FIRST UNITED CORP/MD/
Form 424B3
September 04, 2014

Filed Pursuant to Rule 424(b)(3)

Registration Statement No. 333-180514

PROSPECTUS SUPPLEMENT NO. 1

(to Prospectus dated April 7, 2014)

Dividend Reinvestment and Stock Purchase Plan

800,000 Shares of Common Stock, Par Value $.01 Per Share

This Prospectus Supplement No. 1 supplements and amends our Prospectus dated April 7, 2014 and includes our attached Quarterly Report on Form 10-Q for the quarter ended March 31, 2014 that was filed with the Securities and Exchange Commission on May 12, 2014.

The Prospectus and this Prospectus Supplement No. 1 relate to our sale of up to 800,000 shares of our common stock, par value $.01 per share, to our shareholders under our Dividend Reinvestment and Stock Purchase Plan, as amended (the "Plan"). We will receive all of the net proceeds from sales of newly issued shares to you under the Plan. We will not receive any proceeds from sales of shares that the Plan's administrator buys from persons other than us.

Our common stock is listed on The NASDAQ Global Select Market under the symbol "FUNC". As of September 3, 2014, the 20-day average of the high and low sales prices of the common stock as reported on The NASDAQ Global Select Market was $8.55 per share. On September 3, 2014, the closing sales price of our common stock as reported on The NASDAQ Global Select Market was $8.45 per share.

This Prospectus Supplement No. 1 should be read in conjunction with the Prospectus. Any statement contained in the Prospectus shall be deemed to be modified or superseded to the extent that information in this Prospectus Supplement No. 1 modifies or supersedes such statement. Any statement that is modified or superseded shall not be deemed to constitute a part of the Prospectus except as modified or superseded by this Prospectus Supplement No. 1.

Investing in our common stock involves certain risks. You should review carefully the risks described under "Risk Factors" beginning on page 5 of the Prospectus and under similar headings in any amendments or supplements to the Prospectus.

NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

THE SECURITIES OFFERED HEREBY ARE NOT DEPOSIT OR SAVINGS ACCOUNTS OR OTHER OBLIGATIONS OF ANY BANK OR NON-BANK SUBSIDIARY OF FIRST UNITED CORPORATION, AND THEY ARE NOT INSURED BY THE FEDERAL DEPOSIT INSURANCE CORPORATION OR ANY OTHER GOVERNMENT AGENCY OR INSTRUMENTALITY.

The date of this Prospectus Supplement No. 1 is September 4, 2014.

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For quarterly period ended March 31, 2014

¨ TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT
For the transition period from _______________ to ________________

Commission file number 0-14237

First United Corporation

(Exact name of registrant as specified in its charter)

Maryland	52-1380770
(State or other jurisdiction of incorporation or organization)	(I. R. S. Employer Identification No.)

19 South Second Street, Oakland, Maryland 21550-0009

(Address of principal executive offices) (Zip Code)

(800) 470-4356

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes R No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes R No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition 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 ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company R

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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: 6,210,587 shares of common stock, par value $.01 per share, as of April 30, 2014.

INDEX TO QUARTERLY REPORT

FIRST UNITED CORPORATION

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST UNITED CORPORATION

Consolidated Statement of Financial Condition

(In thousands, except per share and percentage data)

	March 31, 2014 (Unaudited)	December 31, 2013
Assets		
Cash and due from banks	$34,521	$ 32,895
Interest bearing deposits in banks	9,287	10,168
Cash and cash equivalents	43,808	43,063
Investment securities – available-for-sale (at fair value)	361,465	336,589
Investment securities – held to maturity (fair value $2,444 at March 31, 2014 and $3,590 at December 31, 2013, respectively)	2,860	3,900
Restricted investment in bank stock, at cost	7,529	7,913
Loans	814,037	810,240
Allowance for loan losses	(12,572)	(13,594)
Net loans	801,465	796,646
Premises and equipment, net	26,628	26,905
Goodwill and other intangible assets, net	11,004	11,004
Bank owned life insurance	32,656	32,413
Deferred tax assets	25,478	29,209
Other real estate owned	15,613	17,031
Accrued interest receivable and other assets	26,978	28,830
Total Assets	$1,355,484	$ 1,333,503
Liabilities and Shareholders' Equity		
Liabilities:		
Non-interest bearing deposits	$212,187	$ 189,500
Interest bearing deposits	788,842	787,903
Total deposits	1,001,029	977,403
Short-term borrowings	43,617	43,676
Long-term borrowings	182,656	182,672
Accrued interest payable and other liabilities	20,303	28,412
Total Liabilities	1,247,605	1,232,163
Shareholders' Equity:		

Preferred stock – no par value;		
Authorized 2,000 shares of which 30 shares of Series A, $1,000 per share liquidation preference, 5% cumulative increasing to 9% cumulative on February 15, 2014, were issued and outstanding on March 31, 2014 and December 31, 2013 (discount of $0 and $6, respectively)	30,000	29,994
Common Stock – par value $.01 per share;		
Authorized 25,000 shares; issued and outstanding 6,211 shares at March 31, 2014 and December 31, 2013	62	62
Surplus	21,684	21,661
Retained earnings	74,747	73,836
Accumulated other comprehensive loss	(18,614)	(24,213)
Total Shareholders' Equity	107,879	101,340
Total Liabilities and Shareholders' Equity	$ 1,355,484	$ 1,333,503

See accompanying notes to the consolidated financial statements

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FIRST UNITED CORPORATION

Consolidated Statement of Income

(In thousands, except per share data)

	Three Months Ended March 31,	
	2014	2013
	(Unaudited)	
Interest income		
Interest and fees on loans	$ 9,338	$ 10,685
Interest on investment securities		
Taxable	1,988	1,142
Exempt from federal income tax	411	428
Total investment income	2,399	1,570
Other	17	33
Total interest income	11,754	12,288
Interest expense		
Interest on deposits	1,167	1,327
Interest on short-term borrowings	14	14
Interest on long-term borrowings	1,654	1,614
Total interest expense	2,835	2,955
Net interest income	8,919	9,333
Provision for loan losses	364	865
Net interest income after provision for loan losses	8,555	8,468
Other operating income		
Changes in fair value on impaired securities	4,389	1,663
Portion of gain recognized in other comprehensive income (before taxes)	(4,389)	(1,663)
Net securities impairment losses recognized in operations	0	0
Net (losses)/gains – other	(63)	329
Total net (losses)/gains	(63)	329
Service charges	709	886
Trust department	1,252	1,199
Debit card income	457	476
Bank owned life insurance	243	249
Brokerage commissions	205	162
Other	174	257
Total other income	3,040	3,229
Total other operating income	2,977	3,558
Other operating expenses		
Salaries and employee benefits	4,685	4,844
FDIC premiums	391	451
Equipment	655	642
Occupancy	655	704
Data processing	782	729

Other Real Estate Owned	457	18
Other	2,135	2,148
Total other operating expenses	9,760	9,536
Income before income tax expense	1,772	2,490
Applicable income tax expense	414	568
Net Income	1,358	1,922
Accumulated preferred stock dividends and discount accretion	(447)	(437)
Net Income Available to Common Shareholders	$ 911	$ 1,485
Basic and diluted net income per common share	$ 0.15	$ 0.24
Weighted average number of basic and diluted shares outstanding	6,211	6,199

See accompanying notes to the consolidated financial statements

FIRST UNITED CORPORATION

Consolidated Statement of Comprehensive Income

(In thousands)

	Three Months Ended March 31,	
	2014	2013
	(Unaudited)	
Net Income	$ 1,358	$ 1,922
Other comprehensive income/(loss), net of tax and reclassification adjustments:		
Net unrealized gains on investments with OTTI	2,634	995
Net unrealized gains/(losses) on all other AFS securities	3,036	(265)
Net unrealized gains on cash flow hedges	55	60
Net unrealized (losses)/gains on Pension	(127)	715
Net unrealized gains on SERP	1	4
Other comprehensive income, net of tax	5,599	1,509
Comprehensive income	$ 6,957	$ 3,431

See accompanying notes to the consolidated financial statements

FIRST UNITED CORPORATION

Consolidated Statement of Changes in Shareholders’ Equity

(In thousands, except share and per share data)

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
	(unaudited)					
Balance at January 1, 2013	$29,925	$ 62	$21,573	$69,168	$ (21,823)	$ 98,905
Net income				6,446		6,446
Other comprehensive loss					(2,390)	(2,390)
Stock based compensation			88			88
Preferred stock discount accretion	69			(69)		0
Preferred stock dividends deferred				(1,709)		(1,709)
Balance at December 31, 2013	29,994	62	21,661	73,836	(24,213)	101,340
Net income				1,358		1,358
Other comprehensive income					5,599	5,599
Stock based compensation			23			23
Preferred stock discount accretion	6			(6)		0
Preferred stock dividends deferred				(441)		(441)
Balance at March 31, 2014	$30,000	$ 62	$21,684	$74,747	$ (18,614)	$ 107,879

See accompanying notes to the consolidated financial statements

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FIRST UNITED CORPORATION

Consolidated Statement of Cash Flows

(In thousands)

	Three Months Ended March 31,	
	2014	2013
	(Unaudited)	
Operating activities		
Net income	$ 1,358	$ 1,922
Adjustments to reconcile net income to net cash (used in)/provided by operating activities:		
Provision for loan losses	364	865
Depreciation	505	509
Stock compensation	23	19
Gain on sales of other real estate owned	(25)	(7)
Write-downs of other real estate owned	371	20
Gain on loan sales	(8)	(79)
Loss on disposal of fixed assets	3	0
Net amortization of investment securities discounts and premiums	34	395
Loss/(gain) on sales of investment securities – available-for-sale	68	(250)
Amortization of deferred loan fees	(75)	(191)
Decrease/(increase) in accrued interest receivable and other assets	1,810	(810)
(Increase)/decrease in deferred tax benefit	(168)	1
(Decrease)/increase in accrued interest payable and other liabilities	(8,457)	364
Earnings on bank owned life insurance	(243)	(249)
Net cash (used in)/provided by operating activities	(4,440)	2,509
Investing activities		
Proceeds from maturities/calls of investment securities available-for-sale	14,283	13,381
Proceeds from maturities/calls of investment securities held-to-maturity	1,040	0
Proceeds from sales of investment securities available-for-sale	8,585	35,136
Purchases of investment securities available-for-sale	(38,399)	(63,611)
Proceeds from sales of other real estate owned	1,583	1,765
Proceeds from loan sales	849	11,313
Net decrease in FHLB stock	384	496
Net (increase)/decrease in loans	(6,460)	2,777
Purchases of premises and equipment	(231)	(283)
Net cash (used in)/provided by investing activities	(18,366)	974
Financing activities		
Net increase/(decrease) in deposits	23,626	(1,084)
Net decrease in short-term borrowings	(59)	(624)
Payments on long-term borrowings	(16)	(15)
Net cash provided by/(used in) financing activities	23,551	(1,723)

Increase in cash and cash equivalents	745	1,760
Cash and cash equivalents at beginning of the year	43,063	83,068
Cash and cash equivalents at end of period	$43,808	$84,828
Supplemental information		
Interest paid	$9,582	$2,489
Non-cash investing activities:		
Transfers from loans to other real estate owned	$511	$453

See accompanying notes to the consolidated financial statements

FIRST UNITED CORPORATION

NoteS to Consolidated Financial Statements (UNAUDITED)

for the quarter ended MARCH 31, 2014

Note 1 – Basis of Presentation

The accompanying unaudited consolidated financial statements of First United Corporation and its consolidated subsidiaries, including First United Bank & Trust (the "Bank"), have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information, as required by the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 270, *Interim Reporting*, and with the instructions to Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all the information and footnotes required for annual financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation, consisting of normal recurring items, have been included. Operating results for the three months ended March 31, 2014 are not necessarily indicative of the results that may be expected for the full year or for any future interim period. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in First United Corporation's Annual Report on Form 10-K for the year ended December 31, 2013. For purposes of comparability, certain prior period amounts have been reclassified to conform to the 2014 presentation. Such reclassifications had no impact on net income or equity.

First United Corporation has evaluated events and transactions occurring subsequent to the statement of financial condition date of March 31, 2014 for items that should potentially be recognized or disclosed in these financial statements as prescribed by ASC Topic 855, *Subsequent Events*.

As used in these notes to consolidated financial statements, First United Corporation and its consolidated subsidiaries are sometimes collectively referred to as the "Corporation".

Note 2 – Earnings Per Common Share

Basic earnings per common share is derived by dividing net income available to common shareholders by the weighted-average number of common shares outstanding during the period and does not include the effect of any potentially dilutive common stock equivalents. Diluted earnings per share is derived by dividing net income available to common shareholders by the weighted-average number of shares outstanding, adjusted for the dilutive effect of outstanding common stock equivalents. No common stock equivalents were outstanding during the three months ended March 31, 2014 and 2013.

The following table sets forth the calculation of basic and diluted earnings per common share for the three months ended March 31, 2014 and 2013:

	Three Months Ended March 31,					
	2014			2013		
(in thousands, except for per share amount)	Income	Average Shares	Per Share Amount	Income	Average Shares	Per Share Amount
Basic and Diluted Earnings Per Share:						
Net income	$1,358			$1,922		
Preferred stock dividends deferred	(441)			(420)		
Discount accretion on preferred stock	(6)			(17)		
Net income available to common shareholders	$911	6,211	$ 0.15	$1,485	6,199	$ 0.24

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Note 3 – Net (Losses)/Gains

The following table summarizes the (loss)/gain activity for the three months ended March 31, 2014 and 2013:

	Three months ended March 31,	
(in thousands)	2014	2013
Net (losses)/gains – other:		
Available-for-sale securities:		
Realized gains	$ 95	$ 412
Realized losses	(163)	(162)
Gain on sale of consumer loans	8	79
Loss on disposal of fixed assets	(3)	0
Net (losses)/gains – other	$ (63)	$ 329

Note 4 – Cash and Cash Equivalents

Cash and due from banks, which represents vault cash in the retail offices and invested cash balances at the Federal Reserve, is carried at fair value.

(in thousands)	March 31, 2014	December 31, 2013
Cash and due from banks, weighted average interest rate of 0.15% (at March 31, 2014)	$ 34,521	$ 32,895

Interest bearing deposits in banks, which represent funds invested at a correspondent bank, are carried at fair value and, as of March 31, 2014 and December 31, 2013, consisted of daily funds invested at the Federal Home Loan Bank (“FHLB”) of Atlanta, First Tennessee Bank (“FTN”), Merchants and Traders (“M&T”) and Community Bankers Bank (“CBB”).

(in thousands)	March 31, 2014	December 31, 2013
FHLB daily investments, interest rate of 0.005% (at March 31, 2014)	$ 1,293	$ 1,677
FTN daily investments, interest rate of 0.06% (at March 31, 2014)	850	1,350
M&T daily investments, interest rate of 0.22% (at March 31, 2014)	5,045	5,043
M&T daily investments, interest rate of 0.20% (at March 31, 2014)	1,009	1,008
CBB Fed Funds sold, interest rate of 0.22% (at March 31, 2014)	1,090	1,090

	$ 9,287	$ 10,168

Note 5 – Investments

The investment portfolio is classified and accounted for based on the guidance of ASC Topic 320, *Investments – Debt and Equity Securities*.

The amortized cost of debt securities classified as available-for-sale is adjusted for the amortization of premiums to the first call date, if applicable, or to maturity, and for the accretion of discounts to maturity, or, in the case of mortgage-backed securities, over the estimated life of the security. Such amortization and accretion is included in interest income from investments. Interest and dividends are included in interest income from investments. Gains and losses on the sale of securities are recorded using the specific identification method.

The following table shows a comparison of amortized cost and fair values of investment securities at March 31, 2014 and December 31, 2013:

(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses		Fair Value	OTTI in AOCI
March 31, 2014						
Available for Sale:						
U.S. Treasuries	$ 23,500	$ 0	$ 0	*	$ 23,500	$ 0
U.S. government agencies	89,761	84	3,880		85,965	0
Residential mortgage-backed agencies	113,815	347	3,710		110,452	0
Commercial mortgage-backed agencies	39,296	63	1,021		38,338	0
Collateralized mortgage obligations	29,498	75	573		29,000	0
Obligations of states and political subdivisions	50,629	1,177	689		51,117	0
Collateralized debt obligations	37,249	975	15,131		23,093	8,314
Total available for sale	$ 383,748	$ 2,721	$ 25,004		$ 361,465	$ 8,314
* DeMinimus						
Held to Maturity:						
Obligations of states and political subdivisions	$ 2,860	$ 0	$ 416		$ 2,444	$ 0
December 31, 2013						
Available for Sale:						
U.S. government agencies	$ 97,242	$ 14	$ 5,221		$ 92,035	$ 0
Residential mortgage-backed agencies	116,933	334	4,823		112,444	0
Commercial mortgage-backed agencies	31,025	14	1,134		29,905	0
Collateralized mortgage obligations	30,468	84	1,162		29,390	0
Obligations of states and political subdivisions	55,505	895	1,123		55,277	0
Collateralized debt obligations	37,146	778	20,386		17,538	12,703
Total available for sale	$ 368,319	$ 2,119	$ 33,849		$ 336,589	$ 12,703
Held to Maturity:						
Obligations of states and political subdivisions	$ 3,900	$ 249	$ 559		$ 3,590	$ 0

Proceeds from sales of securities and the realized gains and losses are as follows:

	Three Months Ended March 31,	
(in thousands)	2014	2013
Proceeds	$ 8,585	$ 35,136
Realized gains	95	412
Realized losses	163	162

The following table shows the Corporation's securities with gross unrealized losses and fair values at March 31, 2014 and December 31, 2013, aggregated by investment category and the length of time that individual securities have been in a continuous unrealized loss position:

	Less than 12 months			12 months or more	
(in thousands)	Fair Value	Unrealized Losses		Fair Value	Unrealized Losses
March 31, 2014					
Available for Sale:					
U.S. Treasuries	$ 12,000	$ 0	*	$ 0	$ 0
U.S. government agencies	34,814	1,223		21,417	2,657
Residential mortgage-backed agencies	22,928	937		52,347	2,773
Commercial mortgage-backed agencies	25,570	634		4,732	387
Collateralized mortgage obligations	20,448	573		0	0
Obligations of states and political subdivisions	10,877	447		1,761	242
Collateralized debt obligations	0	0		18,029	15,131
Total available for sale	$ 126,637	$ 3,814		$ 98,286	$ 21,190
* DeMinimus					
Held to Maturity:					
Obligations of states and political subdivisions	$ 0	$ 0		$ 2,444	$ 416
December 31, 2013					
Available for Sale:					
U.S. government agencies	$ 62,962	$ 3,154		$ 13,996	$ 2,067
Residential mortgage-backed agencies	60,781	1,801		46,570	3,022
Commercial mortgage-backed agencies	21,889	1,134		0	0
Collateralized mortgage obligations	21,201	1,149		3,051	13
Obligations of states and political subdivisions	15,422	1,123		0	0
Collateralized debt obligations	0	0		16,434	20,386
Total available for sale	$ 182,255	$ 8,361		$ 80,051	$ 25,488
Held to Maturity:					
Obligations of states and political subdivisions	$ 0	$ 0		$ 2,301	$ 559

Management systematically evaluates securities for impairment on a quarterly basis. Management assesses whether (a) the Corporation has the intent to sell a security being evaluated and (b) it is more likely than not that the Corporation will be required to sell the security prior to its anticipated recovery. If neither applies, then declines in the fair values of securities below their cost that are considered other-than-temporary declines are split into two components. The first component is the loss attributable to declining credit quality. Credit losses are recognized in earnings as realized losses in the period in which the impairment determination is made. The second component consists of all other losses, which are recognized in other comprehensive loss. In estimating other-than-temporary impairment ("OTTI") losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) adverse conditions specifically related to the security, an industry, or a geographic area, (3) the historic and implied volatility of the fair value of the security, (4) changes in the rating of the security by a rating agency, (5) recoveries or additional declines in fair value subsequent to the balance sheet date, (6) failure of the issuer of the security to make scheduled interest or principal payments, and (7) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future. Management also monitors cash flow projections for securities that are considered beneficial interests under the guidance of ASC Subtopic 325-40, *Investments – Other – Beneficial Interests in Securitized Financial Assets*, (ASC Section 325-40-35). Further discussion about the evaluation of securities for impairment can be found in Item 2 of Part I of this report under the heading "*Investment Securities*".

Management believes that the valuation of certain securities is a critical accounting policy that requires significant estimates in preparation of its consolidated financial statements. Management utilizes an independent third party to prepare both the impairment valuations and fair value determinations for its collateralized debt obligation (“CDO”) portfolio consisting of pooled trust preferred securities. Based on management’s review of the assumptions and results of the third-party review, it does not believe that there were any material differences in the valuations between December 31, 2013 and March 31, 2014.

U.S. Government Treasuries - One U.S. government treasury has been in an unrealized loss position for less than 12 months as of March 31, 2014. There were no U.S. government treasuries in an unrealized loss position for 12 months or more.

U.S. Government Agencies - Six U.S. government agencies have been in an unrealized loss position for less than 12 months as of March 31, 2014. There were three U.S. government agencies in an unrealized loss position for 12 months or more. The securities are of the highest investment grade and the Corporation does not intend to sell them, and it is not more likely than not that the Corporation will be required to sell them before recovery of their amortized cost basis, which may be at maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at March 31, 2014.

Residential Mortgage-Backed Agencies - Ten residential mortgage-backed agencies have been in an unrealized loss position for less than 12 months as of March 31, 2014. There were eight residential mortgage-backed agency securities in an unrealized loss position for 12 months or more. The securities are of the highest investment grade and the Corporation does not intend to sell them, and it is not more likely than not that the Corporation will be required to sell the securities before recovery of their amortized cost basis, which may be at maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at March 31, 2014.

Commercial Mortgage-Backed Agencies - Eleven commercial mortgage-backed agencies have been in an unrealized loss position for less than 12 months as of March 31, 2014. There was one commercial mortgage-backed agency security in an unrealized loss position for 12 months or more. The securities are of the highest investment grade and the Corporation does not intend to sell them, and it is not more likely than not that the Corporation will be required to sell the securities before recovery of their amortized cost basis, which may be at maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at March 31, 2014.

Collateralized Mortgage Obligations - Three collateralized mortgage obligation securities at March 31, 2014 were in an unrealized loss position for 12 months or less. The securities are of the highest investment grade and the Corporation does not intend to sell them, and it is not more likely than not that the Corporation will be required to sell the securities before recovery of their amortized cost basis. Accordingly, management does not consider these investments to be other-than-temporarily impaired at March 31, 2014. There were no collateralized mortgage obligation securities in an unrealized loss position for 12 months or more.

Obligations of State and Political Subdivisions - Five securities have been in an unrealized loss position for less than 12 months at March 31, 2014. There were two securities that have been in an unrealized loss position for 12 months or more. These investments are of investment grade as determined by the major rating agencies and management reviews the ratings of the underlying issuers. The bonds continue to perform according to their contractual terms. The Corporation does not intend to sell these investments and it is not more likely than not that the Corporation will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at March 31, 2014.

Collateralized Debt Obligations - The $15.1 million in unrealized losses greater than 12 months at March 31, 2014 relates to 14 pooled trust preferred securities that are included in the CDO portfolio. See Note 9 for a discussion of the methodology used by management to determine the fair values of these securities. Based upon a review of credit quality and the cash flow tests performed by the independent third party, management determined that there were no securities that had credit-related non-cash OTTI charges during the first three months of 2014. The unrealized losses on the remaining securities in the portfolio are primarily attributable to continued depression in market interest rates, marketability, liquidity and the current economic environment.

The following table presents a cumulative roll-forward of the amount of non-cash OTTI charges related to credit losses which have been recognized in earnings for the trust preferred securities in the CDO portfolio held and not intended to be sold for the three months ended March 31, 2014 and 2013:

	Three Months Ended March 31,	
(in thousands)	2014	2013
Balance of credit-related OTTI at January 1	$ 13,422	$ 13,959
Reduction for increases in cash flows expected to be collected	(160)	(125)
Balance of credit-related OTTI at March 31	$ 13,262	$ 13,834

The amortized cost and estimated fair value of securities by contractual maturity at March 31, 2014 are shown in the following table. Actual maturities may differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

	March 31, 2014	
(in thousands)	Amortized Cost	Fair Value
Contractual Maturity		
Available for sale:		
Due in one year or less	$23,500	$23,500
Due after one year through five years	30,407	30,188
Due after five years through ten years	67,845	67,107
Due after ten years	79,387	62,880
	201,139	183,675
Residential mortgage-backed agencies	113,815	110,452
Commercial mortgage-backed agencies	39,296	38,338
Collateralized mortgage obligations	29,498	29,000
	$383,748	$361,465
Held to Maturity:		
Due after ten years	$2,860	$2,444

Note 6 - Restricted Investment in Bank Stock

Restricted stock, which represents required investments in the common stock of the FHLB of Atlanta, Atlantic Community Bankers Bank ("ACBB") and CBB, is carried at cost and is considered a long-term investment.

Management evaluates the restricted stock for impairment in accordance with ASC Industry Topic 942, *Financial Services – Depository and Lending*, (ASC Section 942-325-35). Management's evaluation of potential impairment is based on management's assessment of the ultimate recoverability of the cost of the restricted stock rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability is influenced by criteria such as (a) the significance of the decline in net assets of the issuing bank as compared to the capital stock amount for that bank and the length of time this situation has persisted, (b) commitments by the issuing bank to make payments required by law or regulation and the level of such payments in relation to the operating performance of that bank, and (c) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the issuing bank. Management has evaluated the restricted stock for impairment and believes that no impairment charge is necessary as of March 31, 2014.

The Corporation recognizes dividends received on its restricted stock investments on a cash basis. For the three months ended March 31, 2014, dividends of $72,998 were recognized in earnings. For the comparable period of 2013, dividends of $50,517 were recognized in earnings.

Note 7 – Loans and Related Allowance for Loan Losses

The following table summarizes the primary segments of the loan portfolio as of March 31, 2014 and December 31, 2013:

(in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Consumer	Total
March 31, 2014						
Total loans	$ 259,837	$ 101,985	$ 78,724	$ 349,698	$ 23,793	$ 814,037
Individually evaluated for impairment	$ 11,616	$ 10,379	$ 2,152	$ 7,578	$ 0	$ 31,725
Collectively evaluated for impairment	$ 248,221	$ 91,606	$ 76,572	$ 342,120	$ 23,793	$ 782,312
December 31, 2013						

Total loans	$ 267,978	$ 107,250	$ 59,788	$ 350,906	$ 24,318	$ 810,240
Individually evaluated for impairment	$ 11,740	$ 11,703	$ 2,299	$ 7,546	$ 21	$ 33,309
Collectively evaluated for impairment	$ 256,238	$ 95,547	$ 57,489	$ 343,360	$ 24,297	$ 776,931

The segments of the Bank's loan portfolio are disaggregated to a level that allows management to monitor risk and performance. The commercial real estate ("CRE") loan segment is then segregated into two classes. Non-owner occupied CRE loans, which include loans secured by non-owner occupied, nonfarm, and nonresidential properties, generally have a greater risk profile than all other CRE loans, which include loans secured by farmland, multifamily structures and owner-occupied commercial structures. The acquisition and development ("A&D") loan segment is segregated into two classes. One-to-four family residential construction loans are generally made to individuals for the acquisition of and/or construction on a lot or lots on which a residential dwelling is to be built. All other A&D loans are generally made to developers or investors for the purpose of acquiring, developing and constructing residential or commercial structures. A&D loans have a higher risk profile because the ultimate buyer, once development is completed, is generally not known at the time of the loan is made. The commercial and industrial ("C&I") loan segment consists of loans made for the purpose of financing the activities of commercial customers. The residential mortgage loan segment is segregated into two classes. Amortizing term loans are primarily first lien loans. Home equity lines of credit are generally second lien loans. The consumer loan segment consists primarily of installment loans (direct and indirect) and overdraft lines of credit connected with customer deposit accounts.

Management uses a 10-point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first six categories are considered not criticized, and are aggregated as “Pass” rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The Special Mention category includes assets that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk, but not to the point of justifying a Substandard classification. Loans in the Substandard category have well-defined weaknesses that jeopardize the liquidation of the debt, and have a distinct possibility that some loss will be sustained if the weaknesses are not corrected. All loans greater than 90 days past due are considered Substandard. The portion of a specific allocation of the allowance for loan losses that management believes is associated with a pending event that could trigger loss in the short-term will be classified in the Doubtful category. Any portion of a loan that has been charged off is placed in the Loss category.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Bank has a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as bankruptcy, repossession, or death occurs to raise awareness of a possible credit event. The Bank’s Commercial Loan Officers are responsible for the timely and accurate risk rating of the loans in the commercial segments at origination and on an ongoing basis. The Bank’s experienced Credit Quality and Loan Review Department performs an annual review of all commercial relationships of $500,000 or greater. Confirmation of the appropriate risk grade is included as part of the review process on an ongoing basis. The Credit Quality and Loan Review Department continually reviews and assesses loans within the portfolio. In addition, the Bank engages an external consultant to conduct loan reviews on at least an annual basis. Generally, the external consultant reviews commercial relationships greater than $750,000 and/or criticized relationships greater than $500,000. Detailed reviews, including plans for resolution, are performed on loans classified as Substandard on a quarterly basis. Loans in the Special Mention and Substandard categories that are collectively evaluated for impairment are given separate consideration in the determination of the allowance.

The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention and Substandard within the internal risk rating system as of March 31, 2014 and December 31, 2013:

(in thousands)	Pass	Special Mention	Substandard	Total
March 31, 2014				
Commercial real estate				
Non owner-occupied	$103,862	$9,171	$ 25,782	$138,815
All other CRE	90,646	8,392	21,984	121,022
Acquisition and development				
1-4 family residential construction	10,095	0	2,070	12,165
All other A&D	70,008	1,744	18,068	89,820
Commercial and industrial	74,879	418	3,427	78,724
Residential mortgage				
Residential mortgage - term	262,992	839	11,104	274,935

Residential mortgage - home equity	72,387	469	1,907	74,763
Consumer	23,677	0	116	23,793
Total	$708,546	$21,033	$ 84,458	$814,037
December 31, 2013				
Commercial real estate				
Non owner-occupied	$103,556	$9,243	$ 24,745	$137,544
All other CRE	100,461	8,479	21,494	130,434
Acquisition and development				
1-4 family residential construction	8,764	0	4,497	13,261
All other A&D	73,198	1,787	19,004	93,989
Commercial and industrial	55,768	140	3,880	59,788
Residential mortgage				
Residential mortgage - term	261,735	752	11,980	274,467
Residential mortgage - home equity	73,901	628	1,910	76,439
Consumer	24,143	5	170	24,318
Total	$701,526	$21,034	$ 87,680	$810,240

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. A loan is considered to be past due when a payment has not been received for 30 days past its contractual due date. For all loan segments, the accrual of interest is discontinued when principal or interest is delinquent for 90 days or more unless the loan is well-secured and in the process of collection. All non-accrual loans are considered to be impaired. Interest payments received on non-accrual loans are applied as a reduction of the loan principal balance. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. The Corporation's policy for recognizing interest income on impaired loans does not differ from its overall policy for interest recognition.

The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and non-accrual loans as of March 31, 2014 and December 31, 2013:

(in thousands)	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due and Accruing	Non-Accrual	Total Loans
March 31, 2014							
Commercial real estate							
Non owner-occupied	$137,655	$ 0	$ 263	$ 214	$ 477	$ 683	$ 138,815
All other CRE	114,118	54	204	0	258	6,646	121,022
Acquisition and development							
1-4 family residential construction	11,107	46	0	0	46	1,012	12,165
All other A&D	82,459	2,050	112	3	2,165	5,196	89,820
Commercial and industrial	78,323	327	0	33	360	41	78,724
Residential mortgage							
Residential mortgage - term	262,620	8,612	676	0	9,288	3,027	274,935
Residential mortgage - home equity	73,500	538	70	117	725	538	74,763
Consumer	23,360	357	68	8	433	0	23,793
Total	$783,142	$ 11,984	$ 1,393	$ 375	$ 13,752	$ 17,143	$ 814,037
December 31, 2013							
Commercial real estate							
Non owner-occupied	$136,462	$ 191	$ 145	$ 65	$ 401	$ 681	$ 137,544
All other CRE	121,985	1,490	207	0	1,697	6,752	130,434
Acquisition and development							
1-4 family residential construction	12,018	0	139	0	139	1,104	13,261
All other A&D	88,071	1,075	33	282	1,390	4,528	93,989
Commercial and industrial	59,320	87	57	133	277	191	59,788
Residential mortgage							
Residential mortgage - term	259,239	8,258	2,541	634	11,433	3,795	274,467
Residential mortgage - home equity	74,917	656	439	96	1,191	331	76,439

Consumer	23,802	350	128	24	502	14	24,318
Total	$775,814	$ 12,107	$ 3,689	$ 1,234	$ 17,030	$ 17,396	$ 810,240

Non-accrual loans which have been subject to a partial charge-off totaled $5.6 million as of March 31, 2014, compared to $1.9 million as of December 31, 2013.

An allowance for loan losses (“ALL”) is maintained to absorb losses from the loan portfolio. The ALL is based on management’s continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated loss experience, and the amount of non-performing loans.

The Bank's methodology for determining the ALL is based on the requirements of ASC Section 310-10-35, *Receivables-Overall-Subsequent Measurement*, for loans individually evaluated for impairment and ASC Subtopic 450-20, *Contingencies-Loss Contingencies*, for loans collectively evaluated for impairment, as well as the Interagency Policy Statement on the Allowance for Loan and Lease Losses and other bank regulatory guidance. The total of the two components represents the Bank's ALL.

The following table summarizes the primary segments of the ALL, segregated by the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment as of March 31, 2014 and December 31, 2013.

(in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Consumer	Total
March 31, 2014						
Total ALL	$ 3,399	$ 3,896	$ 1,070	$ 3,962	$ 245	$12,572
Individually evaluated for impairment	$ 226	$ 1,816	$ 0	$ 0	$ 0	$2,042
Collectively evaluated for impairment	$ 3,173	$ 2,080	$ 1,070	$ 3,962	$ 245	$10,530
December 31, 2013						
Total ALL	$ 4,052	$ 4,172	$ 766	$ 4,320	$ 284	$13,594
Individually evaluated for impairment	$ 236	$ 1,967	$ 0	$ 80	$ 0	$2,283
Collectively evaluated for impairment	$ 3,816	$ 2,205	$ 766	$ 4,240	$ 284	$11,311

Management evaluates individual loans in all of the commercial segments for possible impairment if the loan (a) is greater than $500,000 or (b) is part of a relationship that is greater than $750,000 and is either (i) in nonaccrual status or (ii) risk-rated Substandard and greater than 60 days past due. Loans are considered to be 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. Factors considered by management in evaluating impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. The Bank does not separately evaluate individual consumer and residential mortgage loans for impairment, unless such loans are part of a larger relationship that is impaired; otherwise loans in these segments are considered impaired when they are classified as non-accrual.

Once the determination has been made that a loan is impaired, the determination of whether a specific allocation of the allowance is necessary is measured by comparing the recorded investment in the loan to the fair value of the loan using one of three methods: (a) the present value of expected future cash flows discounted at the loan's effective interest rate; (b) the loan's observable market price; or (c) the fair value of the collateral less selling costs. The method is selected on a loan-by-loan basis, with management primarily utilizing the fair value of collateral method. If the fair value of the collateral less selling costs method is utilized for collateral securing loans in the commercial segments, then an updated external appraisal is ordered on the collateral supporting the loan if the loan balance is greater than $500,000 and the existing appraisal is greater than 18 months old. If an appraisal is less than 12 months old (the age at which the internal appraisal grid begins) and if management believes that general market conditions in that geographic market have changed considerably, the property has deteriorated or perhaps lost an income stream, or a recent appraisal for a similar property indicates a significant change, then management may adjust the fair value indicated by the existing appraisal until a new appraisal is obtained. If the most recent appraisal is greater than 12 months old or if an updated appraisal has not been received and reviewed in time for the determination of estimated fair value at quarter (or year) end, then the estimated fair value of the collateral is determined by adjusting the existing appraisal by the appropriate percentage from an internally prepared appraisal discount grid. This grid considers the age of a third party appraisal and the geographic region where the collateral is located in order to discount an appraisal that is greater than 12 months old. The discount rates in the appraisal discount grid are updated quarterly to reflect the most current knowledge that management has available, including the results of current appraisals. If there is a delay in receiving an updated appraisal or if the appraisal is found to be deficient in our internal appraisal review process and re-ordered, then the Bank continues to use a discount factor from the appraisal discount grid based on the collateral location and current appraisal age in order to determine the estimated fair value. A specific allocation of the ALL is recorded if there is any deficiency in collateral value determined by comparing the estimated fair value to the recorded investment of the loan. When updated appraisals are received and reviewed, adjustments are made to the specific allocation as needed.

The evaluation of the need and amount of a specific allocation of the ALL and whether a loan can be removed from impairment status is made on a quarterly basis.

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of March 31, 2014 and December 31, 2013:

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance	Total Impaired Loans	
(in thousands)	Recorded Investment	Related Allowances	Recorded Investment	Recorded Investment	Unpaid Principal Balance
March 31, 2014					
Commercial real estate					
Non owner-occupied	$ 277	$ 79	$ 922	$ 1,199	$ 1,209
All other CRE	1,071	147	9,346	10,417	10,545
Acquisition and development					
1-4 family residential construction	1,053	308	1,018	2,071	2,319
All other A&D	4,601	1,508	3,707	8,308	13,309
Commercial and industrial	0	0	2,152	2,152	2,152
Residential mortgage					
Residential mortgage - term	280	0	6,511	6,791	7,305
Residential mortgage – home equity	0	0	787	787	787
Consumer	0	0	0	0	0
Total impaired loans	$ 7,282	$ 2,042	$ 24,443	$ 31,725	$ 37,626
December 31, 2013					
Commercial real estate					
Non owner-occupied	$ 257	$ 59	$ 922	$ 1,179	$ 1,191
All other CRE	1,080	177	9,481	10,561	10,689
Acquisition and development					
1-4 family residential construction	2,651	634	7	2,658	2,704
All other A&D	4,037	1,333	5,008	9,045	13,394
Commercial and industrial	0	0	2,299	2,299	2,299
Residential mortgage					
Residential mortgage - term	988	80	5,979	6,967	7,372
Residential mortgage – home equity	0	0	579	579	579
Consumer	0	0	21	21	21
Total impaired loans	$ 9,013	$ 2,283	$ 24,296	$ 33,309	$ 38,249

Loans that are collectively evaluated for impairment are analyzed with general allowances being made as appropriate. For general allowances, historical loss trends are used in the estimation of losses in the current portfolio. These historical loss amounts are modified by other qualitative factors.

The classes described above, which are based on the Federal call code assigned to each loan, provide the starting point for the ALL analysis. Management tracks the historical net charge-off activity (full and partial charge-offs, net of full and partial recoveries) at the call code level. A historical charge-off factor is calculated utilizing a defined number of consecutive historical quarters. Consumer pools currently utilize a rolling 12 quarters, while Commercial pools currently utilize a rolling eight quarters.

“Pass” rated credits are segregated from “Criticized” credits for the application of qualitative factors. “Pass” pools for commercial and residential real estate are further segmented based upon the geographic location of the underlying collateral. There are seven geographic regions utilized – six that represent the Bank’s lending footprint and a seventh for all out-of-market credits. Different economic environments and resultant credit risks exist in each region that are acknowledged in the assignment of qualitative factors. Loans in the criticized pools, which possess certain qualities or characteristics that may lead to collection and loss issues, are closely monitored by management and subject to additional qualitative factors.

Management supplements the historical charge-off factor with a number of additional qualitative factors that are likely to cause estimated credit losses associated with the existing loan pools to differ from historical loss experience. The additional factors, which are evaluated quarterly and updated using information obtained from internal, regulatory, and governmental sources, are: (a) national and local economic trends and conditions; (b) levels of and trends in delinquency rates and non-accrual loans; (c) trends in volumes and terms of loans; (d) effects of changes in lending policies; (e) experience, ability, and depth of lending staff; (f) value of underlying collateral; and (g) concentrations of credit from a loan type, industry and/or geographic standpoint.

Management reviews the loan portfolio on a quarterly basis using a defined, consistently applied process in order to make appropriate and timely adjustments to the ALL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALL. Residential mortgage and consumer loans are charged off after they are 120 days contractually past due. All other loans are charged off based on an evaluation of the facts and circumstances of each individual loan. When the Bank believes that its ability to collect is solely dependent on the liquidation of the collateral, a full or partial charge-off is recorded promptly to bring the recorded investment to an amount that the Bank believes is supported by an ability to collect on the collateral. The circumstances that may impact the Bank’s decision to charge-off all or a portion of a loan include default or non-payment by the borrower, scheduled foreclosure actions, and/or prioritization of the Bank’s claim in bankruptcy. There may be circumstances where, due to pending events, the Bank will place a specific allocation of the ALL on a loan for which a partial charge-off has been previously recognized. This specific allocation may be either charged off or removed depending upon the outcome of the pending event. Full or partial charge-offs are not recovered until full principal and interest on the loan have been collected, even if a subsequent appraisal supports a higher value. Loans with partial charge-offs remain in non-accrual status. Both full and partial charge-offs reduce the recorded investment of the loan and the ALL and are considered to be charge-offs for purposes of all credit loss metrics and trends, including the historical rolling charge-off rates used in the determination of the ALL.

Activity in the ALL is presented for the three months ended March 31, 2014 and March 31, 2013:

(in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Consumer	Total
ALL balance at January 1, 2014	$ 4,052	$ 4,172	$ 766	$ 4,320	$ 284	$13,594
Charge-offs	(21)	(819)	(152)	(468)	(179)	(1,639)

Recoveries	10	12	3	49	179	253
Provision	(642)	531	453	61	(39)	364
ALL balance at March 31, 2014	$ 3,399	$ 3,896	$ 1,070	$ 3,962	$ 245	$12,572
ALL balance at January 1, 2013	$ 5,206	$ 5,029	$ 906	$ 4,507	$ 399	$16,047
Charge-offs	0	(4)	(876)	(155)	(143)	(1,178)
Recoveries	100	8	49	31	103	291
Provision	483	(273)	566	100	(11)	865
ALL balance at March 31, 2013	$ 5,789	$ 4,760	$ 645	$ 4,483	$ 348	$16,025

The ALL is based on estimates, and actual losses may vary from current estimates. Management believes that the granularity of the homogeneous pools and the related historical loss ratios and other qualitative factors, as well as the consistency in the application of assumptions, result in an ALL that is representative of the risk found in the components of the portfolio at any given date.

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The following tables present the average recorded investment in impaired loans by class and related interest income recognized for the periods indicated:

(in thousands)	Three months ended March 31, 2014 Average investment	Interest income recognized on an accrual basis	Interest income recognized on a cash basis	Three months ended March 31, 2013 Average investment	Interest income recognized on an accrual basis	Interest income recognized on a cash basis
Commercial real estate						
Non owner-occupied	$1,189	$ 7	$ 0	$5,274	$ 12	$ 0
All other CRE	10,489	41	1	10,692	89	46
Acquisition and development						
1-4 family residential construction	2,365	14	0	2,828	24	0
All other A&D	8,677	61	0	21,350	142	0
Commercial and industrial	2,226	26	2	3,432	35	0
Residential mortgage						
Residential mortgage - term	6,879	54	9	3,947	19	2
Residential mortgage – home equity	683	3	1	573	6	0
Consumer	11	0	0	76	0	0
Total	$32,519	$ 206	$ 13	$48,172	$ 327	$ 48

In the normal course of business, the Bank modifies loan terms for various reasons. These reasons may include as a retention strategy, remaining competitive in the current interest rate environment, and re-amortizing or extending a loan term to better match the loan's payment stream with the borrower's cash flows. A modified loan is considered to be a troubled debt restructuring ("TDR") when the Bank has determined that the borrower is troubled (i.e., experiencing financial difficulties). The Bank evaluates the probability that the borrower will be in payment default on any of its debt obligations in the foreseeable future without modification. To make this determination, the Bank performs a global financial review of the borrower and loan guarantors to assess their current ability to meet their financial obligations.

When the Bank restructures a loan to a troubled borrower, the loan terms (i.e., interest rate, payment amount, amortization period, and/or maturity date) are modified in such a way as to enable the borrower to cover the modified debt service payments based on current financials and cash flow adequacy. If a borrower's hardship is thought to be temporary, then modified terms are only offered for that time period. Where possible, the Bank obtains additional collateral and/or secondary payment sources at the time of the restructure in order to put the Bank in the best possible position if the borrower is not able to meet the modified terms. To date, the Bank has not forgiven any principal as a restructuring concession. The Bank will not offer modified terms if it believes that modifying the loan terms will only delay an inevitable permanent default.

All loans designated as TDRs are considered impaired loans and may be in either accruing or non-accruing status. The Corporation's policy for recognizing interest income on impaired loans does not differ from its overall policy for interest recognition. Accordingly, the accrual of interest is discontinued when principal or interest is delinquent for 90 days or more unless the loan is well-secured and in the process of collection. If the loan was accruing at the time of the modification, then it continues to be in accruing status subsequent to the modification. Non-accrual TDRs may return to accruing status when there has been sufficient payment performance for a period of at least six months. Loans may be removed from TDR status in the calendar year following the modification if the interest rate at the time of modification was consistent with the interest rate for a loan with comparable credit risk and the loan has performed according to its modified terms for at least six months.

The volume and type of TDR activity is considered in the assessment of the local economic trends' qualitative factor used in the determination of the ALL for loans that are evaluated collectively for impairment.

There were 32 loans totaling $17.3 million and 31 loans totaling $17.9 million that were classified as TDRs at March 31, 2014 and December 31, 2013, respectively. The following tables present the volume and recorded investment at the time of modification of TDRs by class and type of modification that occurred during the periods indicated:

(in thousands)	Temporary Rate Modification		Extension of Maturity		Modification of Payment and Other Terms	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Three months ended March 31, 2014						
Commercial real estate						
Non owner-occupied	0	$ 0	2	$ 277	0	$ 0
All other CRE	0	0	0	0	1	454
Acquisition and development						
1-4 family residential construction	0	0	0	0	0	0
All other A&D	0	0	0	0	0	0
Commercial and industrial	0	0	0	0	0	0
Residential mortgage						
Residential mortgage – term	1	90	0	0	0	0
Residential mortgage – home equity	0	0	0	0	0	0
Consumer	0	0	0	0	0	0
Total	1	$ 90	2	$ 277	1	$ 454

(in thousands)	Temporary Rate Modification		Extension of Maturity		Modification of Payment and Other Terms	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Three months ended March 31, 2013						
Commercial real estate						
Non owner-occupied	0	$ 0	2	$ 268	0	$ 0
All other CRE	0	0	0	0	0	0
Acquisition and development						
1-4 family residential construction	0	0	0	0	0	0
All other A&D	0	0	2	252	0	0
Commercial and industrial	0	0	0	0	0	0
Residential mortgage						
Residential mortgage – term	1	172	0	0	0	0
Residential mortgage – home equity	0	0	0	0	0	0
Consumer	0	0	0	0	0	0
Total	1	$ 172	4	$ 520	0	$ 0

During the three months ended March 31, 2014, there were two new TDRs. In addition, two existing TDRs which had reached their previous modification maturity were re-modified. A $1,055 reduction of the ALL resulted from the movement of one loan being evaluated collectively for impairment to being evaluated individually for impairment.

The remaining new TDR was impaired at the time of modification, resulting in no impact to the ALL as a result of the modification. There was no impact to the recorded investment relating to the transfer of these loans.

During the three months ended March 31, 2014, one A&D loan totaling $1.4 million that was modified as a TDR within the previous 12 months was transferred to non-accrual, and is considered a payment default.

During the three months ended March 31, 2013, there were three new TDRs. In addition, two existing TDRs which had reached their original modification maturity were re-modified. An $11,266 reduction of the ALL resulted from the movement of the three new loans being evaluated collectively for impairment to being evaluated individually for impairment. There was no impact to the recorded investment relating to the transfer of these loans. During the quarter ended March 31, 2013, there were no receivables modified as TDRs within the previous 12 months for which there was a payment default during the periods indicated

Note 8 – Other Real Estate Owned

Other Real Estate Owned

The following table presents the components of OREO as of March 31, 2014 and December 31, 2013:

(in thousands)	March 31, 2014	December 31, 2013
Commercial real estate	$ 4,960	$ 5,306
Acquisition and development	9,008	10,509
Residential mortgage	1,645	1,216
Total OREO	$ 15,613	$ 17,031

The following table presents the activity in the OREO valuation allowance for the three months ended March 31, 2014 and 2013:

	For the three months ended March 31,	
(in thousands)	2014	2013
Balance January 1	$ 4,047	$ 2,766
Fair value write-down	371	20
Sales of OREO	(748)	(607)
Balance at end of period	$ 3,670	$ 2,179

The following table presents the components of OREO expenses, net for the three months ended March 31, 2014 and 2013:

	For the three months ended March 31,	
(in thousands)	2014	2013
Gains on real estate, net	$ (25)	$ (7)
Fair value write-down	371	20
Expenses, net	188	117
Rental and other income	(77)	(112)
Total OREO expense, net	$ 457	$ 18

Note 9 – Fair Value of Financial Instruments

The Corporation complies with the guidance of ASC Topic 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements required under other accounting pronouncements. The Corporation also follows the guidance on matters relating to all financial instruments found in ASC Subtopic 825-10, *Financial Instruments – Overall*.

Fair value is defined as the price to sell an asset or to transfer a liability in an orderly transaction between willing market participants as of the measurement date. Fair value is best determined by values quoted through active trading markets. Active trading markets are characterized by numerous transactions of similar financial instruments between willing buyers and willing sellers. Because no active trading market exists for various types of financial instruments, many of the fair values disclosed were derived using present value discounted cash flows or other valuation techniques described below. As a result, the Corporation's ability to actually realize these derived values cannot be assumed.

The Corporation measures fair values based on the fair value hierarchy established in ASC Paragraph 820-10-35-37. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of inputs that may be used to measure fair value under the hierarchy are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets and liabilities. This level is the most reliable source of valuation.

Level 2: Quoted prices that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability. Level 2 inputs include inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates). It also includes inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs). Several sources are utilized for valuing these assets, including a contracted valuation service, Standard & Poor's ("S&P") evaluations and pricing services, and other valuation matrices.

Level 3: Prices or valuation techniques that require inputs that are both significant to the valuation assumptions and not readily observable in the market (i.e. supported with little or no market activity). Level 3 instruments are valued based on the best available data, some of which is internally developed, and consider risk premiums that a market participant would require.

The level established within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The Corporation believes that its valuation techniques are appropriate and consistent with the techniques used by other market participants. However, the use of different methodologies and assumptions could result in a different estimate of fair values at the reporting date. The valuation techniques used by the Corporation to measure, on a recurring and non-recurring basis, the fair value of assets as of March 31, 2014 are discussed in the paragraphs that follow.

Investments – The investment portfolio is classified and accounted for based on the guidance of ASC Topic 320, *Investments – Debt and Equity Securities*.

The fair value of investments available-for-sale is determined using a market approach. As of March 31, 2014, the U.S. Government agencies, residential and commercial mortgage-backed securities, and municipal bonds segments are classified as Level 2 within the valuation hierarchy. Their fair values were determined based upon market-corroborated inputs and valuation matrices, which were obtained through third party data service providers or securities brokers through which the Corporation has historically transacted both purchases and sales of investment securities.

The CDO segment, which consists of pooled trust preferred securities issued by banks, thrifts and insurance companies, is classified as Level 3 within the valuation hierarchy. At March 31, 2014, the Corporation owned 18 pooled trust preferred securities with an amortized cost of $37.2 million and a fair value of $23.1 million. The market for these securities at March 31, 2014 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which these securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive, as few CDOs have been issued since 2007. There are currently very few market participants who are willing to effect transactions in these securities. The market values for these securities or any securities other than those issued or guaranteed by the U.S. Department of the Treasury (the "Treasury") are depressed relative to historical levels. Therefore, in the current market, a low market price for a particular bond may only provide evidence of stress in the credit markets in general rather than being an indicator of credit problems with a particular issue. Given the conditions in the current debt markets and the absence of observable transactions in the secondary and new issue markets, management has determined that (a) the few observable transactions and market quotations that are available are not reliable for the purpose of obtaining fair value at March 31, 2014, (b) an income valuation approach technique (i.e. present value) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than a market approach, and (c) the CDO segment is appropriately classified within Level 3 of the valuation hierarchy because management determined that significant adjustments were required to determine fair value at the measurement date.

Management utilizes an independent third party to prepare both the evaluations of OTTI as well as the fair value determinations for its CDO portfolio. Management does not believe that there were any material differences in the OTTI evaluations and pricing between March 31, 2014 and December 31, 2013.

The approach used by the third party to determine fair value involves several steps, including detailed credit and structural evaluation of each piece of collateral in each bond, default, recovery and prepayment/amortization probabilities for each piece of collateral in the bond, and discounted cash flow modeling. The discount rate methodology used by the third party combines a baseline current market yield for comparable corporate and structured credit products with adjustments based on evaluations of the differences found in structure and risks associated with actual and projected credit performance of each CDO being valued. Currently, the only active and liquid trading market that exists is for stand-alone trust preferred securities. Therefore, adjustments to the baseline discount rate are also made to reflect the additional leverage found in structured instruments.

Derivative financial instruments (Cash flow hedge) – The Corporation's open derivative positions are interest rate swaps that are classified as Level 3 within the valuation hierarchy. Open derivative positions are valued using externally developed pricing models based on observable market inputs provided by a third party and validated by management. The Corporation has considered counterparty credit risk in the valuation of its interest rate swap assets.

Impaired loans – Loans included in the table below are those that are considered impaired with a specific allocation or with a partial charge-off, based upon the guidance of the loan impairment subsection of the *Receivables* Topic, ASC Section 310-10-35, under which the Corporation has measured impairment generally based on the fair value of the loan's collateral. Fair value consists of the loan balance less its valuation allowance and is generally determined based on independent third-party appraisals of the collateral or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values based upon the lowest level of input that is significant to the fair value measurements.

Other real estate owned – Other real estate owned included in the table below are considered impaired with specific write-downs. Fair value of other real estate owned is based on independent third-party appraisals of the properties. These values were determined based on the sales prices of similar properties in the approximate geographic area. These assets are included as Level 3 fair values based upon the lowest level of input that is significant to the fair value measurements.

For Level 3 assets and liabilities measured at fair value on a recurring and non-recurring basis as of March 31, 2014, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value at March 31, 2014	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Value
Recurring:				
Investment Securities – available for sale	$ 23,093	Discounted Cash Flow	Discount Rate	Swap+17%; Range of Libor+ 6.00% to 18%
Cash Flow Hedge	$ (365)	Discounted Cash Flow	Reuters Third Party Market Quote	99.9% (weighted avg 99.9%)
Non-recurring:				
Impaired Loans	$ 10,819	Market Comparable Properties	Marketability Discount	10% (1) (weighted avg 10%)
OREO	$ 960	Market Comparable Properties	Marketability Discount	10% (1) (weighted avg 10%)

NOTE:

(1) Range would include discounts taken since appraisal and estimated values

For assets measured at fair value on a recurring and non-recurring basis, the fair value measurements by level within the fair value hierarchy used at March 31, 2014 and December 31, 2013 are as follows:

		Fair Value Measurements at March 31, 2014 Using		
	Assets Measured at Fair Value	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
(in thousands)	03/31/2014	(Level 1)	(Level 2)	(Level 3)
Recurring:				
Investment securities available-for-sale:				
U.S. Treasuries	$ 23,500		$ 23,500	
U.S. government agencies	$ 85,965		$ 85,965	

Residential mortgage-backed agencies	$ 110,452	$ 110,452	
Commercial mortgage-backed agencies	$ 38,338	$ 38,338	
Collateralized mortgage obligations	$ 29,000	$ 29,000	
Obligations of states and political subdivisions	$ 51,117	$ 51,117	
Collateralized debt obligations	$ 23,093		$ 23,093
Financial Derivative	$ (365)		$ (365)
Non-recurring:			
Impaired loans	$ 10,819		$ 10,819
Other real estate owned	$ 960		$ 960

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		Fair Value Measurements at December 31, 2013 Using		
	Assets Measured at Fair Value	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
(in thousands)	12/31/2013	(Level 1)	(Level 2)	(Level 3)
Recurring:				
Investment securities available-for-sale:				
U.S. government agencies	$ 92,035		$ 92,035	
Residential mortgage-backed agencies	$ 112,444		$ 112,444	
Commercial mortgage-backed agencies	$ 29,905		$ 29,905	
Collateralized mortgage obligations	$ 29,390		$ 29,390	
Obligations of states and political subdivisions	$ 55,277		$ 55,277	
Collateralized debt obligations	$ 17,538			$ 17,538
Financial Derivative	$ (457)			$ (457)
Non-recurring:				
Impaired loans	$ 8,613			$ 8,613
Other real estate owned	$ 5,591			$ 5,591

There were no transfers of assets between any of the fair value hierarchy for the three-month periods ended March 31, 2014 and March 31, 2013.

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The following tables show a reconciliation of the beginning and ending balances for fair valued assets measured on a recurring basis using Level 3 significant unobservable inputs for the three months ended March 31, 2014 and 2013:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
(In thousands)	Investment Securities Available for Sale	Cash Flow Hedge
Beginning balance January 1, 2014	$ 17,538	$ (457)
Total gains realized/unrealized:		
Included in other comprehensive income	5,555	92
Ending balance March 31, 2014	$ 23,093	$ (365)
The amount of total gains or losses for the period included in earnings attributable to the change in realized/unrealized gains or losses related to assets still held at the reporting date	$ 0	$ 0

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
(in thousands)	Investment Securities Available for Sale	Cash Flow Hedge
Beginning balance January 1, 2013	$ 11,442	$ (849)
Total gains realized/unrealized:		
Included in other comprehensive income	2,356	101
Ending balance March 31, 2013	$ 13,798	$ (748)
The amount of total gains or losses for the period included in earnings attributable to the change in realized/unrealized gains or losses related to assets still held at the reporting date	$ 0	$ 0

Gains and losses (realized and unrealized) included in earnings for the periods identified above are reported in the Consolidated Statement of Operations in Other Operating Income.

The disclosed fair values may vary significantly between institutions based on the estimates and assumptions used in the various valuation methodologies. The derived fair values are subjective in nature and involve uncertainties and significant judgment. Therefore, they cannot be determined with precision. Changes in the assumptions could significantly impact the derived estimates of fair value. Disclosure of non-financial assets such as buildings as well as certain financial instruments such as leases is not required. Accordingly, the aggregate fair values presented do not represent the underlying value of the Corporation.

The following methods and assumptions were used by the Corporation to estimate its fair value disclosures for financial instruments: