Community Bankers Trust Corp
Form 10-K
March 16, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2016

or

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

For the transition period from to

Commission file number 001-32590

COMMUNITY BANKERS TRUST CORPORATION

(Exact name of registrant as specified in its charter)

Virginia	**20-2652949**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

9954 Mayland Drive, Suite 2100 **Richmond, Virginia**	**23233**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code (804) 934-9999

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

Title of each class	**Name of each exchange on which registered**
Common Stock, $0.01 par value	**The NASDAQ Stock Market, LLC**

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K ¨

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

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant’s most recently completed second fiscal quarter. $109,426,941

On February 28, 2017, there were 21,959,468 shares of the registrant’s common stock, par value $0.01, outstanding, which is the only class of the registrant’s common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant’s definitive Proxy Statement to be used in conjunction with the registrant’s

2017 Annual Meeting of Shareholders are incorporated into Part III of this Form 10-K.

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PART I

ITEM 1. ***BUSINESS***

GENERAL

The Company is the holding company for Essex Bank (the "Bank"), a Virginia state bank with 23 full-service offices in Virginia and Maryland. The Bank also operates one loan production office in Virginia.

The Bank was established in 1926. The Bank engages in a general commercial banking business and provides a wide range of financial services primarily to individuals and small businesses, including individual and commercial demand and time deposit accounts, commercial and industrial loans, consumer and small business loans, real estate and mortgage loans, investment services, on-line and mobile banking products, and safe deposit box facilities.

Essex Services, Inc. is a wholly-owned subsidiary of the Bank. Essex Services and its financial consultants offer a broad range of investment products and alternatives through an affiliation with Infinex Investments, Inc., an independent broker-dealer. It also offers insurance products through an ownership interest in Bankers Insurance, LLC, an independent insurance agency.

The Company's corporate headquarters are located at 9954 Mayland Drive, Suite 2100, Richmond, Virginia 23233. The telephone number of the corporate headquarters is (804) 934-9999.

The Company's common stock trades on the NASDAQ Capital Market under the symbol "ESXB".

STRATEGY

The Company operates under a community banking philosophy that seeks to develop strong relationships by being recognized as the premier provider of complete financial services and delivering those products with unsurpassed service to the customer. The Company will accomplish this goal while operating in a safe and sound manner to provide a competitive return to its investors.

The Company believes that its community bank framework and philosophy provide a competitive advantage, particularly with regard to larger national and regional institutions, allowing the Company to compete effectively and expand market share. During 2016, the Company expanded in its core markets by increasing loan and deposit production and adding two new retail banking offices, in Fairfax and Cumberland, Virginia. Additionally, the Company's loan portfolio continues to become more diverse through the expansion of the commercial and Industrial and small business lending groups. The Company expects to continue this growth through a combination of internal growth, de novo branching, expansion of loan production offices and the acquisition of other community banks that are accretive in value in a reasonable time frame.

Historically, the Company has been able to accomplish its growth goals while controlling risk and adding shareholder value. Management believes that it has the ability, the capacity and the capital strength to successful execute its strategies and to continue to enhance the major profit drivers of the Company. The implementation of these strategies will lead to an increase in profitability and value for shareholders.

OPERATIONS

The Company's operating strategy is delineated by business lines and by the functional support areas that help accomplish the stated goals and financial budget of the organization. A major component of future income is growth in three core business lines – retail and small business banking, commercial and industrial banking and real estate lending. These core businesses, combined with the Company's geographic locations, dictate the market position that the Company needs to take to be successful. The majority of new loan growth will occur in all three lines, although the retail segment primarily provides the funding through core deposit relationship growth.

Retail and Small Business Banking

The Company markets to consumers in geographic areas around its branch network not only through existing bricks and mortar, but also with alternative delivery mechanisms and new product development such as online banking, remote deposit capture, mobile banking and telephonic banking. In addition, the Company attracts new customers by making its service through these distribution points convenient. All of the Company's existing markets are prime targets for expanding the consumer side of its business with full loan and deposit relationships, and the Company has restructured its retail group to accommodate growth. In addition, the Company is focused on potential growth in new market areas in which it currently operates loan production offices.

Commercial and Industrial Banking

In the commercial and industrial banking group, the Company focuses on small to mid-sized business customers (sales of $5 million to $15 million each year) who are not targeted by larger banks and for whom smaller community banks have limited expertise. The Company has an experienced team with a strong loan pipeline. The typical relationship consists of working capital lines and equipment loans with the primary deposit accounts of the customer. Most of these relationships will be new to the Company and create strong and positive growth potential.

Commercial Real Estate Lending

The Company has historically held a significant concentration in real estate loans. The current strategy is to manage the existing real estate portfolio and add income producing property loans and builders and other development loans to the portfolio. The Company originates both owner occupied and non-owner occupied borrowings where the cash flows provide significant debt coverage for the relationship.

COMPETITION

Within its market areas in Virginia and Maryland, the Company operates in a highly competitive environment, competing for deposits and loans with commercial corporations, savings banks and other financial institutions, including non-bank competitors, many of which possess substantially greater financial resources than those available to the Company. Many of these institutions have significantly higher lending limits than the Company. In addition, there can be no assurance that other financial institutions, with substantially greater resources than the Company, will not establish operations in its service area. The financial services industry remains highly competitive and is constantly evolving.

The activities in which the Company engages are highly competitive. Financial institutions such as credit unions, consumer finance companies, insurance companies, brokerage companies and other financial institutions with varying degrees of regulatory restrictions compete vigorously for a share of the financial services market. Brokerage and insurance companies continue to become more competitive in the financial services arena and pose an ever increasing challenge to banks. Legislative changes also greatly affect the level of competition that the Company faces. Federal legislation allows credit unions to use their expanded membership capabilities, combined with tax-free status, to compete more fiercely for traditional bank business. The tax-free status granted to credit unions provides them a significant competitive advantage. Many of the largest banks operating in Virginia and Maryland, including some of the largest banks in the country, have offices in the Company’s market areas. Many of these institutions have capital resources, broader geographic markets, and legal lending limits substantially in excess of those available to the

Company. The Company faces competition from institutions that offer products and services that it does not or cannot currently offer. Some institutions with which the Company competes offer interest rate levels on loan and deposit products that the Company is unwilling to offer due to interest rate risk and overall profitability concerns. The Company expects the level of competition to increase.

Factors such as rates offered on loan and deposit products, types of products offered, and the number and location of branch offices, as well as the reputation of institutions in the market, affect competition for loans and deposits. The Company emphasizes customer service, establishing long-term relationships with its customers, thereby creating customer loyalty, and providing adequate product lines for individuals and small to medium-sized business customers.

The Company would not be materially or adversely impacted by the loss of a single customer. The Company is not dependent upon a single or a few customers.

CORPORATE HISTORY

The Company was initially formed as a special purpose acquisition company under the name “Community Bankers Acquisition Corp.” As a “Targeted Acquisition Corporation[SM]” or “TAC,[SM]” the Company was formed to effect a merger, capital stock exchange, asset acquisition or other similar business combination with an operating business in the banking industry. In May 2008, the Company acquired each of TransCommunity Financial Corporation, a Virginia corporation (TFC), and BOE Financial Services of Virginia, Inc., a Virginia corporation (BOE). The Company changed its corporate name in connection with the acquisitions.

Formed in 2001, TFC was a financial holding company and the parent company of TransCommunity Bank, N.A. Until June 2007, TFC was the holding company for four separately-chartered banking subsidiaries — Bank of Powhatan, Bank of Goochland, Bank of Louisa and Bank of Rockbridge. In June 2007, these four subsidiaries were consolidated into a new TransCommunity Bank, N.A. Each former subsidiary then operated as a division of TransCommunity Bank, but retained its name and local identity in the community that it served.

BOE was incorporated under Virginia law in 2000 to become the holding company for the Bank.

In connection with the May 2008 mergers, each of the Bank, then a wholly-owned subsidiary of BOE, and TransCommunity Bank, N.A., a wholly-owned subsidiary of TFC, became a wholly-owned subsidiary of the Company, and they were operated initially as separate banking subsidiaries. In July 2008, TransCommunity Bank was consolidated into the Bank under the Bank’s state charter. Until 2010, the former branch offices of TFC operated as separate divisions under the Bank’s charter, using the names of TFC’s former banking subsidiaries.

In November 2008, the Bank acquired certain fixed assets and assumed all deposit liabilities relating to four former branch offices of The Community Bank (TCB), a Georgia state-chartered bank, following its failure. The transaction was consummated pursuant to a Purchase and Assumption Agreement by and among the FDIC, both as Receiver for The Community Bank and in its corporate capacity, and the Bank. The Bank sold those offices and related deposits to Community & Southern Bank on November 8, 2013.

In January 2009, the Bank acquired substantially all assets and assumed all deposit and certain other liabilities relating to seven former branch offices of Suburban Federal Savings Bank, Crofton, Maryland (SFSB), following its failure. The transaction was consummated pursuant to a Purchase and Assumption Agreement by and among the FDIC, both as Receiver for SFSB and in its corporate capacity, and the Bank. The Bank entered into a shared loss arrangement with the FDIC with respect to loans and real estate assets acquired. The Bank terminated this arrangement on September 10, 2015.

On January 1, 2014, the Company completed a reincorporation from Delaware, its original state of incorporation, to Virginia. As a result of the reincorporation, the Company’s corporate affairs are now governed by Virginia law. The purpose of the reincorporation to Virginia was annual cost savings of over $175,000 that the Company realizes from the difference between Delaware’s franchise tax and Virginia’s annual corporate fee. The form of the reincorporation was the merger of the then existing Delaware corporation into a newly created Virginia corporation. The Company retained the same name and conducts business in the same manner as before the reincorporation. In addition, all of the issued and outstanding shares of the Company’s common stock and preferred stock became shares of a Virginia corporation. The reincorporation had no effect on the Bank and its operations.

TARP INVESTMENT

In December 2008, the Company issued 17,680 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the “Series A Preferred Stock”) and a related common stock warrant to the Treasury for a total price of $17,680,000. The issuance and receipt of proceeds from the Treasury were made under its voluntary Capital Purchase Program. The Series A Preferred Stock qualified as Tier 1 capital. The Series A Preferred Stock had a liquidation amount per share equal to $1,000. The Series A Preferred Stock paid cumulative dividends at a rate of 5% per year for the first five years and thereafter at a rate of 9% per year. The Company could have deferred dividend payments, but the dividend was a cumulative dividend that accrued for payment in the future. The common stock warrant permitted the Treasury

to purchase 780,000 shares of common stock at an exercise price of $3.40 per share.

During 2013 and 2014, the Company repurchased all of the outstanding shares of Series A Preferred Stock. In 2013, the Company repurchased 7,000 shares and funded it through the earnings of its banking subsidiary. The Company paid the Treasury $7.0 million, which represented 100% of the par value of the preferred stock repurchased plus accrued dividends with respect to such shares. On April 23, 2014, the Company repurchased the remaining 10,680 shares and funded it through an unsecured third-party term loan. The Company paid the Treasury $10.9 million, which represented 100% of the par value of the preferred stock repurchased plus accrued dividends with respect to such shares. The form of all repurchases were redemptions under the terms of the Series A Preferred Stock.

On June 4, 2014, the Company paid the Treasury $780,000 to repurchase the warrant that had been associated with the Series A Preferred Stock. The Company used its own funds to repurchase the warrant.

There are no other investments from the Company’s participation in the Capital Purchase Program that remain outstanding.

EMPLOYEES

As of December 31, 2016, the Company had 232 full-time equivalent employees, including executive officers, loan and other banking officers, branch personnel, operations personnel and other support personnel. None of the Company’s employees is represented by a union or covered under a collective bargaining agreement. Management of the Company considers its employee relations to be excellent.

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AVAILABLE INFORMATION

The Company files with or furnishes to the Securities and Exchange Commission annual, quarterly and current reports, proxy statements, and various other documents under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The public may read and copy any materials that the Company files with or furnishes to the SEC at the SEC's Public Reference Room, which is located at 100 F Street, NE, Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at (800) SEC-0330. Also, the SEC maintains an internet website at *www.sec.gov* that contains reports, proxy and information statements and other information regarding registrants, including the Company, that file or furnish documents electronically with the SEC.

The Company also makes available free of charge on or through our internet website (*www.cbtrustcorp.com*) its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and, if applicable, amendments to those reports as filed or furnished pursuant to Section 13(a) of the Exchange Act as soon as reasonably practicable after the Company electronically files such materials with, or furnishes them to, the SEC.

SUPERVISION AND REGULATION

General

As a bank holding company, we are subject to regulation under the Bank Holding Company Act of 1956, as amended (the "BHCA"), and the examination and reporting requirements of the Board of Governors of the Federal Reserve System (the "Federal Reserve"). Other federal and state laws govern the activities of our bank subsidiary, including the activities in which it may engage, the investments that it makes, the aggregate amount of loans that it may grant to one borrower, and the dividends it may declare and pay to us. Our bank subsidiary is also subject to various consumer and compliance laws. As a state-chartered bank, the Bank is primarily subject to regulation, supervision and examination by the Bureau of Financial Institutions of the Virginia State Corporation Commission (the "SCC"). Our bank subsidiary also is subject to regulation, supervision and examination by the FDIC.

The following description discusses certain provisions of federal and state laws and certain regulations and the potential impact of such provisions on the Company and the Bank. These federal and state laws and regulations have been enacted generally for the protection of depositors in banks and not for the protection of shareholders of bank holding companies or banks.

Bank Holding Companies

The Company is registered as a bank holding company under the BHCA and, as a result, is subject to regulation by the Federal Reserve. Accordingly, the Company is subject to periodic examination by the Federal Reserve and is required to file periodic reports regarding its operations and any additional information that the Federal Reserve may require. The BHCA generally limits the activities of a bank holding company and its subsidiaries to that of banking, managing or controlling banks, or any other activity that is so closely related to banking or to managing or controlling banks as to be a proper incident to it. While federal law permits bank holding companies from any state to acquire banks and bank holding companies located in any other state, or to establish interstate de novo branches, the Federal Reserve has jurisdiction under the BHCA to approve any bank or nonbank acquisition, merger or consolidation, or the establishment of any interstate de novo branches, proposed by a bank holding company.

There are a number of obligations and restrictions imposed on bank holding companies and their depository institution subsidiaries by federal law and regulatory policy that are designed to reduce potential loss exposure to the depositor of such depository institutions and to the FDIC's Deposit Insurance Fund (the "DIF") in the event the depository institution becomes in danger of default or in default. For example, under a policy of the Federal Reserve with respect to bank holding company operations, a bank holding company is required to serve as a source of financial strength to its subsidiary depository institutions and to commit resources to support such institutions in circumstances where it might not do so otherwise.

The Federal Deposit Insurance Act (the "FDIA") also provides that amounts received from the liquidation or other resolution of any insured depository institution by any receiver must be distributed (after payment of secured claims) to pay the deposit liabilities of the institution prior to payment of any other general or unsecured senior liability, subordinated liability, general creditor or shareholders in the event that a receiver is appointed to distribute the assets of the Bank.

The Company was required to register in Virginia with the SCC under the financial institution holding company laws of Virginia. Accordingly, the Company is subject to regulation and supervision by the SCC.

The Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") significantly restructures the financial regulatory regime in the United States and has a broad impact on the financial services industry. While some rulemaking under the Dodd-Frank Act has occurred, many of the act's provisions require study or rulemaking by federal agencies, a process which will take years to implement fully.

Among other things, the Dodd-Frank Act provides for new capital standards that eliminate the treatment of trust preferred securities as Tier 1 capital. Existing trust preferred securities were grandfathered for banking entities with less than $15 billion of assets, such as the Company. The Dodd-Frank Act permanently raised deposit insurance levels to $250,000. Pursuant to modifications under the Dodd-Frank Act, deposit insurance assessments are calculated based on an insured depository institution’s assets rather than its insured deposits, and the minimum reserve ratio of the FDIC’s DIF is to be raised to 1.35%. The payment of interest on business demand deposit accounts is permitted by the Dodd-Frank Act. Further, the Dodd-Frank Act bars banking organizations, such as the Company, from engaging in proprietary trading and from sponsoring and investing in hedge funds and private equity funds, except as permitted under certain limited circumstances.

The Dodd-Frank Act established the Consumer Financial Protection Bureau (the “CFPB”) as an independent bureau of the Federal Reserve System. The CFPB has the exclusive authority to prescribe rules governing the provision of consumer financial products and services, which in the case of the Bank will be enforced by the Federal Reserve. The Dodd-Frank Act also provides that debit card interchange fees must be reasonable and proportional to the cost incurred by the card issuer with respect to the transaction. This provision is known as the “Durbin Amendment.” In 2011, the Federal Reserve adopted regulations setting the maximum permissible interchange fee as the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction, with an additional adjustment of up to one cent per transaction if the card issuer implements certain fraud-prevention standards. The interchange fee restriction only applies to financial institutions with assets of $10 billion or more and therefore has no effect on the Company.

The Dodd-Frank Act enhances the requirements for certain transactions with affiliates under Sections 23A and 23B of the Federal Reserve Act, including an expansion of the definition of “covered transactions” and an increase in the amount of time for which collateral requirements regarding covered transactions must be maintained. The Dodd-Frank Act also provides that the appropriate federal regulators must establish standards prohibiting as an unsafe and unsound practice any compensation plan of a bank holding company or other “covered financial institution” that provides an insider or other employee with “excessive compensation” or compensation that gives rise to excessive risk or could lead to a material financial loss to such firm. Prior to the Dodd-Frank Act, the bank regulatory agencies promulgated the *Interagency Guidance on Sound Incentive Compensation Policies*, which requires that financial institutions establish metrics for measuring the impact of activities to achieve incentive compensation with the related risk to the financial institution of such behaviour.

Although a significant number of the rules and regulations mandated by the Dodd-Frank Act have been finalized, many of the new requirements have yet to be implemented and will likely be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies, the full extent of the impact such requirements will have on the operations of the Company and the Bank is unclear. The changes resulting from the Dodd-Frank Act may affect the profitability of business activities, require changes to certain business practices, impose more stringent capital requirements, liquidity and leverage ratio requirements, or otherwise adversely affect the business of the Company and the Bank. These changes may also require the Company to invest significant management attention and resources to evaluate and make necessary changes to comply with new statutory and

regulatory requirements.

Capital Requirements

The Federal Reserve has issued risk-based and leverage capital guidelines applicable to banking organizations that it supervises. Under the risk-based capital requirements, the Company and the Bank are each generally required to maintain a minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) of 8%. At least half of the total capital must be composed of “Tier 1 Capital,” which is defined as common equity, retained earnings and qualifying perpetual preferred stock, less certain intangibles. The remainder may consist of “Tier 2 Capital,” which is defined as specific subordinated debt, some hybrid capital instruments and other qualifying preferred stock and a limited amount of the loan loss allowance. In addition, each of the federal banking regulatory agencies has established minimum leverage capital requirements for banking organizations.

In 2013, the Federal Reserve adopted a final rule (the “Basel III Rule”) revising the risk-based and leverage capital requirements and the method for calculating risk-weighted assets to be consistent with the agreements reached by the Basel Committee on Banking Supervision in “Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems” (Basel III) and certain provisions of the Dodd-Frank Act. The Basel III Rule applies to all depository institutions, top-tier bank holding companies with total consolidated assets of $500 million or more, and top-tier savings and loan holding companies (referred to as “banking organizations”). For community banking organizations, like the Company, these revised capital requirements began being phased in beginning on January 1, 2015.

Under the requirements prior to effectiveness of the Basel III Rule, banking organizations must have maintained a minimum ratio of Tier 1 capital to adjusted average quarterly assets equal to 3% to 5%, subject to federal bank regulatory evaluation of an organization's overall safety and soundness. In summary, the capital measures used by the federal banking regulators are:

- Total risk-based capital ratio (Total Capital Ratio), which is the total of Tier 1 Capital and Tier 2 Capital as a percentage of total risk-weighted assets;
- Tier 1 risk-based capital ratio (Tier 1 Ratio), which is Tier 1 Capital as a percentage of total risk-weighted assets; and
- Leverage Ratio, which is Tier 1 Capital as a percentage of adjusted average total assets.

Under pre-Basel III Rule regulations, a bank was considered:

- "Well capitalized" if it had a Total Capital Ratio of 10% or greater, Tier 1 Ratio of 6% or greater, a Leverage Ratio of 5% or greater, and is not subject to any written agreement, order, capital directive, or prompt corrective action directive by a federal bank regulatory agency to meet and maintain a specific capital level for any capital measure;
- "Adequately capitalized" if it had a Total Capital Ratio of 8% or greater, a Tier 1 Ratio of 4% or greater, and a Leverage Ratio of 4% or greater — or 3% in certain circumstances — and was not well capitalized;
- "Undercapitalized" if it had a Total Capital Ratio of less than 8% or greater, a Tier 1 Ratio of less than 4%, and a Leverage Ratio of less than 4% — or 3% in certain circumstances;
- "Significantly undercapitalized" if it had a Total Capital Ratio of less than 6%, a Tier 1 Ratio of less than 3%, or a Leverage Ratio of less than 3%; or
- "Critically undercapitalized" if its tangible equity was equal to or less than 2% of average quarterly tangible assets.

Among other things, the Basel III Rule establishes a new common equity tier 1 (CET1) minimum capital requirement, introduces a "capital conservation buffer" and raises minimum risk-based capital requirements. Under the new rule, CET1 is defined as comprising Tier 1 Capital, less non-cumulative perpetual preferred stock and grandfathered trust-preferred and other securities, plus certain regulatory deductions. The Basel III Rule establishes a new minimum required ratio of CET1 to risk-weighted assets (CET1 Ratio) of 4.5%, and raises the minimum Tier 1 Ratio to 6.0% (from the prior 4.0% minimum). Furthermore, the minimum required Leverage Ratio is increased in the final Basel III Rule to 4.0% for all banking organizations irrespective of differences in composite supervisory ratings.

In conjunction with the changes in the required minimum capital ratios, the Basel III Rule also changes the definitions of the five regulatory capitalization categories set forth above, effective January 1, 2015. A table illustrating these changes is set forth below.

Capitalization Category	Total Capital Ratio (%)	Tier 1 Ratio (%)	CET1 Ratio (%)	Leverage Ratio (%)

Well capitalized (prior)	≥ 10	≥ 6	N/A	≥ 5
Well capitalized (Basel III)	≥ 10	≥ 8	≥ 6.5	≥ 5
Adequately capitalized (prior)	≥ 8	≥ 4	N/A	≥ 4
Adequately capitalized (Basel III)	≥ 8	≥ 6	≥ 4.5	≥ 4
Undercapitalized (prior)	< 8	< 4	N/A	< 4
Undercapitalized (Basel III)	< 8	< 6	< 4.5	< 4
Significantly undercapitalized (prior)	< 6	< 3	N/A	< 3
Significantly undercapitalized (Basel III)	< 6	< 4	< 3	< 3
Critically undercapitalized (prior)	GAAP tangible equity ≤ 2% of average quarterly assets			
Critically undercapitalized (Basel III)	Basel III tangible equity (Tier 1 Capital plus non-tier 1 perpetual preferred stock) ≤ 2% of total assets			

The new required capital conservation buffer is comprised of an additional 2.5% above the minimum risk-based capital ratios. Institutions that do not maintain the required capital buffer will be subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. This capital conservation buffer is in addition to, and not included with, the minimum ratios described above. A table illustrating these limitations on the ratio which can be paid out (defined in the Basel III Rule as “maximum payout ratio”) is set forth below.

Capital Conservation Buffer	Maximum payout ratio (as a percentage of eligible retained income)	
Greater than 2.5%	No applicable limitation.	
≤ 2.5% and > 1.875%	60	%
≤ 1.875% and > 1.25%	40	%
≤ 1.25% and > 0.625%	20	%
≤ 0.625%	0	%

The Basel III Rule also introduces new methodologies for determining risk-weighted assets, including higher risk weightings, up to a maximum of 150%, for exposures that are more than 90 days past due or are on nonaccrual status and for certain commercial real estate facilities that finance the acquisition, development or construction of real property. The Basel III Rule also requires unrealized gains and losses on certain securities holdings to be included, or excluded, as applicable, for purposes of calculating certain regulatory capital requirements. Additionally, the Basel III Rule establishes that, for banking organizations with less than $15 billion in assets as of December 31, 2009, the ability to treat trust preferred securities as tier 1 capital would be permanently grandfathered in.

The risk-based capital standards of the Federal Reserve explicitly identify concentrations of credit risk and the risk arising from non-traditional activities, as well as an institution's ability to manage these risks, as important factors to be taken into account by the agency in assessing an institution's overall capital adequacy. The capital guidelines also provide that an institution's exposure to a decline in the economic value of its capital due to changes in interest rates be considered by the agency as a factor in evaluating a banking organization's capital adequacy.

The FDIC may take various corrective actions against any undercapitalized bank and any bank that fails to submit an acceptable capital restoration plan or fails to implement a plan accepted by the FDIC. These powers include, but are not limited to, requiring the institution to be recapitalized, prohibiting asset growth, restricting interest rates paid, requiring prior approval of capital distributions by any bank holding company that controls the institution, requiring divestiture by the institution of its subsidiaries or by the holding company of the institution itself, requiring new election of directors, and requiring the dismissal of directors and officers. The Bank presently maintains sufficient capital to remain in compliance with these capital requirements.

Dividends

The Company is a legal entity, separate and distinct from the Bank. A significant portion of the revenues of the Company result from dividends paid to it by the Bank. There are various legal limitations applicable to the payment of dividends by the Bank to the Company and to the payment of dividends by the Company to its shareholders. The Bank is subject to various statutory restrictions on its ability to pay dividends to the Company. Under current regulations, prior approval from the Federal Reserve is required if cash dividends declared in any given year exceed net income for

that year, plus retained net profits of the two preceding years. The payment of dividends by the Bank or the Company may be limited by other factors, such as requirements to maintain capital above regulatory guidelines. Bank regulatory agencies have the authority to prohibit the Bank or the Company from engaging in an unsafe or unsound practice in conducting its respective business. The payment of dividends, depending on the financial condition of the Bank, or the Company, could be deemed to constitute such an unsafe or unsound practice.

Under the FDIA, insured depository institutions such as the Bank, are prohibited from making capital distributions, including the payment of dividends, if, after making such distributions, the institution would become “undercapitalized” (as such term is used in the statute). Based on the Bank’s current financial condition, the Company does not expect that this provision will have any impact on its ability to receive dividends from the Bank.

Deposit Insurance

The Bank’s deposits are insured by the DIF of the FDIC up to the standard maximum insurance amount for each deposit insurance ownership category. As of January 1, 2015, the basic limit on FDIC deposit insurance coverage is $250,000 per depositor. Under the FDIA, the FDIC may terminate deposit insurance upon a finding that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC, subject to administrative and potential judicial hearing and review processes.

The DIF is funded by assessments on banks and other depository institutions. As required by the Dodd-Frank Act, in 2011, the FDIC approved a final rule that changed the assessment base for DIF assessments from domestic deposits to Tier 1 Capital. In addition, as also required by the Dodd-Frank Act, the FDIC has adopted a new large-bank pricing assessment scheme, set a target “designated reserve ratio” (described in more detail below) of 2 percent for the DIF and established a lower assessment rate schedule when the reserve ratio reaches 1.15 percent and, in lieu of dividends, provides for a lower assessment rate schedule, when the reserve ratio reaches 2 percent and 2.5 percent. An institution’s assessment rate depends upon the institution’s assigned risk category, which is based on supervisory evaluations, regulatory capital levels and certain other factors. Initial base assessment rates range from 2.5 to 45 basis points. The FDIC may make the following further adjustments to an institution’s initial base assessment rates: decreases for long-term unsecured debt including most senior unsecured debt and subordinated debt; increases for holding long-term unsecured debt or subordinated debt issued by other insured depository institutions; and increases for broker deposits in excess of 10 percent of domestic deposits for institutions not well rated and well capitalized.

The Dodd-Frank Act transferred to the FDIC increased discretion with regard to managing the required amount of reserves for the DIF, or the "designated reserve ratio." Among other changes, the Dodd-Frank Act (i) raised the minimum designated reserve ratio to 1.35 percent and removed the upper limit on the designated reserve ratio, (ii) requires that the designated reserve ratio reach 1.35 percent by September 2020, and (iii) requires the FDIC to offset the effect on institutions with total consolidated assets of less than $10 billion by raising the designated reserve ratio from 1.15 percent to 1.35 percent. The FDIA requires that the FDIC consider the appropriate level for the designated reserve ratio on at least an annual basis. In 2010, the FDIC adopted a new DIF restoration plan to ensure that the fund reserve ratio reaches 1.35 percent by September 30, 2020, as required by the Dodd-Frank Act.

Incentive Compensation

In 2010, the federal banking regulators issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization's incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization's ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization's Board of Directors.

The Federal Reserve will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as the Company, that are not "large, complex banking organizations." These reviews will be tailored to each organization based on the scope and complexity of the organization's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization's supervisory ratings, which can affect the organization's ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization's safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies. At December 31, 2016, the Company had not been made aware of any instances of non-compliance with the new guidance.

The Gramm-Leach-Bliley Act of 1999

The Gramm-Leach-Bliley Act of 1999 (Gramm-Leach-Bliley) drew lines between the types of activities that are permitted for banking organizations that are financial in nature and those that are not permitted because they are commercial in nature.

Gramm-Leach-Bliley created a new form of financial organization called a financial holding company that may own and control banks, insurance companies and securities firms, thereby repealing the prohibition in the Glass-Steagall Act on bank affiliations with companies that are engaged primarily in securities underwriting activities. A financial holding company is authorized to engage in any activity that is financial in nature or incidental to an activity that is financial in nature or is a complementary activity, including, for example, insurance, securities transactions (including underwriting, broker/dealer activities and investment advisory services) and traditional banking-related activities. The Company is currently not a financial holding company under Gramm-Leach-Bliley.

Gramm-Leach-Bliley directed federal banking regulators to adopt rules limiting the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a nonaffiliated third party. Pursuant to these rules, financial institutions must provide: initial notices to customers about their privacy policies, including a description of the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates; annual notices of their privacy policies to current customers; and a reasonable method for customers to “opt out” of disclosures to nonaffiliated third parties. These privacy provisions affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors. The Company, as a bank holding company, is subject to these rules.

Community Reinvestment Act

Under the Community Reinvestment Act (CRA) and related regulations, depository institutions have an affirmative obligation to assist in meeting the credit needs of their market areas, including low and moderate-income areas, consistent with safe and sound banking practice. CRA requires the adoption of a statement for each of its market areas describing the depository institution’s efforts to assist in its community’s credit needs. Depository institutions are periodically examined for compliance with CRA and are periodically assigned ratings in this regard. Banking regulators consider a depository institution’s CRA rating when reviewing applications to establish new branches, undertake new lines of business, and/or acquire part or all of another depository institution. An unsatisfactory rating can significantly delay or even prohibit regulatory approval of a proposed transaction by a bank holding company or its depository institution subsidiaries.

Gramm-Leach-Bliley and federal bank regulators have made various changes to CRA. Among other changes, CRA agreements with private parties must be disclosed and annual reports must be made to a bank's primary federal regulator. A financial holding company or any of its subsidiaries will not be permitted to engage in new activities authorized under Gramm-Leach-Bliley if any bank subsidiary received less than a "satisfactory" rating in its latest CRA examination. The Company believes that it is currently in compliance with CRA.

Fair Lending; Consumer Laws

In addition to CRA, other federal and state laws regulate various lending and consumer aspects of the banking business. Governmental agencies, including the Department of Housing and Urban Development, the Federal Trade Commission and the Department of Justice, have become concerned that prospective borrowers experience discrimination in their efforts to obtain loans from depository and other lending institutions. These agencies have brought litigation against depository institutions alleging discrimination against borrowers. Many of these suits have been settled, in some cases for material sums, short of a full trial.

These governmental agencies have clarified what they consider to be lending discrimination and have specified various factors that they will use to determine the existence of lending discrimination under the Equal Credit Opportunity Act and the Fair Housing Act, including evidence that a lender discriminated on a prohibited basis, evidence that a lender treated applicants differently based on prohibited factors in the absence of evidence that the treatment was the result of prejudice or a conscious intention to discriminate, and evidence that a lender applied an otherwise neutral non-discriminatory policy uniformly to all applicants, but the practice had a discriminatory effect, unless the practice could be justified as a business necessity.

Banks and other depository institutions also are subject to numerous consumer-oriented laws and regulations. These laws, which include the Truth in Lending Act, the Truth in Savings Act, the Real Estate Settlement Procedures Act, the Electronic Funds Transfer Act, the Equal Credit Opportunity Act, and the Fair Housing Act, require compliance by depository institutions with various disclosure requirements and requirements regulating the availability of funds after deposit or the making of some loans to customers.

Governmental Policies

The Federal Reserve regulates money, credit and interest rates in order to influence general economic conditions. These policies influence overall growth and distribution of bank loans, investments and deposits. These policies also affect interest rates charged on loans or paid for time and savings deposits. Federal Reserve monetary policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so

in the future.

Future Regulations

From time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and the operating environment of the Company and the Bank in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities, or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Company cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on the financial condition or results of operations of the Company or the Bank.

ITEM 1A. *RISK FACTORS*

Our operations are subject to many risks that could adversely affect our future financial condition and performance and, therefore, the market value of our common stock. The risk factors applicable to us are the following:

Our future success is dependent on our ability to compete effectively in the highly competitive banking and financial services industry.

We face vigorous competition from other commercial banks, savings banks, credit unions, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market funds and other types of financial institutions for deposits, loans and other financial services in our market area. A number of these banks and other financial institutions are significantly larger than we are and have substantially greater access to capital and other resources, as well as larger lending limits and branch systems, and offer a wider array of banking services. Many of our non-bank competitors are not subject to the same extensive regulations that govern us. As a result, these non-bank competitors have advantages over us in providing certain services.

While we believe we compete effectively with these other financial institutions in our primary markets, we may face a competitive disadvantage as a result of our smaller size, smaller asset base, lack of geographic diversification and inability to spread our marketing costs across a broader market. If we have to raise interest rates paid on deposits or lower interest rates charged on loans to compete effectively, our net interest margin and income could be negatively affected. Failure to compete effectively to attract new, or to retain existing, clients may reduce or limit our margins and our market share and may adversely affect our results of operations, financial condition, and growth.

We may be adversely affected by economic conditions in our market area.

We operate in a mixed market environment with influences from both rural and urban areas. Because our lending operation is concentrated in localized areas in Virginia and Maryland, we will be affected by the general economic conditions in these markets. Changes in the local economy may influence the growth rate of our loans and deposits, the quality of the loan portfolio, and loan and deposit pricing. A significant decline in general economic conditions caused by inflation, recession, unemployment or other factors beyond our control would impact these local economic conditions and the demand for banking products and services generally, which could negatively affect our financial condition and performance. Although we might not have significant credit exposure to all the businesses in our areas, the downturn in any of these businesses could have a negative impact on local economic conditions and real estate collateral values generally, which could negatively affect our profitability.

We may not be able to successfully manage our long-term growth, which may adversely affect our results of operations and financial condition.

A key aspect of our long-term business strategy is our continued growth and expansion. Our ability to continue to grow depends, in part, upon our ability to:

- open new branch offices or acquire existing branches or other financial institutions;
- attract deposits to those locations; and
- identify attractive loan and investment opportunities.

We may not be able to successfully implement our growth strategy if we are unable to identify attractive markets, locations or opportunities to expand in the future, or if we are subject to regulatory restrictions on growth or expansion of our operations. In addition, we compete with our companies for acquisition and expansion opportunities, and many of those competitors have greater financial resources than us and thus may be able to pay more for such an opportunity than we can.

Our ability to manage our growth successfully also will depend on whether we can maintain capital levels adequate to support our growth, maintain cost controls and asset quality and successfully integrate any businesses we acquire into our organization. As we identify opportunities to implement our growth strategy by opening new branches or acquiring branches or other banks, we may incur increased personnel, occupancy and other operating expenses. In the case of new branches, we must absorb those higher expenses while we begin to generate new deposits, and there is a further time lag involved in redeploying new deposits into attractively priced loans and other higher yielding earning assets. Thus, any plans for branch expansion could decrease our earnings in the short run, even if we efficiently execute our branching strategy.

We may incur losses if we are unable to successfully manage interest rate risk.

Our profitability depends in substantial part upon the spread between the interest rates earned on investments and loans and interest rates paid on deposits and other interest-bearing liabilities. These rates are normally in line with general market rates and rise and fall based on our view of our financing and liquidity needs. We may selectively pay above-market rates to attract deposits as we have done in some of our marketing promotions in the past. Changes in interest rates will affect our operating performance and financial condition in diverse ways including the pricing of securities, loans and deposits, which, in turn, may affect the growth in loan and retail deposit volume. We attempt to minimize our exposure to interest rate risk, but cannot eliminate it. Our net interest income will be adversely affected if market interest rates change so that the interest we pay on deposits and borrowings increases faster than the interest earned on loans and investments. Our net interest spread will depend on many factors that are partly or entirely outside our control, including competition, federal economic, monetary and fiscal policies and economic conditions generally. Fluctuations in market rates are neither predictable nor controllable and may have a material and negative effect on our business, financial condition and results of operations.

Changes in interest rates also affect the value of our loans. An increase in interest rates could adversely affect our borrowers' ability to pay the principal or interest on existing loans or reduce their desire to borrow more money. This situation may lead to an increase in non-performing assets or a decrease in loan originations, either of which could have a material and negative effect on our results of operations.

Our operations may be adversely affected by cyber security risks.

In the ordinary course of business, we collect and store sensitive data, including proprietary business information and personally identifiable information of our