

PEOPLES BANCORP OF NORTH CAROLINA INC

Form 10-Q

November 04, 2016

UNITED STATES  
SECURITIES AND  
EXCHANGE  
COMMISSION  
Washington, D.C.  
20549

FORM 10-Q

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

For the quarterly  
period ended:  
September 30, 2016

OR

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

For the transition  
period from

\_\_\_\_\_ to

\_\_\_\_\_

PEOPLES BANCORP  
OF NORTH  
CAROLINA, INC.

(Exact name of  
registrant as specified  
in its charter)

North Carolina

(State or other jurisdiction of incorporation or organization)

000-272056-2132396

(Commission File No.) (IRS Employer Identification No.)

518

West C

Street, 28658

Newton,

North

Carolina

(Address of principal executive offices)(Zip Code)

(828) 464-5620

(Registrant's telephone number, including area code)

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 X 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).

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Yes  No

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

Large Accelerate Filer Accelerated Filer  Non-Accelerated Filer

Smaller Reporting Company

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

Yes No

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

5,417,800 shares of common stock, outstanding at October 31, 2016.

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Statements made in this Form 10-Q, other than those concerning historical information, should be considered forward-looking statements pursuant to the safe harbor provisions of the Securities Exchange Act of 1934 and the Private Securities Litigation Act of 1995. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management and on the information available to management at the time that this Form 10-Q was prepared. These statements can be identified by the use of words like "expect," "anticipate," "estimate," and "believe," variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ include, but are not

limited to, (1) competition in the markets served by Peoples Bank, (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environments and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in other filings with the Securities and Exchange Commission, including but not limited to, those described in Peoples Bancorp of North Carolina, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2015.

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

September 30, 2016 and December 31, 2015

(Dollars in thousands)

| <u>Assets</u>   | September<br>30,<br><u>2016</u><br>(Unaudited) | December<br>31,<br><u>2015</u><br>(Audited) |
|---|--|---|
| Cash and due from banks, including reserve requirements of \$15,715 at 9/30/16 and \$14,587 at 12/31/15 | \$ 47,653                                      | 29,194                                      |
| Interest-bearing deposits   | 35,191   | 10,569                                      |
| Cash and cash equivalents   | 82,844   | 39,763                                      |
| Investment securities available for sale  | 262,423  | 268,530                                     |
| Other investments   | 3,634  | 3,636                                       |
| Total securities  | 266,057  | 272,166                                     |
| Mortgage loans held for sale  | 2,776  | 4,149                                       |
| Loans   | 713,019  | 689,091                                     |
| Less allowance for loan losses  | (8,045 )                                       | (9,589 )                                    |
| Net loans   | 704,974  | 679,502                                     |
| Premises and equipment, net   | 16,553   | 16,976                                      |
| Cash surrender value of life insurance  | 14,853   | 14,546                                      |
| Other real estate   | 26   | 739   |
| Accrued interest receivable and other assets  | 9,525  | 10,640                                      |
| Total assets  | \$ 1,097,608                                   | 1,038,481                                   |
| <u>Liabilities and Shareholders' Equity</u>   |  |   |
| Deposits:   |  |   |
| Noninterest-bearing demand  | \$ 253,134                                     | 244,231                                     |
| NOW, MMDA & savings   | 460,767  | 431,052                                     |
| Time, \$250,000 or more   | 26,627   | 26,891                                      |
| Other time  | 121,419  | 130,001                                     |
| Total deposits  | 861,947  | 832,175                                     |
| Securities sold under agreements to repurchase  | 50,920   | 27,874                                      |
| FHLB borrowings   | 43,500   | 43,500                                      |
| Junior subordinated debentures  | 20,619   | 20,619                                      |
| Accrued interest payable and other liabilities  | 9,974  | 9,449                                       |

|   |              |           |
|---|--------------|-----------|
| Total liabilities   | 986,960      | 933,617   |
| Commitments   |              |           |
| Shareholders' equity:   |              |           |
| Series A preferred stock, \$1,000 stated value; authorized<br>5,000,000 shares; no shares issued and outstanding  | -            | -         |
| Common stock, no par value; authorized<br>20,000,000 shares; issued and outstanding 5,417,800 shares<br>at September 30, 2016 and 5,510,538 shares at December 31, 2015 | 44,188       | 46,171    |
| Retained earnings   | 59,502       | 53,183    |
| Accumulated other comprehensive income  | 6,958        | 5,510     |
| Total shareholders' equity  | 110,648      | 104,864   |
| Total liabilities and shareholders' equity  | \$ 1,097,608 | 1,038,481 |

See accompanying Notes to Consolidated Financial Statements.

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Earnings

Three and Nine Months Ended September 30, 2016 and 2015

(Dollars in thousands, except per share amounts)

|  | Three months ended<br>September 30,<br><u>2016</u> <u>2015</u><br>(Unaudited) |       | Nine months ended<br>September 30,<br><u>2016</u> <u>2015</u><br>(Unaudited) |        |
|--|---|-------|--|--------|
| Interest income:   |   |       |  |        |
| Interest and fees on loans                                 | \$8,188   | 8,089 | 24,185   | 23,015 |
| Interest on due from banks                                 | 32  | 4     | 67   | 21     |
| Interest on investment securities:                         |   |       |  |        |
| U.S. Government sponsored enterprises                      | 603   | 633   | 1,910  | 1,959  |
| State and political subdivisions                           | 1,105   | 1,145 | 3,350  | 3,465  |
| Other  | 54  | 76    | 191  | 245    |
| Total interest income                                      | 9,982   | 9,947 | 29,703   | 28,705 |
| Interest expense:  |   |       |  |        |
| NOW, MMDA & savings deposits                               | 126   | 106   | 367  | 324    |
| Time deposits  | 142   | 211   | 452  | 685    |
| FHLB borrowings  | 426   | 443   | 1,248  | 1,294  |
| Junior subordinated debentures                             | 122   | 101   | 353  | 297    |
| Other  | 12  | 13    | 30   | 34     |
| Total interest expense                                     | 828   | 874   | 2,450  | 2,634  |
| Net interest income  | 9,154   | 9,073 | 27,253   | 26,071 |
| Provision for (reduction of provision for) loan losses     | (360 )  | 235   | (1,108 )   | 193    |
| Net interest income after provision for loan losses        | 9,514   | 8,838 | 28,361   | 25,878 |
| Non-interest income:                                       |   |       |  |        |
| Service charges  | 1,163   | 1,193 | 3,291  | 3,498  |
| Other service charges and fees                             | 210   | 173   | 746  | 718    |
| Gain on sale of securities                                 | -   | -     | 324  | -      |
| Mortgage banking income                                    | 426   | 300   | 1,088  | 810    |
| Insurance and brokerage commissions                        | 163   | 179   | 476  | 544    |
| Gain/(loss) on sale and write-down of<br>other real estate | (16 )   | 80    | 64   | 246    |
| Miscellaneous  | 1,468   | 1,341 | 4,320  | 3,992  |
| Total non-interest income                                  | 3,414   | 3,266 | 10,309   | 9,808  |
| Non-interest expense:                                      |   |       |  |        |
| Salaries and employee benefits                             | 4,829   | 4,596 | 14,114   | 13,683 |
| Occupancy  | 1,755   | 1,611 | 5,243  | 4,577  |



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|                                   |         |       |        |        |
|-----------------------------------|---------|-------|--------|--------|
| Professional fees                 | 429     | 163   | 1,603  | 590    |
| Advertising                       | 313     | 172   | 623    | 576    |
| Debit card expense                | 271     | 256   | 870    | 737    |
| FDIC Insurance                    | 71      | 162   | 406    | 510    |
| Other                             | 1,930   | 1,709 | 5,339  | 5,081  |
| Total non-interest expense        | 9,598   | 8,669 | 28,198 | 25,754 |
| Earnings before income taxes      | 3,330   | 3,435 | 10,472 | 9,932  |
| Income tax expense                | 872     | 942   | 2,597  | 2,487  |
| Net earnings                      | \$2,458 | 2,493 | 7,875  | 7,445  |
| Basic net earnings per share      | \$0.45  | 0.45  | 1.43   | 1.34   |
| Diluted net earnings per share    | \$0.44  | 0.45  | 1.42   | 1.32   |
| Cash dividends declared per share | \$0.10  | 0.08  | 0.28   | 0.20   |

See accompanying Notes to Consolidated Financial Statements.

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

Three and Nine Months Ended September 30, 2016 and 2015

(Dollars in thousands)

|   | Three months ended<br>September 30,<br><u>2016</u> <u>2015</u><br>(Unaudited) |       | Nine months ended<br>September 30,<br><u>2016</u> <u>2015</u><br>(Unaudited) |        |
|---|---|-------|--|--------|
| Net earnings  | \$2,458   | 2,493 | 7,875  | 7,445  |
| Other comprehensive income (loss):  |   |       |  |        |
| Unrealized holding (losses) gains on securities available for sale                              | (1,676)   | 1,167 | 2,597  | (819 ) |
| Reclassification adjustment for gains on securities available for sale included in net earnings | -   | -     | (324 )   | -      |
| Total other comprehensive (loss) income, before income taxes                                    | (1,676)   | 1,167 | 2,273  | (819 ) |
| Income tax (benefit) expense related to other comprehensive (loss) income:                      |   |       |  |        |
| Unrealized holding (losses) gains on securities available for sale                              | (614 )  | 455   | 951  | (319 ) |
| Reclassification adjustment for gains on securities available for sale included in net earnings | -   | -     | (126 )   | -      |
| Total income tax expense (benefit) related to other comprehensive income (loss)                 | (614 )  | 455   | 825  | (319 ) |
| Total other comprehensive (loss) income, net of tax   | (1,062)   | 712   | 1,448  | (500 ) |
| Total comprehensive income  | \$1,396   | 3,205 | 9,323  | 6,945  |

See accompanying Notes to Consolidated Financial Statements.

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Changes in Shareholders' Equity

Nine Months Ended September 30, 2016 and 2015

(Dollars in thousands)

|   | Common Stock |             | Retained    | Accumulated<br>Other<br>Comprehensive | Total       |
|---|--------------|-------------|-------------|---------------------------------------|-------------|
|   | Shares       | Amount      | Earnings    | Income                                |             |
|   | (Unaudited)  | (Unaudited) | (Unaudited) | (Unaudited)                           | (Unaudited) |
| Balance, December 31, 2015                                      | 5,510,538    | \$ 46,171   | 53,183      | 5,510                                 | 104,864     |
| Common stock repurchase   | (92,738 )    | (1,983 )    | -           | -                                     | (1,983 )    |
| Cash dividends declared on<br>common stock                      | -            | -           | (1,556 )    | -                                     | (1,556 )    |
| Net earnings  | -            | -           | 7,875       | -                                     | 7,875       |
| Change in accumulated other<br>comprehensive income, net of tax | -            | -           | -           | 1,448                                 | 1,448       |
| Balance, September 30, 2016                                     | 5,417,800    | \$ 44,188   | 59,502      | 6,958                                 | 110,648     |
| Balance, December 31, 2014                                      | 5,612,588    | \$ 48,088   | 45,124      | 5,453                                 | 98,665      |
| Common stock repurchase   | (84,050 )    | (1,576 )    | -           | -                                     | (1,576 )    |
| Cash dividends declared on<br>common stock                      | -            | -           | (1,127 )    | -                                     | (1,127 )    |
| Net earnings  | -            | -           | 7,445       | -                                     | 7,445       |
| Change in accumulated other<br>comprehensive loss, net of tax   | -            | -           | -           | (500 )                                | (500 )      |
| Balance, September 30, 2015                                     | 5,528,538    | \$ 46,512   | 51,442      | 4,953                                 | 102,907     |

See accompanying Notes to Consolidated Financial Statements.

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

Nine Months Ended September 30, 2016 and 2015

(Dollars in thousands)

|   | <u>2016</u> | <u>2015</u> |
|---|-------------|-------------|
|   | (Unaudited) | (Unaudited) |
| Cash flows from operating activities:   |             |             |
| Net earnings  | \$ 7,875    | 7,445       |
| Adjustments to reconcile net earnings to net cash provided by operating activities:   |             |             |
| Depreciation, amortization and accretion  | 4,181       | 4,523       |
| (Reduction)/Provision for loan losses   | (1,108 )    | 193         |
| Deferred income taxes   | (607 )      | 100         |
| Gain on sale of investment securities   | (324 )      | -           |
| Gain on sale of other real estate   | (81 )       | (275 )      |
| Write-down of other real estate   | 17          | 29          |
| Restricted stock expense  | 476         | 282         |
| Origination of mortgage loans held for sale   | (50,813 )   | (38,139 )   |
| Proceeds from sales of mortgage loans held for sale                                   | 52,186      | 37,835      |
| Change in:  |             |             |
| Cash surrender value of life insurance  | (307 )      | (315 )      |
| Other assets  | 897         | 792         |
| Other liabilities   | 49          | 1,788       |
| Net cash provided by operating activities   | 12,441      | 14,258      |
| Cash flows from investing activities:   |             |             |
| Purchases of investment securities available for sale                                 | (12,642 )   | (13,579 )   |
| Proceeds from sales, calls and maturities of investment securities available for sale | 2,899       | 17,984      |
| Proceeds from paydowns of investment securities available for sale                    | 15,946      | 4,250       |
| Purchases of FHLB stock   | -           | (5 )        |
| FHLB stock redemption   | 2           | 125         |
| Net change in loans   | (24,639 )   | (38,098 )   |
| Purchases of premises and equipment   | (1,257 )    | (1,549 )    |
| Proceeds from sale of other real estate and repossessions                             | 1,052       | 4,173       |
| Net cash used by investing activities   | (18,639 )   | (26,699 )   |
| Cash flows from financing activities:   |             |             |
| Net change in deposits  | 29,772      | (8,139 )    |
| Net change in securities sold under agreement to repurchase                           | 23,046      | (1,190 )    |
| Proceeds from FHLB borrowings   | -           | 20,000      |
| Repayments of FHLB borrowings   | -           | (20,000 )   |
| Common stock repurchased  | (1,983 )    | (1,576 )    |

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|  |           |           |
|--|-----------|-----------|
| Cash dividends paid on common stock              | (1,556 )  | (1,127 )  |
| Net cash provided (used) by financing activities | 49,279    | (12,032 ) |
| Net change in cash and cash equivalents          | 43,081    | (24,473 ) |
| Cash and cash equivalents at beginning of period | 39,763    | 69,098    |
| Cash and cash equivalents at end of period       | \$ 82,844 | 44,625    |

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows, continued

Nine Months Ended September 30, 2016 and 2015

(Dollars in thousands)

|  | <u>2016</u> | <u>2015</u> |
|--|-------------|-------------|
|  | (Unaudited) | (Unaudited) |
| Supplemental disclosures of cash flow information:                                   |             |             |
| Cash paid during the period for:   |             |             |
| Interest   | \$ 2,425    | 2,624       |
| Income taxes   | \$ 3,180    | 1,514       |
| Noncash investing and financing activities:  |             |             |
| Change in unrealized gain (loss) on investment securities<br>available for sale, net | \$ 1,448    | (500 )      |
| Transfers of loans to other real estate and repossessions                            | \$ 275      | 4,274       |
| Financed portion of sales of other real estate                                       | \$ -        | 60          |

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1) Summary of Significant Accounting Policies

The consolidated financial statements include the financial statements of Peoples Bancorp of North Carolina, Inc. and its wholly owned subsidiary, Peoples Bank (the "Bank"), along with the Bank's wholly owned subsidiaries, Peoples Investment Services, Inc., Real Estate Advisory Services, Inc. ("REAS") Community Bank Real Estate Solutions, LLC ("CBRES") and PB Real Estate Holdings, LLC (collectively called the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation. CBRES was moved from a wholly owned subsidiary of Peoples Bancorp of North Carolina, Inc. to a wholly owned subsidiary of the Bank effective August 31, 2016.

The Bank operates four banking offices focused on the Latino population under the name Banco de la Gente ("Banco"). These offices are operated as a division of the Bank. Banco offers normal and customary banking services as are offered in the Bank's other branches such as the taking of deposits and the making of loans and therefore is not considered a reportable segment of the Company. The Bank operates one Banco loan production office in Durham County and one Banco loan production office in Forsyth County specifically designed to serve the growing Latino market.

The consolidated financial statements in this report (other than the Consolidated Balance Sheet at December 31, 2015) are unaudited. In the opinion of management, all adjustments (none of which were other than normal accruals) necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Management of the Company has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these consolidated financial statements in conformity with generally accepted accounting principles in the United States ("GAAP"). Actual results could differ from those estimates.

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of the specific accounting guidance. A description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2015 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 5, 2016 Annual Meeting of Shareholders.

Recently Issued Accounting Pronouncements

In January 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-01, (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU No. 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. ASU No. 2016-01 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In February 2016, FASB issued ASU No. 2016-02, (Topic 842): Leases. ASU No. 2016-02 increases transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. ASU No. 2016-02 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In March 2016, FASB issued ASU No. 2016-07, (Topic 323): Simplifying the Transition to the Equity Method of Accounting. ASU No. 2016-07 eliminates the requirement to retrospectively apply the equity method to an investment that subsequently qualifies for such accounting as a result of an increase in the level of ownership interest or degree of influence. ASU No. 2016-07 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2016. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In March 2016, FASB issued ASU No. 2016-08, (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net). ASU No. 2016-08 addresses how an entity should assess whether it is the principal or the agent in contracts that include three or more parties. ASU No. 2016-08 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

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In March 2016, FASB issued ASU No. 2016-09, (Topic 718): Improvements to Employee Share-Based Payment Accounting. ASU No. 2016-09 was issued in an effort to improve the accounting for employee share-based payments. ASU No. 2016-09 is effective for annual periods beginning after December 15, 2016. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In April 2016, FASB issued ASU No. 2016-10, (Topic 606): Identifying Performance Obligations and Licensing. ASU No. 2016-10 clarifies guidance on the recognition of revenue from contracts with customers. ASU No. 2016-10 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In May 2016, FASB issued ASU No. 2016-12, (Topic 606): Narrow-Scope Improvements and Practical Expedients. ASU No. 2016-12 amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification ("ASC") to clarify guidance related to collectability, noncash consideration, presentation of sales tax, and transition. ASU No. 2016-12 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In June 2016, FASB issued ASU No. 2016-13, (Topic 326): Measurement of Credit Losses on Financial Instruments. ASU No. 2016-13 provides guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. ASU No. 2016-13 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2019. The Company is currently evaluating the effect that implementation of the new standard will have on its results of operations, financial position and disclosures.

In August 2016, FASB issued ASU No. 2016-15, (Topic 230): Classification of Certain Cash Receipts and Cash Payments. ASU No. 2016-15 clarifies how certain cash receipts and cash payments are presented and classified in the statement of cash flows under ASC 230, Statement of Cash Flows. ASU No. 2016-15 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

Other accounting standards that have been issued or proposed by FASB or other standards-setting bodies are not expected to have a material impact on the Company's results of operations, financial position or disclosures.

(2) Investment Securities

Investment securities available for sale at September 30, 2016 and December 31, 2015 are as follows:

(Dollars in thousands)

|                                       | September 30, 2016   |                        |                         |                      |
|---------------------------------------|----------------------|------------------------|-------------------------|----------------------|
|                                       | Gross Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Mortgage-backed securities            | \$71,359             | 2,083                  | 49                      | 73,393               |
| U.S. Government sponsored enterprises | 38,575               | 743                    | 240                     | 39,078               |
| State and political subdivisions      | 138,672              | 8,481                  | 11                      | 147,142              |
| Corporate bonds                       | 1,505                | 20                     | -                       | 1,525                |
| Trust preferred securities            | 750                  | -                      | -                       | 750                  |
| Equity securities                     | 264                  | 271                    | -                       | 535                  |

|       |           |        |     |         |
|-------|-----------|--------|-----|---------|
| Total | \$251,125 | 11,598 | 300 | 262,423 |
|-------|-----------|--------|-----|---------|

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(Dollars in thousands)

December 31, 2015

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
| Mortgage-backed securities               | \$76,406          | 1,526                        | 45                            | 77,887                     |
| U.S. Government<br>sponsored enterprises | 38,173            | 399                          | 155                           | 38,417                     |
| State and political subdivisions         | 141,500           | 6,817                        | 72                            | 148,245                    |
| Corporate bonds                          | 1,928             | -                            | 22                            | 1,906                      |
| Trust preferred securities               | 750               | -                            | -                             | 750                        |
| Equity securities                        | 748               | 577                          | -                             | 1,325                      |
| Total                                    | \$259,505         | 9,319                        | 294                           | 268,530                    |

The current fair value and associated unrealized losses on investments in securities with unrealized losses at September 30, 2016 and December 31, 2015 are summarized in the tables below, with the length of time the individual securities have been in a continuous loss position.

(Dollars in thousands)

September 30, 2016

Less than 12 Months    12 Months or More    Total

|  | Fair<br>Value | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
|--|---------------|----------------------|---------------|----------------------|---------------|----------------------|
| Mortgage-backed securities               | \$5,795       | 49                   | -             | -                    | 5,795         | 49                   |
| U.S. Government<br>sponsored enterprises | 7,517         | 66                   | 9,685         | 174                  | 17,202        | 240                  |
| State and political subdivisions         | 426           | 1                    | 582           | 10                   | 1,008         | 11                   |
| Total                                    | \$13,738      | 116                  | 10,267        | 184                  | 24,005        | 300                  |

(Dollars in thousands)

December 31, 2015

Less than 12 Months    12 Months or More    Total

|  | Fair<br>Value | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
|--|---------------|----------------------|---------------|----------------------|---------------|----------------------|
| Mortgage-backed securities               | \$7,891       | 45                   | -             | -                    | 7,891         | 45                   |
| U.S. Government<br>sponsored enterprises | 3,074         | 13                   | 10,828        | 142                  | 13,902        | 155                  |
| State and political subdivisions         | 2,198         | 4                    | 3,930         | 68                   | 6,128         | 72                   |
| Corporate bonds                          | 1,500         | 22                   | -             | -                    | 1,500         | 22                   |
| Total                                    | \$14,663      | 84                   | 14,758        | 210                  | 29,421        | 294                  |

At September 30, 2016, unrealized losses in the investment securities portfolio relating to debt securities totaled \$300,000. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the September 30, 2016 tables above, two out of 170 securities issued by state and political subdivisions contained unrealized losses, 10 out of 82 securities issued by U.S. Government sponsored enterprises contained unrealized losses, and no securities issued by corporations contained unrealized losses. These unrealized losses are considered temporary because of acceptable financial condition and results of operations of entities that issued each security and the repayment sources of principal and interest on U.S. Government sponsored enterprises,

including mortgage-backed securities, are government backed.

The amortized cost and estimated fair value of investment securities available for sale at September 30, 2016, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

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September 30, 2016  
(Dollars in thousands)

|                            | Amortized<br>Cost | Estimated<br>Fair<br>Value |
|----------------------------|-------------------|----------------------------|
| Due within one year        | \$ 8,444          | 8,500                      |
| Due from one to five years | 76,972            | 81,294                     |
| Due from five to ten years | 83,725            | 87,937                     |
| Due after ten years        | 10,361            | 10,764                     |
| Mortgage-backed securities | 71,359            | 73,393                     |
| Equity securities          | 264               | 535                        |
| Total                      | \$ 251,125        | 262,423                    |

Proceeds from sales of securities available for sale during the nine months ended September 30, 2016 were \$804,000 and resulted in gross gains of \$324,000. No securities available for sale were sold during the three months ended September 30, 2016, or the three and nine months ended September 30, 2015.

Securities with a fair value of approximately \$85.2 million and \$91.0 million at September 30, 2016 and December 31, 2015, respectively, were pledged to secure public deposits and for other purposes as required by law.

### (3) Loans

Major classifications of loans at September 30, 2016 and December 31, 2015 are summarized as follows:

(Dollars in thousands)

|  | September<br>30, 2016 | December<br>31, 2015 |
|--|-----------------------|----------------------|
| Real estate loans:   |                       |                      |
| Construction and land development                              | \$ 59,456             | 65,791               |
| Single-family residential                                      | 231,958               | 220,690              |
| Single-family residential -<br>Banco de la Gente stated income | 40,934                | 43,733               |
| Commercial   | 240,150               | 228,526              |
| Multifamily and farmland                                       | 18,727                | 18,080               |
| Total real estate loans  | 591,225               | 576,820              |
| Loans not secured by real estate:                              |                       |                      |
| Commercial loans   | 94,790                | 91,010               |
| Farm loans   | -                     | 3                    |
| Consumer loans   | 10,036                | 10,027               |
| All other loans  | 16,968                | 11,231               |
| Total loans  | 713,019               | 689,091              |
| Less allowance for loan losses                                 | 8,045                 | 9,589                |
| Total net loans  | \$ 704,974            | 679,502              |

The Bank grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties, and also in Mecklenburg, Union, Wake, Durham and

Forsyth counties of North Carolina. Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by improved and unimproved real estate, the value of which is dependent upon the real estate market. Risk characteristics of the major components of the Bank's loan portfolio are discussed below:

Construction and land development loans – The risk of loss is largely dependent on the initial estimate of whether the property's value at completion equals or exceeds the cost of property construction and the availability of take-out financing. During the construction phase, a number of factors can result in delays or cost overruns. If the estimate is inaccurate or if actual construction costs exceed estimates, the value of the property securing the loan may be insufficient to ensure full repayment when completed through a permanent loan, sale of the property, or by seizure of collateral. As of September 30, 2016, construction and land development loans comprised approximately 8% of the Bank's total loan portfolio.

Single-family residential loans – Declining home sales volumes, decreased real estate values and higher than normal levels of unemployment could contribute to losses on these loans. As of September 30, 2016, single-family residential loans comprised approximately 38% of the Bank's total loan portfolio, and include Banco's single-family residential stated income loans, which were approximately 6% of the Bank's total loan portfolio.

Commercial real estate loans – Repayment is dependent on income being generated in amounts sufficient to cover operating expenses and debt service. These loans also involve greater risk because they are generally not fully amortizing over a loan period, but rather have a balloon payment due at maturity. A borrower's ability to make a balloon payment typically will depend on being able to either refinance the loan or timely sell the underlying property. As of September 30, 2016, commercial real estate loans comprised approximately 34% of the Bank's total loan portfolio.

Commercial loans – Repayment is generally dependent upon the successful operation of the borrower's business. In addition, the collateral securing the loans may depreciate over time, be difficult to appraise, be illiquid or fluctuate in value based on the success of the business. As of September 30, 2016, commercial loans comprised approximately 13% of the Bank's total loan portfolio.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The following tables present an age analysis of past due loans, by loan type, as of September 30, 2016 and December 31, 2015:

September 30, 2016  
(Dollars in thousands)

|  | Loans<br>30-89<br>Days<br>Past<br>Due | Loans<br>90 or<br>More<br>Days<br>Past<br>Due | Total<br>Past<br>Due<br>Loans | Total<br>Current<br>Loans | Total<br>Loans | Accruing<br>Loans 90<br>or<br>More<br>Days<br>Past Due |
|--|---------------------------------------|---|-------------------------------|---------------------------|----------------|--|
| Real estate loans:   |                                       |   |                               |                           |                |  |
| Construction and land development                              | \$18                                  | 13  | 31                            | 59,425                    | 59,456         | -  |
| Single-family residential                                      | 1,344                                 | 310   | 1,654                         | 230,304                   | 231,958        | -  |
| Single-family residential -<br>Banco de la Gente stated income | 1,588                                 | 257   | 1,845                         | 39,089                    | 40,934         | -  |
| Commercial   | 58                                    | -   | 58                            | 240,092                   | 240,150        | -  |
| Multifamily and farmland                                       | -                                     | -   | -                             | 18,727                    | 18,727         | -  |
| Total real estate loans  | 3,008                                 | 580   | 3,588                         | 587,637                   | 591,225        | -  |
| Loans not secured by real estate:                              |                                       |   |                               |                           |                |  |
| Commercial loans   | 85                                    | -   | 85                            | 94,705                    | 94,790         | -  |
| Farm loans   | -                                     | -   | -                             | -                         | -              | -  |
| Consumer loans   | 95                                    | 7   | 102                           | 9,934                     | 10,036         | -  |

|                 |         |     |       |         |         |   |
|-----------------|---------|-----|-------|---------|---------|---|
| All other loans | -       | -   | -     | 16,968  | 16,968  | - |
| Total loans     | \$3,188 | 587 | 3,775 | 709,244 | 713,019 | - |

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December 31, 2015  
(Dollars in thousands)

|  | Loans<br>30-89<br>Days<br>Past<br>Due | Loans<br>90 or<br>More<br>Days<br>Past<br>Due | Total<br>Past<br>Due<br>Loans | Total<br>Current<br>Loans | Total<br>Loans | Accruing<br>Loans 90<br>or<br>More<br>Days<br>Past Due |
|--|---------------------------------------|---|-------------------------------|---------------------------|----------------|--|
| Real estate loans:   |                                       |   |                               |                           |                |  |
| Construction and land development                              | \$ 330                                | 17  | 347                           | 65,444                    | 65,791         | -  |
| Single-family residential                                      | 2,822                                 | 1,385   | 4,207                         | 216,483                   | 220,690        | -  |
| Single-family residential -<br>Banco de la Gente stated income | 7,021                                 | 114   | 7,135                         | 36,598                    | 43,733         | -  |
| Commercial   | 2,619                                 | 157   | 2,776                         | 225,750                   | 228,526        | -  |
| Multifamily and farmland                                       | -                                     | -   | -                             | 18,080                    | 18,080         | -  |
| Total real estate loans  | 12,792                                | 1,673   | 14,465                        | 562,355                   | 576,820        | -  |
| Loans not secured by real estate:                              |                                       |   |                               |                           |                |  |
| Commercial loans   | 185                                   | 40  | 225                           | 90,785                    | 91,010         | 17   |
| Farm loans   | -                                     | -   | -                             | 3                         | 3              | -  |
| Consumer loans   | 136                                   | 8   | 144                           | 9,883                     | 10,027         | -  |
| All other loans  | -                                     | -   | -                             | 11,231                    | 11,231         | -  |
| Total loans  | \$ 13,113                             | 1,721   | 14,834                        | 674,257                   | 689,091        | 17   |

The following table presents non-accrual loans as of September 30, 2016 and December 31, 2015:

(Dollars in thousands)

|  | September<br>30, 2016 | December<br>31, 2015 |
|--|-----------------------|----------------------|
| Real estate loans:   |                       |                      |
| Construction and land development                              | \$ 31                 | 146                  |
| Single-family residential                                      | 1,797                 | 4,023                |
| Single-family residential -<br>Banco de la Gente stated income | 1,251                 | 1,106                |
| Commercial   | 1,571                 | 2,992                |
| Multifamily and farmland                                       | -                     | -                    |
| Total real estate loans  | 4,650                 | 8,267                |
| Loans not secured by real estate:                              |                       |                      |
| Commercial loans   | 66                    | 113                  |
| Consumer loans   | 41                    | 52                   |
| Total  | \$ 4,757              | 8,432                |

At each reporting period, the Bank determines which loans are impaired. Accordingly, the Bank's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan that is collateral-dependent is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by REAS, a subsidiary of the Bank. REAS is staffed by certified appraisers that also perform appraisals for other companies. Factors, including the assumptions and techniques utilized by the appraiser, are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the

collateral, a valuation allowance is recorded as a component of the allowance for loan losses. An allowance for each impaired loan that is not collateral dependent is calculated based on the present value of projected cash flows. If the recorded investment in the impaired loan exceeds the present value of projected cash flows, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under \$250,000 are not individually evaluated for impairment with the exception of the Bank's troubled debt restructured ("TDR") loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Accruing impaired loans were \$22.9 million, \$25.0 million and \$25.5 million at September 30, 2016, December 31, 2015 and September 30, 2015, respectively. Interest income recognized on accruing impaired loans was \$871,000, \$968,000 and \$1.3 million for the nine months ended September 30, 2016, the nine months ended September 30, 2015 and the year ended December 31, 2015, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as non-accrual.

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The following tables present impaired loans as of September 30, 2016 and December 31, 2015:

September  
30, 2016  
(Dollars in  
thousands)

|   | Unpaid Contractual Principal Balance |       | Recorded Investment With Allowance | Recorded Investment With Allowance | Recorded Investment in Impaired Loans | Related Allowance | Nine months ended<br>Average Outstanding Impaired Loans | Interest Income Recognized | Three months ended<br>Average Outstanding Impaired Loans | Interest Income Recognized |
|---|--------------------------------------|-------|------------------------------------|------------------------------------|---------------------------------------|-------------------|---|----------------------------|--|----------------------------|
| Real estate loans:  |                                      |       |                                    |                                    |                                       |                   |   |                            |  |                            |
| Construction and land development                           | \$292                                | -     | 288                                | 288                                | 288                                   | 13                | 375   | 10                         | 369  | 3                          |
| Single-family residential                                   | 5,731                                | 878   | 4,473                              | 5,351                              | 5,351                                 | 46                | 8,921   | 122                        | 6,556  | 40                         |
| Single-family residential - Banco de la Gente stated income | 18,603                               | -     | 18,094                             | 18,094                             | 18,094                                | 1,188             | 17,673  | 657                        | 17,395   | 207                        |
| Commercial Multifamily and farmland                         | 3,775                                | 1,221 | 2,222                              | 3,443                              | 3,443                                 | 174               | 5,376   | 73                         | 4,013  | 24                         |
|   | 78                                   | -     | 78                                 | 78                                 | 78                                    | -                 | 79  | 3                          | 78   | -                          |
| Total impaired real estate loans                            | 28,479                               | 2,099 | 25,155                             | 27,254                             | 27,254                                | 1,421             | 32,424  | 865                        | 28,411   | 274                        |
| Loans not secured by real estate:                           |                                      |       |                                    |                                    |                                       |                   |   |                            |  |                            |
| Commercial loans  | 74                                   | -     | 73                                 | 73                                 | 73                                    | 1                 | 123   | -                          | 116  | -                          |
| Consumer loans  | 226                                  | -     | 219                                | 219                                | 219                                   | 4                 | 235   | 6                          | 225  | 2                          |
| Total impaired loans  | \$28,779                             | 2,099 | 25,447                             | 27,546                             | 27,546                                | 1,426             | 32,782  | 871                        | 28,752   | 276                        |

December 31, 2015  
(Dollars in thousands)

|                    | Unpaid Contractual Principal Balance | Recorded Investment With Allowance | Recorded Investment With Allowance | Recorded Investment in Impaired Loans | Related Allowance | Average Outstanding Impaired Loans | YTD Interest Income Recognized |
|--------------------|--------------------------------------|------------------------------------|------------------------------------|---------------------------------------|-------------------|------------------------------------|--------------------------------|
| Real estate loans: | \$ 643                               | 216                                | 226                                | 442                                   | 12                | 705                                | 18                             |

|   |           |       |        |        |       |        |       |
|---|-----------|-------|--------|--------|-------|--------|-------|
| Construction and land development             |           |       |        |        |       |        |       |
| Single-family residential                     | 8,828     | 1,489 | 6,805  | 8,294  | 189   | 10,852 | 224   |
| Single-family residential - Banco de la Gente |           |       |        |        |       |        |       |
| stated income                                 | 20,375    | -     | 19,215 | 19,215 | 1,143 | 18,414 | 921   |
| Commercial                                    | 4,556     | -     | 4,893  | 4,893  | 179   | 5,497  | 89    |
| Multifamily and farmland                      | 96        | -     | 83     | 83     | -     | 93     | 6     |
| Total impaired real estate loans              | 34,498    | 1,705 | 31,222 | 32,927 | 1,523 | 35,561 | 1,258 |
| Loans not secured by real estate:             |           |       |        |        |       |        |       |
| Commercial loans                              | 180       | -     | 161    | 161    | 3     | 132    | 5     |
| Consumer loans                                | 286       | -     | 260    | 260    | 4     | 283    | 11    |
| Total impaired loans                          | \$ 34,964 | 1,705 | 31,643 | 33,348 | 1,530 | 35,976 | 1,274 |

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Changes in the allowance for loan losses for the three and nine months ended September 30, 2016 and 2015 were as follows:

(Dollars in thousands)

|  | Real Estate Loans                 |                           | Single-Family Residential - Banco de la Gente Stated Income | Commercial | Multifamily and Farmland | Commercial | Farm | Consumer and All Other | Unallocated | Total   |
|--|-----------------------------------|---------------------------|---|------------|--------------------------|------------|------|------------------------|-------------|---------|
|  | Construction and Land Development | Single-Family Residential |   |            |                          |            |      |                        |             |         |
| Nine months ended September 30, 2016:            |                                   |                           |   |            |                          |            |      |                        |             |         |
| Allowance for loan losses:                       |                                   |                           |   |            |                          |            |      |                        |             |         |
| Beginning  |                                   |                           |   |            |                          |            |      |                        |             |         |
| balance  | \$2,185                           | 2,534                     | 1,460   | 1,917      | -                        | 842        | -    | 172                    | 479         | 9,589   |
| Charge-offs                                      | -                                 | (158)                     | )-  | (106)      | )-                       | (129)      | )-   | (361)                  | )-          | (754)   |
| Recoveries                                       | 8                                 | 18                        | -   | 15         | -                        | 165        | -    | 112                    | -           | 318     |
| Provision  | (808)                             | (388)                     | (60)  | (250)      | )47                      | (118)      | )-   | 291                    | 178         | (1,108) |
| Ending balance                                   | \$1,385                           | 2,006                     | 1,400   | 1,576      | 47                       | 760        | -    | 214                    | 657         | 8,045   |
| Three months ended September 30, 2016:           |                                   |                           |   |            |                          |            |      |                        |             |         |
| Allowance for loan losses:                       |                                   |                           |   |            |                          |            |      |                        |             |         |
| Beginning  |                                   |                           |   |            |                          |            |      |                        |             |         |
| balance  | \$1,582                           | 2,233                     | 1,354   | 1,650      | 46                       | 803        | -    | 234                    | 638         | 8,540   |
| Charge-offs                                      | -                                 | (35)                      | )-  | -          | -                        | (89)       | )-   | (122)                  | )-          | (246)   |
| Recoveries                                       | 2                                 | 6                         | -   | 5          | -                        | 60         | -    | 38                     | -           | 111     |
| Provision  | (199)                             | (198)                     | )46   | (79)       | )1                       | (14)       | )-   | 64                     | 19          | (360)   |
| Ending balance                                   | \$1,385                           | 2,006                     | 1,400   | 1,576      | 47                       | 760        | -    | 214                    | 657         | 8,045   |
| Allowance for loan losses at September 30, 2016: |                                   |                           |   |            |                          |            |      |                        |             |         |
| Ending balance:                                  |                                   |                           |   |            |                          |            |      |                        |             |         |
| individually evaluated for impairment            |                                   |                           |   |            |                          |            |      |                        |             |         |
| \$-  | -                                 | -                         | 1,164   | 167        | -                        | -          | -    | -                      | -           | 1,331   |
| Ending balance:                                  |                                   |                           |   |            |                          |            |      |                        |             |         |
| collectively evaluated for impairment            |                                   |                           |   |            |                          |            |      |                        |             |         |
| 1,385  | 2,006                             | 236                       | 1,409   | 47         | 760                      | -          | 214  | 657                    | 6,714       | 6,714   |
| Ending balance                                   | \$1,385                           | 2,006                     | 1,400   | 1,576      | 47                       | 760        | -    | 214                    | 657         | 8,045   |

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Loans at September  
30, 2016:

|                   |          |         |        |         |        |        |   |        |   |         |
|-------------------|----------|---------|--------|---------|--------|--------|---|--------|---|---------|
| Ending<br>balance | \$59,456 | 231,958 | 40,934 | 240,150 | 18,727 | 94,790 | - | 27,004 | - | 713,019 |
|-------------------|----------|---------|--------|---------|--------|--------|---|--------|---|---------|

Ending balance:  
individually  
evaluated

|                       |  |       |        |       |   |   |   |   |   |        |
|-----------------------|--|-------|--------|-------|---|---|---|---|---|--------|
| for<br>impairment \$- |  | 1,019 | 16,890 | 3,586 | - | - | - | - | - | 21,495 |
|-----------------------|--|-------|--------|-------|---|---|---|---|---|--------|

Ending balance:  
collectively  
evaluated

|                      |        |         |        |         |        |        |   |        |   |         |
|----------------------|--------|---------|--------|---------|--------|--------|---|--------|---|---------|
| for<br>impairment \$ | 59,456 | 230,939 | 24,044 | 236,564 | 18,727 | 94,790 | - | 27,004 | - | 691,524 |
|----------------------|--------|---------|--------|---------|--------|--------|---|--------|---|---------|

(Dollars in  
thousands)

Real Estate Loans

|  |  |                                  |  |            |                                |            |                             |                                 |             |       |
|--|--|----------------------------------|--|------------|--------------------------------|------------|-----------------------------|---------------------------------|-------------|-------|
|  | Construction<br>and<br>Land<br>Development | Single-<br>Family<br>Residential | Single-<br>Family<br>Residential<br>- Banco de<br>la Gente<br>Stated<br>Income | Commercial | Multifamily<br>and<br>Farmland | Commercial | Farm<br>and<br>All<br>Other | Consumer<br>and<br>All<br>Other | Unallocated | Total |
|--|--|----------------------------------|--|------------|--------------------------------|------------|-----------------------------|---------------------------------|-------------|-------|

Nine months ended  
September 30, 2015:

Allowance  
for loan  
losses:

Beginning

|         |         |       |       |       |   |       |   |     |     |        |
|---------|---------|-------|-------|-------|---|-------|---|-----|-----|--------|
| balance | \$2,785 | 2,566 | 1,610 | 1,902 | 7 | 1,098 | - | 233 | 881 | 11,082 |
|---------|---------|-------|-------|-------|---|-------|---|-----|-----|--------|

|             |       |       |      |      |   |      |   |       |   |         |
|-------------|-------|-------|------|------|---|------|---|-------|---|---------|
| Charge-offs | (198) | (447) | (59) | (62) | - | (16) | - | (394) | - | (1,176) |
|-------------|-------|-------|------|------|---|------|---|-------|---|---------|

|            |    |    |    |    |   |    |   |     |   |     |
|------------|----|----|----|----|---|----|---|-----|---|-----|
| Recoveries | 43 | 30 | 22 | 15 | - | 96 | - | 115 | - | 321 |
|------------|----|----|----|----|---|----|---|-----|---|-----|

|           |     |     |       |      |     |       |   |     |       |       |
|-----------|-----|-----|-------|------|-----|-------|---|-----|-------|-------|
| Provision | 119 | 676 | (113) | (75) | (2) | (297) | - | 258 | (523) | (193) |
|-----------|-----|-----|-------|------|-----|-------|---|-----|-------|-------|

Ending

|         |         |       |       |       |   |     |   |     |     |        |
|---------|---------|-------|-------|-------|---|-----|---|-----|-----|--------|
| balance | \$2,749 | 2,825 | 1,460 | 1,930 | 5 | 881 | - | 212 | 358 | 10,420 |
|---------|---------|-------|-------|-------|---|-----|---|-----|-----|--------|

Three months ended  
September 30, 2015:

Allowance  
for loan  
losses:

Beginning

|         |         |       |       |       |   |     |   |     |     |        |
|---------|---------|-------|-------|-------|---|-----|---|-----|-----|--------|
| balance | \$2,924 | 2,456 | 1,528 | 1,749 | 2 | 902 | - | 231 | 586 | 10,378 |
|---------|---------|-------|-------|-------|---|-----|---|-----|-----|--------|

|             |       |      |   |   |   |     |   |       |   |       |
|-------------|-------|------|---|---|---|-----|---|-------|---|-------|
| Charge-offs | (110) | (48) | - | - | - | (1) | - | (156) | - | (315) |
|-------------|-------|------|---|---|---|-----|---|-------|---|-------|

|            |    |    |   |   |   |    |   |    |   |     |
|------------|----|----|---|---|---|----|---|----|---|-----|
| Recoveries | 20 | 21 | - | 5 | - | 43 | - | 33 | - | 122 |
|------------|----|----|---|---|---|----|---|----|---|-----|

|           |      |       |      |       |   |      |   |     |       |       |
|-----------|------|-------|------|-------|---|------|---|-----|-------|-------|
| Provision | (85) | (396) | (68) | (176) | 3 | (63) | - | 104 | (228) | (235) |
|-----------|------|-------|------|-------|---|------|---|-----|-------|-------|

|  |         |       |       |       |   |     |   |     |     |        |
|--|---------|-------|-------|-------|---|-----|---|-----|-----|--------|
|  | \$2,749 | 2,825 | 1,460 | 1,930 | 5 | 881 | - | 212 | 358 | 10,420 |
|--|---------|-------|-------|-------|---|-----|---|-----|-----|--------|

Ending  
balance

Allowance for loan losses  
September 30, 2015:

Ending  
balance:  
individually  
evaluated

|                   |     |    |       |     |   |   |   |   |   |       |
|-------------------|-----|----|-------|-----|---|---|---|---|---|-------|
| for<br>impairment | \$- | 96 | 1,128 | 227 | - | - | - | - | - | 1,451 |
|-------------------|-----|----|-------|-----|---|---|---|---|---|-------|

Ending  
balance:

collectively  
evaluated

|                   |       |       |     |       |   |     |   |     |     |       |
|-------------------|-------|-------|-----|-------|---|-----|---|-----|-----|-------|
| for<br>impairment | 2,749 | 2,729 | 332 | 1,703 | 5 | 881 | - | 212 | 358 | 8,969 |
|-------------------|-------|-------|-----|-------|---|-----|---|-----|-----|-------|

Ending  
balance

|  |         |       |       |       |   |     |   |     |     |        |
|--|---------|-------|-------|-------|---|-----|---|-----|-----|--------|
|  | \$2,749 | 2,825 | 1,460 | 1,930 | 5 | 881 | - | 212 | 358 | 10,420 |
|--|---------|-------|-------|-------|---|-----|---|-----|-----|--------|

Loans

September  
30, 2015:

|                   |          |         |        |         |        |        |   |        |   |         |
|-------------------|----------|---------|--------|---------|--------|--------|---|--------|---|---------|
| Ending<br>balance | \$61,748 | 218,365 | 44,433 | 234,003 | 14,003 | 88,931 | 3 | 23,314 | - | 684,800 |
|-------------------|----------|---------|--------|---------|--------|--------|---|--------|---|---------|

Ending  
balance:

individually  
evaluated

|                   |       |       |        |       |   |   |   |   |   |        |
|-------------------|-------|-------|--------|-------|---|---|---|---|---|--------|
| for<br>impairment | \$241 | 2,944 | 18,193 | 3,525 | - | - | - | - | - | 24,903 |
|-------------------|-------|-------|--------|-------|---|---|---|---|---|--------|

Ending  
balance:

collectively  
evaluated

|                   |          |         |        |         |        |        |   |        |   |         |
|-------------------|----------|---------|--------|---------|--------|--------|---|--------|---|---------|
| for<br>impairment | \$61,507 | 215,421 | 26,240 | 230,478 | 14,003 | 88,931 | 3 | 23,314 | - | 659,800 |
|-------------------|----------|---------|--------|---------|--------|--------|---|--------|---|---------|

The provision for loan losses for the three months ended September 30, 2016 was a credit of \$360,000, as compared to an expense of \$235,000 for the three months ended September 30, 2015. The decrease in the provision for loan losses is primarily attributable to a reduction in the required level of the allowance for loan losses resulting from lower historical loss rates used to calculate the ASC 450-20 reserve as the elevated level of loan losses incurred in 2010 and 2011 are no longer included in the historical loss calculations.

The provision for loan losses for the nine months ended September 30, 2016 was a credit of \$1.1 million, as compared to an expense of \$193,000 for the nine months ended September 30, 2015. The decrease in the provision for loan losses is primarily attributable to a reduction in the required level of the allowance for loan losses resulting from lower historical loss rates used to calculate the ASC 450-20 reserve as the elevated level of loan losses incurred in 2010 and 2011 are no longer included in the historical loss calculations.

The Company utilizes an internal risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 1 to 8. These risk grades are evaluated on an ongoing basis. A description of the general characteristics of the eight risk grades is as follows:

Risk Grade 1 – Excellent Quality: Loans are well above average quality and a minimal amount of credit risk exists. CD or cash secured loans or properly margined actively traded stock or bond secured loans would fall in this grade.

Risk Grade 2 – High Quality: Loans are of good quality with risk levels well within the Company's range of acceptability. The organization or individual is established with a history of successful performance though somewhat susceptible to economic changes.

Risk Grade 3 – Good Quality: Loans of average quality with risk levels within the Company's range of acceptability but higher than normal. This may be a new organization or an existing organization in a transitional phase (e.g. expansion, acquisition, market change).

Risk Grade 4 – Management Attention: These loans have higher risk and servicing needs but still are acceptable. Evidence of marginal performance or deteriorating trends is observed. These are not problem credits presently, but may be in the future if the borrower is unable to change its present course.

Risk Grade 5 – Watch: These loans are currently performing satisfactorily, but there has been some recent past due history on repayment and there are potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Company's position at some future date.

Risk Grade 6 – Substandard: A Substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or the collateral pledged (if there is any). There is a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. There is a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Risk Grade 7 – Doubtful: Loans classified as Doubtful have all the weaknesses inherent in loans classified as Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.

Risk Grade 8 – Loss: Loans classified as Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be realized in the future. Loss is a temporary grade until the appropriate authority is obtained to charge the loan off.



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The following tables present the credit risk profile of each loan type based on internally assigned risk grades as of September 30, 2016 and December 31, 2015:

September  
30, 2016  
(Dollars in  
thousands)

|                               | Real Estate Loans                          |                                  |   |            |                                |            |      |          |              |         |
|-------------------------------|--|----------------------------------|---|------------|--------------------------------|------------|------|----------|--------------|---------|
|                               | Construction<br>and<br>Land<br>Development | Single-<br>Family<br>Residential | Single-<br>Family<br>Residential<br>-<br>Banco de<br>la Gente<br>Stated<br>Income | Commercial | Multifamily<br>and<br>Farmland | Commercial | Farm | Consumer | All<br>Other | Total   |
| 1- Excellent<br>Quality       | \$-  | 12,340                           | -   | -          | -                              | 546        | -    | 1,069    | 50           | 14,005  |
| 2- High<br>Quality            | 8,012                                      | 103,847                          | -   | 39,701     | 2,915                          | 28,510     | -    | 3,399    | 2,580        | 188,964 |
| 3- Good<br>Quality            | 32,958                                     | 81,307                           | 17,136  | 166,724    | 12,150                         | 59,125     | -    | 4,838    | 12,565       | 386,803 |
| 4-<br>Management<br>Attention | 11,406                                     | 25,846                           | 15,811  | 27,507     | 1,187                          | 6,248      | -    | 632      | 1,773        | 90,410  |
| 5- Watch                      | 6,858                                      | 3,854                            | 2,807   | 3,321      | 2,475                          | 250        | -    | 43       | -            | 19,608  |
| 6-<br>Substandard             | 222  | 4,764                            | 5,180   | 2,897      | -                              | 111        | -    | 54       | -            | 13,228  |
| 7- Doubtful                   | -  | -                                | -   | -          | -                              | -          | -    | -        | -            | -       |
| 8- Loss                       | -  | -                                | -   | -          | -                              | -          | -    | 1        | -            | 1       |
| Total                         | \$59,456                                   | 231,958                          | 40,934  | 240,150    | 18,727                         | 94,790     | -    | 10,036   | 16,968       | 713,019 |

December  
31, 2015  
(Dollars in  
thousands)

|                         | Real Estate Loans                          |                                  |   |            |                                |            |      |          |              |         |
|-------------------------|--|----------------------------------|---|------------|--------------------------------|------------|------|----------|--------------|---------|
|                         | Construction<br>and<br>Land<br>Development | Single-<br>Family<br>Residential | Single-<br>Family<br>Residential<br>-<br>Banco de<br>la Gente<br>Stated<br>Income | Commercial | Multifamily<br>and<br>Farmland | Commercial | Farm | Consumer | All<br>Other | Total   |
| 1- Excellent<br>Quality | \$-  | 15,189                           | -   | -          | -                              | 700        | -    | 1,091    | -            | 16,980  |
| 2- High<br>Quality      | 10,144                                     | 86,061                           | -   | 38,647     | 2,998                          | 24,955     | -    | 3,647    | 1,665        | 168,117 |

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|                         |          |         |        |         |        |        |   |        |        |         |
|-------------------------|----------|---------|--------|---------|--------|--------|---|--------|--------|---------|
| 3- Good Quality         | 35,535   | 78,843  | 19,223 | 148,805 | 12,058 | 58,936 | 3 | 4,571  | 7,828  | 365,802 |
| 4- Management Attention | 12,544   | 30,259  | 15,029 | 31,824  | 335    | 5,905  | - | 620    | 1,738  | 98,254  |
| 5- Watch                | 7,265    | 4,322   | 3,308  | 4,561   | 2,689  | 332    | - | 43     | -      | 22,520  |
| 6- Substandard          | 303      | 6,016   | 6,173  | 4,689   | -      | 182    | - | 55     | -      | 17,418  |
| 7- Doubtful             | -        | -       | -      | -       | -      | -      | - | -      | -      | -       |
| 8- Loss                 | -        | -       | -      | -       | -      | -      | - | -      | -      | -       |
| Total                   | \$65,791 | 220,690 | 43,733 | 228,526 | 18,080 | 91,010 | 3 | 10,027 | 11,231 | 689,091 |

Current year TDR modifications, past due TDR loans and non-accrual TDR loans totaled \$4.3 million and \$8.8 million at September 30, 2016 and December 31, 2015, respectively. The terms of these loans have been renegotiated to provide a concession to original terms, including a reduction in principal or interest as a result of the deteriorating financial position of the borrower. There were \$41,000 and \$354,000 in performing loans classified as TDR loans at September 30, 2016 and December 31, 2015, respectively.

The following table presents an analysis of TDR loan modifications during the three and nine months ended September 30, 2016.

Three and nine months ended September 30, 2016  
(Dollars in thousands)

|                             | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|-----------------------------|---------------------|--|---|
| Real estate loans           |                     |  |   |
| Single-family residential   | 1                   | \$ 41  | 41  |
| Total real estate TDR loans | 1                   | 41   | 41  |
| Total TDR loans             | 1                   | \$ 41  | 41  |

During the three and nine months ended September 30, 2016, one loan was modified that was considered to be a new TDR loan. The interest rate was modified on this TDR loan.

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There were no TDR modifications during the three months ended September 30, 2015. The following table presents an analysis of TDR loan modifications during the nine months ended September 30, 2015.

Nine months ended September 30, 2015  
(Dollars in thousands)

|                             | Number of<br>Contracts | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification Outstanding<br>Recorded<br>Investment |
|-----------------------------|------------------------|---|---|
| Real estate loans           |                        |   |   |
| Single-family residential   | 1                      | \$ 146  | 142   |
| Total real estate TDR loans | 1                      | 146   | 142   |
| <br>                        |                        |   |   |
| Total TDR loans             | 1                      | \$ 146  | 142   |

During the nine months ended September 30, 2015, one loan was modified that was considered to be a new TDR loan. The interest rate was modified on this TDR loan.

There were no loans modified as TDR that defaulted during the three and nine months ended September 30, 2016 and 2015, which were within 12 months of their modification date. Generally, a TDR loan is considered to be in default once it becomes 90 days or more past due following a modification.

(4) Net Earnings Per Share

Net earnings per share is based on the weighted average number of shares outstanding during the period while the effects of potential shares outstanding during the period are included in diluted earnings per share. The average market price during the year is used to compute equivalent shares.

The reconciliation of the amounts used in the computation of both "basic earnings per share" and "diluted earnings per share" for the three and nine months ended September 30, 2016 and 2015 is as follows:

For the three months ended September 30, 2016

|                                | Net<br>Earnings<br>(Dollars in<br>thousands) | Weighted<br>Average<br>Number<br>of Shares | Per<br>Share<br>Amount |
|--------------------------------|--|--|------------------------|
| Basic earnings per share       | \$ 2,458                                     | 5,470,826                                  | \$ 0.45                |
| Effect of dilutive securities: |  |  |                        |
| Restricted stock units         | -  | 74,042                                     |                        |
| Diluted earnings per share     | \$ 2,458                                     | 5,544,868                                  | \$ 0.44                |

For the nine months ended September 30, 2016

|                                | Net<br>Earnings<br>(Dollars in<br>thousands) | Weighted<br>Average<br>Number<br>of Shares | Per<br>Share<br>Amount |
|--------------------------------|--|--|------------------------|
| Basic earnings per share       | \$ 7,875                                     | 5,497,204                                  | \$ 1.43                |
| Effect of dilutive securities: |  |  |                        |
| Restricted stock units         | -  | 68,122                                     |                        |

|                            |          |           |         |
|----------------------------|----------|-----------|---------|
| Diluted earnings per share | \$ 7,875 | 5,565,326 | \$ 1.42 |
|----------------------------|----------|-----------|---------|

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For the three months ended September 30, 2015

|                                | Net<br>Earnings<br>(Dollars in<br>thousands) | Weighted<br>Average<br>Number<br>of Shares | Per<br>Share<br>Amount |
|--------------------------------|--|--|------------------------|
| Basic earnings per share       | \$ 2,493                                     | 5,534,581                                  | \$ 0.45                |
| Effect of dilutive securities: |  |  |                        |
| Restricted stock units         | -  | 52,861                                     |                        |
| Diluted earnings per share     | \$ 2,493                                     | 5,587,442                                  | \$ 0.45                |

For the nine months ended September 30, 2015

|                                | Net<br>Earnings<br>(Dollars in<br>thousands) | Weighted<br>Average<br>Number<br>of Shares | Per<br>Share<br>Amount |
|--------------------------------|--|--|------------------------|
| Basic earnings per share       | \$ 7,445                                     | 5,573,743                                  | \$ 1.34                |
| Effect of dilutive securities: |  |  |                        |
| Restricted stock units         | -  | 45,466                                     |                        |
| Diluted earnings per share     | \$ 7,445                                     | 5,619,209                                  | \$ 1.32                |

(5) Stock-Based Compensation

The Company has an Omnibus Stock Ownership and Long Term Incentive Plan that was approved by shareholders on May 7, 2009 (the "Plan") whereby certain stock-based rights, such as stock options, restricted stock, restricted stock units, performance units, stock appreciation rights or book value shares, may be granted to eligible directors and employees. A total of 262,520 shares are currently reserved for possible issuance under the Plan. All stock-based rights under the Plan must be granted or awarded by May 7, 2019 (or ten years from the Plan effective date).

The Company granted 29,514 restricted stock units under the Plan at a grant date fair value of \$7.90 per share during the first quarter of 2012, of which 5,355 restricted stock units were forfeited by the executive officers of the Company as required by the agreement with the U.S. Department of the Treasury ("UST") in conjunction with the Company's participation in the Capital Purchase Program ("CPP") under the Troubled Asset Relief Program ("TARP"). In July 2012, the Company granted 5,355 restricted stock units at a grant date fair value of \$8.25 per share. The Company granted 26,795 restricted stock units under the Plan at a grant date fair value of \$11.90 per share during the second quarter of 2013. The Company granted 21,056 restricted stock units under the Plan at a grant date fair value of \$15.70 per share during the first quarter of 2014. The Company granted 15,075 restricted stock units under the Plan at a grant date fair value of \$17.97 per share during the first quarter of 2015. The Company granted 5,040 restricted stock units under the Plan at a grant date fair value of \$18.60 per share during the first quarter of 2016. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (five years from the grant date for the 2012 grants, four years from the grant date for the 2013, 2015 and 2016 grants and three years from the grant date for the 2014 grants). The amount of expense recorded each period reflects the changes in the Company's stock price during such period. As of September 30, 2016, the total unrecognized compensation expense related to the restricted stock unit grants under the Plan was \$460,000.

The Company recognized compensation expense for restricted stock unit awards granted under the Plan of \$476,000 and \$282,000 for the nine months ended September 30, 2016 and 2015, respectively.

(6) Fair Value

The Company is required to disclose fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation

of the fair value of the Company's financial instruments are detailed below. Where quoted prices are not available, fair values are based on estimates using discounted cash flows and other valuation techniques. The use of discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following disclosures should not be considered a surrogate of the liquidation value of the Company, but rather a good faith estimate of the increase or decrease in the value of financial instruments held by the Company since purchase, origination or issuance.

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

- Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

#### Cash and Cash Equivalents

For cash, due from banks and interest-bearing deposits, the carrying amount is a reasonable estimate of fair value. Cash and cash equivalents are reported in the Level 1 fair value category.

#### Investment Securities Available for Sale

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Fair values for investment securities with quoted market prices are reported in the Level 1 fair value category. Fair value measurements obtained from independent pricing services are reported in the Level 2 fair value category. All other fair value measurements are reported in the Level 3 fair value category.

#### Other Investments

For other investments, the carrying value is a reasonable estimate of fair value. Other investments are reported in the Level 3 fair value category.

#### Mortgage Loans Held for Sale

Mortgage loans held for sale are carried at the lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value. Mortgage loans held for sale are reported in the Level 3 fair value category.

#### Loans

The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. For variable rate loans, the carrying amount is a reasonable estimate of fair value. Loans are reported in the Level 3 fair value category, as the pricing of loans is more subjective than the pricing of other financial instruments.

#### Cash Surrender Value of Life Insurance

For cash surrender value of life insurance, the carrying value is a reasonable estimate of fair value. Cash surrender value of life insurance is reported in the Level 2 fair value category.

#### Other Real Estate

The fair value of other real estate is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. Other real estate is reported in the Level 3 fair value category.

#### Deposits

The fair value of demand deposits, interest-bearing demand deposits and savings is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounting the future cash flows using the

rates currently offered for deposits of similar remaining maturities. Deposits are reported in the Level 2 fair value category.

Securities Sold Under Agreements to Repurchase

For securities sold under agreements to repurchase, the carrying value is a reasonable estimate of fair value. Securities sold under agreements to repurchase are reported in the Level 2 fair value category.

Federal Home Loan Bank ("FHLB") Borrowings

The fair value of FHLB borrowings is estimated based upon discounted future cash flows using a discount rate comparable to the current market rate for such borrowings. FHLB borrowings are reported in the Level 2 fair value category.

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Junior Subordinated Debentures

Because the Company's junior subordinated debentures were issued at a floating rate, the carrying amount is a reasonable estimate of fair value. Junior subordinated debentures are reported in the Level 2 fair value category.

Commitments to Extend Credit and Standby Letters of Credit

Commitments to extend credit and standby letters of credit are generally short-term and at variable interest rates. Therefore, both the carrying value and estimated fair value associated with these instruments are immaterial.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on many judgments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial instruments include deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

The table below presents the balance of securities available for sale, which are measured at fair value on a recurring basis by level within the fair value hierarchy, as of September 30, 2016 and December 31, 2015.

(Dollars in thousands)

|                                       | September 30, 2016     |                   |                   |                   |
|---------------------------------------|------------------------|-------------------|-------------------|-------------------|
|                                       | Fair Value Measurement | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation |
| Mortgage-backed securities            | \$73,393               | -                 | 73,393            | -                 |
| U.S. Government sponsored enterprises | 39,078                 | -                 | 39,078            | -                 |
| State and political subdivisions      | 147,142                | -                 | 147,142           | -                 |
| Corporate bonds                       | 1,525                  | -                 | 1,525             | -                 |
| Trust preferred securities            | 750                    | -                 | -                 | 750               |
| Equity securities                     | 535                    | 535               | -                 | -                 |
| Total                                 | \$ 262,423             | 535               | 261,138           | 750               |

(Dollars in thousands)

|                                       | December 31, 2015      |                   |                   |                   |
|---------------------------------------|------------------------|-------------------|-------------------|-------------------|
|                                       | Fair Value Measurement | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation |
| Mortgage-backed securities            | \$77,887               | -                 | 77,887            | -                 |
| U.S. Government sponsored enterprises | 38,417                 | -                 | 38,417            | -                 |
| State and political subdivisions      | 148,245                | -                 | 148,245           | -                 |
| Corporate bonds                       | 1,906                  | -                 | 1,906             | -                 |
| Trust preferred securities            | 750                    | -                 | -                 | 750               |
| Equity securities                     | 1,325                  | 1,325             | -                 | -                 |

|       |           |       |         |     |
|-------|-----------|-------|---------|-----|
| Total | \$268,530 | 1,325 | 266,455 | 750 |
|-------|-----------|-------|---------|-----|

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the nine months ended September 30, 2016.

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(Dollars in thousands)

|   | Investment<br>Securities<br>Available<br>for Sale<br>Level 3<br>Valuation |
|---|---|
| Balance, beginning of period                  | \$ 750  |
| Change in book value                          | -   |
| Change in gain/(loss) realized and unrealized | -   |
| Purchases/(sales and calls)                   | -   |
| Transfers in and/or (out) of Level 3          | -   |
| Balance, end of period                        | \$ 750  |

Change in unrealized gain/(loss) for assets still held in Level 3 \$ -

The fair value measurements for mortgage loans held for sale, impaired loans and other real estate on a non-recurring basis at September 30, 2016 and December 31, 2015 are presented below. The fair value measurement process uses certified appraisals and other market-based information; however, in many cases, it also requires significant input based on management's knowledge of, and judgment about, current market conditions, specific issues relating to the collateral and other matters. As a result, all fair value measurements for impaired loans and other real estate are considered Level 3.

(Dollars in thousands)

|                              | Fair Value<br>Measurements<br>September 30,<br>2016 | Level 1<br>Valuation | Level 2<br>Valuation | Level 3<br>Valuation |
|------------------------------|---|----------------------|----------------------|----------------------|
| Mortgage loans held for sale | \$ 2,776  | -                    | -                    | 2,776                |
| Impaired loans               | \$ 26,120   | -                    | -                    | 26,120               |
| Other real estate            | \$ 26   | -                    | -                    | 26                   |

(Dollars in thousands)

|                              | Fair Value<br>Measurements<br>December 31,<br>2015 | Level 1<br>Valuation | Level 2<br>Valuation | Level 3<br>Valuation |
|------------------------------|--|----------------------|----------------------|----------------------|
| Mortgage loans held for sale | \$ 4,149   | -                    | -                    | 4,149                |
| Impaired loans               | \$ 31,818  | -                    | -                    | 31,818               |
| Other real estate            | \$ 739   | -                    | -                    | 739                  |

(Dollars in thousands)

|                              | Fair Value<br>September<br>30, 2016 | Fair Value<br>December<br>31, 2015 | Valuation<br>Technique                          | Significant<br>Unobservable<br>Inputs                | General Range<br>of Significant<br>Unobservable<br>Input Values |
|------------------------------|-------------------------------------|------------------------------------|---|--|---|
| Mortgage loans held for sale | \$ 2,776                            | 4,149                              | Rate lock<br>commitment                         | N/A  | N/A   |
| Impaired loans               | \$ 26,120                           | 31,818                             | Appraised value<br>and discounted<br>cash flows | Discounts to<br>reflect current<br>market conditions | 0 - 25%   |

|                   |       |     |                 |   |         |
|-------------------|-------|-----|-----------------|---|---------|
| Other real estate |       |     | Appraised value | and ultimate collectability<br>Discounts to reflect current market conditions and estimated costs to sell | 0 - 25% |
|                   | \$ 26 | 739 |                 |   |         |

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The carrying amount and estimated fair value of financial instruments at September 30, 2016 and December 31, 2015 are as follows:

(Dollars in thousands)

|  | Carrying Amount | Fair Value Measurements at September 30, 2016 |         |         |         |
|--|-----------------|---|---------|---------|---------|
|  |                 | Level 1                                       | Level 2 | Level 3 | Total   |
| <b>Assets:</b>                                 |                 |   |         |         |         |
| Cash and cash equivalents                      | \$82,844        | 82,844  | -       | -       | 82,844  |
| Investment securities available for sale       | \$262,423       | 535   | 261,138 | 750     | 262,423 |
| Other investments                              | \$3,634         | -   | -       | 3,634   | 3,634   |
| Mortgage loans held for sale                   | \$2,776         | -   | -       | 2,776   | 2,776   |
| Loans, net                                     | \$704,974       | -   | -       | 698,402 | 698,402 |
| Cash surrender value of life insurance         | \$14,853        | -   | 14,853  | -       | 14,853  |
| <b>Liabilities:</b>                            |                 |   |         |         |         |
| Deposits                                       | \$861,947       | -   | -       | 855,156 | 855,156 |
| Securities sold under agreements to repurchase | \$50,920        | -   | 50,920  | -       | 50,920  |
| FHLB borrowings                                | \$43,500        | -   | 40,560  | -       | 40,560  |
| Junior subordinated debentures                 | \$20,619        | -   | 20,619  | -       | 20,619  |

(Dollars in thousands)

|  | Carrying Amount | Fair Value Measurements at December 31, 2015 |         |         |         |
|--|-----------------|--|---------|---------|---------|
|  |                 | Level 1                                      | Level 2 | Level 3 | Total   |
| <b>Assets:</b>                                 |                 |  |         |         |         |
| Cash and cash equivalents                      | \$39,763        | 39,763                                       | -       | -       | 39,763  |
| Investment securities available for sale       | \$268,530       | 1,325  | 266,455 | 750     | 268,530 |
| Other investments                              | \$3,636         | -  | -       | 3,636   | 3,636   |
| Mortgage loans held for sale                   | \$4,149         | -  | -       | 4,149   | 4,149   |
| Loans, net                                     | \$679,502       | -  | -       | 683,540 | 683,540 |
| Cash surrender value of life insurance         | \$14,546        | -  | 14,546  | -       | 14,546  |
| <b>Liabilities:</b>                            |                 |  |         |         |         |
| Deposits                                       | \$832,175       | -  | -       | 827,874 | 827,874 |
| Securities sold under agreements to repurchase | \$27,874        | -  | 27,874  | -       | 27,874  |
| FHLB borrowings                                | \$43,500        | -  | 43,144  | -       | 43,144  |
| Junior subordinated debentures                 | \$20,619        | -  | 20,619  | -       | 20,619  |

(7) Regulatory Matters

On August 31, 2015, the Federal Deposit Insurance Corporation ("FDIC") and the North Carolina Office of the Commissioner of Banks ("Commissioner") issued a Consent Order (the "Order") in connection with compliance by the Bank with the Bank Secrecy Act and its implementing regulations (collectively, the "BSA"). The Order was issued pursuant to the consent of the Bank. In consenting to the issuance of the Order, the Bank did not admit or deny any unsafe or unsound banking practices or violations of law or regulation.

The Order requires the Bank to take certain affirmative actions to comply with its obligations under the BSA, including, without limitation, strengthening its Board of Directors' oversight of BSA activities; reviewing, enhancing, adopting and implementing a revised BSA compliance program; completing a BSA risk assessment; developing a revised system of internal controls designed to ensure full compliance with the BSA; reviewing and revising customer due diligence and risk assessment processes, policies and procedures; developing, adopting and implementing effective BSA training programs; assessing BSA staffing needs and resources and appointing a qualified BSA officer; establishing an independent BSA testing program; ensuring that all reports required by the BSA are accurately and properly filed and engaging an independent firm to review past account activity to determine whether suspicious activity was properly identified and reported.

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Prior to implementation, certain of the actions described above are subject to review by, and approval or non-objection from, the FDIC and the Commissioner. The Order will remain in effect and be enforceable until it is modified, terminated, suspended or set aside by the FDIC and the Commissioner.

The Bank continues to make progress in addressing the issues identified in the Order and expects that it will be able to undertake and implement all required actions within the time period specified in the Order. The Bank has incurred and will continue to incur additional non-interest expenses associated with the implementation of corrective actions; however, these expenses are not expected to have a significant impact on the results of operations or financial position of the Company. Operating under the Order will limit the Bank's and the Company's ability to participate in acquisitions, to open new branches, and to allocate funds to its stock repurchase plan until such time as the Order has been modified, terminated, suspended or set aside by the FDIC and the Commissioner.

(8) Subsequent Events

The Company has reviewed and evaluated subsequent events and transactions for material subsequent events through the date the financial statements are issued. Management has concluded that there were no material subsequent events.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following is a discussion of our financial position and results of operations and should be read in conjunction with the information set forth under Item 1A Risk Factors and the Company's Consolidated Financial Statements and Notes thereto on pages A-24 through A-64 of the Company's 2015 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 5, 2016 Annual Meeting of Shareholders.

### Introduction

Management's discussion and analysis of earnings and related data are presented to assist in understanding the consolidated financial condition and results of operations of the Company. The Company is the parent company of the Bank and a registered bank holding company operating under the supervision of the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander, Mecklenburg, Iredell, Union, Wake, Durham and Forsyth counties, operating under the banking laws of North Carolina and the rules and regulations of the FDIC.

### Overview

Our business consists principally of attracting deposits from the general public and investing these funds in commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. Our profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment securities portfolios and our cost of funds, which consists of interest paid on deposits and borrowed funds. Net interest income also is affected by the relative amounts of our interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, a positive interest rate spread will generate net interest income. Our profitability is also affected by the level of other income and operating expenses. Other income consists primarily of miscellaneous fees related to our loans and deposits, mortgage banking income and commissions from sales of annuities and mutual funds. Operating expenses consist of compensation and benefits, occupancy related expenses, federal deposit and other insurance premiums, data processing, advertising and other expenses.

Our operations are influenced significantly by local economic conditions and by policies of financial institution regulatory authorities. The earnings on our assets are influenced by the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System (the "Federal Reserve"), inflation, interest rates, market and monetary fluctuations. Lending activities are affected by the demand for commercial and other types of loans, which in turn is affected by the interest rates at which such financing may be offered. Our cost of funds is influenced by interest rates on competing investments and by rates offered on similar investments by competing financial institutions in our market area, as well as general market interest rates. These factors can cause fluctuations in our net interest income and other income. In addition, local economic conditions can impact the credit risk of our loan portfolio, in that (1) local employers may be required to eliminate employment positions of individual borrowers, and (2) small businesses and commercial borrowers may experience a downturn in their operating performance and become unable to make timely payments on their loans. Management evaluates these factors in estimating the allowance for loan losses and changes in these economic factors could result in increases or decreases to the provision for loan losses.

Current economic conditions, while not as robust as those experienced in the pre-crisis period from 2004 to 2007, have stabilized such that businesses in our market area are growing and investing again. The uncertainty expressed in the local, national and international markets through the primary economic indicators of activity, however, continues to limit the level of activity in our markets.

Although we are unable to control the external factors that influence our business, by maintaining high levels of balance sheet liquidity, managing our interest rate exposures and by actively monitoring asset quality, we seek to minimize the potentially adverse risks of unforeseen and unfavorable economic trends.



Our business emphasis has been and continues to be to operate as a well-capitalized, profitable and independent community-oriented financial institution dedicated to providing quality customer service. We are committed to meeting the financial needs of the communities in which we operate. We expect growth to be achieved in our local markets and through expansion opportunities in contiguous or nearby markets. While we would be willing to consider growth by acquisition in certain circumstances, we do not consider the acquisition of another company to be necessary for our continued ability to provide a reasonable return to our shareholders. We believe that we can be more effective in serving our customers than many of our non-local competitors because of our ability to quickly and effectively provide senior management responses to customer needs and inquiries. Our ability to provide these services is enhanced by the stability and experience of our Bank officers and managers.

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The Federal Reserve maintained the Federal Funds rate at 0.25% from December 2008 to December 2015 before increasing the Fed Funds rate to 0.50% on December 16, 2015. This continued period of very low interest rates has presented a challenge to the Company to maintain its net interest margin as loan rates have continued to fall, primarily because of competition for credit worthy customers. The cost of deposits has also fallen and has gotten to the point that there is little room left to reduce this cost. While the December 2015 0.25% Fed Funds rate increase is helpful, the negative impact of such low interest rates will remain until the Fed Funds rate increases to a level approaching historical norms.

#### Summary of Significant Accounting Policies

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of specific accounting guidance. A more complete description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2015 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 5, 2016 Annual Meeting of Shareholders.

Many of the Company's assets and liabilities are recorded using various techniques that require significant judgment as to recoverability. The collectibility of loans is reflected through the Company's estimate of the allowance for loan losses. The Company performs periodic and systematic detailed reviews of its lending portfolio to assess overall collectibility. In addition, certain assets and liabilities are reflected at their estimated fair value in the consolidated financial statements. Such amounts are based on either quoted market prices or estimated values derived from dealer quotes used by the Company, market comparisons or internally generated modeling techniques. The Company's internal models generally involve present value of cash flow techniques. The various techniques are discussed in greater detail elsewhere in this management's discussion and analysis and the Notes to the Consolidated Financial Statements. Fair value of the Company's financial instruments is discussed in Note (6) of the Notes to Consolidated Financial Statements (Unaudited) included in this Quarterly Report.

#### Results of Operations

**Summary.** Net earnings were \$2.5 million or \$0.45 basic net earnings per share and \$0.44 diluted net earnings per share for the three months ended September 30, 2016, as compared to \$2.5 million or \$0.45 basic and diluted net earnings per share for the same period one year ago. The \$35,000 decrease in third quarter net earnings is primarily attributable to an increase in non-interest expense, which was partially offset by an increase in net interest income, a decrease in the provision for loan losses and an increase in non-interest income, as discussed below.

The annualized return on average assets was 0.90% for the three months ended September 30, 2016, compared to 0.95% for the same period one year ago, and annualized return on average shareholders' equity was 8.68% for the three months ended September 30, 2016, compared to 9.57% for the same period one year ago.

Year-to-date net earnings as of September 30, 2016 were \$7.9 million or \$1.43 basic net earnings per share and \$1.42 diluted net earnings per share, as compared to \$7.4 million or \$1.34 basic net earnings per share and \$1.32 diluted net earnings per share for the same period one year ago. The increase in year-to-date net earnings is primarily attributable to an increase in net interest income, a decrease in the provision for loan losses and an increase in non-interest income, which were partially offset by an increase in non-interest expense, as discussed below.

The annualized return on average assets was 0.99% for the nine months ended September 30, 2016, compared to 0.96% for the same period one year ago, and annualized return on average shareholders' equity was 9.29% for the nine months ended September 30, 2016, compared to 9.48% for the same period one year ago.

**Net Interest Income.** Net interest income, the major component of the Company's net earnings, was \$9.2 million for the three months ended September 30, 2016, compared to \$9.1 million for the three months ended September 30, 2015. The increase in net interest income was primarily due to a \$35,000 increase in interest income, which was

primarily attributable to an increase in the average outstanding balance of loans and a 0.25% increase in the prime rate in December 2015, combined with a \$46,000 decrease in interest expense, which was primarily attributable to a decrease in the average outstanding balance of time deposits and FHLB borrowings during the three months ended September 30, 2016, as compared to the same period one year ago.

Interest income was \$10.0 million for the three months ended September 30, 2016, compared to \$9.9 million for the three months ended September 30, 2015. The increase in interest income was primarily due to an increase in interest income on loans, which was partially offset by a decrease in interest income on investment securities. During the quarter ended September 30, 2016, average loans increased \$33.7 million to \$709.7 million from \$676.0 million for the quarter ended September 30, 2015. During the quarter ended September 30, 2016, average investment securities available for sale decreased \$12.1 million to \$252.3 million from \$264.4 million for the quarter ended September 30, 2015. The average yield on loans for the quarters ended September 30, 2016 and 2015 was 4.59% and 4.75%, respectively. The average yield on investment securities available for sale was 3.63% for the quarters ended September 30, 2016 and 2015. The average yield on earning assets for the quarters ended September 30, 2016 and 2015 was 4.23% and 4.39%, respectively.

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Interest expense was \$828,000 for the three months ended September 30, 2016, compared to \$874,000 for the three months ended September 30, 2015. The decrease in interest expense was the result of lower cost of funds and reductions in certificates of deposit and FHLB borrowings. The average rate paid on interest-bearing checking and savings accounts was 0.11% for the three months ended September 30, 2016, as compared to 0.10% for the same period one year ago. The average rate paid on certificates of deposit was 0.38% for the quarter ended September 30, 2016, as compared to 0.49% for the same period one year ago. The average rate paid on interest-bearing liabilities was 0.46% for the three months ended September 30, 2016, as compared to 0.49% for the same period one year ago. During the quarter ended September 30, 2016, average certificates of deposit decreased \$20.2 million to \$149.9 million from \$170.1 million for the quarter ended September 30, 2015. Average FHLB borrowings decreased \$6.5 million to \$43.5 million for the three months ended September 30, 2016 from \$50.0 million for the three months ended September 30, 2015.

The following table sets forth for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest incurred on such amounts and the average rate earned or incurred for the three months ended September 30, 2016 and 2015. The table also sets forth the average rate earned on total interest-earning assets, the average rate paid on total interest-bearing liabilities, and the net yield on total average interest-earning assets for the same periods. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields and interest income on tax-exempt investments have been adjusted to a tax equivalent basis using an effective tax rate of 36.64% for securities that are both federal and state tax exempt and an effective tax rate of 32.64% for federal tax exempt securities. Non-accrual loans and the interest income that was recorded on non-accrual loans, if any, are included in the yield calculations for loans in all periods reported.

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| (Dollars in thousands)  | Three months ended<br>September 30, 2016 |                |                    | Three months ended<br>September 30, 2015 |               |                    |
|---|--|----------------|--------------------|--|---------------|--------------------|
|   | Average<br>Balance                       | Interest       | Yield<br>/<br>Rate | Average<br>Balance                       | Interest      | Yield<br>/<br>Rate |
| <b>Interest-earning assets:</b>                                   |  |                |                    |  |               |                    |
| Loans receivable  | \$709,742                                | 8,189          | 4.59 %             | \$676,049                                | 8,089         | 4.75 %             |
| Investments - taxable   | 78,033                                   | 454            | 2.31 %             | 86,274                                   | 516           | 2.37 %             |
| Investments - nontaxable*   | 178,500                                  | 1,869          | 4.17 %             | 182,628                                  | 1,919         | 4.17 %             |
| Other   | 26,327                                   | 32             | 0.48 %             | 6,892                                    | 4             | 0.23 %             |
| <b>Total interest-earning assets</b>                              | <b>992,602</b>                           | <b>10,544</b>  | <b>4.23 %</b>      | <b>951,843</b>                           | <b>10,528</b> | <b>4.39 %</b>      |
| <b>Non-interest earning assets:</b>                               |  |                |                    |  |               |                    |
| Cash and due from banks   | 47,263                                   |                |                    | 40,657                                   |               |                    |
| Allowance for loan losses   | (8,603 )                                 |                |                    | (10,381 )                                |               |                    |
| Other assets  | 55,894                                   |                |                    | 54,439                                   |               |                    |
| <b>Total assets</b>   | <b>\$1,087,156</b>                       |                |                    | <b>\$1,036,558</b>                       |               |                    |
| <b>Interest-bearing liabilities:</b>                              |  |                |                    |  |               |                    |
| NOW, MMDA & savings deposits                                      | \$453,008                                | 126            | 0.11 %             | \$412,976                                | 106           | 0.10 %             |
| Time deposits   | 149,914                                  | 142            | 0.38 %             | 170,148                                  | 211           | 0.49 %             |
| FHLB borrowings   | 43,500                                   | 426            | 3.90 %             | 50,000                                   | 443           | 3.52 %             |
| Trust preferred securities  | 20,619                                   | 122            | 2.35 %             | 20,619                                   | 102           | 1.96 %             |
| Other   | 47,217                                   | 12             | 0.10 %             | 49,425                                   | 12            | 0.10 %             |
| <b>Total interest-bearing liabilities</b>                         | <b>714,258</b>                           | <b>828</b>     | <b>0.46 %</b>      | <b>703,168</b>                           | <b>874</b>    | <b>0.49 %</b>      |
| <b>Non-interest bearing liabilities and shareholders' equity:</b> |  |                |                    |  |               |                    |
| Demand deposits   | 257,707                                  |                |                    | 227,658                                  |               |                    |
| Other liabilities   | 2,610                                    |                |                    | 2,332                                    |               |                    |
| Shareholders' equity  | 112,581                                  |                |                    | 103,400                                  |               |                    |
| <b>Total liabilities and shareholder's equity</b>                 | <b>\$1,087,156</b>                       |                |                    | <b>\$1,036,558</b>                       |               |                    |
| <b>Net interest spread</b>  |  | <b>\$9,716</b> | <b>3.77 %</b>      |  | <b>9,654</b>  | <b>3.90 %</b>      |
| <b>Net yield on interest-earning assets</b>                       |  |                | <b>3.89 %</b>      |  |               | <b>4.02 %</b>      |
| <b>Taxable equivalent adjustment</b>                              |  |                |                    |  |               |                    |
| Investment securities   |  | \$562          |                    |  | 581           |                    |
| <b>Net interest income</b>  |  | <b>\$9,154</b> |                    |  | <b>9,073</b>  |                    |

\*Includes U.S. Government agency securities that are non-taxable for state income tax purposes of \$39.5 million in 2016 and \$39.3 million in 2015. Tax rates of 4.00% and 5.00% were used to calculate the tax equivalent yield on these securities in 2016 and 2015, respectively.

Year-to-date net interest income as of September 30, 2016 was \$27.3 million compared to \$26.1 million for same period one year ago. The increase in net interest income was primarily due to a \$998,000 increase in interest income, which was primarily attributable to an increase in the average outstanding balance of loans combined with a \$184,000 decrease in interest expense, which was primarily attributable to a decrease in the average outstanding balance of time deposits and FHLB borrowings during the nine months ended September 30, 2016, as compared to the same period one year ago.

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Interest income was \$29.7 million for the nine months ended September 30, 2016 compared to \$28.7 million for the same period one year ago. Interest income on loans increased by \$1.2 million primarily due to a \$34.7 million increase in the average outstanding balance of loans during the nine months ended September 30, 2016, as compared to the same period one year ago. Interest income on investment securities decreased \$218,000 primarily due to a \$14.5 million decrease in the average outstanding balance of available for sale securities during the nine months ended September 30, 2016, as compared to the same period one year ago. During the nine months ended September 30, 2016, the average outstanding balance of loans increased \$34.7 million to \$698.3 million from \$663.6 million for the nine months ended September 30, 2015. During the nine months ended September 30, 2016, average investment securities available for sale decreased \$14.5 million to \$254.1 million from \$268.6 million for the nine months ended September 30, 2015. The average yield on loans for the nine months ended September 30, 2016 and 2015 was 4.63% and 4.64%, respectively. The average yield on earning assets for the nine months ended September 30, 2016 and 2015 was 4.30% and 4.29%, respectively.

Interest expense was \$2.5 million for the nine months ended September 30, 2016, compared to \$2.6 million for the nine months ended September 30, 2015. The decrease in interest expense was the result of lower cost of funds and reductions in certificates of deposit and FHLB borrowings. The average rate paid on interest-bearing checking and savings accounts was 0.11% for the nine months ended September 30, 2016, as compared to 0.10% for the same period one year ago. The average rate paid on certificates of deposits was 0.40% for the nine months ended September 30, 2016 compared to 0.52% for the same period one year ago. Average certificates of deposit decreased \$25.7 million to \$152.0 million for the nine months ended September 30, 2016 from \$177.7 million for the nine months ended September 30, 2015. Average FHLB borrowings decreased \$6.4 million to \$43.6 million for the nine months ended September 30, 2016 from \$50.0 million for the nine months ended September 30, 2015.

The following table sets forth for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest incurred on such amounts and the average rate earned or incurred for the nine months ended September 30, 2016 and 2015. The table also sets forth the average rate earned on total interest-earning assets, the average rate paid on total interest-bearing liabilities, and the net yield on total average interest-earning assets for the same periods. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields and interest income on tax-exempt investments have been adjusted to a tax equivalent basis using an effective tax rate of 36.64% for securities that are both federal and state tax exempt and an effective tax rate of 32.64% for federal tax exempt securities. Non-accrual loans and the interest income that was recorded on non-accrual loans, if any, are included in the yield calculations for loans in all periods reported.

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| (Dollars in thousands)  | Nine months ended<br>September 30, 2016 |                 |                 | Nine months ended<br>September 30, 2015 |               |                 |
|---|---|-----------------|-----------------|---|---------------|-----------------|
|   | Average<br>Balance                      | Interest        | Yield<br>/ Rate | Average<br>Balance                      | Interest      | Yield<br>/ Rate |
| <b>Interest-earning assets:</b>                                   |   |                 |                 |   |               |                 |
| Loans receivable  | \$698,313                               | 24,185          | 4.63 %          | \$663,574                               | 23,015        | 4.64 %          |
| Investments - taxable   | 79,476                                  | 1,485           | 2.50 %          | 91,664                                  | 1,701         | 2.48 %          |
| Investments - nontaxable*   | 178,921                                 | 5,671           | 4.23 %          | 181,524                                 | 5,723         | 4.22 %          |
| Other   | 18,816                                  | 67              | 0.48 %          | 12,020                                  | 21            | 0.23 %          |
| <b>Total interest-earning assets</b>                              | <b>975,526</b>                          | <b>31,408</b>   | <b>4.30 %</b>   | <b>948,782</b>                          | <b>30,460</b> | <b>4.29 %</b>   |
| <b>Non-interest earning assets:</b>                               |   |                 |                 |   |               |                 |
| Cash and due from banks   | 43,050                                  |                 |                 | 43,793                                  |               |                 |
| Allowance for loan losses   | (9,144 )                                |                 |                 | (10,767 )                               |               |                 |
| Other assets  | 55,223                                  |                 |                 | 55,104                                  |               |                 |
| <b>Total assets</b>   | <b>\$1,064,655</b>                      |                 |                 | <b>\$1,036,912</b>                      |               |                 |
| <b>Interest-bearing liabilities:</b>                              |   |                 |                 |   |               |                 |
| NOW, MMDA & savings deposits                                      | \$441,161                               | 367             | 0.11 %          | \$416,703                               | 324           | 0.10 %          |
| Time deposits   | 152,050                                 | 452             | 0.40 %          | 177,745                                 | 685           | 0.52 %          |
| FHLB borrowings   | 43,646                                  | 1,248           | 3.82 %          | 50,000                                  | 1,294         | 3.46 %          |
| Trust preferred securities  | 20,619                                  | 353             | 2.29 %          | 20,619                                  | 297           | 1.93 %          |
| Other   | 39,941                                  | 30              | 0.10 %          | 45,283                                  | 34            | 0.10 %          |
| <b>Total interest-bearing liabilities</b>                         | <b>697,417</b>                          | <b>2,450</b>    | <b>0.47 %</b>   | <b>710,350</b>                          | <b>2,634</b>  | <b>0.50 %</b>   |
| <b>Non-interest bearing liabilities and shareholders' equity:</b> |   |                 |                 |   |               |                 |
| Demand deposits   | 254,829                                 |                 |                 | 221,166                                 |               |                 |
| Other liabilities   | (798 )                                  |                 |                 | 427                                     |               |                 |
| Shareholders' equity  | 113,207                                 |                 |                 | 104,969                                 |               |                 |
| <b>Total liabilities and shareholder's equity</b>                 | <b>\$1,064,655</b>                      |                 |                 | <b>\$1,036,912</b>                      |               |                 |
| <b>Net interest spread</b>  |   | <b>\$28,958</b> | <b>3.83 %</b>   |   | <b>27,826</b> | <b>3.79 %</b>   |
| <b>Net yield on interest-earning assets</b>                       |   |                 | <b>3.97 %</b>   |   |               | <b>3.92 %</b>   |
| <b>Taxable equivalent adjustment</b>                              |   |                 |                 |   |               |                 |
| Investment securities   |   | \$1,705         |                 |   | 1,755         |                 |
| <b>Net interest income</b>  |   | <b>\$27,253</b> |                 |   | <b>26,071</b> |                 |



\*Includes U.S. Government agency securities that are non-taxable for state income tax purposes of \$38.8 million in 2016 and \$36.9 million in 2015. Tax rates of 4.00% and 5.00% were used to calculate the tax equivalent yield on these securities in 2016 and 2015, respectively.

Changes in interest income and interest expense can result from variances in both volume and rates. The following table presents the impact on the Company's tax equivalent net interest income resulting from changes in average balances and average rates for the periods indicated. The changes in interest due to both volume and rate have been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the changes in each.

| (Dollars in thousands)        | Three months ended<br>September 30,<br>2016 compared to three<br>months ended<br>September 30, 2015 |                                   |                                 | Nine months ended September<br>30,<br>2016 compared to nine months<br>ended<br>September 30, 2015 |                                   |                                 |
|-------------------------------|---|-----------------------------------|---------------------------------|---|-----------------------------------|---------------------------------|
|                               | Changes<br>in<br>average<br>volume  | Changes<br>in<br>average<br>rates | Total<br>Increase<br>(Decrease) | Changes<br>in<br>average<br>volume  | Changes<br>in<br>average<br>rates | Total<br>Increase<br>(Decrease) |
| <b>Interest income:</b>       |   |                                   |                                 |   |                                   |                                 |
| Loans: Net of unearned income | \$396   | (296 )                            | 100                             | \$1,204   | (34 )                             | 1,170                           |
| Investments - taxable         | (49 )   | (13 )                             | (62 )                           | (227 )  | 11                                | (216 )                          |
| Investments - nontaxable      | (43 )   | (7 )                              | (50 )                           | (82 )   | 30                                | (52 )                           |
| Other                         | 17  | 11                                | 28                              | 18  | 28                                | 46                              |
| Total interest income         | 321   | (305 )                            | 16                              | 913   | 35                                | 948                             |
| <b>Interest expense:</b>      |   |                                   |                                 |   |                                   |                                 |
| NOW, MMDA & savings deposits  | 11  | 9                                 | 20                              | 20  | 23                                | 43                              |
| Time deposits                 | (22 )   | (47 )                             | (69 )                           | (88 )   | (145 )                            | (233 )                          |
| FHLB borrowings               | (61 )   | 44                                | (17 )                           | (173 )  | 127                               | (46 )                           |
| Trust preferred securities    | -   | 20                                | 20                              | -   | 56                                | 56                              |
| Other                         | -   | -                                 | -                               | (4 )  | -                                 | (4 )                            |
| Total interest expense        | (72 )   | 26                                | (46 )                           | (245 )  | 61                                | (184 )                          |
| Net interest income           | \$393   | (331 )                            | 62                              | \$1,158   | (26 )                             | 1,132                           |

Provision for Loan Losses. The provision for loan losses for the three months ended September 30, 2016 was a credit of \$360,000, as compared to an expense of \$235,000 for the three months ended September 30, 2015. The decrease in the provision for loan losses is primarily attributable to a reduction in the required level of the allowance for loan losses resulting from lower historical loss rates used to calculate the ASC 450-20 reserve as the elevated level of loan losses incurred in 2010 and 2011 are no longer included in the historical loss calculations.

The provision for loan losses for the nine months ended September 30, 2016 was a credit of \$1.1 million, as compared to an expense of \$193,000 for the nine months ended September 30, 2015. The decrease in the provision for loan losses is primarily attributable to a reduction in the required level of the allowance for loan losses resulting from lower historical loss rates used to calculate the ASC 450-20 reserve as the elevated level of loan losses incurred in 2010 and 2011 are no longer included in the historical loss calculations.

Non-Interest Income. Total non-interest income was \$3.4 million for the three months ended September 30, 2016, compared to \$3.3 million for the three months ended September 30, 2015. The increase in non-interest income is primarily attributable to a \$126,000 increase in mortgage banking income during the three months ended September 30, 2016, as compared to the three months ended September 30, 2015.

Non-interest income was \$10.3 million for the nine months ended September 30, 2016, compared to \$9.8 million for the nine months ended September 30, 2015. The increase in non-interest income is primarily attributable to \$324,000 in gains on the sale of securities and a \$278,000 increase in mortgage banking income during the nine months ended September 30, 2016, as compared to the nine months ended September 30, 2015.

Non-Interest Expense. Total non-interest expense was \$9.6 million for the three months ended September 30, 2016, compared to \$8.7 million for the three months ended September 30, 2015. The increase in non-interest expense was primarily due to a \$266,000 increase in professional fees, a \$221,000 increase in other non-interest expense, a

\$233,000 increase in salaries and benefits expense, and a \$144,000 increase in occupancy expense during the three months ended September 30, 2016, as compared to the three months ended September 30, 2015. The increase in professional fees is primarily due to a \$173,000 increase in consulting fees.

Non-interest expense was \$28.2 million for the nine months ended September 30, 2016, as compared to \$25.8 million for the nine months ended September 30, 2015. The increase in non-interest expense was primarily due to a \$1.0 million increase in professional fees, a \$666,000 increase in occupancy expense, and a \$431,000 increase in salaries and benefits expense during the nine months ended September 30, 2016, as compared to the nine months ended September 30, 2015. The increase in professional fees is primarily due to a \$1.2 million increase in consulting fees due to expenses associated with the Order issued in August 2015. The Bank continues to make progress in addressing the issues identified in the Order and expects that it will be able to undertake and implement all required actions within the time periods specified in the Order.

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Income Taxes. The Company reported income tax expense of \$872,000 and \$942,000 for the three months ended September 30, 2016 and 2015, respectively. This represented an effective tax rate of 26% and 27% for the respective periods.

The Company reported income tax expense of \$2.6 million and \$2.5 million for the nine months ended September 30, 2016 and 2015, respectively. This represented an effective tax rate of 25% for the nine months ended September 30, 2016 and 2015.

#### Analysis of Financial Condition

Investment Securities. Available for sale securities were \$262.4 million at September 30, 2016, compared to \$268.5 million at December 31, 2015. Average investment securities available for sale for the nine months ended September 30, 2016 were \$254.1 million, compared to \$266.8 million for the year ended December 31, 2015.

Loans. At September 30, 2016, loans were \$713.0 million, compared to \$689.1 million at December 31, 2015. Average loans represented 72% and 66% of average earning assets for the nine months ended September 30, 2016 and the year ended December 31, 2015, respectively. The Company had \$2.8 million and \$4.1 million in mortgage loans held for sale as of September 30, 2016 and December 31, 2015, respectively.

Although the Company has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by real estate, which is dependent upon the real estate market. Real estate mortgage loans include both commercial and residential mortgage loans. At September 30, 2016, the Company had \$111.3 million in residential mortgage loans, \$98.6 million in home equity loans and \$320.1 million in commercial mortgage loans, which include \$258.2 million secured by commercial property and \$61.9 million secured by residential property. Residential mortgage loans include \$70.3 million made to customers in the Company's traditional banking offices and \$41.0 million in mortgage loans originated in the Company's Latino banking offices. All residential mortgage loans are originated as fully amortizing loans, with no negative amortization.

At September 30, 2016, the Company had \$59.5 million in construction and land development loans. The following table presents a breakout of these loans.

(Dollars in thousands)

|   | Number<br>of<br>Loans | Balance<br>Outstanding | Non-accrual<br>Balance |
|---|-----------------------|------------------------|------------------------|
| Land acquisition and development - commercial purposes  | 58                    | \$ 9,786               | \$ -                   |
| Land acquisition and development - residential purposes | 227                   | 24,767                 | 31                     |
| 1 to 4 family residential construction                  | 82                    | 15,055                 | -                      |
| Commercial construction                                 | 20                    | 9,848                  | -                      |
| Total construction and land development                 | 387                   | \$ 59,456              | \$ 31                  |

Current year TDR modifications, past due TDR loans and non-accrual TDR loans totaled \$4.3 million and \$8.8 million at September 30, 2016 and December 31, 2015, respectively. The terms of these loans have been renegotiated to provide a concession to original terms, including a reduction in principal or interest as a result of the deteriorating financial position of the borrower. There were \$41,000 and \$354,000 in performing loans classified as TDR loans at September 30, 2016 and December 31, 2015, respectively

Allowance for Loan Losses. The allowance for loan losses reflects management's assessment and estimate of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. The Bank periodically analyzes the loan portfolio in an effort to review asset quality and to establish an allowance for loan losses that management believes will be adequate in light of anticipated risks and loan losses. In assessing the adequacy of the allowance, size, quality and risk of loans in the portfolio are reviewed. Other factors considered are:

- the Bank's loan loss experience;
  - the amount of past due and non-performing loans;
- specific known risks;
- the status and amount of other past due and non-performing assets;
- underlying estimated values of collateral securing loans;
- current and anticipated economic conditions; and
- other factors which management believes affect the allowance for potential credit losses.

Management uses several measures to assess and monitor the credit risks in the loan portfolio, including a loan grading system that begins upon loan origination and continues until the loan is collected or collectability becomes doubtful. Upon loan origination, the Bank's originating loan officer evaluates the quality of the loan and assigns one of eight risk grades. The loan officer monitors the loan's performance and credit quality and makes changes to the credit grade as conditions warrant. When originated or renewed, all loans over a certain dollar amount receive in-depth reviews and risk assessments by the Bank's Credit Administration. Before making any changes in these risk grades, management considers assessments as determined by the third party credit review firm (as described below), regulatory examiners and the Bank's Credit Administration. Any issues regarding the risk assessments are addressed by the Bank's senior credit administrators and factored into management's decision to originate or renew the loan. The Bank's Board of Directors reviews, on a monthly basis, an analysis of the Bank's reserves relative to the range of reserves estimated by the Bank's Credit Administration.

As an additional measure, the Bank engages an independent third party to review the underwriting, documentation and risk grading analyses. This independent third party reviews and evaluates loan relationships greater than \$1.0 million, excluding loans in default, and loans in process of litigation or liquidation. The third party's evaluation and report is shared with management and the Bank's Board of Directors.

Management considers certain commercial loans with weak credit risk grades to be individually impaired and measures such impairment based upon available cash flows and the value of the collateral. Allowance or reserve levels are estimated for all other graded loans in the portfolio based on their assigned credit risk grade, type of loan and other matters related to credit risk.

Management uses the information developed from the procedures described above in evaluating and grading the loan portfolio. This continual grading process is used to monitor the credit quality of the loan portfolio and to assist management in estimating the allowance for loan losses. The provision for loan losses charged or credited to earnings is based upon management's judgment of the amount necessary to maintain the allowance at a level appropriate to absorb probable incurred losses in the loan portfolio at the balance sheet date. The amount each quarter is dependent upon many factors, including growth and changes in the composition of the loan portfolio, net charge-offs, delinquencies, management's assessment of loan portfolio quality, the value of collateral, and other macro-economic factors and trends. The evaluation of these factors is performed quarterly by management through an analysis of the appropriateness of the allowance for loan losses.

The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment. When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Bank's loss exposure for each credit, given the appraised value of any underlying collateral. Loans for which specific reserves are provided are excluded from the general allowance calculations as described below.

The general allowance reflects reserves established under GAAP for collective loan impairment. These reserves are based upon historical net charge-offs using the greater of the last two, three, four or five years' loss experience. This charge-off experience may be adjusted to reflect the effects of current conditions. The Bank considers information derived from its loan risk ratings and external data related to industry and general economic trends in establishing reserves.

The unallocated allowance is determined through management's assessment of probable losses that are in the portfolio but are not adequately captured by the other two components of the allowance, including consideration of current economic and business conditions and regulatory requirements. The unallocated allowance also reflects management's acknowledgement of the imprecision and subjectivity that underlie the modeling of credit risk. Due to the subjectivity involved in determining the overall allowance, including the unallocated portion, the unallocated portion may fluctuate from period to period based on management's evaluation of the factors affecting the assumptions used in

calculating the allowance.

Effective December 31, 2012, stated income mortgage loans from the Banco division of the Bank were analyzed separately from other single family residential loans in the Bank's loan portfolio. These loans are first mortgage loans made to the Latino market, primarily in Mecklenburg and surrounding counties. These loans are non-traditional mortgages in that the customer normally did not have a credit history, so all credit information was accumulated by the loan officers. These loans were made as stated income loans rather than full documentation loans because the customer may not have had complete documentation on the income supporting the loan.

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Various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require adjustments to the allowance based on their judgments of information available to them at the time of their examinations. Management believes it has established the allowance for credit losses pursuant to GAAP, and has taken into account the views of its regulators and the current economic environment. Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Bank's loan portfolio as of the date of the financial statements. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the nine months ended September 30, 2016 as compared to the nine months ended September 30, 2015. Revisions, estimates and assumptions may be made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

The allowance for loan losses at September 30, 2016 was \$8.0 million or 1.13% of total loans, compared to \$9.6 million or 1.39% of total loans at December 31, 2015.

The following table presents the percentage of loans assigned to each risk grade at September 30, 2016 and December 31, 2015.

| Risk Grade                          | Percentage of Loans<br>By Risk Grade |            |
|-------------------------------------|--------------------------------------|------------|
|                                     | 9/30/2016                            | 12/31/2015 |
| Risk Grade 1 (Excellent Quality)    | 1.38%                                | 1.66%      |
| Risk Grade 2 (High Quality)         | 26.50%                               | 24.40%     |
| Risk Grade 3 (Good Quality)         | 54.53%                               | 53.64%     |
| Risk Grade 4 (Management Attention) | 12.68%                               | 14.26%     |
| Risk Grade 5 (Watch)                | 2.74%                                | 3.26%      |
| Risk Grade 6 (Substandard)          | 1.86%                                | 2.53%      |
| Risk Grade 7 (Doubtful)             | 0.00%                                | 0.00%      |
| Risk Grade 8 (Loss)                 | 0.00%                                | 0.00%      |

At September 30, 2016, including non-accrual loans, there were three relationships exceeding \$1.0 million in the Watch risk grade (which totaled \$6.9 million) and one relationship exceeding \$1.0 million in the Substandard risk grade (which totaled \$1.3 million). There was one relationship with loans in both the Watch and Substandard risk grades, which exceeded \$1.0 million for loans in both risk grades combined.

Non-performing Assets. Non-performing assets totaled \$4.8 million at September 30, 2016 or 0.44% of total assets, compared to \$9.2 million or 0.88% of total assets at December 31, 2015. Non-accrual loans were \$4.8 million at September 30, 2016 and \$8.4 million at December 31, 2015. As a percentage of total loans outstanding, non-accrual loans were 0.67% at September 30, 2016, compared to 1.22% at December 31, 2015. Non-accrual loans include \$4.6 million in commercial and residential mortgage loans, \$31,000 in construction and land development loans and \$107,000 in other loans at September 30, 2016, compared to \$8.1 million in commercial and residential mortgage loans, \$146,000 in construction and land development loans and \$165,000 in other loans at December 31, 2015. The Bank had no loans 90 days past due and still accruing at September 30, 2016. The Bank had loans 90 days past due and still accruing totaling \$17,000 at December 31, 2015. Other real estate totaled \$26,000 at September 30, 2016, compared to \$739,000 at December 31, 2015.

Deposits. Total deposits at September 30, 2016 were \$861.9 million compared to \$832.2 million at December 31, 2015. Core deposits, which include non-interest bearing demand deposits, NOW, MMDA, savings and non-brokered certificates of deposit of denominations less than \$250,000, were \$828.1 million at September 30, 2016 as compared



to \$801.2 million at December 31, 2015. Certificates of deposit in amounts of \$250,000 or more totaled \$26.6 million at September 30, 2016, as compared to \$26.9 million at December 31, 2015. At September 30, 2016, brokered deposits were \$7.2 million as compared to \$4.3 million at December 31, 2015. Brokered deposits outstanding as of September 30, 2016 had a weighted average rate of 0.06% with a weighted average original term of 23 months as compared to brokered deposits outstanding at December 31, 2015, which had a weighted average rate of 0.10% with a weighted average original term of 14 months.

**Borrowed Funds.** Borrowings from the FHLB totaled \$43.5 million at September 30, 2016 and December 31, 2015. The average balance of FHLB borrowings for the nine months ended September 30, 2016 was \$43.6 million, compared to \$49.8 million for the year ended December 31, 2015. The FHLB borrowings outstanding at September 30, 2016 had interest rates ranging from 2.59% to 4.18% and all mature in 2018.

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Securities sold under agreements to repurchase were \$50.9 million at September 30, 2016 compared to \$27.9 million at December 31, 2015.

Junior Subordinated Debentures (related to Trust Preferred Securities). In June 2006, the Company formed a wholly owned Delaware statutory trust, PEBK Capital Trust II ("PEBK Trust II"), which issued \$20.0 million of guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures. All of the common securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase \$20.6 million of junior subordinated debentures of the Company, which pay a floating rate equal to three-month LIBOR plus 163 basis points. The proceeds received by the Company from the sale of the junior subordinated debentures were used to repay in December 2006 the trust preferred securities issued in December 2001 by PEBK Capital Trust, a wholly owned Delaware statutory trust of the Company, and for general purposes. The debentures represent the sole asset of PEBK Trust II. PEBK Trust II is not included in the Consolidated Financial Statements.

The trust preferred securities issued by PEBK Trust II accrue and pay quarterly at a floating rate of three-month LIBOR plus 163 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust II does not have funds with which to make the distributions and other payments. The net combined effect of the trust preferred securities transaction is that the Company is obligated to make the distributions and other payments required on the trust preferred securities.

These trust preferred securities are mandatorily redeemable upon maturity of the debentures on June 28, 2036, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust II, in whole or in part, which became effective on June 28, 2011. As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be the principal amount plus any accrued but unpaid interest.

Asset Liability and Interest Rate Risk Management. The objective of the Company's Asset Liability and Interest Rate Risk strategies is to identify and manage the sensitivity of net interest income to changing interest rates and to minimize the interest rate risk between interest-earning assets and interest-bearing liabilities at various maturities. This is to be done in conjunction with the need to maintain adequate liquidity and the overall goal of maximizing net interest income.

The Company manages its exposure to fluctuations in interest rates through policies established by our Asset/Liability Committee ("ALCO"). ALCO meets quarterly and has the responsibility for approving asset/liability management policies, formulating and implementing strategies to improve balance sheet positioning and/or earnings and reviewing the interest rate sensitivity of the Company. ALCO tries to minimize interest rate risk between interest-earning assets and interest-bearing liabilities by attempting to minimize wide fluctuations in net interest income due to interest rate movements. The ability to control these fluctuations has a direct impact on the profitability of the Company. Management monitors this activity on a regular basis through analysis of its portfolios to determine the difference between rate sensitive assets and rate sensitive liabilities.

The Company's rate sensitive assets are those earning interest at variable rates and those with contractual maturities within one year. Rate sensitive assets therefore include both loans and available for sale securities. Rate sensitive liabilities include interest-bearing checking accounts, money market deposit accounts, savings accounts, time deposits and borrowed funds. Average rate sensitive assets for the nine months ended September 30, 2016 totaled \$975.5 million, exceeding average rate sensitive liabilities of \$697.4 million by \$278.1 million.

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative

instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. The Company did not have any interest rate derivatives outstanding as of September 30, 2016.

Included in the rate sensitive assets are \$286.4 million in variable rate loans indexed to prime rate subject to immediate repricing upon changes by the Federal Open Market Committee ("FOMC"). The Company utilizes interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At September 30, 2016, the Company had \$180.1 million in loans with interest rate floors. The floors were in effect on \$132.0 million of these loans pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 0.77% higher than the indexed rate on the promissory notes without interest rate floors.

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Liquidity. The objectives of the Company's liquidity policy are to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities and to satisfy regulatory requirements. Both deposit and loan customer cash needs can fluctuate significantly depending upon business cycles, economic conditions and yields and returns available from alternative investment opportunities. In addition, the Company's liquidity is affected by off-balance sheet commitments to lend in the form of unfunded commitments to extend credit and standby letters of credit. As of September 30, 2016, such unfunded commitments to extend credit were \$189.6 million, while commitments in the form of standby letters of credit totaled \$3.8 million.

The Company uses several sources to meet its liquidity requirements. The primary source is core deposits, which includes demand deposits, savings accounts and non-brokered certificates of deposit of denominations less than \$250,000. The Company considers these to be a stable portion of the Company's liability mix and the result of on-going consumer and commercial banking relationships. As of September 30, 2016, the Company's core deposits totaled \$828.1 million, or 96% of total deposits.

The other sources of funding for the Company are through large denomination certificates of deposit, including brokered deposits, federal funds purchased, securities under agreements to repurchase and FHLB borrowings. The Bank is also able to borrow from the Federal Reserve Bank ("FRB") on a short-term basis. The Company's policies include the ability to access wholesale funding of up to 40% of total assets. The Company's wholesale funding includes FHLB borrowings, FRB borrowings, brokered deposits, internet certificates of deposit and certificates of deposit issued to the State of North Carolina. The Company's ratio of wholesale funding to total assets was 4.62% as of September 30, 2016.

The Bank has a line of credit with the FHLB equal to 20% of the Bank's total assets, with an outstanding balance of \$43.5 million at September 30, 2016 and December 31, 2015. At September 30, 2016, the carrying value of loans pledged as collateral to the FHLB totaled \$128.5 million compared to \$124.8 million at December 31, 2015. The remaining availability under the line of credit with the FHLB was \$42.5 million at September 30, 2016 compared to \$38.5 million at December 31, 2015. The Bank had no borrowings from the FRB at September 30, 2016 or December 31, 2015. FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At September 30, 2016, the carrying value of loans pledged as collateral to the FRB totaled \$374.0 million compared to \$365.9 million at December 31, 2015.

The Bank also had the ability to borrow up to \$59.5 million for the purchase of overnight federal funds from five correspondent financial institutions as of September 30, 2016.

The liquidity ratio for the Bank, which is defined as net cash, interest-bearing deposits, federal funds sold and certain investment securities, as a percentage of net deposits and short-term liabilities was 29.27% at September 30, 2016 and 26.10% at December 31, 2015. The minimum required liquidity ratio as defined in the Bank's Asset/Liability and Interest Rate Risk Management Policy was 10% at September 30, 2016 and December 31, 2015.

Contractual Obligations and Off-Balance Sheet Arrangements. The Company's contractual obligations and other commitments as of September 30, 2016 and December 31, 2015 are summarized in the table below. The Company's contractual obligations include the repayment of principal and interest related to FHLB advances and junior subordinated debentures, as well as certain payments under current lease agreements. Other commitments include commitments to extend credit. Because not all of these commitments to extend credit will be drawn upon, the actual cash requirements are likely to be significantly less than the amounts reported for other commitments below.

(Dollars in thousands)

|  | September | December |
|--|-----------|----------|
|  | 30, 2016  | 31, 2015 |

|                              |  |  |
|------------------------------|--|--|
| Contractual Cash Obligations |  |  |
|------------------------------|--|--|

|  |           |         |
|--|-----------|---------|
| Long-term borrowings                                       | \$43,500  | 43,500  |
| Junior subordinated debentures                             | 20,619    | 20,619  |
| Operating lease obligations                                | 3,677     | 4,175   |
| Total  | \$67,796  | 68,294  |
| Other Commitments  |           |         |
| Commitments to extend credit                               | \$189,606 | 189,351 |
| Standby letters of credit and financial guarantees written | 3,843     | 3,872   |
| Total  | \$193,449 | 193,223 |

The Company enters into derivative contracts from time to time to manage various financial risks. A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index or referenced interest rate. Derivative contracts are carried at fair value on the consolidated balance sheet with the fair value representing the net present value of expected future cash receipts or payments based on market interest rates as of the balance sheet date. Derivative contracts are written in amounts referred to as notional amounts, which only provide the basis for calculating payments between counterparties and are not a measure of financial risk. Further discussions of derivative instruments are included above in the section entitled "Asset Liability and Interest Rate Risk Management".

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Capital Resources. Shareholders' equity was \$110.6 million, or 10.1% of total assets, as of September 30, 2016, compared to \$102.2 million, or 9.9% of total assets, as of September 30, 2015. The increase in shareholders' equity is primarily due to an increase in retained earnings due to net income and an increase in accumulated other comprehensive income resulting from an increase in the unrealized gain on investment securities.

Annualized return on average equity for the nine months ended September 30, 2016 was 9.29% compared to 9.48% for the nine months ended September 30, 2015. Total cash dividends paid on common stock were \$1.6 million and \$1.1 million for the nine months ended September 30, 2016 and 2015, respectively.

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights. The Board of Directors does not currently anticipate issuing any additional series of preferred stock.

In 2014, the Company's Board of Directors authorized a stock repurchase program ("the 2014 Stock Repurchase Program"), pursuant to which up to \$2 million was allocated to repurchase the Company's common stock. All purchases under the 2014 Stock Repurchase Program were made periodically as permitted by securities laws and other legal requirements in the open market or in privately negotiated transactions. The timing and amount of the repurchase of shares was determined by the Company's management, based on its evaluation of market conditions and other factors. The Company has repurchased approximately \$2.0 million, or 106,587 shares of its common stock, under the 2014 Stock Repurchase Program as of September 30, 2016.

In the second quarter of 2016, the Company's Board of Directors authorized a stock repurchase program ("the 2016 Stock Repurchase Program"), pursuant to which up to \$2 million will be allocated to repurchase the Company's common stock. Any purchases under the 2016 Stock Repurchase Program may be made periodically as permitted by securities laws and other legal requirements in the open market or in privately negotiated transactions. The timing and amount of any repurchase of shares will be determined by the Company's management, based on its evaluation of market conditions and other factors. The 2016 Stock Repurchase Program may be suspended at any time or from time-to-time without prior notice. The Company has repurchased approximately \$2.0 million, or 92,738 shares of its common stock, under the 2016 Stock Repurchase Program as of September 30, 2016.

In 2013, the Federal Reserve Board approved its final rule on the Basel III capital standards, which implement changes to the regulatory capital framework for banking organizations. The Basel III capital standards, which became effective January 1, 2015, include new risk-based capital and leverage ratios, which will be phased in from 2015 to 2019. The new minimum capital level requirements applicable to the Company and the Bank under the final rules are as follows: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total risk based capital ratio of 8% (unchanged from previous rules); and (iv) a Tier 1 leverage ratio of 4% (unchanged from previous rules). An additional capital conservation buffer will be added to the minimum requirements for capital adequacy purposes beginning on January 1, 2016 at 0.625% and will be phased in through 2019 (increasing by 0.625% on each subsequent January 1, until it reaches 2.5% on January 1, 2019). This will result in the following minimum ratios beginning in 2019: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. Under the final rules, institutions would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained earnings that could be utilized for such actions.

Under the regulatory capital guidelines, financial institutions are currently required to maintain a total risk-based capital ratio of 8.0% or greater, with a Tier 1 risk-based capital ratio of 6.0% or greater and a common equity Tier 1 capital ratio of 4.5% or greater, as required by the Basel III capital standards referenced above. Tier 1 capital is generally defined as shareholders' equity and trust preferred securities less all intangible assets and goodwill. Tier 1 capital at September 30, 2016 and December 31, 2015 includes \$20.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 15.05% and 15.37% at September 30, 2016 and December 31, 2015, respectively.

Total risk-based capital is defined as Tier 1 capital plus supplementary capital. Supplementary capital, or Tier 2 capital, consists of the Company's allowance for loan losses, not exceeding 1.25% of the Company's risk-weighted assets. Total risk-based capital ratio is therefore defined as the ratio of total capital (Tier 1 capital and Tier 2 capital) to risk-weighted assets. The Company's total risk-based capital ratio was 16.04% and 16.63% at September 30, 2016 and December 31, 2015, respectively. The Company's common equity Tier 1 capital consists of common stock and retained earnings. The Company's common equity Tier 1 capital ratio was 12.62% and 12.79% at September 30, 2016 and December 31, 2015, respectively. Financial institutions are also required to maintain a leverage ratio of Tier 1 capital to total average assets of 4.0% or greater. The Company's Tier 1 leverage capital ratio was 11.38% and 11.44% at September 30, 2016 and December 31, 2015, respectively.

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The Bank's Tier 1 risk-based capital ratio was 14.67% and 14.85% at September 30, 2016 and December 31, 2015, respectively. The total risk-based capital ratio for the Bank was 15.65% and 16.11% at September 30, 2016 and December 31, 2015, respectively. The Bank's common equity Tier 1 capital ratio was 14.67% and 14.85% at September 30, 2016 and December 31, 2015, respectively. The Bank's Tier 1 leverage capital ratio was 11.04% and 11.03% at September 30, 2016 and December 31, 2015, respectively.

A bank is considered to be "well capitalized" if it has a total risk-based capital ratio of 10.0 % or greater, a Tier 1 risk-based capital ratio of 8.0% or greater, a common equity Tier 1 capital ratio of 6.5% or greater and a leverage ratio of 5.0% or greater. Based upon these guidelines, the Bank was considered to be "well capitalized" at September 30, 2016.



Item 3. Quantitative and Qualitative Disclosures About Market Risk

There are no material changes from the Quantitative and Qualitative Disclosures About Market Risk as previously disclosed in the Company's Form 10-K in response to Item 3 to Form 10-K, filed with Securities and Exchange Commission on March 14, 2016.

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Item 4T. Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART  
II. OTHER INFORMATION

Item 1. Legal Proceedings

The discussion of the Order issued by the FDIC and the Commissioner in conjunction with compliance by the Bank with the BSA and its implementing regulations on August 31, 2015 as set forth in Note (7) of the Consolidated Financial Statements included in Item 1 hereof is incorporated by reference.

Item  
1A. Risk Factors

There are no material changes from the Risk Factors as previously disclosed in the Company's Form 10-K in response to Item 1A. Part I to Form 10-K, filed with the Securities and Exchange Commission on March 14, 2016.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

ISSUER PURCHASES OF EQUITY SECURITIES

| Period                 | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid<br>per<br>Share | Total<br>Number of<br>Shares<br>Purchased as<br>Part of<br>Publicly<br>Announced<br>Plans or<br>Programs (2) | Maximum<br>Number (or<br>Approximate<br>Dollar<br>Value) of<br>Shares that<br>May Yet Be<br>Purchased<br>Under the<br>Plans<br>or Programs<br>(3) |
|------------------------|---|--|--|---|
| July 1 - 31, 2016      | 1,171                                     | \$ 20.60                                 | -  | \$ 2,000,000  |
| August 1 - 31, 2016    | 48,738                                    | 21.03                                    | 48,738   | \$ 975,018  |
| September 1 - 30, 2016 | 44,394                                    | 21.79                                    | 44,000   | \$ 16,180   |
| Total                  | 94,303                                    | (1) \$ 20.60                             | 92,738   |   |

(1) The Company purchased 1,565 shares on the open market in the three months ended September 30, 2016 for its deferred compensation plan. All purchases were funded by participant contributions to the plan.

(2) Reflects shares purchased under the Stock Repurchase Plan authorized by the Company's Board of Directors in 2016.

(3) Reflects dollar value of shares that may yet be purchased under the Stock Repurchase Plan authorized by the Company's Board of Directors in 2016.

Item 3. Defaults Upon Senior Securities

Not applicable

Item 5. Other Information

Not applicable

Item 6. Exhibits

Exhibit (3)(i)(a) Articles of Incorporation of the Registrant, incorporated by reference to Exhibit (3)(i) to the Form 8-A filed with the Securities and Exchange Commission on September 2, 1999

- Exhibit (3)(i)(b) Articles of Amendment dated December 19, 2008, regarding the Series A Preferred Stock, incorporated by reference to Exhibit (3)(1) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (3)(i)(c) Articles of Amendment dated February 26, 2010, incorporated by reference to Exhibit (3)(2) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010
- Exhibit (3)(ii) Second Amended and Restated Bylaws of the Registrant, incorporated by reference to Exhibit (3)(ii) to the Form 8-K filed with the Securities and Exchange Commission on June 24, 2015
- Exhibit (4) Specimen Stock Certificate, incorporated by reference to Exhibit (4) to the Form 8-A filed with the Securities and Exchange Commission on September 2, 1999
- Exhibit (10)(i) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Tony W. Wolfe dated December 18, 2008, incorporated by reference to Exhibit (10)(a)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(ii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Joseph F. Beaman, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(b)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and William D. Cable, Sr. dated December 18, 2008, incorporated by reference to Exhibit (10)(c)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(iv) Employment agreement dated January 22, 2015 between the Registrant and William D. Cable, Sr., incorporated by reference to Exhibit (10)(c) to the Form 8-K filed with the Securities and Exchange Commission on February 9, 2015
- Exhibit (10)(v) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Lance A. Sellers dated December 18, 2008, incorporated by reference to Exhibit (10)(d)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(vi) Employment agreement dated January 22, 2015 between the Registrant and Lance A. Sellers, incorporated by reference to Exhibit (10)(a) to the Form 8-K filed with the Securities and Exchange Commission on February 9, 2015
- Exhibit (10)(vii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and A. Joseph Lampron, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(f)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(viii) Employment agreement dated January 22, 2015 between the Registrant and A. Joseph Lampron, Jr., incorporated by reference to Exhibit (10)(b) to the Form 8-K

filed with the Securities and Exchange Commission on February 9, 2015

Exhibit (10)(ix) Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(h) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002

Exhibit (10)(x) Rabbi Trust for the Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002

- Exhibit (10)(xi) Description of Service Recognition Program maintained by Peoples Bank, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 27, 2003
- Exhibit (10)(xii) Capital Securities Purchase Agreement dated as of June 26, 2006, by and among the Registrant, PEBK Capital Trust II and Bear, Sterns Securities Corp., incorporated by reference to Exhibit (10)(j) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(xiii) Amended and Restated Trust Agreement of PEBK Capital Trust II, dated as of June 28, 2006, incorporated by reference to Exhibit (10)(k) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(xiv) Guarantee Agreement of the Registrant dated as of June 28, 2006, incorporated by reference to Exhibit (10)(l) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(xv) Indenture, dated as of June 28, 2006, by and between the Registrant and LaSalle Bank National Association, as Trustee, relating to Junior Subordinated Debt Securities Due September 15, 2036, incorporated by reference to Exhibit (10)(m) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(xvi) Form of Amended and Restated Director Supplemental Retirement Agreement between Peoples Bank and Directors Robert C. Abernethy, James S. Abernethy, Douglas S. Howard, John W. Lineberger, Jr., Gary E. Matthews, Dr. Billy L. Price, Jr., Larry E. Robinson, W. Gregory Terry, Dan Ray Timmerman, Sr. and Benjamin I. Zachary, incorporated by reference to Exhibit (10)(n) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(xvii) 2009 Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(o) to the Form 10-K filed with the Securities and Exchange Commission on March 20, 2009
- Exhibit (14) Code of Business Conduct and Ethics of Peoples Bancorp of North Carolina, Inc., incorporated by reference to Exhibit (14) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2005
- Exhibit (31)(a) Certification of principal executive officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit (31)(b) Certification of principal financial officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit (32) Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- Exhibit (101) The following materials from the Company's 10-Q Report for the quarterly period ended September 30, 2016 formatted in XBRL: (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of

Income, (iii) the Condensed Consolidated Statements of Changes in Shareholders' Equity, (iv) the Condensed Consolidated Statements of Cash Flows, and (v) the Notes to the Condensed Consolidated Financial Statements, tagged as blocks of text.\*

\*Furnished, not filed.



SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Peoples Bancorp of North Carolina, Inc.

November 4, 2016 /s/ Lance A. Sellers  
Date Lance A. Sellers  
President and Chief Executive Officer  
(Principal Executive Officer)

November 4, 2016 /s/ A. Joseph Lampron, Jr.  
Date A. Joseph Lampron, Jr.  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Principal Accounting Officer)