

CAPITAL CITY BANK GROUP INC
Form 10-Q
May 06, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended March 31, 2016

OR

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

For the transition period from _____ to _____

Commission File Number: 0-13358

(Exact name of registrant as specified in its charter)

Florida

(State or other jurisdiction of incorporation or organization)

59-2273542

(I.R.S. Employer Identification No.)

217 North Monroe Street, Tallahassee, Florida

(Address of principal executive office)

32301

(Zip Code)

(850) 402-7000

(Registrant's telephone number, including area code)

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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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if 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

At April 30, 2016, 17,221,682 shares of the Registrant’s Common Stock, \$.01 par value, were outstanding.

CAPITAL CITY BANK GROUP, INC.

QUARTERLY REPORT ON FORM 10-Q

FOR THE PERIOD ENDED MARCH 31, 2016

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INTRODUCTORY NOTE

Caution Concerning Forward-Looking Statements

This Quarterly Report on Form 10-Q contains “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, among others, statements about our beliefs, plans, objectives, goals, expectations, estimates and intentions that are subject to significant risks and uncertainties and are subject to change based on various factors, many of which are beyond our control. The words “may,” “could,” “should,” “would,” “believe,” “anticipate,” “estimate,” “expect,” “intend,” “plan,” “target,” “goal,” and similar expressions are used to identify forward-looking statements.

All forward-looking statements, by their nature, are subject to risks and uncertainties. Our actual future results may differ materially from those set forth in our forward-looking statements.

Our ability to achieve our financial objectives could be adversely affected by the factors discussed in detail in Part I, Item 2. “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and Part II, Item 1A. “Risk Factors” in this Quarterly Report on Form 10-Q and the following sections of our Annual Report on Form 10-K for the year ended December 31, 2015 (the “2015 Form 10-K”): (a) “Introductory Note” in Part I, Item 1. “Business”; (b) “Risk Factors” in Part I, Item 1A, as updated in our subsequent quarterly reports filed on Form 10-Q; and (c) “Introduction” in “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” in Part II, Item 7, as well as:

- § our ability to successfully manage interest rate risk, liquidity risk, and other risks inherent to our industry;
- § legislative or regulatory changes, including the Dodd-Frank Act, Basel III, and the ability to repay and qualified mortgage standards;
- § the effects of security breaches and computer viruses that may affect our computer systems or fraud related to credit or debit card products;
- § the accuracy of our financial statement estimates and assumptions, including the estimates used for our loan loss reserve and deferred tax asset valuation allowance;
- § the frequency and magnitude of foreclosure of our loans;
- § the effects of our lack of a diversified loan portfolio, including the risks of geographic and industry concentrations;
- § the strength of the United States economy in general and the strength of the local economies in which we conduct operations;
- § our ability to declare and pay dividends, the payment of which is now subject to our compliance with heightened capital requirements;
- § our need and our ability to incur additional debt or equity financing;
- § changes in the securities and real estate markets;
- § changes in monetary and fiscal policies of the U.S. Government;
- § inflation, interest rate, market and monetary fluctuations;
- § the effects of harsh weather conditions, including hurricanes, and man-made disasters;
- § our ability to comply with the extensive laws and regulations to which we are subject, including the laws for each jurisdiction where we operate;
- § the willingness of clients to accept third-party products and services rather than our products and services and vice versa;

§ increased competition and its effect on pricing;
§ technological changes;
§ negative publicity and the impact on our reputation;
§ changes in consumer spending and saving habits;
§ growth and profitability of our noninterest income;
§ changes in accounting principles, policies, practices or guidelines;
§ the limited trading activity of our common stock;
§ the concentration of ownership of our common stock;
§ anti-takeover provisions under federal and state law as well as our Articles of Incorporation and our Bylaws;
§ other risks described from time to time in our filings with the Securities and Exchange Commission; and
§ our ability to manage the risks involved in the foregoing.

However, other factors besides those listed in *Item 1A Risk Factors* or discussed in this Form 10-Q also could adversely affect our results, and you should not consider any such list of factors to be a complete set of all potential risks or uncertainties. Any forward-looking statements made by us or on our behalf speak only as of the date they are made. We do not undertake to update any forward-looking statement, except as required by applicable law.

PART I. FINANCIAL INFORMATION**Item 1. CONSOLIDATED FINANCIAL STATEMENTS****CAPITAL CITY BANK GROUP, INC.****CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

(Dollars in Thousands)	(Unaudited)	December
	March 31,	31,
	2016	2015
ASSETS		
Cash and Due From Banks	\$45,914	\$51,288
Federal Funds Sold and Interest Bearing Deposits	304,908	327,617
Total Cash and Cash Equivalents	350,822	378,905
Investment Securities, Available for Sale, at fair value	462,444	451,028
Investment Securities, Held to Maturity, at amortized cost (fair value of \$187,649 and \$187,407)	187,079	187,892
Total Investment Securities	649,523	638,920
Loans Held For Sale	10,475	11,632
Loans, Net of Unearned Income	1,506,835	1,492,275
Allowance for Loan Losses	(13,613)	(13,953)
Loans, Net	1,493,222	1,478,322
Premises and Equipment, Net	98,029	98,819
Goodwill	84,811	84,811
Other Real Estate Owned	17,450	19,290
Other Assets	87,854	87,161
Total Assets	\$2,792,186	\$2,797,860
LIABILITIES		
Deposits:		
Noninterest Bearing Deposits	\$790,040	\$758,283
Interest Bearing Deposits	1,501,368	1,544,566
Total Deposits	2,291,408	2,302,849
Short-Term Borrowings	62,922	61,058
Subordinated Notes Payable	62,887	62,887
Other Long-Term Borrowings	27,062	28,265
Other Liabilities	71,074	68,449
Total Liabilities	2,515,353	2,523,508

SHAREOWNERS' EQUITY

Preferred Stock, \$.01 par value; 3,000,000 shares authorized; no shares issued and outstanding	—	—
Common Stock, \$.01 par value; 90,000,000 shares authorized; 17,221,654 and 17,156,919 shares issued and outstanding at March 31, 2016 and December 31, 2015, respectively	172	172
Additional Paid-In Capital	38,671	38,256
Retained Earnings	259,139	258,181
Accumulated Other Comprehensive Loss, Net of Tax	(21,149)	(22,257)
Total Shareowners' Equity	276,833	274,352
Total Liabilities and Shareowners' Equity	\$2,792,186	\$2,797,860

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CAPITAL CITY BANK GROUP, INC.**CONSOLIDATED STATEMENTS OF INCOME****(Unaudited)**

(Dollars in Thousands, Except Per Share Data)	Three Months Ended March 31,	
	2016	2015
INTEREST INCOME		
Loans, including Fees	\$ 18,045	\$ 17,863
Investment Securities:		
Taxable	1,420	1,198
Tax Exempt	217	96
Funds Sold	362	189
Total Interest Income	20,044	19,346
INTEREST EXPENSE		
Deposits	221	246
Short-Term Borrowings	10	21
Subordinated Notes Payable	387	332
Other Long-Term Borrowings	216	240
Total Interest Expense	834	839
NET INTEREST INCOME	19,210	18,507
Provision for Loan Losses	452	293
Net Interest Income After Provision for Loan Losses	18,758	18,214
NONINTEREST INCOME		
Deposit Fees	5,400	5,541
Bank Card Fees	2,853	2,742
Wealth Management Fees	1,792	2,046
Mortgage Banking Fees	1,030	987
Data Processing Fees	347	373
Other	1,255	1,159
Total Noninterest Income	12,677	12,848
NONINTEREST EXPENSE		
Compensation	16,241	16,524
Occupancy, Net	4,459	4,396
Other Real Estate Owned, Net	1,425	1,497
Other	6,805	6,973
Total Noninterest Expense	28,930	29,390
INCOME BEFORE INCOME TAXES	2,505	1,672
Income Tax Expense	858	686
NET INCOME	\$ 1,647	\$ 986

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BASIC NET INCOME PER SHARE	\$ 0.10	\$ 0.06
DILUTED NET INCOME PER SHARE	\$ 0.10	\$ 0.06
Average Basic Common Shares Outstanding	17,202	17,508
Average Diluted Common Shares Outstanding	17,235	17,555

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CAPITAL CITY BANK GROUP, INC.**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(Unaudited)**

(Dollars in Thousands)	Three Months Ended March	
	31,	
	2016	2015
NET INCOME	\$ 1,647	\$ 986
Other comprehensive income, before tax:		
Investment Securities:		
Change in net unrealized gain/loss on securities available for sale	1,784	1,146
Amortization of unrealized losses on securities transferred from available for sale to held to maturity	19	17
Total Investment Securities	1,803	1,163
Other comprehensive income, before tax	1,803	1,163
Deferred tax expense related to other comprehensive income	(695)	(448)
Other comprehensive income, net of tax	1,108	715
TOTAL COMPREHENSIVE INCOME	\$ 2,755	\$ 1,701

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CAPITAL CITY BANK GROUP, INC.**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREOWNERS' EQUITY****(Unaudited)**

(Dollars In Thousands, Except Share Data)	Shares Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss, Net of Taxes	Total
Balance, January 1, 2015	17,447,223	\$ 174	\$ 42,569	\$ 251,306	\$ (21,509)	\$ 272,540
Net Income		—	—	986	—	986
Other Comprehensive Income, Net of Tax		—	—	—	715	715
Cash Dividends (\$0.0300 per share)		—	—	(527)	—	(527)
Stock Compensation Expense		—	261	—	—	261
Impact of Transactions Under Compensation Plans, net	85,408	1	111	—	—	112
Balance, March 31, 2015	17,532,631	\$ 175	\$ 42,941	\$ 251,765	\$ (20,794)	\$ 274,087
	17,156,919	\$ 172	\$ 38,256	\$ 258,181	\$ (22,257)	\$ 274,352
Balance, January 1, 2016						
Net Income		—	—	1,647	—	1,647
Other Comprehensive Income, Net of Tax		—	—	—	1,108	1,108
Cash Dividends (\$0.0400 per share)		—	—	(689)	—	(689)
Stock Compensation Expense		—	247	—	—	247
Impact of Transactions Under Compensation Plans, net	68,335	—	218	—	—	218
Repurchase of Common Stock	(3,600)	—	(50)	—	—	(50)
Balance, March 31, 2016	17,221,654	\$ 172	\$ 38,671	\$ 259,139	\$ (21,149)	\$ 276,833

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CAPITAL CITY BANK GROUP, INC.**CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

(Dollars in Thousands)	Three Months Ended March 31,	
	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income	\$ 1,647	\$ 986
Adjustments to Reconcile Net Income to Cash Provided by Operating Activities:		
Provision for Loan Losses	452	293
Depreciation	1,705	1,633
Amortization of Premiums, Discounts, and Fees (net)	1,569	1,045
Gain on Securities Transactions	—	(2)
Net Decrease (Increase) in Loans Held-for-Sale	1,157	(2,646)
Stock Compensation	247	261
Deferred Income Taxes	693	(1,349)
Loss on Sales and Write-Downs of Other Real Estate Owned	1,076	989
Loss on Sale or Disposal of Premises and Equipment	2	20
Net (Increase) Decrease in Other Assets	(2,063)	3,021
Net Increase in Other Liabilities	2,765	2,445
Net Cash Provided By Operating Activities	9,250	6,696
CASH FLOWS FROM INVESTING ACTIVITIES		
Securities Held to Maturity:		
Purchases	(5,064)	(33,204)
Payments, Maturities, and Calls	5,631	12,993
Securities Available for Sale:		
Purchases	(39,499)	(92,106)
Payments, Maturities, and Calls	28,566	29,045
Net Increase in Loans	(16,574)	(23,436)
Proceeds From Sales of Other Real Estate Owned	1,965	2,598
Purchases of Premises and Equipment, net	(917)	(945)
Net Cash Used In Investing Activities	(25,892)	(105,055)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net (Decrease) Increase in Deposits	(11,441)	63,220
Net Increase in Short-Term Borrowings	1,427	63
Repayment of Other Long-Term Borrowings	(766)	(679)
Dividends Paid	(689)	(527)
Payments to Repurchase Common Stock	(50)	—
Issuance of Common Stock Under Compensation Plans	78	62
Net Cash (Used In) Provided By Financing Activities	(11,441)	62,139
NET DECREASE IN CASH AND CASH EQUIVALENTS	(28,083)	(36,220)
Cash and Cash Equivalents at Beginning of Period	378,905	385,056

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Cash and Cash Equivalents at End of Period	\$ 350,822	\$ 348,836
Supplemental Cash Flow Disclosures:		
Interest Paid	\$ 829	\$ 844
Income Taxes Paid	\$ 50	\$ 8
Noncash Investing and Financing Activities:		
Loans Transferred to Other Real Estate Owned	\$ 1,201	\$ 1,742
Transfer of Current Portion of Long-Term Borrowings	\$ 437	\$ —

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CAPITAL CITY BANK GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations. Capital City Bank Group, Inc. (“CCBG” or the “Company”) provides a full range of banking and banking-related services to individual and corporate clients through its subsidiary, Capital City Bank, with banking offices located in Florida, Georgia, and Alabama. The Company is subject to competition from other financial institutions, is subject to regulation by certain government agencies and undergoes periodic examinations by those regulatory authorities.

Basis of Presentation. The consolidated financial statements in this Quarterly Report on Form 10-Q include the accounts of CCBG and its wholly-owned subsidiary, Capital City Bank (“CCB” or the “Bank” and together with the Company). All material inter-company transactions and accounts have been eliminated.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included.

The consolidated statement of financial condition at December 31, 2015 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2015.

NOTE 2 - INVESTMENT SECURITIES

Investment Portfolio Composition. The amortized cost and related market value of investment securities available-for-sale were as follows:

March 31, 2016

December 31, 2015

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	Amortized Cost	Unrealized Gains	Unrealized Losses	Market Value	Amortized Cost	Unrealized Gain	Unrealized Losses	Market Value
Available for Sale								
U.S. Government Treasury	\$257,978	\$ 1,083	\$ 1	\$259,060	\$250,458	\$ 101	\$ 213	\$250,346
U.S. Government Agency States and Political Subdivisions	103,802	530	125	104,207	101,730	357	263	101,824
Mortgage-Backed Securities	88,556	321	12	88,865	88,358	103	99	88,362
Equity Securities ⁽¹⁾	1,429	134	—	1,563	1,742	159	—	1,901
Total	8,749	—	—	8,749	8,595	—	—	8,595
	\$460,514	\$ 2,068	\$ 138	\$462,444	\$450,883	\$ 720	\$ 575	\$451,028
Held to Maturity								
U.S. Government Treasury	\$139,501	\$ 596	\$ —	\$140,097	\$134,554	\$ 45	\$ 160	\$134,439
U.S. Government Agency States and Political Subdivisions	10,026	13	—	10,039	10,043	7	5	10,045
Mortgage-Backed Securities	12,495	81	1	12,575	15,693	38	7	15,724
Total	25,057	76	195	24,938	27,602	4	407	27,199
	\$187,079	\$ 766	\$ 196	\$187,649	\$187,892	\$ 94	\$ 579	\$187,407
Total Investment Securities	\$647,593	\$ 2,834	\$ 334	\$650,093	\$638,775	\$ 814	\$ 1,154	\$638,435

Includes Federal Home Loan Bank, Federal Reserve Bank, and FNBB Inc. stock recorded at cost of \$3.7 million, ⁽¹⁾\$4.8 million, and \$0.2 million, respectively, at March 31, 2016 and \$3.6 million, \$4.8 million, and \$0.2 million, respectively, at December 31, 2015.

Securities with an amortized cost of \$326.6 million and \$370.1 million at March 31, 2016 and December 31, 2015, respectively, were pledged to secure public deposits and for other purposes.

The Bank, as a member of the Federal Home Loan Bank of Atlanta (“FHLB”), is required to own capital stock in the FHLB based generally upon the balances of residential and commercial real estate loans, and FHLB advances. FHLB stock, which is included in other securities, is pledged to secure FHLB advances. No ready market exists for this stock, and it has no quoted market value; however, redemption of this stock has historically been at par value.

Maturity Distribution. As of March 31, 2016, the Company's investment securities had the following maturity distribution based on contractual maturity. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations. Mortgage-backed securities and certain amortizing U.S. government agency securities are shown separately because they are not due at a certain maturity date.

(Dollars in Thousands)	Available for Sale		Held to Maturity	
	Amortized Cost	Market Value	Amortized Cost	Market Value
Due in one year or less	\$91,208	\$91,254	\$70,534	\$70,630
Due after one through five years	289,626	291,096	91,488	92,081
Mortgage-Backed Securities	1,429	1,563	25,057	24,938
U.S. Government Agency	69,502	69,782	—	—
Equity Securities	8,749	8,749	—	—
Total	\$460,514	\$462,444	\$187,079	\$187,649

Unrealized Losses on Investment Securities. The following table summarizes the investment securities with unrealized losses aggregated by major security type and length of time in a continuous unrealized loss position:

(Dollars in Thousands)	Less Than 12 Months		Greater Than 12 Months		Total	
	Market Value	Unrealized Losses	Market Value	Unrealized Losses	Market Value	Unrealized Losses
March 31, 2016						
Available for Sale						
U.S. Government Treasury	\$7,497	\$ 1	\$—	\$ —	\$7,497	\$ 1
U.S. Government Agency	15,142	60	12,362	65	27,504	125
States and Political Subdivisions	10,733	11	305	1	11,038	12
Mortgage-Backed Securities	4	—	—	—	4	—
Total	33,376	72	12,667	66	46,043	138
Held to Maturity						
U.S. Government Agencies	1,913	—	—	—	1,913	—
States and Political Subdivisions	1,724	1	—	—	1,724	1
Mortgage-Backed Securities	4,032	19	11,630	176	15,662	195
Total	\$7,669	\$ 20	\$11,630	\$ 176	\$19,299	\$ 196
December 31, 2015						
Available for Sale						
U.S. Government Treasury	\$150,061	\$ 213	\$—	\$ —	\$150,061	\$ 213
U.S. Government Agency	43,508	200	9,644	63	53,152	263
States and Political Subdivisions	39,608	86	5,066	13	44,674	99
Total	233,177	499	14,710	76	247,887	575
Held to Maturity						
U.S. Government Treasury	92,339	160	—	—	92,339	160

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U.S. Government Agency	5,006	5	—	—	5,006	5
States and Political Subdivisions	3,791	7	—	—	3,791	7
Mortgage-Backed Securities	13,267	185	11,889	222	25,156	407
Total	\$ 114,403	\$ 357	\$ 11,889	\$ 222	\$ 126,292	\$ 579

Management evaluates securities for other than temporary impairment at least quarterly, and more frequently when economic or market concerns warrant such evaluation. Declines in the 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, the Company considers, (i) whether it has decided to sell the security, (ii) whether it is more likely than not that the Company will have to sell the security before its market value recovers, and (iii) whether the present value of expected cash flows is sufficient to recover the entire amortized cost basis. When assessing a security's expected cash flows, the Company considers, among other things, (i) the length of time and the extent to which the fair value has been less than cost and (ii) the financial condition and near-term prospects of the issuer. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by rating agencies have occurred, regulatory issues, and analysts' reports.

At March 31, 2016, there were 115 positions (combined AFS and HTM) with unrealized losses at quarter end totaling \$0.3 million. Of the 115 positions, 76 were Ginnie Mae mortgage-backed securities (GNMA), U.S. Treasuries, or SBA securities, all of which carry the full faith and credit guarantee of the U.S. Government. SBA securities float monthly or quarterly to the prime rate and are uncapped. Of these 76 positions, there were 23 GNMA positions and 28 SBA positions in an unrealized loss position for longer than 12 months. There were 37 municipal bonds in an unrealized loss position that were pre-refunded, or rated "AA-" or better. These debt securities are in a loss position because they were acquired when the general level of interest rates was lower than that on March 31, 2016. The Company believes that the unrealized losses in these debt securities are temporary in nature and that the full principal will be collected as anticipated. Because the declines in the market value of these investments are attributable to changes in interest rates and not credit quality and because the Company has the present ability and intent to hold these investments until there is a recovery in fair value, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2016.

NOTE 3 – LOANS, NET

Loan Portfolio Composition. The composition of the loan portfolio was as follows:

(Dollars in Thousands)	March 31, 2016	December 31, 2015
Commercial, Financial and Agricultural	\$ 183,681	\$ 179,816
Real Estate – Construction	42,537	46,484
Real Estate – Commercial Mortgage	503,259	499,813
Real Estate – Residential ⁽¹⁾	296,070	290,585
Real Estate – Home Equity	234,128	233,901
Consumer	247,160	241,676
Loans, Net of Unearned Income	\$ 1,506,835	\$ 1,492,275

⁽¹⁾ *Includes loans in process with outstanding balances of \$10.9 million and \$8.5 million at March 31, 2016 and December 31, 2015, respectively.*

Net deferred fees included in loans were \$0.1 million and \$0.5 million at March 31, 2016 and December 31, 2015.

The Company has pledged a blanket floating lien on all 1-4 family residential mortgage loans, commercial real estate mortgage loans, and home equity loans to support available borrowing capacity at the FHLB of Atlanta and has pledged a blanket floating lien on all consumer loans, commercial loans, and construction loans to support available borrowing capacity at the Federal Reserve Bank of Atlanta.

Nonaccrual Loans. Loans are generally placed on nonaccrual status if principal or interest payments become 90 days past due and/or management deems the collectability of the principal and/or interest to be doubtful. Loans are returned

to accrual status when the principal and interest amounts contractually due are brought current or when future payments are reasonably assured.

The following table presents the recorded investment in nonaccrual loans and loans past due over 90 days and still on accrual by class of loans.

(Dollars in Thousands)	March 31, 2016		December 31, 2015	
	Nonaccrual	90 + Days	Nonaccrual	90 + Days
Commercial, Financial and Agricultural	\$83	—	\$96	—
Real Estate – Construction	—	—	97	—
Real Estate – Commercial Mortgage	3,942	—	4,191	—
Real Estate – Residential	3,490	—	4,739	—
Real Estate – Home Equity	1,323	—	1,017	—
Consumer	211	—	165	—
Total Nonaccrual Loans	\$9,049	—	\$10,305	—

Loan Portfolio Aging. A loan is defined as a past due loan when one full payment is past due or a contractual maturity is over 30 days past due (“DPD”).

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The following table presents the aging of the recorded investment in past due loans by class of loans.

	30-59	60-89	90 +	Total	Total	Total
(Dollars in Thousands)	DPD	DPD	DPD	Past Due	Current	Loans
March 31, 2016						
Commercial, Financial and Agricultural	\$335	\$—	\$ —	\$335	\$183,263	\$183,681
Real Estate – Construction	383	—	—	383	42,154	42,537
Real Estate – Commercial Mortgage	464	122	—	586	498,731	503,259
Real Estate – Residential	732	149	—	881	291,699	296,070
Real Estate – Home Equity	475	121	—	596	232,209	234,128
Consumer	622	196	—	818	246,131	247,160
Total Past Due Loans	\$3,011	\$588	\$ —	\$3,599	\$1,494,187	\$1,506,835
December 31, 2015						
Commercial, Financial and Agricultural	\$153	\$18	\$ —	\$171	\$179,549	\$179,816
Real Estate – Construction	690	—	—	690	45,697	46,484
Real Estate – Commercial Mortgage	754	1,229	—	1,983	493,639	499,813
Real Estate – Residential	567	347	—	914	284,932	290,585
Real Estate – Home Equity	787	97	—	884	232,000	233,901
Consumer	735	398	—	1,133	240,378	241,676
Total Past Due Loans	\$3,686	\$2,089	\$ —	\$5,775	\$1,476,195	\$1,492,275

Allowance for Loan Losses. The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate of incurred losses within the existing portfolio of loans. Loans are charged-off to the allowance when losses are deemed to be probable and reasonably quantifiable.

The following table details the activity in the allowance for loan losses by portfolio class. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

(Dollars in Thousands)	Commercial, Financial, Agricultural	Real Estate Construction	Real Estate Commercial Mortgage	Real Estate Residential	Real Estate Home Equity	Consumer	Total
Three Months Ended							
March 31, 2016							
Beginning Balance	\$ 905	\$ 101	\$ 4,498	\$ 4,409	\$2,473	\$ 1,567	\$13,953
Provision for Loan Losses	(24)	—	44	(30)	118	344	452
Charge-Offs	(37)	—	(274)	(478)	(215)	(439)	(1,443)
Recoveries	39	—	81	236	59	236	651
Net Charge-Offs	2	—	(193)	(242)	(156)	(203)	(792)
Ending Balance	\$ 883	\$ 101	\$ 4,349	\$ 4,137	\$2,435	\$ 1,708	\$13,613

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Three Months Ended

March 31, 2015

Beginning Balance	\$ 784	\$ 843	\$ 5,287	\$ 6,520	\$2,882	\$ 1,223	\$17,539
Provision for Loan Losses	354	(269)	88	(68)	(177)	365	293
Charge-Offs	(290)	—	(904)	(305)	(182)	(576)	(2,257)
Recoveries	55	—	30	48	24	358	515
Net Charge-Offs	(235)	—	(874)	(257)	(158)	(218)	(1,742)
Ending Balance	\$ 903	\$ 574	\$ 4,501	\$ 6,195	\$2,547	\$ 1,370	\$16,090

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The following table details the amount of the allowance for loan losses by portfolio class disaggregated on the basis of the Company's impairment methodology.

<i>(Dollars in Thousands)</i>	Commercial, Financial, Agricultural	Real Estate Construction	Real Estate Commercial Mortgage	Real Estate Residential	Real Estate Home Equity	Consumer	Total
March 31, 2016							
Period-end amount Allocated to:							
Loans Individually Evaluated for Impairment	\$ 72	\$ —	\$ 1,936	\$ 1,954	\$ 389	\$ 4	\$ 4,355
Loans Collectively Evaluated for Impairment	811	101	2,413	2,183	2,046	1,704	9,258
Ending Balance	\$ 883	\$ 101	\$ 4,349	\$ 4,137	\$ 2,435	\$ 1,708	\$ 13,613
December 31, 2015							
Period-end amount Allocated to:							
Loans Individually Evaluated for Impairment	\$ 77	\$ —	\$ 2,049	\$ 2,118	\$ 384	\$ 18	\$ 4,646
Loans Collectively Evaluated for Impairment	828	101	2,449	2,291	2,089	1,549	9,307
Ending Balance	\$ 905	\$ 101	\$ 4,498	\$ 4,409	\$ 2,473	\$ 1,567	\$ 13,953
March 31, 2015							
Period-end amount Allocated to:							
Loans Individually Evaluated for Impairment	\$ 334	\$ —	\$ 2,349	\$ 2,294	\$ 557	\$ 15	\$ 5,549
Loans Collectively Evaluated for Impairment	569	574	2,152	3,901	1,990	1,355	10,541
Ending Balance	\$ 903	\$ 574	\$ 4,501	\$ 6,195	\$ 2,547	\$ 1,370	\$ 16,090

The Company's recorded investment in loans related to each balance in the allowance for loan losses by portfolio class and disaggregated on the basis of the Company's impairment methodology was as follows:

<i>Dollars in Thousands)</i>	Commercial, Financial, Agricultural	Real Estate Construction	Real Estate Commercial Mortgage	Real Estate Residential	Real Estate Home Equity	Consumer	Total
March 31, 2016							
Individually Evaluated for Impairment	\$ 812	\$ —	\$ 20,798	\$ 18,221	\$ 3,211	\$ 206	\$ 43,248

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Collectively Evaluated for Impairment	182,869	42,537	482,461	277,849	230,917	246,954	1,463,587
Total	\$ 183,681	\$ 42,537	\$ 503,259	\$ 296,070	\$ 234,128	\$ 247,160	\$ 1,506,835
December 31, 2015							
Individually Evaluated for Impairment	\$ 834	\$ 97	\$ 20,847	\$ 18,569	\$ 3,144	\$ 261	\$ 43,752
Collectively Evaluated for Impairment	178,982	46,387	478,966	272,016	230,757	241,415	1,448,523
Total	\$ 179,816	\$ 46,484	\$ 499,813	\$ 290,585	\$ 233,901	\$ 241,676	\$ 1,492,275
March 31, 2015							
Individually Evaluated for Impairment	\$ 1,252	\$ 401	\$ 31,213	\$ 19,840	\$ 3,123	\$ 197	\$ 56,026
Collectively Evaluated for Impairment	142,699	41,194	476,468	276,884	225,048	233,135	1,395,428
Total	\$ 143,951	\$ 41,595	\$ 507,681	\$ 296,724	\$ 228,171	\$ 233,332	\$ 1,451,454

Impaired Loans. Loans are deemed to be impaired when, based on current information and events, it is probable that the Company will not be able to collect all amounts due (principal and interest payments), according to the contractual terms of the loan agreement. Loans, for which the terms have been modified, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

The following table presents loans individually evaluated for impairment by class of loans.

(Dollars in Thousands)	Unpaid Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Related Allowance
March 31, 2016				
Commercial, Financial and Agricultural	\$ 812	\$ 273	\$ 539	\$ 72
Real Estate – Construction	—	—	—	—
Real Estate – Commercial Mortgage	20,798	4,108	16,690	1,936
Real Estate – Residential	18,221	2,816	15,405	1,954
Real Estate – Home Equity	3,211	840	2,371	389
Consumer	206	105	101	4
Total	\$ 43,248	\$ 8,142	\$ 35,106	\$ 4,355
December 31, 2015				
Commercial, Financial and Agricultural	\$ 834	\$ 279	\$ 555	\$ 77
Real Estate – Construction	97	97	—	—
Real Estate – Commercial Mortgage	20,847	3,265	17,582	2,049
Real Estate – Residential	18,569	2,941	15,628	2,118
Real Estate – Home Equity	3,144	1,101	2,043	384
Consumer	261	79	182	18
Total	\$ 43,752	\$ 7,762	\$ 35,990	\$ 4,646

The following table summarizes the average recorded investment and interest income recognized by class of impaired loans.

(Dollars in Thousands)	For Three Months Ended March 31,	
	2016	2015
	Average	Average
	Total	Total
	Recorded Interest	Recorded Interest
	Income	Income
	Investment	Investment

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Commercial, Financial and Agricultural	\$823	\$ 13	\$1,252	\$ 11
Real Estate - Construction	49	—	401	—
Real Estate - Commercial Mortgage	20,822	239	31,213	261
Real Estate - Residential	18,395	209	19,840	197
Real Estate - Home Equity	3,178	27	3,123	21
Consumer	234	2	196	2
Total	\$43,501	\$ 490	\$56,025	\$ 492

Credit Risk Management. The Company has adopted comprehensive lending policies, underwriting standards and loan review procedures designed to maximize loan income within an acceptable level of risk. Management and the Board of Directors review and approve these policies and procedures on a regular basis (at least annually).

Reporting systems have been implemented to monitor loan originations, loan quality, concentrations of credit, loan delinquencies and nonperforming loans and potential problem loans. Management and the Credit Risk Oversight Committee periodically review our lines of business to monitor asset quality trends and the appropriateness of credit policies. In addition, total borrower exposure limits are established and concentration risk is monitored. As part of this process, the overall composition of the portfolio is reviewed to gauge diversification of risk, client concentrations, industry group, loan type, geographic area, or other relevant classifications of loans. Specific segments of the loan portfolio are monitored and reported to the Board on a quarterly basis and have strategic plans in place to supplement Board approved credit policies governing exposure limits and underwriting standards. Detailed below are the types of loans within the Company's loan portfolio and risk characteristics unique to each.

Commercial, Financial, and Agricultural – Loans in this category are primarily made based on identified cash flows of the borrower with consideration given to underlying collateral and personal or other guarantees. Lending policy establishes debt service coverage ratio limits that require a borrower’s cash flow to be sufficient to cover principal and interest payments on all new and existing debt. The majority of these loans are secured by the assets being financed or other business assets such as accounts receivable, inventory, or equipment. Collateral values are determined based upon third party appraisals and evaluations. Loan to value ratios at origination are governed by established policy guidelines.

Real Estate Construction – Loans in this category consist of short-term construction loans, revolving and non-revolving credit lines and construction/permanent loans made to individuals and investors to finance the acquisition, development, construction or rehabilitation of real property. These loans are primarily made based on identified cash flows of the borrower or project and generally secured by the property being financed, including 1-4 family residential properties and commercial properties that are either owner-occupied or investment in nature. These properties may include either vacant or improved property. Construction loans are generally based upon estimates of costs and value associated with the completed project. Collateral values are determined based upon third party appraisals and evaluations. Loan to value ratios at origination are governed by established policy guidelines. The disbursement of funds for construction loans is made in relation to the progress of the project and as such these loans are closely monitored by on-site inspections.

Real Estate Commercial Mortgage – Loans in this category consists of commercial mortgage loans secured by property that is either owner-occupied or investment in nature. These loans are primarily made based on identified cash flows of the borrower or project with consideration given to underlying real estate collateral and personal guarantees. Lending policy establishes debt service coverage ratios and loan to value ratios specific to the property type. Collateral values are determined based upon third party appraisals and evaluations.

Real Estate Residential – Residential mortgage loans held in the Company’s loan portfolio are made to borrowers that demonstrate the ability to make scheduled payments with full consideration to underwriting factors such as current income, employment status, current assets, and other financial resources, credit history, and the value of the collateral. Collateral consists of mortgage liens on 1-4 family residential properties. Collateral values are determined based upon third party appraisals and evaluations. The Company does not originate sub-prime loans.

Real Estate Home Equity – Home equity loans and lines are made to qualified individuals and are generally secured by senior or junior mortgage liens on owner-occupied 1-4 family homes or vacation homes. Borrower qualifications include favorable credit history combined with supportive income and debt ratio requirements and combined loan to value ratios within established policy guidelines. Collateral values are determined based upon third party appraisals and evaluations.

Consumer Loans – This loan portfolio includes personal installment loans, direct and indirect automobile financing, and overdraft lines of credit. The majority of the consumer loan portfolio consists of indirect and direct automobile loans. Lending policy establishes maximum debt to income ratios, minimum credit scores, and includes guidelines for

verification of applicants' income and receipt of credit reports.

Credit Quality Indicators. As part of the ongoing monitoring of the Company's loan portfolio quality, management categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment performance, credit documentation, and current economic/market trends, among other factors. Risk ratings are assigned to each loan and revised as needed through established monitoring procedures for individual loan relationships over a predetermined amount and review of smaller balance homogenous loan pools. The Company uses the definitions noted below for categorizing and managing its criticized loans. Loans categorized as "Pass" do not meet the criteria set forth for the Special Mention, Substandard, or Doubtful categories and are not considered criticized.

Special Mention – Loans in this category are presently protected from loss, but weaknesses are apparent which, if not corrected, could cause future problems. Loans in this category may not meet required underwriting criteria and have no mitigating factors. More than the ordinary amount of attention is warranted for these loans.

Substandard – Loans in this category exhibit well-defined weaknesses that would typically bring normal repayment into jeopardy. These loans are no longer adequately protected due to well-defined weaknesses that affect the repayment capacity of the borrower. The possibility of loss is much more evident and above average supervision is required for these loans.

Doubtful – Loans in this category have all the weaknesses inherent in a loan categorized as Substandard, with the characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

The following table presents the risk category of loans by segment.

(Dollars in Thousands)	Commercial, Financial, Agriculture	Real Estate	Consumer	Total Criticized Loans
March 31, 2016				
Special Mention	\$ 2,567	\$28,361	\$ 47	\$ 30,975
Substandard	1,145	47,956	679	49,780
Doubtful	—	—	—	—
Total Criticized Loans	\$ 3,712	\$76,317	\$ 726	\$ 80,755
December 31, 2015				
Special Mention	\$ 5,938	\$27,838	\$ 69	\$ 33,845
Substandard	1,307	51,425	819	53,551
Doubtful	—	—	—	—
Total Criticized Loans	\$ 7,245	\$79,263	\$ 888	\$ 87,396

Troubled Debt Restructurings (“TDRs”). TDRs are loans in which the borrower is experiencing financial difficulty and the Company has granted an economic concession to the borrower that it would not otherwise consider. In these instances, as part of a work-out alternative, the Company will make concessions including the extension of the loan term, a principal moratorium, a reduction in the interest rate, or a combination thereof. The impact of the TDR modifications and defaults are factored into the allowance for loan losses on a loan-by-loan basis as all TDRs are, by definition, impaired loans. Thus, specific reserves are established based upon the results of either a discounted cash flow analysis or the underlying collateral value, if the loan is deemed to be collateral dependent. In the limited circumstances that a loan is removed from TDR classification it is the Company’s policy to also remove it from the impaired loan category, but to continue to individually evaluate loan impairment based on the contractual terms specified by the loan agreement.

The following table presents loans classified as TDRs.

(Dollars in Thousands)	March 31, 2016		December 31, 2015	
	Accruing	Nonaccruing	Accruing	Nonaccruing
Commercial, Financial and Agricultural	\$878	\$ —	\$897	\$ —
Real Estate – Construction	—	—	—	—
Real Estate – Commercial Mortgage	16,943	799	16,621	1,070
Real Estate – Residential	15,885	1,214	14,979	1,582
Real Estate – Home Equity	2,790	—	2,914	—
Consumer	204	—	223	35
Total TDRs	\$36,700	\$ 2,013	\$35,634	\$ 2,687

Loans classified as TDRs during the periods indicated are presented in the table below. The modifications made during the reporting period involved either an extension of the loan term, a reduction in the interest rate, or a combination thereof. The financial impact of these modifications was not material.

(Dollars in Thousands)	Three Months Ended March 31, 2016			Three Months Ended March 31, 2015		
	Number of Contracts	Pre-Modified	Post-Modified	Number of Contracts	Pre-Modified	Post-Modified
		Recorded Investment	Recorded Investment		Recorded Investment	Recorded Investment
Commercial, Financial and Agricultural	—	\$ —	\$ —	—	\$ —	\$ —
Real Estate - Construction	—	—	—	—	—	—
Real Estate - Commercial Mortgage	1	332	332	1	457	457
Real Estate - Residential	5	499	500	4	464	437
Real Estate - Home Equity	4	188	189	—	—	—
Consumer	—	—	—	—	—	—
Total TDRs	10	\$ 1,019	\$ 1,021	5	\$ 921	\$ 894

The following table provides information on TDR defaults for loans that had been modified within the previous 12 months for the periods indicated.

(Dollars in Thousands)	Three Months Ended March 31, 2016		Three Months Ended March 31, 2015	
	Number of Contracts	Recorded Investment ⁽¹⁾	Number of Contracts	Recorded Investment ⁽¹⁾
Commercial, Financial and Agricultural	—	\$ —	—	\$ —
Real Estate - Construction	—	—	—	—
Real Estate - Commercial Mortgage	—	—	—	—
Real Estate - Residential	—	—	—	—
Real Estate - Home Equity	1	3	—	—
Consumer	1	35	—	—
Total TDRs	2	\$ 38	—	\$ —

The following table provides information on how TDRs were modified during the periods indicated.

(Dollars in Thousands)	Three Months Ended March 31, 2016		Three Months Ended March 31, 2015	
	Number of Contracts	Recorded Investment ⁽¹⁾	Number of Contracts	Recorded Investment ⁽¹⁾
Extended amortization	—	\$ —	1	\$ 118
Interest rate adjustment	—	—	1	156
Extended amortization and interest rate adjustment	10	1,021	3	620
Other	—	—	—	—
Total TDRs	10	\$ 1,021	5	\$ 894

⁽¹⁾ Recorded investment reflects charge-offs and additional funds advanced at time of restructure, if applicable.

NOTE 4 – OTHER REAL ESTATE OWNED

The following table presents other real estate owned activity for the periods indicated.

(Dollars in Thousands)	Three Months Ended March 31,	
	2016	2015
Beginning Balance	\$ 19,290	\$ 35,680
Additions	1,201	1,742

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Valuation Write-downs	(835)	(801)
Sales	(2,206)	(2,737)
Other	—	(49)
Ending Balance	\$ 17,450	\$ 33,835

Net expenses applicable to other real estate owned include the following:

(Dollars in Thousands)	Three Months Ended March 31,	
	2016	2015
Gains from the Sale of Properties	\$ (129)	\$ (121)
Losses from the Sale of Properties	369	310
Rental Income from Properties	—	(188)
Property Carrying Costs	350	695
Valuation Adjustments	835	801
Total	\$ 1,425	\$ 1,497

As of March 31, 2016, the Company had \$2.9 million of loans secured by residential real estate in the process of foreclosure.

NOTE 5 - EMPLOYEE BENEFIT PLANS

The Company has a defined benefit pension plan covering substantially all full-time and eligible part-time associates and a Supplemental Executive Retirement Plan (“SERP”) covering its executive officers.

The components of the net periodic benefit costs for the Company’s qualified benefit pension plan were as follows:

(Dollars in Thousands)	Three Months Ended March 31,			
	2016		2015	
Service Cost	\$ 1,613		\$ 1,675	
Interest Cost	1,397		1,425	
Expected Return on Plan Assets	(1,934)	(1,950)
Prior Service Cost Amortization	69		75	
Net Loss Amortization	801		800	
Net Periodic Benefit Cost	\$ 1,946		\$ 2,025	
Discount Rate	4.52	%	4.15	%
Long-Term Rate of Return on Assets	7.50	%	7.50	%

The components of the net periodic benefit costs for the Company’s SERP were as follows:

(Dollars in Thousands)	Three Months Ended March 31,			
	2016		2015	
Interest Cost	\$ 40		\$ 28	
Prior Service Cost Amortization	—		2	
Net Loss (Gain) Amortization	190		(90)
Net Periodic Benefit Income	\$ 230		\$ (60)
Discount Rate	4.13	%	4.15	%

Effective December 31, 2015, the Company changed the method used to estimate the service and interest components of net periodic benefit cost for the defined benefit and supplemental executive retirement plans. This new estimation approach discounts the individual expected cash flows underlying the service cost and interest cost using the applicable spot rates derived from the yield curve used to discount the cash flows for the benefit obligations. Historically, the estimated service and interest cost components utilized a single weighted-average discount rate derived from the yield curve used to measure the benefit obligations at the beginning of the period. The Company elected this change to provide a more precise measurement of service and interest costs by improving the correlation between projected benefit cash flows to the corresponding spot yield curve rates. The change was accounted for as a change in accounting estimate that is inseparable from a change in accounting principle and was accounted for prospectively. While the benefit obligations for the plans measured under this approach was unchanged, the more

granular application of the spot rates decreased the combined service and interest costs for the defined benefit retirement plan for fiscal 2016 by \$0.7 million and the supplemental executive retirement plans by \$34,000.

NOTE 6 - COMMITMENTS AND CONTINGENCIES

Lending Commitments. The Company is a party to financial instruments with off-balance sheet risks in the normal course of business to meet the financing needs of its clients. These financial instruments consist of commitments to extend credit and standby letters of credit.

The Company's maximum exposure to credit loss under standby letters of credit and commitments to extend credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in establishing commitments and issuing letters of credit as it does for on-balance sheet instruments. The amounts associated with the Company's off-balance sheet obligations were as follows:

(Dollars in Thousands)	March 31, 2016			December 31, 2015		
	Fixed	Variable	Total	Fixed	Variable	Total
Commitments to Extend Credit ⁽¹⁾	\$55,130	\$326,561	\$381,691	\$57,571	\$306,642	\$364,213
Standby Letters of Credit	6,092	—	6,092	6,095	—	6,095
Total	\$61,222	\$326,561	\$387,783	\$63,666	\$306,642	\$370,308

(1) *Commitments include unfunded loans, revolving lines of credit, and other unused commitments.*

Commitments to extend credit are agreements to lend to a client so long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a client to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities. In general, management does not anticipate any material losses as a result of participating in these types of transactions. However, any potential losses arising from such transactions are reserved for in the same manner as management reserves for its other credit facilities.

For both on- and off-balance sheet financial instruments, the Company requires collateral to support such instruments when it is deemed necessary. The Company evaluates each client's creditworthiness on a case-by-case basis. The amount of collateral obtained upon extension of credit is based on management's credit evaluation of the counterparty. Collateral held varies, but may include deposits held in financial institutions; U.S. Treasury securities;

other marketable securities; real estate; accounts receivable; property, plant and equipment; and inventory.

Contingencies. The Company is a party to lawsuits and claims arising out of the normal course of business. In management's opinion, there are no known pending claims or litigation, the outcome of which would, individually or in the aggregate, have a material effect on the consolidated results of operations, financial position, or cash flows of the Company.

Indemnification Obligation. The Company is a member of the Visa U.S.A. network. Visa U.S.A believes that its member banks are required to indemnify it for potential future settlement of certain litigation (the "Covered Litigation") that relates to several antitrust lawsuits challenging the practices of Visa and MasterCard International. In 2008, the Company, as a member of the Visa U.S.A. network, obtained Class B shares of Visa, Inc. upon its initial public offering. Since its initial public offering, Visa, Inc. has funded a litigation reserve for the Covered Litigation resulting in a reduction in the Class B shares held by the Company. During the first quarter of 2011, the Company sold its remaining Class B shares resulting in a \$3.2 million pre-tax gain. Associated with this sale, the Company entered into a swap contract with the purchaser of the shares that requires a payment to the counterparty in the event that Visa, Inc. makes subsequent revisions to the conversion ratio for its Class B shares.

In December 2013, a settlement agreement was approved by the court in resolution of the aforementioned Covered Litigation matter. Visa's share of the settlement is to be paid from the litigation reserve account, which was further funded during the third quarter of 2014 resulting in a payment of \$161,000 to the counterparty. Fixed charges included in the liability are payable quarterly until the litigation reserve is fully liquidated and at which time the aforementioned swap contract will be terminated. Quarterly fixed payments approximate \$66,000. Conversion ratio payments and ongoing fixed quarterly charges are reflected in earnings in the period incurred.

NOTE 7 – FAIR VALUE MEASUREMENTS

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, the Company utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. ASC Topic 820 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

§ *Level 1 Inputs* - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting 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 or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices

that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from, or corroborated, by market data by correlation or other means.

§ *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.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

Securities Available for Sale. U.S. Treasury securities and certain U.S. Government Agency securities are reported at fair value utilizing Level 1 inputs. Other securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, credit information and the bond's terms and conditions, among other things.

In general, the Company does not purchase securities that have a complicated structure. The Company's entire portfolio consists of traditional investments, nearly all of which are U.S. Treasury obligations, federal agency bullet or mortgage pass-through securities, or general obligation or revenue based municipal bonds. Pricing for such instruments is easily obtained. From time to time, the Company will validate, on a sample basis, prices supplied by the independent pricing service by comparison to prices obtained from third-party sources or derived using internal models.

Fair Value Swap. The Company entered into a stand-alone derivative contract with the purchaser of its Visa Class B shares. The valuation represents an internally developed estimate of the exposure based upon probability-weighted potential Visa litigation losses and related carrying cost obligations required under the contract.

A summary of fair values for assets and liabilities consisted of the following:

<i>(Dollars in Thousands)</i>	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
March 31, 2016				
Securities Available for Sale:				
U.S. Government Treasury	\$259,060	\$—	\$ —	\$259,060
U.S. Government Agency	—	104,207	—	104,207
States and Political Subdivisions	—	88,865	—	88,865
Mortgage-Backed Securities	—	1,563	—	1,563
Equity Securities	—	8,749	—	8,749
December 31, 2015				
Securities Available for Sale:				
U.S. Government Treasury	\$250,346	\$—	\$ —	\$250,346
U.S. Government Agency	—	101,824	—	101,824
State and Political Subdivisions	—	88,362	—	88,362
Mortgage-Backed Securities	—	1,901	—	1,901
Equity Securities	—	8,595	—	8,595

Assets Measured at Fair Value on a Non-Recurring Basis

Certain assets are measured at fair value on a non-recurring basis (i.e., the assets are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances). An example would be assets exhibiting evidence of impairment. The following is a description of valuation methodologies used for assets measured on a non-recurring basis.

Impaired Loans. Impairment for collateral dependent loans is measured using the fair value of the collateral less selling costs. The fair value of collateral is determined by an independent valuation or professional appraisal in conformance with banking regulations. Collateral values are estimated using Level 3 inputs due to the volatility in the real estate market, and the judgment and estimation involved in the real estate appraisal process. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly. Valuation techniques are consistent with those techniques applied in prior periods. Impaired collateral dependent loans had a carrying value of \$7.3 million with a valuation allowance of \$0.5 million at March 31, 2016 and \$8.8 million and \$0.9 million, respectively, at December 31, 2015.

Loans Held for Sale. These loans are carried at the lower of cost or fair value and are adjusted to fair value on a non-recurring basis. Fair value is based on observable markets rates for comparable loan products, which is considered a Level 2 fair value measurement.

Other Real Estate Owned. During the first three months of 2016, certain foreclosed assets, upon initial recognition, were measured and reported at fair value through a charge-off to the allowance for loan losses based on the fair value of the foreclosed asset less estimated cost to sell. The fair value of the foreclosed asset is determined by an independent valuation or professional appraisal in conformance with banking regulations. On an ongoing basis, we obtain updated appraisals on foreclosed assets and realize valuation adjustments as necessary. The fair value of foreclosed assets is estimated using Level 3 inputs due to the judgment and estimation involved in the real estate valuation process.

Assets and Liabilities Disclosed at Fair Value

The Company is required to disclose the estimated fair value of financial instruments, both assets and liabilities, for which it is practical to estimate fair value and the following is a description of valuation methodologies used for those assets and liabilities.

Cash and Short-Term Investments. The carrying amount of cash and short-term investments is used to approximate fair value, given the short time frame to maturity and as such assets do not present unanticipated credit concerns.

Securities Held to Maturity. Securities held to maturity are valued in accordance with the methodology previously noted in this footnote under the caption “Assets and Liabilities Measured at Fair Value on a Recurring Basis – Securities Available for Sale”.

Loans. The loan portfolio is segregated into categories and the fair value of each loan category is calculated using present value techniques based upon projected cash flows and estimated discount rates that reflect the credit, interest rate, and liquidity risks inherent in each loan category. The calculated present values are then reduced by an allocation of the allowance for loan losses against each respective loan category.

Deposits. The fair value of Noninterest Bearing Deposits, NOW Accounts, Money Market Accounts and Savings Accounts are the amounts payable on demand at the reporting date. The fair value of fixed maturity certificates of deposit is estimated using present value techniques and rates currently offered for deposits of similar remaining maturities.

Subordinated Notes Payable. The fair value of each note is calculated using present value techniques, based upon projected cash flows and estimated discount rates as well as rates being offered for similar obligations.

Short-Term and Long-Term Borrowings. The fair value of each note is calculated using present value techniques, based upon projected cash flows and estimated discount rates as well as rates being offered for similar debt.

A summary of estimated fair values of significant financial instruments consisted of the following:

(Dollars in Thousands)	March 31, 2016			
	Carrying Value	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
ASSETS:				
Cash	\$45,914	\$45,914	\$—	\$—
Short-Term Investments	304,908	304,908	—	—
Investment Securities, Available for Sale	462,444	259,060	203,384	—
Investment Securities, Held to Maturity	187,079	140,097	47,552	—
Loans Held for Sale	10,475	—	10,475	—
Loans, Net of Allowance for Loan Losses	1,493,222	—	—	1,502,154
LIABILITIES:				
Deposits	\$2,291,408	\$—	\$2,259,999	\$—
Short-Term Borrowings	62,922	—	62,938	—
Subordinated Notes Payable	62,887	—	49,200	—
Long-Term Borrowings	27,062	—	27,929	—

(Dollars in Thousands)	December 31, 2015			
	Carrying Value	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
ASSETS:				
Cash	\$51,288	\$51,288	\$—	\$—
Short-Term Investments	327,617	327,617	—	—
Investment Securities, Available for Sale	451,028	250,346	200,682	—
Investment Securities, Held to Maturity	187,892	134,439	52,968	—
Loans Held for Sale	11,632	—	11,632	—
Loans, Net of Allowance for Loan Losses	1,478,322	—	—	1,483,926

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LIABILITIES:

Deposits	\$2,302,849	\$—	\$2,228,210	\$—
Short-Term Borrowings	61,058	—	64,947	—
Subordinated Notes Payable	62,887	—	49,230	—
Long-Term Borrowings	28,265	—	30,448	—

All non-financial instruments are excluded from the above table. The disclosures also do not include goodwill. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

NOTE 8 – OTHER COMPREHENSIVE INCOME

The amounts allocated to other comprehensive income are presented in the table below. Reclassification adjustments related to securities held for sale are included in net gain (loss) on securities transactions in the accompanying consolidated statements of comprehensive income. For the periods presented, reclassifications adjustments related to securities held for sale was not material.

<i>(Dollars in Thousands)</i>	Before Tax Amount	Tax Expense	Net of Tax Amount
March 31, 2016			
Investment Securities:			
Change in net unrealized gain/loss on securities available for sale	\$ 1,784	\$ (688)	\$ 1,096
Amortization of losses on securities transferred from available for sale to held to maturity	19	(7)	12
Total Other Comprehensive Income	\$ 1,803	\$ (695)	\$ 1,108
March 31, 2015			
Investment Securities:			
Change in net unrealized gain/loss on securities available for sale	\$ 1,146	\$ (441)	\$ 705
Amortization of losses on securities transferred from available for sale to held to maturity	17	(7)	10
Total Other Comprehensive Income	\$ 1,163	\$ (448)	\$ 715

Accumulated other comprehensive loss was comprised of the following components:

<i>(Dollars in Thousands)</i>	Securities Available for Sale	Retirement Plans	Accumulated Other Comprehensive Loss
Balance as of January 1, 2016	\$ (127)	\$ (22,130)	\$ (22,257)
Other comprehensive income during the period	1,108	—	1,108
Balance as of March 31, 2016	\$ 981	\$ (22,130)	\$ (21,149)
Balance as of January 1, 2015	\$ 59	\$ (21,568)	\$ (21,509)
Other comprehensive income during the period	715	—	715
Balance as of March 31, 2015	\$ 774	\$ (21,568)	\$ (20,794)

NOTE 9 – ACCOUNTING STANDARDS UPDATES

ASU 2016-02, "Leases (Topic 842) – ASU 2016-02 requires the lease rights and obligations arising from lease contracts, including existing and new arrangements, to be recognized as assets and liabilities on the balance sheet. ASU 2016-02 is effective for the Company January 1, 2019. The Company is currently evaluating the effect that this guidance will have on its consolidated financial statements.

ASU 2016-07, "Investments-Equity Method and Joint Ventures (Topic 323) – Simplifying the Transition to the Equity Method of Accounting." ASU 2016-07 eliminates the requirement that when an investment qualifies for the use of the equity method as a result in the increase in ownership interest, to retroactively apply the equity method of accounting to all previous periods that the investment was held. The amendments require that the equity method investor add the cost of acquiring the additional interest to the current basis of the investment. ASU 2016-07 will be effective for the Company on January 1, 2017 and is not expected to have a significant impact on its financial statements.

ASU 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting." Under ASU 2016-09 all excess tax benefits and tax deficiencies related to share-based payment awards should be recognized as income tax expense or benefit in the income statement during the period in which they occur. Previously, such amounts were recorded in the pool of excess tax benefits included in additional paid-in capital, if such pool was available. Because excess tax benefits are no longer recognized in additional paid-in capital, the assumed proceeds from applying the treasury stock method when computing earnings per share should exclude the amount of excess tax benefits that would have previously been recognized in additional paid-in capital. Additionally, excess tax benefits should be classified along with other income tax cash flows as an operating activity rather than a financing activity, as was previously the case. ASU 2016-09 also provides that an entity can make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest (current GAAP) or account for forfeitures when they occur. ASU 2016-09 changes the threshold to qualify for equity classification (rather than as a liability) to permit withholding up to the maximum statutory tax rates (rather than the minimum as was previously the case) in the applicable jurisdictions. ASU 2016-09 will be effective for the Company on January 1, 2017 and is not expected to have a significant impact on its financial statements.

NOTE 10 – SUBSEQUENT EVENTS

On April 12, 2016, the Company repurchased \$10 million in face value of trust preferred securities that were auctioned as part of a liquidation of a pooled collateralized debt obligation fund. The trust preferred securities were originally issued through CCBG Capital Trust I, a wholly-owned business trust subsidiary of the Company. The \$10 million in trust preferred securities were retired, resulting in a commensurate reduction in the Company's related floating rate junior subordinated note. The Company's winning bid equated to approximately 75% of the \$10 million par value, with the 25% discount resulting in a pre-tax gain of approximately \$2.5 million that will be realized in the second quarter of 2016. The Company utilized internal resources and a \$3.75 million draw on a short-term borrowing facility to fund the repurchase.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's discussion and analysis ("MD&A") provides supplemental information, which sets forth the major factors that have affected our financial condition and results of operations and should be read in conjunction with the Consolidated Financial Statements and related notes. The following information should provide a better understanding of the major factors and trends that affect our earnings performance and financial condition, and how our performance during the first quarter of 2016 compares with prior periods. Throughout this section, Capital City Bank Group, Inc., and subsidiaries are collectively referred to as "CCBG," "Company," "we," "us," or "our."

CAUTION CONCERNING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, including this MD&A section, contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, among others, statements about our beliefs, plans, objectives, goals, expectations, estimates and intentions that are subject to significant risks and uncertainties and are subject to change based on various factors, many of which are beyond our control. The words "may," "could," "should," "would," "believe," "anticipate," "estimate," "expect," "intend," "plan," "target," similar expressions are intended to identify forward-looking statements.

All forward-looking statements, by their nature, are subject to risks and uncertainties. Our actual future results may differ materially from those set forth in our forward-looking statements. Please see the Introductory Note and *Item 1A. Risk Factors* of our 2015 Report on Form 10-K, as updated in our subsequent quarterly reports filed on Form 10-Q, and in our other filings made from time to time with the SEC after the date of this report.

However, other factors besides those listed in our Quarterly Report or in our Annual Report also could adversely affect our results, and you should not consider any such list of factors to be a complete set of all potential risks or uncertainties. Any forward-looking statements made by us or on our behalf speak only as of the date they are made. We do not undertake to update any forward-looking statement, except as required by applicable law.

BUSINESS OVERVIEW

We are a financial holding company headquartered in Tallahassee, Florida, and we are the parent of our wholly owned subsidiary, Capital City Bank (the "Bank" or "CCB"). The Bank offers a broad array of products and services through a total of 61 banking offices located in Florida, Georgia, and Alabama. The Bank offers commercial and retail banking services, as well as trust and asset management, retail securities brokerage and data processing services.

Our profitability, like most financial institutions, is dependent to a large extent upon net interest income, which is the difference between the interest and fees received on interest earning assets, such as loans and securities, and the interest paid on interest-bearing liabilities, principally deposits and borrowings. Results of operations are also affected by the provision for loan losses, operating expenses such as salaries and employee benefits, occupancy and other operating expenses including income taxes, and noninterest income such as deposit fees, wealth management fees, mortgage banking fees, bank card fees, and data processing fees.

A detailed discussion regarding the economic conditions in our markets and our long-term strategic objectives is included as part of the MD&A section of our 2015 Form 10-K.

SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

	2016		2015		2014			
	First	Second	Third	Fourth	First	Second	Third	Fourth
Thousands, Except Per Share								
Operations:								
Income	\$20,044	\$19,833	\$19,877	\$20,602	\$19,346	\$19,871	\$19,766	\$19,346
Expense	834	849	811	808	839	852	868	900
Net Income	19,210	18,984	19,066	19,794	18,507	19,019	18,898	18,446
For Loan Losses	452	375	413	513	293	623	424	490
Net Income After For Loan Losses	18,758	18,609	18,653	19,281	18,214	18,396	18,474	17,956
Net Income	12,677	14,794	13,228	13,221	12,848	13,053	13,351	13,351
Expense	28,930	28,439	29,164	28,280	29,390	28,309	28,607	29,390
Before Income Taxes	2,505	4,964	2,717	4,222	1,672	3,140	3,218	2,505
Income Tax Expense	858	1,119	1,034	1,620	686	1,219	1,103	730
Net Income	1,647	3,845	1,683	2,602	986	1,921	2,115	1,775
Net Income (FTE)	19,421	19,119	19,253	20,006	18,611	19,124	19,020	18,611
Per Share:								
Income Basic	\$0.10	\$0.22	\$0.09	\$0.16	\$0.06	\$0.11	\$0.12	\$0.10
Income Diluted	0.10	0.22	0.09	0.16	0.06	0.11	0.12	0.10
Dividends Declared	0.04	0.03	0.03	0.04	0.03	0.03	0.02	0.03
Book Value	16.04	15.80	15.91	15.93	15.59	15.53	16.18	16.04
Price:	15.88	16.32	15.75	16.05	16.33	16.00	14.98	15.88
	12.83	13.94	14.39	13.56	13.16	13.00	13.26	12.83
	14.59	15.27	14.92	15.35	16.25	15.54	13.54	14.59
Average Balances:								
Total Assets	\$1,507,508	\$1,473,954	\$1,483,657	\$1,492,521	\$1,448,617	\$1,426,756	\$1,421,327	\$1,507,508
Loans	2,440,718	2,328,012	2,310,823	2,353,729	2,306,485	2,212,781	2,209,429	2,440,718
Deposits	2,763,746	2,670,701	2,639,692	2,678,214	2,648,551	2,549,736	2,530,571	2,763,746
Shareholders' Equity	2,258,600	2,178,399	2,137,433	2,174,718	2,163,376	2,077,365	2,062,881	2,258,600
Equivalent Average Shares:	277,464	274,421	274,956	275,893	275,304	286,029	284,130	277,464
	17,202	17,296	17,150	17,145	17,508	17,433	17,440	17,202
	17,235	17,358	17,229	17,214	17,555	17,530	17,519	17,235
Key Ratios:								
Average Assets	0.24	0.58	0.25	0.39	0.15	0.30	0.33	0.24
Average Equity	2.39	5.62	2.43	3.74	1.45	2.66	2.95	2.39
Net Margin (FTE)	3.20	3.29	3.31	3.37	3.27	3.43	3.42	3.20
Net Income as % of Revenue	39.76	43.80	40.96	40.05	40.98	40.70	41.40	39.76
Return Ratio	90.13	83.85	89.79	85.11	93.42	87.98	88.37	90.13
Other:								

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for Loan Losses	\$13,613		\$13,953		\$14,737		\$15,236		\$16,090		\$17,539		\$19,093		\$20,000
for Loan Losses to Loans	0.90	%	0.93	%	0.99	%	1.03	%	1.10	%	1.22	%	1.34	%	1.40
ning Assets ("NPAs")	26,499		29,595		38,357		45,487		50,625		52,449		65,208		68,000
total Assets	0.95		1.06		1.47		1.71		1.88		2.00		2.61		2.70
oans plus ORE	1.73		1.94		2.54		3.00		3.38		3.55		4.45		4.60
to Non-Performing Loans	150.44		135.40		112.17		99.46		95.83		104.60		81.31		80.00
e-Offs to Average Loans	0.21		0.34		0.24		0.33		0.49		0.61		0.52		0.50
Ratios:															
ital	16.39	%	16.42	%	16.36	%	15.83	%	16.16	%	16.67	%	16.88	%	16.90
tal	17.20		17.25		17.24		16.72		17.11		17.76		18.08		18.00
Equity Tier 1 ⁽¹⁾	12.82		12.84		12.76		12.34		12.57		NA		NA		NA
	10.34		10.65		10.71		10.53		10.73		10.99		10.97		10.90
Capital ⁽²⁾	7.09		6.99		7.46		7.29		7.26		7.38		8.22		7.90

(1) *Not applicable prior to January 1, 2015.*

(2) *Total shareowners equity minus goodwill divided by total assets minus goodwill.*

FINANCIAL OVERVIEW

A summary overview of our financial performance is provided below.

Results of Operations

Net income of \$1.6 million, or \$0.10 per diluted share, for the first quarter of 2016 compared to net income of \$2.6 million, or \$0.16 per diluted share, for the fourth quarter of 2015, and net income of \$1.0 million, or \$0.06 per diluted share, for the first quarter of 2015.

Tax equivalent net interest income for the first quarter of 2016 totaled \$19.4 million, a \$0.6 million, or 2.9%, decrease from the fourth quarter of 2015 and a \$0.8 million, or 4.4%, increase over the first quarter of 2015. The decrease from the fourth quarter of 2015 primarily reflects an interest recovery in the fourth quarter for a paid off loan and one less calendar day, partially offset by higher income on overnight funds and prime-based loans. The increase over the comparable prior year primarily reflects a favorable shift in earning asset mix due to growth in the loan and investment portfolios.

Total credit costs (loan loss provision plus other real estate owned (“OREO”) expenses) were \$1.9 million for the first quarter of 2016 compared to \$1.8 million for the fourth quarter of 2015 and \$1.8 million for the first quarter of 2015.

Noninterest income for the first quarter of 2016 totaled \$12.7 million, a decrease of \$0.5 million, or 4.1%, from the fourth quarter of 2015 primarily attributable to an expected lower level of deposit fees driven by a lower utilization of our overdraft service in the first quarter as clients receive tax refunds. Compared to the first quarter of 2015, noninterest income decreased \$0.2 million, or 1.3%, primarily due to lower wealth management fees.

Noninterest expense (excluding OREO expense) for the first quarter of 2016 totaled \$27.5 million, an increase of \$0.5 million, or 1.7%, over the fourth quarter of 2015 and a decrease of \$0.4 million, or 1.4%, from the first quarter of 2015. The increase compared to the fourth quarter of 2015 was primarily driven by higher compensation expense reflective of the re-set of social security and unemployment taxes. The decrease from the first quarter of 2015 was primarily due to lower compensation expense, primarily a higher level of deferred loan cost.

Financial Condition

Average earning assets totaled \$2.441 billion for the first quarter of 2016, an increase of \$87.0 million, or 3.7%, over the fourth quarter of 2015 and \$134.2 million, or 5.8%, over the first quarter of 2015. The increase over prior periods was due to a higher level of deposits. Growth in both the loan and investment portfolios led to a more favorable earning asset mix compared to both prior periods.

Average loans increased \$15.0 million, or 1.0%, over the fourth quarter of 2015 and \$58.9 million, or 4.1%, over the first quarter of 2015. Growth over both prior periods was broad based as we realized increases in all loan products,

with the exception of commercial mortgages.

Average total deposits were \$2.259 billion for the first quarter of 2016, an increase of \$83.9 million, or 3.9%, over the fourth quarter of 2015 and \$95.2 million, or 4.4%, over the first quarter of 2015. Higher NOW account (primarily public funds) drove the increase from the fourth quarter of 2015 and higher noninterest bearing checking and savings account balances drove the increase over the first quarter of 2015.

Nonperforming assets totaled \$26.5 million at March 31, 2016, a decrease of \$3.1 million from December 31, 2015 and \$24.1 million from March 31, 2015. Nonperforming assets represented 0.95% of total assets at March 31, 2016 compared to 1.06% at December 31, 2015 and 1.88% at March 31, 2015.

As of March 31, 2016, we were well-capitalized with a risk based capital ratio of 17.20% and a tangible capital ratio of 7.09% compared to 17.25% and 6.99%, respectively at December 31, 2015 and 17.11% and 7.26%, respectively, at March 31, 2015. All of our regulatory capital ratios significantly exceed the threshold to be well-capitalized under the Basel III capital standards.

RESULTS OF OPERATIONS**Net Income**

For the first quarter of 2016, we realized net income of \$1.6 million, or \$0.10 per diluted share, compared to net income of \$2.6 million, or \$0.16 per diluted share, for the fourth quarter of 2015, and net income of \$1.0 million, or \$0.06 per diluted share, for the first quarter of 2015.

Compared to the fourth quarter of 2015, performance reflected lower net interest income of \$0.6 million, noninterest income of \$0.5 million, and higher noninterest expense of \$0.7 million, partially offset by lower income tax expense of \$0.8 million.

Compared to the first quarter of 2015, the increase in earnings was due to higher net interest income of \$0.7 million and lower noninterest expense of \$0.5 million, partially offset by lower noninterest income of \$0.2 million, a \$0.2 million increase in the loan loss provision, and higher income tax expense of \$0.2 million.

A condensed earnings summary of each major component of our financial performance is provided below:

	Three Months Ended		
	March 31, 2016	December 31, 2015	March 31, 2015
(Dollars in Thousands, except per share data)			
Interest Income	\$20,044	\$20,602	\$19,346
Taxable Equivalent Adjustments	211	212	104
Total Interest Income (FTE)	20,255	20,814	19,450
Interest Expense	834	808	839
Net Interest Income (FTE)	19,421	20,006	18,611
Provision for Loan Losses	452	513	293
Taxable Equivalent Adjustments	211	212	104
Net Interest Income After Provision for Loan Losses	18,758	19,281	18,214
Noninterest Income	12,677	13,221	12,848
Noninterest Expense	28,930	28,280	29,390
Income Before Income Taxes	2,505	4,222	1,672
Income Tax Expense	858	1,620	686
Net Income	\$1,647	\$2,602	\$986
Basic Net Income Per Share	\$0.10	\$0.16	\$0.06
Diluted Net Income Per Share	\$0.10	\$0.16	\$0.06

Net Interest Income

Net interest income represents our single largest source of earnings and is equal to interest income and fees generated by earning assets less interest expense paid on interest-bearing liabilities. This information is provided on a “taxable equivalent” basis to reflect the tax-exempt status of income earned on certain loans and investments, the majority of which are state and local government debt obligations. We provide an analysis of our net interest income including average yields and rates in Table I on page 38.

Tax equivalent net interest income for the first quarter of 2016 was \$19.4 million compared to \$20.0 million for the fourth quarter of 2015 and \$18.6 million for the first quarter of 2015. The decrease in tax equivalent net interest income compared to the fourth quarter of 2015 reflects an interest recovery in the fourth quarter for a paid off loan and one less calendar day, partially offset by higher income on overnight funds and prime-based loans. The increase in tax equivalent net interest income compared to the first quarter of 2015 reflects a favorable shift in the earning asset mix due to growth in the loan and investment portfolios, partially offset by lower loan fees.

Despite favorable volume variance in both the loan and investment portfolios, the low rate environment continues to negatively affect the loan yields. Aggressive lending competition in all markets has also unfavorably impacted the pricing for loans. The recent 25 basis point increase in the Federal Reserve’s target rate had a favorable impact on net interest income as our overnight funds and Prime based loans repriced higher with no corresponding increase in our deposit costs.

The net interest margin for the first quarter of 2016 was 3.20%, a decrease of 17 basis points from the fourth quarter of 2015, and a decrease of seven basis points from the first quarter of 2015. The decrease in the margin compared to the fourth quarter of 2015 was primarily attributable to the aforementioned interest recovery and an increase in the level of average earning assets. The decrease in the margin compared to the first quarter of 2015 was primarily attributable to overall growth in earning assets and a decline in loan yields.

Our current strategy, which is consistent with our historical strategy, is to not accept greater interest rate risk by reaching further out the curve for yield, particularly given the fact that short term rates are at historical lows. We continue to maintain short duration portfolios on both sides of the balance sheet and believe we are well positioned to respond to changing market conditions. Over time, this strategy has historically produced fairly consistent outcomes and a net interest margin that is significantly above peer comparisons.

Provision for Loan Losses

The provision for loan losses for the first quarter of 2016 was \$0.5 million comparable to the fourth quarter of 2015 and \$0.3 million for the first quarter of 2015. The slight increase in the provision over the first quarter of 2015 reflects growth in our loan portfolio. We continue to realize favorable problem loan migration and improvement in key credit metrics.

Net charge-offs for the first quarter of 2016 totaled \$0.8 million, or 0.21% (annualized) of average loans, compared to \$1.3 million, or 0.34% (annualized) for the fourth quarter of 2015 and \$1.7 million, or 0.49% (annualized) for the first quarter of 2015. At March 31, 2016, the allowance for loan losses was \$13.6 million, or 0.90% of outstanding loans (net of overdrafts) and provided coverage of 150% of nonperforming loans compared to 0.93% and 135%, respectively, at December 31, 2015, and 1.10% and 96%, respectively, at March 31, 2015.

Charge-off activity for the respective periods is set forth below:

	Three Months Ended		
	March	December	March
(Dollars in Thousands, except per share data)	31,	31,	31,
	2016	2015	2015
CHARGE-OFFS			
Commercial, Financial and Agricultural	\$37	\$135	\$290
Real Estate – Construction	—	—	—
Real Estate – Commercial Mortgage	274	87	904
Real Estate – Residential	478	587	305
Real Estate – Home Equity	215	397	182
Consumer	439	656	576
Total Charge-offs	1,443	1,862	2,257
RECOVERIES			
Commercial, Financial and Agricultural	39	57	55
Real Estate – Construction	—	—	—
Real Estate – Commercial Mortgage	81	13	30
Real Estate – Residential	236	264	48
Real Estate – Home Equity	59	37	24

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Consumer	236	194	358
Total Recoveries	651	565	515
Net Charge-offs	\$792	\$1,297	\$1,742
Net Charge-offs (Annualized) as a Percent of Average Loans Outstanding, Net of Overdrafts	0.21 %	0.34 %	0.49 %

Noninterest Income

Noninterest income for the first quarter of 2016 totaled \$12.7 million, a decrease of \$0.5 million, or 4.1%, from the fourth quarter of 2015 primarily attributable to lower deposit fees of \$0.3 million and wealth management fees of \$0.1 million. Compared to the first quarter of 2015, noninterest income decreased \$0.2 million, or 1.3%, largely reflective of a \$0.2 million decline in wealth management fees.

Noninterest income represented 39.76% of operating revenues (net interest income plus noninterest income) in the first quarter of 2016 compared to 40.05% in the fourth quarter of 2015 and 40.98% in the first quarter of 2015.

The table below reflects the major components of noninterest income.

	Three Months Ended		
	March 31, 2016	December 31, 2015	March 31, 2015
(Dollars in Thousands)			
Deposit Fees	\$5,400	\$5,664	\$5,541
Bank Card Fees	2,853	2,866	2,742
Wealth Management Fees	1,792	1,893	2,046
Mortgage Banking Fees	1,030	1,043	987
Data Processing Fees	347	335	373
Other	1,255	1,420	1,159
Total Noninterest Income	\$12,677	\$13,221	\$12,848

Significant components of noninterest income are discussed in more detail below.

Deposit Fees. Deposit fees decreased \$0.3 million, or 4.7%, from the fourth quarter of 2015 and \$0.1 million, or 2.5%, from the first quarter of 2015. The decline from the fourth quarter of 2015 was primarily due to an expected lower utilization of our overdraft protection service during the first quarter as clients receive tax refunds. Compared to the first quarter of 2015, the decline was due to a lower level of overdraft fees generally reflective of improved financial management by our clients.

Bank Card Fees. Bank card fees (including interchange fees and ATM/debit card fees) were comparable to the fourth quarter of 2015 and increased \$0.1 million, or 4.0%, over the first quarter of 2015. The increase compared to the first quarter of 2015 was attributable to higher card activity and average ticket amount.

Wealth Management Fees. Wealth management fees include both trust fees (i.e., managed accounts, trusts/estates, and retirement plans) and retail brokerage fees (i.e., investment and insurance products), which totaled \$1.8 million for the first quarter of 2016, a decrease of \$0.1 million, or 5.3%, from the fourth quarter of 2015 and \$0.2 million, or 12.4%, from the first quarter of 2015. The decrease from the fourth quarter of 2015 reflects lower fees from our trust business which had a very strong fourth quarter due to higher estate management fees. Compared to the first quarter of 2015, the decrease generally reflects a lower level of assets under management. At March 31, 2016, total assets under management were approximately \$1.159 billion compared to \$1.139 billion at December 31, 2015 and \$1.226 billion at March 31, 2015.

Noninterest Expense

Noninterest expense for the first quarter of 2016 totaled \$28.9 million, an increase of \$0.7 million, or 2.3%, over the fourth quarter of 2015 and a decrease of \$0.5 million, or 1.6%, from the first quarter of 2015. Compared to the fourth quarter of 2015, the increase reflects higher compensation expense of \$0.4 million, other real estate expense of \$0.2 million, and other expense (excluding OREO expenses) of \$0.3 million, partially offset by lower occupancy expense of \$0.2 million.

Compared to the first quarter of 2015, the decrease was attributable to lower compensation expense of \$0.3 million, other real estate expense of \$0.1 million and other expense (excluding OREO expenses) of \$0.1 million. Expense management is an important part of our culture and strategic focus and we will continue to review and evaluate opportunities to optimize our operations, reduce operating costs and manage our discretionary expenses.

The table below reflects the major components of noninterest expense.

(Dollars in Thousands)	Three Months Ended		
	March 31, 2016	December 31, 2015	March 31, 2015
Salaries	\$ 11,934	\$ 11,505	\$ 12,515
Associate Benefits	4,307	4,328	4,009
Total Compensation	16,241	15,833	16,524
Premises	2,307	2,260	2,276
Equipment	2,152	2,378	2,120
Total Occupancy	4,459	4,638	4,396
Legal Fees	699	512	705
Professional Fees	862	873	1,045
Processing Services	1,702	1,424	1,778
Advertising	340	404	340
Travel and Entertainment	196	227	211
Printing and Supplies	203	213	204
Telephone	470	491	535
Postage	261	242	281
Insurance – Other	628	653	705
Other Real Estate Owned, Net	1,425	1,241	1,497
Miscellaneous	1,444	1,529	1,169
Total Other	8,230	7,809	8,470
Total Noninterest Expense	\$28,930	\$28,280	\$29,390

Significant components of noninterest expense are discussed in more detail below.

Compensation. Compensation expense totaled \$16.2 million for the first quarter of 2016, an increase of \$0.4 million, or 2.6%, over the fourth quarter of 2015 due to higher salary expense. The increase was primarily due to increased payroll tax expense reflecting the reset of social security taxes and higher unemployment taxes as a large portion of the annual premium is paid in the first quarter. Compared to the first quarter of 2015, total compensation expense decreased \$0.3 million, or 1.7%, attributable to lower salary expense of \$0.6 million partially offset by higher associate benefit expense of \$0.3 million. The reduction in salary expense was primarily attributable to a higher level of deferred loan cost and the increase in associate benefits expense was primarily due to higher pension plan expense.

Occupancy. Occupancy expense (including premises and equipment) totaled \$4.5 million for the first quarter of 2016, a decrease of \$0.2 million, or 3.9%, from the fourth quarter of 2015 driven by lower furniture, fixtures, and equipment (“FF&E”) maintenance agreement expense and FF&E maintenance/repairs. Compared to the first quarter of 2015, occupancy expense increased \$0.1 million, or 1.4%, primarily attributable to higher FF&E depreciation expense and

software license expense.

Other. Other noninterest expense totaled \$8.2 million for the first quarter of 2016, an increase of \$0.5 million, or 5.4%, over the fourth quarter of 2015 and a decrease of \$0.2 million, or 2.8%, from the first quarter of 2015. The increase compared to the fourth quarter of 2015 was primarily due to higher processing services of \$0.3 million, OREO expense of \$0.2 million and legal fees of \$0.2 million, partially offset by lower advertising expense of \$0.1 million and miscellaneous expense of \$0.1 million. The increase in processing services was attributable to a volume credit received from our debit card processor during the fourth quarter. The increase in OREO expense was attributable to higher property valuation adjustments. The increase in legal fees reflects higher fees to support loan workouts. Depending on the specific activity during the quarter, legal fees can be volatile but have been trending down for the last four years. The decrease in advertising reflects lower spend for various media campaigns. The reduction in miscellaneous expense was due to lower training costs and repossession expense. The decrease compared to the first quarter of 2015 reflects lower OREO expense and professional fees.

Our operating efficiency ratio (expressed as noninterest expense as a percent of the sum of taxable-equivalent net interest income plus noninterest income) was 90.13% for the first quarter of 2016 compared to 85.11% for the fourth quarter of 2015 and 93.42% for the first quarter of 2015. The unfavorable variance in this metric compared to the fourth quarter of 2015 was driven by higher operating expenses. The improvement in this metric compared to the first quarter of 2015 reflects higher operating revenues and lower operating expenses.

Income Taxes

We realized income tax expense of \$0.8 million (34.3% effective rate) million for the first quarter of 2016 compared to \$1.6 million (38.4% effective rate) for the fourth quarter of 2015 and \$0.6 million (41.0% effective rate) million for the first quarter of 2015. Income taxes for the fourth quarter of 2015 and the first quarter of 2015 include deferred tax write-offs of \$0.1 million and \$0.2 million, respectively, related to forfeited/expired stock awards. Absent future discrete events, we anticipate our effective income tax rate will normalize within a range of 34% - 35%.

FINANCIAL CONDITION

Average assets totaled approximately \$2.764 billion for the first quarter of 2016, an increase of \$85.5 million, or 3.2%, over the fourth quarter of 2015, and an increase of \$115.2 million, or 4.4%, over the fourth quarter of 2015. Average earning assets were \$2.441 billion for the first quarter of 2016, an increase of \$87.0 million, or 3.7%, over the fourth quarter of 2015 and an increase of \$134.2 million, or 5.8%, over the first quarter of 2015. The increase in earning assets from the fourth quarter of 2015 reflects a higher level of public fund deposits. The increase compared to the first quarter of 2015 reflects deposit growth, primarily noninterest bearing and savings accounts.

Investment Securities

In the first quarter of 2016, our average investment portfolio increased \$8.7 million, or 1.4%, over the fourth quarter of 2015 and increased \$91.6 million, or 16.5%, over the first quarter of 2015. As a percentage of average earning assets, the investment portfolio represented 26.5% in the first quarter of 2016, compared to 27.1% in the fourth quarter of 2015 and 24.1% in the first quarter of 2015. The investment portfolio increased over the prior year consistent with our strategy primarily by adding positions in U.S. Treasury and highly rated municipal bonds. For the remainder of 2016, we anticipate that a majority of the cash flow from the investment portfolio will be reinvested into securities. We will continue to closely monitor liquidity levels, as well as look for new investment products that are prudent relative to our risk profile and the Bank's overall investment strategy.

The investment portfolio is a significant component of our operations and, as such, it functions as a key element of liquidity and asset/liability management. Two types of classifications are approved for investment securities which are Available-for-Sale ("AFS") and Held-for-Maturity ("HTM"). During the first quarter of 2016, securities were purchased under both the AFS and HTM designations. As of March 31, 2016, \$462.4 million, or 71.2% of the investment portfolio was classified as AFS, with the remaining \$187.6 million classified as HTM.

At acquisition, the classification of the security will be determined based on how the purchase will affect our asset/liability strategy and future business plans and opportunities. Such decisions will be weighed against multiple

factors, including regulatory capital requirements, volatility in earnings or other comprehensive income, and liquidity needs. Securities in the AFS portfolio are recorded at fair value with unrealized gains and losses associated with these securities recorded net of tax, in the accumulated other comprehensive income (loss) component of shareowners' equity. Securities that are HTM will be acquired or owned with the intent of holding them to maturity (final payment date). HTM investments are measured at amortized cost. It is neither management's current intent nor practice to participate in the trading of investment securities for the purpose of recognizing gains and therefore we do not maintain a trading portfolio.

At March 31, 2016, the investment portfolio had a net pre-tax unrealized gain in the AFS portfolio of \$1.9 million compared to an unrealized gain of \$0.1 million and \$1.7 million at December 31, 2015 and March 31, 2015, respectively. At quarter-end, there were 115 positions (combined AFS and HTM) with unrealized losses at quarter end totaling \$0.3 million. Of the 115 positions, 76 were GNMA, U.S. Treasuries, or SBA securities, all of which carry the full faith and credit guarantee of the US Government. SBA securities float monthly or quarterly to the prime rate and are uncapped. Of these 76 positions, there were 23 GNMA positions and 28 SBA positions in an unrealized loss position for longer than 12 months, and have unrealized losses of \$176k and \$65k, respectively. There were 37 municipal bonds in an unrealized loss position that were pre-refunded, or rated "AA-" or better. One of these positions was in an unrealized loss position for longer than 12 months, and had an unrealized loss of \$1,000. The remaining two securities were government agency bonds, which have been in an unrealized loss position for less than 12 months, with an unrealized loss of less than \$1,000. None of the positions with unrealized losses are considered impaired, and all are expected to mature at par.

The average maturity of the total portfolio at March 31, 2016 was 1.79 years compared to 1.83 years and 2.14 years for the December 31, 2015 and March 31, 2015 periods, respectively. The average life of the total portfolio in the first quarter of 2016 was shorter compared to both prior periods mainly attributable to the natural aging of the existing portfolio, partially offset by new investments with average maturities in the 2-4 year range.

Loans

Average loans increased \$15.0 million, or 1.0%, when compared to the fourth quarter of 2015, and have grown \$58.9 million, or 4.1% compared to the first quarter of 2015. Growth over both prior periods has been experienced in all loan products, with the exception of commercial mortgages.

The resolution of problem loans, which includes loan charge-offs and loans transferred to OREO, totaled \$2.6 million for the first quarter of 2016, compared to \$3.5 million from the fourth quarter of 2015, and \$4.0 million from the first quarter of 2015. The problem loan resolutions are based on “as of” balances, not averages.

Without compromising our credit standards or taking on inordinate interest rate risk, we continue to make minor modifications on some of our lending programs to try and foster loan growth within our markets where it is appropriate and within our risk appetite. These programs, coupled with economic improvements in our anchor markets, have helped to increase overall production.

Nonperforming Assets

Nonperforming assets (nonaccrual loans and OREO) totaled \$26.5 million at the end of the first quarter of 2016, a decrease of \$3.1 million, or 10.5%, from the fourth quarter of 2015 and \$24.1 million, or 47.7%, from the first quarter of 2015. Nonaccrual loans totaled \$9.0 million at the end of the first quarter of 2016, a decrease of \$1.3 million from the fourth quarter of 2015 and a decrease of \$7.7 million from the first quarter of 2015.

Nonaccrual loan additions in the first quarter of 2016 totaled \$3.8 million compared to \$3.6 million and \$5.8 million for the fourth and first quarters of 2015, respectively. The balance of OREO totaled \$17.4 million at the end of the first quarter of 2016, a decrease of \$1.8 million and \$16.4 million, respectively, from the fourth and first quarters of 2015. For the first quarter of 2016, we added properties totaling \$1.2 million, sold properties totaling \$2.2 million, and recorded valuation adjustments totaling \$0.8 million. Nonperforming assets represented 0.95% of total assets at March 31, 2016 compared to 1.06% at December 31, 2015 and 1.88% at March 31, 2015.

(Dollars in Thousands)	March 31, 2016	December 31, 2015	March 31, 2015
Nonaccruing Loans:			
Commercial, Financial and Agricultural	\$ 83	\$ 96	\$ 626
Real Estate - Construction	—	97	424
Real Estate - Commercial Mortgage	3,942	4,191	6,909

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Real Estate - Residential	3,490	4,739		6,123
Real Estate - Home Equity	1,323	1,017		2,253
Consumer	211	165		455
Total Nonperforming Loans (“NPLs” ⁽¹⁾)	\$9,049	\$ 10,305		\$ 16,790
Other Real Estate Owned	17,450	19,290		33,835
Total Nonperforming Assets (“NPAs”)	\$26,499	\$ 29,595		\$ 50,625
Past Due Loans 30 – 89 Days	\$3,599	\$ 5,775		\$ 3,689
Past Due Loans 90 Days or More (accruing)	—	—		—
Performing Troubled Debt Restructurings	36,700	35,634		42,590
Nonperforming Loans/Loans	0.60 %	0.69 %		1.15 %
Nonperforming Assets/Total Assets	0.95	1.06		1.88
Nonperforming Assets/Loans Plus OREO	1.73	1.94		3.38
Allowance/Nonperforming Loans	150.44 %	135.40 %		95.83 %

(1) *Nonperforming TDRs are included in the Nonaccrual/NPL totals*

Activity within our nonperforming asset portfolio is provided in the table below.

(Dollars in Thousands)	Three Months Ended March 31,	
	2016	2015
NPA Beginning Balance:	\$ 29,595	\$ 52,449
Change in Nonaccrual Loans:		
Beginning Balance	10,305	16,769
Additions	3,796	5,767
Charge-Offs	(931)	(1,620)
Transferred to OREO	(1,201)	(617)
Paid Off/Payments	(933)	(944)
Restored to Accrual	(1,987)	(2,565)
Ending Balance	9,049	16,790
Change in OREO:		
Beginning Balance	19,290	35,680
Additions	1,201	1,742
Valuation Write-downs	(835)	(801)
Sales	(2,206)	(2,737)
Other	—	(49)
Ending Balance	17,450	33,835
NPA Net Change	(3,096)	(1,824)
NPA Ending Balance	\$ 26,499	\$ 50,625

Activity within our TDR portfolio is provided in the table below.

(Dollars in Thousands)	Three Months Ended March 31,	
	2016	2015
TDR Beginning Balance:	\$ 38,321	\$ 49,154
Additions	1,021	894
Charge-Offs	—	(884)
Paid Off/Payments	(445)	(611)
Removal Due to Change in TDR Status	—	(202)
Transfer to OREO	(184)	(1,193)
TDR Ending Balance	\$ 38,713	\$ 47,158

Allowance for Loan Losses

We maintain an allowance for loan losses at a level that management believes to be sufficient to provide for probable losses inherent in the loan portfolio as of the balance sheet date. Credit losses arise from borrowers' inability or unwillingness to repay, and from other risks inherent in the lending process, including collateral risk, operations risk,

concentration risk and economic risk. All related risks of lending are considered when assessing the adequacy of the loan loss reserve. The allowance for loan losses is established through a provision charged to expense. Loans are charged against the allowance when management believes collection of the principal is unlikely. The allowance for loan losses is based on management's judgment of overall loan quality. This is a significant estimate based on a detailed analysis of the loan portfolio. The balance can and will change based on changes in the assessment of the loan portfolio's overall credit quality. We evaluate the adequacy of the allowance for loan losses on a quarterly basis.

The allowance for loan losses was \$13.6 million at March 31, 2016 compared to \$14.0 million at December 31, 2015 and \$16.1 million at March 31, 2015. The allowance for loan losses was 0.90% of outstanding loans and provided coverage of 150% of nonperforming loans at March 31, 2016 compared to 0.93% and 135%, respectively, at December 31, 2015 and 1.10% and 96%, respectively, at March 31, 2015. The reduction in the allowance from prior periods was attributable to a lower level of both general reserves and impaired loan reserves. The decrease in general reserves reflects slower problem loan migration, lower loan loss experience, and continued improvement in credit metrics, partially offset by reserves for growth in the loan portfolio. The decrease in impaired loan reserves was driven by a lower level of impaired loans reflecting reduced inflow and successful resolutions as well as lower loss content. It is management's opinion that the allowance at March 31, 2016 is adequate to absorb losses inherent in the loan portfolio at quarter-end.

Deposits

Average total deposits were \$2.259 billion for the first quarter of 2016, an increase of \$83.9 million, or 3.9%, over the fourth quarter of 2015, and an increase of \$95.2 million, or 4.4%, over the first quarter of 2015. The increase in deposits when compared to the fourth quarter of 2015 primarily reflected higher levels of public fund NOW and savings accounts, partially offset by a decline in money market accounts and certificates of deposit. The increase in deposits when compared to the first quarter of 2015 is attributable to higher levels of noninterest bearing and savings accounts. The seasonal inflows of public funds most likely peaked in the first quarter of 2016, and are expected to decline through the fourth quarter of 2016.

Deposit levels remain strong, particularly given the recent increase in the fed funds rate. Although competitive rates will be closely monitored given this change, we do not attempt to compete with higher rate paying competitors for deposits. We believe that prudent pricing discipline will continue to be the key to managing our mix of deposits.

MARKET RISK AND INTEREST RATE SENSITIVITY

Market Risk and Interest Rate Sensitivity

Overview. Market risk management arises from changes in interest rates, exchange rates, commodity prices, and equity prices. We have risk management policies to monitor and limit exposure to market risk and do not participate in activities that give rise to significant market risk involving exchange rates, commodity prices, or equity prices. In asset and liability management activities, our policies are designed to minimize structural interest rate risk.

Interest Rate Risk Management. Our net income is largely dependent on net interest income. Net interest income is susceptible to interest rate risk to the degree that interest-bearing liabilities mature or re-price on a different basis than interest-earning assets. When interest-bearing liabilities mature or re-price more quickly than interest-earning assets in a given period, a significant increase in market rates of interest could adversely affect net interest income. Similarly, when interest-earning assets mature or re-price more quickly than interest-bearing liabilities, falling interest rates could result in a decrease in net interest income. Net interest income is also affected by changes in the portion of interest-earning assets that are funded by interest-bearing liabilities rather than by other sources of funds, such as noninterest-bearing deposits and shareowners' equity.

We have established a comprehensive interest rate risk management policy, which is administered by management's Asset/Liability Management Committee ("ALCO"). The policy establishes limits of risk, which are quantitative measures of the percentage change in net interest income (a measure of net interest income at risk) and the fair value of equity capital (a measure of economic value of equity ("EVE") at risk) resulting from a hypothetical change in

interest rates for maturities from one day to 30 years. We measure the potential adverse impacts that changing interest rates may have on our short-term earnings, long-term value, and liquidity by employing simulation analysis through the use of computer modeling. The simulation model captures optionality factors such as call features and interest rate caps and floors imbedded in investment and loan portfolio contracts. As with any method of gauging interest rate risk, there are certain shortcomings inherent in the interest rate modeling methodology we use. When interest rates change, actual movements in different categories 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. Finally, the methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan clients' ability to service their debts, or the impact of rate changes on demand for loan and deposit products.

We prepare a current base case and multiple alternative simulations, at least once per quarter, and report the analysis to the Board of Directors. In addition, more frequent forecasts may be produced when interest rates are particularly uncertain or when other business conditions so dictate.

Our interest rate risk management goal is to avoid unacceptable variations in net interest income and capital levels due to fluctuations in market rates. Management attempts to achieve this goal by balancing, within policy limits, the volume of floating-rate liabilities with a similar volume of floating-rate assets, by keeping the average maturity of fixed-rate asset and liability contracts reasonably matched, by maintaining our core deposits as a significant component of our total funding sources, and by adjusting pricing rates to market conditions on a continuing basis.

The balance sheet is subject to testing for interest rate shock possibilities to indicate the inherent interest rate risk. Average interest rates are shocked by plus or minus 100, 200, 300, and 400 basis points ("bp"), although we may elect not to use particular scenarios that we determined are impractical in a current rate environment. It is management's goal to structure the balance sheet so that net interest earnings at risk over a 12-month period and the economic value of equity at risk do not exceed policy guidelines at the various interest rate shock levels.

We augment our interest rate shock analysis with alternative external interest rate scenarios on a quarterly basis. These alternative interest rate scenarios may include non-parallel rate ramps.

Analysis. Measures of net interest income at risk produced by simulation analysis are indicators of an institution's short-term performance in alternative rate environments. These measures are typically based upon a relatively brief period, usually one year. They do not necessarily indicate the long-term prospects or economic value of the institution.

ESTIMATED CHANGES IN NET INTEREST INCOME ⁽¹⁾

Changes in Interest Rates +400 bp +300 bp +200 bp +100 bp -100 bp