

SANDY SPRING BANCORP INC  
Form 10-Q  
November 06, 2014

**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, 2014**

OR

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

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

Commission File Number: 0-19065

SANDY SPRING BANCORP, INC.

(Exact name of registrant as specified in its charter)

**Maryland**

(State of incorporation)

**52-1532952**

(I.R.S. Employer Identification Number)

**17801 Georgia Avenue, Olney, Maryland 20832**

(Address of principal executive office) (Zip Code)

**301-774-6400**

(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 filing requirements for the past 90 days.

Yes  No

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

Yes  No

Indicate by check mark 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  Non-accelerated filer  Smaller reporting company

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

Yes  No

The number of outstanding shares of common stock outstanding as of October 31, 2014

**Common stock, \$1.00 par value – 25,040,890 shares**

**SANDY SPRING BANCORP, INC.**

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## Forward-Looking Statements

This Quarterly Report on Form 10-Q, as well as other periodic reports filed with the Securities and Exchange Commission, and written or oral communications made from time to time by or on behalf of Sandy Spring Bancorp and its subsidiaries (the “Company”), may contain statements relating to future events or future results of the Company that are considered “forward-looking statements” under the Private Securities Litigation Reform Act of 1995. These forward-looking statements may be identified by the use of words such as “believe,” “expect,” “anticipate,” “plan,” “estimate,” “intend” and “potential,” or words of similar meaning, or future or conditional verbs such as “should,” “could,” or “may.” Forward-looking statements include statements of Company goals, intentions and expectations; statements regarding our business plans, prospects, growth and operating strategies; statements regarding the quality of our loan and investment portfolios; and estimates of our risks and future costs and benefits.

Forward-looking statements reflect the Company’s expectation or prediction of future conditions, events or results based on information currently available. These forward-looking statements are subject to significant risks and uncertainties that may cause actual results to differ materially from those in such statements. These risk and uncertainties include, but are not limited to, the risks identified in Item 1A of the Company’s 2013 Annual Report on Form 10-K, Item 1A of Part II of this report and the following:

- general business and economic conditions nationally or in the markets that the Company serves could adversely affect, among other things, real estate prices, unemployment levels, and consumer and business confidence, which could lead to decreases in the demand for loans, deposits and other financial services that we provide and increases in loan delinquencies and defaults;

- changes or volatility in the capital markets and interest rates may adversely impact the value of securities, loans, deposits and other financial instruments and the interest rate sensitivity of our balance sheet as well as the Company’s liquidity;

- the Company’s liquidity requirements could be adversely affected by changes in our assets and liabilities;

- the Company’s investment securities portfolio is subject to credit risk, market risk, and liquidity risk as well as changes in the estimates the Company uses to value certain of the securities in the portfolio;

- the effect of legislative or regulatory developments including changes in laws concerning taxes, banking, securities, insurance and other aspects of the financial services industry;

- competitive factors among financial services companies, including product and pricing pressures and the Company’s ability to attract, develop and retain qualified banking professionals;

the effect of changes in accounting policies and practices, as may be adopted by the Financial Accounting Standards Board, the Securities and Exchange Commission, the Public Company Accounting Oversight Board and other regulatory agencies; and

· the effect of fiscal and governmental policies of the United States federal government.

Forward-looking statements speak only as of the date of this report. The Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date of this report or to reflect the occurrence of unanticipated events except as required by federal securities laws.

**PART I****Item 1. FINANCIAL STATEMENTS****Sandy spring bancorp, inc. and subsidiaries****CONDENSED Consolidated STATEMENTS OF CONDITION**

| (Dollars in thousands)   | September<br>30,<br>2014 | December<br>31,<br>2013 |
|--|--------------------------|-------------------------|
| <b>Assets</b>  |                          |                         |
| Cash and due from banks  | \$48,665                 | \$46,755                |
| Federal funds sold   | 474                      | 475                     |
| Interest-bearing deposits with banks   | 42,820                   | 27,197                  |
| Cash and cash equivalents  | 91,959                   | 74,427                  |
| Residential mortgage loans held for sale (at fair value)   | 6,656                    | 8,365                   |
| Investments available-for-sale (at fair value)   | 692,107                  | 751,284                 |
| Investments held-to-maturity -- fair value of \$223,130 and \$216,007 at September 30,<br>2014 and December 31, 2013, respectively | 221,690                  | 224,638                 |
| Other equity securities  | 37,072                   | 40,687                  |
| Total loans and leases   | 2,975,912                | 2,784,266               |
| Less: allowance for loan and lease losses  | (37,574 )                | (38,766 )               |
| Net loans and leases   | 2,938,338                | 2,745,500               |
| Premises and equipment, net  | 45,841                   | 45,916                  |
| Other real estate owned  | 1,762                    | 1,338                   |
| Accrued interest receivable  | 12,277                   | 12,532                  |
| Goodwill   | 84,171                   | 84,171                  |
| Other intangible assets, net   | 622                      | 1,330                   |
| Other assets   | 116,236                  | 115,912                 |
| <b>Total assets</b>  | <b>\$4,248,731</b>       | <b>\$4,106,100</b>      |
| <b>Liabilities</b>   |                          |                         |
| Noninterest-bearing deposits   | \$986,549                | \$836,198               |
| Interest-bearing deposits  | 2,042,239                | 2,041,027               |
| Total deposits   | 3,028,788                | 2,877,225               |
| Securities sold under retail repurchase agreements and federal funds purchased   | 71,384                   | 53,842                  |
| Advances from FHLB   | 558,000                  | 615,000                 |
| Subordinated debentures  | 35,000                   | 35,000                  |



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|   |             |             |
|---|-------------|-------------|
| Accrued interest payable and other liabilities  | 33,155      | 25,670      |
| Total liabilities   | 3,726,327   | 3,606,737   |
| Stockholders' Equity  |             |             |
| Common stock -- par value \$1.00; shares authorized 50,000,000; shares issued and outstanding 25,076,794 and 24,990,021 at September 30, 2014 and December 31, 2013, respectively | 25,077      | 24,990      |
| Additional paid in capital  | 194,899     | 193,445     |
| Retained earnings   | 298,796     | 283,898     |
| Accumulated other comprehensive income (loss)   | 3,632       | (2,970 )    |
| Total stockholders' equity  | 522,404     | 499,363     |
| Total liabilities and stockholders' equity  | \$4,248,731 | \$4,106,100 |

The accompanying notes are an integral part of these statements

## Sandy Spring Bancorp, Inc. and Subsidiaries

## CONDENSED Consolidated Statements of Income – UNAUDITED

|  | Three Months |          | Nine Months Ended |               |
|--|--------------|----------|-------------------|---------------|
|  | Ended        |          | September 30,     | September 30, |
| (Dollars in thousands, except per share data)                          | 2014         | 2013     | 2014              | 2013          |
| Interest Income:   |              |          |                   |               |
| Interest and fees on loans and leases                                  | \$31,030     | \$33,079 | \$91,470          | \$91,937      |
| Interest on loans held for sale  | 81           | 176      | 211               | 838           |
| Interest on deposits with banks  | 24           | 22       | 66                | 65            |
| Interest and dividends on investment securities:                       |              |          |                   |               |
| Taxable  | 3,712        | 4,558    | 11,704            | 12,411        |
| Exempt from federal income taxes                                       | 2,303        | 2,345    | 6,940             | 6,987         |
| Total interest income  | 37,150       | 40,180   | 110,391           | 112,238       |
| Interest Expense:  |              |          |                   |               |
| Interest on deposits   | 1,208        | 1,358    | 3,585             | 4,209         |
| Interest on retail repurchase agreements and federal funds purchased   | 42           | 39       | 117               | 126           |
| Interest on advances from FHLB   | 3,258        | 3,255    | 9,709             | 9,667         |
| Interest on subordinated debt  | 222          | 222      | 659               | 672           |
| Total interest expense   | 4,730        | 4,874    | 14,070            | 14,674        |
| Net interest income  | 32,420       | 35,306   | 96,321            | 97,564        |
| Provision (credit) for loan and lease losses                           | (192 )       | 1,128    | (1,016 )          | (1,670 )      |
| Net interest income after provision (credit) for loan and lease losses | 32,612       | 34,178   | 97,337            | 99,234        |
| Non-interest Income:   |              |          |                   |               |
| Investment securities gains  | 8            | -        | 8                 | 118           |
| Service charges on deposit accounts                                    | 2,226        | 2,171    | 6,287             | 6,390         |
| Mortgage banking activities  | 596          | (26 )    | 1,482             | 2,738         |
| Wealth management income   | 4,974        | 4,503    | 14,181            | 13,077        |
| Insurance agency commissions   | 1,410        | 1,193    | 4,011             | 3,578         |
| Income from bank owned life insurance                                  | 611          | 629      | 1,817             | 1,864         |
| Bank card fees   | 1,148        | 1,077    | 3,295             | 3,113         |
| Other income   | 1,617        | 1,676    | 4,452             | 4,979         |
| Total non-interest income  | 12,590       | 11,223   | 35,533            | 35,857        |
| Non-interest Expenses:   |              |          |                   |               |
| Salaries and employee benefits   | 16,765       | 16,382   | 49,594            | 48,891        |
| Occupancy expense of premises  | 3,032        | 3,149    | 9,778             | 9,327         |
| Equipment expenses   | 1,337        | 1,200    | 3,855             | 3,676         |
| Marketing  | 744          | 713      | 2,088             | 1,983         |
| Outside data services  | 1,231        | 1,152    | 3,663             | 3,418         |
| FDIC insurance   | 594          | 678      | 1,687             | 1,855         |
| Amortization of intangible assets                                      | 115          | 462      | 709               | 1,384         |
| Litigation expenses  | 236          | -        | 6,364             | -             |

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|                             |          |          |          |          |
|-----------------------------|----------|----------|----------|----------|
| Other expenses              | 4,578    | 3,157    | 12,584   | 11,690   |
| Total non-interest expenses | 28,632   | 26,893   | 90,322   | 82,224   |
| Income before income taxes  | 16,570   | 18,508   | 42,548   | 52,867   |
| Income tax expense          | 5,428    | 6,419    | 13,496   | 18,058   |
| Net income                  | \$11,142 | \$12,089 | \$29,052 | \$34,809 |

Net Income Per Share Amounts:

|                              |        |        |        |        |
|------------------------------|--------|--------|--------|--------|
| Basic net income per share   | \$0.44 | \$0.48 | \$1.16 | \$1.40 |
| Diluted net income per share | \$0.44 | \$0.48 | \$1.16 | \$1.39 |
| Dividends declared per share | \$0.20 | \$0.16 | \$0.56 | \$0.46 |

The accompanying notes are an integral part of these statements

**Sandy Spring Bancorp, Inc. and Subsidiaries****CONDENSED Consolidated Statements of COMPREHENSIVE INCOME - UNAUDITED**

| (In thousands)  | Three Months        |          | Nine Months         |          |
|---|---------------------|----------|---------------------|----------|
|   | Ended September 30, |          | Ended September 30, |          |
|   | 2014                | 2013     | 2014                | 2013     |
| Net income  | \$11,142            | \$12,089 | \$29,052            | \$34,809 |
| Other comprehensive income (loss):  |                     |          |                     |          |
| Investments available-for-sale:   |                     |          |                     |          |
| Net change in unrealized gains (losses) on investments available-for-sale | (2,714 )            | (1,032 ) | 10,779              | (24,925) |
| Related income tax (expense) benefit                                      | 1,061               | 407      | (4,284 )            | 9,935    |
| Net investment gains reclassified into earnings                           | 8                   | -        | 8                   | 118      |
| Related income tax expense  | (3 )                | -        | (3 )                | (47 )    |
| Net effect on other comprehensive income (loss) for the period            | (1,648 )            | (625 )   | 6,500               | (14,919) |
| Defined benefit pension plan:   |                     |          |                     |          |
| Recognition of unrealized gain  | 67                  | 249      | 183                 | 1,176    |
| Related income tax benefit  | (20 )               | (91 )    | (81 )               | (461 )   |
| Net effect on other comprehensive income (loss) for the period            | 48                  | 158      | 102                 | 715      |
| Total other comprehensive income (loss)                                   | (1,600 )            | (467 )   | 6,602               | (14,204) |
| Comprehensive income  | \$9,541             | \$11,622 | \$35,654            | \$20,605 |

The accompanying notes are an integral part of these statements

**Sandy Spring Bancorp, Inc. and Subsidiaries****CONDENSED Consolidated Statements of Cash Flows – UNAUDITED**

| (Dollars in thousands)   | Nine Months Ended     |           |
|--|-----------------------|-----------|
|  | September 30,<br>2014 | 2013      |
| Operating activities:  |                       |           |
| Net income   | \$29,052              | \$34,809  |
| Adjustments to reconcile net income to net cash provided by operating activities:        |                       |           |
| Depreciation and amortization  | 5,415                 | 6,033     |
| Credit for loan and lease losses   | (1,016 )              | (1,670 )  |
| Share based compensation expense   | 1,101                 | 1,307     |
| Deferred income tax expense  | 1,119                 | 2,945     |
| Origination of loans held for sale   | (90,531 )             | (219,153) |
| Proceeds from sales of loans held for sale   | 93,554                | 248,907   |
| Gains on sales of loans held for sale  | (1,314 )              | (4,147 )  |
| Loss on sales of other real estate owned   | 162                   | 1,072     |
| Investment securities gains  | (8 )                  | (118 )    |
| Net decrease (increase) in accrued interest receivable                                   | 255                   | (72 )     |
| Net (increase) decrease in other assets  | (7,319 )              | 6,441     |
| Net increase in accrued expenses and other liabilities                                   | 7,683                 | 2,010     |
| Other – net  | 3,256                 | 3,706     |
| Net cash provided by operating activities  | 41,409                | 82,070    |
| Investing activities:  |                       |           |
| Purchases of other equity securities   | -                     | (2,776 )  |
| Purchases of investments held-to-maturity  | -                     | (20,666 ) |
| Purchases of investments available-for-sale  | -                     | (161,379) |
| Proceeds from other equity securities  | 3,615                 | -         |
| Proceeds from maturities, calls and principal payments of investments held-to-maturity   | 2,293                 | 9,959     |
| Proceeds from maturities, calls and principal payments of investments available-for-sale | 67,700                | 143,220   |
| Net increase in loans and leases   | (192,794 )            | (135,100) |
| Proceeds from the sales of other real estate owned                                       | 465                   | 7,137     |
| Expenditures for premises and equipment  | (3,547 )              | (1,883 )  |
| Net cash used in investing activities  | (122,268 )            | (161,488) |
| Financing activities:  |                       |           |
| Net increase in deposits   | 151,563               | 3,432     |
| Net increase (decrease) in retail repurchase agreements and federal funds purchased      | 17,542                | (33,752 ) |
| Proceeds from advances from FHLB   | 1,330,000             | 745,000   |
| Repayment of advances from FHLB  | (1,387,000)           | (630,058) |
| Proceeds from issuance of common stock   | 440                   | 48        |
| Dividends paid   | (14,154 )             | (11,590 ) |
| Net cash provided by financing activities  | 98,391                | 73,080    |

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|  |          |          |
|--|----------|----------|
| Net increase (decrease) in cash and cash equivalents | 17,532   | (6,338 ) |
| Cash and cash equivalents at beginning of period     | 74,427   | 86,406   |
| Cash and cash equivalents at end of period           | \$91,959 | \$80,068 |
| Supplemental Disclosures:                            |          |          |
| Interest payments                                    | \$14,066 | \$15,031 |
| Income tax payments                                  | 11,908   | 12,470   |
| Transfers from loans to other real estate owned      | 971      | 2,353    |

The accompanying notes are an integral part of these statements.

## Sandy Spring Bancorp, Inc. and Subsidiaries

## CONDENSED Consolidated Statements of changes in stockholders' equity - UNAUDITED

| (Dollars in thousands, except per share data) | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Stockholders'<br>Equity |
|---|-----------------|----------------------------------|----------------------|--|----------------------------------|
| Balances at January 1, 2014                   | \$ 24,990       | \$ 193,445                       | \$ 283,898           | \$ (2,970 )  | \$ 499,363                       |
| Net income                                    |                 |                                  | 29,052               |  | 29,052                           |
| Other comprehensive income, net of tax        |                 |                                  |                      | 6,602  | 6,602                            |
| Common stock dividends - \$0.56 per share     |                 |                                  | (14,154 )            |  | (14,154 )                        |
| Stock compensation expense                    |                 | 1,318                            |                      |  | 1,318                            |
| Common stock issued pursuant to:              |                 |                                  |                      |  | -                                |
| Stock option plan - 13,834 shares             | 14              | 176                              |                      |  | 190                              |
| Employee stock purchase plan - 18,404 shares  | 18              | 365                              |                      |  | 383                              |
| Restricted stock - 54,535 shares              | 55              | (405 )                           |                      |  | (350 )                           |
| Balances at September 30, 2014                | \$ 25,077       | \$ 194,899                       | 298,796              | \$ 3,632   | \$ 522,404                       |
| <br>  |                 |                                  |                      |  |                                  |
| Balances at January 1, 2013                   | \$ 24,905       | \$ 191,689                       | \$ 255,606           | \$ 11,312  | \$ 483,512                       |
| Net income                                    |                 |                                  | 34,809               |  | 34,809                           |
| Other comprehensive loss, net of tax          |                 |                                  |                      | (14,204 )  | (14,204 )                        |
| Common stock dividends - \$0.46 per share     |                 |                                  | (11,590 )            |  | (11,590 )                        |
| Stock compensation expense                    |                 | 1,307                            |                      |  | 1,307                            |
| Common stock issued pursuant to:              |                 |                                  |                      |  | -                                |
| Stock option plan - 10,964 shares             | 11              | 128                              |                      |  | 139                              |
| Employee stock purchase plan - 19,971 shares  | 20              | 336                              |                      |  | 356                              |
| Restricted stock - 48,819 shares              | 49              | (496 )                           |                      |  | (447 )                           |
| Balances at September 30, 2013                | \$ 24,985       | \$ 192,964                       | \$ 278,825           | \$ (2,892 )  | \$ 493,882                       |

The accompanying notes are an integral part of these statements

## **Sandy Spring Bancorp, Inc. and Subsidiaries**

Notes to the CONDENSED Consolidated Financial Statements - UNAUDITED

### **Note 1 – Significant Accounting Policies**

#### **Nature of Operations**

Sandy Spring Bancorp (the “Company”), a Maryland corporation, is the bank holding company for Sandy Spring Bank (the “Bank”), which conducts a full-service commercial banking, mortgage banking and trust business. Services to individuals and businesses include accepting deposits, extending real estate, consumer and commercial loans and lines of credit, equipment leasing, general insurance, personal trust, and investment and wealth management services. The Company operates in the Maryland counties of Anne Arundel, Carroll, Frederick, Howard, Montgomery, and Prince George's, and in Arlington, Fairfax and Loudoun counties in Virginia. The Company offers investment and wealth management services through the Bank's subsidiary, West Financial Services. Insurance products are available to clients through Sandy Spring Insurance, and Neff & Associates, which are agencies of Sandy Spring Insurance Corporation.

#### **Basis of Presentation**

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (“GAAP”) and prevailing practices within the financial services industry for interim financial information and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required for complete financial statements and prevailing practices within the banking industry. The following summary of significant accounting policies of the Company is presented to assist the reader in understanding the financial and other data presented in this report. Operating results for the three and nine months ended September 30, 2014 are not necessarily indicative of the results that may be expected for any future periods or for the year ending December 31, 2014. In the opinion of management, all adjustments (comprising only normal recurring accruals) necessary for a fair presentation of the results of the interim periods have been included. Certain reclassifications have been made to prior period amounts, as necessary, to conform to the current period presentation. The Company has evaluated subsequent events through the date of the issuance of its financial statements.

These statements should be read in conjunction with the financial statements and accompanying notes included in the Company's 2013 Annual Report on Form 10-K as filed with the Securities and Exchange Commission (“SEC”) on March 14, 2014. There have been no significant changes to the Company's accounting policies as disclosed in the 2013 Annual Report on Form 10-K.

#### **Principles of Consolidation**

The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Sandy Spring Bank and its subsidiaries, Sandy Spring Insurance Corporation and West Financial Services, Inc. Consolidation has resulted in the elimination of all intercompany accounts and transactions.



## Use of Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements, and affect the reported amounts of revenues earned and expenses incurred during the reporting period. Actual results could differ from those estimates. Estimates that could change significantly relate to the provision for loan and lease losses and the related allowance, determination of impaired loans and the related measurement of impairment, potential impairment of goodwill or other intangible assets, valuation of investment securities and the determination of whether impaired securities are other-than-temporarily impaired, valuation of other real estate owned, prepayment rates, valuation of share-based compensation, the assessment that a liability should be recognized with respect to any matters under litigation, the calculation of current and deferred income taxes and the actuarial projections related to pension expense and the related liability.

## Cash Flows

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks, federal funds sold and interest-bearing deposits with banks (items with stated original maturity of three months or less).

## Loans Acquired with Deteriorated Credit Quality

Acquired loans are evaluated for evidence of credit deterioration since their origination as of the date of the acquisition are recorded at their initial fair value. Credit deterioration is determined based on the probability of collection of all contractually required principal and interest payments. The historical allowance for loan and lease losses related to the purchased loans is not carried over to the Company. The determination of credit quality deterioration as of the purchase date may include parameters such as past due and non-accrual status, commercial risk ratings, cash flow projections, type of loan and collateral, collateral value and recent loan-to-value ratios or appraised values. For loans acquired with no evidence of credit deterioration, the fair value discount or premium is amortized over the contractual life of the loan as an adjustment to yield. For loans acquired with evidence of credit deterioration, the Company determines at the acquisition date the excess of the loan's contractually required payments over all cash flows expected to be collected as an amount that should not be accreted into interest income (nonaccretable difference). The remaining amount representing the difference in the expected cash flows of acquired loans and the initial investment in the acquired loans is accreted into interest income over the remaining life of the loan or pool of loans (accretable yield). The present value of any decreases in expected cash flows after the purchase date is recognized as an impairment through a charge to the provision for loan losses. Increases in the present value of expected cash flows after the purchase date are recognized as an adjustment to the accretable yield. Subsequent to the purchase date, the methods utilized to estimate the required allowance for loan and lease losses ("ALLL") are similar to originated loans. Loans carried at fair value, mortgage loans held for sale and loans under revolving credit agreements are excluded from the scope of this guidance on loans acquired with deteriorated credit quality.

## Pending Accounting Pronouncements

The FASB issued a standard in May 2014 that provides accounting guidance for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to customers. The guidance also provides for a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate. This standard may affect an entity's financial statements, business processes and internal control over financial reporting. The guidance is effective for the first interim or annual period beginning after December 15, 2016. The guidance must be adopted using either a full retrospective approach for all periods presented in the period of adoption or a modified retrospective approach. The Company is assessing this guidance to determine its impact on the Company's financial position, results of operations and cash flows.

## Note 2 – Investments

### Investments available-for-sale

The amortized cost and estimated fair values of investments available-for-sale at the dates indicated are presented in the following table:

| (In thousands)                       | September 30, 2014 |                        |                         |                      | December 31, 2013 |                        |                         |                      |
|--------------------------------------|--------------------|------------------------|-------------------------|----------------------|-------------------|------------------------|-------------------------|----------------------|
|                                      | Amortized Cost     | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. government agencies             | \$144,473          | \$ -                   | \$ (3,757 )             | \$140,716            | \$147,688         | \$ -                   | \$ (8,222 )             | \$139,466            |
| State and municipal                  | 157,854            | 9,731                  | -                       | 167,585              | 159,524           | 6,060                  | (156 )                  | 165,428              |
| Mortgage-backed                      | 374,326            | 9,995                  | (4,417 )                | 379,904              | 439,054           | 10,188                 | (6,992 )                | 442,250              |
| Corporate debt                       | 2,000              | 2                      | -                       | 2,002                | 2,000             | 4                      | -                       | 2,004                |
| Trust preferred                      | 1,349              | -                      | (172 )                  | 1,177                | 1,701             | -                      | (288 )                  | 1,413                |
| Total debt securities                | 680,002            | 19,728                 | (8,346 )                | 691,384              | 749,967           | 16,252                 | (15,658 )               | 750,561              |
| Marketable equity securities         | 723                | -                      | -                       | 723                  | 723               | -                      | -                       | 723                  |
| Total investments available-for-sale | \$680,725          | \$19,728               | \$ (8,346 )             | \$692,107            | \$750,690         | \$16,252               | \$ (15,658 )            | \$751,284            |

Any unrealized losses in the U.S. government agencies, state and municipal, mortgage-backed or corporate debt investment securities at September 30, 2014 are not the result of credit related events but due to changes in interest rates. These declines are considered temporary in nature and are expected to decline over time and recover as these securities approach maturity.

The mortgage-backed securities portfolio at September 30, 2014 is composed entirely of either the most senior tranches of GNMA, FNMA or FHLMC collateralized mortgage obligations (\$176.2 million), or GNMA, FNMA or FHLMC mortgage-backed securities (\$203.7 million). The Company does not intend to sell these securities and has sufficient liquidity to hold these securities for an adequate period of time, which may be maturity, to allow for any anticipated recovery in fair value.

At September 30, 2014, the trust preferred portfolio consisted of one pooled trust preferred security. The pooled trust preferred security, which is backed by debt issued by banks and thrifts, totals \$1.3 million with a fair value of \$1.2 million. The fair value of this security was determined by management through the use of a third party valuation specialist due to the limited trading activity for this security.

The income valuation approach technique (present value) used maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. The methodology and significant assumptions employed by the specialist to determine fair value included:

- Evaluation of the structural terms as established in the indenture;
  - Detailed credit and structural evaluation for each piece of issuer collateral in the pool;
  - Overall default (.52%), recovery and prepayment (2%)/amortization probabilities by issuers in the pool;
  - Identification of adverse conditions specifically related to the security, industry and geographical area;
  - Projection of estimated cash flows that incorporate default expectations and loss severities;
  - Review of historical and implied volatility of the fair value of the security;
  - Evaluation of credit risk concentrations;
  - Evaluation of the length of time and the extent to which the fair value has been less than the amortized cost; and
- A discount rate of 11.8% was established using credit adjusted financial institution spreads for comparably rated institutions and a liquidity adjustment that considered the previously noted characteristics.

As a result of this evaluation, it was determined that the pooled trust preferred security had not incurred any credit-related other-than-temporary impairment (“OTTI”) for the quarter ended September 30, 2014. Non-credit related decline in fair value on this security, which is not expected to be sold and which the Company has the ability to hold until maturity, was \$0.2 million at September 30, 2014. This non-credit related decline in fair value was recognized in other comprehensive income (“OCI”) at September 30, 2014.

The methodology and significant inputs used to measure the amount related to credit loss consisted of the following:

- Default rates were developed based on the financial condition of the trust preferred issuers in the pool and the payment or deferral status. Conditional default rates were estimated based on the payment characteristics of the security and the financial condition of the issuers in the pool. Near term and future defaults are estimated using third party industry data in addition to a review of key financial ratios and other pertinent data on the financial stability of the underlying issuer;
- Loss severity is forecasted based on the type of impairment using research performed by third parties;
- The security contains one level of subordination below the senior tranche, with the senior tranche receiving the spread from the subordinate bonds;
- Credit ratings of the underlying issuers are reviewed in conjunction with the development of the default rates applied to determine the credit amounts related to the credit loss; and
- Potential prepayments are estimated based on terms and rates of the underlying trust preferred securities to determine the impact of excess spread on the credit enhancement, the removal of the strongest institutions from the underlying pool and any impact that prepayments might have on diversity and concentration.

The following table provides the activity of OTTI on investment securities due to credit losses recognized in earnings for the period indicated:

| (In thousands)  | OTTI<br>Losses |
|---|----------------|
| Cumulative credit losses on investment securities, through December 31, 2013  | \$ 531         |
| Additions for credit losses not previously recognized                         | -              |
| Cumulative credit losses on investment securities, through September 30, 2014 | \$ 531         |

Gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in an unrealized loss position at the dates indicated are presented in the following table:

| September 30, 2014                                  |                            |               |              |                              |                               |
|---|----------------------------|---------------|--------------|------------------------------|-------------------------------|
| Continuous<br>Unrealized<br>Losses Existing<br>for: |                            |               |              |                              |                               |
| (Dollars in thousands)                              | Number<br>of<br>securities | Fair<br>Value | Less than    |                              | Total<br>Unrealized<br>Losses |
|   |                            |               | 12<br>months | More<br>than<br>12<br>months |                               |
| U.S. government agencies                            | 14                         | \$ 140,716    | \$-          | \$ 3,757                     | \$ 3,757                      |
| Mortgage-backed                                     | 26                         | 140,189       | 341          | 4,076                        | 4,417                         |
| Trust preferred                                     | 1                          | 1,177         | -            | 172                          | 172                           |
| Total   | 41                         | \$282,082     | \$341        | \$ 8,005                     | \$ 8,346                      |

| December 31, 2013                                   |                            |               |              |                              |                               |
|---|----------------------------|---------------|--------------|------------------------------|-------------------------------|
| Continuous<br>Unrealized<br>Losses Existing<br>for: |                            |               |              |                              |                               |
| (Dollars in thousands)                              | Number<br>of<br>securities | Fair<br>Value | Less than    |                              | Total<br>Unrealized<br>Losses |
|   |                            |               | 12<br>months | More<br>than<br>12<br>months |                               |
| U.S. government agencies                            | 15                         | \$ 139,466    | \$8,222      | \$ -                         | \$ 8,222                      |
| State and municipal                                 | 12                         | 11,680        | 156          | -                            | 156                           |
| Mortgage-backed                                     | 30                         | 169,377       | 6,865        | 127                          | 6,992                         |
| Trust preferred                                     | 1                          | 1,413         | -            | 288                          | 288                           |
| Total   | 58                         | \$321,936     | \$15,243     | \$ 415                       | \$ 15,658                     |

The amortized cost and estimated fair values of debt securities available-for-sale by contractual maturity at the dates indicated are provided in the following table. The Company has allocated mortgage-backed securities into the four maturity groupings reflected in the following table using the expected average life of the individual securities based on statistics provided by independent third party industry sources. Expected maturities will differ from contractual maturities as borrowers may have the right to prepay obligations with or without prepayment penalties.

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| (In thousands)                           | September 30, 2014 |            | December 31, 2013 |            |
|--|--------------------|------------|-------------------|------------|
|  | Estimated          |            | Estimated         |            |
|  | Amortized Cost     | Fair Value | Amortized Cost    | Fair Value |
| Due in one year or less                  | \$2,000            | \$2,002    | \$2,080           | \$2,085    |
| Due after one year through five years    | 43,148             | 44,500     | 12,766            | 13,285     |
| Due after five years through ten years   | 341,678            | 348,934    | 392,389           | 392,339    |
| Due after ten years                      | 293,176            | 295,948    | 342,732           | 342,852    |
| Total debt securities available for sale | \$680,002          | \$691,384  | \$749,967         | \$750,561  |

At September 30, 2014 and December 31, 2013, investments available-for-sale with a book value of \$200.2 million and \$186.6 million, respectively, were pledged as collateral for certain government deposits and for other purposes as required or permitted by law. The outstanding balance of no single issuer, except for U.S. Agencies securities, exceeded ten percent of stockholders' equity at September 30, 2014 and December 31, 2013.

Investments held-to-maturity

The amortized cost and estimated fair values of investments held-to-maturity at the dates indicated are presented in the following table:

| (In thousands)                     | September 30, 2014 |                        |                         |                      | December 31, 2013 |                        |                         |                      |
|------------------------------------|--------------------|------------------------|-------------------------|----------------------|-------------------|------------------------|-------------------------|----------------------|
|                                    | Amortized Cost     | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. government agencies           | \$64,510           | \$ -                   | \$ (1,984 )             | \$62,526             | \$64,505          | \$ -                   | \$ (4,827 )             | \$59,678             |
| State and municipal                | 156,971            | 4,121                  | (724 )                  | 160,368              | 159,889           | 1,920                  | (5,753 )                | 156,056              |
| Mortgage-backed                    | 209                | 27                     | -                       | 236                  | 244               | 29                     | -                       | 273                  |
| Total investments held-to-maturity | \$221,690          | \$ 4,148               | \$ (2,708 )             | \$223,130            | \$224,638         | \$ 1,949               | \$ (10,580 )            | \$216,007            |

Gross unrealized losses and fair value by length of time that the individual held-to-maturity securities have been in a continuous unrealized loss position at the dates indicated are presented in the following tables:

| (Dollars in thousands)   | Number of securities | Fair Value | September 30, 2014  |                     | Total Unrealized Losses |
|--------------------------|----------------------|------------|---|---------------------|-------------------------|
|                          |                      |            | Continuous Unrealized Losses Existing for:<br>Less than 12 months | More than 12 months |                         |
| U.S. government agencies | 8                    | \$62,526   | \$-   | \$ 1,984            | \$ 1,984                |
| State and municipal      | 57                   | 52,941     | 55  | 669                 | 724                     |
| Total                    | 65                   | \$ 115,467 | \$55  | \$ 2,653            | \$ 2,708                |

| December 31, 2013                          |                     |
|--|---------------------|
| Continuous Unrealized Losses Existing for: |                     |
| Less than 12 months                        | More than 12 months |
|  |                     |



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|                          | Number     |           | Less     | More   | Total      |
|--------------------------|------------|-----------|----------|--------|------------|
|                          | of         |           | than     | than   | Unrealized |
| (Dollars in thousands)   | securities | Fair      | 12       | 12     | Losses     |
|                          |            | Value     | months   | months |            |
| U.S. government agencies | 8          | \$59,678  | \$4,827  | \$-    | \$ 4,827   |
| State and municipal      | 113        | 94,243    | 5,366    | 387    | 5,753      |
| Total                    | 121        | \$153,921 | \$10,193 | \$ 387 | \$ 10,580  |

The Company does not intend to sell these securities and has sufficient liquidity to hold these securities for an adequate period of time, which may be maturity, to allow for any anticipated recovery in fair value, and considers the unrealized losses in the held-to-maturity portfolio temporary in nature.

The amortized cost and estimated fair values of debt securities held-to-maturity by contractual maturity at the dates indicated are reflected in the following table. Expected maturities will differ from contractual maturities as borrowers may have the right to prepay obligations with or without prepayment penalties.

| (In thousands)                         | September 30, 2014 |            | December 31, 2013 |            |
|--|--------------------|------------|-------------------|------------|
|  | Estimated          |            | Estimated         |            |
|  | Amortized Cost     | Fair Value | Amortized Cost    | Fair Value |
| Due in one year or less                | \$3,099            | \$3,112    | \$1,720           | \$1,725    |
| Due after one year through five years  | 4,563              | 4,618      | 3,249             | 3,269      |
| Due after five years through ten years | 154,865            | 163,345    | 139,033           | 135,074    |
| Due after ten years                    | 59,163             | 52,055     | 80,636            | 75,939     |
| Total debt securities held-to-maturity | \$221,690          | \$223,130  | \$224,638         | \$216,007  |

At September 30, 2014 and December 31, 2013, investments held-to-maturity with a book value of \$206.6 million and \$165.8 million, respectively, were pledged as collateral for certain government deposits and for other purposes as required or permitted by law. The outstanding balance of no single issuer, except for U.S. Agency securities, exceeded ten percent of stockholders' equity at September 30, 2014 and December 31, 2013.

#### Equity securities

Other equity securities at the dates indicated are presented in the following table:

| (In thousands)                          | September 30, 2014 | December 31, 2013 |
|---|--------------------|-------------------|
| Federal Reserve Bank stock              | \$ 8,269           | \$ 8,269          |
| Federal Home Loan Bank of Atlanta stock | 28,803             | 32,418            |
| Total equity securities                 | \$ 37,072          | \$ 40,687         |

#### Note 3 – Loans and Leases

Outstanding loan balances at September 30, 2014 and December 31, 2013 are net of unearned income including net deferred loan costs of \$0.1 million and \$0.7 million, respectively. The loan portfolio segment balances at the dates indicated are presented in the following table:

| (In thousands)           | September 30, 2014 | December 31, 2013 |
|--------------------------|--------------------|-------------------|
| Residential real estate: |                    |                   |
| Residential mortgage     | \$698,925          | \$618,381         |
| Residential construction | 141,883            | 129,177           |
| Commercial real estate:  |                    |                   |

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|  |             |             |
|--|-------------|-------------|
| Commercial owner occupied real estate                | 584,964     | 592,823     |
| Commercial investor real estate                      | 575,984     | 552,178     |
| Commercial acquisition, development and construction | 194,666     | 160,696     |
| Commercial Business                                  | 368,611     | 356,651     |
| Leases   | 156         | 703         |
| Consumer   | 410,723     | 373,657     |
| Total loans and leases                               | \$2,975,912 | \$2,784,266 |

**Note 4 – CREDIT QUALITY ASSESSMENT****Allowance for Loan and Lease Losses**

Summary information on the allowance for loan and lease loss activity for the period indicated is provided in the following table:

| (In thousands)                               | Nine Months<br>Ended September<br>30, |          |
|--|---------------------------------------|----------|
|  | 2014                                  | 2013     |
| Balance at beginning of year                 | \$38,766                              | \$42,957 |
| Provision (credit) for loan and lease losses | (1,016 )                              | (1,670 ) |
| Loan and lease charge-offs                   | (1,541 )                              | (9,639 ) |
| Loan and lease recoveries                    | 1,365                                 | 7,774    |
| Net charge-offs                              | (176 )                                | (1,865 ) |
| Balance at period end                        | \$37,574                              | \$39,422 |

The following tables provide information on the activity in the allowance for loan and lease losses by the respective loan portfolio segment for the period indicated:

**For the Nine Months Ended September 30, 2014**

| (Dollars in thousands)       | Commercial Real Estate |                 |                         |                               |                    |                     | Residential Real Estate |                          | Total       |
|------------------------------|------------------------|-----------------|-------------------------|-------------------------------|--------------------|---------------------|-------------------------|--------------------------|-------------|
|                              | Commercial Business    | Commercial AD&C | Commercial Investor R/E | Commercial Owner Occupied R/E | Commercial Leasing | Commercial Consumer | Residential Mortgage    | Residential Construction |             |
| Balance at beginning of year | \$6,308                | \$3,754         | \$9,263                 | \$6,308                       | \$16               | \$4,142             | \$7,819                 | \$1,156                  | \$38,766    |
| Provision (credit)           | (1,119 )               | 799             | (681 )                  | 630                           | (6 )               | 41                  | (355 )                  | (325 )                   | (1,016 )    |
| Charge-offs                  | (225 )                 | -               | (4 )                    | (265 )                        | -                  | (720 )              | (324 )                  | (3 )                     | (1,541 )    |
| Recoveries                   | 1,023                  | -               | 34                      | -                             | -                  | 134                 | 105                     | 69                       | 1,365       |
| Net recoveries (charge-offs) | 798                    | -               | 30                      | (265 )                        | -                  | (586 )              | (219 )                  | 66                       | (176 )      |
| Balance at end of period     | \$5,987                | \$4,553         | \$8,612                 | \$6,673                       | \$10               | \$3,597             | \$7,245                 | \$897                    | \$37,574    |
|                              | \$368,611              | \$194,666       | \$575,984               | \$584,964                     | \$156              | \$410,723           | \$698,925               | \$141,883                | \$2,975,912 |

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|  |           |   |           |   |           |   |           |   |            |            |   |           |   |            |   |             |   |
|--|-----------|---|-----------|---|-----------|---|-----------|---|------------|------------|---|-----------|---|------------|---|-------------|---|
| Total loans and leases Allowance for loans and leases to total loans and leases ratio                            | 1.62      | % | 2.34      | % | 1.50      | % | 1.14      | % | 6.42%      | 0.88       | % | 1.04      | % | 0.63       | % | 1.26        | % |
| Balance of loans specifically evaluated for impairment Allowance for loans specifically evaluated for impairment | \$5,943   |   | \$3,792   |   | \$10,352  |   | \$10,742  |   | <i>na.</i> | \$27       |   | \$6,039   |   | \$1,689    |   | \$38,584    |   |
| Specific allowance to specific loans ratio   | 23.66     | % | 31.33     | % | 3.85      | % | 7.39      | % | <i>na.</i> | <i>na.</i> |   | 9.22      | % | <i>na.</i> |   | 11.26       | % |
| Balance of loans collectively evaluated Allowance for loans collectively evaluated                               | \$362,668 |   | \$190,874 |   | \$565,632 |   | \$574,222 |   | \$156      | \$410,696  |   | \$692,886 |   | \$140,194  |   | \$2,937,328 |   |
| Collective allowance to collective loans ratio   | 1.26      | % | 1.76      | % | 1.45      | % | 1.02      | % | 6.42%      | 0.88       | % | 0.97      | % | 0.64       | % | 1.13        | % |

## For the Year Ended December 31, 2013

| (Dollars in thousands)   | Commercial Real Estate |                 |                         |                               |         |           |                      |                          | Residential Real Estate |  | Total |
|--|------------------------|-----------------|-------------------------|-------------------------------|---------|-----------|----------------------|--------------------------|-------------------------|--|-------|
|  | Commercial Business    | Commercial AD&C | Commercial Investor R/E | Commercial Owner Occupied R/E | Leasing | Consumer  | Residential Mortgage | Residential Construction |                         |  |       |
| Balance at beginning of year                                   | \$6,495                | \$4,737         | \$9,583                 | \$6,997                       | \$332   | \$3,846   | \$8,522              | \$2,445                  | \$42,957                |  |       |
| Provision (credit)   | 1,910                  | (3,978 )        | 1,100                   | (874 )                        | (326)   | 1,951     | 329                  | (1,196 )                 | (1,084 )                |  |       |
| Charge-offs  | (2,915 )               | (85 )           | (4,774 )                | (240 )                        | -       | (1,853 )  | (1,194 )             | (104 )                   | (11,165 )               |  |       |
| Recoveries   | 818                    | 3,080           | 3,354                   | 425                           | 10      | 198       | 162                  | 11                       | 8,058                   |  |       |
| Net recoveries (charge-offs )                                  | (2,097 )               | 2,995           | (1,420 )                | 185                           | 10      | (1,655 )  | (1,032 )             | (93 )                    | (3,107 )                |  |       |
| Balance at end of period                                       | \$6,308                | \$3,754         | \$9,263                 | \$6,308                       | \$16    | \$4,142   | \$7,819              | \$1,156                  | \$38,766                |  |       |
| Total loans and leases   | \$356,651              | \$160,696       | \$552,178               | \$592,823                     | \$703   | \$373,657 | \$618,381            | \$129,177                | \$2,784,266             |  |       |
| Allowance for loans and leases to total loans and leases ratio | 1.77 %                 | 2.34 %          | 1.68 %                  | 1.06 %                        | 2.28 %  | 1.11 %    | 1.26 %               | 0.89 %                   | 1.39 %                  |  |       |
| Balance of loans specifically evaluated for impairment         | \$5,608                | \$4,128         | \$7,654                 | \$7,111                       | \$na.   | \$29      | \$6,141              | \$1,852                  | \$32,523                |  |       |
| Allowance for loans specifically evaluated for impairment      | \$849                  | \$1,031         | \$126                   | \$426                         | \$na.   | \$na.     | \$626                | \$-                      | \$3,058                 |  |       |
| Specific allowance to specific loans ratio                     | 15.14 %                | 24.98 %         | 1.65 %                  | 5.99 %                        | \$na.   | na.       | 10.19 %              | na.                      | 9.40 %                  |  |       |

|  |           |           |           |           |        |           |           |           |             |
|--|-----------|-----------|-----------|-----------|--------|-----------|-----------|-----------|-------------|
| Balance of loans collectively evaluated        | \$351,043 | \$156,568 | \$544,524 | \$585,712 | \$703  | \$373,628 | \$612,240 | \$127,325 | \$2,751,743 |
| Allowance for loans collectively evaluated     | \$5,459   | \$2,723   | \$9,137   | \$5,882   | \$16   | \$4,142   | \$7,193   | \$1,156   | \$35,708    |
| Collective allowance to collective loans ratio | 1.56      | % 1.74    | % 1.68    | % 1.00    | % 2.28 | % 1.11    | % 1.17    | % 0.91    | % 1.30      |

The following table provides summary information regarding impaired loans at the dates indicated and for the periods then ended:

| (In thousands)  | September<br>30, 2014 | December<br>31, 2013 |
|---|-----------------------|----------------------|
| Impaired loans with a specific allowance                                    | \$ 15,608             | \$ 12,217            |
| Impaired loans without a specific allowance                                 | 22,976                | 20,306               |
| Total impaired loans  | \$ 38,584             | \$ 32,523            |
| Allowance for loan and lease losses related to impaired loans               | \$ 4,344              | \$ 3,058             |
| Allowance for loan and lease losses related to loans collectively evaluated | 33,230                | 35,708               |
| Total allowance for loan and lease losses                                   | \$ 37,574             | \$ 38,766            |
| Average impaired loans for the period                                       | \$ 35,559             | \$ 38,379            |
| Contractual interest income due on impaired loans during the period         | \$ 2,217              | \$ 2,612             |
| Interest income on impaired loans recognized on a cash basis                | \$ 665                | \$ 1,374             |
| Interest income on impaired loans recognized on an accrual basis            | \$ 281                | \$ 473               |

The following tables present the recorded investment with respect to impaired loans, the associated allowance by the applicable portfolio segment and the principal balance of the impaired loans prior to amounts charged-off at the dates indicated:

| (In thousands)  | September 30, 2014     |          |                 |  |                       | Total<br>Recorded<br>Investment<br>in<br>Impaired<br>Loans |
|---|------------------------|----------|-----------------|--|-----------------------|--|
|   | Commercial Real Estate |          |                 |  |                       |  |
|   | Commercial             | AD&C     | Investor<br>R/E | Commercial<br>Owner<br>Occupied<br>R/E | All<br>Other<br>Loans |  |
|   |                        |          |                 |  |                       |  |
| <b>Impaired loans <i>with</i> a specific allowance</b>    |                        |          |                 |  |                       |  |
| Non-accruing  | \$1,182                | \$1,437  | \$ 2,044        | \$ 5,051                               | \$947                 | \$ 10,661  |
| Restructured accruing                                     | 793                    | -        | -               | -                                      | 779                   | 1,572  |
| Restructured non-accruing                                 | 230                    | 1,211    | 78              | 1,245                                  | 611                   | 3,375  |
| Balance   | \$2,205                | \$2,648  | \$ 2,122        | \$ 6,296                               | \$2,337               | \$ 15,608  |
| Allowance   | \$1,406                | \$1,188  | \$ 399          | \$ 794                                 | \$557                 | \$ 4,344   |
| <b>Impaired loans <i>without</i> a specific allowance</b> |                        |          |                 |  |                       |  |
| Non-accruing  | \$1,745                | \$-      | \$ 6,088        | \$ 1,808                               | \$784                 | \$ 10,425  |
| Restructured accruing                                     | 999                    | -        | 2,142           | -                                      | 2,669                 | 5,810  |
| Restructured non-accruing                                 | 994                    | 1,144    | -               | 2,638                                  | 1,965                 | 6,741  |
| Balance   | \$3,738                | \$1,144  | \$ 8,230        | \$ 4,446                               | \$5,418               | \$ 22,976  |
| <b>Total impaired loans</b>                               |                        |          |                 |  |                       |  |
| Non-accruing  | \$2,927                | \$1,437  | \$ 8,132        | \$ 6,859                               | \$1,731               | \$ 21,086  |
| Restructured accruing                                     | 1,792                  | -        | 2,142           | -                                      | 3,448                 | 7,382  |
| Restructured non-accruing                                 | 1,224                  | 2,355    | 78              | 3,883                                  | 2,576                 | 10,116   |
| Balance   | \$5,943                | \$3,792  | \$ 10,352       | \$ 10,742                              | \$7,755               | \$ 38,584  |
| Unpaid principal balance in total impaired loans          | \$7,752                | \$13,245 | \$ 14,998       | \$ 12,725                              | \$7,908               | \$ 56,628  |

| (In thousands)                        | Commercial Real Estate |         |                 |  |                       | Total<br>Recorded<br>Investment<br>in<br>Impaired<br>Loans |
|---------------------------------------|------------------------|---------|-----------------|--|-----------------------|--|
|                                       | Commercial Real Estate |         |                 |  |                       |  |
|                                       | Commercial             | AD&C    | Investor<br>R/E | Commercial<br>Owner<br>Occupied<br>R/E | All<br>Other<br>Loans |  |
|                                       |                        |         |                 |  |                       |  |
| Average impaired loans for the period | \$ 5,662               | \$3,948 | \$ 9,089        | \$ 8,968                               | \$7,892               | \$ 35,559  |
|                                       | \$ 319                 | \$512   | \$ 553          | \$ 694                                 | \$139                 |  |



Contractual interest income due on impaired loans during the period

|  |        |      |       |        |       |
|--|--------|------|-------|--------|-------|
| Interest income on impaired loans recognized on a cash basis     | \$ 232 | \$68 | \$ 76 | \$ 250 | \$39  |
| Interest income on impaired loans recognized on an accrual basis | \$ 98  | \$-  | \$ 83 | \$ -   | \$100 |

| (In thousands)                                     | December 31, 2013      |          |                 |  |            | Total<br>Recorded<br>Investment<br>in<br>Impaired<br>Loans |                |
|--|------------------------|----------|-----------------|--|------------|--|----------------|
|  | Commercial Real Estate |          |                 |  |            |  |                |
|  | Commercial             | AD&C     | Investor<br>R/E | Commercial<br>Owner<br>Occupied<br>R/E | Commercial |  | All            |
|  |                        |          |                 |  | Loans      |  | Other<br>Loans |
| Impaired loans <i>with</i> a specific allowance    |                        |          |                 |  |            |  |                |
| Non-accruing                                       | \$374                  | \$1,360  | \$ 749          | \$ 2,022                               | \$-        | \$ 4,505   |                |
| Restructured accruing                              | 790                    | -        | -               | 1,174                                  | 2,365      | 4,329  |                |
| Restructured non-accruing                          | 349                    | 1,122    | -               | 1,274                                  | 638        | 3,383  |                |
| Balance  | \$1,513                | \$2,482  | \$ 749          | \$ 4,470                               | \$3,003    | \$ 12,217  |                |
| Allowance  | \$849                  | \$1,031  | \$ 126          | \$ 426                                 | \$626      | \$ 3,058   |                |
| Impaired loans <i>without</i> a specific allowance |                        |          |                 |  |            |  |                |
| Non-accruing                                       | \$1,532                | \$382    | \$ 5,440        | \$ 646                                 | \$-        | \$ 8,000   |                |
| Restructured accruing                              | 1,417                  | -        | 852             | -                                      | 2,861      | 5,130  |                |
| Restructured non-accruing                          | 1,146                  | 1,264    | 613             | 1,995                                  | 2,158      | 7,176  |                |
| Balance  | \$4,095                | \$1,646  | \$ 6,905        | \$ 2,641                               | \$5,019    | \$ 20,306  |                |
| Total impaired loans                               |                        |          |                 |  |            |  |                |
| Non-accruing                                       | \$1,906                | \$1,742  | \$ 6,189        | \$ 2,668                               | \$-        | \$ 12,505  |                |
| Restructured accruing                              | 2,207                  | -        | 852             | 1,174                                  | 5,226      | 9,459  |                |
| Restructured non-accruing                          | 1,495                  | 2,386    | 613             | 3,269                                  | 2,796      | 10,559   |                |
| Balance  | \$5,608                | \$4,128  | \$ 7,654        | \$ 7,111                               | \$8,022    | \$ 32,523  |                |
| Unpaid principal balance in total impaired loans   | \$7,943                | \$10,318 | \$ 12,351       | \$ 8,684                               | \$8,650    | \$ 47,946  |                |

| (In thousands)  | December 31, 2013      |         |                 |  |            | Total<br>Recorded<br>Investment<br>in<br>Impaired<br>Loans |                |
|---|------------------------|---------|-----------------|--|------------|--|----------------|
|   | Commercial Real Estate |         |                 |  |            |  |                |
|   | Commercial             | AD&C    | Investor<br>R/E | Commercial<br>Owner<br>Occupied<br>R/E | Commercial |  | All            |
|   |                        |         |                 |  | Loans      |  | Other<br>Loans |
| Average impaired loans for the period                               | \$7,153                | \$5,451 | \$ 10,605       | \$ 8,386                               | \$6,784    | \$ 38,379  |                |
| Contractual interest income due on impaired loans during the period | \$452                  | \$654   | \$ 587          | \$ 692                                 | \$227      |  |                |
| Interest income on impaired loans recognized on a cash basis        | \$238                  | \$253   | \$ 75           | \$ 725                                 | \$83       |  |                |
| Interest income on impaired loans recognized on an accrual basis    | \$133                  | \$-     | \$ 30           | \$ 77                                  | \$233      |  |                |



**Credit Quality**

The following tables provide information on the credit quality of the loan portfolio by segment at the dates indicated:

| (In thousands)                        | September 30, 2014     |         |              |                  |              |                         |                   |                          | Total    |
|---------------------------------------|------------------------|---------|--------------|------------------|--------------|-------------------------|-------------------|--------------------------|----------|
|                                       | Commercial Real Estate |         |              |                  |              | Residential Real Estate |                   |                          |          |
|                                       | Commercial             | AD&C    | Investor R/E | Commercial Owner |              | Leasing                 | Consumer Mortgage | Residential Construction |          |
|                                       |                        |         |              | Commercial       | Occupied R/E |                         |                   |                          |          |
| Non-performing loans and assets:      |                        |         |              |                  |              |                         |                   |                          |          |
| Non-accrual loans and leases          | \$4,151                | \$3,792 | \$8,210      | \$10,742         | \$-          | \$1,830                 | \$4,417           | \$2,497                  | \$35,639 |
| Loans and leases 90 days past due     | -                      | -       | -            | 649              | -            | 6                       | -                 | -                        | 655      |
| Restructured loans and leases         | 1,792                  | -       | 2,142        | -                | -            | -                       | 3,448             | -                        | 7,382    |
| Total non-performing loans and leases | 5,943                  | 3,792   | 10,352       | 11,391           | -            | 1,836                   | 7,865             | 2,497                    | 43,676   |
| Other real estate owned               | 39                     | 365     | -            | -                | -            | -                       | 1,358             | -                        | 1,762    |
| Total non-performing assets           | \$5,982                | \$4,157 | \$10,352     | \$11,391         | \$-          | \$1,836                 | \$9,223           | \$2,497                  | \$45,438 |

| (In thousands)                        | December 31, 2013      |         |              |                  |              |                         |                   |                          | Total    |
|---------------------------------------|------------------------|---------|--------------|------------------|--------------|-------------------------|-------------------|--------------------------|----------|
|                                       | Commercial Real Estate |         |              |                  |              | Residential Real Estate |                   |                          |          |
|                                       | Commercial             | AD&C    | Investor R/E | Commercial Owner |              | Leasing                 | Consumer Mortgage | Residential Construction |          |
|                                       |                        |         |              | Commercial       | Occupied R/E |                         |                   |                          |          |
| Non-performing loans and assets:      |                        |         |              |                  |              |                         |                   |                          |          |
| Non-accrual loans and leases          | \$3,400                | \$4,127 | \$6,802      | \$5,936          | \$-          | \$2,259                 | \$5,735           | \$2,315                  | \$30,574 |
| Loans and leases 90 days past due     | -                      | -       | -            | -                | -            | 1                       | -                 | -                        | 1        |
| Restructured loans and leases         | 2,207                  | -       | 852          | 1,174            | -            | 29                      | 5,197             | -                        | 9,459    |
| Total non-performing loans and leases | 5,607                  | 4,127   | 7,654        | 7,110            | -            | 2,289                   | 10,932            | 2,315                    | 40,034   |
| Other real estate owned               | 54                     | 365     | -            | -                | -            | -                       | 919               | -                        | 1,338    |
| Total non-performing assets           | \$5,661                | \$4,492 | \$7,654      | \$7,110          | \$-          | \$2,289                 | \$11,851          | \$2,315                  | \$41,372 |

September 30, 2014

| (In thousands)                                  | Commercial Real Estate |           |                         |                               |                    | Residential Real Estate |             |              |             |
|---|------------------------|-----------|-------------------------|-------------------------------|--------------------|-------------------------|-------------|--------------|-------------|
|   | Commercial             | AD&C      | Commercial Investor R/E | Commercial Owner Occupied R/E | Commercial Leasing | Consumer                | Residential |              | Total       |
|   |                        |           |                         |                               |                    |                         | Mortgage    | Construction |             |
| <u>Past due loans and leases</u>                |                        |           |                         |                               |                    |                         |             |              |             |
| 31-60 days                                      | \$564                  | \$948     | \$169                   | \$839                         | \$-                | \$732                   | \$4,014     | \$-          | \$7,266     |
| 61-90 days                                      | 403                    | -         | 2,009                   | -                             | -                  | 20                      | 162         | -            | 2,594       |
| > 90 days                                       | -                      | -         | -                       | 649                           | -                  | 6                       | -           | -            | 655         |
| Total past due                                  | 967                    | 948       | 2,178                   | 1,488                         | -                  | 758                     | 4,176       | -            | 10,515      |
| Non-accrual loans and leases                    |                        |           |                         |                               |                    |                         |             |              |             |
| Loans acquired with deteriorated credit quality | 1,267                  | -         | 53                      | 1,814                         | -                  | -                       | -           | -            | 3,134       |
| Current loans                                   | 362,226                | 189,926   | 565,543                 | 570,920                       | 156                | 408,135                 | 690,332     | 139,386      | 2,926,624   |
| Total loans and leases                          | \$368,611              | \$194,666 | \$575,984               | \$584,964                     | \$156              | \$410,723               | \$698,925   | \$141,883    | \$2,975,912 |

| December 31, 2013                               |                        |           |                         |                               |         |                         |           |                          |                   |
|---|------------------------|-----------|-------------------------|-------------------------------|---------|-------------------------|-----------|--------------------------|-------------------|
| (In thousands)                                  | Commercial Real Estate |           |                         |                               |         | Residential Real Estate |           |                          |                   |
|   | Commercial             | AD&C      | Commercial Investor R/E | Commercial Owner Occupied R/E | Leasing | Consumer                | Mortgage  | Residential Construction | Residential Total |
|   |                        |           |                         |                               |         |                         |           |                          |                   |
| Past due loans and leases                       |                        |           |                         |                               |         |                         |           |                          |                   |
| 31-60 days                                      | \$382                  | \$-       | \$5,826                 | \$876                         | \$4     | \$716                   | \$4,119   | \$-                      | \$11,923          |
| 61-90 days                                      | 1,142                  | -         | -                       | 2,540                         | -       | 176                     | 208       | -                        | 4,066             |
| > 90 days                                       | -                      | -         | -                       | -                             | -       | 1                       | -         | -                        | 1                 |
| Total past due                                  | 1,524                  | -         | 5,826                   | 3,416                         | 4       | 893                     | 4,327     | -                        | 15,990            |
| Non-accrual loans and leases                    |                        |           |                         |                               |         |                         |           |                          |                   |
| Loans acquired with deteriorated credit quality | 1,363                  | -         | 571                     | 2,366                         | -       | -                       | -         | -                        | 4,300             |
| Current loans                                   | 350,364                | 156,569   | 538,979                 | 581,105                       | 699     | 370,505                 | 608,319   | 126,862                  | 2,733,402         |
| Total loans and leases                          | \$356,651              | \$160,696 | \$552,178               | \$592,823                     | \$703   | \$373,657               | \$618,381 | \$129,177                | \$2,784,266       |

The following tables provide information by credit risk rating indicators for each segment of the commercial loan portfolio at the dates indicated:

| September 30, 2014 |                        |           |                         |                               |             |
|--------------------|------------------------|-----------|-------------------------|-------------------------------|-------------|
| (In thousands)     | Commercial Real Estate |           |                         |                               | Total       |
|                    | Commercial             | AD&C      | Commercial Investor R/E | Commercial Owner Occupied R/E |             |
|                    |                        |           |                         |                               |             |
| Pass               | \$344,076              | \$189,604 | \$557,036               | \$553,795                     | \$1,644,511 |
| Special Mention    | 14,752                 | -         | 3,882                   | 9,799                         | 28,433      |
| Substandard        | 9,783                  | 5,062     | 15,066                  | 21,370                        | 51,281      |
| Doubtful           | -                      | -         | -                       | -                             | -           |
| Total              | \$368,611              | \$194,666 | \$575,984               | \$584,964                     | \$1,724,225 |

December 31, 2013

Commercial Real Estate

| (In thousands)  | Commercial Real Estate |           |                 | Commercial               | Total       |
|-----------------|------------------------|-----------|-----------------|--------------------------|-------------|
|                 | Commercial             | AD&C      | Investor<br>R/E | Owner<br>Occupied<br>R/E |             |
| Pass            | \$324,941              | \$154,869 | \$523,901       | \$553,604                | \$1,557,315 |
| Special Mention | 16,166                 | -         | 2,944           | 15,702                   | 34,812      |
| Substandard     | 15,274                 | 5,827     | 25,333          | 23,517                   | 69,951      |
| Doubtful        | 270                    | -         | -               | -                        | 270         |
| Total           | \$356,651              | \$160,696 | \$552,178       | \$592,823                | \$1,662,348 |

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Homogeneous loan pools do not have individual loans subjected to internal risk ratings therefore, the credit indicator applied to these pools is based on their delinquency status. The following tables provide information by credit risk rating indicators for those remaining segments of the loan portfolio at the dates indicated:

|                               | September 30, 2014 |           |                         |              |             |
|-------------------------------|--------------------|-----------|-------------------------|--------------|-------------|
|                               |                    |           | Residential Real Estate |              |             |
| (In thousands)                | Leasing            | Consumer  | Mortgage                | Construction | Total       |
| Performing                    | \$156              | \$408,887 | \$691,060               | \$139,386    | \$1,239,489 |
| Non-performing:               |                    |           |                         |              |             |
| 90 days past due              | -                  | 6         | -                       | -            | 6           |
| Non-accruing                  | -                  | 1,830     | 4,417                   | 2,497        | 8,744       |
| Restructured loans and leases | -                  | -         | 3,448                   | -            | 3,448       |
| Total                         | \$156              | \$410,723 | \$698,925               | \$141,883    | \$1,251,687 |

|                               | December 31, 2013 |           |                         |              |             |
|-------------------------------|-------------------|-----------|-------------------------|--------------|-------------|
|                               |                   |           | Residential Real Estate |              |             |
| (In thousands)                | Leasing           | Consumer  | Mortgage                | Construction | Total       |
| Performing                    | \$703             | \$371,368 | \$607,449               | \$126,862    | \$1,106,382 |
| Non-performing:               |                   |           |                         |              |             |
| 90 days past due              | -                 | 1         | -                       | -            | 1           |
| Non-accruing                  | -                 | 2,259     | 5,735                   | 2,315        | 10,309      |
| Restructured loans and leases | -                 | 29        | 5,197                   | -            | 5,226       |
| Total                         | \$703             | \$373,657 | \$618,381               | \$129,177    | \$1,121,918 |

During the nine months ended September 30, 2014, the Company restructured \$1.7 million in loans that were designated as troubled debt restructurings. Modifications consisted principally of interest rate concessions. No modifications resulted in the reduction of the recorded principal in the associated loan balances. Restructured loans are subject to periodic credit reviews to determine the necessity and adequacy of a specific loan loss allowance based on the collectability of the recorded principal in the restructured loan. Loans restructured during 2014 did not require significant specific reserves at September 30, 2014. For the year ended December 31, 2013, the Company restructured \$3.4 million in loans. Modifications consisted principally of interest rate concessions and no modifications resulted in the reduction of the recorded principal in the associated loan balances. Loans restructured during 2013 had specific reserves of \$0.1 million at December 31, 2013. Commitments to lend additional funds on loans that have been restructured at September 30, 2014 and December 31, 2013 amounted to \$5.4 million and \$5.5 million, respectively.



The following table provides the amounts of the restructured loans at the date of restructuring for specific segments of the loan portfolio during the period indicated:

| (In thousands)                          | For the Nine Months Ended September 30, 2014 |                               |  |  |                       |         |
|---|--|-------------------------------|--|--|-----------------------|---------|
|   | Commercial Real Estate                       |                               |  |  |                       |         |
|   | Commercial<br>AD&C<br>R/E                    | Commercial<br>Investor<br>R/E | Commercial<br>Owner<br>Occupied<br>R/E | Commercial<br>Owner<br>Occupied<br>R/E | All<br>Other<br>Loans | Total   |
| Troubled debt restructurings            |  |                               |  |  |                       |         |
| Restructured accruing                   | \$185  | \$-                           | \$ 1,290                               | \$ -                                   | \$ -                  | \$1,475 |
| Restructured non-accruing               | -  | 192                           | -                                      | -                                      | -                     | 192     |
| Balance                                 | \$185  | \$192                         | \$ 1,290                               | \$ -                                   | \$ -                  | \$1,667 |
| Specific allowance                      | \$-  | \$-                           | \$ -                                   | \$ -                                   | \$ -                  | \$-     |
| Restructured and subsequently defaulted | \$-  | \$-                           | \$ -                                   | \$ 720                                 | \$ -                  | \$720   |

| (In thousands)                          | For the Year Ended December 31, 2013 |                               |  |  |                       |         |
|---|--------------------------------------|-------------------------------|--|--|-----------------------|---------|
|   | Commercial Real Estate               |                               |  |  |                       |         |
|   | Commercial<br>AD&C<br>R/E            | Commercial<br>Investor<br>R/E | Commercial<br>Owner<br>Occupied<br>R/E | Commercial<br>Owner<br>Occupied<br>R/E | All<br>Other<br>Loans | Total   |
| Troubled debt restructurings            |                                      |                               |  |  |                       |         |
| Restructured accruing                   | \$87                                 | \$-                           | \$ 852                                 | \$ -                                   | \$2,064               | \$3,003 |
| Restructured non-accruing               | 425                                  | -                             | -                                      | -                                      | -                     | 425     |
| Balance                                 | \$512                                | \$-                           | \$ 852                                 | \$ -                                   | \$2,064               | \$3,428 |
| Specific allowance                      | \$141                                | \$-                           | \$ -                                   | \$ -                                   | \$-                   | \$141   |
| Restructured and subsequently defaulted | \$-                                  | \$-                           | \$ -                                   | \$ -                                   | \$-                   | \$-     |

#### Other Real Estate Owned

Other real estate owned totaled \$1.8 million and \$1.3 million at September 30, 2014 and December 31, 2013.

## Note 5 – Goodwill and Other Intangible Assets

The gross carrying amounts and accumulated amortization of intangible assets and goodwill are presented at the dates indicated in the following table:

| (Dollars in thousands)             | September 30, 2014          |                             |                           | Weighted<br>Average<br>Remaining<br>Life | December 31, 2013           |                             |                           | Weighted<br>Average<br>Remaining<br>Life |
|------------------------------------|-----------------------------|-----------------------------|---------------------------|--|-----------------------------|-----------------------------|---------------------------|--|
|                                    | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |  | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |  |
| Amortizing intangible assets:      |                             |                             |                           |  |                             |                             |                           |  |
| Core deposit intangibles           | \$9,716                     | \$ (9,716 )                 | \$ -                      | -  | \$9,716                     | \$ (9,352 )                 | \$ 364                    | 0.3<br>years                             |
| Other identifiable intangibles     | 8,623                       | (8,001 )                    | 622                       | <b>1.4<br/>years</b>                     | 8,623                       | (7,657 )                    | 966                       | 2.1<br>years                             |
| Total amortizing intangible assets | \$18,339                    | \$ (17,717 )                | \$ 622                    |  | \$18,339                    | \$ (17,009 )                | \$ 1,330                  |  |
| Goodwill                           | \$84,171                    |                             | \$84,171                  |  | \$84,171                    |                             | \$84,171                  |  |

The following table presents the estimated future amortization expense for amortizing intangible assets within the years ending December 31:

| (In thousands)                     | Amount |
|------------------------------------|--------|
| 2014                               | 112    |
| 2015                               | 372    |
| 2016                               | 94     |
| 2017                               | 16     |
| Thereafter                         | 28     |
| Total amortizing intangible assets | \$ 622 |

## Note 6 – Deposits

The following table presents the composition of deposits at the dates indicated:

| (In thousands)               | September<br>30, 2014 | December<br>31, 2013 |
|------------------------------|-----------------------|----------------------|
| Noninterest-bearing deposits | \$986,549             | \$836,198            |

## Interest-bearing deposits:

|                                      |             |             |
|--------------------------------------|-------------|-------------|
| Demand                               | 485,112     | 460,824     |
| Money market savings                 | 846,625     | 870,653     |
| Regular savings                      | 259,848     | 243,813     |
| Time deposits of less than \$100,000 | 244,085     | 263,636     |
| Time deposits of \$100,000 or more   | 206,569     | 202,101     |
| Total interest-bearing deposits      | 2,042,239   | 2,041,027   |
| Total deposits                       | \$3,028,788 | \$2,877,225 |

**Note 7 – Stockholders’ Equity**

The Company re-approved a stock repurchase program in August 2013 that permits the repurchase of up to 5% of the Company’s outstanding shares of common stock or approximately 1,260,000 shares. Repurchases, which will be conducted through open market purchases or privately negotiated transactions, will be made depending on market conditions and other factors. No shares were repurchased during the first nine months of 2014.

**Note 8 – Share Based Compensation**

At September 30, 2014, the Company had two share based compensation plans in existence, the 1999 Stock Option Plan (expired but having outstanding options that may still be exercised) and the 2005 Omnibus Stock Plan, which is described below.

The Company's 2005 Omnibus Stock Plan ("Omnibus Plan") provides for the granting of non-qualifying stock options to the Company's directors, and incentive and non-qualifying stock options, stock appreciation rights and restricted stock grants to selected key employees on a periodic basis at the discretion of the board. The Omnibus Plan authorizes the issuance of up to 1,800,000 shares of common stock of which 1,015,421 are available for issuance at September 30, 2014, has a term of ten years, and is administered by a committee of at least three directors appointed by the board of directors. Options granted under the plan have an exercise price which may not be less than 100% of the fair market value of the common stock on the date of the grant and must be exercised within seven to ten years from the date of grant. The exercise price of stock options must be paid for in full in cash or shares of common stock, or a combination of both. The board committee has the discretion when making a grant of stock options to impose restrictions on the shares to be purchased upon the exercise of such options. Options granted under the expired 1999 Stock Option Plan remain outstanding until exercised or they expire. The Company generally issues authorized but previously unissued shares to satisfy option exercises.

The fair values of all of the options granted for the periods indicated have been estimated using a binomial option-pricing model with the weighted-average assumptions for the periods shown are presented in the following table:

|  | Nine Months<br>Ended September<br>30, |        |
|--|---------------------------------------|--------|
|  | 2014                                  | 2013   |
| Dividend yield                             | 3.04 %                                | 2.80 % |
| Weighted average expected volatility       | 46.78%                                | 53.87% |
| Weighted average risk-free interest rate   | 1.56 %                                | 0.83 % |
| Weighted average expected lives (in years) | 5.08                                  | 5.34   |
| Weighted average grant-date fair value     | \$8.05                                | \$7.99 |

The dividend yield is based on estimated future dividend yields. The risk-free rate for periods within the contractual term of the share option is based on the U.S. Treasury yield curve in effect at the time of the grant. Expected volatilities are generally based on historical volatilities. The expected term of share options granted is generally derived from historical experience.

Compensation expense is recognized on a straight-line basis over the vesting period of the respective stock option or restricted stock grant. The Company recognized compensation expense of \$0.4 million and \$0.4 million for the three months ended September 30, 2014 and 2013, respectively, related to the awards of stock options and restricted stock grants. Compensation expense of \$1.3 million and \$1.2 million was recognized for the nine months ended September 30, 2014 and 2013, respectively. Stock options exercised were 13,834 and 10,964 for the nine months ended September 30, 2014 and 2013, respectively. The intrinsic value for the stock options exercised amounted to \$0.1 million and \$0.1 million for the nine months ended September 30, 2014 and 2013, respectively. The total of unrecognized compensation cost related to stock options was approximately \$0.2 million as of September 30, 2014. That cost is expected to be recognized over a weighted average period of approximately 2.0 years. The total of unrecognized compensation cost related to restricted stock was approximately \$4.0 million as of September 30, 2014. That cost is expected to be recognized over a weighted average period of approximately 3.3 years. The fair value of the options vested during the nine months ended September 30, 2014 and 2013, was \$0.2 million and \$0.2 million, respectively.

In the first quarter of 2014, 21,251 stock options were granted, subject to a three year vesting schedule with one third of the options vesting each year on the anniversary date of the grant. Additionally, 79,416 shares of restricted stock were granted, subject to a five year vesting schedule with one fifth of the shares vesting each year on the grant date anniversary. No shares were granted during the second or third quarter of 2014.

A summary of share option activity for the period indicated is reflected in the following table:

|   | Number<br>of<br>Common<br>Shares | Weighted<br>Average<br>Exercise<br>Share<br>Price | Weighted<br>Average<br>Contractual<br>Remaining<br>Life(Years) | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) |
|---|----------------------------------|---|--|--|
| Balance at January 1, 2014  | 307,800                          | \$ 25.23  |  | \$ 1,768   |
| Granted   | 21,251                           | \$ 24.75  |  |  |
| Exercised   | (13,834 )                        | \$ 13.72  |  | \$ 147   |
| Forfeited or expired  | (2,500 )                         | 28.59   |  |  |
| Balance at September 30, 2014                                     | 312,717                          | \$ 25.68  | 2.0  | \$ 848   |
| Exercisable at September 30, 2014                                 | 271,580                          | \$ 26.18  | 1.4  | \$ 787   |
| Weighted average fair value of options<br>granted during the year |                                  | \$ 8.05   |  |  |

A summary of the activity for the Company's restricted stock for the period indicated is presented in the following table:

|  | Number<br>of<br>Common<br>Shares | Weighted<br>Average<br>Grant-Date<br>Fair Value |
|--|----------------------------------|---|
| (In dollars, except share data):       |                                  |   |
| Restricted stock at January 1, 2014    | 227,064                          | \$ 18.61  |
| Granted                                | 79,416                           | \$ 24.75  |
| Vested                                 | (76,037 )                        | \$ 17.53  |
| Forfeited                              | (2,885 )                         | \$ 21.95  |
| Restricted stock at September 30, 2014 | 227,558                          | \$ 21.07  |

## Note 9 – Pension, Profit Sharing, and Other Employee Benefit Plans

### Defined Benefit Pension Plan

The Company has a qualified, noncontributory, defined benefit pension plan (the "Plan") covering substantially all employees. Benefits after January 1, 2005, are based on the benefit earned as of December 31, 2004, plus benefits earned in future years of service based on the employee's compensation during each such year. All benefit accruals for employees were frozen as of December 31, 2007 based on past service and thus future salary increases and additional

years of service will no longer affect the defined benefit provided by the plan although additional vesting may continue to occur.

The Company's funding policy is to contribute amounts to the plan sufficient to meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended. In addition, the Company contributes additional amounts as it deems appropriate based on benefits attributed to service prior to the date of the plan freeze. The Plan invests primarily in a diversified portfolio of managed fixed income and equity funds.

The components of net periodic benefit cost for the periods indicated are presented in the following table:

|   | Three Months        |       | Nine Months         |         |
|---|---------------------|-------|---------------------|---------|
|   | Ended September 30, |       | Ended September 30, |         |
| (In thousands)                                | 2014                | 2013  | 2014                | 2013    |
| Interest cost on projected benefit obligation | \$403               | \$390 | \$1,197             | \$1,163 |
| Expected return on plan assets                | (493)               | (425) | (1,480)             | (1,259) |
| Recognized net actuarial loss                 | 67                  | 249   | 183                 | 1,176   |
| Net periodic benefit cost                     | \$(23 )             | \$214 | \$(100 )            | \$1,080 |

#### Contributions

The decision as to whether or not to make a plan contribution and the amount of any such contribution is dependent on a number of factors. Such factors include the investment performance of the plan assets in the current economy and, since the plan is currently frozen, the remaining investment horizon of the plan. Given these uncertainties, management continues to monitor the funding level of the pension plan and may make contributions as necessary during 2014.

#### Note 10 – Net Income per Common Share

The calculation of net income per common share for the periods indicated is presented in the following table:

|   | Three Months        |          | Nine Months         |          |
|---|---------------------|----------|---------------------|----------|
|   | Ended September 30, |          | Ended September 30, |          |
| (Dollars and amounts in thousands, except per share data) | 2014                | 2013     | 2014                | 2013     |
| Net income  | \$11,142            | \$12,089 | \$29,052            | \$34,809 |
| Basic:  |                     |          |                     |          |
| Basic weighted average EPS shares                         | 25,074              | 24,979   | 25,045              | 24,952   |
| Basic net income per share                                | \$0.44              | \$0.48   | \$1.16              | \$1.40   |
| Diluted:  |                     |          |                     |          |
| Basic weighted average EPS shares                         | 25,074              | 24,979   | 25,045              | 24,952   |
| Dilutive common stock equivalents                         | 78                  | 92       | 90                  | 97       |
| Dilutive EPS shares                                       | 25,152              | 25,071   | 25,135              | 25,049   |



|                              |        |        |        |        |
|------------------------------|--------|--------|--------|--------|
| Diluted net income per share | \$0.44 | \$0.48 | \$1.16 | \$1.39 |
| Anti-dilutive shares         | 64     | 146    | 59     | 195    |

**NOTE 11 – OTHER COMPREHENSIVE INCOME**

Comprehensive income is defined as net income plus transactions and other occurrences that are the result of non-owner changes in equity. For condensed financial statements presented for the Company, non-equity changes are comprised of unrealized gains or losses on available-for-sale debt securities and any minimum pension liability adjustments. These do not have an impact on the Company's net income. The following table presents the activity in net accumulated other comprehensive income (loss) and the components of the activity for the periods indicated:

| (In thousands)   | Unrealized Gains (Losses) on<br>Investments Available-for-Sale | Defined Benefit<br>Pension Plan | Total        |
|--|--|---------------------------------|--------------|
| Balance at January 1, 2014   | \$358  | \$(3,328)                       | ) \$(2,970 ) |
| Other comprehensive income before<br>reclassification, net of tax            | 6,495  | -                               | 6,495        |
| Reclassifications from accumulated other<br>comprehensive income, net of tax | 5  | 102                             | 107          |
| Current period change in other<br>comprehensive income, net of tax           | 6,500  | 102                             | 6,602        |
| Balance at September 30, 2014  | \$6,858  | \$(3,226)                       | ) \$3,632    |

| (In thousands)   | Unrealized Gains (Losses) on<br>Investments Available-for-Sale | Defined Benefit<br>Pension Plan | Total        |
|--|--|---------------------------------|--------------|
| Balance at January 1, 2013   | \$20,258   | \$(8,946)                       | ) \$11,312   |
| Other comprehensive income before<br>reclassification, net of tax            | (14,990)   | ) -                             | (14,990)     |
| Reclassifications from accumulated other<br>comprehensive income, net of tax | 71   | 715                             | 786          |
| Current period change in other<br>comprehensive income, net of tax           | (14,919)   | ) 715                           | (14,204)     |
| Balance at September 30, 2013  | \$5,339  | \$(8,231)                       | ) \$(2,892 ) |

The following table provides the information on the reclassification adjustments out of accumulated other comprehensive income for the periods indicated:

| (In thousands)  | Nine Months<br>Ended<br>September 30,<br>2014 2013 |         |
|---|--|---------|
| Unrealized gains/(losses) on investments available-for-sale |  |         |
| Affected line item in the Statements of Income:             |  |         |
| Investment securities gains                                 | \$8  | \$118   |
| Income before taxes   | 8  | 118     |
| Tax expense   | 3  | 47      |
| Net income  | \$5  | \$71    |
| <br>  |  |         |
| Amortization of defined benefit pension plan items          |  |         |
| Affected line item in the Statements of Income:             |  |         |
| Recognized actuarial loss <sup>1</sup>                      | \$183  | \$1,176 |
| Income before taxes   | 183  | 1,176   |
| Tax expense   | 81   | 461     |
| Net income  | \$102  | \$715   |

1 This amount is included in the computation of net periodic pension cost, see Note 9

#### Note 12 – Financial Instruments with Off-balance Sheet Risk and Derivatives

The Company has entered into interest rate swaps (“swaps”) to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments. Interest rate swap contracts involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument contract is positive, this generally indicates that the counterparty or customer owes the Company, and results in credit risk to the Company. When the fair value of a derivative instrument contract is negative, the Company owes the customer or counterparty and therefore, has no credit risk. The notional value of commercial loan swaps outstanding was \$21.1 million with a fair value of \$1.4 million as of September 30, 2014 compared to \$46.4 million with a fair value of \$1.6 million as of December 31, 2013. The offsetting nature of the swaps results in a neutral effect on the Company’s operations. Fair values of the swaps are carried as both gross assets and gross liabilities in the condensed consolidated statements of condition. The associated net gains and losses on the swaps are recorded in other non-interest income.

Note 13 – LITIGATION

For the nine months ended September 30, 2014, the Company accrued \$6.4 million for litigation expenses as a result of an adverse jury verdict rendered in the second quarter associated with the actions of a former employee of CommerceFirst Bank, which was acquired in 2012. The Company is currently in the process of appealing the decision.

Note 14 – Fair Value

Generally accepted accounting principles provide entities the option to measure eligible financial assets, financial liabilities and commitments at fair value (i.e. the fair value option), on an instrument-by-instrument basis, that are otherwise not permitted to be accounted for at fair value under other accounting standards. The election to use the fair value option is available when an entity first recognizes a financial asset or financial liability or upon entering into a commitment. Subsequent changes in fair value must be recorded in earnings. The Company applies the fair value option on residential mortgage loans held for sale. The fair value option on residential mortgage loans allows the recognition of gains on sale of mortgage loans to more accurately reflect the timing and economics of the transaction.

The standard for fair value measurement establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described on the following page.

**Basis of Fair Value Measurement:**

Level 1- Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2- Quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;

Level 3- Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported by little or no market activity).

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

Changes to interest rates may result in changes in the cash flows due to prepayments or extinguishments, which could result in higher or lower measurements of the fair values.

**Assets and Liabilities**

*Mortgage loans held for sale*

Mortgage loans held for sale are valued based on quotations from the secondary market for similar instruments and are classified as Level 2 of the fair value hierarchy.

*Investments available-for-sale*

U.S. government agencies, mortgage-backed securities and corporate debt

Valuations are based on active market data and use of evaluated broker pricing models that vary based by asset class and includes available trade, bid, and other market information. Generally, the methodology includes broker quotes, proprietary models, descriptive terms and conditions databases coupled with extensive quality control programs. Multiple quality control evaluation processes review available market, credit and deal level information to support the evaluation of the security. If there is a lack of objectively verifiable information available to support the valuation, the

evaluation of the security is discontinued. Additionally, proprietary models and pricing systems, mathematical tools, actual transacted prices, integration of market developments and experienced evaluators are used to determine the value of a security based on a hierarchy of market information regarding a security or securities with similar characteristics. The Company does not adjust the quoted price for such securities. Such instruments are generally classified within Level 2 of the fair value hierarchy.

#### State and municipal securities

Proprietary valuation matrices are used for valuing all tax-exempt municipals that can incorporate changes in the municipal market as they occur. Market evaluation models include the ability to value bank qualified municipals and general market municipals that can be broken down further according to insurer, credit support, state of issuance and rating to incorporate additional spreads and municipal curves. Taxable municipals are valued using a third party model that incorporates a methodology that captures the trading nuances associated with these bonds. Such instruments are generally classified within Level 2 of the fair value hierarchy.

#### Trust preferred securities

In active markets, these types of instruments are valued based on quoted market prices that are readily accessible at the measurement date and are classified within Level 1 of the fair value hierarchy. Positions that are not traded in active markets or are subject to transfer restrictions are valued or adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence. In the absence of such evidence, management uses a process that employs certain assumptions to determine the present value. For further information, refer to Note 2 – Investments. Positions that are not traded in active markets or are subject to transfer restrictions are classified within Level 3 of the fair value hierarchy.

*Interest rate swap agreements*

Interest rate swap agreements are measured by alternative pricing sources with reasonable levels of price transparency in markets that are not active. Based on the complex nature of interest rate swap agreements, the markets these instruments trade in are not as efficient and are less liquid than that of the more mature Level 1 markets. These markets do however have comparable, observable inputs in which an alternative pricing source values these assets in order to arrive at a fair market value. These characteristics classify interest rate swap agreements as Level 2.

**Assets Measured at Fair Value on a Recurring Basis**

The following tables set forth the Company's financial assets and liabilities at the dates indicated that were accounted for or disclosed at fair value. Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

| (In thousands)                              | September 30, 2014<br>Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total      |
|---|---|---|--|------------|
| <b>Assets</b>                               |   |   |  |            |
| Residential mortgage<br>loans held for sale | \$-   | \$6,656   | \$-  | \$6,656    |
| Investments<br>available-for-sale:          |   |   |  |            |
| U.S. government<br>agencies                 | -   | 140,716   | -  | 140,716    |
| State and municipal                         | -   | 167,585   | -  | 167,585    |
| Mortgage-backed                             | -   | 379,904   | -  | 379,904    |
| Corporate debt                              | -   | 2,002   | -  | 2,002      |
| Trust preferred                             | -   | -   | 1,177  | 1,177      |
| Marketable equity<br>securities             | -   | 723   | -  | 723        |
| Interest rate swap<br>agreements            | -   | 1,446   | -  | 1,446      |
| <b>Liabilities</b>                          |   |   |  |            |
| Interest rate swap<br>agreements            | \$-   | \$(1,446)   | ) \$-  | \$(1,446 ) |

| (In thousands) | December 31, 2013<br>Quoted Prices in Active<br>Markets for Identical<br>Assets | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) | Total |
|----------------|---|---|---|-------|
|----------------|---|---|---|-------|

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(Level 1)

Assets

|  |     |          |       |            |
|--|-----|----------|-------|------------|
| Residential mortgage loans held for sale | \$- | \$8,365  | \$-   | \$8,365    |
| Investments available-for-sale:          |     |          |       |            |
| U.S. government agencies                 | -   | 139,466  | -     | 139,466    |
| State and municipal                      | -   | 165,428  | -     | 165,428    |
| Mortgage-backed                          | -   | 442,250  | -     | 442,250    |
| Corporate debt                           | -   | 2,004    | -     | 2,004      |
| Trust preferred                          | -   | -        | 1,413 | 1,413      |
| Marketable equity securities             | -   | 723      | -     | 723        |
| Interest rate swap agreements            | -   | 1,608    | -     | 1,608      |
| Liabilities                              |     |          |       |            |
| Interest rate swap agreements            | \$- | \$(1,608 | ) \$- | \$(1,608 ) |

The following table provides unrealized losses included in assets measured in the Condensed Consolidated Statements of Condition at fair value on a recurring basis for the period indicated:

| (In thousands)  | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|---|--|
| Investments available-for-sale:                                       |  |
| Balance at January 1, 2014  | \$ 1,413   |
| Total OTTI included in earnings                                       | -  |
| Principal redemption  | (352 )   |
| Total unrealized losses included in other comprehensive income (loss) | 116  |
| Balance at September 30, 2014   | \$ 1,177   |

#### Assets Measured at Fair Value on a Nonrecurring Basis

The following table sets forth the Company's financial assets subject to fair value adjustments (impairment) on a nonrecurring basis at the date indicated that are valued at the lower of cost or market. Assets are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

| (In thousands)             | September 30, 2014   |   | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total    | Total<br>Losses |
|----------------------------|--|---|--|----------|-----------------|
|                            | Quoted Prices in Active Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) |  |          |                 |
| Impaired loans             | \$-  | \$-   | \$11,220   | \$11,220 | \$21,384        |
| Other real estate<br>owned | -  | -   | 1,762  | 1,762    | (227 )          |
| Total                      | \$-  | \$-   | \$12,982   | \$12,982 | \$21,157        |

| (In thousands)             | December 31, 2013  |   | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total    | Total<br>Losses |
|----------------------------|--|---|--|----------|-----------------|
|                            | Quoted Prices in Active Markets<br>for Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) |  |          |                 |
| Impaired loans             | \$-  | \$-   | \$11,011   | \$11,011 | \$17,655        |
| Other real estate<br>owned | -  | -   | 1,338  | 1,338    | (309 )          |
| Total                      | \$-  | \$-   | \$12,349   | \$12,349 | \$17,346        |





At September 30, 2014, impaired loans totaling \$38.6 million were written down to fair value of \$34.3 million as a result of specific loan loss allowances of \$4.3 million associated with the impaired loans which was included in the allowance for loan losses. Impaired loans totaling \$32.5 million were written down to fair value of \$29.5 million at December 31, 2013 as a result of specific loan loss allowances of \$3.0 million associated with the impaired loans.

Loan impairment is measured using the present value of expected cash flows, the loan's observable market price or the fair value of the collateral (less selling costs) if the loans are collateral dependent. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable. The value of business equipment, inventory and accounts receivable collateral is based on net book value on the business' financial statements and, if necessary, discounted based on management's review and analysis. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the factors identified above. Valuation techniques are consistent with those techniques applied in prior periods.

Other real estate owned ("OREO") is adjusted to fair value upon transfer of the loans to OREO. Subsequently, OREO is carried at the lower of carrying value or fair value. The estimated fair value for other real estate owned included in Level 3 is determined by independent market based appraisals and other available market information, less cost to sell, that may be reduced further based on market expectations or an executed sales agreement. If the fair value of the collateral deteriorates subsequent to initial recognition, the Company records the OREO as a non-recurring Level 3 adjustment. Valuation techniques are consistent with those techniques applied in prior periods.

#### Fair Value of Financial Instruments

The Company discloses fair value information about financial instruments for which it is practicable to estimate the value, whether or not such financial instruments are recognized on the balance sheet. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation, and is best evidenced by a quoted market price, if one exists.

Quoted market prices, where available, are shown as estimates of fair market values. Because no quoted market prices are available for a significant portion of the Company's financial instruments, the fair value of such instruments has been derived based on the amount and timing of future cash flows and estimated discount rates.

Present value techniques used in estimating the fair value of many of the Company's financial instruments are significantly affected by the assumptions used. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate cash settlement of the instrument. Additionally, the accompanying estimates of fair values are only representative of the fair values of the individual financial assets and liabilities, and should not be considered an indication of the fair value of the Company.



The carrying amounts and fair values of the Company's financial instruments at the dates indicated are presented in the following table:

|  | September 30, 2014 |            | Fair Value Measurements   |   |   |
|--|--------------------|------------|---|---|---|
|  | Carrying Amount    | Fair Value | Quoted Prices in Active Markets for Identifiable Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Financial Assets</b>  |                    |            |   |   |   |
| Investments held-to-maturity and other equity securities                       | \$258,762          | \$260,202  | \$-   | \$260,202                                     | \$-                                       |
| Loans, net of allowance  | 2,938,338          | 2,882,093  | -   | -   | 2,882,093                                 |
| Other assets   | 88,031             | 88,031     | -   | 88,031  | -   |
| <b>Financial Liabilities</b>   |                    |            |   |   |   |
| Time Deposits  | \$450,654          | \$450,323  | \$-   | \$450,323                                     | \$-                                       |
| Securities sold under retail repurchase agreements and federal funds purchased | 71,384             | 71,384     | -   | 71,384  | -   |
| Advances from FHLB   | 558,000            | 580,738    | -   | 580,738                                       | -   |
| Subordinated debentures  | 35,000             | 12,652     | -   | -   | 12,652                                    |

|  | December 31, 2013 |            | Fair Value Measurements   |   |   |
|--|-------------------|------------|---|---|---|
|  | Carrying Amount   | Fair Value | Quoted Prices in Active Markets for Identifiable Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Financial Assets</b>                                  |                   |            |   |   |   |
| Investments held-to-maturity and other equity securities | \$265,325         | \$256,694  | \$-   | \$256,694                                     | \$-                                       |
| Loans, net of allowance                                  | 2,784,266         | 2,692,877  | -   | -   | 2,692,877                                 |
| Other assets   | 86,213            | 86,213     | -   | 86,213  | -   |
| <b>Financial Liabilities</b>                             |                   |            |   |   |   |
| Time Deposits  | \$465,737         | \$465,392  | \$-   | \$465,392                                     | \$-                                       |
|  | 53,842            | 53,842     | -   | 53,842  | -   |

Securities sold under retail repurchase agreements and federal funds purchased

|                         |         |         |   |         |        |
|-------------------------|---------|---------|---|---------|--------|
| Advances from FHLB      | 615,000 | 641,901 | - | 641,901 | -      |
| Subordinated debentures | 35,000  | 11,376  | - | -       | 11,376 |

The following methods and assumptions were used to estimate the fair value of each category of financial instruments for which it is practicable to estimate that value:

**Investments held-to-maturity and other equity securities:** The fair value of marketable securities is based on quoted market prices, prices quoted for similar instruments, and prices obtained from independent pricing services.

**Loans:** For certain categories of loans, such as mortgage, installment and commercial loans, the fair value is estimated by discounting the expected future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and similar remaining maturities. Expected cash flows were projected based on contractual cash flows, adjusted for estimated prepayments. These amounts are presented net of the allowance for loan losses.

**Other assets:** The investment in bank-owned life insurance represents the cash surrender value of the policies at September 30, 2014 and December 31, 2013 as determined by the each insurance carrier.

**Time Deposits:** The fair value of time deposits is estimated by discounting their cash flows based on their future maturities.

**Securities sold under agreements to repurchase and federal funds purchased:** The fair value and the carrying value are the same due to the short maturities of those instruments.

**Advances from FHLB:** The fair value of the Federal Home Loan Bank of Atlanta (“FHLB”) advances is estimated by computing the discounted value of contractual cash flows payable at current interest rates for obligations with similar remaining terms. The Company's credit risk is not material to calculation of fair value because the FHLB borrowings are collateralized. The Company classifies advances from the Federal Home Loan Bank of Atlanta within Level 2 of the fair value hierarchy since the fair value of such borrowings is based on rates currently available for borrowings with similar terms and remaining maturities.

**Subordinated debentures:** The fair value is estimated by computing the discounted value of contractual cash flows payable at current interest rates for obligations with similar remaining terms. The subordinated debentures are classified as Level 3 in the fair value hierarchy due to the lack of market activity of such instruments.

#### **Note 15 - Segment Reporting**

Currently, the Company conducts business in three operating segments—Community Banking, Insurance and Investment Management. Each of the operating segments is a strategic business unit that offers different products and services. The Insurance and Investment Management segments were businesses that were acquired in separate transactions where management of acquisition was retained. The accounting policies of the segments are the same as those of the Company. However, the segment data reflect inter-segment transactions and balances.

The Community Banking segment is conducted through Sandy Spring Bank and involves delivering a broad range of financial products and services, including various loan and deposit products to both individuals and businesses. Parent company income is included in the Community Banking segment, as the majority of effort of these functions is related to this segment. Major revenue sources include net interest income, gains on sales of mortgage loans, trust income, fees on sales of investment products and service charges on deposit accounts. Expenses include personnel, occupancy, marketing, equipment and other expenses. Amortization of intangibles related to the acquired entities was not significant for the three months ended September 30, 2014 was not significant. Non-cash charges associated with amortization of intangibles related to the acquired entities amounted to \$0.3 million for the three months ended September 30, 2013. These non-cash charges amounted to \$0.4 million and \$1.1 million for the nine months ended September 30, 2014 and 2013.

The Insurance segment is conducted through Sandy Spring Insurance Corporation, a subsidiary of the Bank, and offers annuities as an alternative to traditional deposit accounts. Sandy Spring Insurance Corporation operates Sandy Spring Insurance, a general insurance agency located in Annapolis, Maryland, and Neff and Associates, located in Ocean City, Maryland. Major sources of revenue are insurance commissions from commercial lines, personal lines, and medical liability lines. Expenses include personnel and support charges. Non-cash charges associated with amortization of intangibles related to the acquired entities was not significant for the three and nine months ended September 30, 2014 and 2013, respectively.

The Investment Management segment is conducted through West Financial Services, Inc., a subsidiary of the Bank. This asset management and financial planning firm, located in McLean, Virginia, provides comprehensive investment management and financial planning to individuals, families, small businesses and associations including cash flow analysis, investment review, tax planning, retirement planning, insurance analysis and estate planning. West Financial currently has approximately \$1.0 billion in assets under management. Major revenue sources include non-interest income earned on the above services. Expenses include personnel and support charges. Non-cash charges associated with amortization of intangibles related to the acquired entities was not significant for the three and nine months ended September 30, 2014 and 2013, respectively.

Information for the operating segments and reconciliation of the information to the condensed consolidated financial statements for the periods indicated is presented in the following tables:

| (In thousands)                               | Three Months Ended September 30, 2014 |           |                     |                              |               |
|--|---------------------------------------|-----------|---------------------|------------------------------|---------------|
|  | Community<br>Banking                  | Insurance | Investment<br>Mgmt. | Inter-Segment<br>Elimination | Total         |
| Interest income                              | \$37,150                              | \$1       | \$1                 | \$(2)                        | ) \$37,150    |
| Interest expense                             | 4,732                                 | -         | -                   | (2)                          | ) 4,730       |
| Provision for loan and lease losses          | (192)                                 | ) -       | -                   | -                            | (192)         |
| Noninterest income                           | 9,545                                 | 1,498     | 1,722               | (175)                        | ) 12,590      |
| Noninterest expenses                         | 26,632                                | 1,226     | 949                 | (175)                        | ) 28,632      |
| Income before income taxes                   | 15,523                                | 273       | 774                 | -                            | 16,570        |
| Income tax expense                           | 5,014                                 | 110       | 304                 | -                            | 5,428         |
| Net income                                   | \$10,509                              | \$163     | \$470               | \$-                          | \$11,142      |
| Assets                                       | \$4,250,103                           | \$6,053   | \$11,409            | \$(18,834)                   | ) \$4,248,731 |
| (In thousands)                               | Three Months Ended September 30, 2013 |           |                     |                              |               |
|  | Community<br>Banking                  | Insurance | Investment<br>Mgmt. | Inter-Segment<br>Elimination | Total         |
| Interest income                              | \$40,180                              | \$1       | \$4                 | \$(5)                        | ) \$40,180    |
| Interest expense                             | 4,879                                 | -         | -                   | (5)                          | ) 4,874       |
| Provision (credit) for loan and lease losses | 1,128                                 | -         | -                   | -                            | 1,128         |
| Noninterest income                           | 8,453                                 | 1,271     | 1,573               | (74)                         | ) 11,223      |
| Noninterest expenses                         | 24,939                                | 1,135     | 893                 | (74)                         | ) 26,893      |
| Income before income taxes                   | 17,687                                | 137       | 684                 | -                            | 18,508        |
| Income tax expense                           | 6,094                                 | 55        | 270                 | -                            | 6,419         |
| Net income                                   | \$11,593                              | \$82      | \$414               | \$-                          | \$12,089      |
| Assets                                       | \$4,088,617                           | \$13,907  | \$18,350            | \$(67,905)                   | ) \$4,052,969 |
| (In thousands)                               | Nine Months Ended September 30, 2014  |           |                     |                              |               |
|  | Community<br>Banking                  | Insurance | Investment<br>Mgmt. | Inter-Segment<br>Elimination | Total         |
| Interest income                              | \$110,391                             | \$6       | \$10                | \$(16)                       | ) \$110,391   |
| Interest expense                             | 14,086                                | -         | -                   | (16)                         | ) 14,070      |
| Provision (credit) for loan and lease losses | (1,016)                               | ) -       | -                   | -                            | (1,016)       |
| Noninterest income                           | 29,669                                | 4,273     | 5,117               | (3,526)                      | ) 35,533      |
| Noninterest expenses                         | 87,550                                | 3,542     | 2,756               | (3,526)                      | ) 90,322      |
| Income before income taxes                   | 39,440                                | 737       | 2,371               | -                            | 42,548        |
| Income tax expense                           | 12,272                                | 298       | 926                 | -                            | 13,496        |
| Net income                                   | \$27,168                              | \$439     | \$1,445             | \$-                          | \$29,052      |
| Assets                                       | \$4,250,103                           | \$6,053   | \$11,409            | \$(18,834)                   | ) \$4,248,731 |



| (In thousands)                               | Nine Months Ended September 30, 2013 |           |                     |                              |               |
|--|--------------------------------------|-----------|---------------------|------------------------------|---------------|
|  | Community<br>Banking                 | Insurance | Investment<br>Mgmt. | Inter-Segment<br>Elimination | Total         |
| Interest income                              | \$112,238                            | \$6       | \$11                | \$(17)                       | ) \$112,238   |
| Interest expense                             | 14,691                               | -         | -                   | (17)                         | ) 14,674      |
| Provision (credit) for loan and lease losses | (1,670)                              | ) -       | -                   | -                            | (1,670)       |
| Noninterest income                           | 27,748                               | 3,968     | 4,622               | (481)                        | ) 35,857      |
| Noninterest expenses                         | 76,893                               | 3,270     | 2,542               | (481)                        | ) 82,224      |
| Income before income taxes                   | 50,072                               | 704       | 2,091               | -                            | 52,867        |
| Income tax expense                           | 16,955                               | 285       | 818                 | -                            | 18,058        |
| Net income                                   | \$33,117                             | \$419     | \$1,273             | \$-                          | \$34,809      |
| Assets                                       | \$4,088,617                          | \$13,907  | \$18,350            | \$(67,905)                   | ) \$4,052,969 |

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

### **The Company**

Sandy Spring Bancorp, Inc. (the "Company") is the bank holding company for Sandy Spring Bank (the "Bank"). The Company is registered as a bank holding company pursuant to the Bank Holding Company Act of 1956, as amended (the "Holding Company Act"). As such, the Company is subject to supervision and regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Company began operating in 1988. The Bank was founded in 1868 and is the oldest banking business based in Maryland. The Bank is independent, community oriented, and conducts a full-service commercial banking business through 46 community offices located in Anne Arundel, Carroll, Frederick, Howard, Montgomery and Prince George's counties in Maryland, and Arlington, Fairfax and Loudoun counties in Virginia. The Bank is a state chartered bank subject to supervision and regulation by the Federal Reserve and the State of Maryland. The Bank's deposit accounts are insured by the Deposit Insurance Fund administered by the Federal Deposit Insurance Corporation (the "FDIC") to the maximum permitted by law. The Bank is a member of the Federal Reserve System and is an Equal Housing Lender. The Company, the Bank, and its other subsidiaries are Affirmative Action/Equal Opportunity Employers.

### **Overview**

Net income for the Company for the third quarter of 2014 totaled \$11.1 million (\$0.44 per diluted share) as compared to net income of \$12.1 million (\$0.48 per diluted share) for the third quarter of 2013. For the first nine months of 2014, net income totaled \$29.1 million (\$1.16 per diluted share), compared to net income of \$34.8 million (\$1.39 per diluted share) for the first nine months of 2013. During the third quarter of 2013, the Company recognized interest income of \$3.7 million, non-interest income of \$0.4 million and a credit to non-interest expenses of \$0.5 million due to the resolution of two previously non-performing commercial real estate loans. These results reflect the following events:

Average total loans for the third quarter of 2014 increased 12% compared to the third quarter of 2013 due primarily to organic growth in the residential mortgage, commercial investor real estate and consumer loan portfolios.

The provision for loan and lease losses was a credit of \$0.2 million for the third quarter of 2014 compared to a charge of \$1.1 million for the third quarter of 2013 and a charge of \$0.2 million for the second quarter of 2014. The decrease in the provision for the third quarter of 2014 compared to the prior year quarter was due primarily to a decrease in historical losses which offset the growth in the loan portfolio.

The net interest margin was 3.42% for the third quarter of 2014, compared to 3.88% for the third quarter of 2013 and 3.48% for the second quarter of 2014. The decline from the prior year was the result of lower loan yields, primarily in the commercial loan portfolio, combined with the impact of interest recoveries in 2013 on two non-performing commercial real estate loans. Excluding the effect of the loan recoveries, the net interest margin was 3.49% for the third quarter of 2013.

Non-interest income increased \$1.4 million or 12% for the third quarter of 2014 compared to the third quarter of 2013 due primarily to increases in income from wealth management, insurance agency commissions and mortgage banking activities.

For the year-to-date, the Company recorded litigation-related expenses in 2014 of \$6.4 million before taxes for damages resulting from claims against the Company based on the actions of a former employee of CommerceFirst Bank, which was acquired by the Company in 2012.

In the first nine months of 2014, the Mid-Atlantic region continued to experience moderate economic improvement. Concerns over the growth of the national economy and consumer and business uncertainty continued to impede both the regional and national economic outlook. A declining unemployment rate has been somewhat offset by uneven trends in housing and consumer spending and concerns over the current status of the job market together with the possibility of higher interest rates in the coming year. The effect of geopolitical events in Europe and the Middle East and slower growth abroad, particularly in China, also continue to provide underlying volatility. These factors have caused uncertainty, particularly among both individual consumers and small and large businesses and have continued to suppress confidence and thus constrain the pace of economic growth and lending. Despite this challenging business environment, the Company has emphasized the fundamentals of community banking as it has maintained strong levels of liquidity, capital and credit quality.

During 2014, lower rates on average interest-earning assets and a slowing decline in funding costs served to offset the effect of loan growth. Average loans increased 12% for the third quarter of 2014 compared to the prior year quarter, while average total deposits increased 5% for the quarter compared to 2013.

Liquidity remained strong due to the borrowing lines with the Federal Home Loan Bank of Atlanta and the Federal Reserve and the size and composition of the investment portfolio.

Non-performing assets increased to \$45.4 million at September 30, 2014 from \$39.9 million at September 30, 2013. This increase was due primarily to several loans in the owner-occupied commercial real estate portfolio that were placed on non-accrual status. Non-performing assets represented 1.07% of total assets at September 30, 2014 compared to 0.98% at September 30, 2013. The ratio of net charge-offs to average loans and leases was 0.03% for the third quarter of 2014 compared to 0.11% for the prior year quarter.

Non-interest income increased 12% in the third quarter of 2014 compared to the third quarter of 2013. This increase was driven by an 10% increase in wealth management income due primarily to growth in assets under management. In addition, insurance agency commissions increased 18% for the quarter due to an increase in commissions on physicians' liability lines while mortgage banking income increased over the prior year quarter due to higher accrued gains on loans held for sale and related interest rate lock commitments.

Non-interest expenses increased 6% in the third quarter of 2014 compared to the third quarter of 2013 due primarily to higher salaries and benefits, professional fees and other non-interest expenses. Excluding the credits to non-interest expense from the loan recoveries mentioned above, non-interest expenses increased 4% over the prior year quarter.

Total assets at September 30, 2014 increased 3% compared to December 31, 2013 primarily due to organic loan growth which was funded by a 5% increase in deposits. Loan balances increased 7% compared to the prior year end

due primarily to increases of 12% in residential mortgage and construction loans, 10% in consumer loans and 21% in commercial ADC loans. Customer funding sources, which include deposits plus other short-term borrowings from core customers, increased 5% compared to balances at December 31, 2013. The increase in customer funding sources was driven primarily by a combined increase of 13% in interest-bearing and noninterest-bearing checking accounts and an increase of 7% in regular savings accounts. The Company continued to manage its net interest margin, primarily by managing rates on certificates of deposit and by utilizing short-term FHLB borrowings during this extended period of historically low interest rates. During the same period, stockholders' equity increased \$23 million due to net income in the first nine months of 2014.

## Consolidated Average Balances, Yields and Rates

## CONSOLIDATED AVERAGE BALANCES, YIELDS AND RATES - UNAUDITED

| (Dollars in thousands<br>and tax-equivalent)      | Nine Months Ended September 30<br>2014 |                 |                                     | 2013                |                 |                                     | Annualized<br>Average<br>Yield/Rate |  |
|---|--|-----------------|-------------------------------------|---------------------|-----------------|-------------------------------------|-------------------------------------|--|
|   | Average<br>Balances                    | (1)<br>Interest | Annualized<br>Average<br>Yield/Rate | Average<br>Balances | (1)<br>Interest | Annualized<br>Average<br>Yield/Rate |                                     |  |
| Assets  |  |                 |                                     |                     |                 |                                     |                                     |  |
| Residential mortgage<br>loans (2)                 | \$660,828                              | 17,085          | 3.45                                | % \$583,105         | 16,001          | 3.66                                | %                                   |  |
| Residential construction<br>loans                 | 142,709                                | 3,988           | 3.74                                | 120,053             | 3,142           | 3.50                                |                                     |  |
| Commercial ADC loans                              | 170,365                                | 6,450           | 5.06                                | 155,965             | 7,540           | 6.46                                |                                     |  |
| Commercial investor<br>real estate loans          | 570,176                                | 20,881          | 4.90                                | 486,624             | 20,927          | 5.75                                |                                     |  |
| Commercial owner<br>occupied real estate<br>loans | 583,044                                | 21,304          | 5.05                                | 565,108             | 22,464          | 5.45                                |                                     |  |
| Commercial business<br>loans                      | 355,242                                | 12,268          | 4.62                                | 338,869             | 13,288          | 5.10                                |                                     |  |
| Leasing   | 374                                    | 16              | 5.54                                | 1,764               | 88              | 6.67                                |                                     |  |
| Consumer loans                                    | 390,749                                | 9,689           | 3.34                                | 361,624             | 9,325           | 3.47                                |                                     |  |
| Total loans and leases<br>(3)                     | 2,873,487                              | 91,681          | 4.30                                | 2,613,112           | 92,775          | 4.77                                |                                     |  |
| Taxable securities                                | 687,359                                | 12,786          | 2.48                                | 765,054             | 13,536          | 2.36                                |                                     |  |
| Tax-exempt securities<br>(4)                      | 302,148                                | 9,767           | 4.31                                | 300,826             | 9,829           | 4.36                                |                                     |  |
| Interest-bearing deposits<br>with banks           | 35,004                                 | 66              | 0.25                                | 34,379              | 65              | 0.25                                |                                     |  |
| Federal funds sold                                | 474                                    | -               | 0.22                                | 475                 | -               | 0.22                                |                                     |  |
| Total interest-earning<br>assets                  | 3,898,472                              | 114,300         | 3.94                                | 3,713,846           | 116,205         | 4.19                                |                                     |  |
| Less: allowance for loan<br>and lease losses      | (38,645 )                              |                 |                                     | (42,223 )           |                 |                                     |                                     |  |
| Cash and due from<br>banks                        | 45,380                                 |                 |                                     | 45,932              |                 |                                     |                                     |  |
| Premises and equipment,<br>net                    | 45,845                                 |                 |                                     | 47,479              |                 |                                     |                                     |  |
| Other assets                                      | 210,325                                |                 |                                     | 216,958             |                 |                                     |                                     |  |
| Total assets                                      | \$4,161,377                            |                 |                                     | \$3,981,992         |                 |                                     |                                     |  |

|  |             |           |      |   |             |           |      |   |
|--|-------------|-----------|------|---|-------------|-----------|------|---|
| Liabilities and Stockholders' Equity       |             |           |      |   |             |           |      |   |
| Interest-bearing demand deposits           | \$475,459   | 306       | 0.09 | % | \$436,236   | 280       | 0.09 | % |
| Regular savings deposits                   | 258,224     | 131       | 0.07 |   | 238,627     | 159       | 0.09 |   |
| Money market savings deposits              | 871,399     | 839       | 0.13 |   | 880,794     | 1,131     | 0.17 |   |
| Time deposits                              | 460,548     | 2,309     | 0.67 |   | 497,136     | 2,639     | 0.71 |   |
| Total interest-bearing deposits            | 2,065,630   | 3,585     | 0.23 |   | 2,052,793   | 4,209     | 0.27 |   |
| Other borrowings                           | 68,301      | 117       | 0.23 |   | 59,734      | 126       | 0.28 |   |
| Advances from FHLB                         | 556,663     | 9,709     | 2.33 |   | 482,679     | 9,667     | 2.68 |   |
| Subordinated debentures                    | 35,000      | 659       | 2.51 |   | 35,000      | 672       | 2.56 |   |
| Total interest-bearing liabilities         | 2,725,594   | 14,070    | 0.69 |   | 2,630,206   | 14,674    | 0.75 |   |
| Noninterest-bearing demand deposits        | 894,508     |           |      |   | 833,059     |           |      |   |
| Other liabilities                          | 30,184      |           |      |   | 33,230      |           |      |   |
| Stockholders' equity                       | 511,091     |           |      |   | 485,497     |           |      |   |
| Total liabilities and stockholders' equity | \$4,161,377 |           |      |   | \$3,981,992 |           |      |   |
| Net interest income and spread             |             | \$100,230 | 3.25 | % |             | \$101,531 | 3.44 | % |
| Less: tax-equivalent adjustment            |             | 3,909     |      |   |             | 3,967     |      |   |
| Net interest income                        |             | \$96,321  |      |   |             | \$97,564  |      |   |
| Interest income/earning assets             |             |           | 3.94 | % |             |           | 4.19 | % |
| Interest expense/earning assets            |             |           | 0.48 |   |             |           | 0.53 |   |
| Net interest margin                        |             |           | 3.46 | % |             |           | 3.66 | % |

Tax-equivalent income has been adjusted using the combined marginal federal and state rate of 39.88% for 2014 (1) and 2013. The annualized taxable-equivalent adjustments utilized in the above table to compute yields aggregated to \$3.9 million and \$4.0 million in 2014 and 2013, respectively .

(2) Includes residential mortgage loans held for sale. Home equity loans and lines are classified as consumer loans.

(3) Non-accrual loans are included in the average balances.

(4) Includes only investments that are exempt from federal taxes.





## Results of Operations

### For the Nine Months Ended September 30, 2014 Compared to the Nine Months Ended September 30, 2013

Net income for the Company for the first nine months of 2014 totaled \$29.1 million (\$1.16 per diluted share) compared to net income of \$34.8 million (\$1.39 per diluted share) for the first nine months of 2013. Excluding the effect of the loan recoveries mentioned previously, net income for the first nine months of 2013 was \$32.1 million (\$1.28 per diluted share).

### Net Interest Income

The largest source of the Company's operating revenue is net interest income, which is the difference between the interest earned on interest-earning assets and the interest paid on interest-bearing liabilities. For purposes of this discussion and analysis, the interest earned on tax-exempt investment securities has been adjusted to an amount comparable to interest subject to normal income taxes. The result is referred to as tax-equivalent interest income and tax-equivalent net interest income. The following discussion of net interest income should be considered in conjunction with the review of the information provided in the preceding table.

Net interest income for the first nine months of 2014 was \$96.3 million compared to \$97.6 million for the first nine months of 2013. On a tax-equivalent basis, net interest income for the nine months ended September 30, 2014 was \$100.2 million compared to \$101.5 million for the nine months ended September 30, 2013, a decrease of 1%. The preceding table provides an analysis of net interest income performance that reflects a net interest margin that decreased to 3.46% for the first nine months of 2014 compared to 3.66% for the first nine months of 2013. Excluding interest recoveries of \$3.7 million on non-performing commercial real estate loans, the net interest margin was 3.53% for the first nine months of 2013. Average interest-earning assets increased by 5% while average interest-bearing liabilities increased 4% in the first nine months of 2014. Average noninterest-bearing deposits increased 7% in the first nine months of 2014 while the percentage of average noninterest-bearing deposits to total deposits increased to 30% for the first nine months of 2014 compared to 29% for the first nine months of 2013. The decrease in the net interest margin was caused by the effect of lower rates on interest-earning assets that exceeded the benefit of lower rates on interest-bearing deposits and borrowings.

### Effect of Volume and Rate Changes on Net Interest Income

The following table analyzes the reasons for the changes from year-to-year in the principal elements that comprise net interest income:

| (Dollars in thousands and tax equivalent)      | <b>2014 vs. 2013</b> |                  |           | <b>2013 vs. 2012</b> |               |           |
|--|----------------------|------------------|-----------|----------------------|---------------|-----------|
|  | <b>Increase</b>      |                  |           | <b>Increase</b>      |               |           |
|  | Or                   | Due to Change In |           | Or                   | Due to Change |           |
|  |                      | Average:*        | Rate      |                      | In Average:*  |           |
|  | (Decrease)           | Volume           | Rate      | (Decrease)           | Volume        | Rate      |
| Interest income from earning assets:           |                      |                  |           |                      |               |           |
| Loans and leases                               | \$(1,094)            | \$8,718          | \$(9,812) | \$6,024              | \$8,054       | \$(2,030) |
| Securities                                     | (812 )               | (1,706)          | 894       | (1,508)              | 160           | (1,668)   |
| Other earning assets                           | 1                    | 1                | -         | (19 )                | (14 )         | (5 )      |
| Total interest income                          | (1,905)              | 7,013            | (8,918)   | 4,497                | 8,200         | (3,703)   |
| Interest expense on funding of earning assets: |                      |                  |           |                      |               |           |
| Interest-bearing demand deposits               | 26                   | 35               | (9 )      | 24                   | 28            | (4 )      |
| Regular savings deposits                       | (28 )                | 13               | (41 )     | 4                    | 21            | (17 )     |
| Money market savings deposits                  | (292 )               | (12 )            | (280 )    | (340 )               | 20            | (360 )    |
| Time deposits                                  | (330 )               | (188 )           | (142 )    | (1,186)              | (472 )        | (714 )    |
| Total borrowings                               | 20                   | 1,401            | (1,381)   | (1,197)              | 1,353         | (2,550)   |
| Total interest expense                         | (604 )               | 1,249            | (1,853)   | (2,695)              | 950           | (3,645)   |
| Net interest income                            | \$(1,301)            | \$5,764          | \$(7,065) | \$7,192              | \$7,250       | \$(58 )   |

\* Variances that are the combined effect of volume and rate, but cannot be separately identified, are allocated to the volume and rate variances based on their respective relative amounts.

## Interest Income

The Company's total tax-equivalent interest income for the first nine months of 2014 decreased 2% compared to the prior year period. The previous table shows that, in 2014, the increase in average loans and leases was offset by a continued decline in earning asset yields with respect to the loan portfolio.

In the first nine months of 2014, the average balance of the loan portfolio increased 10% compared to the prior year period. This growth was primarily in the commercial investor real estate, residential mortgage and consumer loan portfolios. These increases were driven by organic loan growth as the regional economy improved. The yield on average loans and leases decreased by 47 basis points due to the continued prevailing low interest rate environment as relatively higher rate loans were paid off and new loans were originated at comparatively lower rates. The decline in the portfolio yield was driven primarily by a decrease of 15 basis points in the yield in the combined residential mortgage portfolio, a decrease of 66 basis points in the commercial loan portfolio and a decrease of 13 basis points in the yield on the overall consumer loan portfolio. The decrease in the yield on the mortgage loan portfolio was due to declining rates on both new and existing adjustable rate mortgage loans, which the Company does not sell but maintains in the portfolio. Excluding the interest recoveries mentioned previously, the yield on the commercial loan portfolio declined 35 basis points. This decrease was due to the continuing low interest rate environment and competition for quality loans.

The average yield on total investment securities increased 12 basis points while the average balance of the portfolio declined 7% for the first nine months of 2014 compared to the first nine months of 2013. The increase in the yield on investments was due primarily to lower amortization of mortgage-backed securities. The decrease in the average balance of the portfolio was necessary to fund loan growth during the period.

## Interest Expense

Interest expense decreased by \$0.6 million or 4% in the first nine months of 2014 compared to the first nine months of 2013, primarily as a result of a 6 basis point decrease in the average rate paid on interest-bearing liabilities. Average deposits increased 3% during the first nine months of 2014 compared to the first nine months of 2013. Average noninterest-bearing and interest-bearing checking accounts increased \$101 million or 8% and regular savings accounts increased \$20 million or 8% as clients kept funds in short-term instruments to preserve liquidity. This growth was partially offset by a decrease in average certificates of deposit of \$37 million or 7% in the first nine months of 2014 compared to the prior year period. This decrease was primarily due to the Company's management of rates offered on certificates in an effort to preserve the Company's net interest margin during this extended period of historically low interest rates. Average balances of money market accounts decreased \$9 million or 1% in the first nine months of 2014 compared to the first nine months of 2013. In addition, the average rate paid on advances from the Federal Home Loan Bank of Atlanta decreased 35 basis points for the first nine months of 2014 compared to the first nine months of 2013 due to an increase in short-term advances to take advantage of current low interest rates and

the restructuring of \$50 million of such advances into longer term, lower rate instruments during the first six months of 2013.

### Non-interest Income

Non-interest income amounts and trends are presented in the following table for the periods indicated:

| (Dollars in thousands)                | Nine Months<br>Ended<br>September 30,<br>2014 |          | 2014/2013 |          |
|---------------------------------------|---|----------|-----------|----------|
|                                       | 2014  | 2013     | \$ Change | % Change |
| Securities gains                      | \$8   | \$118    | \$(110)   | (93.2)%  |
| Service charges on deposit accounts   | 6,287   | 6,390    | (103)     | (1.6)    |
| Mortgage banking activities           | 1,482   | 2,738    | (1,256)   | (45.9)   |
| Wealth management income              | 14,181  | 13,077   | 1,104     | 8.4      |
| Insurance agency commissions          | 4,011   | 3,578    | 433       | 12.1     |
| Income from bank owned life insurance | 1,817   | 1,864    | (47)      | (2.5)    |
| Visa check fees                       | 3,295   | 3,113    | 182       | 5.8      |
| Other income                          | 4,452   | 4,979    | (527)     | (10.6)   |
| Total non-interest income             | \$35,533                                      | \$35,857 | \$(324)   | (0.9)    |

Total non-interest income was \$35.5 million for the first nine months of 2014 compared to \$35.9 million for the first nine months of 2013. The primary drivers of non-interest income for the first nine months of 2014 were declines in mortgage banking income and other non-interest income which were somewhat offset by increases in wealth management income and income from insurance agency commissions. Further detail by type of non-interest income follows:

Wealth management income is comprised of income from trust and estate services, investment management fees earned by West Financial Services, the Company's investment management subsidiary, and fees on sales on investment products and services. Trust services fees increased 15% compared to the prior year period, due to an increase in assets under management. Investment management fees in West Financial Services increased 11% for the first nine months of 2014 compared to the first nine months of 2013, also due to higher assets under management. Fees on sales of investment products and services decreased 9% for the first half of 2014, due to one-time sales of insurance policies in 2013 and lower sales of securities products in the third quarter of 2014. Overall total assets under management increased to \$2.7 billion at September 30, 2014 compared to \$2.5 billion at September 30, 2013 as a result of positive market movements and additions from new clients.

Insurance agency commissions increased in 2014 compared to 2013 due primarily to higher annual contingency commissions in the first quarter based on annual policy performance and an increase in commissions from physicians' liability lines.

Income from mortgage banking activities decreased in 2014 compared to 2013 due primarily to significantly reduced loan origination volumes from refinancing activity.

Other non-interest income decreased during the first nine months of 2014 compared to the prior year period due mainly to gains on sales and dispositions of loans and fixed assets and a non-recurring legal settlement, all of which occurred in the first quarter of 2013.

Service charges on deposits decreased in 2014 compared to 2013 due primarily to a decline in overdraft fees.

Income from bank owned life insurance decreased in the first nine months of 2014 compared to the first nine months of 2013 due to the decline in the interest rates paid on these policies. The Company invests in bank owned life insurance products in order to manage the cost of employee benefit plans. Investments totaled \$88.0 million at September 30, 2014 and \$85.6 million at September 30, 2013 and were well diversified by carrier in accordance with defined policies and practices. The average tax-equivalent yield on these insurance contract assets was 4.62% for the first nine months of 2014 compared to 4.90% for the prior year period.

No net OTTI losses were recognized in earnings in either the first nine months of 2014 or 2013.



**Non-interest Expense**

Non-interest expense amounts and trends are presented in the following table for the periods indicated:

|  | Nine Months |          | 2014/2013 |          |   |
|--|-------------|----------|-----------|----------|---|
|  | Ended       |          | \$ Change | % Change |   |
| (Dollars in thousands)                     | 2014        | 2013     |           |          |   |
| Salaries and employee benefits             | \$49,594    | \$48,891 | 703       | 1.4      | % |
| Occupancy expense of premises              | 9,778       | 9,327    | 451       | 4.8      |   |
| Equipment expenses                         | 3,855       | 3,676    | 179       | 4.9      |   |
| Marketing                                  | 2,088       | 1,983    | 105       | 5.3      |   |
| Outside data services                      | 3,663       | 3,418    | 245       | 7.2      |   |
| FDIC insurance                             | 1,687       | 1,855    | (168)     | (9.1)    | ) |
| Amortization of intangible assets          | 709         | 1,384    | (675)     | (48.8)   | ) |
| Litigation settlement and associated costs | 6,364       | -        | 6,364     | -        |   |
| Professional fees                          | 3,298       | 3,093    | 205       | 6.6      |   |
| Other real estate owned                    | 49          | (394)    | 443       | (112.4)  | ) |
| Other expenses                             | 9,237       | 8,991    | 246       | 2.7      |   |
| Total non-interest expense                 | \$90,322    | \$82,224 | 8,098     | 9.8      |   |

Non-interest expenses totaled \$90.3 million in 2014 compared to \$82.2 million in 2013. This increase in expenses was driven primarily by nonrecurring litigation expenses mentioned previously. Excluding the litigation expenses, non-interest expenses remained virtually level with the prior year period.

Further detail by category of non-interest expense follows:

Salaries and employee benefits, the largest component of non-interest expenses, remained virtually level compared to the prior year period. Salaries increased 4% compared to the prior year period due to a larger staff and merit increases which were offset by decreases in commission and incentive compensation due largely to lower mortgage origination volumes. Benefits expense decreased 7% in 2014 compared to 2013 due primarily to a decrease in pension expense resulting from a higher discount rate assumption and higher projected returns on plan assets. This decrease was partially offset by an increase in health insurance expenses due to higher claims. The average number of full-time equivalent employees was 718 in the first nine months of 2014 compared to 712 in the first nine months of 2013.

Occupancy expenses increased in 2014 compared to 2013 due primarily to a significant increase in weather-related expenses in the first nine months of 2014. Equipment expenses increased due to higher software costs.

Marketing expenses increased in 2014 compared to 2013 due to higher advertising and public relations expenses.

The growth in outside data services expenses was due to contractual increases by providers and higher bankcard account activity.

FDIC insurance expense decreased in 2014 compared to 2013 as the Company's growth in assets was more than offset by a lower assessment rate due to improved financial ratios.

Intangibles amortization decreased in 2014 due to the costs of prior acquisitions that were fully amortized during the period.

Professional fees increased due to the recovery of \$0.5 million in legal fees in 2013 associated with two commercial loan workouts mentioned previously.

Other real estate owned expenses increased compared to the prior year period due to a gain on the sale of one property in the third quarter of 2013.

Other non-interest expenses increased 3% in 2014 compared to 2013 due mainly to accrued expenses on performance letters of credit and losses from fraudulent bankcard charges.

## **Income Taxes**

The Company had income tax expense of \$13.5 million in the first nine months of 2014, compared to expense of \$18.1 million in the first nine months of 2013. The resulting effective rate was 32% for the first nine months of 2014 and 34% for the first nine months of 2013. The effective rate decreased in 2014 compared to 2013 due to tax exempt income comprising a greater proportion of income before taxes.



**Results of Operations****For the Three Months Ended September 30, 2014 Compared to the Three Months Ended September 30, 2013**

Net income for the Company for the third quarter of 2014 totaled \$11.1 million (\$0.44 per diluted share) compared to net income of \$12.1 million (\$0.48 per diluted share) for the third quarter of 2013.

**Consolidated Average Balances, Yields and Rates****CONSOLIDATED AVERAGE BALANCES, YIELDS AND RATES - UNAUDITED**

| (Dollars in thousands and tax equivalent)   | Three Months Ended September 30<br>2014 |                 |                                     | 2013                |                 |                                     | Annualized<br>Average<br>Yield/Rate | % |
|---|---|-----------------|-------------------------------------|---------------------|-----------------|-------------------------------------|-------------------------------------|---|
|   | Average<br>Balances                     | (1)<br>Interest | Annualized<br>Average<br>Yield/Rate | Average<br>Balances | (1)<br>Interest | Annualized<br>Average<br>Yield/Rate |                                     |   |
| <b>Assets</b>                               |   |                 |                                     |                     |                 |                                     |                                     |   |
| Residential mortgage loans (2)              | \$689,531                               | \$ 5,894        | 3.42                                | % \$593,335         | \$ 5,315        | 3.57                                |                                     | % |
| Residential construction loans              | 147,750                                 | 1,376           | 3.69                                | 120,676             | 1,106           | 3.63                                |                                     |   |
| Commercial ADC loans                        | 180,293                                 | 2,196           | 4.83                                | 158,557             | 3,438           | 8.60                                |                                     |   |
| Commercial investor real estate loans       | 577,851                                 | 7,009           | 4.81                                | 499,896             | 8,608           | 6.83                                |                                     |   |
| Commercial owner occupied real estate loans | 585,014                                 | 7,091           | 4.98                                | 566,366             | 7,361           | 5.30                                |                                     |   |
| Commercial business loans                   | 367,203                                 | 4,177           | 4.53                                | 331,374             | 4,246           | 4.94                                |                                     |   |
| Leasing                                     | 206                                     | 4               | 6.91                                | 1,152               | 20              | 7.11                                |                                     |   |
| Consumer loans                              | 404,062                                 | 3,364           | 3.32                                | 366,562             | 3,161           | 3.45                                |                                     |   |
| Total loans and leases (3)                  | 2,951,910                               | 31,111          | 4.22                                | 2,637,918           | 33,255          | 5.03                                |                                     |   |
| Taxable securities                          | 663,550                                 | 4,071           | 2.43                                | 794,344             | 4,942           | 2.49                                |                                     |   |
| Tax-exempt securities (4)                   | 301,656                                 | 3,240           | 4.26                                | 303,299             | 3,305           | 4.36                                |                                     |   |
| Interest-bearing deposits with banks        | 37,268                                  | 24              | 0.25                                | 34,819              | 22              | 0.25                                |                                     |   |
| Federal funds sold                          | 474                                     | -               | 0.22                                | 475                 | -               | 0.22                                |                                     |   |
| Total interest-earning assets               | 3,954,858                               | 38,446          | 3.89                                | 3,770,855           | 41,524          | 4.39                                |                                     |   |
| Less: allowance for loan and lease losses   | (38,213 )                               |                 |                                     | (41,385 )           |                 |                                     |                                     |   |
| Cash and due from banks                     | 45,600                                  |                 |                                     | 45,322              |                 |                                     |                                     |   |

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|  |             |          |      |             |          |      |   |
|--|-------------|----------|------|-------------|----------|------|---|
| Premises and equipment, net                | 45,959      |          |      | 46,784      |          |      |   |
| Other assets                               | 211,880     |          |      | 217,493     |          |      |   |
| Total assets                               | \$4,220,084 |          |      | \$4,039,069 |          |      |   |
| Liabilities and Stockholders' Equity       |             |          |      |             |          |      |   |
| Interest-bearing demand deposits           | \$488,800   | 112      | 0.09 | % \$442,210 | 97       | 0.09 | % |
| Regular savings deposits                   | 263,255     | 34       | 0.05 | 240,910     | 53       | 0.09 |   |
| Money market savings deposits              | 871,271     | 293      | 0.13 | 874,946     | 342      | 0.16 |   |
| Time deposits                              | 456,530     | 769      | 0.67 | 483,814     | 866      | 0.71 |   |
| Total interest-bearing deposits            | 2,079,856   | 1,208    | 0.23 | 2,041,880   | 1,358    | 0.26 |   |
| Other borrowings                           | 73,046      | 42       | 0.23 | 56,983      | 39       | 0.27 |   |
| Advances from FHLB                         | 523,304     | 3,258    | 2.47 | 525,543     | 3,255    | 2.46 |   |
| Subordinated debentures                    | 35,000      | 222      | 2.54 | 35,000      | 222      | 2.55 |   |
| Total interest-bearing liabilities         | 2,711,206   | 4,730    | 0.69 | 2,659,406   | 4,874    | 0.73 |   |
| Noninterest-bearing demand deposits        | 956,830     |          |      | 862,046     |          |      |   |
| Other liabilities                          | 34,514      |          |      | 33,806      |          |      |   |
| Stockholders' equity                       | 517,534     |          |      | 483,811     |          |      |   |
| Total liabilities and stockholders' equity | \$4,220,084 |          |      | \$4,039,069 |          |      |   |
| Net interest income and spread             |             | \$33,716 | 3.20 | %           | \$36,650 | 3.66 | % |
| Less: tax-equivalent adjustment            |             | 1,296    |      |             | 1,344    |      |   |
| Net interest income                        |             | \$32,420 |      |             | \$35,306 |      |   |
| Interest income/earning assets             |             |          | 3.89 | %           |          | 4.39 | % |
| Interest expense/earning assets            |             |          | 0.47 | %           |          | 0.51 | % |
| Net interest margin                        |             |          | 3.42 | %           |          | 3.88 | % |

Tax-equivalent income has been adjusted using the combined marginal federal and state rate of 39.88% for 2014 (1) and 2013. The annualized taxable-equivalent adjustments utilized in the above table to compute yields aggregated to \$1.3 million and \$1.3 million in 2014 and 2013, respectively .

(2) Includes residential mortgage loans held for sale. Home equity loans and lines are classified as consumer loans.

(3) Non-accrual loans are included in the average balances.

(4) Includes only investments that are exempt from federal taxes.



## Net Interest Income

Net interest income for the third quarter of 2014 was \$32.4 million compared to \$35.3 million for the third quarter of 2013. On a tax-equivalent basis, net interest income for the third quarter of 2014 was \$33.7 million compared to \$36.7 million for the third quarter of 2013, a decrease of 8%. The preceding table provides an analysis of net interest income that reflects a net interest margin that decreased to 3.42% for the third quarter of 2014 compared to 3.88% for the third quarter of 2013. Excluding interest recoveries of \$3.7 million on non-performing commercial real estate loans, the net interest margin was 3.49% for the third quarter of 2013. Average interest-earning assets increased by 5% while average interest-bearing liabilities increased 2% in the third quarter of 2014. Average noninterest-bearing deposits increased 11% in the third quarter of 2014 while the percentage of average noninterest-bearing deposits to total deposits increased to 32% for the third quarter of 2014 compared to 30% for the third quarter of 2013. The decrease in the net interest margin was caused by the effect of lower rates on interest-earning assets that exceeded the benefit of lower rates on interest-bearing deposits and borrowings.

## Interest Income

The Company's tax-equivalent interest income for the third quarter of 2014 totaled \$38.4 million compared to \$41.5 million for the third quarter of 2013, a decrease of 7%. Excluding interest recoveries on previously non-performing commercial real estate loans in the third quarter of 2013, total tax-equivalent interest income would have increased 2% over the prior year quarter. In the third quarter of 2014, the average balance of the loan portfolio increased 12% compared to the prior year period. This growth was primarily in the commercial investor real estate, residential mortgage and construction and consumer loan portfolios. These increases were driven by organic loan growth as the regional economy improved. The yield on average loans and leases decreased by 81 basis points compared to the prior year quarter. Excluding the interest recoveries mentioned above, the yield on average loans and leases decreased 25 basis points for the quarter as compared to the prior year quarter. The decline in the portfolio yield was driven primarily by a decrease of 13 basis points in the yield in the combined residential mortgage portfolio and a decrease of 12 basis points in the yield on the overall consumer loan portfolio. The yield on the commercial loan portfolio decreased 124 basis points compared to the prior year quarter. Excluding the interest recoveries the yield declined 31 basis points. The decrease in the yield on the mortgage loan portfolio was due to declining rates on both new and existing adjustable rate mortgage loans, which the Company does not sell but maintains in the portfolio, while the decline in the yield on the commercial and consumer loan portfolios was due to the continuing low interest rate environment and competition for quality loans.

The average yield on total investment securities remained relatively even while the average balance of the portfolio decreased 12% for the third quarter of 2014 compared to the third quarter of 2013. The increase in the yield on investments was due primarily to amortization of mortgage-backed securities. The decrease in the portfolio was due to calls and maturities, the proceeds of which were used to fund loan growth.

## Interest Expense

Interest expense decreased by \$0.1 million or 3% in the third quarter of 2014 compared to the third quarter of 2013, primarily as a result of a 4 basis point decrease in the average rate paid on interest-bearing liabilities. Deposit activity during the third quarter was driven primarily by growth in regular savings and demand deposit accounts. Average noninterest-bearing and interest-bearing checking accounts increased \$141 million or 11% and regular savings accounts increased \$22 million or 9% as clients kept funds in short-term instruments to preserve liquidity. This growth was partially offset by a decrease in average certificates of deposit of \$27 million or 6% in the third quarter of 2014 compared to the prior year period. This decrease was primarily due to the Company's management of rates offered on certificates in an effort to preserve the Company's net interest margin during this extended period of historically low interest rates. Average balances of money market accounts remained relatively level in the third quarter of 2014 compared to the third quarter of 2013. In addition, the average rate paid on advances from the Federal Home Loan Bank of Atlanta also remained comparatively level for the third quarter of 2014 compared to the third quarter of 2013 as the Company continued to take advantage of comparatively low interest rates on short-term advances.

**Non-interest Income**

Non-interest income amounts and trends are presented in the following table for the periods indicated:

| (Dollars in thousands)                | Three Months |               | 2014/2013 |          |   |
|---------------------------------------|--------------|---------------|-----------|----------|---|
|                                       | Ended        | September 30, | \$ Change | % Change |   |
|                                       | 2014         | 2013          |           |          |   |
| Securities gains                      | \$8          | \$-           | \$8       | -        | % |
| Service charges on deposit accounts   | 2,226        | 2,171         | 55        | 2.5      |   |
| Mortgage banking activities           | 596          | (26 )         | 622       | -        |   |
| Wealth management income              | 4,974        | 4,503         | 471       | 10.5     |   |
| Insurance agency commissions          | 1,410        | 1,193         | 217       | 18.2     |   |
| Income from bank owned life insurance | 611          | 629           | (18 )     | (2.9 )   |   |
| Bank card fees                        | 1,148        | 1,077         | 71        | 6.6      |   |
| Other income                          | 1,617        | 1,676         | (59 )     | (3.5 )   |   |
| Total non-interest income             | \$12,590     | \$11,223      | \$1,367   | 12.2     |   |

Total non-interest income was \$12.6 million for the third quarter of 2014 compared to \$11.2 million for the third quarter of 2013. The primary drivers of non-interest income for the third quarter of 2014 were increases in wealth management income, insurance agency commissions and income from mortgage banking activities. Further detail by type of non-interest income follows:

Wealth management income is comprised of income from trust and estate services, investment management fees earned by West Financial Services, the Company's investment management subsidiary, and fees on sales on investment products and services. Trust services fees increased 17% compared to the prior year period, due to one-time fees and an increase in assets under management. Investment management fees in West Financial Services increased 10% for the third quarter of 2014 compared to the third quarter of 2013, also due to higher assets under management. Overall total assets under management increased to \$2.7 billion at September 30, 2014 compared to \$2.5 billion at September 30, 2013 as a result of positive market movements and additions from new clients.

Insurance agency commissions increased in 2014 compared to 2013 due primarily to an increase in sales of physicians' liability insurance.

Income from mortgage banking activities increased in 2014 compared to 2013 due to higher accrued gains on loans held for sale and related interest rate lock commitments.

Service charges on deposits increased in 2014 compared to 2013 due primarily to a decline in overdraft fees.

Income from bank owned life insurance decreased in the third quarter of 2014 compared to the third quarter of 2013 due to the decline in the interest rates paid on these policies.

Other non-interest income decreased during the third quarter of 2014 compared to the prior year period due mainly to gains on sales and dispositions of loans and fixed assets and a non-recurring legal settlement, all of which occurred in the third quarter of 2013.

- No net OTTI losses were recognized in earnings in either the third quarter of 2014 or 2013.

**Non-interest Expense**

Non-interest expense amounts and trends are presented in the following table for the periods indicated:

|  | Three Months |           | 2014/2013 |          |
|--|--------------|-----------|-----------|----------|
|  | Ended        | September | \$ Change | % Change |
| (Dollars in thousands)                     | 2014         | 2013      |           |          |
| Salaries and employee benefits             | \$16,765     | \$16,382  | \$383     | 2.3 %    |
| Occupancy expense of premises              | 3,032        | 3,149     | (117 )    | (3.7 )   |
| Equipment expenses                         | 1,337        | 1,200     | 137       | 11.4     |
| Marketing                                  | 744          | 713       | 31        | 4.3      |
| Outside data services                      | 1,231        | 1,152     | 79        | 6.9      |
| FDIC insurance                             | 594          | 678       | (84 )     | (12.4 )  |
| Amortization of intangible assets          | 115          | 462       | (347 )    | (75.1 )  |
| Litigation settlement and associated costs | 236          | -         | 236       | -        |
| Professional fees                          | 1,092        | 511       | 581       | 113.7    |
| Other real estate owned                    | 40           | (150 )    | 190       | 126.7    |
| Other expenses                             | 3,446        | 2,796     | 650       | 23.2     |
| Total non-interest expense                 | \$28,632     | \$26,893  | \$1,739   | 6.5      |

Non-interest expenses totaled \$28.6 million in 2014 compared to \$26.9 million in 2013. This increase in expenses was driven primarily by increases in professional fees, salaries and benefits and other noninterest expenses. Further detail by category of non-interest expense follows:

Salaries and benefits increased compared to the prior year quarter due to merit increases which were somewhat offset by decreases in commission and incentive compensation. Benefits expenses increased 5% due primarily to higher health insurance expense due to increased claims. This was somewhat offset by a decrease in pension expense resulting from a higher discount rate assumption and higher projected returns on plan assets. The average number of full-time equivalent employees was 712 in the third quarter of 2014 compared to 722 in the third quarter of 2013.

Occupancy expenses decreased in 2014 compared to 2013 due primarily to lower maintenance and utilities costs in the quarter. Equipment increased during the quarter due to higher amortization of software costs.

Marketing expenses remained level in the third quarter of 2014 compared to the prior year quarter.

Outside data services expenses increased compared to the prior year quarter due to growth in electronic transactions.



FDIC insurance expense decreased for the third quarter of 2014 compared to the third quarter of 2013 due to a lower assessment rate from improved financial ratios.

Intangibles amortization decreased in 2014 due to the costs of prior year acquisitions which were fully amortized during the period.

Professional fees increased in the third quarter of 2014 compared to the prior year quarter due to recovery of \$0.5 million in legal fees in the third quarter of 2013 related to previously non-performing commercial loans.

Other real estate owned expenses increased compared to the prior year period due to a gain on the sale of one property in the third quarter of 2013.

Other non-interest expenses increased in 2014 compared to the prior year quarter due to accrued expense related to performance letters of credit and losses incurred due to fraudulent bankcard charges.

### **Income Taxes**

The Company had income tax expense of \$5.4 million in the third quarter of 2014, compared to expense of \$6.4 million in the third quarter of 2013. The resulting effective rate was 33% for the third quarter of 2014 compared to 35% for the third quarter of 2013. The effective rate decreased in 2014 compared to 2013 due to tax exempt income comprising a greater proportion of income before taxes.

## Operating Expense Performance

Management views the GAAP efficiency ratio as an important financial measure of expense performance and cost management. The ratio expresses the level of non-interest expenses as a percentage of total revenue (net interest income plus total non-interest income). Lower ratios indicate improved productivity.

## Non-GAAP Financial Measures

The Company also uses a traditional efficiency ratio that is a non-GAAP financial measure of operating expense control and efficiency of operations. Management believes that its traditional ratio better focuses attention on the operating performance of the Company over time than does a GAAP ratio, and is highly useful in comparing period-to-period operating performance of the Company's core business operations. It is used by management as part of its assessment of its performance in managing non-interest expenses. However, this measure is supplemental, and is not a substitute for an analysis of performance based on GAAP measures. The reader is cautioned that the non-GAAP efficiency ratio used by the Company may not be comparable to GAAP or non-GAAP efficiency ratios reported by other financial institutions.

In general, the efficiency ratio is non-interest expenses as a percentage of net interest income plus non-interest income. Non-interest expenses used in the calculation of the non-GAAP efficiency ratio exclude goodwill impairment losses, the amortization of intangibles, and non-recurring expenses. Income for the non-GAAP ratio includes the favorable effect of tax-exempt income, and excludes securities gains and losses, which vary widely from period to period without appreciably affecting operating expenses, and non-recurring gains. The measure is different from the GAAP efficiency ratio, which also is presented in this report. The GAAP measure is calculated using non-interest expense and income amounts as shown on the face of the Consolidated Statements of Income. The GAAP and non-GAAP efficiency ratios are reconciled and provided in the following table. Both ratios increased during the third quarter of 2014 compared to the prior year quarter and during the first nine months of 2014 compared to the prior year period. The GAAP efficiency ratio increased for the year-to-date compared to the prior year period due primarily to the litigation expenses mentioned previously. This ratio increased for the third quarter of 2014 compared to the third quarter of 2013 due to the commercial loan recoveries in the third quarter of 2013. The non-GAAP efficiency ratio increased for both the quarter and year-to-date compared to the respective prior year periods due primarily to the loan recoveries mentioned above.

In addition, the Company uses pre-tax, pre-provision income as a measure of the level of recurring income before taxes. Management believes this provides financial statement users with a useful metric of the run-rate of revenues and expenses which is readily comparable to other financial institutions. This measure is calculated by adding (subtracting) the provision (credit) for loan and lease losses, and the provision for income taxes back to net income. This metric decreased in the third quarter of 2014 compared to the prior year period due primarily to recoveries of interest, late fees and legal fees, totaling \$4.5 million in the third quarter of 2013, related to previously non-performing commercial loans.



**GAAP and Non-GAAP Financial Measures**

| (Dollars in thousands)                                     | Three Months Ended |          | Nine Months Ended  |           |
|--|--------------------|----------|--------------------|-----------|
|  | September 30, 2014 | 2013     | September 30, 2014 | 2013      |
| Pre-tax pre-provision income:                              |                    |          |                    |           |
| Net income   | \$11,142           | \$12,089 | \$29,052           | \$34,809  |
| Plus non-GAAP adjustment:                                  |                    |          |                    |           |
| Litigation expenses  | 236                | -        | 6,364              | -         |
| Income taxes   | 5,428              | 6,419    | 13,496             | 18,058    |
| Provision (credit) for loan and lease losses               | (192 )             | 1,128    | (1,016 )           | (1,670 )  |
| Pre-tax pre-provision income                               | \$16,614           | \$19,636 | \$47,896           | \$51,197  |
| Efficiency ratio - GAAP basis:                             |                    |          |                    |           |
| Non-interest expenses                                      | \$28,632           | \$26,893 | \$90,322           | \$82,224  |
| Net interest income plus non-interest income               | \$45,010           | \$46,529 | \$131,854          | \$133,421 |
| Efficiency ratio - GAAP basis                              | 63.61 %            | 57.80 %  | 68.50 %            | 61.63 %   |
| Efficiency ratio - Non-GAAP basis:                         |                    |          |                    |           |
| Non-interest expenses                                      | \$28,632           | \$26,893 | \$90,322           | \$82,224  |
| Less non-GAAP adjustment:                                  |                    |          |                    |           |
| Amortization of intangible assets                          | 115                | 462      | 709                | 1,384     |
| Litigation expenses  | 236                | -        | 6,364              | -         |
| Non-interest expenses - as adjusted                        | \$28,281           | \$26,431 | \$83,249           | \$80,840  |
| Net interest income plus non-interest income               | \$45,010           | \$46,529 | \$131,854          | \$133,421 |
| Plus non-GAAP adjustment:                                  |                    |          |                    |           |
| Tax-equivalent income                                      | 1,296              | 1,344    | 3,909              | 3,967     |
| Less non-GAAP adjustments:                                 |                    |          |                    |           |
| Securities gains   | 8                  | -        | 8                  | 118       |
| Net interest income plus non-interest income - as adjusted | \$46,298           | \$47,873 | \$135,755          | \$137,270 |
| Efficiency ratio - Non-GAAP basis                          | 61.09 %            | 55.21 %  | 61.32 %            | 58.89 %   |

**FINANCIAL CONDITION**

The Company's total assets were \$4.2 billion at September 30, 2014, an increase of \$143 million or 3% compared to \$4.1 billion at December 31, 2013. Interest-earning assets increased \$140 million to \$4.0 billion at September 30, 2014 compared to December 31, 2013. The increase in interest-earning assets was primarily due to organic growth in the loan portfolio which was funded by deposit growth.



## Analysis of Loans and Leases

A comparison of the loan portfolio at the dates indicated is presented in the following table:

| (Dollars in thousands)                               | September 30,<br>2014 |        | December 31, 2013 |        | Period-to-Period<br>Change |             |
|--|-----------------------|--------|-------------------|--------|----------------------------|-------------|
|  | Amount                | %      | Amount            | %      | \$ Change                  | %<br>Change |
| Residential real estate:                             |                       |        |                   |        |                            |             |
| Residential mortgage                                 | \$698,925             | 23.5 % | \$618,381         | 22.2 % | \$80,544                   | 13.0 %      |
| Residential construction                             | 141,883               | 4.8    | 129,177           | 4.7    | 12,706                     | 9.8         |
| Commercial real estate:                              |                       |        |                   |        |                            |             |
| Commercial owner occupied real estate                | 584,964               | 19.6   | 592,823           | 21.3   | (7,859 )                   | (1.3 )      |
| Commercial investor real estate                      | 575,984               | 19.4   | 552,178           | 19.8   | 23,806                     | 4.3         |
| Commercial acquisition, development and construction | 194,666               | 6.5    | 160,696           | 5.8    | 33,970                     | 21.1        |
| Commercial Business                                  | 368,611               | 12.4   | 356,651           | 12.8   | 11,960                     | 3.4         |
| Leases   | 156                   | -      | 703               | -      | (547 )                     | (77.8 )     |
| Consumer   | 410,723               | 13.8   | 373,657           | 13.4   | 37,066                     | 9.9         |
| Total loans and leases                               | \$2,975,912           | 100.0% | \$2,784,266       | 100.0% | \$191,646                  | 6.9         |

Total loans and leases, excluding loans held for sale, increased \$192 million or 7% at September 30, 2014 compared to December 31, 2013. The commercial loan portfolio increased \$62 million or 4% at September 30, 2014 compared to the prior year end largely due to increases in investor real estate and ADC loans. These trends reflect both an improving economy and increased competition in the Company's marketplace for quality commercial loans.

The residential real estate portfolio, which is comprised of residential construction and permanent residential mortgage loans, reflected a 12% increase at September 30, 2014 compared to December 31, 2013. Permanent residential mortgages, most of which are 1-4 family, increased 13% due to higher loan origination volumes of adjustable rate and non-saleable mortgage loans which the Company elected to retain in its portfolio. The Company generally retains adjustable rate mortgages in its portfolio and sells the fixed rate mortgages that it originates in the secondary mortgage market whenever possible. Residential construction loans increased 10% at September 30, 2014 compared to the balance at December 31, 2013 due to increased construction activity as a result of a slowly improving economy.

The consumer loan portfolio increased 10% at September 30, 2014 compared to December 31, 2013 due to growth in home equity lines of credit as the Company continued to aggressively promote this product line.

## Analysis of Investment Securities

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The composition of investment securities at the periods indicated is presented in the following table:

| (Dollars in thousands)                    | <b>September 30,<br/>2014</b> |        | December 31, 2013 |        | Period-to-Period<br>Change |             |   |
|---|-------------------------------|--------|-------------------|--------|----------------------------|-------------|---|
|   | Amount                        | %      | Amount            | %      | \$<br>Change               | %<br>Change |   |
| U.S. government agencies and corporations | \$140,716                     | 14.8   | % \$139,466       | 13.7   | % \$1,250                  | 0.9         | % |
| State and municipal                       | 167,585                       | 17.6   | 165,428           | 16.3   | 2,157                      | 1.3         |   |
| Mortgage-backed                           | 379,904                       | 40.1   | 442,250           | 43.5   | (62,346)                   | (14.1)      | ) |
| Corporate debt                            | 2,002                         | 0.2    | 2,004             | 0.2    | (2)                        | (0.1)       | ) |
| Trust preferred                           | 1,177                         | 0.1    | 1,413             | 0.1    | (236)                      | (16.7)      | ) |
| Marketable equity securities              | 723                           | -      | 723               | -      | -                          | -           |   |
| Total available-for-sale                  | 692,107                       | 72.8   | 751,284           | 73.8   | (59,177)                   | (7.9)       | ) |
| Held-to-Maturity and Other Equity         |                               |        |                   |        |                            |             |   |
| U.S. government agencies and corporations | 64,510                        | 6.8    | 64,505            | 6.4    | 5                          | -           |   |
| State and municipal                       | 156,971                       | 16.5   | 159,889           | 15.8   | (2,918)                    | (1.8)       | ) |
| Mortgage-backed                           | 209                           | -      | 244               | -      | (35)                       | (14.3)      | ) |
| Other equity securities                   | 37,072                        | 3.9    | 40,687            | 4.0    | (3,615)                    | (8.9)       | ) |
| Total held-to-maturity and other equity   | 258,762                       | 27.2   | 265,325           | 26.2   | (6,563)                    | (2.5)       | ) |
| Total securities                          | \$950,869                     | 100.0% | \$1,016,609       | 100.0% | \$(65,740)                 | (6.5)       | ) |

Available-for-sale securities decreased 8% at September 30, 2014 compared to December 31, 2013 due to amortization of mortgage-backed securities and maturities of other investments, while held-to-maturity securities remained virtually level compared to the prior year-end.

The investment portfolio consists primarily of U.S. Agency securities, U.S. Agency mortgage-backed securities, U.S. Agency collateralized mortgage obligations and state and municipal securities. The duration of the portfolio was 3.5 years at September 30, 2014 and 3.9 years at December 31, 2013. The Company considers the duration of the portfolio to be adequate for liquidity purposes. This investment strategy has resulted in a portfolio with low credit risk that would provide the required liquidity needed to meet increased loan demand. The portfolio is monitored on a continuing basis with consideration given to interest rate trends and the structure of the yield curve and with constant assessment of economic projections and analysis.

At September 30, 2014, the trust preferred portfolio included one pooled trust preferred security backed by debt issued by banks and thrifts, which totaled \$1.3 million, with a fair value of \$1.2 million. The fair value of this security was determined by a third party valuation specialist due to the limited trading activity for this security in the marketplace. The specialist used an income valuation approach technique (present value) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. The methodology, observable inputs and significant assumptions employed by the specialist to determine fair value are provided in Note 2 – Investments in the Notes to the Condensed Consolidated Financial Statements.

As a result of this valuation, it was determined that the pooled trust preferred security had not incurred any credit-related OTTI for the three months ended September 30, 2014. Cumulative credit-related OTTI of \$0.5 million has been recognized in earnings through September 30, 2014. Non-credit related OTTI on this security, which is not expected to be sold and which the Company has the ability to hold until maturity, was \$0.2 million at September 30, 2014. This non-credit related

OTTI was recognized in accumulated other comprehensive income (“OCI”) at September 30, 2014.

### **Other Earning Assets**

Residential mortgage loans held for sale at September 30, 2014 totaled \$7 million compared to \$8 million at December 31, 2013. The aggregate of federal funds sold and interest-bearing deposits with banks increased \$16 million to \$43 million at September 30, 2014 compared to December 31, 2013.

### **Deposits**



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The composition of deposits at the periods indicated is presented in the following table:

| (Dollars in thousands)               | September 30, 2014 |        | December 31, 2013 |        | Period-to-Period Change |          |   |
|--------------------------------------|--------------------|--------|-------------------|--------|-------------------------|----------|---|
|                                      | Amount             | %      | Amount            | %      | \$ Change               | % Change |   |
| Noninterest-bearing deposits         | \$986,549          | 32.6   | \$836,198         | 29.1   | \$150,351               | 18.0     | % |
| Interest-bearing deposits:           |                    |        |                   |        |                         |          |   |
| Demand                               | 485,112            | 16.0   | 460,824           | 16.0   | 24,288                  | 5.3      |   |
| Money market savings                 | 846,625            | 28.0   | 870,653           | 30.2   | (24,028 )               | (2.8 )   |   |
| Regular savings                      | 259,848            | 8.5    | 243,813           | 8.5    | 16,035                  | 6.6      |   |
| Time deposits of less than \$100,000 | 244,085            | 8.0    | 263,636           | 9.2    | (19,551 )               | (7.4 )   |   |
| Time deposits of \$100,000 or more   | 206,569            | 6.9    | 202,101           | 7.0    | 4,468                   | 2.2      |   |
| Total interest-bearing deposits      | 2,042,239          | 67.4   | 2,041,027         | 70.9   | 1,212                   | 0.1      |   |
| Total deposits                       | \$3,028,788        | 100.0% | \$2,877,225       | 100.0% | \$151,563               | 5.3      |   |

Total deposits increased \$152 million or 5% at September 30, 2014 compared to December 31, 2013. This increase was due primarily to increases in combined noninterest-bearing and interest-bearing checking accounts together with regular savings. These increases were somewhat offset by a decline in certificates of deposit, as the Company managed its deposit mix. From a funding perspective, the overall increase in deposits enabled the Company to fund loan growth and decrease borrowings at September 30, 2014 compared to December 31, 2013.

## Capital Management

Management monitors historical and projected earnings, dividends and asset growth, as well as risks associated with the various types of on and off-balance sheet assets and liabilities, in order to determine appropriate capital levels. During the third quarter of 2014, total stockholders' equity increased \$23 million to \$522 million at September 30, 2014, from \$499 million at December 31, 2013. This increase was due primarily to net income during the year. The ratio of average equity to average assets was 12.28% for the first nine months of 2014, as compared to 12.19% for the first nine months of 2013.

Bank holding companies and banks are required to maintain capital ratios in accordance with guidelines adopted by the federal bank regulators. These guidelines are commonly known as Risk-Based Capital guidelines. The actual regulatory ratios and required ratios for capital adequacy, in addition to the ratios required to be categorized as "well capitalized", are summarized for the Company in the following table.

## Risk-Based Capital Ratios

|  | Ratios at                |                      |   | Minimum<br>Regulatory |   |
|--|--------------------------|----------------------|---|-----------------------|---|
|  | September<br>30,<br>2014 | December<br>31, 2013 |   | Requirements          |   |
| Total Capital to risk-weighted assets  | 15.68%                   | 15.65%               | % | 8.00                  | % |
| Tier 1 Capital to risk-weighted assets | 14.52%                   | 14.42%               | % | 4.00                  | % |
| Tier 1 Leverage                        | 11.36%                   | 11.32%               | % | 3.00                  | % |

Tier 1 capital of \$470 million and total qualifying capital of \$508 million each included \$35.0 million in trust preferred securities that are considered regulatory capital for purposes of determining the Company's Tier 1 capital ratio. As of September 30, 2014, the most recent notification from the Bank's primary regulator categorized the Bank as a "well-capitalized" institution under the prompt corrective action rules of the Federal Deposit Insurance Act. Designation as a well-capitalized institution under these regulations is not a recommendation or endorsement of the Company or the Bank by federal bank regulators.

In July 2013, the Federal Reserve Board approved revisions to its capital adequacy guidelines and prompt corrective action rules that implement the revised standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of the Dodd-Frank Act. The rules include new risk-based capital and leverage ratios, which are effective January 1, 2015, and revise the definition of what constitutes “capital” for calculating those ratios. The new minimum capital level requirements applicable to the Company and the Bank will be: (1) a new common equity Tier 1 capital ratio of 4.5%; (2) a Tier 1 capital ratio of 6% (increased from 4%); (3) a total capital ratio of 8% (unchanged from current rules); and (4) a Tier 1 leverage ratio of 4%. The rules eliminate the inclusion of certain instruments, such as trust preferred securities, from Tier 1 capital. Instruments issued prior to May 19, 2010 will be grandfathered for companies with consolidated assets of \$15 billion or less. The rules also establish a “capital conservation buffer” of 2.5% above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital. The new capital conservation buffer requirement will be phased in beginning in January 2016 at 0.625% of risk-weighted assets and will increase by that amount each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses to executive officers if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such action.

**Tangible Common Equity**

Tangible equity, tangible assets and tangible book value per share are non-GAAP financial measures calculated using GAAP amounts. Tangible common equity and tangible assets exclude the balances of goodwill and other intangible assets from stockholder's equity and total assets, respectively. Management believes that this non-GAAP financial measure provides information to investors that may be useful in understanding our financial condition. Because not all companies use the same calculation of tangible equity and tangible assets, this presentation may not be comparable to other similarly titled measures calculated by other companies. A reconciliation of the non-GAAP ratio of tangible equity to tangible assets and tangible book value per share is provided in the following table.

**Tangible Common Equity Ratio – Non-GAAP**

| (Dollars in thousands, except per share data) | September<br>30, 2014 | December<br>31, 2013 |
|---|-----------------------|----------------------|
| Tangible common equity ratio:                 |                       |                      |
| Total stockholders' equity                    | \$522,404             | \$499,363            |
| Accumulated other comprehensive income (loss) | (3,632 )              | 2,970                |
| Goodwill                                      | (84,171 )             | (84,171 )            |
| Other intangible assets, net                  | (622 )                | (1,330 )             |
| Tangible common equity                        | \$433,979             | \$416,832            |
|   |                       |                      |
| Total assets                                  | \$4,248,731           | \$4,106,100          |
| Goodwill                                      | (84,171 )             | (84,171 )            |
| Other intangible assets, net                  | (622 )                | (1,330 )             |
| Tangible assets                               | \$4,163,938           | \$4,020,599          |
|   |                       |                      |
| Tangible common equity ratio                  | 10.42 %               | 10.37 %              |
|   |                       |                      |
| Tangible book value per share                 | \$17.31               | \$16.68              |
|   | 25,076,794            | 24,990,021           |

**Credit Risk**

The fundamental lending business of the Company is based on understanding, measuring and controlling the credit risk inherent in the loan portfolio. The Company's loan and lease portfolio is subject to varying degrees of credit risk. Credit risk entails both general risks, which are inherent in the process of lending, and risk specific to individual borrowers. The Company's credit risk is mitigated through portfolio diversification, which limits exposure to any single customer, industry or collateral type. Typically, each consumer and residential lending product has a generally predictable level of credit losses based on historical loss experience. Home mortgage and home equity loans and lines

generally have the lowest credit loss experience. Loans secured by personal property, such as auto loans, generally experience medium credit losses. Unsecured loan products, such as personal revolving credit, have the highest credit loss experience and for that reason, the Company has chosen not to engage in a significant amount of this type of lending. Credit risk in commercial lending can vary significantly, as losses as a percentage of outstanding loans can shift widely during economic cycles and are particularly sensitive to changing economic conditions. Generally, improving economic conditions result in improved operating results on the part of commercial customers, enhancing their ability to meet their particular debt service requirements. Improvements, if any, in operating cash flows can be offset by the impact of rising interest rates that may occur during improved economic times. Inconsistent economic conditions may have an adverse effect on the operating results of commercial customers, reducing their ability to meet debt service obligations.

Current economic data has shown that the Mid-Atlantic region remains one of the stronger markets in the nation. While the Company deals with the effects of a very slow and uneven economic recovery and its resulting effects on its borrowers, it continues to seek relationship opportunities, particularly in the real estate sector. Total non-performing loans increased 9% to \$44 million at September 30, 2014 compared to the balance at December 31, 2013 due to several owner-occupied commercial real estate loans that moved to non-accrual status during the period. While the diversification of the lending portfolio among different commercial, residential and consumer product lines along with different market conditions of the D.C. suburbs, Northern Virginia and Baltimore metropolitan area has mitigated some of the risks in the portfolio, local economic conditions and levels of non-performing loans may continue to be influenced by the economic activity being experienced in various business sectors on both a regional and national level.

To control and manage credit risk, management has a credit process in place to reasonably ensure that credit standards are maintained along with an in-house loan administration accompanied by oversight and review procedures. The primary purpose of loan underwriting is the evaluation of specific lending risks and involves the analysis of the borrower's ability to service the debt as well as the assessment of the value of the underlying collateral. Oversight and review procedures include the monitoring of portfolio credit quality, early identification of potential problem credits and the aggressive management of problem credits. As part of the oversight and review process, the Company maintains an allowance for loan and lease losses (the "allowance").

The allowance represents an estimation of the losses that are inherent in the loan and lease portfolio. The adequacy of the allowance is determined through careful and ongoing evaluation of the credit portfolio, and involves consideration of a number of factors, as outlined below, to establish an adequate allowance for loan losses. Determination of the allowance is inherently subjective and requires significant estimates, including estimated losses on pools of homogeneous loans and leases based on historical loss experience and consideration of current economic trends, which may be susceptible to significant change. Loans and leases deemed uncollectible are charged against the allowance, while recoveries are credited to the allowance. Management adjusts the level of the allowance through the provision for loan and lease losses, which is recorded as a current period operating expense.

The methodology for assessing the appropriateness of the allowance includes: (1) a general allowance that reflects historical losses, as adjusted, by credit category, and (2) a specific allowance for impaired credits on an individual or portfolio basis. This methodology is further described in the section entitled "Critical Accounting Policies" and in "Note 1 – Significant Accounting Policies" of the Notes to the Consolidated Financial Statements. The amount of the allowance is reviewed monthly and approved quarterly by the Credit and Investment Risk Committee of the board of directors.

The Company recognizes a collateral dependent lending relationship as non-performing when either the loan becomes 90 days delinquent or as a result of factors (such as bankruptcy, interruption of cash flows, etc.) considered at the monthly credit committee meeting. When a commercial loan is placed on non-accrual status, it is considered to be impaired and all accrued but unpaid interest is reversed. Classification as an impaired loan is based on a determination that the Company may not collect all principal and interest payments according to contractual terms. Impaired loans exclude large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment such as leases, residential real estate and consumer loans. Typically, all payments received on non-accrual loans are applied to the remaining principal balance of the loans. Integral to the assessment of the allowance process is an evaluation that is performed to determine whether a specific allowance on an impaired loan is warranted and, when losses are confirmed, a charge-off is taken to reduce the loan to its net realizable value. Any further collateral deterioration results in either further specific allowances being established or additional charge-offs. At such time an action plan is agreed upon for the particular loan and an appraisal will be ordered depending on the time elapsed since the prior appraisal, the loan balance and/or the result of the internal evaluation. A current appraisal on large loans is usually obtained if the appraisal on file is more than 12 months old and there has been a material change in market conditions, zoning, physical use or the adequacy of the collateral based on an internal evaluation.

The Company's policy is to strictly adhere to regulatory appraisal standards. If an appraisal is ordered, no more than a 30 day turnaround is requested from the appraiser, who is selected by Credit Administration from an approved appraiser list. After receipt of the updated appraisal, the assigned credit officer will recommend to the Chief Credit Officer whether a specific allowance or a charge-off should be taken. The Chief Credit Officer has the authority to approve a specific allowance or charge-off between monthly credit committee meetings to insure that there are no significant time lapses during this process.

The Company's methodology for evaluating whether a loan is impaired begins with risk-rating credits on an individual basis and includes consideration of the borrower's overall financial condition, payment record and available cash resources that may include the sufficiency of collateral value and, in a select few cases, verifiable support from financial guarantors. In measuring impairment, the Company looks primarily to the discounted cash flows of the project itself or to the value of the collateral as the primary sources of repayment of the loan. The Company may consider the existence of guarantees and the financial strength and wherewithal of the guarantors involved in any loan relationship. Guarantees may be considered as a source of repayment based on the guarantor's financial condition and respective payment capacity. Accordingly, absent a verifiable payment capacity, a guarantee alone would not be sufficient to avoid classifying the loan as impaired.

Management has established a credit process that dictates that structured procedures be performed to monitor these loans between the receipt of an original appraisal and the updated appraisal. These procedures include the following:

- An internal evaluation is updated quarterly to include borrower financial statements and/or cash flow projections.

- The borrower may be contacted for a meeting to discuss an updated or revised action plan which may include a request for additional collateral.

- Re-verification of the documentation supporting the Company's position with respect to the collateral securing the loan.

- At the monthly credit committee meeting the loan may be downgraded and a specific allowance may be decided upon in advance of the receipt of the appraisal.

- Upon receipt of the updated appraisal (or based on an updated internal financial evaluation) the loan balance is compared to the appraisal and a specific allowance is decided upon for the particular loan, typically for the amount of the difference between the appraisal and the loan balance.

The Company will specifically reserve for or charge-off the excess of the loan amount over the amount of the appraisal net of closing costs. In certain cases the Company may establish a larger reserve due to knowledge of current market conditions or the existence of an offer for the collateral that will facilitate a more timely resolution of the loan.

If an updated appraisal is received subsequent to the preliminary determination of a specific allowance or partial charge-off, and it is less than the initial appraisal used in the initial charge-off, an additional specific allowance or charge-off is taken on the related credit. Partially charged-off loans are not written back up based on updated appraisals and always remain on non-accrual with any and all subsequent payments applied to the remaining balance of the loan as principal reductions. No interest income is recognized on loans that have been partially charged-off.

Loans that have their terms restructured (e.g., interest rates, loan maturity date, payment and amortization period, etc.) in circumstances that provide payment relief or other concessions, to a borrower experiencing financial difficulty are considered troubled debt restructured loans (TDR's). All restructurings that constitute concessions to a borrower experiencing financial difficulties are considered impaired loans and may either be in accruing status or non-accruing status. Non-accruing restructured loans may return to accruing status provided there is a sufficient period of payment performance in accordance with the restructure terms. Loans may be removed from disclosure as an impaired loan in the year subsequent to the restructuring if their revised loans terms are considered to be consistent with terms that can be obtained in the credit market for loans with comparable risk.



The Company may extend the maturity of a performing or current loan that may have some inherent weakness associated with the loan. However, the Company generally follows a policy of not extending maturities on non-performing loans under existing terms. Maturity date extensions only occur under revised terms that clearly place the Company in a position to increase the likelihood of or assure full collection of the loan under the contractual terms and /or terms at the time of the extension that may eliminate or mitigate the inherent weakness in the loan. These terms may incorporate, but are not limited to additional assignment of collateral, significant balance curtailments/liquidations and assignments of additional project cash flows. Guarantees may be a consideration in the extension of loan maturities. As a general matter, the Company does not view extension of a loan to be a satisfactory approach to resolving non-performing credits. On an exception basis, certain performing loans that have displayed some inherent weakness in the underlying collateral values, an inability to comply with certain loan covenants which are not affecting the performance of the credit or other identified weakness may be extended.

Collateral values or estimates of discounted cash flows (inclusive of any potential cash flow from guarantees) are evaluated to estimate the probability and severity of potential losses. The actual occurrence and severity of losses involving impaired credits can differ substantially from estimates.

The determination of the allowance requires significant judgment, and estimates of probable losses in the loan and lease portfolio can vary significantly from the amounts actually observed. While management uses available information to recognize probable losses, future additions to the allowance may be necessary based on changes in the credits comprising the portfolio and changes in the financial condition of borrowers, such as may result from changes in economic conditions. In addition, federal and state regulatory agencies, as an integral part of their examination process, and independent consultants engaged by the Bank, periodically review the loan and lease portfolio and the allowance. Such reviews may result in adjustments to the allowance based upon their analysis of the information available at the time of each examination.

The Company makes provisions for loan and lease losses in amounts necessary to maintain the allowance at an appropriate level, as established by use of the allowance methodology previously discussed. The provision for loan and lease losses was a credit of \$1.0 million for the first nine months of 2014 compared to a credit of \$1.7 million for the first nine months of 2013. Historical net charge-offs represent a principal component in the application of the Company's allowance methodology. The timing of confirmed losses compared to that of the related historical period was the primary driver of the change in the provision for the first nine months of 2014 compared to the prior year period.

Substantially all of the fixed-rate residential mortgage loans originated by the Company are sold in the secondary mortgage market. Concurrent with such sales, the Company is required to make customary representations and warranties to the purchasers about the mortgage loans and the manner in which they were originated. The related sale agreements grant the purchasers recourse back to the Company, which could require the Company to repurchase loans or to share in any losses incurred by the purchasers. This recourse exposure typically extends for a period of three to nine months after the sale of the loan although the time frame for repurchase requests can extend for an indefinite period. Such transactions could be due to a number of causes including borrower fraud or early payment default. The Company has seen a very limited number of repurchase and indemnity demands from purchasers for such events and routinely monitors its exposure in this regard. The Company maintains a liability of \$0.5 million for probable losses due to repurchases. The Company believes that this reserve is adequate.

#### **Allowance for Loan and Lease Losses**

During the third quarter of 2014, there were no changes in the Company's methodology for assessing the appropriateness of the allowance for loan and lease losses from the prior year. Variations can occur over time in the estimation of the adequacy of the allowance as a result of the credit performance of borrowers. No portion of the allowance was unallocated at September 30, 2014 or December 31, 2013.

At September 30, 2014, total non-performing loans and leases were \$43.7 million, or 1.47% of total loans and leases, compared to \$40.0 million, or 1.44% of total loans and leases, at December 31, 2013. This increase was due to several owner-occupied commercial real estate loans that moved to non-accrual status during the period. Timely recognition

and aggressive management of problem credits has enabled the Company to limit the migration of problem loans into non-accrual status. The allowance represented 86% of non-performing loans and leases at September 30, 2014 as compared to 97% at December 31, 2013. The decrease in this ratio was due primarily to the increase in non-performing loans and leases mentioned previously. The allowance for loan and lease losses as a percent of total loans and leases was 1.26% at September 30, 2014 as compared to 1.39% at December 31, 2013. This decrease was due to a combination of loan growth and the impact of the decline in historical losses on the allowance calculation at September 30, 2014 compared to the prior year end.

Continued analysis of the actual loss history on the problem credits in 2013 and 2014 provided an indication that the coverage of the inherent losses on the problem credits was adequate. The Company continues to monitor the impact of the economic conditions on our commercial customers, the reduced inflow of non-accruals, lower inflow in criticized loans and the significant decline in early stage delinquencies. The improvement in these credit metrics supports management's outlook for continued improved credit quality performance.

The balance of impaired loans was \$38.6 million, with specific allowances of \$4.3 million against those loans at September 30, 2014, as compared to \$32.5 million with allowances of \$3.1 million, at December 31, 2013.

The Company's borrowers are concentrated in nine counties in Maryland, three counties in Virginia and in Washington D.C. Commercial and residential mortgages, including home equity loans and lines, represented 76% of total loans and leases at September 30, 2014 and at December 31, 2013. Certain loan terms may create concentrations of credit risk and increase the Company's exposure to loss. These include terms that permit the deferral of principal payments or payments that are smaller than normal interest accruals (negative amortization); loans with high loan-to-value ratios; loans, such as option adjustable-rate mortgages, that may expose the borrower to future increases in repayments that are in excess of increases that would result solely from increases in market interest rates; and interest-only loans. The Company does not make loans that provide for negative amortization or option adjustable-rate mortgages.

**Summary of Loan and Lease Loss Experience**

The following table presents the activity in the allowance for loan and lease losses for the periods indicated:

| (Dollars in thousands)                                 | Nine<br>Months<br>Ended<br>September<br>30, 2014 | Year<br>Ended<br>December<br>31, 2013 |      |   |
|--|--|---------------------------------------|------|---|
| Analysis of Allowance for Loan Losses:                 |  |                                       |      |   |
| Balance, January 1                                     | \$ 38,766  | \$ 42,957                             |      |   |
| Provision (credit) for loan and lease losses           | (1,016 )   | (1,084 )                              |      |   |
| Charge-offs:   |  |                                       |      |   |
| Commercial business                                    | (225 )   | (2,915 )                              |      |   |
| Commercial real estate:                                |  |                                       |      |   |
| Commercial acquisition, development and construction   | -  | (85 )                                 |      |   |
| Commercial investor real estate                        | (4 )   | (4,774 )                              |      |   |
| Commercial owner occupied real estate                  | (265 )   | (240 )                                |      |   |
| Leasing  | -  | -                                     |      |   |
| Consumer   | (720 )   | (1,853 )                              |      |   |
| Residential real estate:                               |  |                                       |      |   |
| Residential mortgage                                   | (324 )   | (1,194 )                              |      |   |
| Residential construction                               | (3 )   | (104 )                                |      |   |
| Total charge-offs                                      | (1,541 )   | (11,165 )                             |      |   |
| Recoveries:  |  |                                       |      |   |
| Commercial business                                    | 1,023  | 818                                   |      |   |
| Commercial real estate:                                |  |                                       |      |   |
| Commercial acquisition, development and construction   | -  | 3,080                                 |      |   |
| Commercial investor real estate                        | 34   | 3,354                                 |      |   |
| Commercial owner occupied real estate                  | -  | 425                                   |      |   |
| Leasing  | -  | 10                                    |      |   |
| Consumer   | 134  | 198                                   |      |   |
| Residential real estate:                               |  |                                       |      |   |
| Residential mortgage                                   | 105  | 162                                   |      |   |
| Residential construction                               | 69   | 11                                    |      |   |
| Total recoveries                                       | 1,365  | 8,058                                 |      |   |
| Net charge-offs  | (176 )   | (3,107 )                              |      |   |
| Balance at end of period                               | \$ 37,574  | \$ 38,766                             |      |   |
| Allowance for loan losses to loans                     | 1.26   | %                                     | 1.39 | % |
| Annualized net charge-offs to average loans and leases | 0.01   | %                                     | 0.12 | % |

**Analysis of Credit Risk**

The following table presents information with respect to non-performing assets and 90-day delinquencies for the periods indicated:

|   | September<br>30,<br>2014 | December<br>31,<br>2013 |
|---|--------------------------|-------------------------|
| (Dollars in thousands)                    |                          |                         |
| Non-Performing Assets:                    |                          |                         |
| Loans and leases 90 days past due:        |                          |                         |
| Commercial business                       | \$ -                     | \$ -                    |
| Commercial real estate:                   |                          |                         |
| Commercial AD&C                           | -                        | -                       |
| Commercial investor real estate           | -                        | -                       |
| Commercial owner occupied real estate     | 649                      | -                       |
| Leasing                                   | -                        | -                       |
| Consumer                                  | 6                        | 1                       |
| Residential real estate:                  |                          |                         |
| Residential mortgage                      | -                        | -                       |
| Residential construction                  | -                        | -                       |
| Total loans and leases 90 days past due   | 655                      | 1                       |
| Non-accrual loans and leases:             |                          |                         |
| Commercial business                       | 4,151                    | 3,400                   |
| Commercial real estate:                   |                          |                         |
| Commercial AD&C                           | 3,792                    | 4,127                   |
| Commercial investor real estate           | 8,210                    | 6,802                   |
| Commercial owner occupied real estate     | 10,742                   | 5,936                   |
| Leasing                                   | -                        | -                       |
| Consumer                                  | 1,830                    | 2,259                   |
| Residential real estate:                  |                          |                         |
| Residential mortgage                      | 4,417                    | 5,735                   |
| Residential construction                  | 2,497                    | 2,315                   |
| Total non-accrual loans and lease         | 35,639                   | 30,574                  |
| Total restructured loans - accruing       | 7,382                    | 9,459                   |
| Total non-performing loans and leases     | 43,676                   | 40,034                  |
| Other assets and real estate owned (OREO) | 1,762                    | 1,338                   |
| Total non-performing assets               | \$ 45,438                | \$ 41,372               |

## Market Risk Management

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

The Company's interest rate risk management goals are (1) to increase net interest income at a growth rate consistent with the growth rate of total assets, and (2) to minimize fluctuations in net interest margin as a percentage of interest-earning assets. Management attempts to achieve these goals by balancing, within policy limits, the volume of floating-rate liabilities with a similar volume of floating-rate assets; by keeping the average maturity of fixed-rate asset and liability contracts reasonably matched; by maintaining a pool of administered core deposits; and by adjusting pricing rates to market conditions on a continuing basis.

The Company's board of directors has established a comprehensive interest rate risk management policy, which is administered by management's Asset Liability Management Committee ("ALCO"). The policy establishes limits on risk, which are quantitative measures of the percentage change in net interest income (a measure of net interest income at risk) and the fair value of equity capital (a measure of economic value of equity or "EVE" at risk) resulting from a hypothetical change in U.S. Treasury interest rates for maturities from one day to thirty years. The Company measures the potential adverse impacts that changing interest rates may have on its short-term earnings, long-term value, and liquidity by employing simulation analysis through the use of computer modeling. The simulation model captures optionality factors such as call features and interest rate caps and floors imbedded in investment and loan portfolio contracts. As with any method of gauging interest rate risk, there are certain shortcomings inherent in the interest rate modeling methodology used by the Company. When interest rates change, actual movements in different categories of interest-earning assets and interest-bearing liabilities, loan prepayments, and withdrawals of time and other deposits, may deviate significantly from assumptions used in the model. As an example, certain money market deposit accounts are assumed to reprice at 100% of the interest rate change in each of the up rate shock scenarios even though this is not a contractual requirement. As a practical matter, management would likely lag the impact of any upward movement in market rates on these accounts as a mechanism to manage the bank's net interest margin. Finally, the methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan customers' ability to service their debts, or the impact of rate changes on demand for loan, lease, and deposit products.

The Company prepares a current base case and eight alternative simulations at least once a quarter and reports the analysis to the board of directors. In addition, more frequent forecasts are produced when interest rates are particularly uncertain or when other business conditions so dictate.

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

The Company augments its quarterly interest rate shock analysis with alternative external interest rate scenarios on a monthly basis. These alternative interest rate scenarios may include non-parallel rate ramps and non-parallel yield curve twists. If a measure of risk produced by the alternative simulations of the entire balance sheet violates policy guidelines, ALCO is required to develop a plan to restore the measure of risk to a level that complies with policy limits within two quarters.

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

**Estimated Changes in Net Interest Income**

|                           |             |             |             |             |             |             |            |            |
|---------------------------|-------------|-------------|-------------|-------------|-------------|-------------|------------|------------|
| Change in Interest Rates: | + 400<br>bp | + 300<br>bp | + 200<br>bp | + 100<br>bp | - 100<br>bp | - 200<br>bp | -300<br>bp | -400<br>bp |
| Policy Limit              | 23.50%      | 17.50%      | 15.00%      | 10.00%      | 10.00%      | 15.00%      | 17.50%     | 23.50%     |
| September 30, 2014        | (3.67)%     | (1.53)%     | (0.07)%     | (0.15)%     | N/A         | N/A         | N/A        | N/A        |
| December 31, 2013         | (7.20)%     | (4.14)%     | (1.63)%     | (0.88)%     | N/A         | N/A         | N/A        | N/A        |

As shown above, measures of net interest income at risk improved from December 31, 2013 at all rising interest rate shock levels. All measures remained well within prescribed policy limits.

The decrease in the risk position with respect to net interest income from December 31, 2013 to September 30, 2014 was the result of an increase in interest-bearing deposits with banks, which will reprice immediately should rates rise in the future. Contributing to the decreased risk position is the decline in short-term FHLB borrowings which reduces the Company's exposure to increases in interest rates, in addition to an increase in short-term loans, which is beneficial in a rising interest rate environment.

The measures of equity value at risk indicate the ongoing economic value of the Company by considering the effects of changes in interest rates on all of the Company's cash flows, and by discounting the cash flows to estimate the present value of assets and liabilities. The difference between these discounted values of the assets and liabilities is the economic value of equity, which, in theory, approximates the fair value of the Company's net assets.

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

|                           |             |             |             |             |             |             |            |            |
|---------------------------|-------------|-------------|-------------|-------------|-------------|-------------|------------|------------|
| Change in Interest Rates: | + 400<br>bp | + 300<br>bp | + 200<br>bp | + 100<br>bp | - 100<br>bp | - 200<br>bp | -300<br>bp | -400<br>bp |
| Policy Limit              | 35.00%      | 25.00%      | 20.00%      | 10.00%      | 10.00%      | 20.00%      | 25.00%     | 35.00%     |
| September 30, 2014        | (10.73)%    | (7.42)%     | (4.47)%     | (2.01)%     | N/A         | N/A         | N/A        | N/A        |
| December 31, 2013         | (15.27)%    | (10.86)%    | (6.21)%     | (2.15)%     | N/A         | N/A         | N/A        | N/A        |

Measures of the economic value of equity ("EVE") at risk improved from December 31, 2013 to September 30, 2014 in all rising shock scenarios. The significant positive impact in EVE was driven by higher core deposit balances in noninterest-bearing and interest-bearing checking accounts and regular savings accounts resulting in increased premiums should rates increase. Shorter durations in the investment portfolio are also a contributing factor to the reduced risk in EVE.

**Liquidity Management**



Liquidity is measured by a financial institution's ability to raise funds through loan and lease repayments, maturing investments, deposit growth, borrowed funds, capital and the sale of highly marketable assets such as investment securities and residential mortgage loans. The Company's liquidity position, considering both internal and external sources available, exceeded anticipated short-term and long-term needs at September 30, 2014. Management considers core deposits, defined to include all deposits other than time deposits of \$100 thousand or more, to be a relatively stable funding source. Core deposits equaled 71% of total interest-earning assets at September 30, 2014. In addition, loan and lease payments, maturities, calls and pay downs of securities, deposit growth and earnings contribute a flow of funds available to meet liquidity requirements. In assessing liquidity, management considers operating requirements, the seasonality of deposit flows, investment, loan and deposit maturities and calls, expected funding of loans and deposit withdrawals, and the market values of available-for-sale investments, so that sufficient funds are available on short notice to meet obligations as they arise and to ensure that the Company is able to pursue new business opportunities.

Liquidity is measured using an approach designed to take into account, in addition to factors already discussed above, the Company's growth and mortgage banking activities. Also considered are changes in the liquidity of the investment portfolio due to fluctuations in interest rates. Under this approach, implemented by the Funds Management Subcommittee of ALCO under formal policy guidelines, the Company's liquidity position is measured weekly, looking forward at thirty day intervals from thirty (30) to three hundred sixty (360) days. The measurement is based upon the projection of funds sold or purchased position, along with ratios and trends developed to measure dependence on purchased funds and core growth. Resulting projections as of September 30, 2014, show short-term investments exceeding short-term borrowings by \$25 million over the subsequent 360 days. This projected excess of liquidity versus requirements provides the Company with flexibility in how it funds loans and other earning assets.

The Company also has external sources of funds, which can be drawn upon when required. The main sources of external liquidity are available lines of credit with the Federal Home Loan Bank of Atlanta and the Federal Reserve. The line of credit with the Federal Home Loan Bank of Atlanta totaled \$1.3 billion, of which \$1.0 billion was available for borrowing based on pledged collateral, with \$558 million borrowed against it as of September 30, 2014. The line of credit at the Federal Reserve totaled \$333 million, all of which was available for borrowing based on pledged collateral, with no borrowings against it as of September 30, 2014. Other external sources of liquidity available to the Company in the form of unsecured lines of credit granted by correspondent banks totaled \$55 million at September 30, 2014, against which there were no outstanding borrowings. In addition, the Company had a secured line of credit with a correspondent bank of \$20 million as of September 30, 2014. Based upon its liquidity analysis, including external sources of liquidity available, management believes the liquidity position was appropriate at September 30, 2014.

The parent company (“Bancorp”) is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, Bancorp is responsible for paying any dividends declared to its common shareholders and interest and principal on outstanding debt. Bancorp’s primary source of income is dividends received from the Bank. The amount of dividends that the Bank may declare and pay to Bancorp in any calendar year, without the receipt of prior approval from the Federal Reserve, cannot exceed net income for that year to date plus retained net income (as defined) for the preceding two calendar years. Based on this requirement, as of September 30, 2014, the Bank could have declared a dividend of \$68 million to Bancorp. At September 30, 2014, Bancorp had liquid assets of \$13 million.

Arrangements to fund credit products or guarantee financing take the form of loan commitments (including lines of credit on revolving credit structures) and letters of credit. Approvals for these arrangements are obtained in the same manner as loans. Generally, cash flows, collateral value and risk assessment are considered when determining the amount and structure of credit arrangements.

Commitments to extend credit in the form of consumer, commercial real estate and business at the dates indicated were as follows:

|   | September<br>30,<br>2014 | December<br>31,<br>2013 |
|---|--------------------------|-------------------------|
| (In thousands)  |                          |                         |
| Commercial  | \$194,388                | \$184,083               |
| Real estate-development and construction                    | 102,176                  | 100,826                 |
| Real estate-residential mortgage                            | 14,778                   | 13,908                  |
| Lines of credit, principally home equity and business lines | 793,135                  | 710,202                 |

|   |             |             |
|---|-------------|-------------|
| Standby letters of credit                                     | 58,877      | 59,745      |
| Total Commitments to extend credit and available credit lines | \$1,163,354 | \$1,068,764 |

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

See “Financial Condition - Market Risk and Interest Rate Sensitivity” in Management’s Discussion and Analysis of Financial Condition and Results of Operations, above, which is incorporated herein by reference.

**Item 4. CONTROLS AND PROCEDURES**

The Company’s management, under the supervision and with the participation of the Company’s Chief Executive Officer and Chief Financial Officer, evaluated as of the last day of the period covered by this report, the effectiveness of the design and operation of the Company’s disclosure controls and procedures, as defined in Rule 13a-15 under the Securities Exchange Act of 1934. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures were effective. There were no changes in the Company’s internal controls over financial reporting (as defined in Rule 13a-15 under the Securities Act of 1934) during the three months ended September 30, 2014, 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**

In the normal course of business, the Company becomes involved in litigation arising from the banking, financial and other activities it conducts. Management, after consultation with legal counsel, does not anticipate that the ultimate liability, if any, arising from these matters will have a material effect on the Company's financial condition, operating results or liquidity.

### **Item 1A. Risk Factors**

There have been no material changes in the risk factors as discussed in the 2013 Annual Report on Form 10-K.

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

The Company re-approved a stock repurchase program in August 2013 that permits the repurchase of up to 5% of the Company's outstanding shares of common stock or approximately 1,260,000 shares. Repurchases which will be conducted through open market purchases or privately negotiated transactions, will be made depending on market conditions and other factors. There were no repurchase transactions executed during the nine months ended September 30, 2014.

### **Item 3. Defaults Upon Senior Securities – None**

### **Item 4. Mine Safety Disclosures – Not applicable**

### **Item 5. Other Information - None**

### **Item 6. Exhibits**

Exhibit  
31(a) Certification of Chief Executive Officer

Exhibit  
31(b) Certification of Chief Financial Officer

Exhibit  
32 (a) Certification of Chief Executive Officer pursuant to 18 U.S. Section 1350

Exhibit  
32 (b) Certification of Chief Financial Officer pursuant to 18 U.S. Section 1350

Exhibit  
101 The following materials from the Sandy Spring Bancorp, Inc. Quarterly Report on Form 10-Q for the quarter end September 30, 2014 formatted in Extensible Business Reporting Language (XBRL): (i) the Condensed Consolidated Statements of Condition; (ii) The Condensed Consolidated Statements of Income; (iii) The Condensed Consolidated Statements of Comprehensive Income; (iv) The Condensed Consolidated Statements of Cash Flows; (v) The Condensed Consolidated Statements of Changes in Stockholders' Equity; (vi) related notes.

**SIGNATURES**

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Registrant has duly caused this quarterly report to be signed on its behalf by the undersigned, thereunto duly authorized.

SANDY SPRING  
BANCORP, INC.  
(Registrant)

By: /s/ Daniel J. Schrider  
Daniel J. Schrider  
President and Chief  
Executive Officer

Date: November 6, 2014

By: /s/ Philip J. Mantua  
Philip J. Mantua  
Executive Vice President  
and Chief Financial  
Officer

Date: November 6, 2014