(dollars in thousands, except per share amounts )	Years Ended December 31,		
	2015	2014	2013
Interest and Dividend Income			
Loans, including fees	\$41,386	\$39,475	\$37,196
Taxable interest and dividends on investment securities	2,473	2,270	2,466
Interest on deposits with banks	14	14	16
Total Interest and Dividend Income	43,873	41,759	39,678
Interest Expense			
Deposits	4,152	4,586	5,581
Short-term borrowings	37	12	14
Long-term debt	3,156	2,100	2,051
Total Interest Expense	7,345	6,698	7,646
Net Interest Income	36,528	35,061	32,032
Provision for loan losses	1,433	2,653	940
Net Interest Income After Provision For Loan Losses	35,095	32,408	31,092
Noninterest Income			
Loan appraisal, credit, and miscellaneous charges	315	368	391
Gain on sale of asset	19	7	11
Net (losses) gains on sale of OREO	(20 )	322	179
Net gains on sale of investment securities	4	19	-
Loss on premises and equipment held for sale	(426 )	-	-
Income from bank owned life insurance	815	671	620
Service charges	2,488	2,213	2,346
Gain on sale of loans held for sale	104	493	627
Total Noninterest Income	3,299	4,093	4,174
Noninterest Expense			
Salary and employee benefits	16,366	15,851	14,521
Occupancy expense	2,427	2,371	2,139
Advertising	583	545	477
Data processing expense	2,044	1,556	1,289
Professional fees	1,323	1,129	1,095
Depreciation of furniture, fixtures, and equipment	810	753	765
Telephone communications	188	185	200
Office supplies	157	204	226
FDIC Insurance	799	709	1,115
OREO valuation allowance and expenses	1,059	386	787
Other	2,662	2,546	2,230
Total Noninterest Expense	28,418	26,235	24,844

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Income before income taxes	9,976	10,266	10,422
Income tax expense	3,633	3,776	3,771
Net Income	\$6,343	\$6,490	\$6,651
Preferred stock dividends	23	200	200
Net Income Available to Common Stockholders	\$6,320	\$6,290	\$6,451
Earnings Per Common Share			
Basic	\$1.36	\$1.35	\$1.90
Diluted	\$1.35	\$1.35	\$1.88
Cash dividends paid per common share	\$0.40	\$0.40	\$0.40

*See notes to Consolidated Financial Statements*



**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(dollars in thousands)	Years Ended December 31,		
	2015	2014	2013
Net Income	\$6,343	\$6,490	\$6,651
Net unrealized holding gains (losses) arising during period, net of tax expense (benefit) of \$85, \$300 and \$(617), respectively	131	681	(1,196)
Reclassification adjustment for losses included in net income, net of tax benefit of \$2, \$1 and \$0, respectively	(4)	(2)	-
Comprehensive Income	\$6,470	\$7,169	\$5,455

*See notes to Consolidated Financial Statements*

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY****Years Ended December 31, 2015, 2014 and 2013**

(dollars in thousands)	SBLF Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned ESOP Shares	Total
Balance at January 1, 2013	\$ 20,000	\$ 30	\$ 17,874	\$ 41,987	\$ 139	\$ (983 )	\$ 79,047
<b>Comprehensive Income</b>							
Net income	-	-	-	6,651	-	-	6,651
Unrealized holding loss on investment securities net of tax benefit of \$620	-	-	-	-	(1,203 )	-	(1,203 )
Other than temporary impairment amortization on HTM securities net of tax of \$3	-	-	-	-	7	-	7
<b>Total Comprehensive Income</b>							<b>5,455</b>
Cash dividend at \$0.40 per common share	-	-	-	(1,379 )	-	-	(1,379 )
Preferred stock dividends	-	-	-	(200 )	-	-	(200 )
Proceeds from public offering	-	16	27,371	-	-	-	27,387
Exercise of stock options	-	-	317	-	-	-	317
Net change in unearned ESOP shares	-	-	-	-	-	320	320
Repurchase of common stock	-	-	-	(536 )	-	-	(536 )
Stock based compensation	-	-	249	-	-	-	249
Tax effect of exercise of stock based compensation	-	-	35	-	-	-	35
Tax effect of the ESOP dividend	-	-	35	-	-	-	35
Balance at December 31, 2013	\$ 20,000	\$ 46	\$ 45,881	\$ 46,523	\$ (1,057 )	\$ (663 )	\$ 110,730

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY****Years Ended December 31, 2015, 2014 and 2013****(continued)**

(dollars in thousands)	SBLF	Additional	Retained	Accumulated	Unearned	Total	
	Preferred Stock	Common Stock	Paid-in Capital	Earnings	Other Comprehensive Income (Loss)		ESOP Shares
Balance at January 1, 2014	\$ 20,000	\$ 46	\$ 45,881	\$ 46,523	\$ (1,057 )	\$ (663 )	\$ 110,730
Comprehensive Income							
Net income	-	-	-	6,490	-	-	6,490
Unrealized holding loss on investment securities net of tax of \$238	-	-	-	-	541	-	541
Other than temporary impairment amortization on HTM securities net of tax of \$61	-	-	-	-	138	-	138
Total Comprehensive Income							7,169
Cash dividend at \$0.40 per common share	-	-	-	(1,855 )	-	-	(1,855 )
Preferred stock dividends	-	-	-	(200 )	-	-	(200 )
Dividend Reinvestment	-	-	22	(22 )	-	-	-
Exercise of stock options	-	1	225	-	-	-	226
Net change in unearned ESOP shares	-	-	-	-	-	201	201
Stock based compensation	-	-	182	-	-	-	182
Tax effect of exercise of stock based compensation	-	-	71	-	-	-	71
Tax effect of the ESOP dividend	-	-	35	-	-	-	35
Balance at December 31, 2014	\$ 20,000	\$ 47	\$ 46,416	\$ 50,936	\$ (378 )	\$ (462 )	\$ 116,559

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY****Years Ended December 31, 2015, 2014 and 2013****(continued)**

(dollars in thousands)	SBLF	Common	Paid-in	Retained	Accumulated	Unearned	Total
	Preferred Stock	Stock	Capital	Earnings	Other Comprehensive Income (Loss)	ESOP Shares	
Balance at January 1, 2015	\$20,000	\$ 47	\$46,416	\$50,936	\$ (378 )	\$ (462 )	\$116,559
Comprehensive Income							
Net Income	-	-	-	6,343	-	-	6,343
Unrealized holding loss on investment securities net of tax of \$83	-	-	-	-	127	-	127
Total Comprehensive Income							6,470
Cash dividend at \$0.40 per common share	-	-	-	(1,843 )	-	-	(1,843 )
Preferred stock dividends	-	-	-	(73 )	-	-	(73 )
Dividend Reinvestment	-	-	42	(42 )	-	-	-
Redemption of SBLF Loan	(20,000)	-	-	-	-	-	(20,000 )
Net change in unearned ESOP shares	-	-	-	-	-	146	146
Repurchase of common stock	-	(1 )	-	(1,826 )	-	-	(1,827 )
Stock Based Compensation	-	-	319	-	-	-	319
Tax effect of the ESOP dividend	-	-	32	-	-	-	32
Balance at December 31, 2015	\$-	\$ 46	\$46,809	\$53,495	\$ (251 )	\$ (316 )	\$99,783

*See notes to Consolidated Financial Statements*

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(dollars in thousands)	Years Ended December 31,		
	2015	2014	2013
<b>Cash Flows from Operating Activities</b>			
Net income	\$6,343	\$6,490	\$6,651
Adjustments to reconcile net income to net cash provided by operating activities			
Provision for loan losses	1,433	2,653	940
Depreciation and amortization	1,439	1,299	1,274
Provision for loss on premises held for sale	426	-	-
Loans originated for resale	(4,192 )	(13,579 )	(23,283 )
Proceeds from sale of loans originated for sale	4,296	13,990	23,773
Gain on sale of loans held for sale	(104 )	(493 )	(627 )
Net loss (gains) on the sale of OREO	20	(322 )	(179 )
Losses (gains) on sales of HTM investment securities	1	(11 )	-
Gains on sales of AFS investment securities	(5 )	(8 )	-
Gain on sale of asset	(19 )	(7 )	(11 )
Net amortization of premium/discount on investment securities	245	344	540
Increase in OREO valuation allowance	664	234	601
Increase in cash surrender of bank owned life insurance	(815 )	(671 )	(620 )
Increase (decrease) in deferred income tax benefit	(750 )	1,138	(117 )
Increase in accrued interest receivable	(182 )	(62 )	(70 )
Stock based compensation	319	191	216
Decrease in deferred loan fees	85	265	307
Increase (decrease) in accrued expenses and other liabilities	1,770	(1,060 )	489
Decrease (increase) in other assets	1,523	242	(1,377 )
<b>Net Cash Provided by Operating Activities</b>	<b>12,497</b>	<b>10,633</b>	<b>8,507</b>
<b>Cash Flows from Investing Activities</b>			
Purchase of AFS investment securities	(2,084 )	(3,253 )	(13,517 )
Proceeds from redemption or principal payments of AFS investment securities	8,986	8,111	10,476
Purchase of HTM investment securities	(42,949 )	(16,230 )	(11,683 )
Proceeds from maturities or principal payments of HTM investment securities	17,860	14,020	37,551
Net increase of FHLB and FRB stock	(497 )	(842 )	(117 )
Purchase of bank owned life insurance policies	-	(7,000 )	-
Loans originated or acquired	(258,844)	(261,971)	(275,037)
Principal collected on loans	205,100	193,113	220,810
Purchase of premises and equipment	(3,450 )	(2,355 )	(1,035 )
Proceeds from sale of OREO	1,184	3,742	1,300
Proceeds from sale of HTM investment securities	66	4,153	-
Proceeds from sale of AFS investment securities	-	2,056	-
Proceeds from disposal of asset	34	20	11
<b>Net Cash Used in Investing Activities</b>	<b>(74,594 )</b>	<b>(66,436 )</b>	<b>(31,241 )</b>



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

(dollars in thousands)	Years Ended December 31,		
	2015	2014	2013
<b>Cash Flows from Financing Activities</b>			
Net increase in deposits	\$37,515	\$48,089	\$1,064
Proceeds from long-term debt	-	5,000	15,000
Payments of long-term debt	(19,055)	(804)	(5,051)
Net increase in short term borrowings	34,000	2,000	(1,000)
Exercise of stock options	-	226	317
Proceeds from public offering	-	-	27,387
Proceeds from subordinated notes	23,000	-	-
Redemption of Small Business Lending Fund Preferred Stock	(20,000)	-	-
Dividends paid	(1,916)	(2,055)	(1,579)
Net change in unearned ESOP shares	146	201	355
Repurchase of common stock	(1,827)	-	(536)
Net Cash Provided by Financing Activities	51,863	52,657	35,957
(Decrease) Increase in Cash and Cash Equivalents	\$(10,234)	\$(3,146)	\$13,223
Cash and Cash Equivalents - January 1	21,373	24,519	11,296
Cash and Cash Equivalents - December 31	\$11,139	\$21,373	\$24,519
<b>Supplemental Disclosures of Cash Flow Information</b>			
Cash paid during the period for			
Interest	\$6,799	\$6,661	\$7,648
Income taxes	\$3,604	\$3,732	\$4,069
<b>Supplemental Schedule of Non-Cash Operating Activities</b>			
Issuance of common stock for payment of compensation	\$319	\$182	\$249
Transfer from loans to OREO	\$5,436	\$2,742	\$1,852
Transfer of OREO to loans	\$-	\$1,000	
Transfer from premises and equipment to premises and equipment held for sale	\$2,426	\$-	\$-

*See notes to Consolidated Financial Statements*

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### *Principles of Consolidation*

The Consolidated Financial Statements include the accounts of The Community Financial Corporation and its wholly owned subsidiary Community Bank of the Chesapeake (the “Bank”), and the Bank’s wholly owned subsidiary Community Mortgage Corporation of Tri-County (collectively, the “Company”). All significant intercompany balances and transactions have been eliminated in consolidation. The accounting and reporting policies of the Company conform with accounting principles generally accepted in the United States of America and to general practices within the banking industry.

### *Reclassification*

Certain reclassifications have been made in the Consolidated Financial Statements for 2014 to conform to the classification presented in 2015.

### *Nature of Operations*

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

The Bank conducts business through its main office in Waldorf, Maryland, and eleven branch offices in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick, Lusby, California, Maryland; and Fredericksburg, Virginia. The Company maintains five loan production offices (“LPOs”) in Annapolis, La Plata, Prince Frederick and Leonardtown, Maryland; and Fredericksburg, Virginia. The Leonardtown and Fredericksburg LPOs are co-located with branches. The Company’s second branch in Fredericksburg is scheduled to open during the first quarter of 2016.

The Company agreed to sell its King George, Virginia branch building and equipment to a credit union. The transaction closed in the first quarter of 2016. The Company’s 2015 operating results reflect the financial impact of the transaction. See Note 10 for additional information.

### *Use of Estimates*



In preparing Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the evaluation of other-than-temporary impairment on debt securities, and the valuation of OREO and deferred tax assets.

### ***Significant Group Concentrations of Credit Risk***

Most of the Company's activities are with customers located in the Fredericksburg area of Virginia and the Southern Maryland counties of Calvert, Charles and St. Mary's. Notes 5 and 6 discuss the types of securities and loans held by the Company. The Company does not have significant concentration in any one customer or industry.

### ***Cash and Cash Equivalents***

For purposes of the consolidated statements of cash flows, the Company considers all highly liquid debt instruments with original maturities of three months or less when purchased to be cash equivalents.

### ***Securities***

Debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity ("HTM") and recorded at amortized cost. Securities purchased and held principally for trading in the near term are classified as "trading securities" and are reported at fair value, with unrealized gains and losses included in earnings. The Company held no trading securities for the years ended December 31, 2015, 2014 and 2013. Securities not classified as held to maturity or trading securities, including equity securities with readily determinable fair values, are classified as available for sale ("AFS") and recorded at estimated fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the estimated fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other than temporary impairment losses, management considers: (1) the length of time and the extent to which the fair value has been less than cost; (2) the financial condition and near term prospects of the issuer; and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method. Investments in Federal Reserve Bank and Federal Home Loan Bank of Atlanta stocks are recorded at cost and are considered restricted as to marketability. The Bank is required to maintain investments in the Federal Reserve Bank as a condition of membership and the Federal Home Loan Bank based upon levels of borrowings.

Debt securities are evaluated quarterly to determine whether a decline in their value is other-than-temporary impairment (“OTTI”). The term other-than-temporary is not necessarily intended to indicate a permanent decline in value. It means that the prospects for near term recovery of value are not necessarily favorable, or that there is a lack of evidence to support fair values equal to, or greater than, the carrying value of the investment. Under accounting guidance, for recognition and presentation of other-than-temporary impairments the amount of other-than-temporary impairment that is recognized through earnings for debt securities is determined by comparing the present value of the expected cash flows to the amortized cost of the security. The discount rate used to determine the credit loss is the expected book yield on the security. The Company does not evaluate declines in the value of securities of Government Sponsored Enterprises (“GSEs”) or investments backed by the full faith and credit of the United States government (e.g. US Treasury Bills), for other-than-temporary impairment.

### ***Loans Held for Sale***

Residential mortgage loans intended for sale in the secondary market are carried at the lower of cost or estimated fair value, in the aggregate. Fair value is derived from secondary market quotations for similar instruments. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

Residential mortgage loans held for sale are generally sold with the mortgage servicing rights retained by the Company. The carrying value of mortgage loans sold is reduced by the cost allocated to the associated servicing rights. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold, using the specific identification method.

The Company exited the residential mortgage origination line of business in April 2015 for individual owner occupied residential first mortgages and established third party sources to supply its residential whole loan portfolio. The Company continues to underwrite non-owner occupied residential loans. The Company may sell certain loans forward into the secondary market at a specified price with a specified date on a best efforts basis. These forward sales are derivative financial instruments. The Company does not recognize gains or losses due to interest rate changes for

loans sold forward on a best efforts basis. The Bank had no loans held for sale at December 31, 2015 and 2014, respectively.

### ***Loans Receivable***

The Company originates real estate mortgages, construction and land development loans, commercial loans and consumer loans. A substantial portion of the loan portfolio is comprised of loans throughout Southern Maryland and the Fredericksburg area of Virginia. The ability of the Company's debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loans that the Company has the intent and ability to hold for the foreseeable future, or until maturity or payoff, are reported at their outstanding unpaid principal balances, adjusted for the allowance for loan losses and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

Loans are reviewed on a regular basis and are placed on non-accrual status when, in the opinion of management, the collection of additional interest is doubtful. The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in the process of collection. Non-accrual loans include certain loans that are current with all loan payments and are placed on non-accrual status due to customer operating results and cash flows. Non-accrual loans are evaluated for impairment on a loan-by-loan basis in accordance with the Company's impairment methodology. Interest is recognized on non-accrual loans on a cash-basis.

Consumer loans are typically charged-off no later than 90 days past due. Mortgage and commercial loans are fully or partially charged-off when in management's judgment all reasonable efforts to return a loan to performing status have occurred. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected from loans that are placed on non-accrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

### ***Allowance for Loan Losses and Impaired Loans***

The allowance for loan losses is established as probable losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes that the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the composition and size of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance for loan losses consists of a general and a specific component. The general component is based upon historical loss experience and a review of qualitative risk factors by portfolio segment (See Note 5 for a description of portfolio segments). The historical loss experience factor is tracked over various time horizons for each portfolio segment. It is weighted as the most important factor of the general component of the allowance. The Company considers qualitative factors in addition to the loss experience factor. These include trends by portfolio segment in charge-offs, delinquencies, classified loans, loan concentrations and the rate of portfolio segment growth. Qualitative factors also include an assessment of the current regulatory environment, the quality of credit administration and loan portfolio management and national and local economic trends.

The specific component of the allowance for loan losses relates to individual impaired loans with an identified impairment loss. The Company evaluates substandard and doubtful classified loans, loans delinquent 90 days or greater, non-accrual loans and troubled debt restructured loans ("TDRs") to determine whether a loan is impaired. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral

value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and shortfalls on a case-by-case basis, taking into consideration the circumstances surrounding the loan. These circumstances include the length of the delay, the reasons for the delay, the borrower's payment record and the amount of the shortfall in relation to the principal and interest owed. Loans not impaired are included in the pool of loans evaluated in the general component of the allowance.

If a specific loan is deemed to be impaired it is evaluated for impairment. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral, if the loan is collateral dependent. An allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than carrying value of the loan.

The Company considers all TDRs to be impaired and defines TDRs as loans whose terms have been modified to provide for a reduction or a delay in the payment of either interest or principal because of deterioration in the financial condition of the borrower. A loan extended or renewed at a stated interest rate equal to the current interest rate for new debt with similar risk is not considered a TDR. Once an obligation has been classified as a TDR it continues to be considered a TDR until paid in full or until the debt is refinanced at market rates with no debt forgiveness. TDRs are evaluated for impairment on a loan-by-loan basis in accordance with the Company's impairment methodology. The Company does not participate in any specific government or Company-sponsored loan modification programs. All restructured loan agreements are individual contracts negotiated with a borrower.

### ***Servicing***

Servicing assets are recognized as separate assets when rights are acquired through the purchase or sale of financial assets. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage loans, a portion of the cost of originating the loan is allocated to the servicing based on relative estimated fair value. Estimated fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. Capitalized servicing rights are reported in other assets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

Servicing assets are evaluated for impairment based upon the estimated fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranche. If the Company later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as an increase to income.

Servicing fee income is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal and recorded as income when earned. The amortization of mortgage servicing rights is netted against loan servicing fee income.

### ***Premises and Equipment***

Land is carried at cost. Premises, improvements and equipment are carried at cost, less accumulated depreciation and amortization, computed by the straight-line method over the estimated useful lives of the assets, which are as follows:

Buildings and Improvements: 10 to 50 years

Furniture and Equipment: three to 15 years

Automobiles: five years

Maintenance and repairs are charged to expense as incurred, while improvements that extend the useful life of premises and equipment are capitalized.

***Other Real Estate Owned (“OREO”)***

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lower of cost or estimated fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management, and the assets are carried at the lower of carrying amount or estimated fair value less the cost to sell. Revenues and expenses from operations and changes in the valuation allowance are included in noninterest expense. Gains or losses on disposition are included in noninterest income.

***Transfers of Financial Assets***

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Company; (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets; and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

### ***Advertising Costs***

The Company expenses advertising costs as incurred.

### ***Income Taxes***

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

### ***Off Balance Sheet Credit Related Financial Instruments***

In the ordinary course of business, the Company has entered into commitments to extend credit, including commitments under commercial lines of credit, letters of credit and standby letters of credit. Such financial instruments are recorded when they are funded.

### ***Stock-Based Compensation***

The Company has stock-based incentive arrangements to attract and retain key personnel in order to promote the success of the business. In May 2015, the 2015 Equity Compensation Plan (the "2015 plan") was approved by shareholders, which authorizes the issuance of restricted stock, stock appreciation rights, stock units and stock options to the Board of Directors and key employees. The 2015 plan replaced the 2005 Equity Compensation Plan.

Compensation cost for all stock-based awards is measured at fair value on date of grant and recognized over the vesting period. Such value is recognized as expense over the service period, net of estimated forfeitures. The estimation of stock awards that ultimately vest requires judgment, and to the extent actual results or updated estimates differ from our current estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. The Company considers many factors when estimating expected forfeitures, including types of awards, employee class and historical experience.

The Company and the Bank currently maintain incentive compensation plans which provide for payments to be made in cash or other share-based compensation. The Company has accrued the full amounts due under these plans, but as of year-end, it is not possible to identify the portion that will be paid out in the form of share-based compensation.



***Earnings Per Common Share (“EPS”)***

Basic earnings per common share represent income available to common stockholders, divided by the weighted average number of common shares outstanding during the period. Unencumbered shares held by the Employee Stock Ownership Plan (“ESOP”) are treated as outstanding in computing earnings per share. Shares issued to the ESOP but pledged as collateral for loans obtained to provide funds to acquire the shares are not treated as outstanding in computing earnings per share.

Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock options and are determined using the treasury stock method. The Company excludes from the diluted EPS calculation anti-dilutive options, because the exercise price of the options were greater than the average market price of the common shares.

***Comprehensive Income***

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities, are reported as components of comprehensive income as a separate statement in the Consolidated Statements of Comprehensive Income. Additionally, the Company discloses accumulated other comprehensive income as a separate component in the equity section of the balance sheet.

### ***Recent Accounting Pronouncements***

Financial Accounting Standards Board (“FASB”) Accounting Standards Update (“ASU”) No. 2014-04 - *Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40) - Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. The amendments clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate that are in the process of foreclosure according to local requirements of the applicable jurisdiction. ASU 2014-04 is effective for interim and annual periods beginning after December 15, 2014. The adoption of ASU 2014-04 did not have a material impact on the Company’s consolidated financial statements.

ASU 2014-09 - *Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 states that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This update affects entities that enter into contracts with customers to transfer goods or services or enter into contracts for the transfer of nonfinancial assets, unless those contracts are within the scope of other standards. ASU 2014-09 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted, but not before the original effective date of December 15, 2016. The adoption of this guidance is not expected to have a material impact on the Company’s consolidated financial statements.

ASU 2014-11 - *Transfers and Servicing (Topic 860) - Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*. ASU 2014-11 requires that repurchase-to-maturity transactions be accounted for as secured borrowings consistent with the accounting for other repurchase agreements. In addition, ASU 2014-11 requires separate accounting for repurchase financings, which entails the transfer of a financial asset executed contemporaneously with a repurchase agreement from the same counterparty. ASU 2014-11 requires entities to disclose certain information about transfers accounted for as sales in transactions that are economically similar to repurchase agreements. In addition, ASU 2014-11 requires disclosures related to collateral, remaining contractual term and of the potential risks associated with repurchase agreements, securities lending transactions and repurchase-to-maturity transactions. ASU 2014-11 was effective for the Company on January 1, 2015 and did not have a material impact on the Company’s consolidated financial statements.

ASU 2015-05 - *Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement*. ASU 2015-05 provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The new guidance does not change the accounting for a customer’s accounting for service contracts. ASU No. 2015-05 is effective for

interim and annual reporting periods beginning after December 15, 2015 and is not expected to have a material impact on the Company's consolidated financial statements.

*ASU 2015-16 - Business Combinations (Topic 805) – Simplifying the Accounting for Measurement-Period Adjustments.* ASU 2015-16 requires that adjustments to provisional amounts that are identified during the measurement period of a business combination be recognized in the reporting period in which the adjustment amounts are determined. Furthermore, the income statement effects of such adjustments, if any, must be calculated as if the accounting had been completed at the acquisition date. The portion of the amount recorded in current-period earnings that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. Under previous guidance, adjustments to provisional amounts identified during the measurement period are to be recognized retrospectively. ASU 2015-16 will be effective January 1, 2016 and is not expected to have a significant impact on the Company's consolidated financial statements.

*ASU 2016-1 - Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.* ASU 2016-1, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (viii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale. ASU 2016-1 will be effective on January 1, 2018 and is not expected to have a significant impact on the Company's consolidated financial statements.

## NOTE 2 – ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table presents the components of comprehensive gain (loss) for the years ended December 31, 2015, 2014 and 2013. The Company's comprehensive gains and losses were solely for securities for the years ended December 31, 2015, 2014 and 2013.

(dollars in thousands)	Year Ended December 31, 2015			Year Ended December 31, 2014			Year Ended December 31, 2013		
	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
Net unrealized holding gains (losses) arising during period	\$ 216	\$ 85	\$ 131	\$ 981	\$ 300	\$ 681	\$(1,813 )	\$(617 )	\$(1,196 )
Reclassification adjustments	(6 )	(2 )	(4 )	(3 )	(1 )	(2 )	-	-	-
Other comprehensive gain (loss)	\$ 210	\$ 83	\$ 127	\$ 978	\$ 299	\$ 679	\$(1,813 )	\$(617 )	\$(1,196 )

The following table presents the changes in each component of accumulated other comprehensive loss, net of tax, for the years ended December 31, 2015, 2014 and 2013.

(dollars in thousands)	Year Ended December 31, 2015	Year Ended December 31, 2014	Year Ended December 31, 2013
	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses
Beginning of period	\$ (378 )	\$ (1,057 )	\$ 139
Other comprehensive gain (loss) before reclassifications	131	681	(1,196 )
Amounts reclassified from accumulated other comprehensive income	(4 )	(2 )	-
Net other comprehensive gain (loss)	127	679	(1,196 )
End of period	\$ (251 )	\$ (378 )	\$ (1,057 )

**NOTE 3 – EARNINGS PER SHARE**

Basic earnings per common share represent income available to common shareholders, divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock options and are determined using the treasury stock method. As of December 31, 2015, 2014 and 2013, there were 21,211, 87,435 and 184,201 options, respectively, which were excluded from the calculation as their effect would be anti-dilutive, because the exercise price of the options were greater than the average market price of the common shares. The Company has not granted any stock options since 2007 and all options outstanding at December 31, 2015 were anti-dilutive. Unvested restricted stock is excluded from the calculation of basic earnings per share. At December 31, 2015 there were 37,048 unvested shares of restricted stock. Basic and diluted earnings per share have been computed based on weighted-average common and common equivalent shares outstanding as follows:

(dollars in thousands)	Years Ended December 31,		
	2015	2014	2013
Net Income	\$6,343	\$6,490	\$6,651
Less: dividends paid and accrued on preferred stock	(23 )	(200 )	(200 )
Net income available to common shareholders	\$6,320	\$6,290	\$6,451
Weighted average number of common shares outstanding	4,639,700	4,646,424	3,402,432
Dilutive effect of common stock equivalents	37,048	8,703	24,361
Weighted average number of shares used to calculate diluted EPS	4,676,748	4,655,127	3,426,793

**NOTE 4 – RESTRICTIONS ON CASH AND AMOUNTS DUE FROM BANKS**

The Bank is required to maintain average balances on hand or with the Federal Reserve Bank. At December 31, 2015 and 2014, these reserve balances amounted to \$797,000 and \$500,000, respectively.

**NOTE 5 – SECURITIES**

(dollars in thousands)	December 31, 2015			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Securities available for sale (AFS)				
Asset-backed securities issued by GSEs				
Residential Mortgage Backed Securities ("MBS")	\$22	\$ 4	\$ -	\$ 26
Residential Collateralized Mortgage Obligations ("CMOs")	31,182	39	557	30,664
Corporate equity securities	37	2	-	39
Bond mutual funds	4,289	98	-	4,387
Total securities available for sale	\$35,530	\$ 143	\$ 557	\$ 35,116
Securities held to maturity (HTM)				
Asset-backed securities issued by GSEs				
Residential MBS	\$34,085	\$ 552	\$ 242	\$ 34,395
Residential CMOs	73,492	278	599	73,171
Asset-backed securities issued by Others:				
Residential CMOs	1,093	-	100	993
Total debt securities held to maturity	108,670	830	941	108,559
U.S. government obligations	750	-	-	750
Total securities held to maturity	\$109,420	\$ 830	\$ 941	\$ 109,309

(dollars in thousands)	December 31, 2014			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Securities available for sale (AFS)				
Asset-backed securities issued by GSEs				
Residential MBS	\$33	\$ 4	\$ -	\$ 37
Residential CMOs	38,294	77	830	37,541
Corporate equity securities	37	3	-	40
Bond mutual funds	4,199	122	-	4,321
Total securities available for sale	\$42,563	\$ 206	\$ 830	\$ 41,939
Securities held to maturity (HTM)				
Asset-backed securities issued by GSEs				
Residential MBS	\$19,501	\$ 767	\$ 45	\$ 20,223
Residential CMOs	62,683	379	580	62,482
Asset-backed securities issued by Others:				
Residential CMOs	1,472	-	112	1,360
Total debt securities held to maturity	83,656	1,146	737	84,065

U.S. government obligations	850	-	-	850
Total securities held to maturity	\$84,506	\$ 1,146	\$ 737	\$ 84,915

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



At December 31, 2015, 99% of the asset-backed securities portfolio was rated AAA by Standard & Poor's or the equivalent credit rating from another major rating agency. AFS asset-backed securities issued by GSEs had an average life of 4.39 years and average duration of 4.04 years and are guaranteed by their issuer as to credit risk. HTM asset-backed securities issued by GSEs had an average life of 5.07 years and average duration of 4.58 years and are guaranteed by their issuer as to credit risk.

At December 31, 2014, certain asset-backed securities with an amortized cost of \$37.7 million were pledged to secure certain deposits. At December 31, 2014, asset-backed securities with an amortized cost of \$2.3 million were pledged as collateral for advances from the Federal Home Loan Bank ("FHLB") of Atlanta.

At December 31, 2014, 99% of the asset-backed securities portfolio was rated AAA by Standard & Poor's or the equivalent credit rating from another major rating agency. AFS asset-backed securities issued by GSEs had an average life of 3.66 years and average duration of 3.41 years and are guaranteed by their issuer as to credit risk. HTM asset-backed securities issued by GSEs had an average life of 3.40 years and average duration of 3.21 years and are guaranteed by their issuer as to credit risk.

We believe that AFS securities with unrealized losses will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity. We believe that the losses are the result of general perceptions of safety and creditworthiness of the entire sector and a general disruption of orderly markets in the asset class.

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

No charges related to other-than-temporary impairment were made during for the years ended December 31, 2015, 2014 and 2013.

During the year ended December 31, 2015, the Company recognized net gains on the sale of securities of \$4,000, which consisted of the sale of one HTM security with a carrying value of \$67,000 and the call of an AFS agency bond with a carrying value of \$2.0 million. These sales resulted in a loss of \$1,000 for the HTM security and a gain of \$5,000 for the AFS security. During the year ended December 31, 2014, the Company recognized net gains on the sale of securities of \$19,000. The Company sold five AFS securities with aggregate carrying values of \$2.1 million and 12

HTM securities with aggregate carrying values of \$4.2 million, recognizing gains of \$8,000 and \$11,000, respectively. There were no sales of AFS and HTM securities during the year ended December 31, 2013.

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

***AFS Securities***

Gross unrealized losses and estimated fair value by length of time that the individual AFS securities have been in a continuous unrealized loss position at December 31, 2015 were as follows:

December 31, 2015  (dollars in thousands)	Less Than 12 Months		More Than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
	Asset-backed securities issued by GSEs	\$4,658	\$ 28	\$17,344	\$ 529	\$22,002

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

AFS securities issued by GSEs are guaranteed by the issuer. Total unrealized losses on the asset-backed securities issued by GSEs were \$557,000 of the portfolio amortized cost of \$31.2 million. AFS asset-backed securities issued by GSEs with unrealized losses had an average life of 4.45 years and an average duration of 4.04 years. We believe that the securities will either recover in market value or be paid off as agreed.

Gross unrealized losses and estimated fair value by length of time that the individual AFS securities have been in a continuous unrealized loss position at December 31, 2014 were as follows:

December 31, 2014  (dollars in thousands)	Less Than 12 Months		More Than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
Asset-backed securities issued by GSEs	\$ 294	\$ -	\$26,856	\$ 830	\$27,150	\$ 830

At December 31, 2014, the AFS investment portfolio had an estimated fair value of \$41.9 million, of which \$27.2 million of the securities had some unrealized losses from their amortized cost. The securities with unrealized losses were CMOs issued by GSEs.

AFS securities issued by GSEs are guaranteed by the issuer. Total unrealized losses on the asset-backed securities issued by GSEs were \$830,000 of the portfolio amortized cost of \$38.3 million. AFS asset-backed securities issued by GSEs with unrealized losses had an average life of 3.77 years and an average duration of 3.46 years. We believe that the securities will either recover in market value or be paid off as agreed.

### *HTM Securities*

Gross unrealized losses and estimated fair value by length of time that the individual HTM securities have been in a continuous unrealized loss position at December 31, 2015 were as follows:

December 31, 2015	Less Than 12 Months	More Than 12 Months	Total
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(dollars in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
Asset-backed securities issued by GSEs	\$36,337	\$ 346	\$16,431	\$ 495	\$52,768	\$ 841
Asset-backed securities issued by other	-	-	992	100	992	100
	\$36,337	\$ 346	\$17,423	\$ 595	\$53,760	\$ 941

At December 31, 2015, the HTM investment portfolio had an estimated fair value of \$109.3 million, of which \$53.8 million of the securities had some unrealized losses from their amortized cost. Of these securities, \$52.8 million were asset-backed securities issued by GSEs and the remaining \$992,000 were asset-backed securities issued by others.

HTM securities issued by GSEs are guaranteed by the issuer. Total unrealized losses on the asset-backed securities issued by GSEs were \$841,000 of the portfolio amortized cost of \$107.6 million. HTM asset-backed securities issued by GSEs with unrealized losses had an average life of 5.42 years and an average duration of 4.78 years. We believe that the securities will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity.

HTM asset-backed securities issued by others are collateralized mortgage obligation securities. The securities have credit support tranches that absorb losses prior to the tranches that the Company owns. The Company reviews credit support positions on its securities regularly. Total unrealized losses on the asset-backed securities issued by others were \$100,000 of the portfolio amortized cost of \$1.1 million. HTM asset-backed securities issued by others with unrealized losses have an average life of 4.04 years and an average duration of 3.29 years.

Gross unrealized losses and estimated fair value by length of time that the individual HTM securities have been in a continuous unrealized loss position at December 31, 2014 were as follows:

December 31, 2014 (dollars in thousands)	Less Than 12 Months		More Than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
Asset-backed securities issued by GSEs	\$ 14,508	\$ 85	\$ 21,091	\$ 540	\$ 35,599	\$ 625
Asset-backed securities issued by other	-	-	1,291	112	1,291	112
	\$ 14,508	\$ 85	\$ 22,382	\$ 652	\$ 36,890	\$ 737

At December 31, 2014, the HTM investment portfolio had an estimated fair value of \$84.9 million, of which \$36.9 million of the securities had some unrealized losses from their amortized cost. Of these securities, \$35.6 million were asset-backed securities issued by GSEs and the remaining \$1.3 million were asset-backed securities issued by others.

HTM securities issued by GSEs are guaranteed by the issuer. Total unrealized losses on the asset-backed securities issued by GSEs were \$625,000 of the portfolio amortized cost of \$82.2 million. HTM asset-backed securities issued by GSEs with unrealized losses had an average life of 3.23 years and an average duration of 3.01 years. We believe that the securities will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity.

HTM asset-backed securities issued by others are collateralized mortgage obligation securities. All of the securities have credit support tranches that absorb losses prior to the tranches that the Company owns. The Company reviews credit support positions on its securities regularly. Total unrealized losses on the asset-backed securities issued by others were \$112,000 of the portfolio amortized cost of \$1.5 million. HTM asset-backed securities issued by others with unrealized losses have an average life of 4.27 years and an average duration of 3.62 years.

### *Maturities*

The amortized cost and estimated fair value of debt securities at December 31, 2015 and 2014 by contractual maturity, are shown below. The Company has allocated the asset-backed securities into the four maturity groups listed below using the expected average life of the individual securities based on statistics provided by industry sources. Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties.

December 31, 2015 (dollars in thousands)	Available for Sale		Held to Maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Within one year				
Bond mutual funds	\$4,289	\$ 4,387	\$-	\$-
U.S. government obligations	-	-	750	750
Asset-backed securities				
Within one year	6,075	5,975	21,850	21,828
Over one year through five years	15,355	15,102	50,895	50,843
Over five years through ten years	7,727	7,600	23,259	23,235
After ten years	2,047	2,013	12,666	12,653
Total asset-backed securities	31,204	30,690	108,670	108,559
	\$35,493	\$ 35,077	\$109,420	\$ 109,309

December 31, 2014	Available for Sale		Held to Maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
(dollars in thousands)				
Within one year				
Bond mutual funds	\$4,198	\$ 4,320	\$-	\$ -
U.S. government obligations	-	-	850	850
Asset-backed securities				
Within one year	8,084	7,926	20,647	20,748
Over one year through five years	19,708	19,323	44,575	44,793
Over five years through ten years	8,671	8,501	14,299	14,369
After ten years	1,865	1,829	4,135	4,155
Total asset-backed securities	38,328	37,579	83,656	84,065
	\$42,526	\$ 41,899	\$84,506	\$ 84,915

### *Credit Quality of Asset-Backed Securities*

The tables below present the Standard & Poor's ("S&P") or equivalent credit rating from other major rating agencies for AFS and HTM asset-backed securities and agency bonds issued by GSEs and others at December 31, 2015 and 2014 by carrying value. The Company considers noninvestment grade securities rated BB+ or lower as classified assets for regulatory and financial reporting. GSE asset-backed securities and GSE agency bonds with S&P AA+ ratings were treated as AAA based on regulatory guidance.

December 31, 2015		December 31, 2014	
Credit Rating	Amount	Credit Rating	Amount
(dollars in thousands)			
AAA	\$ 138,267	AAA	\$ 119,762
BBB	-	BBB	68
BB	518	BB	695
BB-	-	BB-	-
B+	575	B+	-
CCC+	-	CCC+	709
Total	\$ 139,360	Total	\$ 121,234

**NOTE 6 – LOANS**

Loans consist of the following:

(dollars in thousands)	December 31, 2015	December 31, 2014
Commercial real estate	\$ 613,479	\$ 561,080
Residential first mortgages	149,967	152,837
Construction and land development	36,189	36,370
Home equity and second mortgages	21,716	21,452
Commercial loans	67,246	73,625
Consumer loans	366	613
Commercial equipment	29,931	26,152
	918,894	872,129
Less:		
Deferred loan fees	1,154	1,239
Allowance for loan losses	8,540	8,481
	9,694	9,720
	\$ 909,200	\$ 862,409

At December 31, 2015 and 2014, the Bank's allowance for loan losses totaled \$8.5 million, or 0.93% and 0.97%, respectively, of loan balances. Management's determination of the adequacy of the allowance is based on a periodic evaluation of the portfolio with consideration given to the overall loss experience, current economic conditions, size, growth and composition of the loan portfolio, financial condition of the borrowers and other relevant factors that, in management's judgment, warrant recognition in providing an adequate allowance.

***Risk Characteristics of Portfolio Segments***

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

***Commercial Real Estate ("CRE")***

Commercial and other real estate projects include office buildings, retail locations, churches, other special purpose buildings and commercial construction. Commercial construction balances were 5.3% and 4.4% of the CRE portfolio at December 31, 2015 and 2014, respectively. The Bank offers both fixed-rate and adjustable-rate loans under these product lines. The primary security on a commercial real estate loan is the real property and the leases that produce income for the real property. Loans secured by commercial real estate are generally limited to 80% of the lower of the appraised value or sales price at origination and have an initial contractual loan payment period ranging from three to



20 years.

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

#### *Residential First Mortgages*

Residential first mortgage loans are generally long-term loans, amortized on a monthly basis, with principal and interest due each month. The contractual loan payment period for residential loans typically ranges from ten to 30 years. The Bank's experience indicates that real estate loans remain outstanding for significantly shorter time periods than their contractual terms. Borrowers may refinance or prepay loans at their option, without penalty. The Bank's residential portfolio has both fixed-rate and adjustable-rate residential first mortgages.

The annual and lifetime limitations on interest rate adjustments may limit the increases in interest rates on these loans. There are also credit risks resulting from potential increased costs to the borrower as a result of repricing of adjustable-rate mortgage loans. During periods of rising interest rates, the risk of default on adjustable-rate mortgage loans may increase due to the upward adjustment of interest cost to the borrower. The Bank's adjustable rate residential first mortgage portfolio was \$33.6 million or 3.7% of gross loans of \$918.9 million at December 31, 2015 compared to \$27.4 million or 3.1% of total gross loans of \$872.1 million at December 31, 2014.

### *Construction and Land Development*

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

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

### *Home Equity and Second Mortgage Loans*

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

### *Commercial Loans*

The Bank offers commercial loans to its business customers. The Bank offers a variety of commercial loan products including term loans and lines of credit. These loans are generally made for terms of five years or less. The Bank offers both fixed-rate and adjustable-rate loans under these product lines. When making commercial business loans,

the Bank considers the financial condition of the borrower, the borrower's payment history of both corporate and personal debt, the projected cash flows of the business, the viability of the industry in which the consumer operates, the value of the collateral, and the borrower's ability to service the debt from income. These loans are primarily secured by equipment, real property, accounts receivable, or other security as determined by the Bank.

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

#### *Consumer Loans*

Consumer loans consist of loans secured by automobiles, boats, recreational vehicles and trucks. The Bank also makes home improvement loans and offers both secured and unsecured personal lines of credit. Consumer loans have greater risk from other loan types due to being secured by rapidly depreciating assets or the reliance on the borrower's continuing financial stability.

#### *Commercial Equipment Loans*

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

*Non-accrual and Past Due Loans*

Non-accrual loans as of December 31, 2015 and December 31, 2014 were as follows:

(dollars in thousands)	December 31, 2015					
	90 or Greater Days Delinquent	Number of Loans	Non-accrual Only Loans	Number of Loans	Total Non-accrual Loans	Total Number of Loans
Commercial real estate	\$3,480	11	\$ -	-	\$ 3,480	11
Residential first mortgages	1,948	7	-	-	1,948	7
Construction and land development	3,555	3	-	-	3,555	3
Home equity and second mortgages	48	3	-	-	48	3
Commercial loans	1,361	8	693	2	2,054	10
Commercial equipment	348	4	-	-	348	4
	\$10,740	36	\$ 693	2	\$ 11,433	38

(dollars in thousands)	December 31, 2014					
	90 or Greater Days Delinquent	Number of Loans	Non-accrual Only Loans	Number of Loans	Total Non-accrual Loans	Total Number of Loans
Commercial real estate	\$3,824	11	\$ -	-	\$ 3,824	11
Residential first mortgages	533	2	-	-	533	2
Construction and land development	3,634	2	-	-	3,634	2
Home equity and second mortgages	399	6	-	-	399	6
Commercial loans	1,587	6	-	-	1,587	6
Commercial equipment	286	4	-	-	286	4
	\$10,263	31	\$ -	-	\$ 10,263	31

Non-accrual loans (90 days or greater delinquent and non-accrual only loans) increased \$1.1 million from \$10.3 million or 1.18% of total loans at December 31, 2014 to \$11.4 million or 1.24% of total loans at December 31, 2015. Non-accrual only loans are loans classified as non-accrual due to customer operating results or payment history. In accordance with the Company's policy, interest income is recognized on a cash basis for these loans.

The Company had 38 non-accrual loans at December 31, 2015 compared to 31 non-accrual loans at December 31, 2014. Non-accrual loans at December 31, 2015 included \$8.1 million, or 71% of non-accrual loans, attributed to 19 loans representing six customer relationships classified as substandard. Non-accrual loans at December 31, 2014 included \$8.8 million, or 86% of nonperforming loans, attributed to 16 loans representing six customer relationships

classified as substandard. Of these loans at December 31, 2015 and December 31, 2014, four loans totaling \$3.8 million and \$3.9 million, respectively, represented a stalled residential development project. During the second quarter of 2014, the Company deferred the collection of principal and interest to enable the project to use available funds to build units and complete the project. The stalled development project loans are considered both troubled debt restructures (“TDRs”) and non-accrual loans. At December 31, 2015, the Company had an additional three TDR loans totaling \$1.7 million classified non-accrual. At December 31, 2014, the Company had one additional TDR loan totaling \$1.0 million that was non-accrual. These loans are classified solely as non-accrual loans for the calculation of financial ratios.

Non-accrual loans on which the recognition of interest has been discontinued, which did not have a specific allowance for impairment, amounted to \$10.5 million and \$9.3 million at December 31, 2015 and 2014, respectively. Interest due but not recognized on these balances at December 31, 2015 and 2014 was \$953,000 and \$781,000, respectively. Non-accrual loans with a specific allowance for impairment on which the recognition of interest has been discontinued amounted to \$902,000 and \$1.0 million at December 31, 2015 and 2014, respectively. Interest due but not recognized on these balances at December 31, 2015 and 2014 was \$34,000 and \$64,000, respectively.

An analysis of past due loans as of December 31, 2015 and 2014 was as follows:

(dollars in thousands)	December 31, 2015				Total Past Due	Total Loan Receivables
	Current	31-60 Days	61-89 Days	90 or Greater Days		
	Commercial real estate	\$609,999	\$-	\$-		
Residential first mortgages	147,720	-	299	1,948	2,247	149,967
Construction and land dev.	32,634	-	-	3,555	3,555	36,189
Home equity and second mtg.	21,603	65	-	48	113	21,716
Commercial loans	65,747	-	138	1,361	1,499	67,246
Consumer loans	365	-	1	-	1	366
Commercial equipment	29,138	152	293	348	793	29,931
Total	\$907,206	\$ 217	\$ 731	\$ 10,740	\$ 11,688	\$ 918,894

(dollars in thousands)	December 31, 2014				Total Past Due	Total Loan Receivables
	Current	31-60 Days	61-89 Days	90 or Greater Days		
	Commercial real estate	\$556,584	\$-	\$672		
Residential first mortgages	151,375	133	796	533	1,462	152,837
Construction and land dev.	32,736	-	-	3,634	3,634	36,370
Home equity and second mtg.	20,939	90	24	399	513	21,452
Commercial loans	71,952	86	-	1,587	1,673	73,625
Consumer loans	612	1	-	-	1	613
Commercial equipment	25,848	17	1	286	304	26,152
Total	\$860,046	\$ 327	\$ 1,493	\$ 10,263	\$ 12,083	\$ 872,129

There were no loans greater than 90 days still accruing interest at December 31, 2015 and 2014, respectively.

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

Impaired loans, including TDRs, at December 31, 2015 and 2014 were as follows:

December 31, 2015

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(dollars in thousands)	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	<b>Total Recorded Investment</b>	Related Allowance	Average Recorded Investment	Interest Income Recognized
Commercial real estate	\$25,429	\$ 22,634	\$ 2,367	\$ 25,001	\$ 602	\$ 25,655	\$ 908
Residential first mortgages	4,747	4,070	676	4,746	66	4,807	177
Construction and land dev.	4,283	3,780	504	4,284	471	4,302	13
Home equity and second mtg.	154	154	-	154	-	163	8
Commercial loans	4,775	4,195	380	4,575	330	4,524	251
Commercial equipment	518	338	139	477	139	491	9
<b>Total</b>	<b>\$39,906</b>	<b>\$ 35,171</b>	<b>\$ 4,066</b>	<b>\$ 39,237</b>	<b>\$ 1,608</b>	<b>\$ 39,942</b>	<b>\$ 1,366</b>

(dollars in thousands)	December 31, 2014		Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance					
Commercial real estate	\$ 31,812	\$ 28,907	\$ 2,622	\$ 31,529	\$ 97	\$ 31,672	\$ 1,258
Residential first mortgages	3,407	2,526	881	3,407	76	3,426	155
Construction and land dev.	6,402	6,102	-	6,102	-	6,474	133
Home equity and second mtg.	708	649	-	649	-	630	19
Commercial loans	7,587	7,030	406	7,436	155	7,196	252
Commercial equipment	605	373	213	586	123	623	23
Total	\$ 50,521	\$ 45,587	\$ 4,122	\$ 49,709	\$ 451	\$ 50,021	\$ 1,840

TDRs, included in the impaired loan schedules above, as of December 31, 2015 and 2014 were as follows:

(dollars in thousands)	December 31, 2015		December 31, 2014	
	Dollars	Number of Loans	Dollars	Number of Loans
Commercial real estate	\$ 11,897	13	\$ 10,438	9
Residential first mortgages	881	3	906	3
Construction and land development	4,283	5	4,376	4
Commercial loans	1,384	7	2,262	6
Commercial equipment	123	2	154	2
Total TDRs	\$ 18,568	30	\$ 18,136	24
Less: TDRs included in non-accrual loans	(5,435 )	(7 )	(4,887 )	(5 )
Total accrual TDR loans	\$ 13,133	23	\$ 13,249	19

At December 31, 2015, the Company had 23 accruing TDRs totaling \$13.1 million compared to 19 accruing TDRs totaling \$13.2 million as of December 31, 2014. The Company had specific reserves of \$1.3 million on nine TDRs totaling \$3.6 million at December 31, 2015 and \$251,000 on five TDRs totaling \$2.5 million at December 31, 2014. Interest income in the amount of \$508,000 and \$563,000 was recognized on outstanding TDR loans for the years ended December 31, 2015 and 2014, respectively.

During the years ended December 31, 2015 and 2014 the Company added 10 TDR loans totaling \$3.2 million and 19 TDR loans totaling \$16.6 million, respectively. TDR disposals, which included payoffs and refinancing with other institutions for the years ended December 31, 2015 and 2014 decreased by four loans or \$2.1 million and eight loans or \$2.4 million, respectively. TDR loan principal curtailment was \$677,000 and \$810,000 for the years ended



December 31, 2015 and 2014, respectively.

During the year ended December 31, 2015, the \$3.2 million of TDRs added consisted primarily of commercial real estate loans. During the year ended December 31, 2014, \$10.1 million of the \$16.6 million of new TDRs added related to concessions granted on two substandard customer loan relationships described below. In the fourth quarter of 2014, the Bank granted concessions on two loan relationships, each of which was classified as substandard. As a result of these concessions, the Bank determined that the loans were TDRs. As such, the loans became impaired and were evaluated for impairment in accordance with Bank policy. The first loan relationship, which totaled \$8.6 million, consisted of commercial real estate and construction loans. The borrower agreed to provide additional collateral to cover most of the deficiency determined as a result of the impairment analysis and the Bank charged-off \$500,000 in principal. The carrying value of the loans at December 31, 2015 and 2014 were \$8.1 million and \$8.2 million, respectively. The second loan relationship, which totaled approximately \$3.8 million, consisted of construction and land development and commercial loans. As a result of the concessions granted and the impairment analysis, the Bank charged-off \$843,000 and took 11 finished residential lots into other real estate owned (“OREO”). At December 31, 2015 and 2014, the carrying value of the loans and the OREO were \$1.4 million and \$1.9 million, respectively and \$486,000 and \$757,000, respectively. Both loan relationships were current and making payments in accordance with their original contract terms before the restructuring occurred. Accordingly, the two loan relationships remained on accrual status at December 31, 2015 and 2014.

**Allowance for Loan Losses**

The following tables detail activity in the allowance for loan losses at and for the years ended December 31, 2015, 2014 and 2013 and loan receivable balances at December 31, 2015, 2014 and 2013. An allocation of the allowance to one category of loans does not prevent the Company's ability to utilize the allowance to absorb losses in a different category. The loan receivables are disaggregated on the basis of the Company's impairment methodology.

(dollars in thousands)	Commercial Real Estate	Residential First Mortgage	Construction and Land Development	Home Equity and Second Mtg.	Commercial Loans	Consumer Loans	Commercial Equipment	Total
At and For the Year Ended December 31, 2015								
Allowance for loan losses:								
Balance at January 1,	\$ 4,076	\$ 1,092	\$ 1,071	\$ 173	\$ 1,677	\$ 3	\$ 389	\$ 8,481
Charge-offs	(78 )	(30 )	-	(100 )	(432 )	-	(818 )	(1,458 )
Recoveries	17	1	32	-	11	-	23	84
Provisions	(133 )	(358 )	-	69	221	(1 )	1,635	1,433
Balance at December 31,	\$ 3,882	\$ 705	\$ 1,103	\$ 142	\$ 1,477	\$ 2	\$ 1,229	\$ 8,540
Ending balance:								
individually evaluated for impairment	\$ 602	\$ 66	\$ 471	\$ -	\$ 330	\$ -	\$ 139	\$ 1,608
Ending balance:								
collectively evaluated for impairment	\$ 3,280	\$ 639	\$ 632	\$ 142	\$ 1,147	\$ 2	\$ 1,090	\$ 6,932
Loan receivables:								
Ending balance	\$ 613,479	\$ 149,967	\$ 36,189	\$ 21,716	\$ 67,246	\$ 366	\$ 29,931	\$ 918,894
Ending balance:								
individually evaluated for impairment	\$ 25,001	\$ 4,746	\$ 4,284	\$ 154	\$ 4,575	\$ -	\$ 477	\$ 39,237
Ending balance:								
collectively evaluated for impairment	\$ 588,478	\$ 145,221	\$ 31,905	\$ 21,562	\$ 62,671	\$ 366	\$ 29,454	\$ 879,657

(dollars in thousands)	Commercial Real Estate	Residential First Mortgage	Construction and Land Development	Home Equity and Second Mtg.	Commercial Loans	Consumer Loans	Commercial Equipment	Total
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At and For the Year  
Ended December 31,  
2014

Allowance for loan  
losses:

Balance at January 1,	\$ 3,525	\$ 1,401	\$ 584	\$ 249	\$ 1,916	\$ 10	\$ 453	\$ 8,138
Charge-offs	(350 )	(94 )	(992 )	(59 )	(1,134 )	(3 )	(10 )	(2,642 )
Recoveries	11	186	84	10	5	11	25	332
Provisions	890	(401 )	1,395	(27 )	890	(15 )	(79 )	2,653
Balance at December 31,	\$ 4,076	\$ 1,092	\$ 1,071	\$ 173	\$ 1,677	\$ 3	\$ 389	\$ 8,481
Ending balance:								
individually evaluated for \$97 impairment		\$ 76	\$ -	\$ -	\$ 155	\$ -	\$ 123	\$ 451
Ending balance:								
collectively evaluated for impairment	\$ 3,979	\$ 1,016	\$ 1,071	\$ 173	\$ 1,522	\$ 3	\$ 266	\$ 8,030
Loan receivables:								
Ending balance	\$ 561,080	\$ 152,837	\$ 36,370	\$ 21,452	\$ 73,625	\$ 613	\$ 26,152	\$ 872,129
Ending balance:								
individually evaluated for impairment	\$ 31,529	\$ 3,407	\$ 6,102	\$ 649	\$ 7,436	\$ -	\$ 586	\$ 49,709
Ending balance:								
collectively evaluated for impairment	\$ 529,551	\$ 149,430	\$ 30,268	\$ 20,803	\$ 66,189	\$ 613	\$ 25,566	\$ 822,420

(dollars in thousands)	Commercial Real Estate	Residential First Mortgage	Construction and Land Development	Home Equity and Second Mtg.	Commercial Loans	Consumer Loans	Commercial Equipment	Total
At and For the Year Ended December 31, 2013								
Allowance for loan losses:								
Balance at January 1,	\$ 4,092	\$ 1,083	\$ 533	\$ 280	\$ 1,948	\$ 19	\$ 292	\$ 8,247
Charge-offs	(140 )	(348 )	(36 )	(111 )	(480 )	(12 )	(35 )	(1,162 )
Recoveries	-	11	1	17	23	3	58	113
Provisions	(427 )	655	86	63	425	-	138	940
Balance at December 31,	\$ 3,525	\$ 1,401	\$ 584	\$ 249	\$ 1,916	\$ 10	\$ 453	\$ 8,138
Ending balance:								
individually evaluated for impairment	\$ 372	\$ 171	\$ 55	\$ -	\$ 304	\$ -	\$ 83	\$ 985
Ending balance:								
collectively evaluated for impairment	\$ 3,153	\$ 1,230	\$ 529	\$ 249	\$ 1,612	\$ 10	\$ 370	\$ 7,153
Loan receivables:								
Ending balance	\$ 476,648	\$ 159,147	\$ 32,001	\$ 21,692	\$ 94,176	\$ 838	\$ 23,738	\$ 808,240
Ending balance:								
individually evaluated for impairment	\$ 18,173	\$ 3,401	\$ 5,666	\$ 207	\$ 10,218	\$ 24	\$ 317	\$ 38,006
Ending balance:								
collectively evaluated for impairment	\$ 458,475	\$ 155,746	\$ 26,335	\$ 21,485	\$ 83,958	\$ 814	\$ 23,421	\$ 770,234

### ***Credit Quality Indicators***

Credit quality indicators as of December 31, 2015 and 2014 were as follows:

### **Credit Risk Profile by Internally Assigned Grade**

(dollars in thousands)	Commercial Real Estate 12/31/2015	Commercial Real Estate 12/31/2014	Construction and Land Dev. 12/31/2015	Construction and Land Dev. 12/31/2014
Unrated	\$ 70,661	\$ 74,955	\$ 4,399	\$ 3,108
Pass	519,330	451,256	27,507	27,160

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Special mention	1,095	4,383	-	-
Substandard	22,393	30,486	3,845	6,102
Doubtful	-	-	438	-
Loss	-	-	-	-
Total	\$ 613,479	\$ 561,080	\$ 36,189	\$ 36,370

(dollars in thousands)	Commercial Loans		Commercial Equipment	
	12/31/2015	12/31/2014	12/31/2015	12/31/2014
Unrated	\$ 11,281	\$ 12,296	\$ 10,074	\$ 7,173
Pass	51,569	53,844	19,610	18,517
Special mention	-	49	-	-
Substandard	4,110	7,436	110	462
Doubtful	286	-	137	-
Loss	-	-	-	-
Total	\$ 67,246	\$ 73,625	\$ 29,931	\$ 26,152

**Credit Risk Profile Based on Payment Activity**

(dollars in thousands)	Residential First Mortgages		Home Equity and Second Mtg.		Consumer Loans	
	12/31/2015	12/31/2014	12/31/2015	12/31/2014	12/31/2015	12/31/2014
Performing	\$ 148,019	\$ 152,304	\$ 21,668	\$ 21,053	\$ 366	\$ 613
Nonperforming	1,948	533	48	399	-	-
Total	\$ 149,967	\$ 152,837	\$ 21,716	\$ 21,452	\$ 366	\$ 613

**Summary of Total Classified Loans**

(dollars in thousands)	12/31/2015	12/31/2014
By Internally Assigned Grade	\$ 31,319	\$ 44,486
By Payment Activity	1,485	2,249
Total Classified	\$ 32,804	\$ 46,735

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

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

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

regulatory and financial reporting.

*Ratings 1 thru 6 - Pass*

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

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

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

*Rating 8 - Substandard*

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

*Rating 9 - Doubtful*

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

*Rating 10 – Loss*

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

*Maturity of Loan Portfolio*

The following table sets forth certain information at December 31, 2015 and 2014 regarding the dollar amount of loans maturing in the Bank’s portfolio based on their contractual terms to maturity. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less.

December 31, 2015 (dollars in thousands)	Due within one year after December 31, 2015	Due after one year through five years from December 31, 2015	Due more than five years from December 31, 2015
Description of Asset			
Real Estate Loans			
Commercial	\$ 53,502	\$ 122,043	\$ 437,934
Residential first mortgage	7,417	31,614	110,936
Construction and land development	27,609	5,025	3,555
Home equity and second mortgage	330	1,134	20,252
Commercial loans	67,246	-	-



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Consumer loans	200	150	16
Commercial equipment	7,899	17,635	4,397
Total loans	\$ 164,203	\$ 177,601	\$ 577,090

December 31, 2014 (dollars in thousands) Description of Asset	Due within one year after December 31, 2014	Due after one year through five years from December 31, 2014	Due more than five years from December 31, 2014
Real Estate Loans			
Commercial	\$ 114,300	\$ 184,317	\$ 262,463
Residential first mortgage	21,110	58,320	73,407
Construction and land development	26,867	9,503	-
Home equity and second mortgage	2,238	6,926	12,288
Commercial loans	73,625	-	-
Consumer loans	303	275	35
Commercial equipment	17,497	5,826	2,829
Total loans	\$ 255,940	\$ 265,167	\$ 351,022

The following table sets forth the dollar amount of all loans due after one year from December 31, 2015 and 2014, which have predetermined interest rates and have floating or adjustable interest rates.

December 31, 2015 (dollars in thousands)			
Description of Asset	Fixed Rates	Floating or Adjustable Rates	Total
Real Estate Loans			
Commercial	\$ 114,570	\$ 445,407	\$559,977
Residential first mortgage	109,041	33,509	142,550
Construction and land development	3,555	5,025	8,580
Home equity and second mortgage	1,806	19,580	21,386
Commercial loans	-	-	-
Consumer loans	166	-	166
Commercial equipment	20,145	1,887	22,032
	\$ 249,283	\$ 505,408	\$754,691

December 31, 2014 (dollars in thousands)			
Description of Asset	Fixed Rates	Floating or Adjustable Rates	Total
Real Estate Loans			
Commercial	\$ 92,367	\$ 354,413	\$446,780
Residential first mortgage	105,082	26,645	131,727
Construction and land development	3,859	5,644	9,503
Home equity and second mortgage	2,362	16,852	19,214
Commercial loans	-	-	-
Consumer loans	310	-	310
Commercial equipment	6,625	2,030	8,655
	\$ 210,605	\$ 405,584	\$616,189

### ***Related Party Loans***

Included in loans receivable were loans made to executive officers and directors of the Bank. These loans were made in the ordinary course of business at substantially the same terms and conditions as those prevailing at the time for comparable transactions with persons not affiliated with the Bank and are not considered to involve more than the normal risk of collectability. For the years ended December 31, 2015, 2014 and 2013, all loans to directors and executive officers of the Bank performed according to original loan terms. Activity in loans outstanding to executive officers and directors are summarized as follows:

(dollars in thousands)	At and For the Years Ended December 31,		
	2015	2014	2013

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Balance, beginning of period	\$ 24,403		\$ 16,601		\$ 6,987
Loans and additions	6,822		407		536
Change in Directors' status	(642	)	8,953		10,077
Repayments	(2,478	)	(1,558	)	(999
Balance, end of period	\$ 28,105		\$ 24,403		\$ 16,601

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**NOTE 7 – LOAN SERVICING**

Loans serviced for others are not reflected in the accompanying balance sheets. The unpaid principal balances of mortgages serviced for others were \$63.0 million and \$68.7 million at December 31, 2015 and 2014, respectively.

Servicing loans for others generally consists of collecting mortgage payments, maintaining escrow accounts, disbursing payments to investors and foreclosure processing. Loan servicing income is recorded on an accrual basis and includes servicing fees from investors and certain charges collected from borrowers, such as late payment fees. The following table presents the activity of the mortgage servicing rights.

(dollars in thousands)	Years Ended December 31,		
	2015	2014	2013
Balance, beginning of the year	\$ 295	\$ 306	\$ 245
Additions	31	102	174
Amortization	(107 )	(113 )	(113 )
Balance, end of the year	\$ 219	\$ 295	\$ 306

**NOTE 8 – OTHER REAL ESTATE OWNED (“OREO”)**

OREO assets are presented net of the allowance for losses. The Company considers OREO as classified assets for regulatory and financial reporting. OREO carrying amounts reflect management’s estimate of the realizable value of these properties incorporating current appraised values, local real estate market conditions and related costs. An analysis of the activity follows.

(dollars in thousands)	Years Ended December 31,		
	2015	2014	2013
Balance at beginning of year	\$5,883	\$6,797	\$6,892
Additions of underlying property	5,436	2,742	1,852
Disposals of underlying property	(1,206)	(2,422)	(1,346)
Transfers of OREO to loans	-	(1,000)	-
Valuation allowance	(664 )	(234 )	(601 )
Balance at end of period	\$9,449	\$5,883	\$6,797

During the year ended December 31, 2015, the Bank recognized \$20,000 in losses on the sale of OREO which consisted of the sale of eight properties for net proceeds of \$1.2 million.

During the year ended December 31, 2014, the Bank recognized \$322,000 in gains on the sale of OREO which consisted of the sale of eight properties for net proceeds of \$3.7 million, which included the financing of \$1.0 million dollars on a residential subdivision that was transferred from OREO to loans during the fourth quarter of 2014. The contracted sales price of \$1.4 million on the residential subdivision qualified for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition".

During the year ended December 31, 2013, the Bank recognized \$179,000 in gains on the sale of OREO which consisted of the sale of six properties for net proceeds of \$1.3 million and net losses of \$46,000 and the recognition of \$225,000 of previously deferred gain from an OREO property that the Bank financed during 2011 that did not initially qualify for full accrual sales treatment. The Bank utilized the cost recovery method (ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition") to account for the sale.

Expenses applicable to OREO assets include the following.

(dollars in thousands)	Years Ended December 31,		
	2015	2014	2013
Valuation allowance	\$ 664	\$ 234	\$ 601
Operating expenses	395	152	186
	\$ 1,059	\$ 386	\$ 787

#### NOTE 9 – PREMISES AND EQUIPMENT AND HELD FOR SALE PREMISES AND EQUIPMENT

A summary of the cost and accumulated depreciation of premises and equipment at December 31, 2015 and 2014 follows:

(dollars in thousands)	December 31,	
	2015	2014
Land	\$4,172	\$5,602
Building and improvements	19,737	18,286
Furniture and equipment	8,310	7,599
Automobiles	382	444
Total cost	32,601	31,931
Less accumulated depreciation	12,445	11,345
Premises and equipment, net	\$20,156	\$20,586

Certain Bank facilities are leased under various operating leases. Rent expense was \$701,000, \$647,000 and \$569,000 for the years ended December 31, 2015, 2014 and 2013, respectively. Future minimum rental commitments under non-cancellable operating leases are as follows at December 31, 2015:

(dollar in thousands)	
2016	\$705
2017	720
2018	585
2019	467
2020	356
Thereafter	3,430
Total	\$6,263

The Company agreed to sell its King George, Virginia branch building and equipment to a credit union. The required conditions were met during the three months ended September 30, 2015 to classify the asset as held for sale (“HFS”) under FASB 360-10-45-9 which addresses accounting and reporting for long-lived assets to be disposed of by sale. FASB ASC 360-10-35-43 states that a long-lived asset classified as HFS should be measured at the lower of carrying amount or fair value less cost to sell. Based on the contracted sales price, the Company recorded an impairment of \$426,000 during the third quarter of 2015. The transaction closed on January 28, 2016.

**NOTE 10 – DEPOSITS**

Deposits consist of the following:

	December 31,	
(dollars in thousands)	2015	2014
Noninterest-bearing demand	\$ 142,771	\$ 122,195
Interest-bearing:		
Demand	120,918	108,350
Money market deposits	219,956	211,929
Savings	47,703	41,499
Certificates of deposit	375,551	385,411
Total interest-bearing	764,128	747,189
<b>Total Deposits</b>	<b>\$906,899</b>	<b>\$869,384</b>

The aggregate amount of certificates of deposit in denominations of \$100,000 or more at December 31, 2015 and 2014 was \$222.3 million and \$216.2 million, respectively. The aggregate amount of certificates of deposit in denominations of \$250,000 or more at December 31, 2015, and 2014 was \$98.6 million and \$83.9 million, respectively.

At December 31, 2015 and 2014, the scheduled contractual maturities of certificates of deposit are as follows:

	December 31,	
(dollars in thousands)	2015	2014
Within one year	\$230,559	\$240,648
Year 2	96,098	87,959
Year 3	32,975	40,675
Year 4	5,454	10,042
Year 5	10,465	6,087
	\$375,551	\$385,411



**NOTE 11 – SHORT-TERM BORROWINGS AND LONG-TERM DEBT**

The Bank's long-term debt and short-term borrowings consist of advances from the FHLB of Atlanta. The Bank classifies debt based upon original maturity and does not reclassify debt to short-term status during its life. Long-term debt and short-term borrowings include fixed-rate long-term advances, short-term advances, daily advances, fixed-rate convertible advances, and variable-rate convertible advances.

Rates and maturities on long-term advances and short-term borrowings were as follows:

	Fixed- Rate	Fixed-Rate Convertible	Variable Convertible
December 31, 2015			
Highest rate	2.83 %	3.47 %	4.00 %
Lowest rate	0.26 %	3.47 %	4.00 %
Weighted average rate	1.07 %	3.47 %	4.00 %
Matures through	2036	2018	2020
December 31, 2014			
Highest rate	3.99 %	3.47 %	4.00 %
Lowest rate	0.31 %	3.47 %	4.00 %
Weighted average rate	1.80 %	3.47 %	4.00 %
Matures through	2036	2018	2020

Average rates of long-term debt and short-term borrowings were as follows:

(dollars in thousands)	At or for the Year Ended December 31,		
	2015	2014	2013
Long-term debt			
Long-term debt outstanding at end of period	\$ 55,617	\$ 74,672	\$ 70,476
Weighted average rate on outstanding long-term debt	2.47 %	2.35 %	2.49 %
Maximum outstanding long-term debt of any month end	74,668	75,471	70,519
Average outstanding long-term debt	68,924	74,714	68,996
Approximate average rate paid on long-term debt	2.26 %	2.39 %	2.53 %
Short-term borrowings			
Short-term borrowings outstanding at end of period	\$ 36,000	\$ 2,000	\$ -

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Weighted average rate on short-term borrowings	0.38	%	0.31	%	0.00	%
Maximum outstanding short-term borrowings at any month end	36,000		15,000		24,000	
Average outstanding short-term borrowings	13,463		4,344		4,278	
Approximate average rate paid on short-term borrowings	0.27	%	0.28	%	0.33	%

The Bank's fixed-rate debt generally consists of advances with monthly interest payments and principal due at maturity.

The Bank's fixed-rate convertible long-term debt is callable by the issuer, after an initial period ranging from six months to five years. The instruments are callable at the end of the initial period. As of December 31, 2015 and 2014, all fixed-rate convertible debt has passed its call date. All advances have a prepayment penalty, determined based upon prevailing interest rates.

Variable convertible advances have an initial variable rate based on a discount to LIBOR. Variable convertible debt is scheduled to mature in 2020. As of December 31, 2015 and 2014, all variable convertible debt has passed its call date and is fixed at 4.0%.

During the year ended December 31, 2015, the Bank paid off \$19.0 million of maturing long-term debt. There were no long-term advances added during the year ended December 31, 2015. During the year ended December 31, 2014, the Bank added \$2.0 million and \$5.0 million fixed-rate advances maturing in 2015 and 2016 at rates of 0.31% and 0.52%, respectively. Additionally, the Bank paid off a \$750,000 maturing five year fixed-rate advance. During the year ended December 31, 2013, the Bank added \$10.0 million and \$5.0 million fixed-rate advances maturing in 2017 and 2015 at rates of 0.87% and 0.41%, respectively.

At December 31, 2015 and 2014, \$55.6 million or 100% and \$74.7 million or 100%, respectively, of the Bank's long-term debt was fixed for rate and term, as the conversion optionality of the advances have either been exercised or expired. The contractual maturities of long-term debt were as follows at December 31, 2015 and 2014:

(dollars in thousands)	December 31, 2015			Total
	Fixed-Rate	Fixed-Rate Convertible	Variable Convertible	
Due in 2016	\$5,000	\$ -	\$ -	\$5,000
Due in 2017	20,000	-	-	20,000
Due in 2018	-	10,000	-	10,000
Due in 2019	-	-	-	-
Due in 2020	-	-	10,000	10,000
Thereafter	10,617	-	-	10,617
	\$35,617	\$ 10,000	\$ 10,000	\$55,617

(dollars in thousands)	December 31, 2014			Total
	Fixed-Rate	Fixed-Rate Convertible	Variable Convertible	
Due in 2015	\$19,000	\$ -	\$ -	\$19,000
Due in 2016	5,000	-	-	5,000
Due in 2017	20,000	-	-	20,000
Due in 2018	-	10,000	-	10,000
Due in 2019	-	-	-	-
Thereafter	10,672	-	10,000	20,672
	\$54,672	\$ 10,000	\$ 10,000	\$74,672

The Bank also has daily advances outstanding and short-term advances with terms of less than one year, which are classified as short-term borrowings. Daily advances are repayable at the Bank's option at any time and are re-priced daily. Daily advances were \$7.0 million at December 31, 2015. There were no daily advances outstanding at December 31, 2014. The Bank had short-term advances of \$29.0 million and \$2.0 million, respectively, at December 31, 2015 and 2014.

Under the terms of an Agreement for Advances and Security Agreement with Blanket Floating Lien (the “Agreement”), the Bank maintains collateral with the FHLB consisting of one-to four-family residential first mortgage loans, second mortgage loans, commercial real estate and securities. The Agreement limits total advances to 30% of assets, which were \$332.8 million and \$312.2 million at December 31, 2015 and 2014, respectively.

At December 31, 2015, \$365.4 million of loans and securities were pledged or in safekeeping at the FHLB. Loans and securities are subject to collateral eligibility rules and are adjusted for market value and collateral value factors to arrive at lendable collateral values. At December 31, 2015, FHLB lendable collateral was valued at \$277.2 million. At December 31, 2015, the Bank had total lendable pledged collateral at the FHLB of \$165.8 million of which \$74.2 million was available to borrow in addition to outstanding advances of \$91.6 million. Unpledged lendable collateral was \$111.4 million, bringing total available borrowing capacity to \$185.6 million at December 31, 2015.

At December 31, 2014, \$345.0 million of loans and securities were pledged or in safekeeping at the FHLB. Loans and securities are subject to collateral eligibility rules and are adjusted for market value and collateral value factors to arrive at lendable collateral values. At December 31, 2014, FHLB lendable collateral was valued at \$265.3 million. At December 31, 2014, the Bank had total lendable pledged collateral at the FHLB of \$188.0 million of which \$111.3 million was available to borrow in addition to outstanding advances of \$76.7 million. Unpledged lendable collateral was \$77.3 million, bringing total available borrowing capacity to \$188.6 million at December 31, 2014.

Additionally, the Bank has established a short-term credit facility with the Federal Reserve Bank of Richmond under its Borrower in Custody program. The Bank had segregated collateral sufficient to draw \$7.2 million and \$10.8 million under this agreement at December 31, 2015 and 2014, respectively. In addition, the Bank has established short-term credit facilities with other commercial banks totaling \$12.0 million at December 31, 2015 and 2014. No amounts were outstanding under the Borrower in Custody or commercial lines at December 31, 2015 and 2014.

## NOTE 12 – INCOME TAXES

Allocation of federal and state income taxes between current and deferred portions is as follows:

(dollars in thousands)	Years Ended December 31,		
	2015	2014	2013
Current			
Federal	\$ 3,255	\$ 2,005	\$ 3,043
State	1,128	699	845
	4,383	2,704	3,888
Deferred			
Federal	(643 )	926	(94 )
State	(107 )	146	(23 )
	(750 )	1,072	(117 )
Income Tax Expense	\$ 3,633	\$ 3,776	\$ 3,771

The reasons for the differences between the statutory federal income tax rate and the effective tax rates are summarized as follows:

(dollars in thousands)	Years Ended December 31,		
	2015	2014	2013
	Amount	Amount	Amount

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	Percent of Pre-Tax Income			Percent of Pre-Tax Income			Percent of Pre-Tax Income		
Expected income tax expense at federal tax rate	\$3,392	34.00	%	\$3,490	34.00	%	\$3,544	34.00	%
State taxes net of federal benefit	647	6.49	%	604	5.88	%	577	5.54	%
Nondeductible expenses	40	0.40	%	39	0.38	%	35	0.34	%
Nontaxable income	(398 )	(3.99 )	%	(345 )	(3.36 )	%	(340 )	(3.26 )	%
Other	(48 )	(0.48 )	%	(12 )	(0.12 )	%	(45 )	(0.43 )	%
	\$3,633	36.42	%	\$3,776	36.78	%	\$3,771	36.18	%

The net deferred tax assets in the accompanying balance sheets include the following components:

(dollars in thousands)	December 31,	
	2015	2014
Deferred tax assets		
Deferred fees	\$ 168	\$-
Allowance for loan losses	3,369	3,346
Deferred compensation	2,332	2,181
OREO valuation allowance & expenses	507	308
Unrealized loss on investment securities	163	246
Other	442	228
	6,981	6,309
Deferred tax liabilities		
FHLB stock dividends	156	156
Depreciation	56	51
	212	207
Net Deferred Tax Assets	\$6,769	\$6,102

Retained earnings at December 31, 2015 and 2014 included approximately \$1.2 million of bad debt deductions allowed for federal income tax purposes (the “base year tax reserve”) for which no deferred income tax has been recognized. If, in the future, this portion of retained earnings is used for any purpose other than to absorb bad debt losses, it would create income for tax purposes only and income taxes would be imposed at the then prevailing rates. The unrecorded income tax liability on the above amount was approximately \$463,000 at December 31, 2015 and 2014.

The Company does not have uncertain tax positions that are deemed material and did not recognize any adjustments for unrecognized tax benefits. The Company’s policy is to recognize interest and penalties on income taxes as a component of tax expense. The Company is no longer subject to U.S. Federal tax examinations by tax authorities for years before 2012.

### NOTE 13 – COMMITMENTS AND CONTINGENCIES

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments are commitments to extend credit. These instruments may, but do not necessarily, involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the balance sheets. The Bank’s exposure to credit loss in the event of nonperformance by the other party to the financial instrument is represented by the contractual amount of those instruments. The Bank uses

the same credit policies in making commitments as it does for on-balance-sheet loans receivable.

As of December 31, 2015 and 2014, the Bank had outstanding loan commitments of approximately \$73.5 million and \$36.3 million, respectively.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. These guarantees are issued primarily to support construction borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds cash or a secured interest in real estate as collateral to support those commitments for which collateral is deemed necessary. Standby letters of credit outstanding amounted to \$21.4 million and \$16.9 million at December 31, 2015 and 2014, respectively. In addition to the commitments noted above, customers had approximately \$128.8 million and \$114.7 million available under lines of credit at December 31, 2015 and 2014, respectively.



**NOTE 14 – STOCK-BASED COMPENSATION**

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

Stock-based compensation expense totaled \$319,000, \$191,000 and \$216,000 for the years ended December 31, 2015, 2014 and 2013, respectively, which consisted of grants of restricted stock and restricted stock units. Stock-based compensation for the years ended December 31, 2013 included director compensation of \$3,000 for stock granted in lieu of cash compensation.

All outstanding options were fully vested at December 31, 2015 and 2014. The Company has not granted any stock options since 2007. The fair value of the Company’s outstanding employee stock options is estimated on the date of grant using the Black-Scholes option pricing model. The Company estimates expected market price volatility and expected term of the options based on historical data and other factors.

The exercise price for options granted is set at the discretion of the committee administering the Plan, but is not less than the market value of the shares as of the date of grant. An option’s maximum term is 10 years and the options vest at the discretion of the committee.

The following tables below summarize outstanding and exercisable options at December 31, 2015 and 2014.

(dollars in thousands, except per share amounts)	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted- Average Contractual Life Remaining In Years
Outstanding at January 1, 2015	87,436	\$ 23.60	\$ -	
Expired	(66,225)	22.29		
Outstanding at December 31, 2015	21,211	\$ 27.70	\$ -	1.0

Exercisable at December 31, 2015	21,211	\$ 27.70	\$ -	1.0
		Weighted		Weighted-
		Average	Aggregate	Average
		Exercise	Intrinsic	Contractual Life
(dollars in thousands, except per share amounts)	Shares	Price	Value	Remaining In
				Years
Outstanding at January 1, 2014	159,517	\$ 20.12	\$ 347	
Exercised	(45,163 )	15.89	207	
Forfeited	(26,918 )	15.89		
Outstanding at December 31, 2014	87,436	\$ 23.60	\$ -	1.4
Exercisable at December 31, 2014	87,436	\$ 23.60	\$ -	1.4

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

Shares	Weighted Average	Weighted
Outstanding	Remaining Contractual Life	Average
December		Exercise
31, 2015		Price
21,211	1 year	\$ 27.70

The aggregate intrinsic value of outstanding stock options and exercisable stock options was \$0 at December 31, 2015 and 2014 because all options outstanding were anti-dilutive. Aggregate intrinsic value represents the difference between the Company's closing stock price on the last trading day of the period, which was \$20.96 and \$20.07 per share at December 31, 2015 and 2014, respectively, and the exercise price multiplied by the number of options outstanding.

The Company has outstanding restricted stock and stock units granted in accordance with the Plan. The following tables summarize the unvested restricted stock awards and units outstanding at December 31, 2015 and 2014, respectively.

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

	Restricted Stock		Restricted Stock Units	
	Number of Shares	Weighted Average Grant Date Fair Value	Number of Units	Fair Value
Nonvested at January 1, 2014	16,832	\$ 17.86	4,210	\$ 20.71
Granted	33,460	21.35	-	-
Vested	(20,820)	19.26	(4,210 )	20.28
Nonvested at December 31, 2014	29,472	\$ 20.83	-	\$ -

#### NOTE 15 – EMPLOYEE BENEFIT PLANS

The Company has an Employee Stock Ownership Plan (“ESOP”) that covers substantially all its employees. Employees qualify to participate after one year of service and vest in allocated shares after three years of service. The ESOP acquires stock of The Community Financial Corporation by purchasing shares. Dividends on ESOP shares are recorded as a reduction of retained earnings. Contributions are made at the discretion of the Board of Directors. ESOP contributions recognized for the years ended 2015, 2014 and 2013 totaled \$129,000, \$141,000 and \$262,000,

respectively. As of December 31, 2015 and 2014, the ESOP held 214,819 and 205,612 allocated shares and 19,044 and 29,362 unallocated shares. The approximate market values of the shares were \$4.9 million and \$4.7 million, respectively as of December 31, 2015 and 2014. The estimated value was determined using the Company's closing stock price of \$20.96 and \$20.07 per share as of December 31, 2015 and 2014, respectively.

The ESOP has promissory notes with the Company of \$316,000 and \$489,000 at December 31, 2015 and 2014, respectively. The promissory notes were originated for the purchase of TCFC common stock for the benefit of the participants in the Plan. Loan terms are at prime rate plus one-percentage point and amortize over seven (7) years. As principal is repaid, common shares are allocated to participants based on the participant account allocation rules described in the Plan. The Bank is a guarantor of the ESOP debt with the Company.

The Company also has a 401(k) plan. The Company matches a portion of the employee contributions. This ratio is determined annually by the Board of Directors. In 2015, 2014 and 2013, the Company matched one-half of the first 8% of the employee's contribution. Employees who have completed six months of service are covered under this defined contribution plan. Employee's vest in the Company's matching contributions after three years of service. Contributions are determined at the discretion of the Board of Directors. For the years ended December 31, 2015, 2014 and 2013, the expense recorded for this plan totaled \$332,000, \$324,000 and \$336,000, respectively.

The Company has a separate nonqualified retirement plan for non-employee directors. Directors are eligible for a maximum benefit of \$3,500 a year for ten years following retirement from the Board of Community Bank of the Chesapeake. The maximum benefit is earned at 15 years of service as a non-employee director. Full vesting occurs after two years of service. Expense recorded for this plan was \$22,000, \$21,000 and \$20,000 for the years ended December 31, 2015, 2014 and 2013, respectively.

In addition, the Company has established individual supplemental retirement plans and life insurance benefits for certain key executives and officers of the Bank. These plans and benefits provide a retirement income payment for 15 years from the date of the employee's expected retirement date. The payments are set at the discretion of the Board of Directors and vesting occurs ratably from the date of employment to the expected retirement date. Expense recorded for this plan totaled \$519,000, \$441,000 and \$395,000 for 2015, 2014 and 2013, respectively.

**NOTE 16 – GUARANTEED PREFERRED BENEFICIAL INTEREST IN JUNIOR SUBORDINATED DEBENTURES (“TRUPs”)**

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

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

**NOTE 17 – SUBORDINATED NOTES**

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

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

of each year, commencing August 15, 2015, through February 15, 2020, and thereafter February 15, May 15, August 15 and November 15 of each year through the maturity date or earlier redemption date.

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

**NOTE 18 – REGULATORY CAPITAL**

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

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

As of December 31, 2015, the Company and Bank were well-capitalized under the regulatory framework for prompt corrective action under the new Basel III Capital Rules. Management believes, as of December 31, 2015 and 2014, that the Company and the Bank met all capital adequacy requirements to which they were subject. The Company's and the Bank's actual regulatory capital amounts and ratios are presented in the following table.

Regulatory Capital and Ratios (dollars in thousands)	The Company		The Bank	
	December 31, 2015	December 31, 2014	December 31, 2015	December 31, 2014
Common Equity	\$ 99,783	\$ 96,559	\$ 132,571	\$ 126,838
Preferred Stock -SBLF	-	20,000	-	-
Total Stockholders' Equity	99,783	116,559	132,571	126,838
AOCI Losses (Gains)	251	378	251	378
Common Equity Tier 1 Capital	100,034	116,937	132,822	127,216



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TRUPs	12,000	12,000	-	-
Tier 1 Capital	112,034	128,937	132,822	127,216
Allowable Reserve for Credit Losses and Other Tier 2 Adjustments	8,540	8,537	8,540	8,537
Subordinated Notes	23,000	-	-	-
Tier 2 Capital	\$ 143,574	\$ 137,474	\$ 141,362	\$ 135,753
Risk-Weighted Assets ("RWA")	\$ 984,614	\$ 903,931	\$ 982,347	\$ 902,136
Average Assets ("AA")	\$ 1,118,843	\$ 1,053,424	\$ 1,116,576	\$ 1,051,627

**2019 Regulatory  
Min. Ratio + CCB  
(1)**

Common Tier 1 Capital to RWA <sup>(2)</sup>	7.00	%	10.16	%	n/a	%	13.52	%	n/a	%
Tier 1 Capital to RWA	8.50		11.38		14.26		13.52		14.10	
Tier 2 Capital to RWA	10.50		14.58		15.21		14.39		15.05	
Tier 1 Capital to AA (Leverage)	<i>n/a</i>		10.01		12.24		11.90		12.10	

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

(2) The Common Tier 1 ratio became effective for regulatory reporting purposes when the Company and the Bank became subject to the new Basel III Capital Rules during the three months ended March 31, 2015.

## NOTE 19 – FAIR VALUE MEASUREMENTS

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

FASB ASC Topic 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC Topic 820 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

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

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

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

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

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

Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Company's monthly or quarterly valuation process.

There were no transfers between levels of the fair value hierarchy and the Company had no Level 3 fair value assets or liabilities for the years ended December 31, 2015 and 2014, respectively.

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

#### *Securities Available for Sale*

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

### ***Loans Receivable***

The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Management estimates the fair value of impaired loans using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At December 31, 2015 and 2014, substantially all of the impaired loans were evaluated based upon the fair value of the collateral. In accordance with FASB ASC 820, impaired loans where an allowance is established based on the fair value of collateral (loans with impairment) require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.

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

Premises and equipment are adjusted to fair value upon transfer of the assets to held for sale. Subsequently, premises and equipment held for sale are carried at the lower of carrying value or fair value. Fair value is based upon independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price (e.g., contracted sales price) or a current appraised value, the Company records the assets as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the asset at nonrecurring Level 3.

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

OREO is adjusted for fair value upon transfer of the loans to foreclosed assets. Subsequently, OREO is carried at the lower of carrying value and fair value. Fair value is based upon independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset at nonrecurring Level 3.

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

The tables below present the recorded amount of assets as of December 31, 2015 and December 31, 2014 measured at fair value on a recurring basis.

(dollars in thousands)	December 31, 2015			
	Fair Value	Level 1	Level 2	Level 3
Description of Asset				
Available for sale securities				
Asset-backed securities issued by GSEs				
CMOs	\$30,664	\$ -	\$30,664	\$ -
MBS	26	-	26	-
Corporate equity securities	39	-	39	-
Bond mutual funds	4,387	-	4,387	-
Total available for sale securities	\$35,116	\$ -	\$35,116	\$ -

(dollars in thousands)	December 31, 2014			
	Fair Value	Level 1	Level 2	Level 3
Description of Asset				
Available for sale securities				
Asset-backed securities issued by GSEs				
CMOs	\$37,541	\$ -	\$37,541	\$ -
MBS	37	-	37	-
Corporate equity securities	40	-	40	-
Bond mutual funds	4,321	-	4,321	-
Total available for sale securities	\$41,939	\$ -	\$41,939	\$ -

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

The Company may be required from time to time to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. GAAP. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Assets measured at fair value on a nonrecurring basis as of December 31, 2015 and 2014 are included in the tables below.

(dollars in thousands)	December 31, 2015			
Description of Asset	Fair Value	Level 1	Level 2	Level 3
Loans with impairment				
Commercial real estate	\$1,765	\$ -	\$1,765	\$ -
Residential first mortgages	610	-	610	-
Construction and land development	33	-	33	-
Commercial loans	50	-	50	-
Total loans with impairment	\$2,458	\$ -	\$2,458	\$ -
Premises and equipment held for sale	\$2,000	\$ -	\$2,000	\$ -
Other real estate owned	\$9,449	\$ -	\$9,449	\$ -

(dollars in thousands)	December 31, 2014			
Description of Asset	Fair Value	Level 1	Level 2	Level 3
Loans with impairment				
Commercial real estate	\$2,524	\$ -	\$2,524	\$ -
Residential first mortgage	805	-	805	-
Commercial loans	251	-	251	-
Commercial equipment	90	-	90	-
Total loans with impairment	\$3,670	\$ -	\$3,670	\$ -
Other real estate owned	\$5,883	\$ -	\$5,883	\$ -

Loans with impairment have unpaid principal balances of \$4.0 million and \$4.1 million at December 31, 2015 and 2014, respectively, and include impaired loans with a specific allowance.

**NOTE 20 – FAIR VALUE OF FINANCIAL INSTRUMENTS**

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

### **Valuation Methodology**

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

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

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

*Loans receivable* - For conforming residential first-mortgage loans, the market price for loans with similar coupons and maturities was used. For nonconforming loans with maturities similar to conforming loans, the coupon was adjusted for credit risk. Loans that did not have quoted market prices were priced using the discounted cash flow method. The discount rate used was the rate currently offered on similar products. Loans priced using the discounted cash flow method included residential construction loans, commercial real estate loans and consumer loans.

*Loans held for sale* – Fair values are derived from secondary market quotations for similar instruments. There were no loans held for sale at December 31, 2015 and 2014.

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

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

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

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

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

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

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



December 31, 2015		Fair Value Measurements			
<b>Description of Asset</b> (dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Assets</b>					
Investment securities - AFS	\$35,116	\$35,116	\$ -	\$ 35,116	\$ -
Investment securities - HTM	109,420	109,309	750	108,559	-
FHLB and FRB Stock	6,931	6,931	-	6,931	-
Loans Receivable	909,200	913,506	-	913,506	-
Investment in BOLI	27,836	27,836	-	27,836	-
<b>Liabilities</b>					
Savings, NOW and money market accounts	\$531,348	\$531,348	\$ -	\$ 531,348	\$ -
Time deposits	375,551	375,376	-	375,376	-
Long-term debt	55,617	56,987	-	56,987	-
Short term borrowings	36,000	36,000	-	36,000	-
TRUPs	12,000	8,400	-	8,400	-
Subordinated notes	23,000	23,000	-	23,000	-

December 31, 2014		Fair Value Measurements			
Description of Asset (dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Assets</b>					
Investment securities - AFS	\$41,939	\$41,939	\$ -	\$ 41,939	\$ -
Investment securities - HTM	84,506	84,915	850	84,065	-
FHLB and FRB Stock	6,434	6,434	-	6,434	-
Loans Receivable	862,409	861,427	-	861,427	-
Investment in BOLI	27,021	27,021	-	27,021	-
<b>Liabilities</b>					
Savings, NOW and money market accounts	\$483,973	\$483,973	\$ -	\$ 483,973	\$ -
Time deposits	385,411	386,510	-	386,510	-
Long-term debt	74,672	77,919	-	77,919	-
Short term borrowings	2,000	2,000	-	2,000	-
TRUPs	12,000	7,400	-	7,400	-

At December 31, 2015 and 2014, the Company had outstanding loan commitments and standby letters of credit of \$73.5 million and \$36.3 million, respectively, and \$21.4 million and \$16.9 million, respectively. Based on the short-term lives of these instruments, the Company does not believe that the fair value of these instruments differs significantly from their carrying values.

The fair value estimates presented herein are based on pertinent information available to management as of December 31, 2015 and 2014, respectively. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date and, therefore, current estimates of fair value may differ significantly from the amount presented herein.

**NOTE 21 – CONDENSED FINANCIAL STATEMENTS – PARENT COMPANY ONLY**

## Balance Sheets

(dollars in thousands)	December 31,	
	2015	2014
<b>Assets</b>		
Cash - noninterest bearing	\$1,541	\$1,064
Investment in wholly owned subsidiaries	132,943	127,210
Other assets	1,895	1,423
<b>Total Assets</b>	<b>\$136,379</b>	<b>\$129,697</b>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities	\$1,224	\$766
Guaranteed preferred beneficial interest in junior subordinated debentures	12,372	12,372
Subordinated notes - 6.25%	23,000	-
<b>Total Liabilities</b>	<b>36,596</b>	<b>13,138</b>
<b>Stockholders' Equity</b>		
Preferred Stock - Series C	-	20,000
Common stock	46	47
Additional paid in capital	46,809	46,416
Retained earnings	53,495	50,936
Accumulated other comprehensive loss	(251 )	(378 )
Unearned ESOP shares	(316 )	(462 )
<b>Total Stockholders' Equity</b>	<b>99,783</b>	<b>116,559</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$136,379</b>	<b>\$129,697</b>

## Condensed Statements of Income

(dollars in thousands)	Years Ended December 31,		
	2015	2014	2013
<b>Interest and Dividend Income</b>			
Dividends from subsidiary	\$2,775	\$3,500	\$-
Interest income	51	6	46
Interest expense	1,599	312	305
<b>Net Interest Income (Expense)</b>	<b>1,227</b>	<b>3,194</b>	<b>(259 )</b>
Miscellaneous expenses	(1,421)	(1,427)	(825 )
<b>Income (Loss) before income taxes and equity in undistributed net income of subsidiary</b>	<b>(194 )</b>	<b>1,767</b>	<b>(1,084)</b>
Federal and state income tax benefit	1,009	589	368
Equity in undistributed net income of subsidiary	5,528	4,134	7,367
<b>Net Income</b>	<b>\$6,343</b>	<b>\$6,490</b>	<b>\$6,651</b>
Preferred stock dividends	23	200	200

Net Income Available to Common Shareholders	\$6,320	\$6,290	\$6,451
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## Condensed Statements of Cash Flows

(dollars in thousands)	Years Ended December 31,		
	2015	2014	2013
Cash Flows from Operating Activities			
Net income	\$6,343	\$6,490	\$6,651
Adjustments to reconcile net income to net cash provided by operating activities			
Equity in undistributed earnings of subsidiary	(5,528 )	(4,134 )	(7,367 )
Stock based compensation	139	191	216
(Increase) Decrease in other assets	(284 )	(259 )	1,730
Decrease (Increase) deferred income tax benefit	23	162	(26 )
(Decrease) Increase in current liabilities	459	(145 )	67
Net Cash Provided by Operating Activities	1,152	2,305	1,271
Cash Flows from Financing Activities			
Dividends paid	(1,916 )	(2,055 )	(1,579 )
Proceeds from public offering	-	-	27,387
Downstream of capital to subsidiary	(78 )	(15 )	(27,474)
Proceeds from Subordinated Notes	23,000	-	-
Redemption of Small Business Lending Fund Preferred Stock	(20,000)	-	-
Exercise of stock options	-	226	317
Net change in ESOP loan	146	201	355
Repurchase of common stock	(1,827 )	-	(536 )
Net Cash Used in Financing Activities	(675 )	(1,643 )	(1,530 )
Increase (Decrease) in Cash	477	662	(259 )
Cash at Beginning of Year	1,064	402	661
Cash at End of Year	\$1,541	\$1,064	\$402

**NOTE 22 – QUARTERLY FINANCIAL COMPARISON (Unaudited)**

(dollars in thousands)	2015			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest and dividend income	\$11,208	\$11,002	\$10,935	\$10,728
Interest expense	1,860	1,918	1,902	1,665
Net interest income	9,348	9,084	9,033	9,063
Provision for loan losses	362	501	392	178
Net interest income after provision	8,986	8,583	8,641	8,885
Noninterest income	909	466	962	962
Noninterest expense	7,556	7,031	6,888	6,943
Income before income taxes	2,339	2,018	2,715	2,904
Provision for income taxes	811	735	1,004	1,083
Net Income (NI)	\$1,528	\$1,283	\$1,711	\$1,821
Preferred stock dividends	-	-	-	23
NI Available to Common Stockholders	\$1,528	\$1,283	\$1,711	\$1,798
<b>Earnings Per Common Share<sup>1</sup></b>				
Basic	\$0.33	\$0.28	\$0.37	\$0.38
Diluted	\$0.33	\$0.27	\$0.37	\$0.38

(dollars in thousands)	2014			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest and dividend income	\$10,663	\$10,667	\$10,254	\$10,175
Interest expense	1,610	1,663	1,684	1,741
Net interest income	9,053	9,004	8,570	8,434
Provision for loan losses	1,502	385	563	203
Net interest income after provision	7,551	8,619	8,007	8,231
Noninterest income	1,225	1,118	855	895
Noninterest expense	6,652	6,485	6,767	6,331
Income before income taxes	2,124	3,252	2,095	2,795
Provision for income taxes	579	1,363	760	1,074
Net Income (NI)	\$1,545	\$1,889	\$1,335	\$1,721
Preferred stock dividends	50	50	50	50
NI Available to Common Stockholders	\$1,495	\$1,839	\$1,285	\$1,671

**Earnings Per Common Share<sup>1</sup>**

Basic	\$0.32	\$0.40	\$0.28	\$0.36
Diluted	\$0.32	\$0.39	\$0.28	\$0.36

(dollars in thousands)	2013			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest and dividend income	\$10,112	\$9,975	\$9,750	\$9,841
Interest expense	1,732	1,873	2,018	2,023
Net interest income	8,380	8,102	7,732	7,818
Provision for loan losses	300	286	200	154
Net interest income after provision	8,080	7,816	7,532	7,664
Noninterest income	797	1,119	1,069	1,189
Noninterest expense	6,348	6,245	6,107	6,144
Income before income taxes	2,529	2,690	2,494	2,709
Provision for income taxes	885	987	909	990
Net Income (NI)	\$1,644	\$1,703	\$1,585	\$1,719
Preferred stock dividends	50	50	50	50
NI Available to Common Stockholders	\$1,594	\$1,653	\$1,535	\$1,669
<b>Earnings Per Common Share<sup>1</sup></b>				
Basic	\$0.35	\$0.55	\$0.51	\$0.55
Diluted	\$0.35	\$0.55	\$0.51	\$0.54

<sup>(1)</sup> Earnings per share are based upon quarterly results and, when added, may not total the annual earnings per share amounts. In October 2013, the Company issued 1,591,300 shares of common stock at a price of \$18.75 per share resulting in net proceeds of \$27.4 million after commissions and related offering expenses. The additional shares outstanding impacted year to year comparability of per share earnings beginning with fourth quarter 2013 results.



Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

(a) Disclosure Controls and Procedures

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the Securities and Exchange Commission (the "SEC") (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

(b) Internal Controls Over Financial Reporting

Management's annual report on internal control over financial reporting is provided at Item 8 in this 10K.

(c) Changes to Internal Control Over Financial Reporting

Except as indicated herein, there were no changes in the Company's internal control over financial reporting during the three months ended December 31, 2015 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Item 9B. Other Information

Not applicable.

### **PART III**

#### Item 10. Directors, Executive Officers and Corporate Governance

For information concerning the Company's directors, the information contained under the section captioned "*Items to be voted on by Stockholders- Item 1 – Election of Directors*" in the Company's definitive proxy statement for the Company's 2016 Annual Meeting of Stockholders (the "Proxy Statement") is incorporated herein by reference. For information concerning the executive officers of the Company, see "*Item 1 – Business – Executive Officers of the Registrant*" under Part I of this Annual Report on Form 10-K.

For information regarding compliance with Section 16(a) of the Exchange Act, the cover page of this Annual Report on Form 10-K and the information contained under the section captioned "*Other Information Relating to Directors and Executive Officers Section 16(a) Beneficial Ownership Reporting Compliance*" in the Proxy Statement are incorporated herein by reference.

For information concerning the Company's code of ethics, the information contained under the section captioned "*Corporate Governance – Code of Ethics*" in the Proxy Statement is incorporated by reference. A copy of the code of ethics and business conduct is filed as Exhibit 14 hereto.

For information regarding the audit committee and its composition and the audit committee financial expert, the section captioned “*Corporate Governance – Committees of the Board of Directors – Audit Committee*” in the Proxy Statement is incorporated by reference.

**Item 11. Executive Compensation**

For information regarding executive compensation, the information contained under the sections captioned “*Executive Compensation*” and “*Directors’ Compensation*” in the Proxy Statement is incorporated herein by reference.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

**(a) Security Ownership of Certain Owners**

The information required by this item is incorporated herein by reference to the section captioned “*Principal Holders of Voting Securities*” in the Proxy Statement.

**(b) Security Ownership of Management**

Information required by this item is incorporated herein by reference to the section captioned “*Principal Holders of Voting Securities*” in the Proxy Statement.

**(c) Changes in Control**

Management of the Company knows of no arrangements, including any pledge by any person of securities of the Company, the operation of which may, at a subsequent date, result in a change in control of the registrant.

**(d) Equity Compensation Plan Information**

The Company’s Tri-County 2005 Equity Compensation Plan was terminated in May 2015 and replaced with the the 2015 Equity Compensation Plan (the “2015 plan”), The 2015 plan was approved by shareholders, which authorizes the issuance of restricted stock, stock appreciation rights, stock units and stock options to the Board of Directors and key employees. The following table sets forth certain information with respect to the remaining options from the 2005 Equity Compensation Plan as of December 31, 2015.

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants, and rights	(b) Weighted average exercise price of outstanding options, warrants, and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)
Equity plans approved by security holders	21,211	\$ 27.70	-

**Item 13. Certain Relationships, Related Transactions and Director Independence**

The information regarding certain relationships and related transactions, the section captioned “*Other Information Relating to Directors and Executive Officers – Policies and Procedures for Approval and Related Parties Transactions and Relationships and Transactions with the Company and the Bank*” in the Proxy Statement is incorporated herein by reference.

For information regarding director independence, the section captioned “*Proposal 1 – Election of Directors*” in the Proxy Statement is incorporated by reference.

**Item 14. Principal Accountant Fees and Services**

The information required by this item is incorporated herein by reference to the section captioned “*Audit Related Matters – Audit Fees*” and “*— an Pre-Approval of Services by the Independent Registered Public Accounting Firm*” in the Proxy Statement.

**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

**(a) List of Documents Filed as Part of this Report**

**(1) Financial Statements.** The following consolidated financial statements and notes related thereto are incorporated by reference from Item 8 hereof:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2015 and 2014

Consolidated Statements of Income for the Years Ended December 31, 2015, 2014 and 2013

Consolidated Statements of Comprehensive Income for the Years Ended December 31, 2015, 2014 and 2013

Consolidated Statements of Changes in Stockholders' Equity for the Years Ended December 31, 2015, 2014 and 2013

Consolidated Statements of Cash Flows for the Years Ended December 31, 2015, 2014 and 2013

Notes to Consolidated Financial Statements

(2) ***Financial Statement Schedules.*** All schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are omitted because of the absence of conditions under which they are required or because the required information is included in the consolidated financial statements and related notes thereto.

(3) **Exhibits.** The following is a list of exhibits filed as part of this Annual Report on Form 10-K and is also the Exhibit Index.

<b>Exhibit No</b>	<b>Description</b>	<b>Incorporated by Reference to</b>
3.1	Articles of Incorporation of Tri-County Financial Corporation	Form S-4 (Registration No. 333-31287).
3.2	Articles of Amendment to Articles of Incorporation of Tri-County Financial Corporation	Form 8-K as filed on May 14, 2012
3.3	Articles of Amendment to Articles of Incorporation of Tri-County Financial Corporation	Form 8-K as filed on August 27, 2010
3.4	Amended and Restated Bylaws of The Community Financial Corporation	Form 8-K as filed on February 10, 2016.
4.1	Amended and Restated Articles Supplementary establishing Senior Non-cumulative Perpetual Preferred Stock, Series C, of Tri-County Financial Corporation	Form 8-K as filed on September 23, 2011
4.2	Form of Subordinated Indenture between The Community Financial Corporation and Wilmington Trust, National Association, as Trustee	Form 8-K as filed on February 4, 2015
4.3	Form of First Supplemental Indenture between The Community Financial Corporation and Wilmington Trust, National Association, as Trustee	Form 8-K as filed on February 4, 2015
4.4	Form of Global Note to represent the 6.25% Fixed to Floating Rate Subordinated Notes due 2025 (included in Exhibit 4.3)	Form 8-K as filed on February 4, 2015
10.1*	Tri-County Financial Corporation 1995 Stock Option and Incentive Plan, as amended	Form 10-K for the year ended December 31, 2000 as filed on March 30, 2001.
10.2*	Tri-County Financial Corporation 1995 Stock Option Plan for Non-Employee Directors, as amended	Form 10-K for the year ended December 31, 2000 as filed on March 30, 2001.
10.3*	Employment Agreement with Michael L. Middleton	Form 10-Q for the quarter ended September 30, 2006 as filed on November 14, 2006.
10.4*		Form 8-K as filed on February 10, 2016.

Community Bank of the Chesapeake Executive Incentive  
Compensation Plan, as amended and restated

10.5\* Community Bank of the Chesapeake Retirement Plan for Directors,  
as amended and restated

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10.6*	Split Dollar Agreements with Michael L. Middleton	Form 10-K for the year ended December 31, 2000 as filed on March 30, 2001.
10.7*	Split Dollar Agreement with William J. Pasenelli	Form 10-K for the year ended December 31, 2001 as filed on April 1, 2002.
10.8*	Salary Continuation Agreement with Michael L. Middleton, dated September 6, 2003	Form 10-K for the year ended December 31, 2003 as filed on March 26, 2004.
10.9*	First Amendment to the Salary Continuation Agreement, dated September 6, 2003, with Michael L. Middleton	Form 10-K for the year ended December 31, 2008 as filed on March 9, 2009.
10.10*	Tri-County Financial Corporation 2005 Equity Compensation Plan	Definitive Proxy Statement as filed on April 11, 2005
10.11*	Amendment No. 1 to the Tri-County Financial Corporation 2005 Equity Compensation Plan	Form 10-Q for the quarter ended September 30, 2007 as filed on November 13, 2007.
10.12*	Community Bank of the Chesapeake Executive Deferred Compensation Plan, as amended and restated	
10.13*	Amended and Restated Employment Agreement by and among Community Bank of Tri-County, William J. Pasenelli and Tri-County Financial Corporation, as guarantor	Form 10-Q for the quarter ended March 31, 2007 as filed on May 11, 2007.
10.14*	First Amendment to the Employment Agreement, dated April 20, 2007, with William J. Pasenelli	Form 10-Q for the quarter ended June 30, 2013 as filed on August 14, 2013
10.15*	Supplemental Executive Retirement Plan agreement, dated January 1, 2011 and First Amendment to the Supplemental Executive Retirement Plan agreement, dated January 1, 2011, with William J. Pasenelli	Form 10-Q for the quarter ended June 30, 2013 as filed on August 14, 2013
10.16*	Amended and Restated Employment Agreement by and among Community Bank of Tri-County, Gregory C. Cockerham and Tri-County Financial Corporation, as guarantor	Form 10-Q for the quarter ended March 31, 2007 as filed on May 11, 2007.
10.17*	Supplemental Executive Retirement Plan agreement, dated January 1, 2011 and First Amendment to the Supplemental Executive Retirement Plan agreement, dated January 1, 2011, with Gregory C. Cockerham	Form 10-Q for the quarter ended June 30, 2013 as filed on August 14, 2013
10.18*		

Salary Continuation Agreement with Gregory C. Cockerham, dated August 21, 2006

Form 10-Q for the quarter ended September 30, 2006 as filed on November 14, 2006.

10.19\* First Amendment to the Salary Continuation Agreement, dated August 21, 2006, with Gregory C. Cockerham

Form 10-K/A for the year ended December 31, 2008 as filed on April 20, 2009.

10.20*	Second Amendment to the Salary Continuation Agreement, dated August 21, 2006, with Gregory C. Cockerham	Form 10-K/A for the year ended December 31, 2008 as filed on April 20, 2009.
10.21*	Salary Continuation Agreement with William J. Pasenelli, dated August 21, 2006	Form 10-Q for the quarter ended September 30, 2006 as filed on November 14, 2006.
10.22*	First Amendment to the Salary Continuation Agreement, dated August 21, 2006, with William J. Pasenelli	Form 10-K/A for the year ended December 31, 2008 as filed on April 20, 2009.
10.23*	Second Amendment to the Salary Continuation Agreement, dated August 21, 2006, with William J. Pasenelli	Form 10-K/A for the year ended December 31, 2008 as filed on April 20, 2009.
10.24*	Securities Purchase Agreement dated September 22, 2011, between Tri-County Financial Corporation and the Secretary of the United States Department of the Treasury	Form 8-K as filed on September 23, 2011
10.25*	Repurchase Letter dated September 22, 2011 between Tri-County Financial Corporation and the United States Department of the Treasury with respect to the Series A Preferred Stock and Series B Preferred Stock	Form 8-K as filed on September 23, 2011
10.26*	Form of Letter Agreement between Tri-County Financial Corporation and each of Michael L. Middleton, Gregory C. Cockerham and William J. Pasenelli	Form 8-K as filed on September 23, 2011
10.27*	Salary Continuation Agreement between Gregory C. Cockerham and Community Bank of Tri-County, dated September 6, 2003, as amended on December 22, 2008	Form 10-K/A for the year ended December 31, 2008 as filed on April 20, 2009.
10.28*	Salary Continuation Agreement between William J. Pasenelli and Community Bank of Tri-County, dated September 6, 2003, as amended on June 11, 2004 and December 22, 2008	Form 10-K/A for the year ended December 31, 2008 as filed on April 20, 2009.
10.29*	Employment Agreement with Michael L. Middleton dated July 1, 2014	Form 10-K/A for the year ended December 31, 2014 as filed on March 17, 2015.
10.30*	Supplemental Executive Retirement Plan agreement, dated November 1, 2014 with William J. Pasenelli	Form 10-K/A for the year ended December 31, 2014 as filed on March 17, 2015.
10.31*	Supplemental Executive Retirement Plan agreement, dated November 1, 2014 with Gregory C. Cockerham	Form 10-K/A for the year ended December 31, 2014 as filed on

March 17, 2015.

- 10.32\* The Community Financial Corporation 2015 Equity Compensation Plan
- 10.33\* Supplemental Executive Retirement Plan agreement, dated January 1, 2011, with Todd L. Capitani, as amended
- 10.34\* Supplemental Executive Retirement Plan agreement, dated January 1, 2011, with James Burke, as amended
- 10.35\* Supplemental Executive Retirement Plan agreement, dated November 1, 2014, with Todd L. Capitani
- 10.36\* Supplemental Executive Retirement Plan agreement, dated November 1, 2014, with James Burke
- 10.37\* Split Dollar Agreement with Todd L. Capitani dated March 3, 2011
- 10.38\* Split Dollar Agreement with James Burke dated March 15, 2011
- 10.39\* Employment Agreement with Todd L. Capitani dated April 23, 2013
- 10.40\* Employment Agreement James Burke dated April 20, 2007, as amended on November 24, 2008 and April 23, 2013
- 10.41\* Salary Continuation Agreement between James M. Burke and Community Bank of Tri-County, dated August 21, 2006, as amended on April 13, 2007 and December 30, 2007
- 10.42\* Supplemental Executive Retirement Plan agreement, dated January 1, 2011, with Michael L. Middleton
- 10.43\* Supplemental Life Insurance Agreement between Community Bank of Tri-County and Michael L. Middleton dated January 12, 2004
- 10.44\* Supplemental Life Insurance Agreement between Community Bank of Tri-County and William J. Pasenelli dated January 12, 2004
- 10.45\* Split Dollar Agreement with William J. Pasenelli dated March 15, 2011
- 14.0 Code of Ethics
- 21.0 List of Subsidiaries

Definitive Proxy Statement  
as filed on March 25, 2015.

23.1 Consent of Stegman & Company

31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

32.0 Section 1350 Certification of Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer

The following materials from the Company's Annual Report on Form 10-K for the year ended December 31, 2015, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) 101.0 the Consolidated Statements of Income and Comprehensive Income, (iii) the Consolidated Statements of Changes In Stockholders' Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes in the Consolidated Financial Statements.

(\*) Management contract or compensating arrangement.

**(b) Exhibits.** The exhibits required by Item 601 of Regulation S-K are either filed as part of this Annual Report on Form 10-K or incorporated by reference herein.

**(c) Financial Statements and Schedules Excluded From Annual Report.** There are no other financial statements and financial statement schedules which were excluded from this Annual Report pursuant to Rule 14a-3(b)(1) which are required to be included herein.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

THE COMMUNITY FINANCIAL  
CORPORATION

Date: March 10, 2016 By: /s/ William J. Pasenelli  
William J. Pasenelli  
President and Chief Executive Officer  
(Duly Authorized Representative)

Pursuant to the requirement of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ Michael L. Middleton  
Michael L. Middleton  
Director, Executive Chairman

Date: March 10, 2016

By: /s/ Todd L. Capitani  
Todd L. Capitani  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)

Date: March 10, 2016

By: /s/ Louis P. Jenkins, Jr.  
Louis P. Jenkins, Jr.  
Director

Date: March 10, 2016

By: /s/ Philip T. Goldstein  
Philip T. Goldstein  
Director

By: /s/ William J. Pasenelli  
William J. Pasenelli  
Director, President and Chief Executive  
Officer  
(Principal Executive Officer)

Date: March 10, 2016

By: /s/ Austin J. Slater, Jr.  
Austin J. Slater, Jr.  
Director

Date: March 10, 2016

By: /s/ James R. Shepherd  
James R. Shepherd  
Director

Date: March 10, 2016

By: /s/ Joseph V. Stone, Jr.  
Joseph V. Stone, Jr.  
Director

Date: March 10, 2016

By: /s/ Mary Todd Peterson  
Mary Todd Peterson  
Director

Date: March 10, 2016

Date: March 10, 2016

By: /s/ M. Arshed Javaid  
M. Arshed Javaid  
Director

Date: March 10, 2016