COMMUNITY FINANCIAL CORP /MD/
Form 10-K
March 12, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2017

OR

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

For the transition period from _______ to _______

Commission File No. **001-36094**

The Community Financial Corporation

(Exact name of registrant as specified in its charter)

Maryland	**52-1652138**

(State of other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3035 Leonardtown Road, Waldorf, Maryland	20601
(Address of principal executive offices)	(Zip Code)

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

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

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

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

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

Yes x No ¨

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

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

Large Accelerated Filer ¨	Accelerated Filer x
Non-Accelerated Filer ¨	Smaller Reporting Company ¨
Emerging growth company ¨	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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

Yes ¨ No x

The aggregate market value of voting stock held by non-affiliates of the registrant was approximately $148.0 million based on the closing price $38.50 per share at which the common stock was sold on the last business day of the Company’s most recently completed second fiscal quarter. For purposes of this calculation only, the shares held by directors, executive officers and the Company’s Employee Stock Ownership Plan of the registrant are deemed to be shares held by affiliates.

Number of shares of common stock outstanding as of March 2, 2018: 5,567,505

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2018 Annual Meeting of Stockholders. (Part III)

INDEX

	Page
Part I	
Item 1. Business	1
Supervision and Regulation	19
Management	25
Item 1A. Risk Factors	27
Item 1B. Unresolved Staff Comments	38
Item 2. Properties	38
Item 3. Legal Proceedings	38
Item 4. Mine Safety Disclosures	38
Part II	
Item 5 - Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	39
Item 6 - Selected Financial Data	42
Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations	44
Item 8 - Financial Statements and Supplementary Data	80
Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	144
Item 9A. Controls and Procedures	144
Item 9B. Other Information	145
Part III	
Item 10. Directors, Executive Officers and Corporate Governance	145
Item 11. Executive Compensation	145
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	145

Item 13. Certain Relationships, Related Transactions and Director Independence	146
Item 14. Principal Accountant Fees and Services	146
Part IV	
Item 15. Exhibits and Financial Statement Schedules	146
Item 16. Form 10-K Summary	150

PART I

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

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

Item 1. Business

Business

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

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

The Bank maintains its main office and operations center in Waldorf, Maryland, in addition to its branch offices in Lexington Park, Leonardtown, La Plata, Dunkirk, Bryans Road, Waldorf, Charlotte Hall, Prince Frederick and Lusby, Maryland; and downtown Fredericksburg, Virginia. The Company closed its Central Park Fredericksburg branch during the third quarter of 2017. This location continues to serve as a loan production office and the branch closure did not have a material effect on operations. During the third quarter of 2015, the Company agreed to sell its King George, Virginia branch building and equipment and the transaction closed on January 28, 2016. In addition, the Bank maintains five loan production offices ("LPOs") in La Plata, Prince Frederick, Leonardtown and Annapolis, Maryland and Central Park in Fredericksburg, Virginia. The Leonardtown LPO is co-located with the branch.

On January 1, 2018, the Company completed its previously announced merger of County First Bank ("County First") with and into the Bank, with the Bank as the surviving bank (the "Merger") pursuant to the Agreement and Plan of Merger, dated as of July 31, 2017, by and among the Company, the Bank and County First. County First had five branch offices in La Plata, Waldorf, New Market, Prince Frederick and California, Maryland. The Bank intends to keep the La Plata branch open and consolidate the remaining four branches with legacy Community Bank of the Chesapeake branch offices in May of 2018.

As of December 31, 2017, the Bank operated 15 automated teller machines which includes four stand-alone locations. The Bank offers telephone and internet banking services. The Bank is engaged in the commercial and retail banking business as authorized by the banking statutes of the States of Maryland and Virginia and applicable federal regulations, including the acceptance of deposits, and the origination of loans to individuals, associations, partnerships and corporations. The Bank's real estate loan portfolio consists of commercial mortgage loans, residential first and second mortgage loans and home equity lines of credit. Commercial lending consists of both secured and unsecured loans. The Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund administered by the Federal Deposit Insurance Corporation ("FDIC"), the Bank's primary federal regulator.

Market Area

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

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

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

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

The Bank's primary market areas also boast a strong median household income. According to SNL Financial, the median household income in our market area is $97,000 compared to $61,000 for the United States. According to SNL Financial, the Bank's market areas have strong demographics with below average unemployment rates. The Bank's primary market areas have unemployment rates below 3.6% with projected population growth in excess of 4.25% over the next five years.

Competition

The Bank faces strong competition in the attraction of deposits and in the origination of loans. Its most direct competition for deposits and loans comes from other banks and federal and state credit unions located in its primary market area. There are more than 25 FDIC-insured depository institutions as well as several large credit unions operating in the Bank's footprint including several large regional and national bank holding companies. The Bank also faces additional significant competition for customers' funds from mutual funds, brokerage firms, online Banks, and other financial service companies. The Bank competes for loans by providing competitive rates and flexibility of terms and service, including customer access to senior decision makers. It competes for deposits by offering depositors a wide variety of account types, convenient office locations and competitive rates. Other services offered include tax deferred retirement programs, brokerage services through an affiliation with Community Wealth Advisors, cash management services and safe deposit boxes. The Bank has used targeted direct mail, print and online advertising and community outreach to increase its market share of deposits, loans and other services in its market area. It provides ongoing training for its staff in an attempt to ensure high-quality service.

Lending Activities

General

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

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

The permanent financing of commercial and other improved real estate projects, including office buildings, retail locations, churches, and other special purpose buildings, is the largest component of the Bank's loan portfolio. Commercial real estate loans amounted to $727.3 million or 63.3% of the loan portfolio and $667.1 million or 61.3% of the loan portfolio, respectively at December 31, 2017 and 2016. This portfolio has increased in both absolute size and as a percentage of the loan portfolio in each of the last six years. The CRE portfolio includes commercial construction balances. At December 31, 2017 and 2016, commercial construction balances were $44.8 million or 6.2% and $62.1 million or 9.3%, respectively, of the CRE portfolio.

The primary security on a commercial real estate loan is the real property and the leases or businesses that produce income for the real property. The Bank generally limits its exposure to a single borrower to 15% of the Bank's capital and participates with other lenders on larger projects. Loans secured by commercial real estate are generally limited to 80% of the lower of the appraised value or sales price and have an initial contractual loan amortization period ranging from three to 20 years. Interest rates and payments on these loans typically adjust after an initial fixed-rate period, which is generally between three and ten years. Interest rates and payments on adjustable-rate loans are adjusted to a rate based on the United States Treasury Bill Index. Almost all the Bank's commercial real estate loans are secured by real estate located in the Bank's primary market area. At December 31, 2017 and 2016, the largest outstanding commercial real estate loans were $21.8 million and $12.8 million, respectively, which were secured by commercial real estate and performing according to their terms.

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

If a determination is made that there is a potential environmental hazard, the Bank will complete an Environmental Assessment Checklist. If this checklist or the appraisal indicates potential issues, a Phase 1 environmental survey will generally be required.

Residential First Mortgage Loans

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

The Company stopped underwriting owner-occupied residential first mortgages in April 2015 and established third party sources to fund its residential whole loan portfolio. The third-party sources allow the Company to maintain a well-diversified residential portfolio while addressing the credit needs of the communities in its footprint. The Bank's practice has been to purchase individual residential first mortgage loans as well as purchase the right to service the loans acquired.

Total fixed-rate loans in our residential first mortgage portfolio amounted to $113.4 million and $125.4 million, respectively, as of December 31, 2017 and 2016. Fixed-rate loans may be packaged and sold to investors or retained in the Bank's loan portfolio. The Bank generally retains the right to service loans sold for a payment based upon a percentage (generally 0.25% of the outstanding loan balance). As of December 31, 2017 and 2016, the Bank serviced $43.7 million and $52.0 million, respectively, in residential mortgage loans for others.

Adjustable mortgages are generally adjustable on a one-, three- and five-year terms with limitations on upward adjustments per re-pricing period and an upward cap over the life of the loan. As of December 31, 2017 and 2016, the Bank had $59.9 million and $45.6 million, respectively, in adjustable-rate residential mortgage loans. At December 31, 2017 and 2016, the largest outstanding residential first mortgage loans were $2.1 million and $2.2 million, respectively, which were secured by residences located in the Bank's market area. The loans were performing according to terms.

Residential first mortgage loans with loan-to-value ratios in excess of 80% generally carry private mortgage insurance to lower the Bank's exposure to approximately 80% of the value of the property. The Bank had fewer than 10 loans with private mortgage insurance at December 31, 2017 and 2016.

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

Longer-term fixed-rate and adjustable-rate residential mortgage loans are subject to greater interest-rate risk due to term and annual and lifetime limitations on interest rate adjustments that limit the increases in interest rates on these loans. There are also credit risks resulting from potential increased costs to the borrower as a result of repricing of adjustable-rate mortgage loans. During periods of rising interest rates, the risk of default on adjustable-rate mortgage loans may increase due to the upward adjustment of interest cost to the borrower.

Residential Rentals

Residential rental mortgage loans are amortizing, with principal and interest due each month. These loans are non-owner occupied and secured by income-producing 1-4 family units and apartments. The Bank originates both fixed-rate and adjustable-rate residential rental first mortgages. Loans secured by residential rental properties are generally limited to 80% of the lower of the appraised value or sales price at origination and have an initial contractual loan payment period ranging from three to 20 years. The primary security on a residential rental loan is the property and the leases that produce income.

Total fixed-rate loans in our residential rental first mortgage portfolio amounted to $16.8 million and $17.9 million, respectively, as of December 31, 2017 and 2016. As of December 31, 2017 and 2016, the Bank had $93.4 million and $84.0 million, respectively, in adjustable-rate residential rental mortgage loans. As of December 31, 2017 and 2016, $85.0 million and $84.9 million, respectively, were 1-4 family units and $25.2 million and $17.0 million, respectively, were apartment buildings.

At December 31, 2017 and 2016, the largest outstanding residential rental mortgage loan was $10.2 million and $10.5 million, respectively, which was secured by over 120 single family homes located in the Bank's market area. The loan was performing according to its terms at December 31, 2017 and 2016.

Loans secured by residential rental properties involve greater risks than 1-4 family residential mortgage loans. Although, there are similar risk characteristics shared with commercial real estate loans, the balances for the loans secured by residential rental properties are generally smaller. Because payments on loans secured by residential rental properties are often dependent on the successful operation or management of the properties, repayment of these loans may be subject to a greater extent to adverse conditions in the rental real estate market or the economy than similar owner occupied properties.

Construction and Land Development Loans

The Bank offers construction loans for the construction of one- to four-family dwellings to home builders. Construction loans totaled $8.8 million and $12.1 million, respectively, at December 31, 2017 and 2016. Generally, these loans are secured by the real estate under construction as well as by guarantees of the principals involved. Draws are made upon satisfactory completion of predefined stages of construction. The Bank will typically lend up to 80% of the lower of appraised value or the contract purchase price of the homes to be constructed. In addition, the Bank offers loans to acquire and develop land, as well as loans on undeveloped, subdivided lots for home building by individuals. Land acquisition and development loans totaled $19.1 million and $24.9 million, respectively, at December 31, 2017 and 2016. Bank policy requires that zoning and permits must be in place prior to making development loans. The Bank will typically lend up to the lower of 75% of the appraised value or cost. At December 31, 2017 and 2016, the largest outstanding construction and land development loans were $3.5 million and $4.9 million, respectively, which were secured by land in the Bank's market area.

The Bank's ability to originate residential construction and development loans is heavily dependent on the continued demand for single-family housing construction in the Bank's market area. The Bank's investment in these loans has declined in recent years. Construction and land development loans as a percentage of the total loan portfolio have been decreasing since 2008 from greater than 10% as of December 31, 2008 to 2.4% at December 31, 2017. If the demand for new houses being built from smaller builders in the Bank's market areas continues to decline, this portion of the loan portfolio may continue to decline. In addition, a decline in demand for new housing might adversely affect the ability of borrowers to repay these loans.

Construction and land development loans are inherently riskier than providing financing on owner-occupied real estate. The Bank's risk of loss is affected by the accuracy of the initial estimate of the market value of the completed project as well as the accuracy of the cost estimates made to complete the project. In addition, the volatility of the real estate market makes it increasingly difficult to ensure that the valuation of land associated with these loans is accurate. During the construction phase, a number of factors could result in delays and cost overruns. If the estimate of construction costs proves to be inaccurate, the Bank may be required to advance funds beyond the amount originally committed to permit completion of the development. If the estimate of completed value proves to be inaccurate, the Bank may be confronted, at or before the maturity of the loan, with a project having a value that is insufficient to assure full repayment. As a result of these factors, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the project rather than the ability of the borrower or guarantor to repay principal and interest. If the Bank forecloses on a project, the Bank may not be able to recover all of the unpaid balance of, and accrued interest on, the loan as well as related foreclosure and holding costs.

Home Equity and Second Mortgage Loans

The Bank maintains a portfolio of home equity and second mortgage loans. Home equity loans, which totaled $20.0 million and $19.7 million, respectively at December 31, 2017 and 2016, are generally made in the form of lines of credit with minimum amounts of $5,000, have terms of up to 20 years, variable rates priced at the then current Wall Street Journal prime rate plus a margin, and require an 80% or 90% loan-to-value ratio (including any prior liens), depending on the specific loan program. Second mortgage loans, which totaled $1.4 million and $1.7 million, respectively at December 31, 2017 and 2016, are fixed or variable-rate loans that have original terms between five and 15 years. These products contain a higher risk of default than residential first mortgages as in the event of foreclosure, the first mortgage would need to be paid off prior to collection of the second mortgage. This risk is heightened as the market value of residential property has not fully returned to pre-financial crisis levels and interest rates began to increase in 2017.

Commercial Loans

The Bank offers commercial loans to its business customers. The Bank offers a variety of commercial loan products including term loans and lines of credit. The portfolio consists primarily of demand loans and lines of credit. Such loans can be made for terms of up to five years. However, most of the loans are originated for a term of two years or less. The Bank offers both fixed-rate and adjustable-rate loans (typically tied to the then current Wall Street Journal prime rate plus a margin with a floor) under these product lines. Commercial loans remain an important class of the

Bank's loan portfolio. At $56.4 million and 4.9% of total loans and $50.5 million and 4.6% of total loans at December 31, 2017 and 2016, respectively, the commercial loan portfolio increased a modest $5.9 million compared to the prior year end balance.

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

Commercial business loans entail greater risk than residential mortgage loans. Unlike residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income and which are secured by real property whose value tends to be more easily ascertainable, commercial loans are made on the basis of the borrower's ability to make repayment from the cash flows of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. In the case of business failure, collateral would need to be liquidated to provide repayment for the loan. In many cases, the highly specialized nature of collateral would make full recovery from the sale of collateral unlikely. The Bank controls these risks by establishing guidelines that provide for loans with low loan-to-value ratios. At December 31, 2017 and 2016, the largest outstanding commercial loans were $4.4 million and $4.0 million, respectively, which was secured by commercial real estate (all of which were located in the Bank's market area), cash and investments. These loans were performing according to terms at December 31, 2017 and 2016.

Consumer Loans

The Bank has consumer loans secured by automobiles, boats, recreational vehicles and trucks. The Bank also makes home improvement loans and offers both secured and unsecured personal lines of credit. Consumer loans totaled $573,000 and $422,000, respectively, at December 31, 2017 and 2016. Consumer loans entail greater risk from other loan types due to being secured by rapidly depreciating assets or the reliance on the borrower's continuing financial stability.

Commercial Equipment Loans

The Bank also maintains an amortizing commercial portfolio consisting primarily of commercial equipment loans. Commercial equipment loans totaled $35.9 million and $39.7 million, or 3.1% and 3.7% of the total loan portfolio, respectively, at December 31, 2017 and 2016. These loans consist primarily of fixed-rate, short-term loans collateralized by customers' equipment including trucks, cars, construction and other more specialized equipment. When making commercial equipment loans, the Bank considers the same factors it considers when underwriting a commercial business loan. The higher interest rates and shorter loan terms available on commercial equipment lending make these products attractive to the Bank. These loans entail greater risk than loans such as residential mortgage loans. Unlike residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income and which are secured by real property whose value tends to be more easily ascertainable, commercial loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flows of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. In the case of business failure, collateral would need to be liquidated to provide repayment for the loan. In many cases, the highly specialized nature of collateral equipment would make full recovery from the sale of collateral problematic. The Bank assesses the amount of collateral required for a loan based upon the credit worthiness of the borrowers.

Loan Portfolio Analysis

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

	At December 31,												
	2017			2016			2015			2014			2013
(dollars in thousands)	Amount	%		Amount	%		Amount	%		Amount	%		Amount
Commercial real estate	$727,314	63.25	%	$667,105	61.25	%	$538,888	58.64	%	$485,601	55.68	%	$476,648
Residential first mtgs.	170,374	14.81	%	171,004	15.70	%	131,401	14.30	%	146,539	16.80	%	159,147
Residential rentals [(1)]	110,228	9.58	%	101,897	9.36	%	93,157	10.14	%	81,777	9.38	%	-
Construction and land dev.	27,871	2.42	%	36,934	3.39	%	36,189	3.94	%	36,370	4.17	%	32,001

Home equity and second mtgs.	21,351	1.86	%	21,399	1.97	%	21,716	2.36	%	21,452	2.46	%	21,692		
Commercial loans	56,417	4.91	%	50,484	4.64	%	67,246	7.32	%	73,625	8.44	%	94,176		
Consumer loans	573	0.05	%	422	0.04	%	366	0.04	%	613	0.07	%	838		
Commercial equipment	35,916	3.12	%	39,737	3.65	%	29,931	3.26	%	26,152	3.00	%	23,738		
Total Loans	1,150,044	100.00	%	1,088,982	100.00	%	918,894	100.00	%	872,129	100.00	%	808,240		
Deferred loan fees and premiums	(1,086)			(397)			1,154			1,239			972		
Allowance for loan losses	10,515			9,860			8,540			8,481			8,138		
Loans receivable, net	$1,140,615			$1,079,519			$909,200			$862,409			$799,130		

(1) Loans secured by residential rental property were included in the residential first mortgage and commercial real estate loan portfolios prior to a reclassification in 2016. See Note 6 of the Consolidated Financial Statements for more information. Comparative financial information was reclassified to conform to the classification presented in the Consolidated Financial Statements at and for the years ended December 31, 2016 , 2015 and 2014.

6

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

	For the Years Ended December 31,									
	2017		2016		2015		2014		2013	
dollars in thousands	Average Balance	Average Yield	Average Balance	Average Yield	Average Balance	Average Yield	Average Balance	Average Yield	Average Balance	Average Yield
Commercial real estate	$699,349	4.42%	$602,648	4.50%	$518,329	4.64%	$460,014	4.84%	$434,889	5.08%
Residential first mortgages	176,186	3.77%	151,366	3.99%	134,728	4.35%	148,367	4.43%	169,671	4.68%
Residential rentals (1)	106,000	4.62%	96,611	4.69%	88,251	4.63%	75,104	4.65%	-	
Construction and land development	33,798	4.96%	36,938	4.58%	37,665	4.99%	29,921	4.68%	27,065	4.75%
Home equity and second mortgages	21,515	4.38%	21,781	4.08%	21,332	4.09%	21,426	4.21%	21,647	4.33%
Commercial and equipment loans (2)	86,871	5.21%	87,705	5.27%	81,957	5.61%	92,199	5.21%	95,316	5.11%
Consumer loans	477	7.76%	397	8.56%	465	8.82%	701	7.99%	954	7.23%
Allowance for loan losses	(10,374)	n/a	(9,157)	n/a	(8,541)	n/a	(8,351)	n/a	(8,173)	n/a
Net Average Loans	$1,113,822	4.45%	$988,289	4.55%	$874,186	4.73%	$819,381	4.82%	$741,369	5.02%

(1) Loans secured by residential rental property were included in the residential first mortgage and commercial real estate loan portfolios prior to a reclassification in 2016. See Note 6 of the Consolidated Financial Statements for more information. Comparative financial information was reclassified to conform to the classification presented in the Consolidated Financial Statements at and for the years ended December 31, 2016, 2015 and 2014.

(2) Includes both commercial loans and commercial equipment loans.

Loan Originations, Purchases and Sales

The Bank solicits loan applications through marketing by commercial loan officers, its branch network, and referrals from customers. Loans are processed and approved according to guidelines established by the Bank. Loan requirements such as income verification, collateral appraisal, and credit reports vary by loan type. Additionally, residential mortgages are purchased from third party providers after reviewing loan documents, underwriting support, and completing other procedures, as necessary. During the years ended December 31, 2017 and 2016, the Bank purchased residential first mortgages of $25.5 million and $64.2 million, respectively

Loan processing functions are generally centralized except for small consumer loans. Depending on market conditions, residential mortgage loans may be classified with the intent to sell to third parties such as FHLMC. The Company sold no residential mortgage loans for the years ended December 31, 2017 and 2016. Residential mortgage loans in the amounts of $4.2 million were sold by the Bank for the years ended December 31, 2015. During the year ended December 31, 2017, the Company sold the guaranteed portion of a U.S. Small Business Administration (“SBA”) Loan for proceeds of $2.8 million and recognized a gain of $294,000.

To comply with internal and regulatory limits on loans to one borrower, the Bank may sell portions of commercial and commercial real estate loans to other lenders. In 2017, the Bank sold no other CRE participations except for the SBA guaranteed position of $2.8 million. CRE participations sold were $3.0 million in 2016 and $1.5 million in 2015. The Bank may also buy loans, portions of loans, or participation certificates from other lenders to limit overall exposure and to ensure that all participants remain below internal and regulatory limits. The Bank only purchases loans or portions of loans after reviewing loan documents, underwriting support, and completing other procedures, as necessary. The Bank participated in a commercial real estate commercial construction project during 2017 with $1.6 million advanced and outstanding at December 31, 2017 of a $4.5 million commitment. The Bank purchased no other commercial real estate or commercial loans during 2017, 2016 and 2015. Purchased participation loans are subject to the same regulatory and internal policy requirements as other loans in the Bank’s portfolio as described below.

Loan Approvals, Procedures and Authority

Loan approval authority is established by Board policy. The Officer's Loan Committee (OLC) consists of the following members of the Bank's executive management; the Chief Executive Officer ("CEO"), President and Chief Risk Officer ("CRO"), Chief Operating Officer ("COO") and the Chief Lending Officer ("CLO"). In addition, the OLC includes the Senior Credit Officer ("SCO") and Senior Loan Officers ("SLO's"). The OLC must have three (3) members of Executive Management approve all loans presented above individual loan authorities granted to the SCO and the SLOs. The SCO and the SLOs have been granted individual loan authority up to $1.0 million. Loan approval authorities vary by individual. The individual lending authority of the other lenders is set by management and is based on their individual abilities.

All loans and loan relationships that exceed the Bank's in-house lending limit are required to be approved by at least three (3) members of the Bank's Credit Risk Committee ("CRC"). In addition, the Board of Directors or the CRC approve all loans required to be approved by regulation, such as Regulation O loans or commercial loans to employees. The in-house lending guideline is approved by the Board on an annual basis or as needed if more frequently and is less than the Bank's legal lending limit.

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

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

Loans to One Borrower

Under Maryland law, the maximum amount that the Bank is permitted to lend to any one borrower and his or her related interests may generally not exceed 10% of the Bank's unimpaired capital and surplus, which is defined to include the Bank's capital, surplus, retained earnings and 50% of its reserve for possible loan losses. Under this authority, the Bank would have been permitted to lend up to $14.4 million and $14.1 million, respectively, to any one borrower at December 31, 2017 and 2016. By interpretive ruling of the Maryland Commissioner, Maryland banks have the option of lending up to the amount that would be permissible for a national bank, which is generally 15% of unimpaired capital and surplus (defined to include a bank's total capital for regulatory capital purposes plus any loan loss allowances not included in regulatory capital). Under this formula, the Bank would have been permitted to lend up to $22.4 million and $21.9 million, respectively, to any one borrower at December 31, 2017 and 2016. At December 31, 2017 and 2016, the largest amount outstanding to any one borrower and borrower's related interests was $21.8 million and $12.8 million, respectively.

Loan Commitments

The Bank does not normally negotiate standby commitments for the construction and purchase of real estate. The Bank's outstanding commitments to originate loans at December 31, 2017 and 2016 were approximately $63.5 million and $67.0 million, respectively, excluding undisbursed portions of loans in process. It has been the Bank's experience that few commitments expire unfunded.

Maturity of Loan Portfolio

See Note 6 of the Consolidated Financial Statements for information regarding the dollar amount of loans maturing in the Bank's portfolio based on their contractual terms to maturity as of December 31, 2017 and 2016. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less.

Asset Classification

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

When an insured institution classifies assets as “substandard” or “doubtful,” it is required that a specific valuation allowance for loan losses be established in an amount deemed prudent by management. When an insured institution classifies assets as “loss,” it is required either to establish a specific allowance for losses equal to 100% of the amount of the asset so classified or to charge off such amount.

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

(dollars in thousands)	December 31, 2017	December 31, 2016	December 31, 2015	December 31, 2014	December 31, 2013
Classified assets					
Substandard	$ 50,298	$ 39,109	$ 42,485	$ 54,022	$ 56,880
Doubtful	-	137	861	-	-
Loss	-	-	-	-	-
Total classified assets	50,298	39,246	43,346	54,022	56,880
Special mention assets	96	-	1,642	5,460	9,246
	$ 50,394	$ 39,246	$ 44,988	$ 59,482	$ 66,126

Delinquencies

The Bank’s collection procedures provide that when a loan is 15 days delinquent, the borrower is contacted and payment is requested. If the delinquency continues, efforts will be made to contact the delinquent borrower and obtain payment. If these efforts prove unsuccessful, the Bank will pursue appropriate legal action including repossession of the collateral. In certain instances, the Bank will attempt to modify the loan or grant a limited moratorium on loan payments to enable the borrower to reorganize borrower’s financial affairs. For an analysis of past due loans as of December 31, 2017 and 2016, respectively, refer to Note 6 in the Consolidated Financial Statements.

Impaired Loans

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

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

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

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

Specific loan loss reserves of $1.0 million and $1.3 million, respectively, related to impaired loans at December 31, 2017 and 2016. The following table sets forth information with respect to the Bank's impaired loans at the dates indicated. The table includes a breakdown between impaired loans with and without an allowance:

	December 31,				
(dollars in thousands)	2017	2016	2015	2014	2013
Recorded investment with no allowance	$39,028	$26,436	$35,171	$45,587	$28,220
Recorded investment with allowance	4,226	8,924	4,066	4,122	9,786
Total impaired loans	$43,254	$35,360	$39,237	$49,709	$38,006
Specific allocations of allowance	$1,024	$1,289	$1,608	$451	$985
Interest income recognized	$1,829	$1,309	$1,366	$1,841	$1,608

For additional information regarding impaired loans by class at December 31, 2017 and 2016, respectively, refer to Note 6 in the Consolidated Financial Statements.

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

10

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

	At December 31,									
	2017		2016		2015		2014		2013	
(dollars in thousands)	Amount	% [1]	Amount	% [1]	Amount	% [1]	Amount	% [1]	Amount	% [1]
Commercial real estate	$6,451	63.25 %	$5,212	61.25 %	$3,465	58.64 %	$3,528	55.68 %	$3,051	58.97 %
Residential first mtgs.	1,144	14.81 %	1,406	15.70 %	584	14.30 %	1,047	16.80 %	1,343	19.69 %
Residential rentals [2]	512	9.58 %	362	9.36 %	538	10.14 %	593	9.38 %	532	
Construction and land dev.	462	2.42 %	941	3.39 %	1,103	3.94 %	1,071	4.17 %	584	3.96 %
Home equity and second mtgs.	162	1.86 %	138	1.97 %	142	2.36 %	173	2.46 %	249	2.68 %
Commercial loans	1,013	4.91 %	794	4.64 %	1,477	7.32 %	1,677	8.44 %	1,916	11.65 %
Consumer loans	7	0.05 %	3	0.04 %	2	0.04 %	3	0.07 %	10	0.10 %
Commercial equipment	764	3.12 %	1,004	3.65 %	1,229	3.26 %	389	3.00 %	453	2.94 %
Total allowance for loan losses	$10,515	100.00%	$9,860	100.00%	$8,540	100.00%	$8,481	100.00%	$8,138	100.00%

(1) Percent of loans in each category to total loans

(2) Loans secured by residential rental property were included in the residential first mortgage and commercial real estate loan portfolios prior to a reclassification in 2016. See Note 6 of the Consolidated Financial Statements for more information. Comparative financial information was reclassified to conform to the classification presented in the Consolidated Financial Statements at and for the years ended December 31, 2016, 2015 and 2014.

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

	At December 31,				
(dollars in thousands)	2017	2016	2015	2014	2013
Balance at beginning of period	$9,860	$8,540	$8,481	$8,138	$8,247
Charge-offs:					
Commercial real estate	217	-	78	195	140
Residential first mtgs.	-	-	30	94	348
Residential rentals [1]	42	14	-	155	-
Construction and land dev.	26	526	-	992	36
Home equity and second mtgs.	14	-	100	59	111
Commercial loans	13	594	432	1,134	480
Consumer loans	2	1	-	3	12
Commercial equipment	168	34	818	10	35
Total Charge-offs	482	1,169	1,458	2,642	1,162
Recoveries:					
Commercial real estate	63	58	17	11	-
Residential first mtgs.	-	-	1	186	11
Residential rentals [1]	-	-	-		-
Construction and land dev.	-	1	32	84	1
Home equity and second mtgs.	1	5	-	10	17
Commercial loans	1	18	11	5	23
Consumer loans	-	.	-	11	3
Commercial equipment	62	48	23	25	58
Total Recoveries	127	130	84	332	113
Net Charge-offs	355	1,039	1,374	2,310	1,049
Provision for Loan Losses	1,010	2,359	1,433	2,653	940
Balance at end of period	$10,515	$9,860	$8,540	$8,481	$8,138
Allowance for loan losses to total loans	0.91 %	0.91 %	0.93 %	0.97 %	1.01 %
Net charge-offs to average loans	0.03 %	0.11 %	0.16 %	0.28 %	0.14 %

[1] Loans secured by residential rental property were included in the residential first mortgage and commercial real estate loan portfolios prior to a reclassification in 2016. See Note 6 of the Consolidated Financial Statements for more information. Comparative financial information was reclassified to conform to the classification presented in the Consolidated Financial Statements at and for the years ended December 31, 2016, 2015 and 2014.

Non-performing Assets

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

Other Real Estate Owned ("OREO")

Real estate acquired by the Bank as a result of foreclosure or by deed in lieu of foreclosure is classified as foreclosed real estate until such time as it is sold. When such property is acquired, it is recorded at its estimated fair value. Subsequent to foreclosure, the property is carried at the lower of cost or fair value less selling costs. Additional write-downs as well as carrying expenses of the foreclosed properties are charged to expenses in the current period. The Bank had foreclosed real estate with a carrying value of approximately $9.3 million and $7.8 million, respectively at December 31, 2017 and 2016. For a discussion of the accounting for foreclosed real estate, see *"Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies - Other Real Estate Owned"* and Notes 1 and 8 in the Consolidated Financial Statements.

Non-accrual Loans

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

All interest accrued but not collected from loans that are placed on non-accrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. Non-accrual loans include certain loans that are current with all loan payments and are placed on non-accrual status due to customer operating results and cash flows. Interest is recognized on non-accrual loans on a cash-basis if the loans are not impaired or there is no impairment. For a discussion of the accounting for non-accrual loans, see *"Management's Discussion and Analysis of Financial Condition and Results of Operations-Asset Quality"* and Notes 1 and 6 in the Consolidated Financial Statements.

The following table sets forth information with respect to the Bank's non-performing assets. There were no loans 90 days or more past due that were still accruing interest at the dates indicated.

	December 31,				
(dollars in thousands)	2017	2016	2015	2014	2013
Non-accrual loans:					
Commercial real estate	$1,987	$2,371	$2,875	$3,824	$7,930
Residential first mtgs.	985	623	1,948	533	2,245
Residential rentals [3]	825	577	605	-	-
Construction and land dev.	-	3,048	3,555	3,634	2,968
Home equity and second mtgs.	257	61	48	399	115
Commercial loans	172	1,044	2,054	1,587	1,935
Consumer loans	-	-	-	-	24
Commercial equipment	467	650	348	286	234
Total non-accrual loans [1]	4,693	8,374	11,433	10,263	15,451
OREO	9,341	7,763	9,449	5,883	6,797
TDRs: [2]					
Commercial real estate	9,273	9,587	9,839	10,438	3,141
Residential first mtgs.	527	545	881	906	1,485
Residential rentals [3]	221	227	2,058		
Construction and land dev.	729	3,777	4,283	4,376	-
Home equity and second mtgs.	-	872	-	-	-
Commercial loans	4	-	1,384	2,262	-
Commercial equipment	36	113	123	154	67
Total TDRs	10,790	15,121	18,568	18,136	4,693
Total Accrual TDRs	10,021	10,448	13,133	13,249	4,364
Total non-accrual loans, OREO and Accrual TDRs	$24,055	$26,585	$34,015	$29,395	$26,612
Interest income due at stated rates, but not recognized on non-accruals	$185	$1,103	$987	$845	$599
Non-accrual loans to total loans	0.41 %	0.77 %	1.24 %	1.18 %	1.91 %
Non-accrual loans and Accrual TDRs to total loans [2]	1.28 %	1.73 %	2.67 %	2.70 %	2.45 %
Non-accrual loans, OREO and Accrual TDRs to total assets [2]	1.71 %	1.99 %	2.98 %	2.71 %	2.60 %

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

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

(3) Loans secured by residential rental property were included in the residential first mortgage and commercial real estate loan portfolios prior to a reclassification in 2016. See Note 6 of the Consolidated Financial Statements for more information. Comparative financial information was reclassified to conform to the classification presented in the Consolidated Financial Statements at December 31, 2016 and 2015.

Investment Activities

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

The following table sets forth the carrying value of the Company's investment securities portfolio and FHLB of Atlanta and Federal Reserve Bank stock at the dates indicated. HTM securities and FHLB of Atlanta and Federal Reserve Bank stock are carried at amortized cost and AFS securities are carried at fair value. At December 31, 2017, 2016, 2015, 2014 and 2013, their estimated fair value was $173.6 million, $168.3 million, $151.4 million, $133.3 million and $139.9 million, respectively. On April 18, 2016, the Bank terminated its membership in the Federal Reserve System and cancelled its stock in the Federal Reserve Bank of Richmond effective as of that date.

	At December 31,				
(dollars in thousands)	2017	2016	2015	2014	2013
Asset-backed securities:					
Freddie Mac, Fannie Mae and Ginnie Mae	$135,142	$136,206	$138,267	$119,762	$126,607
U.S. Agencies	21,177	16,889	-	-	-
Other	651	884	1,093	1,472	3,120
Total asset-backed securities	156,970	153,979	139,360	121,234	129,727
Corporate equity securities	37	37	39	40	41
Bond mutual funds	4,507	4,413	4,387	4,321	4,130
Callable GSE Agency Bonds	5,017	3,001	-	-	-
Treasury bills	1,000	850	750	850	750
Total investment securities	167,531	162,280	144,536	126,445	134,648
FHLB and FRB stock	7,276	7,235	6,931	6,434	5,593
Total investment securities and FHLB and FRB stock	$174,807	$169,515	$151,467	$132,879	$140,241

The maturities and weighted average yields for investment securities available for sale ("AFS") and held to maturity ("HTM") at December 31, 2017 and 2016 are shown below.

	One year or Less		After One Through Five Years		After Five Through Ten Years		After Ten Years	
December 31, 2017	Amortized	Average	Amortized	Average	Amortized	Average	Amortized	Average
(dollars in thousands)	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield

AFS Investment securities:								
Asset-backed securities	$ 9,852	2.47 %	$ 28,832	2.46 %	$ 20,358	2.50 %	$ 6,369	2.59 %
Mutual funds	4,480	1.97 %	-	0.00 %	-	0.00 %	-	0.00 %
Total AFS investment securities	$ 14,332	2.31 %	$ 28,832	2.46 %	$ 20,358	2.50 %	$ 6,369	2.59 %
HTM Investment securities:								
Asset-backed securities	$ 18,722	2.57 %	$ 41,433	2.59 %	$ 25,309	2.63 %	$ 12,782	2.64 %
U.S. government obligations	1,000	0.00 %	-	0.00 %	-	0.00 %	-	0.00 %
Other investments	-	0.00 %	-	0.00 %	-	0.00 %	-	0.00 %
Total HTM investment securities	$ 19,722	2.44 %	$ 41,433	2.59 %	$ 25,309	2.63 %	$ 12,782	2.64 %

December 31, 2016 (dollars in thousands)	One year or Less Amortized Cost	One year or Less Average Yield		After One Through Five Years Amortized Cost	After One Through Five Years Average Yield		After Five Through Ten Years Amortized Cost	After Five Through Ten Years Average Yield		After Ten Years Amortized Cost	After Ten Years Average Yield	
AFS Investment securities:												
Asset-backed securities	$ 7,879	2.17	%	$ 21,481	2.15	%	$ 13,093	2.05	%	$ 7,689	1.91	%
Mutual funds	4,386	2.01	%	-	0.00	%	-	0.00	%	-	0.00	%
Total AFS investment securities	$ 12,265	2.11	%	$ 21,481	2.15	%	$ 13,093	2.05	%	$ 7,689	1.91	%
HTM Investment securities:												
Asset-backed securities	$ 18,844	2.35	%	$ 47,168	2.34	%	$ 29,803	2.29	%	$ 12,582	2.41	%
U.S. government obligations	850	0.00	%	-	0.00	%	-	0.00	%	-	0.00	%
Other investments	-	0.00	%	-	0.00	%	-	0.00	%	-	0.00	%
Total HTM investment securities	$ 19,694	2.25	%	$ 47,168	2.34	%	$ 29,803	2.29	%	$ 12,582	2.41	%

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

Deposits and Other Sources of Funds

General

The funds needed by the Bank to make loans are primarily generated by deposit accounts solicited from its market area. Total deposits were $1,106.2 million and $1,038.8 million, respectively, as of December 31, 2017 and 2016. The Company uses both traditional brokered deposits and reciprocal brokered deposits. Traditional brokered deposits at December 31, 2017 and December 31, 2016 were $118.9 million and $131.0 million, respectively. Reciprocal brokered deposits at December 31, 2017 and December 31, 2016 were $92.9 million and $70.7 million, respectively. The reciprocal brokered deposits have many characteristics of core deposits and are used to maximize FDIC insurance available to our customers.

Deposits

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

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

	For the Years Ended December 31,									
	2017		2016		2015		2014		2013	
(dollars in thousands)	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Savings	$53,560	0.05%	$48,878	0.08%	$44,963	0.10%	$40,104	0.10%	$37,540	0.10%
Interest-bearing demand and money market accounts	419,817	0.35%	380,592	0.30%	322,717	0.28%	281,960	0.27%	268,832	0.33%
Certificates of deposit	443,181	1.00%	409,621	0.86%	378,179	0.85%	389,641	0.97%	392,675	1.19%
Total interest-bearing deposits	916,558	0.65%	839,091	0.56%	745,859	0.56%	711,705	0.64%	699,047	0.80%
Noninterest-bearing demand deposits	154,225		142,116		120,527		100,783		87,649	
	$1,070,783	0.56%	$981,207	0.48%	$866,386	0.48%	$812,488	0.56%	$786,696	0.71%

The following table indicates the amount of the Bank’s certificates of deposit and other time deposits of $100,000 or more and $250,000 or more by time remaining until maturity as of December 31, 2017 and 2016.

	At December 31, 2017	
Time Deposit Maturity Period	$100,000 or More	$250,000 or More
(dollars in thousands)		
Three months or less	$ 88,714	$ 60,383
Three through six months	54,590	37,497
Six through twelve months	99,263	37,605
Over twelve months	78,392	31,989
Total	$ 320,959	$ 167,474

	At December 31, 2016	
Time Deposit Maturity Period	$100,000 or More	$250,000 or More
(dollars in thousands)		
Three months or less	$ 86,282	$ 61,832
Three through six months	45,703	23,134
Six through twelve months	87,695	46,476
Over twelve months	67,917	22,415
Total	$ 287,597	$ 153,857

For a discussion of deposits, see *"Management's Discussion and Analysis of Financial Condition and Results of Operations-Liabilities"* and Notes 1 and 10 in the Consolidated Financial Statements. Note 10 includes the scheduled contractual maturities of total certificates of deposits of $451.6 million and $432.8 million, respectively at December 31, 2017 and 2016.

Borrowings

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

Subsidiary Activities

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

Supervision and Regulation

Regulation of the Company

General

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

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

Acquisition of Control

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

The Maryland Financial Institutions Code additionally prohibits any person from acquiring more than 10% of the outstanding shares of any class of securities of a bank or bank holding company, or electing a majority of the directors or directing the management or policies of any such entity, without 60 days prior notice to the Commissioner. The Commissioner may deny approval of the acquisition if the Commissioner determines it to be anti-competitive or to threaten the safety or soundness of a banking institution.

Permissible Activities

A bank holding company is limited in its activities to banking, managing or controlling banks, or providing services for its subsidiaries. Other permitted non-bank activities have been identified as closely related to banking. Bank holding companies that are "well capitalized" and "well managed" and whose financial institution subsidiaries have satisfactory Community Reinvestment Act records can elect to become "financial holding companies," which are permitted to engage in a broader range of financial activities than are permitted to bank holding companies. The Company has not opted to become a financial holding company.

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

Dividend

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

Sources of Strength

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

Stock Repurchases

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

Capital Requirement

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

Regulation of the Bank

General

The Bank is a Maryland commercial bank and its deposit accounts are insured by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation ("FDIC"). On April 18, 2016, the Bank terminated its membership in the Federal Reserve System and cancelled its stock in the Federal Reserve Bank of Richmond. Accordingly, as of that date, the Bank's primary regulator became the FDIC. The Bank currently is subject to supervision, examination and regulation by the Commissioner of Financial Regulation of the State of Maryland (the "Commissioner") and the FDIC.

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

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

Capital Adequacy

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

On January 1, 2015, the Company and Bank became subject to the Basel III Capital Rules with full compliance with all of the final rules' requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions compared to the previous U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions' regulatory capital ratios. The Basel III Capital Rules also address risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios and replace the existing risk-weighting approach with a more risk-sensitive approach. The Basel III Capital Rules also implement the requirements of Section 939A of the Dodd-Frank Act to remove references to credit ratings from the federal banking agencies' rules.

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

In September 2017, the Federal Reserve Board, the FDIC, and the Office of the Comptroller of the Currency (OCC) proposed a rule intended to reduce regulatory burden by simplifying several requirements in the agencies' regulatory capital rule. Most aspects of the proposed rule would apply only to banking organizations that are not subject to the "advanced approaches" in the capital rule, which are generally firms with less than $250 billion in total consolidated assets and less than $10 billion in total foreign exposure. The proposal would simplify and clarify a number of the more complex aspects of the existing capital rule. Specifically, the proposed rule simplifies the capital treatment for certain acquisition, development, and construction loans, mortgage servicing assets, certain deferred tax assets, investments in the capital instruments of unconsolidated financial institutions, and minority interest. A final rule has not yet been issued.

Prompt Corrective Regulatory Action

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

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

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

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

Branching

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

Dividend Limitations

Maryland banks may only pay cash dividends from undivided profits or, with the prior approval of the Commissioner, their surplus in excess of 100% of required capital stock. Maryland banks may not declare a stock dividend unless their surplus, after the increase in capital stock, is equal to at least 20% of the outstanding capital stock as increased. If the surplus of the bank, after the increase in capital stock, is less than 100% of its capital stock as increased, the commercial bank must annually transfer to surplus at least 10% of its net earnings until the surplus is 100% of its capital stock as increased.

Insurance of Deposit Accounts

The Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund of the FDIC. The deposit insurance per account owner is currently $250,000.

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

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

Reserve Requirements

Under federal regulations, the Bank is required to maintain non-interest earning reserves against their transaction accounts (primarily Negotiable Order of Withdrawal (NOW) and regular checking accounts). The regulations required that that reserves be maintained against aggregate transaction accounts as follows for 2017: a 3% reserve ratio was assessed on net transaction accounts up to and including $115.1 million; a 10% reserve ratio is applied above $115.1 million. The first $15.5 million of otherwise reservable balances (subject to adjustments by the Federal Reserve Board) are exempted from the reserve requirements. The amounts are adjusted annually and, for 2018, will require a 3% ratio for up to $122.3 million and an exemption of $16.0 million. At December 31, 2017, the Bank met applicable reserve requirements.

Transactions with Affiliates

A state nonmember bank, such as the Bank, is limited in the amount of “covered transactions” with any affiliate. Covered transactions must also be on terms substantially the same, or at least as favorable, to the Bank or subsidiary as those provided to a non-affiliate. The term “covered transaction” includes the making of loans, purchase of assets, issuance of a guarantee and similar types of transactions. Certain covered transactions, such as loans to affiliates, must meet collateral requirements. At December 31, 2017, we had no transactions with affiliates.

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

Enforcement

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

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

Other Regulations

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

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

- Real Estate Settlement Procedures Act, requiring that borrowers for mortgage loans for one- to four-family residential real estate receive various disclosures, including good faith estimates of settlement costs, lender servicing and escrow account practices, and prohibiting certain practices that increase the cost of settlement services;

- Bank Secrecy Act of 1970, requiring financial institutions to assist U.S. government agencies to detect and prevent money laundering;

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

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

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

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

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

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

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

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

- Gramm-Leach-Bliley Act privacy statute which requires each depository institution to disclose its privacy policy, identify parties with whom certain nonpublic customer information is shared and provide customers with certain rights to "opt out" of disclosure to certain third parties;

- Title III of The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (referred to as the "USA PATRIOT Act"), which significantly expands the responsibilities of financial institutions in preventing the use of the United States financial system to fund terrorist activities. Among other things, the USA PATRIOT Act and the related regulations requires banks operating in the United States to develop anti-money laundering compliance programs, due diligence policies and controls to facilitate the detection and reporting of money laundering;

- The Fair and Accurate Reporting Act of 2003, as an amendment to the Fair Credit Reporting Act, as noted previously, which includes provisions to help reduce identity theft by providing procedures for the identification, detection, and response to patterns, practices, or specific activities—known as "red flags"; and

- Truth in Savings Act, which establishes the requirement for clear and uniform disclosure of terms and conditions regarding deposit interest and fees to help promote economic stability, competition between depository institutions, and allow the consumer to make informed decisions.

Management

Chief Officers

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

William J. Pasenelli, 59, is President and Chief Executive Officer of the Company. He also serves as the Bank's Chief Executive Officer. Mr. Pasenelli joined the Bank as Chief Financial Officer in 2000 and was named President of the Bank in 2010 and President of the Company in May 2012. He relinquished the position of Chief Financial Officer of the Bank in March 2013 and President in July 2016. Before joining the Bank, Mr. Pasenelli had been Chief Financial Officer of Acacia Federal Savings Bank, Annandale, Virginia, since 1987. Mr. Pasenelli has over 30 years of banking experience. He serves on the Board of Directors of the Maryland Bankers Association and the Maryland Chamber of Commerce. Mr. Pasenelli is a member of the American Institute of Certified Public Accountants, the Greater Washington Society of Certified Public Accountants and other civic groups. Mr. Pasenelli is a graduate of the National School of Banking and holds a Bachelor of Arts from Duke University. He also attended the Harvard Business School Program on Negotiation.

Gregory C. Cockerham, 63, joined the Bank in 1988. He serves as Executive Vice President and Chief Lending Officer of the Company and the Bank. Before joining the Bank, he was Vice President of Maryland National Bank. Mr. Cockerham has over 40 years of banking experience. Mr. Cockerham serves as Emeritus and Past Chair of the Board of Directors for the College of Southern Maryland Foundation, Past Chair and Current Board member of Maryland Title Center. He presently serves as the Potomac Baptist Association Finance Chair, is a Paul Harris Fellow, Foundation Chair and Past President of the Rotary Club of Charles County, President of the Rotary Foundation Board, Chair of the Charles County Board of Education CRD Program and serves on various civic boards. Mr. Cockerham is a Maryland Bankers School graduate and holds a Bachelor of Science from West Virginia University. He also attended the Harvard Business School Program on Negotiation.

James M. Burke, 49, joined the Bank in 2005. He serves as the Bank's President and Chief Risk Officer of the Company and the Bank. Before his appointment as President of the Bank in 2016, he served as Executive Vice President and Chief Risk Officer. Before joining the Bank, Mr. Burke served as Executive Vice President and Senior Loan Officer of Mercantile Southern Maryland Bank. Mr. Burke has over 20 years of banking experience. Mr. Burke is the former Chairman of the Board of Directors of University of Maryland Charles Regional Medical Center, serves on the Board of Directors for the ARC of Southern Maryland, Trustee for St. Mary's Ryken High School, Trustee for Historic Sotterley Plantation and is active in other civic groups. Mr. Burke is a Maryland Bankers School graduate and holds a Bachelor of Arts from High Point University. He is also a graduate of the East Carolina Advanced School of Commercial Lending and attended the Harvard Business School Program on Negotiation.

James F. Di Misa, 58, joined the Bank in 2005. He serves as Executive Vice President, Chief Operating Officer of the Company and the Bank. Before joining the Bank, Mr. Di Misa served as Executive Vice President of Mercantile Southern Maryland Bank. Mr. Di Misa has over 30 years of banking experience. Mr. Di Misa is former Chairman of the Board of Trustees for the Maryland Bankers School, a Paul Harris Fellow, Foundation Secretary, Past President of the Rotary Club of Charles County Chairman of Charles County Rotary Scholarships Program, Adjunct Instructor for the College of Southern Maryland, Governor Appointment to the Tri-County Work Force Investment Board (2008-2014), President and Founder of the La Plata Business Association (2002-2010) and of the Board of Trustees for the Maryland Bankers School (2002-2016). He is also a member of several other civic and professional groups. Mr. Di Misa is a Stonier Graduate School of Banking graduate and holds a Masters of Business Administration from Mount St. Mary's College and a Bachelor of Science from George Mason University. He also attended the Harvard Business School Program on Negotiation.

Todd L. Capitani, 51, joined the Bank in 2009. He serves as Executive Vice President, Chief Financial Officer of the Company and the Bank. Before joining the Bank, Mr. Capitani served as a Senior Finance Manager at Deloitte Consulting and as Chief Financial Officer at Ruesch International, Inc. Mr. Capitani has over 25 years of experience in corporate finance, controllership and external audit. Mr. Capitani is involved with several local charities, religious and community organizations. Mr. Capitani is a member of the American Institute of Certified Public Accountants and other civic groups. Mr. Capitani is a Certified Public Accountant and holds a Bachelor of Arts from the University of California at Santa Barbara. He also attended the Harvard Business School Program on Negotiation and the Yale School of Management Strategic Leadership Conference.

Christy M Lombardi, 41, joined the Bank in 1998. She serves as Executive Vice President, Chief Administrative Officer of the Company and the Bank. Ms. Lombardi is responsible for administrative and corporate governance matters for the Company, and oversees human resources and shareholder relations. Ms. Lombardi has 20 years of banking experience. She serves as Immediate Past Chair for the Calvert County Chamber of Commerce Board of Directors, on the Advisory Board of the Maryland Banker's Association Council of Professional Women in Banking and Finance and on the Southern Maryland Workforce Development Board. She is a Maryland Bankers School graduate and holds a Masters in Management from University of Maryland University College as well as a Master's in Business Administration. Ms. Lombardi also attended the Harvard Business School Program on Negotiation.

Item 1A. Risk Factors

Risks

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

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

At December 31, 2017 and 2016, our loan portfolio included $727.3 million, or 63.3%, and $667.1 million, or 61.3%, respectively, of commercial real estate loans, $110.3 million, or 9.6%, and $101.9 million, or 9.4%, respectively, of residential rental loans, $56.4 million, or 4.9% and $50.5 million, or 4.6%, respectively of commercial business loans and $35.9 million, or 3.1% and $39.7 million, or 3.7%, respectively, of commercial equipment loans. We intend to maintain our emphasis on these types of loans. These types of loans generally expose a lender to greater risk of non-payment and loss and require a commensurately higher loan loss allowance than owner-occupied one- to four-family residential mortgage loans because repayment of the loans often depends on the successful operation of the property and the income stream of the borrowers. Such loans typically involve larger loan balances compared to one- to four-family residential mortgage loans. Commercial business and equipment loans expose us to additional risks since they typically are made on the basis of the borrower’s ability to make repayments from the cash flows of the borrower’s business and are secured by non-real estate collateral that may depreciate over time. Also, many of our commercial borrowers have more than one loan outstanding with us. Consequently, an adverse development with respect to one loan or one credit relationship can expose us to a significantly greater risk of loss compared to an adverse development with respect to a one- to four-family residential mortgage loan. At December 31, 2017 and 2016, $3.5 million, or 73.5% and $4.6 million, or 55.4%, respectively, of our non-accrual loans of $4.7 million and $8.4 million, respectively, consisted of commercial loans.

Our provision for loan losses has been improving as the Company’s credit metrics have improved. We may be required to make further increases in our provision for loan losses and to charge-off additional loans in the future. Further, our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio.

For the years ended December 31, 2017 and 2016, we recorded a provision for loan losses of $1.0 million and $2.4 million, respectively. We also recorded net loan charge-offs of $355,000 and $1.0 million for the years ended

December 31, 2017 and 2016, respectively. Our non-accrual loans, OREO and accruing TDRs aggregated $24.1 million, or 1.71% of total assets and $26.6 million, or 1.99% of total assets, respectively, at December 31, 2017 and 2016. Additionally, loans that were classified as special mention and substandard were $40.4 million and $30.4 million, respectively, at December 31, 2017 and 2016. We had $0 and $137,000 in loans classified as doubtful and no loans classified as loss at December 31, 2017 and 2016. If the economy and/or the real estate market weakens, more of our classified loans may become non-performing and we may be required to take additional provisions to increase our allowance for loan losses for these assets as the value of the collateral may be insufficient to pay any remaining net loan balance, which would have a negative effect on our results of operations. We maintain an allowance for loan losses to provide for loans in our portfolio that may not be repaid in their entirety. We believe that our allowance for loan losses is maintained at a level adequate to absorb probable losses inherent in our loan portfolio as of the corresponding balance sheet date. However, our allowance for loan losses may not be sufficient to cover actual loan losses, and future provisions for loan losses could materially adversely affect our operating results.

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

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

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

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

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

At December 31, 2017 and 2016, our non-accrual loans totaled $4.7 million, or 0.41% of our loan portfolio and $8.4 million, or 0.77% of our loan portfolio, respectively. At December 31, 2017 and 2016, our non-accrual loans, OREO and accruing TDRs totaled $24.1 million, or 1.71% of total assets and $26.6 million, or 1.99% of total assets, respectively. Our non-performing assets adversely affect our net income in various ways. We do not accrue interest income on non-accrual loans or foreclosed properties, thereby adversely affecting our net income and returns on assets and equity, increasing our loan administration costs and adversely affecting our efficiency ratio. When we take collateral in foreclosure and similar proceedings, we are required to mark the collateral to its then fair market value, less estimated selling costs, which may result in a loss. These non-performing loans and foreclosed properties also increase our risk profile and the amount of capital our regulators believe is appropriate to maintain in light of such risks. The resolution of non-performing assets requires significant time commitments from management and can be detrimental to the performance of their other responsibilities. If we experience increases in non-performing loans and non-performing assets, our net interest income will be negatively impacted and our loan administration costs could increase, each of which could have an adverse effect on our net income and related ratios, such as return on assets and equity.

At December 31, 2017 and 2016 our total classified assets were $50.3 million and $39.2 million, respectively. While we continue to accrue interest income on classified loans that are performing, classified loans and other classified assets may negatively impact profitability by requiring additional management attention and regular monitoring. Increased monitoring of these assets by management may impact our management's ability to focus on opportunistic growth, potentially adversely impacting future profitability.

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

At December 31, 2017 and 2016, $170.4 million, or 14.8%, of our total loan portfolio, and $171.0 million, or 15.7%, of our total loan portfolio, respectively, consisted of owner-occupied one- to four-family residential mortgage loans. At December 31, 2017 and 2016, $21.4 million, or 1.9%, of our total loan portfolio and $21.4 million, or 2.0%, of our total loan portfolio, respectively, consisted of home equity loans and lines of credit. Declines in the housing market could result in declines in real estate values in our market area. A decline in real estate values could cause some of our mortgage and home equity loans to be inadequately collateralized, which would expose us to a greater risk of loss if we seek to recover on defaulted loans by selling the real estate collateral.

We may be adversely affected by recent changes in U.S. tax laws and regulations.

Changes in tax laws contained in the Tax Cuts and Jobs Act, which was enacted in December 2017, include a number of provisions that will have an impact on the banking industry, borrowers and the market for residential real estate. Included in this legislation was a reduction of the corporate income tax rate from 35% to 21%. In addition, other changes included: (i) a lower limit on the deductibility of mortgage interest on single-family residential mortgage loans, (ii) the elimination of interest deductions for home equity loans, (iii) a limitation on the deductibility of business interest expense and (iv) a limitation on the deductibility of property taxes and state and local income taxes.

The recent changes in the tax laws may have an adverse effect on the market for, and valuation of, residential properties, and on the demand for such loans in the future, and could make it harder for borrowers to make their loan payments. In addition, these recent changes may also have a disproportionate effect on taxpayers in states with high residential home prices and high state and local taxes, such as Maryland. If home ownership becomes less attractive, demand for mortgage loans could decrease. The value of the properties securing loans in our loan portfolio may be adversely impacted as a result of the changing economics of home ownership, which could require an increase in our provision for loan losses, which would reduce our profitability and could materially adversely affect our business, financial condition and results of operations.

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

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

• Economic conditions that negatively affect housing prices and the job market may cause the credit quality of our loan portfolios to deteriorate;

• Market developments that affect consumer confidence may cause adverse changes in payment patterns by our customers, causing increases in delinquencies and default rates on loans and other credit facilities;

• The processes that we use to estimate our allowance for loan losses and reserves may no longer be reliable because they rely on judgments, such as forecasts of economic conditions, that may no longer be capable of accurate estimation;

• The value of our securities portfolio may decline; and

• We face increased regulation of our industry, and the costs of compliance with such regulation may increase.

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

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

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

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

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

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

In addition to being affected by general economic conditions, our earnings and growth are affected by the policies of the Federal Reserve. In recent years, various significant economic and monetary stimulus measures were implemented by the U.S. Congress and the Federal Reserve pursued a highly accommodative monetary policy aimed at keeping interest rates at historically low levels although the Federal Reserve has begun to modify certain aspects of this policy by gradually increasing short-term interest rates and reducing its balance sheet. U.S. economic activity has significantly improved, but there can be no assurance that this progress will continue or will not reverse.

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

Our financial condition and results of operations could be negatively affected if we fail to timely and effectively execute our strategic plan or manage the growth called for in our strategic plan. We have grown through our January 1, 2018 acquisition of County First Bank and may continue to grow through acquisitions. To be successful as a larger institution, we must successfully integrate the operations and retain the customers of acquired institutions, attract and retain the management required to successfully manage larger operations, and control costs.

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

In implementing our strategic plan, we may expand into additional communities or attempt to strengthen our position in our current markets through opportunistic acquisitions of whole banks or branch locations. On January 1, 2018, we acquired County First Bank. Future results of operations will be impacted by our ability to successfully integrate the operations of County First Bank and any other acquired institutions and retain the customers of those institutions. If we are unable to successfully manage the integration of the separate cultures, customer bases and operating systems of the acquired institutions, and any other institutions that may be acquired in the future, our results of operations could be negatively impacted. As a result of the County First Bank acquisition and to the extent that we undertake additional acquisitions, we are likely to experience the effects of higher operating expenses relative to operating income from the new operations during the integration period, which may have an adverse effect on our levels of reported net income, return on average equity and return on average assets. In addition, if we undertake substantial growth, we may need to increase non-interest expenses through additional personnel, occupancy expense and data processing costs, among others. In order to successfully manage growth, we may need to adopt and effectively implement policies, procedures and controls to maintain credit quality, control costs and oversee operations. No assurance can be given that we will be successful in this strategy. Other effects of engaging in such growth strategies may include potential diversion of our management's time and attention and general disruption to our business. We may not be able to adequately, timely and profitably achieve the intended benefits or our growth strategies or manage anticipated growth.

Finally, substantial growth may stress regulatory capital levels, and may require us to raise additional capital. No assurance can be given that we will be able to raise any required capital, or that it will be able to raise capital on terms that are beneficial to stockholders.

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

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

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

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

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

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

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

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

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

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

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

A significant portion of the population in our market area is affiliated with or employed by the federal government or at military facilities located in the area which contribute to the local economy. As a result, a reduction in federal government or military employment or programs could have a negative impact on local economic conditions and real estate collateral values, and could also negatively affect the Company's profitability.

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

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

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

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

• Changes to regulatory capital requirements;

• Creation of new government regulatory agencies (such as the Financial Stability Oversight Council, which oversees systemic risk, and the Consumer Financial Protection Bureau, which develops and enforces rules for bank and non-bank providers of consumer financial products);

• Potential limitations on federal preemption;

• Changes to deposit insurance assessments;

• Regulation of debit interchange fees we earn;

• Changes in retail banking regulations, including potential limitations on certain fees we may charge; and

• Changes in regulation of consumer mortgage loan origination and risk retention.

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

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

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

New capital rules adopted by the Federal Reserve substantially amended the regulatory risk-based capital rules applicable to us. The rule includes new risk-based capital and leverage ratios, which became effective January 1, 2015, and revise the definition of what constitutes "capital" for purposes of calculating those ratios. The rules apply to the Company as well as to the Bank. Beginning in the first quarter of 2015, our minimum capital requirements were (i) a common Tier 1 equity ratio of 4.5%, (ii) a Tier 1 capital (common Tier 1 capital plus Additional Tier 1 capital) of 6% (up from 4%) and (iii) a total capital ratio of 8%. Our leverage ratio requirement will remain at the 4% level. Finally, the new capital rules limit capital distributions and certain discretionary bonus payments if the banking organization does not hold a "capital conservation buffer" consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The capital conservation buffer requirement was phased in beginning January 1, 2016, at 0.625% of risk-weighted assets, increasing each year until fully implemented at 2.5% on January 1, 2019.

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

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

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

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

Our internal control systems are inherently limited.

Our systems of internal controls, disclosure controls and corporate governance policies and procedures are inherently limited. The inherent limitations of our system of internal controls include the use of judgment in decision-making that can be faulty; breakdowns can occur because of human error or mistakes; and controls can be circumvented by individual acts or by collusion of two or more people. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and any design may not succeed in achieving its stated goals under all potential future conditions. Because of the inherent limitation of a cost-effective control system, misstatements due to error or fraud may occur and may not be detected, which may have an adverse effect on our business, results of operations or financial condition. Additionally, any plans of remediation for any identified limitations may be ineffective in improving our internal controls.

The market price and liquidity of our common stock could be adversely affected if the economy were to weaken or the capital markets were to experience volatility.

The market price of our common stock could be subject to significant fluctuations due to changes in sentiment in the market regarding our operations or business prospects. Among other factors, these risks may be affected by:

- Operating results that vary from the expectations of our management or of securities analysts and investors;
- Developments in our business or in the financial services sector generally;
- Regulatory or legislative changes affecting our industry generally or our business and operations;
- Operating and securities price performance of companies that investors consider to be comparable to us;
- Changes in estimates or recommendations by securities analysts or rating agencies;
- Announcements of strategic developments, acquisitions, dispositions, financings, and other material events by us or our competitors;
- Changes or volatility in global financial markets and economies, general market conditions, interest or foreign exchange rates, stock, commodity, credit, or asset valuations; and
- Significant fluctuations in the capital markets.

Economic or market turmoil could occur in the near or long term, which could negatively affect our business, our financial condition, and our results of operations, as well as volatility in the price and trading volume of our common stock.

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

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

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

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

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

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

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

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

We are exposed to many types of operational risks, including reputational risk, legal and compliance risk, the risk of fraud or theft by employees or outsiders, and unauthorized transactions by employees or operational errors, including clerical or record-keeping errors or those resulting from faulty or disabled computer, telecommunications systems, cyber security breaches and other disruptive problems caused by the Internet or other users. Negative public opinion can result from our actual or alleged conduct in any number of activities, including lending practices, corporate governance and acquisitions of other entities, and from actions taken by government regulators and community organizations in response to those activities. Negative public opinion can adversely affect our ability to attract and keep customers and can expose us to litigation and regulatory action. Actual or alleged conduct by the Bank can also result in negative public opinion about our other businesses.

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

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

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

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

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

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

If our information technology is unable to keep pace with industry developments, our business and results of operations may be adversely affected.

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

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

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

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

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

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

The Bank maintains its main office and operations center in Waldorf, Maryland, in addition to its branch offices in Lexington Park, Leonardtown, La Plata, Dunkirk, Bryans Road, Waldorf, Charlotte Hall, Prince Frederick and Lusby, Maryland and one branch in Fredericksburg, Virginia. The Bank owns all of its branches except for the Dunkirk, Maryland branch, the Fredericksburg Central Park, Virginia branch and the land on which the Waldorf, Charlotte Hall, Prince Frederick and Lusby, Maryland branches are located. In addition, the Bank maintains five loan production offices ("LPOs") in La Plata, Prince Frederick, Leonardtown and Annapolis, Maryland; and Fredericksburg, Virginia. The Leonardtown LPO is co-located with branches. Lease expiration dates range from 2019 to 2035 with renewal options of 5 to 10 years. Lease expiration dates range from 2019 to 2035 with renewal options of 5 to 10 years. The net book value of premises, which included land, building and improvements, totaled $19.1 million and $ 19.5 million, respectively, at December 31, 2017 and 2016.

Item 3. Legal Proceedings

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

Item 4. Mine Safety Disclosures

Not applicable.

PART II

Item 5 - Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Price and Dividends on Registrant's and Related Stockholder Matters.

Market Information

The following table sets forth high and low bid quotations reported for the Company's common stock for each quarter during 2017 and 2016 and the dividends declared per share for common stock. These quotes reflect inter-dealer prices without retail mark-up, mark-down or commission and may not necessarily reflect actual transactions.

Quarter Ended	High	Low	Dividends Per Share
December 31, 2017	$40.44	$35.14	$ 0.10
September 30, 2017	40.69	32.06	0.10
June 30, 2017	40.00	32.24	0.10
March 31, 2017	36.00	27.16	0.10
December 31, 2016	30.40	22.61	0.10
September 30, 2016	23.97	21.80	0.10
June 30, 2016	23.76	20.60	0.10
March 31, 2016	21.84	19.19	0.10

Holders

The common stock of the Company is traded on the NASDAQ Stock Exchange (Symbol: TCFC). The number of stockholders of record of the Company at March 2, 2018 was 649**.**

Dividends

During 2017 and 2016, the Company declared and paid four quarters of dividends at $0.10 per share. The Board of Directors considers on a quarterly basis the feasibility of paying a cash dividend to its stockholders. Under the Company's general practice, dividends, if declared during the quarter, are paid prior to the end of the subsequent quarter.

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

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

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

Stock Performance Graph

The following graph and table show the cumulative total return on the common stock of the Company over the last five years, compared with the cumulative total return of a broad stock market index (the NASDAQ Capital Market Composite), and a narrower index of the NASDAQ Bank Index. Cumulative total return on the stock or the index equals the total increase in value since December 31, 2012, assuming reinvestment of all dividends paid into the stock or the index.

The graph and table were prepared assuming that $100 was invested on December 31, 2012, in the common stock and the securities included in the indexes.

Source: Bloomberg

	Year Ended					
Index	**12/31/2012**	**12/31/2013**	**12/31/2014**	**12/31/2015**	**12/31/2016**	**12/31/2017**
The Community Financial Corporation	100.00	132.72	131.19	138.97	194.93	260.13
NASDAQ Bank Index	100.00	141.31	148.11	161.09	221.04	232.84
NASDAQ Capital Market Composite	100.00	136.61	128.96	107.08	122.74	143.36

Recent Sales of Unregistered Securities

Not applicable.

Purchases of Equity Securities by the Issuer

On May 4, 2015, the Board of Directors approved a repurchase plan (“2015 repurchase plan). The 2015 repurchase plan authorizes the repurchase of up to 250,000 shares of outstanding common stock. The 2015 repurchase plan will continue until it is completed or terminated by the Company’s Board of Directors. During the quarter ended December 31, 2015, the 2015 repurchase plan began with the termination of the 2008 repurchase program. As of December 31, 2017, 188,558 shares were available to be repurchased under the 2015 repurchase program. The following schedule shows the repurchases during the three months ended December 31, 2017.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1-31, 2017	-	$ -	-	188,558
November 1-30, 2017	-	-	-	188,558
December 1-31, 2017	-	-	-	188,558
Total	-	$ -	-	188,558

41

Item 6 - Selected Financial Data

SUMMARY OF SELECTED FINANCIAL DATA

The following table shows selected historical consolidated financial data for the Company as of and for each of the five years ended December 31, 2017, which has been derived from our audited consolidated financial statements. You should read this table together with our consolidated financial statements and related notes included elsewhere in this Annual 10-K report.

	At or for the Years Ended December 31,				
(dollars in thousands, except per share amounts)	**2017**	**2016**	**2015**	**2014**	**2013**
FINANCIAL CONDITION DATA					
Total assets	$1,405,961	$1,334,257	$1,143,332	$1,082,878	$1,023,824
Loans receivable, net	1,140,615	1,079,519	909,200	862,409	799,130
Investment securities	167,531	162,280	144,536	126,445	134,648
Deposits	1,106,237	1,038,825	906,899	869,384	821,295
Borrowings	142,998	144,559	91,617	76,672	70,476
Junior subordinated debentures	12,000	12,000	12,000	12,000	12,000
Subordinated notes - 6.25%	23,000	23,000	23,000	-	-
Stockholders’ equity—preferred	-	-	-	20,000	20,000
Stockholders’ equity—common	109,957	104,426	99,783	96,559	90,730
OPERATING DATA					
Interest and dividend income	$53,570	$48,047	$43,873	$41,759	$39,678
Interest expenses	10,182	8,142	7,345	6,698	7,646
Net interest income (NII)	43,388	39,905	36,528	35,061	32,032
Provision for loan losses	1,010	2,359	1,433	2,653	940
NII after provision for loan losses	42,378	37,546	35,095	32,408	31,092
Noninterest income	4,084	3,360	3,299	4,093	4,174
Noninterest expenses	30,097	29,159	28,418	26,235	24,844
Income before income taxes	16,365	11,747	9,976	10,266	10,422
Income taxes	9,157	4,416	3,633	3,776	3,771
Net income	7,208	7,331	6,343	6,490	6,651
Preferred stock dividends declared	-	-	23	200	200
Income available to common shares	$7,208	$7,331	$6,320	$6,290	$6,451
COMMON SHARE DATA					
Basic earnings per common share	$1.56	$1.59	$1.36	$1.35	$1.90
Diluted earnings per common share	1.56	1.59	1.35	1.35	1.88
Dividends declared per common share	0.40	0.40	0.40	0.40	0.40
Book value per common share [(1)]	23.65	22.54	21.48	20.53	19.52
Common shares outstanding at end of period	4,649,658	4,633,868	4,645,429	4,702,715	4,647,407

Basic weighted average common shares	4,627,776	4,599,502	4,676,748	4,646,424	3,402,432
Diluted weighted average common shares	4,629,228	4,599,502	4,676,748	4,655,127	3,426,793
OTHER DATA					
Number of:					
Full-time equivalent employees	165	162	171	172	165
Full-service offices	11	12	12	12	11
Loan Production Offices	5	5	5	5	4
REGULATORY CAPITAL RATIOS (consolidated)					
Tier 1 capital to average assets (Leverage)	8.79 %	9.02 %	10.01 %	12.24 %	12.50 %
Tier 1 common capital to risk-weighted assets	9.51	9.54	10.16	n/a	n/a
Tier 1 capital to risk-weighted assets	10.53	10.62	11.38	14.26	14.66
Total risk-based capital to risk-weighted assets	13.40	13.60	14.58	15.21	15.62

	At or for the Years Ended December 31,				
(dollars in thousands, except per share amounts)	**2017**	**2016**	**2015**	**2014**	**2013**
KEY OPERATING RATIOS					
Return on average assets	0.52 %	0.60 %	0.58 %	0.63 %	0.69 %
Return on average total equity	6.55	7.09	6.21	5.69	7.49
Return on average common equity	6.55	7.09	6.33	6.69	9.38
Interest rate spread	3.24	3.35	3.48	3.55	3.45
Net interest margin	3.37	3.48	3.60	3.68	3.56
Efficiency ratio (2)	63.40	67.40	71.35	67.00	68.62
Common dividend payout ratio	25.64	25.16	29.41	29.63	21.05
Non-interest expense to average assets	2.19	2.37	2.60	2.56	2.56
Net operating expense to average assets(3)	1.89	2.10	2.30	2.16	2.13
Avg. int-earning assets to avg. int-bearing liabilities	116.95	117.56	117.71	118.83	114.57
SELECTED ASSET QUALITY DATA					
Gross loans	$1,150,044	$1,088,982	$918,894	$872,129	$808,240
Classified assets	50,298	39,246	43,346	54,022	56,880
Allowance for loan losses	10,515	9,860	8,540	8,481	8,138
Nonperforming loans (>=90 Days) (4)	2,483	7,705	10,740	10,263	11,170
Non-accrual loans (5)	4,693	8,374	11,433	10,263	15,451
Accruing troubled debt restructures (TDRs) (6)	10,021	10,448	13,133	13,249	4,364
Other Real Estate Owned (OREO)	9,341	7,763	9,449	5,883	6,797
Non-accrual loans, OREO and TDRs	$24,055	$26,585	$34,015	$29,395	$26,612
SELECTED ASSET QUALITY RATIOS					
Average total equity to average total assets	7.99 %	8.41 %	9.35 %	11.11 %	9.16 %
Classified assets to total assets	3.58	2.94	3.79	4.99	5.56
Classified assets to risk-based capital	32.14	26.13	30.19	39.30	43.11
Allowance for loan losses to total loans	0.91	0.91	0.93	0.97	1.01
Allowance for loan losses to nonperforming loans	423.48	127.97	79.52	82.64	72.86
Net charge-offs to avg. outstanding loans	0.03	0.11	0.16	0.28	0.14
Nonperforming loans to total loans	0.22	0.71	1.17	1.18	1.38
Non-accrual loans to total loans	0.41	0.77	1.24	1.18	1.91
Non-accrual loans and TDRs to total loans	1.28	1.73	2.67	2.70	2.45
Non-accrual loans and OREO to total assets	1.00	1.21	1.83	1.49	2.17
Non-accrual loans, OREO and TDRs to total assets	1.71	1.99	2.98	2.71	2.60

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

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

(3) Net operating expense is the sum of non-interest expense offset by non-interest income.

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

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

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

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

Forward-Looking Statements

This report contains forward-looking statements that are based on assumptions and may describe future plans, strategies and expectations of The Community Financial Corporation (the "Company") and Community Bank of the Chesapeake (the "Bank"). Forward-looking statements can generally be identified by the fact that they do not relate strictly to historical or current facts. They often include words like "believe," "expect," "anticipate," "estimate" and "intend" or future or conditional verbs such as "will," "would," "should," "could" or "may." Statements in this Report that are not strictly historical are forward-looking and are based upon current expectations that may differ materially from actual results. These forward-looking statements include, without limitation, those relating to the Company's and Community Bank of the Chesapeake's future growth and management's outlook or expectations for revenue, assets, asset quality, profitability, business prospects, net interest margin, non-interest revenue, allowance for loan losses, the level of credit losses from lending, liquidity levels, capital levels, or other future financial or business performance strategies or expectations.

These forward-looking statements may also include: any statements of the plans and objectives of management for future operations products or services, including the execution of integration plans relating to the County First acquisition; plans regarding branch closings or consolidation; any statement of expectation or belief; projections related to certain financial metrics; and any statement of assumptions underlying the foregoing. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those anticipated by the statements made herein. These risks and uncertainties involve general economic trends, changes in interest rates; loss of deposits and loan demand to other financial institutions; substantial changes in financial markets; changes in real estate value and the real estate market; regulatory changes; the possibility of unforeseen events affecting the industry generally; the uncertainties associated with newly developed or acquired operations; the outcome of litigation that may arise; market disruptions and other effects of terrorist activities; and the matters described in "Item 1A Risk Factors" in this Annual Report on Form 10-K for the Year Ended December 31, 2017, and in the Company's other Reports filed with the Securities and Exchange Commission (the "SEC").

The Company's forward-looking statements may also be subject to other risks and uncertainties, including those that the Company may discuss elsewhere in this Report or in its other filings with the SEC, accessible on the SEC's Web site at www.sec.gov. The Company undertakes no obligation to update these forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unforeseen events, except as required under the rules and regulations of the SEC.

Use of Non-GAAP Financial Measures

Statements included in management's discussion and analysis include non-GAAP financial measures and should be read along with the accompanying tables, which provide a reconciliation of non-GAAP financial measures to GAAP financial measures. The Company's management uses these non-GAAP financial measures, and believes that non-GAAP financial measures provide additional useful information that allows readers to evaluate the ongoing performance of the Company. Non-GAAP financial measures should not be considered as an alternative to any measure of performance or financial condition as promulgated under GAAP, and investors should consider the

Company's performance and financial condition as reported under GAAP and all other relevant information when assessing the performance or financial condition of the Company. Non-GAAP financial measures have limitations as analytical tools, and investors should not consider them in isolation or as a substitute for analysis of the results or financial condition as reported under GAAP. See Non-GAAP reconciliation schedule that immediately follows: Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations.

Critical Accounting Policies

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

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

Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When these sources are not available, management makes estimates based upon what it considers to be the best available information.

Allowance for Loan Losses

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

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

Management uses a risk scale to assign grades to commercial relationships, which include commercial real estate, residential rentals, construction and land development, commercial loans and commercial equipment loans. Commercial loan relationships with an aggregate exposure to the Bank of $1,000,000 or greater are risk rated. Residential first mortgages, home equity and second mortgages and consumer loans are monitored on an ongoing basis based on borrower payment history. Consumer loans and residential real estate loans are classified as unrated unless they are part of a larger commercial relationship that requires grading or are troubled debt restructures or nonperforming loans with an Other Assets Especially Mentioned or higher risk rating due to a delinquent payment history.

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

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

Management has significant discretion in making the judgments inherent in the determination of the allowance for loan losses, including the valuation of collateral, assessing a borrower’s prospects of repayment and in establishing loss factors on the general component of the allowance. Changes in loss factors have a direct impact on the amount of the provision and on net income. Errors in management’s assessment of the global factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions. At December 31, 2017 and 2016, the allowance for loan losses was $10.5 million and $9.9 million, respectively, or 0.91% and 0.91%, respectively, of total loans. An increase or decrease in the allowance could result in a charge or credit to income before income taxes that materially impacts earnings.

For additional information regarding the allowance for loan losses, refer to Notes 1 and 6 of the Consolidated Financial Statements and the discussion the discussion in this MD&A.

Other Real Estate Owned ("OREO")

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

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

For additional information regarding OREO, refer to Notes 1 and 8 of the Consolidated Financial Statements.

Deferred Tax Assets

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

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

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

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

For additional information regarding income taxes and deferred tax assets, refer to Notes 1 and 12 of the Consolidated Financial Statements.

OVERVIEW

Community Bank of the Chesapeake (the "Bank") is headquartered in Southern Maryland with branches located in Maryland and Virginia. The Bank is a wholly owned subsidiary of The Community Financial Corporation (the "Company").

The Company's branches are located at its main office in Waldorf, Maryland, and 10 branch offices in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick, Lusby, California, Maryland; and Fredericksburg, Virginia. The Company maintains five loan production offices ("LPOs") in Annapolis, La Plata, Prince Frederick and Leonardtown, Maryland; and Fredericksburg, Virginia. The Leonardtown LPO is co-located with the branch.

The Bank has increased assets primarily with organic loan growth. During the past five years the Bank's loan portfolio has increased $341.8 million from $808.2 million at December 31, 2013 to $1,150.0 million at December 31, 2017. The Bank believes that its ability to offer fast, flexible, local decision-making will continue to attract significant new business relationships. The Bank focuses its business generation efforts on targeting small and medium sized commercial businesses with revenues between $5.0 million and $35.0 million as well as local municipal agencies and not-for-profits. The Bank's marketing is also directed towards increasing its balances of transactional deposit accounts, which are all deposit accounts other than certificates of deposit. The Bank believes that increases in these account types will lessen the Bank's dependence on higher-cost funding, such as certificates of deposit and borrowings. Although management believes that this strategy will increase financial performance over time, increasing the balances of certain products, such as commercial lending and transaction accounts, may also increase the Bank's noninterest expense. The Bank recognizes that certain lending and deposit products increase the possibility of losses from credit and other risks.

2017 Operations Summary

Net income for year ended December 31, 2017 was $7.2 million or $1.56 per diluted share after the inclusion of the additional tax expense under the recently enacted Tax Cuts and Jobs Act and the expenses associated with the acquisition of County First Bank. The additional income tax and merger and acquisition costs of $724,000, net of tax, resulted in a reduction of earnings per share of approximately $0.75 per share for 2017. Net income for the year ended December 31, 2016 was $7.3 million or $1.59 per diluted share.

Income before taxes (pretax income) increased $619,000 or 18.3% to $4.0 million for the three months ended December 31, 2017 compared to $3.4 million for the three months ended December 31, 2016. The Company’s pretax returns on average assets and common stockholders’ equity for the fourth quarter of 2017 were 1.14% and 14.15%, respectively, compared to 1.04% and 12.84%, respectively, for the fourth quarter of 2016. The Company’s after-tax returns on average assets and common stockholders’ equity for the fourth quarter of 2017 were (0.13%) and (1.62%), respectively, compared to 0.62% and 7.68%, respectively, for the fourth quarter of 2016. Pretax income increased $4.6 million or 39.3% to $16.3 million for the year ended December 31, 2017 compared to $11.7 million for the year ended December 31, 2016. The Company’s pretax returns on average assets and common stockholders’ equity for 2017 were 1.19% and 14.88%, respectively, compared to 0.96% and 11.36%, respectively, for 2016. The Company’s after-tax returns on average assets and common stockholders’ equity for 2017 were 0.52% and 6.55%, respectively, compared to 0.60% and 7.09%, respectively, for 2016.

On January 1, 2018, we completed the legal merger with County First Bank adding total assets of approximately $227 million, which included approximately $143 million in loans and $200 million in deposits. The acquisition should complement the Company’s strategy to enhance net interest income and remain focused on creating operating leverage by growing top line revenue faster than operating expenses. Acquired cash, securities and deposits positively impacted the Company’s liquidity. Cash and securities acquired of approximately $72 million will allow the Bank to pay down more costly wholesale funding in 2018. Approximately $160 million of the acquired deposits were stable low-cost transaction accounts that will fund planned loan growth in 2018. The closing of four of the five acquired branches this spring should begin to positively impact the Company’s operating expense run rate in the second half of 2018. The details of the transaction are more fully described below the 2017 Operations Summary.

Although the increased tax expense related to the deferred tax revaluation and merger and acquisition costs decreased net income, earnings per share and returns on average assets and common equity for the year, management believes the reduced federal income tax rate and the efficiencies from the County First acquisition will be accretive in 2018. The Company completed a very strong 2017 with operating net income [1] growing at a record pace for the Company. Operating earnings per share increased to $2.31 per share, an increase of $0.72 or 45% from $1.59 per share in 2016. Operating return on average assets and operating return on average common equity increased to 0.78% and 9.70%, respectively, compared to 0.60% and 7.09% in 2016.

[1] The Company defines operating net income as net income before merger and acquisition costs and the deferred tax adjustment for Tax Cuts and Jobs Act. Operating earnings per share, operating return on average assets and operating return on average common equity is calculated using adjusted operating net income. See Non-GAAP reconciliation schedule that immediately follows: Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations.

We accomplished the increased profitability primarily by controlling expense growth and improving asset quality. The Company's efficiency ratio[3] averaged in the low 60s for the year ended December 31, 2017. The Company's cost control efforts and continued asset growth continued to create operating leverage[3] in 2017.

Average loans increased $125.5 million or 12.7% from $988.3 million for the year ended December 31, 2016 to $1,113.8 million for the year ended December 31, 2017. Overall, end of period loan growth for 2017 of $61.1 million or 5.6% was lower than the Company's planned 8% to 9% growth. The Company's two largest portfolios, commercial real estate and residential rentals grew $60.2 million or 9.0% to $727.3 million and $8.3 million or 8.2% to $110.2 million, respectively, for the year ended December 31, 2017. Other portfolios decreased a net of $7.5 million or 2.3% to $312.5 million. The decrease in other portfolios included a $630,000 decrease in the residential first mortgage portfolio to $170.4 million and a $9.1 million decrease in the construction and land development to $27.9 million. During 2017, management directed its focus to higher yielding commercial real estate and construction loans and deemphasized residential first mortgage lending.

Deposits increased by 6.5%, or $67.4 million, to $1,106.2 million at December 31, 2017 compared to $1,038.8 million at December 31, 2016. During 2017, balance sheet growth was balanced, with deposit growth of $67.4 million slightly exceeding loan growth of $61.1 million. Retail deposits, which include all deposits except traditional brokered deposits, increased a total of $79.4 million, comprised of increases in transaction accounts of $48.6 million and time deposits of $30.8 million. These retail increases to deposits were partially offset by a decrease to brokered deposits of $12.0 million.

Acquisition of County First Bank

On January 1, 2018, the Company completed its previously announced merger of County First Bank ("County First") with and into the Bank, with the Bank as the surviving bank (the "Merger") pursuant to the Agreement and Plan of Merger, dated as of July 31, 2017, by and among the Company, the Bank and County First. Pursuant to the Merger Agreement, at the effective time of the Merger (the "Effective Time"), each share of common stock, par value $1.00 per share, of County First issued and outstanding immediately prior to the Effective Time was converted into the right to receive 0.9543 shares of Company common stock and $2.20 in cash (the "Merger Consideration"). The $2.20 in cash represents the sum of (i) $1.00 in cash consideration (the "Cash Consideration") plus (ii) $1.20 in Contingent Cash Consideration that was determined before the completion of the Merger in accordance with the terms of the Merger Agreement. The aggregate merger consideration consisted of approximately 919,000 shares of the Company's common stock and approximately $2.1 million in cash. Based upon the $38.78 per share closing price of the Company's common stock on December 28, 2017, the transaction value was approximately $37.7 million.

The County First Bank acquisition is being accounted for under the acquisition method of accounting with the Company treated as the acquirer. Under the acquisition method of accounting, the assets and liabilities of County First Bank, as of January 1, 2018, will be recorded by the Company at their respective fair values, and the excess of the merger consideration over the fair value of County First Bank's net assets will be allocated to goodwill. At December

31, 2017, County First had total assets of approximately $227 million, total loans of $143 million and total deposits of $200 million. County First had five branch offices in La Plata, Waldorf, New Market, Prince Frederick and California, Maryland. The Bank intends to keep the La Plata branch open and consolidate the remaining four branches with legacy Community Bank of the Chesapeake branch offices in May of 2018. The calculations to determine fair values were not complete at the time of filing of the 2017 Annual Report on Form 10-K. Until the determination of the fair values is complete, it is impractical to include disclosures related to the fair value of the assets acquired and liabilities assumed as required by the accounting guidance.

Merger related costs, which included mainly professional fees and investment banking costs, for the year ended December 31, 2017 were $829,000.

[2] **Efficiency Ratio -** noninterest expense divided by the sum of net interest income and noninterest income.

[3] **Operating leverage** occurs when the Company increases its assets, and by extension its net interest income, while limiting increases in noninterest expense. In order for this to be effective, the Company must simultaneously pursue the following: increase the asset size while maintaining asset quality, increase funding at an economically viable cost, and control noninterest expense growth.

2016 Operations Summary

During 2016, the Company planned to increase the loan portfolio by at least 10% and control expenses. Due to the low interest rate environment for most of 2016, and its effect on net interest margin, the Company continued restructuring of operations to reduce costs. In the first quarter of 2016, the Company completed a redesign of the branch system. This redesign, combined with the closure of the King George facility allowed the Company to reduce branch employees by 15% from 73 at March 31, 2015 to 62 at March 31, 2016. The Company focused on reducing other expenses by streamlining internal processes and FTEs as well as by reviewing vendor relationships. The Company's cost control efforts and continued asset growth created operating leverage[4] and increased its earnings per share, return on average assets and return on equity.

The focus on expense control is a continuing initiative and during the second quarter of 2017, the Company announced the closing of its Central Park Fredericksburg branch. The branch closed in the third quarter of 2017. This location continues to serve as a loan production office and the branch closure did not have a material effect on operations. The Company offered branch employees open positions. Changing customer banking preferences, along with the opening of our downtown Fredericksburg branch influenced the decision to close the Central Park branch.

The Company's efficiency ratio improved in every quarter of 2016. The efficiency ratio improved from 73.67% for the fourth quarter of 2015 to 64.38% for the fourth quarter of 2016. Year over year, the efficiency ratio improved 395 basis points to 67.40% from 71.35% for the years ended December 31, 2016 and 2015, respectively. The rate of expense growth was controlled at 2.6% during 2016 compared to 8.3% expense growth in 2015.

During the year ended December 31, 2016 loan growth was very strong with end of period gross loans increasing $170.1 million, or 18.5% from $918.9 million at December 31, 2015 to $1,089.0 million at December 31, 2016. The increase in loan balances resulted in net interest income growing faster than operating expenses. Net interest income increased $3.4 million or 9.2%, compared to noninterest expense growth of $741,000 or 2.6%.

Economy

The presence of federal government agencies, as well as significant government facilities, and the related private sector support for these entities, has led to faster economic growth in our market and lower unemployment compared to the nation as a whole. In addition, the Bank's entry into the greater Annapolis and Fredericksburg markets has provided the Bank with additional loan and deposit opportunities. These opportunities have positively impacted the Bank's organic growth.

In 2017, the national economy continued to improve throughout the year. The economy (GDP) grew 2.30% in 2017, an increase from 1.50% GDP growth in 2016. Consumer confidence has increased due to positive economic trends such as lower unemployment, increased housing metrics and solid performance in the financial markets. The Mid-Atlantic region in which the Company operates continued to experience continued improved regional economic performance. The presence of several major federal facilities located within the Bank's footprint and in adjoining counties contribute to economic growth. Major federal facilities include the Patuxent River Naval Air Station in St. Mary's County, the Indian Head Division, Naval Surface Warfare Center in Charles County and the Naval Surface Warfare –Naval Support Facility in King George County. In addition, there are several major federal facilities located in adjoining markets including Andrews Air Force Base and Defense Intelligence Agency & Defense Intelligence Analysis Center in Prince Georges County, Maryland and the U.S. Marine Base Quantico, Drug Enforcement Administration Quantico facility and Federal Bureau of Investigation Quantico facility in Prince William County, Virginia. These facilities directly employ thousands of local employees and serve as an important player in the region's overall economic health.

The economic health of the region, while stabilized by the influence of the federal government, is not solely dependent on this sector. Calvert County is home to the Dominion Power Cove Point Liquid Natural Gas Terminal, which is one of the nation's largest liquefied natural gas terminals and Dominion Power is currently constructing liquefaction facilities for exporting liquefied natural gas. Based on information from the U.S. Bureau of Labor Statistics, unemployment rates and household income in the Company's footprint have historically performed better than the national average. According to SNL Financial, the median household income in our market area is $97,000 compared to $61,000 for the United States. According to SNL Financial, the Bank's market areas have strong demographics with below average unemployment rates. The Bank's primary market areas have unemployment rates below 3.6% with projected population growth in excess of 4.25% over the next five years.

The greater Fredericksburg area, the Bank's newest area of expansion (2013), continued to experience economic growth. According to the Fredericksburg Regional Alliance, the Fredericksburg Region, including the City of Fredericksburg and the counties of Caroline, King George, Spotsylvania, and Stafford, Virginia, has been the fastest growing region in the Commonwealth of Virginia for the last five years.

COMPARISON OF RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016

Earnings Summary

Net income for year ended December 31, 2017 was $7.2 million or $1.56 per diluted share after the inclusion of the additional tax expense of $2.7million under the recently enacted Tax Cuts and Jobs Act and merger and acquisition costs of $724,000, net of tax, associated with the acquisition of County First Bank. The combined impact of the deferred tax adjustment and merger and acquisition costs, resulted in a reduction of earnings per share of approximately $0.75 per share for 2017. Net income for the year ended December 31, 2016 was $7.3 million or $1.59 per diluted share. The Company's after-tax returns on average assets and common stockholders' equity for 2017 were 0.52% and 6.55%, respectively, compared to 0.60% and 7.09%, respectively, for 2016.

Although the increased tax expense related to the deferred tax revaluation and merger and acquisition costs decreased net income, earnings per share and returns on average assets and common equity for the year ended December 31, 2017, the Company believes the reduced federal income tax rate and the efficiencies from the County First acquisition will be accretive in 2018.

The Company has pursued a strategy of increasing operating leverage over the last several years. This occurs when the Company increases its assets, and by extension its net interest income, while limiting increases in noninterest expense. In order for this to be effective, the Company must simultaneously pursue the following; increase the asset size while maintaining asset quality, increase funding at an economically viable cost, and control noninterest expense growth.

The Company completed a very strong 2017 with pretax net income growing at a record pace. Income before taxes (pretax net income) increased $4.6 million or 39.3% to $16.3 million for the year ended December 31, 2017 compared to $11.7 million for the year ended December 31, 2016. The Company's pretax returns on average assets and common stockholders' equity for 2017 were 1.19% and 14.88%, respectively, compared to 0.96% and 11.36%, respectively, for 2016.

§ The increase in operating income and operating leverage in 2017 was primarily due to the following:

- Net interest income was $43.4 million in 2017, an increase of $3.5 million, or 8.7%, compared to 2016.

  - Interest income increased $5.5 million. The increase was driven by increased average interest-earning assets including increased average loan balances. The Bank increased average net loan balances $125.5 million to $1,113.8 million in 2017 from $988.3 million in 2016. The effect of loan volume on interest income was partially offset by yield declines.

  - Interest expense increased $2.0 million which partially offset increased interest income. The primary reason for the increase in interest expense was larger average interest-bearing liability balances and an increase in the cost of wholesale and time-based funding.

    - The average balances of interest-bearing liabilities increased $127.7 million to $1,102.1 million in 2017 from $974.4 million for 2016.

    - The Company's cost of funds, which includes noninterest-bearing funding, increased by eight basis points from the 2016 comparable period to 0.81% for the year ended December 31, 2017.

Wholesale and time-based funding rates are typically more sensitive to rising interest rates than transactional deposits. Compared to the year ended December 31, 2016, interest rates in 2017 increased by 14 basis points to 1.00% on certificates of deposit, while interest-bearing transactional deposits increased by five basis points to 0.32%. Federal Home Loan Bank ("FHLB") short-term borrowings increased by 66 basis points to 1.15% for the year ended December 31, 2017 compared to 0.49% for the year ended December 31, 2016. The Company's increases in transaction deposits during the last twelve months have decreased downward pressure on net interest margin. The ability to increase transaction deposits faster than wholesale funding could mitigate possible downward pressure on net interest margin in a rising rate environment.

- The Company controlled expense growth. Noninterest expense increased $938,000, or 3.2%, to $30.1 million for the year ended December 31, 2016 compared to $29.2 million the prior year. Merger and acquisition costs (M&A costs) of $829,000 were incurred in 2017. These costs were not incurred in 2016 and excluding M&A costs in 2017, noninterest expense was $29.3 million, an increase of $109,000, or 0.37%, compared to 2016.

During 2017 net operating expense as a percentage of average assets and the efficiency ratio declined (improved) compared to the prior year to 1.89% and 63.40%, respectively for the year ended December 31, 2017 from 2.10% and 67.40%, respectively for the year ended December 31, 2016.

- The Company's continued improvement in asset quality as well as slower 2017 loan growth, have positively impacted pretax earnings. The Company's improving credit metrics have partially offset the provisioning required to provide for loan growth. The provision for loan losses decreased $1.3 million, or 57.2%, to $1.0 million for the year ended December 31, 2017 compared to $2.4 million for the year ended December 31, 2017.

Overall credit metrics improved during 2017; this improvement with more modest loan growth of 5.6% (compared to 18.5% in 2016) kept the loan loss provision below the prior year. Net charge-offs of 0.03% of average loans were the lowest since before the financial crisis (2007 was 0.04%). Nonaccrual loans and OREO decreased $2.2 million to $14.0 million from $16.2 million at December 31, 2016; this is a reduction from 1.21% of assets at December 31, 2016 to 1.00% of assets at December 31, 2017. Although the overall credit trend was positive, the third and fourth quarter of 2017 saw increases to substandard and special mention loans and delinquency. Improvements to baseline charge-off factors for the periods used to evaluate the adequacy of the allowance as well as improvements in some qualitative factors, such as slower portfolio growth, were offset by increases in other qualitative factors, such as concentration to capital factors and increased classified assets. Management believes that the allowance is adequate.

A more detailed analysis comparing the results of operations for the years ended December 31, 2017 and 2016 follows.

Net Interest Income

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

Net interest income increased 8.7% or $3.5 million to $43.4 million for the year ended December 31, 2017 compared to $39.9 million for the year ended December 31, 2016. Net interest margin at 3.37% for the year ended December 31, 2017 decreased 11 basis points from 3.48% for the year ended December 31, 2016. Average interest-earning assets were $1,288.8 million for the full year of 2017, an increase of $143.3 million, or 12.5%, compared to $1,145.5 million for the full year of 2016.

51

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

	Years Ended December 31,			
(dollars in thousands)	2017	2016	$ Change	% Change
Interest and Dividend Income				
Loans, including fees	$ 49,611	$ 44,919	$ 4,692	10.4 %
Taxable interest and dividends on investment securities	3,906	3,108	798	25.7 %
Interest on deposits with banks	53	20	33	165.0 %
Total Interest and Dividend Income	53,570	48,047	5,523	11.5 %
Interest Expenses				
Deposits	5,946	4,695	1,251	26.6 %
Short-term borrowings	1,057	196	861	439.3 %
Long-term debt	3,179	3,251	(72)	(2.2)%
Total Interest Expenses	10,182	8,142	2,040	25.1 %
Net Interest Income (NII)	$ 43,388	$ 39,905	$ 3,483	8.7 %

Net interest income increased during 2017 compared to the prior year as the positive impacts of average interest-earning asset growth and increased investment yields outpaced the negative impacts of declining loan yields, increasing funding costs and growth in the average balances of interest-bearing liabilities.

The net interest margin was 3.37% for the year ended December 31, 2017, an 11 basis point decrease from 3.48% for the year ended December 31, 2016. The decrease in net interest margin was largely the result of an increase in the cost of funding (eight basis points) and a decrease in interest-earning asset yields (three basis points). Net interest margin declined during the year ended December 31, 2017, primarily due to reduced yields on loans and an increase in cost of funds. Yields on the loan portfolio decreased from 4.55% for the year ended December 31, 2016 to 4.45% for year ended December 31, 2017. Yields were reduced compared to the prior year due primarily to the Bank’s increased investment in residential mortgages during 2016, competition for commercial real estate loans and other commercial loans and the timing of scheduled repricing of the Bank’s loan portfolios.

An increase in the cost of funds impacted net interest margin for the comparable periods. The cost of funds increased eight basis points to 0.81% for the year ended December 31, 2017 compared to 0.73% for the year ended December 31, 2016. The Company continued to control deposit costs by increasing transaction deposits as a percentage of overall deposits. Average transaction deposits, which include savings, money market, interest-bearing demand and noninterest bearing demand accounts, for the years ended December 31, 2017 increased $56.0 million, or 9.8%, to $627.6 million compared to $571.6 million for the comparable period in 2016. Average transaction accounts as a percentage of total deposits remained stable at 58.3% for the year ended December 31, 2016 compared to 58.6% for the years ended December 31, 2017. The increase in average transaction deposits included growth in noninterest bearing demand deposits of $12.1 million, or 8.5%, from $142.1 million for the year ended December 31, 2016 to $154.2 million for the year ended December 31, 2017.

Interest and dividend income increased by $5.5 million to $53.5 million for the year ended December 31, 2017 compared to $48.0 million for the year ended December 31, 2016, primarily due to growth in the average balance of loans and investments. Interest and dividend income also increased due to increased investment yields. Interest and dividend income on loans increased $5.6 million due to growth of $125.5 million, or 12.7%, in the average balance of loans from $988.3 million for the year ended December 31, 2016 to $1,113.8 million for the year ended December 31, 2017. Interest and dividend income on investments increased $831,000 during 2017 compared to the prior year as average interest-earning investment balances increased $17.9 million and average yields increased from 1.99% to 2.26%. These increases to interest and dividend income were partially offset by decreased income from reduced yields on loans. Average loan yields declined 10 basis points from 4.55% for the year ended December 31, 2016 to 4.45% for the year ended December 31, 2017, which resulted in a decrease in interest and dividend income of $899,000.

Interest expense increased $2.0 million to $10.2 million for the year ended December 31, 2017 compared to the year ended December 31, 2016 due to an increase in the average balances of interest-bearing liabilities and increased funding costs between the comparable periods. During the year ended December 31, 2017, interest expense increased $1.0 million due to larger average balances of interest-bearing transaction deposit accounts, time deposits and short-term FHLB borrowings compared to the year ended December 31, 2016. Additionally, interest expense increased $1.1 million due to increased rates on interest-bearing deposit accounts, short-term borrowings and junior subordinated debentures (“TRUPS”). These increases to interest expense were partially offset by a reduction in interest expense for long-term debt of $143,000 due to a $1.8 million decrease in average long-term debt balances to $58.7 million and a lower average interest rate of 2.24%.

As a result of an increase in average short-term borrowings, the average rate paid on debt, which includes long-term debt, TRUPS, subordinated notes, and short-term borrowings, decreased from 2.55% for the year ended December 31, 2016 to 2.28% for the year ended December 31, 2017.

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

	For the Years Ended December 31,			
	2017		2016	
(dollars in thousands)	Average Balance	Average Rate	Average Balance	Average Rate
Savings	$ 53,560	0.05 %	$ 48,878	0.08 %
Interest-bearing demand and money market accounts	419,817	0.35 %	380,592	0.30 %
Certificates of deposit	443,181	1.00 %	409,621	0.86 %
Total interest-bearing deposits	916,558	0.65 %	839,091	0.56 %
Noninterest-bearing demand deposits	154,225		142,116	
	$ 1,070,783	0.56 %	$ 981,207	0.48 %

The following table shows the change in funding sources and the cost of funds for the comparable periods.

	For the Years Ended December 31,					
	2017			2016		
(dollars in thousands)	Average Balance	Average Rate	Percentage Funding	Average Balance	Average Rate	Percentage Funding
Interest-bearing deposits	$916,558	0.65 %	72.96 %	$839,091	0.56 %	75.15 %
Debt	185,501	2.28 %	14.77 %	135,305	2.55 %	12.12 %
Total interest-bearing Liabilities	1,102,059	0.92 %	87.72 %	974,396	0.84 %	87.27 %
Noninterest-bearing demand deposits	154,225		12.28 %	142,116		12.73 %
Total funds	$1,256,284	0.81 %	100.00 %	$1,116,512	0.73 %	100.00 %

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

For the Year Ended December 31, 2017

compared to the Year Ended

December 31, 2016

dollars in thousands	Volume	Due to Rate	Total
Interest income:			
Loan portfolio (1)	$ 5,591	$ (899)	$ 4,692
Investment securities, federal funds sold and interest bearing deposits	404	427	831
Total interest-earning assets	$ 5,995	$ (472)	$ 5,523
Interest-bearing liabilities:			
Savings	2	(14)	(12)
Interest-bearing demand and money market accounts	138	215	353
Certificates of deposit	336	574	910
Long-term debt	(40)	(103)	(143)
Short-term borrowings	599	262	861
Subordinated notes	-	-	-
Guaranteed preferred beneficial interest in junior subordinated debentures	-	71	71
Total interest-bearing liabilities	$ 1,035	$ 1,005	$ 2,040
Net change in net interest income	$ 4,960	$ (1,477)	$ 3,483

(1) Average balance includes non-accrual loans

	For the Years Ended December 31,					
	2017			2016		
dollars in thousands	Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest	Average Yield/ Cost
Assets						
Interest-earning assets:						
Commercial real estate	$699,349	$30,897	4.42 %	$602,648	$27,110	4.50 %
Residential first mortgages	176,186	6,636	3.77 %	151,366	6,041	3.99 %
Residential rentals	106,000	4,897	4.62 %	96,611	4,530	4.69 %
Construction and land development	33,798	1,677	4.96 %	36,938	1,693	4.58 %
Home equity and second mortgages	21,515	943	4.38 %	21,781	889	4.08 %
Commercial and equipment loans	86,871	4,524	5.21 %	87,705	4,622	5.27 %
Consumer loans	477	37	7.76 %	397	34	8.56 %
Allowance for loan losses	(10,374)	-	0.00 %	(9,157)	-	0.00 %
Loan portfolio (1)	1,113,822	49,611	4.45 %	988,289	44,919	4.55 %
Investment securities, federal funds sold and interest-bearing deposits	175,027	3,959	2.26 %	157,173	3,128	1.99 %
Total Interest-Earning Assets	1,288,849	53,570	4.16 %	1,145,462	48,047	4.19 %
Cash and cash equivalents	15,012			11,858		
Other assets	73,122			72,151		
Total Assets	$1,376,983			$1,229,471		
Liabilities and Stockholders' Equity						
Interest-bearing liabilities:						
Savings	$53,560	$27	0.05 %	$48,878	$39	0.08 %
Interest-bearing demand and money market accounts	419,817	1,481	0.35 %	380,592	1,128	0.30 %
Certificates of deposit	443,181	4,438	1.00 %	409,621	3,528	0.86 %
Long-term debt	58,704	1,313	2.24 %	60,503	1,456	2.41 %
Short-term borrowings	91,797	1,057	1.15 %	39,802	196	0.49 %
Subordinated Notes	23,000	1,438	6.25 %	23,000	1,438	6.25 %
Guaranteed preferred beneficial interest in junior subordinated debentures	12,000	428	3.57 %	12,000	357	2.98 %
Total Interest-Bearing Liabilities	1,102,059	10,182	0.92 %	974,396	8,142	0.84 %
Noninterest-bearing demand deposits	154,225			142,116		
Other liabilities	10,720			9,562		
Stockholders' equity	109,979			103,397		
Total Liabilities and Stockholders' Equity	$1,376,983			$1,229,471		
Net interest income		$43,388			$39,905	
Interest rate spread			3.24 %			3.35 %
Net yield on interest-earning assets			3.37 %			3.48 %
Ratio of average interest-earning assets to average interest bearing liabilities			116.95 %			117.56 %
Cost of funds			0.81 %			0.73 %

Cost of deposits	0.56	%	0.48	%
Cost of debt	2.28	%	2.55	%

(1) Average balance includes non-accrual loans

Provision for Loan Losses

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

	Years Ended December 31,			
(dollars in thousands)	**2017**	**2016**	**$ Change**	**% Change**
Provision for loan losses	$ 1,010	$ 2,359	$ (1,349)	(57.2)%

The provision for loan losses decreased $1.3 million to $1.0 million for the year ended December 31, 2017 compared to $2.4 million for the year ended December 31, 2016. The Company's continued improvement in asset quality as well as slower 2017 loan growth required lower provisioning compared to 2016. During the year ended December 31, 2017, end of period gross loans increased $61.1 million, or 5.6%, to $1,150.0 million compared to an increase of $170.1 million, or 18.5%, to $1,089.0 million at December 31, 2016. Net charge-offs decreased $684,000 from $1.0 million for the year ended December 31, 2016 to $355,000 for the year ended December 31, 2017. Net charge-offs of 0.03% of average loans were the lowest since before the financial crisis (2007 was 0.04%). Improvements to baseline charge-off factors for the periods used to evaluate the adequacy of the allowance as well as improvements in some qualitative factors, such as slower portfolio growth, were offset by increases in other qualitative factors, such as concentration to capital factors and increased classified assets. Overall, these changes resulted in a lower provision for loan losses for the comparable periods. The specific allowance is based on management's estimate of realizable value for particular loans and has decreased as specific credits have been resolved through a return to performance, charge-offs or additions to OREO. Management believes that the allowance is adequate.

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

Noninterest Income

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

	Years Ended December 31,			
(dollars in thousands)	2017	2016	$ Change	% Change
Noninterest Income				
Loan appraisal, credit, and miscellaneous charges	$ 157	$ 289	$ (132)	(45.7)%
Gain on sale of assets	47	12	35	291.7 %
Net gains (losses) on sale of OREO	43	(436)	479	(109.9)%
Net gains on sale of investment securities	175	31	144	464.5 %

Income from bank owned life insurance	773	789	(16)	(2.0)%
Service charges	2,595	2,675	(80)	(3.0)%
Gain on sale of loans held for sale	294	-	294	n/a
Total Noninterest Income	$ 4,084	$ 3,360	$ 724	21.5 %

Noninterest income increased by $724,000 to $4.1 million for the year ended December 31, 2017 compared to $3.4 million for the year ended December 31, 2016. The increase in income for the year was principally due to OREO losses recognized in 2016 not recognized in 2017 and gains on loans held for sale in 2017 and investment gains, partially offset by a small reduction in service charge income. The Company sold the guaranteed portion of a U.S. Small Business Administration Loan for proceeds of $2.8 million and recognized a gain of $294,000 during the third quarter of 2017.

The Company disposed of five residential properties and multiple residential lots for proceeds of $1.5 million and a gain of $43,000 for the year ended December 31, 2017. The Company recognized net losses on OREO disposals of $436,000 for the year ended December 31, 2016. Disposals consisted of properties with the following carrying values; $337,000 for seven residential lots, $584,000 for four residential properties, $501,000 for two commercial properties, $138,000 for a commercial lot and $2.2 million for an apartment and condominium property.

During the year ended December 31, 2017 the Company recognized net gains on the sale of securities of $175,000. The Company sold three AFS securities with aggregate carrying values of $3.7 million and nine HTM securities with aggregate carrying values of $4.8 million, recognizing gains of $9,000 and $166,000, respectively. During the year ended December 31, 2016 the Company recognized net gains on the sale of securities of $31,000. The Company sold five AFS securities with aggregate carrying values of $6.5 million and one HTM security with a carrying value of $698,000, recognizing gains of $23,000 and $8,000, respectively. The sale of HTM securities was permitted under ASC 320 “Investments - Debt and Equity Securities.” ASC 320 permits the sale of HTM securities for certain changes in circumstances.

Noninterest Expense

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

	Years Ended December 31,			
(dollars in thousands)	2017	2016	$ Change	% Change
Noninterest Expense				
Salary and employee benefits	$ 16,758	$ 16,810	$ (52)	(0.3)%
Occupancy expense	2,632	2,488	144	5.8%
Advertising	543	647	(104)	(16.1)%
Data processing expense	2,354	2,267	87	3.8%
Professional fees	1,662	1,568	94	6.0%
Merger and acquisition costs	829	-	829	n/a
Depreciation of premises and equipment	786	812	(26)	(3.2)%
Telephone communications	191	174	17	9.8%
Office supplies	119	136	(17)	(12.5)%
FDIC Insurance	638	739	(101)	(13.7)%
OREO valuation allowance and expenses	746	861	(115)	(13.4)%
Other	2,839	2,657	182	6.8%
Total Noninterest Expense	$ 30,097	$ 29,159	$ 938	3.2%

	Years Ended December 31,			
(dollars in thousands)	2017	2016	$ Change	% Change
Salary and employee benefits	$ 16,758	$ 16,810	$ (52)	(0.3)%
OREO valuation allowance and expenses	746	861	(115)	(13.4)%
Merger and acquisition costs	829	-	829	n/a
Operating expenses	11,764	11,488	276	2.4%
Total Noninterest Expense	$ 30,097	$ 29,159	$ 938	3.2%

Noninterest expense averaged just below $7.3 million per quarter during 2016. During 2016, the Company focused on controlling the growth of expenses by streamlining internal processes and reviewing vendor relationships. These efforts resulted in a reduction in nine FTEs, from 171 employees to 162 employees, during the year ended December 31, 2016. The Company's strategy to create operating leverage through continued asset growth combined with controlling the growth in expenses continued during 2017.

For the year ended December 31, 2017, noninterest expense increased 3.2%, or $938,000, to $30.1 million from $29.2 million for the comparable period in 2016. Noninterest expense averaged $7.5 million per quarter during 2017. Merger and acquisition costs (M&A costs) of $829,000 were incurred in 2017. These costs were not incurred in 2016 and excluding M&A costs in 2017, noninterest expense was $29.3 million, an increase of $109,000, or 0.37%, compared to 2016. The Company controlled growth in 2017 in salary and employee benefits, reducing expense $52,000 or 0.3%, compared to the same period in the prior year. The Company's 2016 total growth in salary and employee benefit costs was 2.7% or $444,000. Other operating expenses increased $276,000 or 2.4% in 2017 compared to $495,000 or 4.5% in 2016. The moderate increase in operating expenses for both years was primarily due to the increased asset size of the Bank, and included the addition of new products and services for commercial customers, increased costs of proxy related activities and the Bank's increased investment in risk management, including cyber-security and internal audit functions.

The Company's efficiency ratio for the year ended December 31, 2017 and 2016 was 63.40% and 67.40%, respectively. The Company's net operating expense ratio as a percentage of average assets for the year ended December 31, 2017 and 2016 was 1.89% and 2.10%, respectively.

Income Tax Expense

For the years ended December 31, 2017 and 2016, the Company recorded income tax expense of $9.2 million and $4.4 million, respectively. The Company's 2017 income tax expense increased $2.7 million from the revaluation of deferred tax assets because of the reduction in the corporate income tax rate under the enacted Tax Cuts and Jobs Act which was enacted on December 22, 2017. In addition, income tax expense was impacted by non-deductible facilitative merger and acquisition costs of $724,000. The Company's effective tax rates for the years ended December 31, 2017 and 2016 were 55.95% and 37.59%, respectively. The increase in the effective tax rate was primarily the result of the revaluation of deferred tax assets. In addition, the Company's federal tax rate increased from 34% in 2016 to 35% in 2017. An increase in non-deductible expenses and tax-exempt income being relatively lower to total income for 2017 compared to 2016 also slightly increased the effective tax rate. See Note 12 for additional information.

COMPARISON OF RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2016 AND 2015

Earnings Summary

Net income available to common shareholders for 2016 increased $1.0 million to $7.3 million, or 16.0%, compared to 2015. Diluted earnings per share (“EPS”) were $1.59 in 2016, an increase of $0.24 compared to 2015. The Company’s return on average assets was 0.60% in 2016, an increase of two basis points from 2015. The Company’s return on average common stockholders' equity was 7.09% in 2016, an increase of 76 basis points from 2015.

Pretax operating income increased $1.7 million, or 17.8%, to $11.7 million in 2016 compared to $10.0 million in 2015.

§ The increase in operating income and operating leverage in 2016 was primarily due to the following:

· Net interest income was $39.9 million in 2016 an increase of $3.4 million, or 9.2%, compared to 2015.

o Interest income increased $4.2 million. The increase was driven by increased average interest-earning assets including increased average loan balances. The Bank increased average net loan balances $114.1 million to $988.3 million in 2016 from $874.2 million in 2015. The effect of loan volume on interest income was partially offset by yield declines.

o Interest expense increased $797,000 which partially offset increased interest income. The primary reason for the increase in interest expense was larger average interest-bearing liability balances. The average balances of interest-bearing liabilities increased $113.4 million to $974.4 million in 2016 from $861.0 million in 2015.

The increase in interest expense was restrained by the Company’s cost of interest-bearing liabilities decreasing one basis point to 0.84% in 2016 compared to 0.85% in 2015. Further, the Company’s cost of funds, which includes noninterest-bearing funding, decreased two basis points from the comparable period to 0.73% for the year ended December 31, 2016.

· The Company controlled expense growth. Noninterest expense increased $741,000, or 2.6%, to $29.2 million for the year ended December 31, 2016 compared to the prior year.

During 2016 net operating expense as a percentage of average assets and the efficiency ratio declined (improved) compared to the prior year to 2.10% and 67.40%, respectively for the year ended December 31, 2016 from 2.30% and

71.35%, respectively for the year ended December 31, 2015. The net operating expense and efficiency ratios improved in each successive quarter during 2016. The Company’s net operating expense ratio improved to 1.98% for the three months ended December 31, 2016 from 2.38% for the three months ended December 31, 2015. The Company’s efficiency ratio improved to 64.38% for the three months ended December 31, 2016 from 73.67% for the three months ended December 31, 2015.

§ The positive impact of operating leverage on operating income was partially offset by an increased loan loss provision.

The provision for loan losses increased $926,000 to $2.4 million in 2016 due primarily to loan growth. The additions to the provision for loan growth were partially offset by improvements to baseline charge-off factors for the periods used to evaluate the adequacy of the allowance as well as improvements in other qualitative factors, such as reductions in delinquency and classified assets.

A more detailed analysis comparing the results of operations for the years ended December 31, 2016 and 2015 follows.

Net Interest Income

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

Net interest income increased 9.2% or $3.4 million to $39.9 million for the year ended December 31, 2016 compared to $36.5 million for the year ended December 31, 2015. Net interest margin at 3.48% for the year ended December 31, 2016 decreased 12 basis points from 3.60% for the year ended December 31, 2015. Average interest-earning assets were $1,145.5 million for the full year of 2016, an increase of $132.1 million, or 13.0%, compared to $1,013.4 million for the full year of 2015.

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

	Years Ended December 31,				
(dollars in thousands)	2016	2015	$ Change	% Change	
Interest and Dividend Income					
Loans, including fees	$ 44,919	$ 41,386	$ 3,533	8.5	%
Taxable interest and dividends on investment securities	3,108	2,473	635	25.7	%
Interest on deposits with banks	20	14	6	42.9	%
Total Interest and Dividend Income	48,047	43,873	4,174	9.5	%
Interest Expenses					
Deposits	4,695	4,152	543	13.1	%
Short-term borrowings	196	37	159	429.7	%
Long-term debt	3,251	3,156	95	3.0	%
Total Interest Expenses	8,142	7,345	797	10.9	%
Net Interest Income (NII)	$ 39,905	$ 36,528	$ 3,377	9.2	%

Net interest income increased during 2016 compared to the prior year due to the negative impacts of declining loan yields being outpaced by the positive impacts of interest-earning asset growth, increased investment yields and a stable cost of funds.

The net interest margin was 3.48% for the year ended December 31, 2016, a 12 basis point decrease from 3.60% for the year ended December 31, 2015. Net interest margin declined during 2016, primarily due to reduced yields on loans. Yields on the loan portfolio decreased from 4.73% for the year ended December 31, 2015 to 4.55% for the year ended December 31, 2016. Yields were reduced compared to the prior year due to the Bank's increased investment in residential mortgages, increased competition in the Bank's market area and low intermediate term interest rates. Residential first mortgages increased from 14.30% of the loan portfolio at December 31, 2015 to 15.70% of the portfolio at December 31, 2016. The Bank's commercial loan portfolios are primarily indexed to rates in the five to ten year range of U.S. Treasuries. These rates remained below 2015 average rates for most of 2016, with the ten year U.S. Treasury rate as low as 1.37% (July 8, 2016).

Net interest margin was positively impacted by a reduction in its cost of funds during 2016, which decreased two basis points from 0.75% for the year ended December 31, 2015 to 0.73% for the year ended December 31, 2016. The Company continued to make progress in controlling deposit costs by increasing transaction deposits as a percentage of overall deposits. Average transaction deposits, which include savings, money market, interest-bearing demand and noninterest bearing demand accounts, for the year ended December 31, 2016 increased $83.4 million, or 17.1%, to $571.6 million compared to $488.2 million for the comparable period in 2015. Average transaction accounts as a percentage of total deposits increased from 56.3% for the year ended December 31, 2015 to 58.3% for the year ended December 31, 2016. The increase in average transaction deposits included growth in noninterest bearing demand deposits of $21.6 million, or 17.9%, from $120.5 million for the year ended December 31, 2015 to $142.1 million for the year ended December 31, 2016.

Interest and dividend income increased by $4.2 million to $48.0 million for the year ended December 31, 2016 compared to $43.8 million for the year ended December 31, 2015, primarily due to growth in the average balance of loans and investments. Interest and dividend income also increased due to increased investment yields. Interest and dividend income on loans increased $5.2 million due to growth of $114.1 million, or 13.1%, in the average balance of loans from $874.2 million for the year ended December 31, 2015 to $988.3 million for the year ended December 31, 2016. Interest and dividend income on investments increased $641,000 during 2016 compared to the prior year as average interest-earning investment balances increased $17.9 million and average yields increased from 1.79% to 1.99%. These increases to interest and dividend income were partially offset by decreased income from reduced yields on loans. Average loan yields declined 18 basis points from 4.73% for the year ended December 31, 2014 to 4.55% for the year ended December 31, 2015, which resulted in a decrease in interest and dividend income of $1.7 million.

Interest expense increased $797,000 to $8.1 million for the year ended December 31, 2016 compared to the year ended December 31, 2015 due to an increase in the average balances of interest-bearing liabilities and a change in the composition of interest-bearing liabilities between the comparable periods. During the year ended December 31, 2016, interest expense increased $718,000 due to larger average balances of interest-bearing transaction deposit accounts, time deposits, short-term borrowings and subordinated notes compared to the year ended December 31, 2015. Additionally, interest expense increased $282,000 due to increased rates on interest-bearing deposit accounts and debt. These increases to interest expense were partially offset by a reduction in interest expense of $203,000 due to a $8.4 million decrease in average long-term debt balances from the comparable period to $60.5 million for the year ended December 31, 2016. The average rate paid on debt, which includes long-term debt, trust preferred junior subordinated debentures (“TRUPS”), subordinated notes, and short-term borrowings, decreased from 2.77% for the year ended December 31, 2015 to 2.55% for the year ended December 31, 2016. Interest expense for the year ended December 31, 2016 was $148,000 greater than the comparable period as a result of the timing of the funding of the subordinated notes in February 2015.

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

	For the Years Ended December 31,			
	2016		2015	
(dollars in thousands)	Average Balance	Average Rate	Average Balance	Average Rate
Savings	$ 48,878	0.08 %	$ 44,963	0.10 %
Interest-bearing demand and money market accounts	380,592	0.30 %	322,717	0.28 %
Certificates of deposit	409,621	0.86 %	378,179	0.85 %
Total interest-bearing deposits	839,091	0.56 %	745,859	0.56 %
Noninterest-bearing demand deposits	142,116		120,527	
	$ 981,207	0.48 %	$ 866,386	0.48 %

The following table shows the change in funding sources and the cost of funds for the comparable periods.

	For the Years Ended December 31,											
	2016						2015					
(dollars in thousands)	Average Balance	Average Rate		Percentage Funding			Average Balance	Average Rate		Percentage Funding		
Interest-bearing deposits	$839,091	0.56	%	75.15	%		$745,859	0.56	%	75.99	%	
Debt	135,305	2.55	%	12.12	%		115,119	2.77	%	11.73	%	
Total interest-bearing Liabilities	974,396	0.84	%	87.27	%		860,978	0.85	%	87.72	%	
Noninterest-bearing demand deposits	142,116			12.73	%		120,527			12.28	%	
Total funds	$1,116,512	0.73	%	100.00	%		$981,505	0.75	%	100.00	%	

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

For the Year Ended December 31, 2016

compared to the Year Ended

December 31, 2015

		Due to	
dollars in thousands	**Volume**	**Rate**	**Total**
Interest income:			
Loan portfolio (1)	$ 5,186	$ (1,653)	$ 3,533
Investment securities, federal funds sold and interest-bearing deposits	357	284	641
Total interest-earning assets	$ 5,543	$ (1,369)	$ 4,174
Interest-bearing liabilities:			
Savings	3	(9)	(6)
Interest-bearing demand and money market accounts	172	52	224
Certificates of deposit	271	54	325
Long-term debt	(203)	102	(101)
Short-term borrowings	130	29	159
Subordinated notes	142	6	148
Guaranteed preferred beneficial interest in junior subordinated debentures	-	48	48
Total interest-bearing liabilities	$ 515	$ 282	$ 797
Net change in net interest income	$ 5,028	$ (1,651)	$ 3,377

(1) Average balance includes non-accrual loans

	For the Years Ended December 31,					
	2016			2015		
dollars in thousands	Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest	Average Yield/ Cost
Assets						
Interest-earning assets:						
Commercial real estate	$602,648	$27,110	4.50 %	$518,329	$24,053	4.64 %
Residential first mortgages	151,366	6,041	3.99 %	134,728	5,861	4.35 %
Residential rentals	96,611	4,530	4.69 %	88,251	4,084	4.63 %
Construction and land development	36,938	1,693	4.58 %	37,665	1,879	4.99 %
Home equity and second mortgages	21,781	889	4.08 %	21,332	872	4.09 %
Commercial and equipment loans	87,705	4,622	5.27 %	81,957	4,596	5.61 %
Consumer loans	397	34	8.56 %	465	41	8.82 %
Allowance for loan losses	(9,157)	-	0.00 %	(8,541)	-	0.00 %
Loan portfolio (1)	988,289	44,919	4.55 %	874,186	41,386	4.73 %
Investment securities, federal funds sold and interest-bearing deposits	157,173	3,128	1.99 %	139,256	2,487	1.79 %
Total Interest-Earning Assets	1,145,462	48,047	4.19 %	1,013,442	43,873	4.33 %
Cash and cash equivalents	11,858			12,192		
Other assets	72,151			67,272		
Total Assets	$1,229,471			$1,092,906		
Liabilities and Stockholders' Equity						
Interest-bearing liabilities:						
Savings	$48,878	$39	0.08 %	$44,963	$45	0.10 %
Interest-bearing demand and money market accounts	380,592	1,128	0.30 %	322,717	904	0.28 %
Certificates of deposit	409,621	3,528	0.86 %	378,179	3,203	0.85 %
Long-term debt	60,503	1,456	2.41 %	68,924	1,557	2.26 %
Short-term borrowings	39,802	196	0.49 %	13,463	37	0.27 %
Subordinated Notes	23,000	1,438	6.25 %	20,732	1,290	6.22 %
Guaranteed preferred beneficial interest in junior subordinated debentures	12,000	357	2.98 %	12,000	309	2.58 %
Total Interest-Bearing Liabilities	974,396	8,142	0.84 %	860,978	7,345	0.85 %
Noninterest-bearing demand deposits	142,116			120,527		
Other liabilities	9,562			9,244		
Stockholders' equity	103,397			102,157		
Total Liabilities and Stockholders' Equity	$1,229,471			$1,092,906		
Net interest income		$39,905			$36,528	
Interest rate spread			3.35 %			3.48 %
Net yield on interest-earning assets			3.48 %			3.60 %
Ratio of average interest-earning assets to average interest bearing liabilities			117.56 %			117.71 %
Cost of funds			0.73 %			0.75 %
Cost of deposits			0.48 %			0.48 %

Cost of debt	2.55 %	2.77 %

(1) Average balance includes non-accrual loans

63

Provision for Loan Losses

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

	Years Ended December 31,			
(dollars in thousands)	2016	2015	$ Change	% Change
Provision for loan losses	$ 2,359	$ 1,433	$ 926	64.6 %

The provision for loan losses increased $926,000 to $2.4 million for the year ended December 31, 2016 compared to $1.4 million for the year ended December 31, 2015 due primarily to loan growth. During the year ended December 31, 2016 end of period gross loans increased $170.1 million, or 18.5%, from $918.9 million at December 31, 2015 to $1,089.0 million at December 31, 2016. Net charge-offs decreased $335,000 from $1.4 million for the year ended December 31, 2015 to $1.0 million for the year ended December 31, 2016. Improvements to baseline charge-off factors for the periods used to evaluate the adequacy of the allowance as well as improvements in some qualitative factors, such as reductions in classified assets and delinquency, were offset by increases in other qualitative factors, such as increased loan growth. Overall, these changes resulted in a higher provision for loan losses for the comparable periods. The specific allowance is based on management’s estimate of realizable value for particular loans and has decreased as specific credits have been resolved through a return to performance, charge-offs or additions to OREO.

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

Noninterest Income

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

	Years Ended December 31,			
(dollars in thousands)	2016	2015	$ Change	% Change
Noninterest Income				
Loan appraisal, credit, and miscellaneous charges	$ 289	$ 315	$ (26)	(8.3)%
Gain on sale of asset	12	19	(7)	(36.8)%
Net losses on sale of OREO	(436)	(20)	(416)	2080.0 %
Net gains on sale of investment securities	31	4	27	675.0 %
Loss on premises and equipment held for sale	-	(426)	426	(100.0)%
Income from bank owned life insurance	789	815	(26)	(3.2)%
Service charges	2,675	2,488	187	7.5 %

Gain on sale of loans held for sale	-	104	(104)	(100.0)%
Total Noninterest Income	$ 3,360	$ 3,299	$ 61	1.8 %

Noninterest income increased by $61,000 to $3.4 million for the year ended December 31, 2016 compared to $3.3 million for the year ended December 31, 2015. Noninterest income was up $187,000 compared to the prior year due to higher service charge income from the growth in the number of customer accounts, wealth services and rental income on other real estate owned (“OREO”) properties. In addition, there were no losses recognized in 2016 for the sale of branch assets. During the third quarter 2015, the Bank recorded an expense of $426,000 to account for the loss on the sale of the King George, Virginia branch building and equipment. These increases to noninterest income were partially offset by decreases to noninterest income from the Company’s exit from the origination of residential first mortgage loans during the second quarter of 2015. There were no gains on residential loans held for sale in the year ended December 31, 2016 compared to $104,000 for the year ended December 31, 2015. In addition, the Company recognized losses of $436,000 on the disposition of OREO for the year ended December 31, 2016 compared to $20,000 in OREO losses recognized for the comparable period.

Noninterest Expense

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

	Years Ended December 31,			
(dollars in thousands)	2016	2015	$ Change	% Change
Noninterest Expense				
Salary and employee benefits	$ 16,810	$ 16,366	$ 444	2.7 %
Occupancy expense	2,488	2,427	61	2.5 %
Advertising	647	583	64	11.0 %
Data processing expense	2,267	2,044	223	10.9 %
Professional fees	1,568	1,323	245	18.5 %
Depreciation of premises and equipment	812	810	2	0.2 %
Telephone communications	174	188	(14)	(7.4)%
Office supplies	136	157	(21)	(13.4)%
FDIC Insurance	739	799	(60)	(7.5)%
OREO valuation allowance and expenses	861	1,059	(198)	(18.7)%
Other	2,657	2,662	(5)	(0.2)%
Total Noninterest Expense	$ 29,159	$ 28,418	$ 741	2.6 %

	Years Ended December 31,			
(dollars in thousands)	2016	2015	$ Change	% Change
Salary and employee benefits	$ 16,810	$ 16,366	$ 444	2.7 %
OREO valuation allowance and expenses	861	1,059	(198)	(18.7)%
Operating expenses	11,488	10,993	495	4.5 %
Total Noninterest Expense	$ 29,159	$ 28,418	$ 741	2.6 %

For the year ended December 31, 2016, noninterest expense was controlled at an average run rate of just below $7.3 million per quarter. Noninterest expense increased 2.6%, or $741,000, to $29.2 million in 2016 from $28.4 million for the comparable period in 2015. The Company remained focused during 2016 on controlling the growth of expenses by streamlining internal processes and reviewing vendor relationships. The Company’s strategy to create operating leverage through continued interest-earning asset growth combined with controlling the growth in expenses is expected to continue during 2017. The Company’s efficiency ratio for the year ended December 31, 2016 and 2015 was 67.40% and 71.35%, respectively. The Company’s noninterest expense ratio as a percentage of average assets for the year ended December 31, 2016 and 2015 was 2.37% and 2.60%, respectively.

The Company’s 2016 total growth in salary and employee benefit costs was 2.7% or $444,000 compared to 3.2% or $515,000 of growth during 2015. Salary and employee benefit costs have increased from the comparable period as incentive compensation has increased due to interest-earning asset growth as well as higher self-insured health insurance claims. The Company has controlled the growth of salary and benefit costs by restructuring our branch organization and better aligning incentives with Company performance. These efforts resulted in a reduction in nine FTEs from 171 employees at December 31, 2015 to 162 employees at December 31, 2016.

Data processing costs have increased primarily due to the increased asset size of the Bank, and included the addition of new products and services for commercial customers. Professional fees increased over the prior year due to increased costs of proxy related activities and the Bank' increased investment in risk management, including cyber-security and internal audit functions.

Income Tax Expense

For the years ended December 31, 2016 and 2015, the Company recorded income tax expense of $4.4 million and $3.6 million, respectively. The Company's effective tax rates for the years ended December 31, 2016 and 2015 were 37.59% and 36.42%, respectively. The increase in the effective tax rate was the result of tax-exempt income being relatively lower to total income and an increase in state income taxes due to higher Bank net income for 2016 compared to 2015.

COMPARISON OF FINANCIAL CONDITON AT DECEMBER 31, 2017 AND 2016

Assets

Total assets at December 31, 2017 were $1.40 billion, an increase of $71.7 million or 5.4%, compared to total assets of $1.33 billion at December 31, 2016. The increase in total assets was primarily attributable to growth in loans. Net loans increased $61.1 million, or 5.7%, from $1,079.5 million at December 31, 2016 to $1,140.6 million at December 31, 2017, principally due to increases in the commercial real estate and residential rentals portfolios. The increase in total assets was primarily attributable to growth in cash, securities and loans.

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

(dollars in thousands)	December 31, 2017	December 31, 2016	$ Change	% Change
Cash and due from banks	$ 13,315	$ 9,948	$ 3,367	33.8 %
Interest-bearing deposits with banks	2,102	1,315	787	59.8 %
Securities available for sale (AFS), at fair value	68,285	53,033	15,252	28.8 %
Securities held to maturity (HTM), at amortized cost	99,246	109,247	(10,001)	(9.2)%
FHLB stock - at cost	7,276	7,235	41	0.6 %
Loans receivable - net of ALLL	1,140,615	1,079,519	61,096	5.7 %
Premises and equipment, net	21,391	22,205	(814)	(3.7)%
Premises and equipment held for sale	-	345	(345)	(100.0)%
Other real estate owned (OREO)	9,341	7,763	1,578	20.3 %
Accrued interest receivable	4,511	3,979	532	13.4 %
Investment in bank owned life insurance	29,398	28,625	773	2.7 %
Other assets	10,481	11,043	(562)	(5.1)%
Total Assets	$ 1,405,961	$ 1,334,257	$ 71,704	5.4 %

The differences in allocations between the cash and investment categories reflect operational needs. Details of the Company's loan portfolio are presented below:

(dollars in thousands)	December 31, 2017	%	December 31, 2016	%	$ Change	% Change
Commercial real estate	$ 727,314	63.25 %	$ 667,105	61.25 %	$ 60,209	9.0 %
Residential first mortgages	170,374	14.81 %	171,004	15.70 %	(630)	(0.4)%
Residential rentals	110,228	9.58 %	101,897	9.36 %	8,331	8.2 %
	27,871	2.42 %	36,934	3.39 %	(9,063)	(24.5)%

Construction and land development														
Home equity and second mortgages		21,351		1.86	%		21,399		1.97	%	(48	)	(0.2	)%
Commercial loans		56,417		4.91	%		50,484		4.64	%	5,933		11.8	%
Consumer loans		573		0.05	%		422		0.04	%	151		35.8	%
Commercial equipment		35,916		3.12	%		39,737		3.65	%	(3,821	)	(9.6	)%
		1,150,044		100.00	%		1,088,982		100.00	%	61,062		5.6	%
Less:														
Deferred loan fees and premiums		(1,086	)	-0.09	%		(397	)	-0.04	%	(689	)	173.6	%
Allowance for loan losses		10,515		0.91	%		9,860		0.91	%	655		6.6	%
		9,429					9,463				(34	)	(0.4	)%
	$	1,140,615				$	1,079,519				$ 61,096		5.7	%

66

Prior to April 1, 2016, loans secured by residential rental property were included in the residential first mortgage and commercial real estate loan portfolios. Beginning in the second quarter of 2016, the Company segregated loans secured by residential rental property into a new loan portfolio segment. Residential rental property includes income producing properties comprising 1-4 family units and apartment buildings. The Company's decision to segregate the residential rental property portfolio for financial reporting was based on the growth and size of the portfolio and risk characteristics unique to residential rental properties. Comparative financial information was reclassified to conform to the classification presented in 2016.

Asset Quality

(dollars in thousands, except per share amounts)	December 31, 2017	December 31, 2016	$ Change	% Change
SELECTED ASSET QUALITY DATA				
Gross loans	$ 1,150,044	$ 1,088,982	$ 61,062	5.6 %
Classified assets	50,298	39,246	11,052	28.2
Allowance for loan losses	10,515	9,860	655	6.6
Nonperforming loans (>=90 Days) [1]	2,483	7,705	(5,222)	(67.8)
Non-accrual loans [2]	4,693	8,374	(3,681)	(44.0)
Accruing troubled debt restructures (TDRs) [3]	10,021	10,448	(427)	(4.1)
Other Real Estate Owned (OREO)	9,341	7,763	1,578	20.3
Non-accrual loans, OREO and TDRs	$ 24,055	$ 26,585	(2,530)	(9.5)
SELECTED ASSET QUALITY RATIOS				
Average total equity to average total assets	7.99 %	8.41 %		
Classified assets to total assets	3.58	2.94		
Classified assets to risk-based capital	32.14	26.13		
Allowance for loan losses to total loans	0.91	0.91		
Allowance for loan losses to nonperforming loans	423.48	127.97		
Net charge-offs to avg. outstanding loans	0.03	0.11		
Nonperforming loans to total loans	0.22	0.71		
Non-accrual loans to total loans	0.41	0.77		
Non-accrual loans and TDRs to total loans	1.28	1.73		
Non-accrual loans and OREO to total assets	1.00	1.21		
Non-accrual loans, OREO and TDRs to total assets	1.71	1.99		

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

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

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

The Company continues to pursue its approach of maximizing contractual rights with individual classified customer relationships. The objective is to expeditiously resolve non-performing or substandard credits that are not likely to become performing or passing credits in a reasonable timeframe. Management believes this strategy is in the best long-term interest of the Company. Because of these efforts, non-accrual loans and OREO to total assets have decreased from 1.83% at December 31, 2015, to 1.21% at December 31, 2016, and to 1.00% at December 31, 2017. Non-accrual loans, OREO and TDRs to total assets decreased from 2.98% at December 31, 2015, to 1.99%, at December 31, 2016, and to 1.71% at December 31, 2017. Classified assets increased $9.8 million from $30.6 million at December 31, 2016 to $40.4 million at December 31, 2017. The net increase was primarily due to two customer relationships that that are well-secured by commercial real estate that were downgraded to substandard in the third quarter ($4.9 million) and fourth quarter ($10.4 million) of 2017. There was no impairment on these relationships based on our analysis at December 31, 2017.

Management considers classified assets to be an important measure of asset quality. The following is a breakdown of the Company's classified and special mention assets at December 31, 2017, 2016, 2015, 2014 and 2013, respectively:

Classified Assets and Special Mention Assets

(dollars in thousands)	As of December 31, 2017	As of December 31, 2016	As of December 31, 2015	As of December 31, 2014	As of December 31, 2013
Classified loans					
Substandard	$ 40,306	$ 30,463	$ 31,943	$ 46,735	$ 47,645
Doubtful	-	137	861	-	-
Loss	-	-	-	-	-
Total classified loans	40,306	30,600	32,804	46,735	47,645
Special mention loans	96	-	1,642	5,460	9,246
Total classified and special mention loans	$ 40,402	$ 30,600	$ 34,446	$ 52,195	$ 56,891
Classified loans	40,306	30,600	32,804	46,735	47,645
Classified securities	651	883	1,093	1,404	2,438
Other real estate owned	9,341	7,763	9,449	5,883	6,797
Total classified assets	$ 50,298	$ 39,246	$ 43,346	$ 54,022	$ 56,880
Total classified assets as a percentage of total assets	3.58 %	2.94 %	3.79 %	4.99 %	5.56 %
Total classified assets as a percentage of Risk Based Capital	32.14 %	26.13 %	30.19 %	39.30 %	43.11 %

Non-accrual loans (90 days or greater delinquent and non-accrual only loans) decreased $3.7 million from $8.4 million or 0.77% of total loans at December 31, 2016 to $4.7 million or 0.41% of total loans at December 31, 2017. Non-accrual only loans are loans classified as non-accrual due to customer operating results or payment history. All interest accrued but not collected from loans that are placed on non-accrual or charged-off is reversed against interest income. In accordance with the Company's policy, interest income is recognized on a cash basis or cost-recovery method, until qualifying for return to accrual status.

At December 31, 2017, non-accrual loans of $4.7 million included 24 loans, of which $3.3 million, or 71% represented 10 loans and five customer relationships. During the year ended December 31, 2017 non-accrual loans decreased $3.0 million due to the foreclosure of a stalled residential development project. The Bank is working with a construction manager to stabilize and market the project. Before the foreclosure, the loans in this relationship were troubled debt restructures ("TDRs"). Additionally, during the third quarter of 2017, non-accrual loans decreased $607,000 due to the foreclosure of a commercial office building. At December 31, 2016, non-accrual loans of $8.4 million included 29 loans, of which $6.4 million, or 77% of represented 15 loans and six customer relationships.

Non-accrual loans included one TDR totaling $769,000 at December 31, 2017 and six TDRs totaling $4.7 million at December 31, 2016. These loans are classified solely as non-accrual loans for the calculation of financial ratios.

Loan delinquency (90 days or greater delinquent and 31-89 days delinquent) increased $3.0 million from $8.7 million, or 0.80% of loans, at December 31, 2016 to $11.7 million, or 1.02% of loans, at December 31, 2017.

TDRs decreased $4.3 million from $15.1 million at December 31, 2016 to $10.8 million at December 31, 2017. TDRs that are included in non-accrual are classified solely as non-accrual loans for the calculation of financial ratios. The Company had specific reserves of $413,000 on seven TDRs totaling $3.0 million at December 31, 2017 and $844,000 on nine TDRs totaling $5.7 million at December 31, 2016. During the year ended December 31, 2017, TDR disposals, which included payoffs and refinancing decreased by seven loans totaling $3.9 million, of which $3.0 million related to the foreclosure of the stalled residential development project mentioned previously. TDR loan principal curtailment was $385,000 for the year ended December 31, 2017. There were no TDRs added during the year ended December 31, 2017.

During the year ended December 31, 2016 the Company added one TDR loan totaling $196,000. TDR disposals, which included payoffs and refinancing for the year ended December 31, 2016 decreased by nine loans or $2.1 million. TDR loan principal curtailment was $1.6 million for the year ended December 31, 2016.

The following is a breakdown by loan classification of the Company's TDRs at December 31, 2017 and December 31, 2016:

	December 31, 2017		December 31, 2016	
(dollars in thousands)	Dollars	Number of Loans	Dollars	Number of Loans
Commercial real estate	$ 9,273	9	$ 9,587	8
Residential first mortgages	527	2	545	2
Residential rentals	221	1	227	1
Construction and land development	729	2	3,777	4
Commercial loans	4	1	872	5
Commercial equipment	36	1	113	2
Total TDRs	$ 10,790	16	$ 15,121	22
Less: TDRs included in non-accrual loans	(769)	(1)	(4,673)	(6)
Total accrual TDR loans	$ 10,021	15	$ 10,448	16

The OREO balance was $9.3 million at December 31, 2017, an increase of $1.5 million compared to $7.8 million at December 31, 2016. During the year ended December 31, 2017, additions of $3.6 million consisted of $3.0 million related to the foreclosure of a stalled residential development project. The Bank is working with a construction manager to stabilize and market the project. Further, additions included $103,000 for residential lots and $495,000 for a commercial office building. The Company disposed of five residential properties and multiple residential lots for proceeds of $1.5 million and a gain of $43,000 for the year ended December 31, 2017. The Bank provided $200,000 in financing for one residential property and the three residential lots during the first quarter of 2017. The transaction qualified for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition".

The Company recognized net losses on OREO disposals of $436,000 for the year ended December 31, 2016. Disposals consisted of properties with the following carrying values; $337,000 for seven residential lots, $584,000 for four residential properties, $501,000 for two commercial properties, $138,000 for a commercial lot and $2.2 million for an apartment and condominium property. The Bank provided financing for the apartment and condominium purchase and the transaction qualified for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition". In addition, the Company transferred one commercial condominium with a carrying value of $372,000 into premises for commercial lending office space.

Additions to the OREO valuation allowances of $600,000 and $574,000, respectively, were taken to adjust properties to current appraised values for the years ended December 31, 2017 and 2016. OREO carrying amounts reflect management's estimate of the realizable value of these properties incorporating current appraised values, local real estate market conditions and related costs.

The allowance for loan losses was 0.91% of gross loans at December 31, 2017 and December 31, 2016. Management's determination of the adequacy of the allowance is based on a periodic evaluation of the portfolio with consideration given to: overall loss experience; current economic conditions; size, growth and composition of the loan portfolio; financial condition of the borrowers; current appraised values of underlying collateral and other relevant factors that, in management's judgment, warrant recognition in determining an adequate allowance. Improvements to baseline charge-off factors for the periods used to evaluate the adequacy of the allowance as well as improvements in some qualitative factors, such as slower portfolio growth, were offset by increases in other qualitative factors, such as concentration to capital factors and increased classified assets. The specific allowance is based on management's estimate of realizable value for particular loans. Management believes that the allowance is adequate.

The following is a breakdown of the Company's general and specific allowances as a percentage of gross loans at December 31, 2017 and December 31, 2016, respectively:

(dollar in thousands)	December 31, 2017	% of Gross Loans	December 31, 2016	% of Gross Loans
General Allowance	$ 9,491	0.82 %	$ 8,571	0.79 %
Specific Allowance	1,024	0.09 %	1,289	0.12 %
Total Allowance	$ 10,515	0.91 %	$ 9,860	0.91 %

The historical loss experience factor is tracked over various time horizons for each portfolio segment. The following table provides a five-year trend of net charge-offs as a percentage of average loans.

	Years Ended December 31,				
(dollars in thousands)	2017	2016	2015	2014	2013
Average loans	$1,113,822	$988,288	$874,186	$819,381	$741,369
Net charge-offs	355	1,039	1,374	2,309	1,049
Net charge-offs to average loans	0.03 %	0.11 %	0.16 %	0.28 %	0.14 %

At December 31, 2017, 99.6%, or $162.3 million of the asset-backed securities and bonds issued by GSEs and U.S. Agencies and others were rated AAA by Standard & Poor's or the equivalent credit rating from another major rating agency compared to 99.4%, or $156.9 million, at December 31, 2016. Debt securities are evaluated quarterly to determine whether a decline in their value is OTTI. No OTTI charge was recorded for the years ended December 31, 2017 and 2016, respectively. Classified securities decreased $232,000 from $883,000 at December 31, 2016 to $651,000 at December 31, 2017.

Gross unrealized losses on HTM and AFS securities decreased from $3.3 million at December 31, 2016 to $3.1 million at December 31, 2017 (see Note 5) in Consolidated Financial Statements). Gross unrealized losses at December 31, 2017 and 2016 for AFS securities were $1.7 million and $1.6 million, respectively, of amortized cost of $69.9 million and $54.6 million, respectively. Gross unrealized losses at December 31, 2017 and 2016 for HTM securities were $1.4 million and $1.7 million, respectively, of amortized cost of $99.2 million and $109.2 million, respectively. The change in unrealized losses was the result of changes in interest rates, while credit risks remained stable. The Bank holds over 96% of its AFS and HTM securities as asset-backed securities of GSEs or U.S. Agencies, GSE agency bonds or U.S. government obligations. The Company intends to, and has the ability to, hold both AFS and HTM securities with unrealized losses until they mature, at which time the Company will receive full value for the securities. The Company believes that the AFS and HTM securities with unrealized losses will either recover in market value or be paid off as agreed.

Liabilities

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

(dollars in thousands)	December 31, 2017	December 31, 2016	$ Change	% Change
Deposits				
Non-interest-bearing deposits	$ 159,844	$ 144,877	$ 14,967	10.3 %
Interest-bearing deposits	946,393	893,948	52,445	5.9 %
Total deposits	1,106,237	1,038,825	67,412	6.5 %
Short-term borrowings	87,500	79,000	8,500	10.8 %
Long-term debt	55,498	65,559	(10,061)	(15.3)%
Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs)	12,000	12,000	-	0.0 %
Subordinated notes - 6.25%	23,000	23,000	-	0.0 %
Accrued expenses and other liabilities	11,769	11,447	322	2.8 %
Total Liabilities	$ 1,296,004	$ 1,229,831	$ 66,173	5.4 %

The following is a breakdown of the Company’s deposit portfolio at December 31, 2017 and December 31, 2016:

	December 31, 2017		2016			
(dollars in thousands)	Balance	%	Balance	%	$ Change	% Change
Noninterest-bearing demand	$ 159,844	14.45 %	$ 144,877	13.95 %	$ 14,967	10.3 %
Interest-bearing:						
Demand	215,447	19.48 %	162,823	15.67 %	52,624	32.3 %
Money market deposits	226,351	20.46 %	248,049	23.88 %	(21,698)	(8.7)%
Savings	52,990	4.79 %	50,284	4.84 %	2,706	5.4 %
Certificates of deposit	451,605	40.82 %	432,792	41.66 %	18,813	4.3 %
Total interest-bearing	946,393	85.55 %	893,948	86.05 %	52,445	5.9 %
Total Deposits	$ 1,106,237	100.00 %	$ 1,038,825	100.00 %	$ 67,412	6.5 %
Transaction accounts	$ 654,632	59.18 %	$ 606,033	58.34 %	$ 48,599	8.0 %

Deposits and Borrowings

Deposits increased by 6.5%, or $67.4 million, to $1,106.2 million at December 31, 2017 compared to $1,038.8 million at December 31, 2016. During 2017, balance sheet growth was balanced, with deposit growth of $67.4 million slightly exceeding loan growth of $61.1 million. Retail deposits, which include all deposits except traditional brokered deposits, increased a total of $79.4 million, comprised of increases in transaction accounts of $48.6 million and time deposits of $30.8 million. These retail increases to deposits were partially offset by a decrease to brokered deposits of $12.0 million. The Company uses both traditional and reciprocal brokered deposits. Traditional brokered deposits at December 31, 2017 and December 31, 2016 were $119.0 million and $131.0 million, respectively. Reciprocal brokered deposits are used to maximize FDIC insurance available to our customers. Reciprocal brokered deposits at December 31, 2017 and December 31, 2016 were $92.9 million and $70.7 million, respectively.

Long-term debt and short-term borrowings decreased $1.6 million from $144.6 million at December 31, 2016 to $143.0 million at December 31, 2017. During the year ended December 31, 2017, the Bank paid off $20.1 million of maturing long-term debt and added $10.0 million in fixed-rate advances maturing in 2018. During the year ended December 31, 2016, the Bank paid off $5.0 million of maturing long-term debt and added one $15.0 million fixed-rate advances maturing in 2018. The Company uses brokered deposits and other wholesale funding to supplement funding when loan growth exceeds core deposit growth and for asset-liability management purposes.

The more moderate interest-earning asset growth in 2017 compared to 2016, combined with increases in retail transaction and time deposits allowed the Bank to decrease wholesale funding during 2017. Wholesale funding decreased $13.7 million from $275.6 million or 20.65% of assets at December 31, 2016 to $261.9 million or 18.63% of assets at December 31, 2017.

The Bank uses advances from the FHLB of Atlanta to supplement the supply of funds it may lend and to meet deposit withdrawal requirements. Advances from the FHLB are secured by the Bank's stock in the FHLB, a portion of the Bank's loan portfolio and certain investments. Generally, the Bank's ability to borrow from the FHLB of Atlanta is limited by its available collateral and by an overall limitation of 30% of assets. Further, short-term credit facilities are available at the Federal Reserve Bank of Richmond and commercial banks. Long-term debt consists of adjustable-rate advances with rates based upon LIBOR, fixed-rate advances, and convertible advances. At December 31, 2017 and 2016, 100% of the Bank's long-term debt was fixed for rate and term, as the conversion optionality of the advances have either been exercised or expired.

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

	At or for the Year Ended December 31,		
(dollars in thousands)	**2017**	**2016**	**2015**
Long-term debt			
Long-term debt outstanding at end of period	$ 55,498	$ 65,559	$ 55,617
Weighted average rate on outstanding long-term debt	2.38 %	2.27 %	2.47 %
Maximum outstanding long-term debt of any month end	65,554	65,593	74,668
Average outstanding long-term debt	58,704	60,503	68,924
Approximate average rate paid on long-term debt	2.24 %	2.41 %	2.26 %
Short-term borrowings			
Short-term borrowings outstanding at end of period	$ 87,500	$ 79,000	$ 36,000
Weighted average rate on short-term borrowings	1.34 %	0.71 %	0.38 %
Maximum outstanding short-term borrowings at any month end	109,000	79,000	36,000
Average outstanding short-term borrowings	91,797	39,802	13,463
Approximate average rate paid on short-term borrowings	1.15 %	0.49 %	0.27 %

Stockholders' Equity

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

(dollars in thousands)	**December 31, 2017**	**December 31, 2016**	**$ Change**	**% Change**
Common Stock at par of $0.01	$ 46	$ 46	$ -	0.0 %
Additional paid in capital	48,209	47,377	832	1.8 %
Retained earnings	63,648	58,100	5,548	9.5 %
Accumulated other comprehensive loss	(1,191)	(928)	(263)	28.3 %
Unearned ESOP shares	(755)	(169)	(586)	346.7 %
Total Stockholders' Equity	$ 109,957	$ 104,426	$ 5,531	5.3 %

During the year ended December 31, 2017, stockholders' equity increased $5.5 million to $110.0 million. The increase in stockholders' equity was due to net income of $7.2 million, net stock related activities related to stock-based compensation of $670,000 and a net fair market value adjustment of $110,000 for leveraged ESOP shares. These increases to capital were partially offset by quarterly common dividends paid of $1.8 million, a current year increase in accumulated other comprehensive loss of $67,000 and the net increase in unearned ESOP shares of $586,000. During the year ended December 31, 2017, $237,000 or 10,157 ESOP shares were allocated with the payment of promissory notes. This was offset by the purchase of 23,503 shares of the Company's common shares for $823,000 by the Employee Stock Ownership Plan ("ESOP") during the third quarter of 2017. The ESOP has promissory notes with the Company for the purchase of TCFC common stock for the benefit of the participants in the Plan. Loan terms are at prime rate plus one-percentage point and amortize over seven (7) years. As principal is repaid, common shares are allocated to participants based on the participant account allocation rules described in the Plan. The Bank is a guarantor of the ESOP debt with the Company. Unencumbered shares held by the ESOP are treated as outstanding in computing earnings per share. Shares issued to the ESOP but pledged as collateral for loans obtained to provide funds to acquire the shares are not treated as outstanding in computing earnings per share.

Common stockholders' equity of $110.0 million at December 31, 2017 resulted in a book value of $23.65 per common share compared to $22.54 at December 31, 2016. The Company remains well-capitalized at December 31, 2017 with a Tier 1 capital to average assets ratio of 8.79%.

LIQUIDITY AND CAPITAL RESOURCES

Capital Resources

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

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

During the years ended December 31, 2017 and 2016, the Company performed ongoing assessments using the new regulatory capital ratios and determined that the Company meets the new requirements specified in the Basel III rules upon full adoption of such requirements. In addition, our subsidiary bank made the election to continue to exclude most accumulated other comprehensive income ("AOCI") from capital in connection with its March 31, 2015 quarterly financial filing and, in effect, to retain the AOCI treatment under the prior capital rules.

Federal banking regulations require the Company and the Bank to maintain specified levels of capital. As of December 31, 2017 and 2016, the Company and Bank were well-capitalized under the regulatory framework for prompt corrective action under the new Basel III Capital Rules. Management believes, as of December 31, 2017 and 2016, that the Company and the Bank met all capital adequacy requirements to which they were subject. See Note 18 of the Consolidated Financial Statements.

Liquidity

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

Based on management’s going concern evaluation, we believe that there are no conditions or events, considered in the aggregate, that raise substantial doubt about the Company’s or the Bank’s ability to continue as a going concern, within one year of the date of the issuance of the financial statements.

Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. Liquid assets include cash, federal funds sold, and short-term investments in cash deposits with other banks. Liquidity is also provided by access to funding sources, which include core depositors and brokered deposits. Other sources of funds include our ability to borrow, such as purchasing federal funds from correspondent banks, sales of securities under agreements to repurchase and advances from the FHLB.

At December 31, 2017 and 2016, the Bank had $65.6 million and $67.0 million, respectively, in loan commitments outstanding. In addition, at December 31, 2017 and 2016, the Bank had $17.9 million and $17.7 million, respectively, in letters of credit and approximately $162.2 million and $135.3 million, respectively, available under lines of credit. Certificates of deposit due within one year of December 31, 2017 and 2016 totaled $312.4 million or 69.2% and $306.1 million, or 70.7%, respectively, of total certificates of deposit outstanding. If maturing deposits do not remain, the Bank will be required to seek other sources of funds, including other certificates of deposit and borrowings. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposits. We believe, however, based on past experience that a significant portion of our certificates of deposit will remain with us. We have the ability to attract and retain deposits by adjusting the interest rates offered.

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

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

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

Comparison for the Years Ending December 31, 2017 and 2016

Cash and cash equivalents as of December 31, 2017 totaled $15.4 million, an increase of $4.1 million from the December 31, 2016 total of $11.3 million. Ending cash balances were stable compared to the prior year end as net cash provided by operating activities was similar and decreased cash used in investing activities in 2017 compared to 2016 nearly offset decreased cash provided by financing activities in 2017 compared to 2016. Changes to the level of cash and cash equivalents have minimal impact on operational needs as the Bank has substantial sources of funds available from other sources.

During the year ended December 31, 2017, all financing activities provided $63.6 million in cash compared to $182.3 million in cash provided for the same period in 2016. The Company was provided $118.7 million less cash from financing activities compared to the prior year, primarily due to reduced deposit growth and slower growth in net borrowings. Net deposits increased $67.4 million in 2017 compared to $131.9 million in 2016. Long-term debt decreased a net of $10.1 million from $65.6 million at December 31, 2016 to $55.5 million at December 31, 2017 and provided $20.0 million less cash in 2017 compared to 2016. Short-term borrowings increased a net of $8.5 million from $79.0 million at December 31, 2016 to $87.5 million at December 31, 2017, but increased at a slower rate than 2016. Short-term borrowings provided $34.5 million less cash in 2017 compared to 2016. The Company was provided a net increase in cash of $297,000 for stock related activities in 2017 compared to 2016. Net cash provided in 2017 compared to 2016 from the exercise of stock options, no 2017 repurchases of common stock and a small decrease in common dividends paid on 2017 was partially offset by a net change in unearned ESOP shares due primarily to an increase in ESOP stock purchases in 2017.

The Bank's principal use of cash has been in investing activities including its investments in loans, investment securities and other assets. In 2017, the level of net cash used in investing decreased to $69.6 million from $195.1 million in 2016. The decrease in cash used of $125.5 million was primarily the result of net decreases in cash used of $3.2 million for purchases of premises and equipment, $14.0 million from securities transactions and $112.1 million from loan activities. The Company purchased more premises and equipment in 2016 compared to the same period in 2017, mainly due to the construction of a new branch in downtown Fredericksburg, Virginia during the first half of 2016. 2015. The Company's cash used decreased $14.0 million due to net purchases of securities of $5.6 million for the year ended December 31, 2017 compared to $19.6 million for the year ended December 31, 2016. Cash used decreased as principal received on loans in 2017 increased over the prior year comparable period. Principal collected on loans increased $25.7 million from $234.6 million for the year ended December 31, 2016 to $260.3 million for the year ended December 31, 2017. Additionally, cash used decreased for the funding of loans originated, which decreased $86.4 million from $411.6 for the year ended December 31, 2016 to $325.2 million for the year ended December 31, 2017. These reductions in the amount of cash used were partially offset by a decrease in cash provided of $3.8 million from the 2016 sales of the King George branch and OREO compared to less significant sales activity in 2017. Net cash provided decreased from $5.5 million for the year ended December 31, 2016 to $1.7 million for the year ended December 31, 2017

Operating activities provided cash of $10.1 million for the year ended December 31, 2017 compared to $12.9 million of cash provided for the same period of 2016.

Comparison for the Years Ending December 31, 2016 and 2015

Cash and cash equivalents as of December 31, 2016 totaled $11.3 million, an increase of $124,000 from the December 31, 2015 total of $11.1 million. Ending cash balances were stable compared to the prior year end as net cash provided by operating activities was similar and increased cash used in investing activities in 2016 compared to 2015 nearly offset cash provided by financing activities in 2016 compared to 2015. Changes to the level of cash and cash equivalents have minimal impact on operational needs as the Bank has substantial sources of funds available from other sources.

During the year ended December 31, 2016, all financing activities provided $182.3 million in cash compared to $51.9 million in cash provided for the same period in 2015. The Company provided $130.5 million more cash from financing activities in the year ended December 31, 2016 compared to the year ended December 31, 2015, primarily due to increases in deposits of $94.4 million and net increases of $38.0 million in long-term debt and short-term borrowings. Additionally, the Company used $963,000 less cash to repurchase common stock during 2016 and dividends were reduced by $101,000 due to the refinancing of SBLF in the first quarter of 2015. These increases to cash were offset by a $3.0 million reduction in cash due to net proceeds received during the first quarter 2015 for the subordinated notes issued of $23.0 million offset by the SBLF payoff of $20 million.

The Bank’s principal use of cash has been in investing activities including its investments in loans, investment securities and other assets. In 2016, the level of net cash used in investing increased to $195.1 million from $74.6 million in 2015. The increase in cash used in investing activity of $120.5 million in 2016 was primarily due to a net increase in cash used of $123.2 million for loan activities. More cash was used to fund loans as loans originated or acquired increased $152.7 million from $258.9 million for the year ended December 31, 2015 to $411.6 million for the year ended December 31, 2016. This increase in cash used was partially offset as principal collected on loans increased $29.5 million from $205.1 million for the year ended December 31, 2015 to $234.6 million for the year ended December 31, 2016. Additional cash of $520,000 was used to purchase premises and equipment in the year ended December 31, 2016 compared to 2015. The Company’s cash used increased $1.0 million due to net purchases of securities of $19.6 million for the year ended December 31, 2016 compared to $18.6 million for the year ended December 31, 2015. These increases in cash used were partially offset by an increase in net proceeds from the sale of OREO and other assets of $4.2 million compared to the prior year.

Operating activities provided cash of $12.9 million for the year ended December 31, 2016 compared to $12.5 million of cash provided for the same period of 2015.

QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

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

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

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

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

The Company prepares a current base case and several alternative simulations at least quarterly. Current interest rates are shocked by +/- 100, 200, 300, and 400 basis points ("bp"). In addition, the Company simulates additional rate curve scenarios (e.g., bear flattener). The Company may elect not to use particular scenarios that it determines are impractical in a current rate environment.

The Company's internal limits for parallel shock scenarios are as follows:

Shock in Basis Points	**Net Interest Income ("NII")**	**Economic Value of Equity ("EVE")**
+ - 400	25%	40%
+ - 300	20%	30%
+ - 200	15%	20%
+ - 100	10%	10%

76

It is management's goal to manage the portfolios of the Bank so that net interest income at risk over twelve-month and twenty-four month periods and the economic value of equity at risk do not exceed policy guidelines at the various interest rate shock levels. As of December 31, 2017 and 2016, the Company did not exceed any Board approved sensitivity limits. Measures of net interest income at risk produced by simulation analysis are indicators of an institution's short-term performance in alternative rate environments. The below schedule estimates the changes in net interest income over a twelve-month period for parallel rate shocks for up 200, 100 and down 100 scenarios:

Estimated Changes in Net Interest Income			
Change in Interest Rates:	**+ 200 bp**	**+ 100 bp**	**- 100 bp**
Policy Limit	(15.00)%	(10.00)%	(10.00)%
December 31, 2017	(1.28)%	(0.54)%	(1.30)%
December 31, 2016	(2.19)%	(1.10)%	1.51 %

Measures of equity value at risk indicate the ongoing economic value of the Company by considering the effects of changes in interest rates on all of the Company's cash flows, and by discounting the cash flows to estimate the present value of assets and liabilities. The below schedule estimates the changes in the economic value of equity at parallel shocks for up 200, 100 and down 100 scenarios:

Estimated Changes in Economic Value of Equity (EVE)			
Change in Interest Rates:	**+ 200 bp**	**+ 100 bp**	**- 100 bp**
Policy Limit	(20.00)%	(10.00)%	(10.00)%
December 31, 2017	(13.15)%	(6.01)%	18.35 %
December 31, 2016	(13.22)%	(5.64)%	0.63 %

OFF-BALANCE SHEET ARRANGEMENTS

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

For the years ended December 31, 2017 and 2016, the Company did not engage in any off-balance sheet transactions reasonably likely to have a material effect on its financial condition, results of operations or cash flows.

CONTRACTUAL OBLIGATIONS

In the normal course of its business, the Bank commits to make future payments to others to satisfy contractual obligations. These obligations include commitments to repay short and long-term borrowings and commitments incurred under operating lease agreements. The following schedules provide detail of contractual obligations as of December 31, 2017 and 2016:

		Payments due by period			
At December 31, 2017 (In thousands)	Total	Less than One Year	One to Three Years	Three to Five Years	More Than 5 Years
Short-term debt obligations	$87,500	$87,500	$ -	$ -	$ -
Long-term debt obligations	55,498	25,000	10,000	10,302	10,196
Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs)	12,000				12,000
Subordinated notes - 6.25%	23,000				23,000
Time deposits	451,605	312,417	123,384	15,804	-
Operating lease obligations [1]	6,809	747	1,139	904	4,019
Purchase Obligations [2]	4,320	2,129	2,191	-	-
Total	$640,732	$427,793	$ 136,714	$ 27,010	$ 49,215

[1] Payments are for lease of real property.

[2] Represents payments under contract based on average monthly service charges for 2017.

		Payments due by period			
At December 31, 2016 (In thousands)	Total	Less than One Year	One to Three Years	Three to Five Years	More Than 5 Years
Short-term debt obligations	$79,000	$79,000	$ -	$ -	$ -
Long-term debt obligations	65,559	20,000	25,000	10,000	10,559
Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs)	12,000				12,000
Subordinated notes - 6.25%	23,000				23,000
Time deposits	432,792	306,089	111,395	15,308	-
Operating lease obligations [1]	7,622	739	1,377	1,049	4,457

Purchase Obligations [2]	6,459	2,092	4,367	-	-
Total	$626,432	$407,920	$ 142,139	$ 26,357	$ 50,016

[1] Payments are for lease of real property.

[2] Represents payments under contract based on average monthly service charges for 2016.

IMPACT OF INFLATION AND CHANGING PRICES

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

THE COMMUNITY FINANCIAL CORPORATION

RECONCILIATION OF GAAP AND NON-GAAP FINANCIAL MEASURES

Reconciliation of US GAAP Net Income, Earnings Per Share (EPS), Return on Average Assets (ROAA) and Return on Average Common Equity (ROACE) to Non-GAAP Operating Net Income, EPS, ROAA and ROACE[a]

The Company's management discussion and analysis contains financial information determined by methods other than in accordance with generally accepted accounting principles, or GAAP. This financial information includes certain operating performance measures, which exclude merger and acquisition costs, primarily the additional income tax expense from the revaluation of deferred tax assets as a result of the reduction in the corporate income tax rate under the recently enacted Tax Cuts and Jobs Act, that are not considered part of recurring operations, such as “operating net income,” “operating earnings per share,” “operating return on average assets,” and “operating return on average common equity.” These non-GAAP measures are included because the Company believes they may provide useful supplemental information for evaluating the underlying performance trends of the Company.

	Years Ended December 31, 2017		December 31, 2016	
GAAP Net (loss) income	$7,208		$ 7,331	
Impact of Tax Cuts and Jobs Act	2,740		-	
Merger and acquisition costs (net of tax)	724		-	
Non-GAAP Operating Net income before merger and acquisition costs and deferred tax adjustment for Tax Cuts and Jobs Act	$10,672		$ 7,331	
GAAP diluted EPS	$1.56		$ 1.59	
Non-GAAP Operating diluted EPS before merger and acquisition costs and deferred tax adjustment for Tax Cuts and Jobs Act	$2.31		$ 1.59	
GAAP ROAA	0.52	%	0.60	%
Non-GAAP Operating ROAA before merger and acquisition costs and deferred tax adjustment for Tax Cuts and Jobs Act	0.78	%	0.60	%
GAAP ROACE	6.55	%	7.09	%
Non-GAAP Operating ROACE before merger and acquisition costs and deferred tax adjustment for Tax Cuts and Jobs Act	9.70	%	7.09	%
Weighted average common shares outstanding:	4,629,228		4,599,502	

Average Assets	$1,376,983	$ 1,229,470
Average Equity	109,979	103,397

[a] There were no merger and acquisition costs or deferred tax adjustments for the year ended December 31, 2016.

Item 8 - Financial Statements and Supplementary Data

MANAGEMENT’S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

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

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

Management assessed the Company's system of internal control over financial reporting as of December 31, 2017. This assessment was conducted based on the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission "Internal Control — Integrated Framework (2013)." Based on this assessment, management believes that the Company maintained effective internal control over financial reporting as of December 31, 2017. Management's assessment concluded that there were no material weaknesses within the Company's internal control structure. There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15 under the Securities Act of 1934) during the quarter ended December 31, 2017 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

The 2017 financial statements have been audited by the independent registered public accounting firm of Dixon Hughes Goodman LLP ("DHG"). Personnel from DHG were given unrestricted access to all financial records and related data, including minutes of all meetings of the Board of Directors and committees thereof. Management believes that all representations made to all the independent auditors were valid and appropriate. The resulting report from DHG accompanies the financial statements. DHG has also issued a report on the effectiveness of internal control over financial reporting. This report has also been made a part of this Annual Report.

/s/ William J. Pasenelli	/s/ Todd L. Capitani
William J. Pasenelli	Todd L. Capitani
President and Chief Executive Officer	Executive Vice President and Chief Financial Officer
March 12, 2018	March 12, 2018

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Stockholders and Board of Directors

The Community Financial Corporation

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of The Community Financial Corporation (the "Company") as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows, for each of the two years in the period ended December 31, 2017, and the related notes (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of their operations and their cash flows for each of two years in the period ended December 31, 2017, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 12, 2018 expressed an unqualified opinion thereon.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Dixon Hughes Goodman LLP

We have served as the Company's auditor since 2016.

Baltimore, Maryland
March 12, 2018

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Stockholders and Board of Directors

The Community Financial Corporation

Opinion on Internal Control Over Financial Reporting

We have audited The Community Financial Corporation (the "Company")'s internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control—Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. In our opinion, The Community Financial Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017 based on criteria established in *Internal Control—Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated financial statements of The Community Financial Corporation as of December 31, 2017 and 2016 and for each of the years in the two years ended December 31, 2017, and our report dated March 12, 2018, expressed an unqualified opinion on those consolidated financial statements.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

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

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

/s/ Dixon Hughes Goodman LLP

Baltimore, Maryland
March 12, 2018

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

The Community Financial Corporation

Waldorf, Maryland

We have audited the consolidated statement of income, comprehensive income, changes in stockholders' equity, and cash flows of The Community Financial Corporation (the "Company") for the year ended December 31, 2015. The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the Company's results of operations and cash flows for the year ended December 31, 2015, in conformity with accounting principles generally accepted in the United States of America.

/s/ Stegman & Company

Baltimore, Maryland
March 10, 2016

CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except per share amounts)	**December 31, 2017**	**December 31, 2016**
Assets		
Cash and due from banks	$ 13,315	$ 9,948
Interest-bearing deposits with banks	2,102	1,315
Securities available for sale (AFS), at fair value	68,285	53,033
Securities held to maturity (HTM), at amortized cost	99,246	109,247
Federal Home Loan Bank (FHLB) stock - at cost	7,276	7,235
Loans receivable - net of allowance for loan losses of $10,515 and $9,860	1,140,615	1,079,519
Premises and equipment, net	21,391	22,205
Premises and equipment held for sale	-	345
Other real estate owned (OREO)	9,341	7,763
Accrued interest receivable	4,511	3,979
Investment in bank owned life insurance	29,398	28,625
Other assets	10,481	11,043
Total Assets	$ 1,405,961	$ 1,334,257
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Non-interest-bearing deposits	$ 159,844	$ 144,877
Interest-bearing deposits	946,393	893,948
Total deposits	1,106,237	1,038,825
Short-term borrowings	87,500	79,000
Long-term debt	55,498	65,559
Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs)	12,000	12,000
Subordinated notes - 6.25%	23,000	23,000
Accrued expenses and other liabilities	11,769	11,447
Total Liabilities	1,296,004	1,229,831
Stockholders' Equity		
Common stock - par value $.01; authorized - 15,000,000 shares; issued 4,649,658 and 4,633,868 shares, respectively	46	46
Additional paid in capital	48,209	47,377
Retained earnings	63,648	58,100
Accumulated other comprehensive loss	(1,191)	(928)
Unearned ESOP shares	(755)	(169)
Total Stockholders' Equity	109,957	104,426
Total Liabilities and Stockholders' Equity	$ 1,405,961	$ 1,334,257

See notes to Consolidated Financial Statements

84

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31,		
(dollars in thousands, except per share amounts)	**2017**	**2016**	**2015**
Interest and Dividend Income			
Loans, including fees	$49,611	$44,919	$41,386
Interest and dividends on investment securities	3,906	3,108	2,473
Interest on deposits with banks	53	20	14
Total Interest and Dividend Income	53,570	48,047	43,873
Interest Expense			
Deposits	5,946	4,695	4,152
Short-term borrowings	1,057	196	37
Long-term debt	3,179	3,251	3,156
Total Interest Expense	10,182	8,142	7,345
Net Interest Income	43,388	39,905	36,528
Provision for loan losses	1,010	2,359	1,433
Net Interest Income After Provision For Loan Losses	42,378	37,546	35,095
Noninterest Income			
Loan appraisal, credit, and miscellaneous charges	157	289	315
Gain on sale of assets	47	12	19
Net gains (losses) on sale of OREO	43	(436)	(20)
Net gains on sale of investment securities	175	31	4
Loss on premises and equipment held for sale	-	-	(426)
Income from bank owned life insurance	773	789	815
Service charges	2,595	2,675	2,488
Gain on sale of loans held for sale	294	-	104
Total Noninterest Income	4,084	3,360	3,299
Noninterest Expense			
Salary and employee benefits	16,758	16,810	16,366
Occupancy expense	2,632	2,488	2,427
Advertising	543	647	583
Data processing expense	2,354	2,267	2,044
Professional fees	1,662	1,568	1,323
Merger and acquisition costs	829	-	-
Depreciation of premises and equipment	786	812	810
Telephone communications	191	174	188
Office supplies	119	136	157
FDIC Insurance	638	739	799
OREO valuation allowance and expenses	746	861	1,059
Other	2,839	2,657	2,662
Total Noninterest Expense	30,097	29,159	28,418

			9976
Income before income taxes	16,365	11,747	9,976
Income tax expense	9,157	4,416	3,633
Net Income	$7,208	$7,331	$6,343
Preferred stock dividends	-	-	23
Net Income Available to Common Stockholders	$7,208	$7,331	$6,320
Earnings Per Common Share			
Basic	$1.56	$1.59	$1.36
Diluted	$1.56	$1.59	$1.35
Cash dividends paid per common share	$0.40	$0.40	$0.40

See notes to Consolidated Financial Statements

85

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in thousands)	**Years Ended December 31, 2017**	**2016**	**2015**
Net Income	$ 7,208	$ 7,331	$ 6,343
Net unrealized holding (losses) gains arising during period, net of tax (benefit) expense of $(41), $(433) and $85, respectively	(62)	(662)	131
Reclassification adjustment for losses included in net income, net of tax benefit of $3, $7 and $2, respectively	(5)	(15)	(4)
Comprehensive Income	$ 7,141	$ 6,654	$ 6,470

See notes to Consolidated Financial Statements

86

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

Years Ended December 31, 2017, 2016 and 2015

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

87

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

Years Ended December 31, 2017, 2016 and 2015

(continued)

(dollars in thousands)	SBLF Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned ESOP Shares	Total
Balance at January 1, 2016	$ -	$ 46	$ 46,809	$ 53,495	$ (251)	$ (316)	$ 99,783
Comprehensive Income							
Net Income	-	-	-	7,331	-	-	7,331
Unrealized holding loss on investment securities net of tax of $440	-	-	-	-	(677)	-	(677)
Total Comprehensive Income							6,654
Cash dividend at $0.40 per common share	-	-	-	(1,814)	-	-	(1,814)
Dividend reinvestment	-	-	47	(47)	-	-	-
Net change in unearned ESOP shares	-	-	-	-	-	147	147
Repurchase of common stock	-	-	-	(865)	-	-	(865)
Stock based compensation	-	-	489	-	-	-	489
Tax effect of the ESOP dividend	-	-	32	-	-	-	32
Balance at December 31, 2016	$ -	$ 46	$ 47,377	$ 58,100	$ (928)	$ (169)	$ 104,426

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

Years Ended December 31, 2017, 2016 and 2015

(continued)

(dollars in thousands)	SBLF Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned ESOP Shares	Total
Balance at January 1, 2017	$ -	$ 46	$ 47,377	$ 58,100	$ (928)	$ (169)	$ 104,426
Comprehensive Income							
Net Income	-	-	-	7,208	-	-	7,208
Unrealized holding loss on investment securities net of tax of $44	-	-	-	-	(67)	-	(67)
Reclassification due to Accounting Standards Update (ASU 2018-02)	-	-	-	196	(196)	-	-
Total Comprehensive Income							7,141
Cash dividend at $0.40 per common share	-	-	-	(1,804)	-	-	(1,804)
Excess of fair market value over cost of leveraged ESOP shares released	-	-	110	-	-	-	110
Dividend reinvestment	-	-	52	(52)	-	-	-
Exercise of stock options	-	-	155	-	-	-	155
Net change in unearned ESOP shares	-	-	-	-	-	(586)	(586)
Repurchase of common stock	-	-	-	-	-	-	-
Stock based compensation	-	-	515	-	-	-	515
Balance at December 31, 2017	$ -	$ 46	$ 48,209	$ 63,648	$ (1,191)	$ (755)	$ 109,957

See notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF CASH FLOWS