COMMUNITY FINANCIAL CORP /MD/
Form 10-K
March 13, 2017

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, 2016

OR

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

For the transition period from _______ to _______

Commission File 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. x

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

Large Accelerated Filer ¨ Accelerated Filer x
Non-Accelerated Filer ¨ Smaller Reporting Company ¨

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

The aggregate market value of voting stock held by non-affiliates of the registrant was approximately $84.9 million based on the closing price $22.14 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 6, 2017: 4,640,974

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2017 Annual Meeting of Stockholders. (Part III)

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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 Central Park and downtown Fredericksburg, Virginia. 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 and Central Park LPOs are co-located with branches. The Annapolis LPO opened in October 2014.

The Bank operates 16 automated teller machines including 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 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 2016 was between $87,000 and $88,500 in our market areas compared to slightly less than $56,000 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 3.9% with projected population growth in excess of 4.5% 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, savings and loan associations and federal and state credit unions located in its primary market area. There are more than 25 FDIC-insured depository institutions operating in the Bank's footprint including subsidiaries of 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 local municipal agencies and 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 $667.1 million or 61.3% of the loan portfolio and $538.9 million or 58.6% of the loan portfolio, respectively at December 31, 2016 and 2015. This portfolio has increased in both absolute size and as a percentage of the loan portfolio in each of the last five years. The CRE portfolio includes commercial construction balances. At December 31, 2016 and 2015, commercial construction balances were 9.3% and 6.1% 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 of the Bank's commercial real estate loans are secured by real estate located in the Bank's primary market area. At December 31, 2016 and 2015, the largest outstanding commercial real estate loans were $12.8 million and $9.7 million, respectively, which were secured by commercial real estate and performing according to its 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 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 multi-family or 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 $125.4 million and $112.5 million, respectively, as of December 31, 2016 and 2015. 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, 2016 and 2015, the Bank serviced $52.0 million and $63.0 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, 2016 and 2015, the Bank had $45.6 million and $18.9 million, respectively, in adjustable-rate residential mortgage loans. At December 31, 2016 and 2015, the largest outstanding residential first mortgage loans were $2.2 million and $2.0 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, 2016 and 2015.

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 $17.9 million and $17.3 million, respectively, as of December 31, 2016 and 2015. As of December 31, 2016 and 2015, the Bank had $83.9 million and $75.9 million, respectively, in adjustable-rate residential rental mortgage loans. As of December 31, 2016 and 2015, $84.9 million and $80.8 million, respectively, were 1-4 family units and $17.0 million and $12.4 million, respectively, were apartment buildings.

At December 31, 2016 and 2015, the largest outstanding residential rental mortgage loan was $10.5 million and $10.8 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, 2016 and 2015.

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 $12.1 million and $14.1 million, respectively, at December 31, 2016 and 2015. 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 $24.9 million and $22.1 million, respectively, at December 31, 2016 and 2015. 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, 2016 and 2015, the largest outstanding construction and land development loan was $4.9 million, which was 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 3.4% at December 31, 2016. 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 has made 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 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 $19.7 million and $19.5 million, respectively at December 31, 2016 and 2015, 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 $1.7 million and $2.2 million, respectively at December 31, 2016 and 2015, 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 has been heightened as the market value of residential property has declined.

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, but have decreased as a percentage of total loans and in total dollars over the last few years. At $50.5 million and 4.6% of total loans and $67.2 million and 7.3% of total loans at December 31, 2016 and 2015, respectively, the commercial loan portfolio decreased by $16.7 million and $6.4 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, however, 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 problematic. The Bank attempts to control these risks by establishing guidelines that provide for loans with low loan-to-value ratios. At December 31, 2016 and 2015, the largest outstanding commercial loans were $4.0 million and $12.0 million, respectively, which was secured by commercial real estate (all of which was located in the Bank's market area), cash and investments. These loans were performing according to terms at December 31, 2016 and 2015.

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 $422,000 and $366,000, respectively, at December 31, 2016 and 2015. 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 $39.7 million and $29.9 million, or 3.7% and 3.3% of the total loan portfolio, respectively, at December 31, 2016 and 2015. 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,								
	2016		2015		2014		2013		2012
(dollars in thousands)	Amount	%	Amount	%	Amount	%	Amount	%	Amount
Commercial real estate	$667,105	61.25 %	$538,888	58.64 %	$485,601	55.68 %	$476,648	58.97 %	$419,667
Residential first mtgs.	171,004	15.70 %	131,401	14.30 %	146,539	16.80 %	159,147	19.69 %	177,663
Residential rentals [1]	101,897	9.36 %	93,157	10.14 %	81,777	9.38 %	-		-
Construction and land dev.	36,934	3.39 %	36,189	3.94 %	36,370	4.17 %	32,001	3.96 %	31,819

Home equity and second mtgs.	21,399	1.97	%	21,716	2.36	%	21,452	2.46	%	21,692	2.68	%	21,982
Commercial loans	50,484	4.64	%	67,246	7.32	%	73,625	8.44	%	94,176	11.65	%	88,158
Consumer loans	422	0.04	%	366	0.04	%	613	0.07	%	838	0.10	%	995
Commercial equipment	39,737	3.65	%	29,931	3.26	%	26,152	3.00	%	23,738	2.94	%	16,268
Total Loans	1,088,982	100.00	%	918,894	100.00	%	872,129	100.00	%	808,240	100.00	%	756,552
Deferred loan fees and premiums	(397	)		1,154			1,239			972			664
Allowance for loan losses	9,860			8,540			8,481			8,138			8,247
Loans receivable, net	$1,079,519			$909,200			$862,409			$799,130			$747,641

[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.

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

	For the Years Ended December 31,									
	2016		2015		2014		2013		2012	
dollars in thousands	Average Balance	Average Yield/ Cost	Average Balance	Average Yield/ Cost	Average Balance	Average Yield/ Cost	Average Balance	Average Yield/ Cost	Average Balance	Average Yield/ Cost
Commercial real estate	602,648	4.50%	518,329	4.64%	460,014	4.84%	434,889	5.08%	395,276	5.40%
Residential first mortgages	151,366	3.99%	134,728	4.35%	148,367	4.43%	169,671	4.68%	177,401	4.68%
Residential rentals [1]	96,611	4.69%	88,251	4.63%	75,104	4.65%	-		-	
Construction and land development	36,938	4.58%	37,665	4.99%	29,921	4.68%	27,065	4.75%	31,499	4.94%
Home equity and second mortgages	21,781	4.08%	21,332	4.09%	21,426	4.21%	21,647	4.33%	22,703	4.33%
Commercial and equipment loans [2]	87,705	5.27%	81,957	5.61%	92,199	5.21%	95,316	5.11%	99,735	4.88%
Consumer loans	397	8.56%	465	8.82%	701	7.99%	954	7.23%	1,002	7.98%
Allowance for loan losses	(9,157)	n/a	(8,541)	n/a	(8,351)	n/a	(8,173)	n/a	(7,818)	n/a
Net Average Loans	988,289	4.55%	874,186	4.73%	819,381	4.82%	741,369	5.02%	719,798	5.16%

[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. 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 year ended December 31, 2016. Residential mortgage loans in the amounts of $4.2 million and $13.6 million were sold by the Bank for the years ended December 31, 2015 and 2014, respectively.

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. The Bank sold CRE participations of $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. The Bank only purchases loans or portions of loans after reviewing loan documents, underwriting support, and completing other procedures, as necessary. The Bank purchased no commercial real estate or commercial loans during 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.

The Credit Risk Committee of the Board, consisting of three or more directors, has been delegated by the Board of Directors of the Bank to assist 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.

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.

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 $14.1 million and $13.7 million, respectively, to any one borrower at December 31, 2016 and 2015. 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 $21.9 million and $21.2 million, respectively, to any one borrower at December 31, 2016 and 2015. At December 31, 2016 and 2015, the largest amount outstanding to any one borrower and borrower's related interests was

$12.8 million and $12.0 million, respectively.

Loan Commitments

The Bank does not normally negotiate standby commitments for the construction and purchase of real estate. Most loan commitments are granted for a one-month period. The Bank's outstanding commitments to originate loans at December 31, 2016 and 2015 were approximately $67.0 million and $73.5 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, 2016 and 2015. 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 the aforementioned categories but possess weaknesses are required to be designated "special mention."

When an insured institution classifies one or more assets, or portions thereof, as “substandard” or “doubtful,” it is required that a general valuation allowance for loan losses be established in an amount deemed prudent by management. General valuation allowances represent loss allowances that have been established to recognize the inherent losses associated with lending activities, but that, unlike specific allowances, have not been allocated to particular problem assets. When an insured institution classifies one or more assets, or portions thereof, 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, 2016	December 31, 2015	December 31, 2014	December 31, 2013	December 31, 2012
Classified assets					
Substandard	$ 39,109	$ 42,485	$ 54,022	$ 56,880	$ 58,595
Doubtful	137	861	-	-	-
Loss	-	-	-	-	-
Total classified assets	39,246	43,346	54,022	56,880	58,595
Special mention assets	-	1,642	5,460	9,246	6,092
	$ 39,246	$ 44,988	$ 59,482	$ 66,126	$ 64,687

Delinquencies

The Bank’s collection procedures provide that when a loan is 15 days delinquent, the borrower is contacted by mail and payment is requested. If the delinquency continues, subsequent 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 and other actions as deemed necessary. 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, 2016 and 2015, 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 and doubtful classified loans, loans delinquent 90 days or greater, non-accrual loans and troubled debt restructures (“TDRs”) on an individualized basis to determine whether a loan is 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 by either 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 $1.3 million and $1.6 million, respectively, related to impaired loans at December 31, 2016 and 2015. 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)	2016	2015	2014	2013	2012
Recorded investment with no allowance	$26,436	$35,171	$45,587	$28,220	$34,717
Recorded investment with allowance	8,924	4,066	4,122	9,786	4,273
Total impaired loans	$35,360	$39,237	$49,709	$38,006	$38,990
Specific allocations of allowance	$1,289	$1,608	$451	$985	$1,548
Interest income recognized	$1,309	$1,366	$1,841	$1,608	$1,850

For additional information regarding impaired loans by class at December 31, 2016 and 2015, 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, including trends in delinquency, non-performing and classified loans and charge-offs, economic conditions in the Bank's market area, and a review of selected individual loans. 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.

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,														
	2016			2015			2014			2013			2012		
(dollars in thousands)	Amount	% [1]		Amount	% [1]		Amount	% [1]		Amount	% [1]		Amount	% [1]	
Commercial real estate	$5,212	61.25	%	$3,465	58.64	%	$3,528	55.68	%	$3,051	58.97	%	$4,092	55.47	%
Residential first mtgs.	1,406	15.70	%	584	14.30	%	1,047	16.80	%	1,343	19.69	%	1,083	23.48	%
Residential rentals [2]	362	9.36	%	538	10.14	%	593	9.38	%	532			-		
Construction and land dev.	941	3.39	%	1,103	3.94	%	1,071	4.17	%	584	3.96	%	533	4.21	%
Home equity and second mtgs.	138	1.97	%	142	2.36	%	173	2.46	%	249	2.68	%	280	2.91	%
Commercial loans	794	4.64	%	1,477	7.32	%	1,677	8.44	%	1,916	11.65	%	1,948	11.65	%
Consumer loans	3	0.04	%	2	0.04	%	3	0.07	%	10	0.10	%	19	0.13	%
Commercial equipment	1,004	3.65	%	1,229	3.26	%	389	3.00	%	453	2.94	%	292	2.15	%
Total allowance for loan losses	$9,860	100.00	%	$8,540	100.00	%	$8,481	100.00	%	$8,138	100.00	%	$8,247	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)	2016	2015	2014	2013	2012
Balance at beginning of period	$8,540	$ 8,481	$8,138	$8,247	$7,655
Charge-offs:					
Commercial real estate	-	78	195	140	486
Residential first mtgs.	-	30	94	348	11
Residential rentals (1)	14	-	155	-	-
Construction and land dev.	526	-	992	36	141
Home equity and second mtgs.	-	100	59	111	211
Commercial loans	594	432	1,134	480	1,004
Consumer loans	1	-	3	12	5
Commercial equipment	34	818	10	35	169
Total Charge-offs	1,169	1,458	2,642	1,162	2,027
Recoveries:					
Commercial real estate	58	17	11	-	-
Residential first mtgs.	-	1	186	11	38
Residential rentals (1)	-	-		-	-
Construction and land dev.	1	&n			