

FIRST UNITED CORP/MD/  
Form 10-K  
March 08, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

**FORM 10-K**

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

**For the fiscal year ended December 31, 2016**

Commission file number 0-14237

**FIRST UNITED CORPORATION**

*(Exact name of registrant as specified in its charter)*

**Maryland**

*(State or other jurisdiction of incorporation or organization)*

**52-1380770**

*(I.R.S. Employer Identification Number)*

**19 South Second Street, Oakland, Maryland**

*(Address of principal executive offices)*

**21550-0009**

*(Zip Code)*

Registrant's telephone number, including area code: **(800) 470-4356**

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** **NASDAQ Global Select Market**

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

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

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 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  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  No

Indicate by check mark if disclosures of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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

The aggregate market value of the registrant's outstanding voting and non-voting common equity held by non-affiliates as of June 30, 2016: **\$56,944,759.**

The number of shares of the registrant's common stock outstanding as of February 27, 2017: **6,269,004**.

### **Documents Incorporated by Reference**

Portions of the registrant's definitive proxy statement for the 2017 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A are incorporated by reference into Part III of this Annual Report on Form 10-K.

**First United Corporation**

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## Forward-Looking Statements

This Annual Report on Form 10-K of First United Corporation (the “Corporation” and “we”, “our” or “us” on a consolidated basis) contains forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Such statements include projections, predictions, expectations or statements as to beliefs or future events or results or refer to other matters that are not historical facts. Forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause the actual results to differ materially from those contemplated by the statements. The forward-looking statements contained in this annual report are based on various factors and were derived using numerous assumptions. In some cases, you can identify these forward-looking statements by words like “may”, “will”, “should”, “expect”, “plan”, “anticipate”, “intend”, “believe”, “estimate”, “predict”, “continue” or the negative of those words and other comparable words. You should be aware that those statements reflect only our predictions. If known or unknown risks or uncertainties should materialize, or if underlying assumptions should prove inaccurate, actual results could differ materially from past results and those anticipated, estimated or projected. You should bear this in mind when reading this annual report and not place undue reliance on these forward-looking statements. Factors that might cause such differences include, but are not limited to:

- changes in market rates and prices may adversely impact the value of securities, loans, deposits and other financial instruments and the interest rate sensitivity of our balance sheet;

- our liquidity requirements could be adversely affected by changes in our assets and liabilities;

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

- competitive factors among financial services organizations, including product and pricing pressures and our ability to attract, develop and retain qualified banking professionals;

- the effect of changes in accounting policies and practices, as may be adopted by the Financial Accounting Standards Board (the “FASB”), the Securities and Exchange Commission (the “SEC”), and other regulatory agencies; and

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

You should also consider carefully the risk factors discussed in Item 1A of Part I of this annual report, which address additional factors that could cause our actual results to differ from those set forth in the forward-looking statements and could materially and adversely affect our business, operating results and financial condition. The risks discussed in this annual report are factors that, individually or in the aggregate, management believes could cause our actual results to differ materially from expected and historical results. You should understand that it is not possible to predict

or identify all such factors. Consequently, you should not consider such disclosures to be a complete discussion of all potential risks or uncertainties.

The forward-looking statements speak only as of the date on which they are made, and, except to the extent required by federal securities laws, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

## ITEM 1. BUSINESS

### General

First United Corporation is a Maryland corporation chartered in 1985 and a bank holding company registered with the Board of Governors of the Federal Reserve System (the “Federal Reserve”) under the Bank Holding Company Act of 1956, as amended (the “BHC Act”). The Corporation’s primary business is serving as the parent company of First United Bank & Trust, a Maryland trust company with commercial banking powers (the “Bank”), First United Statutory Trust I (“Trust I”) and First United Statutory Trust II (“Trust II”), both Connecticut statutory business trusts, and First United Statutory Trust III, a Delaware statutory business trust (“Trust III” and together with Trust I and Trust II, the “Trusts”). The Trusts were formed for the purpose of selling trust preferred securities that qualified as Tier 1 capital.

The Bank has four wholly-owned subsidiaries: OakFirst Loan Center, Inc., a West Virginia finance company; OakFirst Loan Center, LLC, a Maryland finance company (collectively, the “OakFirst Loan Centers”); First OREO Trust, a Maryland statutory trust; and FUBT OREO I, LLC, a Maryland limited liability company. The OakFirst Loan Centers are consumer financial companies, and First OREO Trust and FUBT OREO I, LLC were formed for the purpose of holding, servicing and disposing of the real estate that the Bank acquires through foreclosure or by deed in lieu of foreclosure. The Bank also owns 99.9% of the limited partnership interests in Liberty Mews Limited Partnership, a Maryland limited partnership formed for the purpose of acquiring, developing and operating low-income housing units in Garrett County, Maryland.

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At December 31, 2016, we had total assets of \$1.3 billion, net loans of \$882.0 million, and deposits of \$1.0 billion. Shareholders' equity at December 31, 2016 was \$113.7 million.

The Corporation maintains an Internet website at [www.mybank.com](http://www.mybank.com) on which it makes available, free of charge, its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC.

### **Banking Products and Services**

The Bank operates 23 banking offices, one call center and 25 Automated Teller Machines ("ATMs") in Allegany County, Frederick County, Garrett County, and Washington County in Maryland, and in Mineral County, Berkeley County and Monongalia County in West Virginia. The Bank is an independent community bank providing a complete range of retail and commercial banking services to businesses and individuals in its market areas. Services offered are essentially the same as those offered by the regional institutions that compete with the Bank and include checking, savings, money market deposit accounts, and certificates of deposit, business loans, personal loans, mortgage loans, lines of credit, and consumer-oriented retirement accounts including individual retirement accounts ("IRAs") and employee benefit accounts. In addition, the Bank provides full brokerage services through a networking arrangement with Cetera Investment Services, LLC., a full service broker-dealer. The Bank also provides safe deposit and night depository facilities, insurance products and trust services. The Bank's deposits are insured by the Federal Deposit Insurance Corporation (the "FDIC").

### ***Lending Activities***

Our lending activities are conducted through the Bank. Since 2010, the Bank has not originated any new loans through the OakFirst Loan Centers and their sole activity is servicing existing loans.

The Bank's commercial loans are primarily secured by real estate, commercial equipment, vehicles or other assets of the borrower. Repayment is often dependent on the successful business operations of the borrower and may be affected by adverse conditions in the local economy or real estate market. The financial condition and cash flow of commercial borrowers is therefore carefully analyzed during the loan approval process, and continues to be monitored throughout the duration of the loan by obtaining business financial statements, personal financial statements and income tax returns. The frequency of this ongoing analysis depends upon the size and complexity of the credit and collateral that secures the loan. It is also the Bank's general policy to obtain personal guarantees from the principals of the commercial loan borrowers.



Commercial real estate (“CRE”) loans are primarily those secured by land for residential and commercial development, agricultural purpose properties, service industry buildings such as restaurants and motels, retail buildings and general purpose business space. The Bank attempts to mitigate the risks associated with these loans through low loan to value ratio standards, thorough financial analyses, and management’s knowledge of the local economy in which the Bank lends.

The risk of loss associated with CRE construction lending is controlled through conservative underwriting procedures such as loan to value ratios of 80% or less, obtaining additional collateral when prudent, analysis of cash flows, and closely monitoring construction projects to control disbursement of funds on loans.

The Bank’s residential mortgage portfolio is distributed between variable and fixed rate loans. Some loans are booked at fixed rates in order to meet the Bank’s requirements under the federal Community Reinvestment Act (the “CRA”) or to complement our asset liability mix. Other fixed rate residential mortgage loans are originated in a brokering capacity on behalf of other financial institutions, for which the Bank receives a fee. As with any consumer loan, repayment is dependent on the borrower’s continuing financial stability, which can be adversely impacted by factors such as job loss, divorce, illness, or personal bankruptcy. Residential mortgage loans exceeding an internal loan-to-value ratio require private mortgage insurance. Title insurance protecting the Bank’s lien priority, as well as fire and casualty insurance, is also required.

Home equity lines of credit, included within the residential mortgage portfolio, are secured by the borrower’s home and can be drawn on at the discretion of the borrower. These lines of credit are at variable interest rates.

The Bank also provides residential real estate construction loans to builders and individuals for single family dwellings. Residential construction loans are usually granted based upon “as completed” appraisals and are secured by the property under construction. Site inspections are performed to determine pre-specified stages of completion before loan proceeds are disbursed. These loans typically have maturities of six to 12 months and may have a fixed or variable rate. Permanent financing for individuals offered by the Bank includes fixed and variable rate loans with three, five, seven or ten-year adjustable rate mortgages.

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A variety of other consumer loans are also offered to customers, including indirect and direct auto loans, and other secured and unsecured lines of credit and term loans. Careful analysis of an applicant's creditworthiness is performed before granting credit, and on-going monitoring of loans outstanding is performed in an effort to minimize risk of loss by identifying problem loans early.

An allowance for loan losses is maintained to provide for probable losses from our lending activities. A complete discussion of the factors considered in determination of the allowance for loan losses is included in Item 7 of Part II of this report.

### *Deposit Activities*

The Bank offers a full array of deposit products including checking, savings and money market accounts, regular and IRA certificates of deposit, Christmas Savings accounts, College Savings accounts, and Health Savings accounts. The Bank also offers the Certificate of Deposit Account Registry Service<sup>®</sup>, or CDARS<sup>®</sup>, program to municipalities, businesses, and consumers through which the Bank provides access to multi-million-dollar certificates of deposit and the Insured Cash Sweep<sup>®</sup>, or ICS<sup>®</sup>, program to municipalities, businesses, and consumers through which the Bank provides access to multi-million-dollar savings and demand deposits. Both programs are FDIC-insured. In addition, we offer our commercial customers packages which include Treasury Management, Cash Sweep and various checking opportunities.

Information about our income from and assets related to our banking business may be found in the Consolidated Statements of Financial Condition and the Consolidated Statements of Income and the related notes thereto included in Item 8 of Part II of this annual report.

### *Trust Services*

The Bank's Trust Department offers a full range of trust services, including personal trust, investment agency accounts, charitable trusts, retirement accounts including IRA roll-overs, 401(k) accounts and defined benefit plans, estate administration and estate planning.

At December 31, 2016 and 2015, the total market value of assets under the supervision of the Bank's Trust Department was approximately \$740 million and \$718 million, respectively. Trust Department revenues for these years may be found in the Consolidated Statements of Income under the heading "Other operating income", which is contained in

Item 8 of Part II of this annual report.

## **COMPETITION**

The banking business, in all of its phases, is highly competitive. Within our market areas, we compete with commercial banks, (including local banks and branches or affiliates of other larger banks), savings and loan associations and credit unions for loans and deposits, with consumer finance companies for loans, and with other financial institutions for various types of products and services, including trust services. There is also competition for commercial and retail banking business from banks and financial institutions located outside our market areas and on the internet.

The primary factors in competing for deposits are interest rates, personalized services, the quality and range of financial services, convenience of office locations and office hours. The primary factors in competing for loans are interest rates, loan origination fees, the quality and range of lending services and personalized services.

To compete with other financial services providers, we rely principally upon local promotional activities, personal relationships established by officers, directors and employees with customers, and specialized services tailored to meet customers' needs. In those instances in which we are unable to accommodate a customer's needs, we attempt to arrange for those services to be provided by other financial services providers with which we have a relationship.

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The following table sets forth deposit data for the Maryland and West Virginia Counties in which the Bank maintains offices as of June 30, 2016, the most recent date for which comparative information is available.

	Offices (in Market)	Deposits (in thousands)	Market Share	
Allegany County, Maryland:				
Branch Banking and Trust Company	7	\$ 321,828	45.39	%
Manufacturers & Traders Trust Company	6	165,452	23.34	%
First United Bank & Trust	3	126,366	17.82	%
Standard Bank, PaSB	2	51,564	7.27	%
PNC Bank NA	1	43,845	6.18	%

Source: FDIC Deposit Market Share Report

Frederick County, Maryland:				
PNC Bank NA	16	\$ 1,135,554	26.66	%
Branch Banking & Trust Co.	12	720,872	16.92	%
Bank Of America NA	5	455,453	10.69	%
Frederick County Bank	5	317,351	7.45	%
Manufacturers & Traders Trust Company	6	283,370	6.65	%
Capital One NA	5	270,577	6.35	%
Woodsboro Bank	7	206,421	4.85	%
Middletown Valley Bank	4	161,112	3.78	%
First United Bank & Trust	4	150,104	3.52	%
Sandy Spring Bank	4	135,057	3.17	%
Revere Bank	1	126,819	2.98	%
SunTrust Bank	2	125,900	2.96	%
Wells Fargo Bank NA	2	70,242	1.65	%
The Columbia Bank	2	38,686	0.91	%
SONABANK	1	32,609	0.77	%
Damascus Community Bank	1	28,691	0.67	%
Woodforest National Bank	1	810	0.02	%

Source: FDIC Deposit Market Share Report

Garrett County, Maryland:				
First United Bank & Trust	6	\$ <b>343,355</b>	58.96	%
Branch Banking and Trust Company	2	90,364	15.52	%
Manufacturers & Traders Trust Company	3	86,744	14.90	%
Clear Mountain Bank	1	45,791	7.86	%
Sumerset Trust Company	1	9,744	1.67	%
Miners & Merchants Bank	1	6,371	1.09	%

Source: FDIC Deposit Market Share Report

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Washington County, Maryland:

Branch Banking & Trust Company	12	\$ 684,688	31.56	%
The Columbia Bank	9	471,104	21.72	%
Manufacturers & Traders Trust Company	10	415,142	19.14	%
PNC Bank NA	4	204,516	9.43	%
First United Bank & Trust	3	81,109	3.74	%
Middletown Valley Bank	2	80,944	3.73	%
United Bank	2	77,983	3.59	%
CNB Bank, Inc.	3	56,420	2.60	%
Capital One NA	2	40,452	1.86	%
Orrstown Bank	1	28,881	1.33	%
Bank of Charles Town	1	19,602	0.90	%
Jefferson Security Bank	1	8,703	0.40	%

Source: FDIC Deposit Market Share Report

Berkeley County, West Virginia:

Branch Banking & Trust Company	5	\$ 362,666	28.77	%
MVB Bank Inc.	4	223,094	17.70	%
United Bank	4	212,442	16.85	%
City National Bank of West Virginia	4	139,905	11.10	%
First United Bank & Trust	4	123,267	9.78	%
Jefferson Security Bank	2	76,376	6.06	%
Bank of Charles Town	2	57,483	4.56	%
CNB Bank, Inc.	3	53,422	4.24	%
Summit Community Bank	1	10,497	0.83	%
Woodforest National Bank	1	1,438	0.11	%

Source: FDIC Deposit Market Share Report

Mineral County, West Virginia:

First United Bank & Trust	2	<b>\$ 94,100</b>	37.74	%
Branch Banking & Trust Company	2	71,948	28.85	%
Manufacturers & Traders Trust Company	2	48,239	19.35	%
Grant County Bank	1	28,572	11.46	%
FNB Bank, Inc.	1	6,482	2.60	%

Source: FDIC Deposit Market Share Report

Monongalia County, West Virginia:

United Bank	6	\$ 700,862	32.59	%
Huntington National Bank	6	386,508	17.97	%
Branch Banking & Trust Company	5	383,063	17.81	%
Clear Mountain Bank	6	204,193	9.50	%
Wesbanco Bank, Inc.	5	144,717	6.73	%
MVB Bank, Inc.	2	128,971	6.00	%
First United Bank & Trust	3	90,444	4.21	%
PNC Bank NA	3	62,473	2.91	%
First Exchange Bank	1	25,873	1.20	%
Citizens Bank of Morgantown, Inc.	1	23,259	1.08	%

Source: FDIC Deposit Market Share Report

[6]

For further information about competition in our market areas, see the Risk Factor entitled “**We operate in a competitive environment, and our inability to effectively compete could adversely and materially impact our financial condition and results of operations**” in Item 1A of Part I of this annual report.

## **SUPERVISION AND REGULATION**

The following is a summary of the material regulations and policies applicable to the Corporation and its subsidiaries and is not intended to be a comprehensive discussion. Changes in applicable laws and regulations may have a material effect on our business.

### **General**

The Corporation is registered with the Federal Reserve System as a bank holding company under the BHC Act and, as such, is subject to the supervision, examination and reporting requirements of the BHC Act and the regulations of the Federal Reserve. As a publicly-traded company whose common stock is registered under Section 12(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and listed on The NASDAQ Global Select Market, the Corporation is also subject to regulation and supervision by the SEC and The NASDAQ Stock Market, LLC (“NASDAQ”).

The Bank is a Maryland trust company subject to the banking laws of Maryland and to regulation by the Commissioner of Financial Regulation of Maryland (the “Maryland Commissioner”), who is required by statute to make at least one examination in each calendar year (or at 18-month intervals if the Maryland Commissioner determines that an examination is unnecessary in a particular calendar year). The Bank also has offices in West Virginia, and the operations of these offices are subject to West Virginia laws and to supervision and examination by the West Virginia Division of Banking. As a member of the FDIC, the Bank is also subject to certain provisions of federal laws and regulations regarding deposit insurance and activities of insured state-chartered banks, including those that require examination by the FDIC. In addition to the foregoing, there are a myriad of other federal and state laws and regulations that affect, or govern the business of banking, including consumer lending, deposit-taking, and trust operations.

All non-bank subsidiaries of the Corporation are subject to examination by the Federal Reserve, and, as affiliates of the Bank, are subject to examination by the FDIC and the Maryland Commissioner. In addition, OakFirst Loan Center, Inc. is subject to licensing and regulation by the West Virginia Division of Banking, and OakFirst Loan Center, LLC is subject to licensing and regulation by the Maryland Commissioner.

## Regulatory Reforms

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which was enacted in July 2010, significantly restructured the financial regulatory regime in the United States. Although the Dodd-Frank Act’s provisions that have received the most public attention generally have been those applying to or more likely to affect larger institutions such as banks and bank holding companies with total consolidated assets of \$50 billion or more, it contains numerous other provisions that affect all financial institutions, including the Bank. The Dodd-Frank Act established the Consumer Financial Protection Bureau (the “CFPB”), discussed below, and contains a wide variety of provisions (many of which are not yet effective) affecting the regulation of depository institutions, including fair lending, fair debt collection practices, mortgage loan origination and servicing obligations, bankruptcy, military service member protections, use of credit reports, privacy matters, and disclosure of credit terms and correction of billing errors. Local, state and national regulatory and enforcement agencies continue efforts to address perceived problems within the mortgage lending and credit card industries through broad or targeted legislative or regulatory initiatives aimed at lenders’ operations in consumer lending markets. There continues to be a significant amount of legislative and regulatory activity, nationally, locally and at the state level, designed to limit certain lending practices while mandating certain servicing procedures. Federal bankruptcy and state debtor relief and collection laws, as well as the Servicemembers Civil Relief Act affect the ability of banks, including the Bank, to collect outstanding balances.

Moreover, the Dodd-Frank Act permits states to adopt stricter consumer protection laws and states’ attorneys general may enforce consumer protection rules issued by the CFPB. Recently, U.S. financial regulatory agencies have increasingly used a general consumer protection statute to address unethical or otherwise bad business practices that may not necessarily fall directly under the purview of a specific banking or consumer finance law. Prior to the Dodd-Frank Act, there was little formal guidance to provide insight to the parameters for compliance with the “unfair or deceptive acts or practices” (“UDAP”) law. However, the UDAP provisions have been expanded under the Dodd-Frank Act to apply to “unfair, deceptive or abusive acts or practices”, which has been delegated to the CFPB for supervision.

Many of the Dodd-Frank Act’s provisions are subject to final rulemaking by the U.S. financial regulatory agencies, and the Dodd-Frank Act’s impact on our business will depend to a large extent on how and when such rules are adopted and implemented by the primary U.S. financial regulatory agencies. We continue to analyze the impact of rules adopted under the Dodd-Frank Act on our business, but the full impact will not be known until the rules and related regulatory initiatives are finalized and their combined impact can be understood. We do anticipate that the Dodd-Frank Act will increase our regulatory compliance burdens and costs and may restrict the financial products and services that we offer to our customers in the future. In particular, the Dodd-Frank Act will require us to invest significant management attention and resources so that we can evaluate the impact of and ensure compliance with this law and its rules.

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## **Regulation of Bank Holding Companies**

The Corporation and its affiliates are subject to the provisions of Section 23A and Section 23B of the Federal Reserve Act. Section 23A limits the amount of loans or extensions of credit to, and investments in, the Corporation and its non-bank affiliates by the Bank. Section 23B requires that transactions between the Bank and the Corporation and its non-bank affiliates be on terms and under circumstances that are substantially the same as with non-affiliates.

Under Federal Reserve policy, the Corporation is expected to act as a source of strength to the Bank, and the Federal Reserve may charge the Corporation with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank when required. This support may be required at times when the bank holding company may not have the resources to provide the support. Under the prompt corrective action provisions, if a controlled bank is undercapitalized, then the regulators could require the bank holding company to guarantee the bank's capital restoration plan. In addition, if the Federal Reserve believes that a bank holding company's activities, assets or affiliates represent a significant risk to the financial safety, soundness or stability of a controlled bank, then the Federal Reserve could require the bank holding company to terminate the activities, liquidate the assets or divest the affiliates. The regulators may require these and other actions in support of controlled banks even if such actions are not in the best interests of the bank holding company or its stockholders. Because the Corporation is a bank holding company, it is viewed as a source of financial and managerial strength for any controlled depository institutions, like the Bank.

On December 10, 2013, to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act"), the four federal banking regulatory agencies and the SEC adopted the Volcker Rule. The Volcker Rule prohibits a banking institution from acquiring or retaining an "ownership interest" in a "covered fund". A "covered fund" is (i) an entity that would be an investment company under the Investment Company Act of 1940, as amended, but for the exemptions contained in Section 3(c)(1) or Section 3(c)(7) of that Act, (ii) a commodity pool with certain characteristics, and/or (iii) a non-US entity with certain characteristics that is sponsored or owned by a banking entity located or organized in the US. The term "ownership interest" is defined as "any equity, partnership, or other similar interest."

On January 14, 2014, the federal banking agencies adopted a final interim rule that exempts collateral debt obligations ("CDOs") from the scope of the Volcker Rule if they were issued in offerings in which, among other things, the proceeds were used primarily to purchase securities issued by depository institutions and their affiliates. In connection with that final interim rule, the agencies published a non-exclusive list of exempt offerings. Of the 12 CDOs held by the Corporation, 10 were issued in exempt offerings. The remaining CDOs are collateralized primarily by securities issued by insurance companies and is not included in the agencies' list of exempt offerings, which fact required management to make a determination as to whether the CDOs constituted an "ownership interest" in a "covered fund", such that the Bank would be required to dispose of them pursuant to the Volcker Rule. To make this determination, management conducted a thorough review of the Indentures that govern the CDOs and the other offering materials used by the issuers to offer and sell the CDOs.

The Volcker Rule defines an “ownership interest” as an equity, partnership or other similar interest. The CDOs are debt securities (promissory notes) issued by corporations that call for regularly-scheduled payments of principal and interest, with interest calculated either at a fixed-rate or at a rate that is tied to LIBOR. Accordingly, none of the CDOs represent an equity or partnership interest in the issuers. In their adopting rule release, the agencies stated that debt securities evidencing “typical extensions of credit” – those that “provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate” – do not generally meet the definition of “other similar interest”. To be considered an “other similar interest”, a debt security must exhibit one or more of seven specified characteristics identified in the Volcker Rule on a current, future, or contingent basis.

Based on its review, management concluded that the two CDOs evidence “typical extensions of credit” and do not exhibit any of these seven characteristics. Accordingly, management concluded that the CDOs constitute an “ownership interest” as defined by the Volcker Rule and that, therefore, as of December 31, 2016, the Corporation has the current intent and ability to hold the CDOs until maturity.

In addition, under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”), depository institutions insured by the FDIC can be held liable for any losses incurred by, or reasonably anticipated to be incurred by, the FDIC in connection with (i) the default of a commonly controlled FDIC-insured depository institution or (ii) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution in danger of default. Accordingly, in the event that any insured subsidiary of the Corporation causes a loss to the FDIC, other insured subsidiaries of the Corporation could be required to compensate the FDIC by reimbursing it for the estimated amount of such loss. Such cross guaranty liabilities generally are superior in priority to obligations of a financial institution to its shareholders and obligations to other affiliates.

[8]

## **Federal Banking Regulation**

Federal banking regulators, such as the Federal Reserve and the FDIC, may prohibit the institutions over which they have supervisory authority from engaging in activities or investments that the agencies believe are unsafe or unsound banking practices. Federal banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to be unsafe or unsound practices. Enforcement actions may include the appointment of a conservator or receiver, the issuance of a cease and desist order, the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers, employees and institution-affiliated parties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the removal of or restrictions on directors, officers, employees and institution-affiliated parties, and the enforcement of any such mechanisms through restraining orders or other court actions.

The Bank is subject to certain restrictions on extensions of credit to executive officers, directors, and principal shareholders or any related interest of such persons, which generally require that such credit extensions be made on substantially the same terms as those available to persons who are not related to the Bank and not involve more than the normal risk of repayment. Other laws tie the maximum amount that may be loaned to any one customer and its related interests to capital levels.

As part of the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”), each federal banking regulator adopted non-capital safety and soundness standards for institutions under its authority. These standards include internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, and compensation, fees and benefits. An institution that fails to meet those standards may be required by the agency to develop a plan acceptable to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. We believe that the Bank meets substantially all standards that have been adopted. FDICIA also imposes capital standards on insured depository institutions.

The Community Reinvestment Act requires the FDIC, in connection with its examination of financial institutions within its jurisdiction, to evaluate the record of those financial institutions in meeting the credit needs of their communities, including low and moderate income neighborhoods, consistent with principles of safe and sound banking practices. These factors are also considered by all regulatory agencies in evaluating mergers, acquisitions and applications to open a branch or facility. As of the date of its most recent examination report, the Bank had a CRA rating of “Satisfactory”.

The Bank is also subject to a variety of other laws and regulations with respect to the operation of its business, including, but not limited to, the Truth in Lending Act, the Truth in Savings Act, the Equal Credit Opportunity Act,

the Electronic Funds Transfer Act, the Fair Housing Act, the Home Mortgage Disclosure Act, the Fair Debt Collection Practices Act, the Fair Credit Reporting Act, Expedited Funds Availability (Regulation CC), Reserve Requirements (Regulation D), Privacy of Consumer Information (Regulation P), Margin Stock Loans (Regulation U), the Right To Financial Privacy Act, the Flood Disaster Protection Act, the Homeowners Protection Act, the Servicemembers Civil Relief Act, the Real Estate Settlement Procedures Act, the Telephone Consumer Protection Act, the CAN-SPAM Act, the Children's Online Privacy Protection Act, and the John Warner National Defense Authorization Act.

## Capital Requirements

We require capital to fund loans, satisfy our obligations under the Bank's letters of credit, meet the deposit withdrawal demands of the Bank's customers, and satisfy our other monetary obligations. To the extent that deposits are not adequate to fund our capital requirements, we can rely on the funding sources identified below under the heading "Liquidity Management". At December 31, 2016, the Bank had \$70.0 million available through unsecured lines of credit with correspondent banks, \$10.6 million available through a secured line of credit with the Fed Discount Window and approximately \$172.4 million available through the Federal Home Loan Bank of Atlanta ("FHLB"). Management is not aware of any demands, commitments, events or uncertainties that are likely to materially affect our ability to meet our future capital requirements.

In addition to operational requirements, the Bank and the Corporation are subject to risk-based capital regulations, which were adopted and are monitored by federal banking regulators. These regulations are used to evaluate capital adequacy and require an analysis of an institution's asset risk profile and off-balance sheet exposures, such as unused loan commitments and stand-by letters of credit.

On July 2, 2013, the Federal Reserve approved final rules that substantially amended the regulatory risk-based capital rules applicable to First United Corporation. The FDIC subsequently approved the same rules. The final rules implement the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act and were implemented as of March 31, 2015.

The Basel III capital rules include new risk-based capital and leverage ratios, which will be phased in from 2015 to 2019, and which refine the definition of what constitutes "capital" for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Corporation under the final rules are: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The final rules also establish a "capital conservation buffer" above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital. The capital conservation buffer will be phased-in over four years beginning on January 1, 2016, as follows: the maximum buffer will be 0.625% of risk-weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. This will result in the following minimum ratios beginning in 2019: (a) a common equity Tier 1 capital ratio of 7.0%, (b) a Tier 1 capital ratio of 8.5% and (c) a total capital ratio of 10.5%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions.

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The Basel III capital final rules also implement revisions and clarifications consistent with Basel III regarding the various components of Tier 1 capital, including common equity, unrealized gains and losses, as well as certain instruments that no longer qualify as Tier 1 capital, some of which will be phased out over time. Under the final rules, the effects of certain accumulated other comprehensive items are not excluded; however, banking organizations like the Corporation and the Bank that are not considered “advanced approaches” banking organizations may make a one-time permanent election to continue to exclude these items. The Corporation and the Bank made this election in their first quarter 2015 regulatory filings in order to avoid significant variations in the level of capital depending upon the impact of interest rate fluctuations on the fair value of the Corporation’s available-for-sale securities portfolio. Additionally, the final rules provide that small depository institution holding companies with less than \$15 billion in total assets as of December 31, 2009 (which includes the Corporation) will be able to permanently include non-qualifying instruments that were issued and included in Tier 1 or Tier 2 capital prior to May 19, 2010 (such as the Corporation’s TPS Debentures) in additional Tier 1 or Tier 2 capital until they redeem such instruments or until the instruments mature.

The Basel III capital rules also contain revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions if their capital levels begin to show signs of weakness. These revisions were effective January 1, 2015. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions are required to meet the following capital level requirements in order to qualify as “well capitalized”: (i) a new common equity Tier 1 capital ratio of 6.5%; (ii) a Tier 1 capital ratio of 8% (increased from 6%); (iii) a total capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (increased from 4%).

The Basel III capital rules set forth certain changes for the calculation of risk-weighted assets. These changes include (i) an increased number of credit risk exposure categories and risk weights; (ii) an alternative standard of creditworthiness consistent with Section 939A of the Dodd-Frank Act; (iii) revisions to recognition of credit risk mitigation; (iv) rules for risk weighting of equity exposures and past due loans, and (v) revised capital treatment for derivatives and repo-style transactions.

Regulators may require higher capital ratios when warranted by the particular circumstances or risk profile of a given banking organization. In the current regulatory environment, banking organizations must stay well-capitalized in order to receive favorable regulatory treatment on acquisition and other expansion activities and favorable risk-based deposit insurance assessments. Our capital policy establishes guidelines meeting these regulatory requirements and takes into consideration current or anticipated risks as well as potential future growth opportunities.

As of December 31, 2016, we were in compliance with the applicable requirements of the new rules.

Additional information about our capital ratios and requirements is contained in Item 7 of Part II of this annual report under the heading “Capital Resources”.

### **Prompt Corrective Action**

The Federal Deposit Insurance (“FDI”) Act requires, among other things, the federal banking agencies to take “prompt corrective action” in respect of depository institutions that do not meet minimum capital requirements. The FDI Act includes the following five capital tiers: “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized” and “critically undercapitalized.” A depository institution’s capital tier will depend upon how its capital levels compare with various relevant capital measures and certain other factors, as established by regulation. The relevant capital measures are the total capital ratio, the Tier 1 capital ratio and the leverage ratio.

A bank will be (i) “well capitalized” if the institution has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 5.0% or greater, and is not subject to any order or written directive by any such regulatory authority to meet and maintain a specific capital level for any capital measure, (ii) “adequately capitalized” if the institution has a total risk-based capital ratio of 8.0% or greater, a Tier 1 risk-based capital ratio of 4.0% or greater, and a leverage ratio of 4.0% or greater and is not “well capitalized”, (iii) “undercapitalized” if the institution has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio of less than 4.0% or a leverage ratio of less than 4.0%, (iv) “significantly undercapitalized” if the institution has a total risk-based capital ratio of less than 6.0%, a Tier 1 risk-based capital ratio of less than 3.0% or a leverage ratio of less than 3.0%, and (v) “critically undercapitalized” if the institution’s tangible equity is equal to or less than 2.0% of average quarterly tangible assets. An institution may be downgraded to, or deemed to be in, a capital category that is lower than indicated by its capital ratios if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters. A bank’s capital category is determined solely for the purpose of applying prompt corrective action regulations, and the capital category may not constitute an accurate representation of the bank’s overall financial condition or prospects for other purposes.

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Effective January 1, 2015, the Basel III capital rules revised the prompt corrective action requirements by (i) introducing the Common Equity Tier 1 (“CET1”) ratio requirement at each level (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category (other than critically undercapitalized), with the minimum Tier 1 capital ratio for well-capitalized status being 8%; and (iii) eliminating the provision that permitted a bank with a composite supervisory rating of 1 but a leverage ratio of at least 3% to be deemed adequately capitalized. The Basel III Capital Rules did not change the total risk-based capital requirement for any prompt corrective action category.

The FDI Act generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be “undercapitalized.” “Undercapitalized” institutions are subject to growth limitations and are required to submit a capital restoration plan. The agencies may not accept such a plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution’s capital. In addition, for a capital restoration plan to be acceptable, the depository institution’s parent holding company must guarantee that the institution will comply with such capital restoration plan. The bank holding company must also provide appropriate assurances of performance. The aggregate liability of the parent holding company is limited to the lesser of (i) an amount equal to 5.0% of the depository institution’s total assets at the time it became undercapitalized and (ii) the amount which is necessary (or would have been necessary) to bring the institution into compliance with all capital standards applicable with respect to such institution as of the time it fails to comply with the plan. If a depository institution fails to submit an acceptable plan, it is treated as if it is “significantly undercapitalized.” Significantly undercapitalized” depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become “adequately capitalized,” requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. “Critically undercapitalized” institutions are subject to the appointment of a receiver or conservator.

The appropriate federal banking agency may, under certain circumstances, reclassify a well-capitalized insured depository institution as adequately capitalized. The FDI Act provides that an institution may be reclassified if the appropriate federal banking agency determines (after notice and opportunity for hearing) that the institution is in an unsafe or unsound condition or deems the institution to be engaging in an unsafe or unsound practice.

The appropriate agency is also permitted to require an adequately capitalized or undercapitalized institution to comply with the supervisory provisions as if the institution were in the next lower category (but not treat a significantly undercapitalized institution as critically undercapitalized) based on supervisory information other than the capital levels of the institution.

As of December 31, 2016, the Bank was “well capitalized” based on the aforementioned ratios.



## Liquidity Requirements

Historically, the regulation and monitoring of bank liquidity has been addressed as a supervisory matter, without required formulaic measures. The Basel III liquidity framework requires banks to measure their liquidity against specific liquidity tests that, although similar in some respects to liquidity measures historically applied by banks and regulators for management and supervisory purposes, going forward would be required by regulation. One test, referred to as the liquidity coverage ratio (“LCR”), is designed to ensure that the banking entity maintains an adequate level of unencumbered high-quality liquid assets equal to the entity’s expected net cash outflow for a 30-day time horizon (or, if greater, 25% of its expected total cash outflow) under an acute liquidity stress scenario. The other test, referred to as the net stable funding ratio (“NSFR”), is designed to promote more medium- and long-term funding of the assets and activities of banking entities over a one-year time horizon. These requirements will incent banking entities to increase their holdings of U.S. Treasury securities and other sovereign debt as a component of assets and increase the use of long-term debt as a funding source. In October 2013, the federal banking agencies proposed rules implementing the LCR for advanced approaches banking organizations and a modified version of the LCR for bank holding companies with at least \$50 billion in total consolidated assets that are not advanced approach banking organizations, neither of which would apply to the Corporation. The NSFR requirement is currently in an international observation period. Based on the results of the observation period, the Basel Committee and U.S. banking regulators may make further changes to the NSFR. The U.S. regulators have not yet proposed rules to implement the NSFR for U.S. banks and bank holding companies but are expected to do so well in advance of the NSFR’s scheduled global implementation by January 1, 2018.

## Deposit Insurance

The Bank is a member of the FDIC and pays an insurance premium to the FDIC based upon its assessable deposits on a quarterly basis. Deposits are insured up to applicable limits by the FDIC and such insurance is backed by the full faith and credit of the United States Government.

Under the Dodd-Frank Act, a permanent increase in deposit insurance was authorized to \$250,000. The coverage limit is per depositor, per insured depository institution for each account ownership category.

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The Dodd-Frank Act also set a new minimum DIF reserve ratio at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020. The Dodd-Frank Act required the FDIC to redefine the deposit insurance assessment base for an insured depository institution. Prior to the Dodd-Frank Act, an institution's assessment base has historically been its domestic deposits, with some adjustments. As redefined pursuant to the Dodd-Frank Act, an institution's assessment base is now an amount equal to the institution's average consolidated total assets during the assessment period minus average tangible equity. Institutions with \$1.0 billion or more in assets at the end of a fiscal quarter, like the Bank, must report their average consolidated total assets on a daily basis and report their average tangible equity on an end-of-month balance basis.

The Federal Deposit Insurance Reform Act of 2005, which created the DIF, gave the FDIC greater latitude in setting the assessment rates for insured depository institutions which could be used to impose minimum assessments. The FDIC has the flexibility to adopt actual rates that are higher or lower than the total base assessment rates adopted without notice and comment, if certain conditions are met.

DIF-insured institutions pay a Financing Corporation ("FICO") assessment in order to fund the interest on bonds issued in the 1980s in connection with the failures in the thrift industry. These assessments will continue until the bonds mature in 2019.

The FDIC is authorized to conduct examinations of and require reporting by FDIC-insured institutions. It is also authorized to terminate a depository bank's deposit insurance upon a finding by the FDIC that the bank's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the bank's regulatory agency. The termination of deposit insurance for our bank subsidiary would have a material adverse effect on our earnings, operations and financial condition.

### **Bank Secrecy Act/Anti-Money Laundering**

The Bank Secrecy Act ("BSA"), which is intended to require financial institutions to develop policies, procedures, and practices to prevent and deter money laundering, mandates that every national bank have a written, board-approved program that is reasonably designed to assure and monitor compliance with the BSA.

The program must, at a minimum: (i) provide for a system of internal controls to assure ongoing compliance; (ii) provide for independent testing for compliance; (iii) designate an individual responsible for coordinating and monitoring day-to-day compliance; and (iv) provide training for appropriate personnel. In addition, state-chartered banks are required to adopt a customer identification program as part of its BSA compliance program. State-chartered

banks are also required to file Suspicious Activity Reports when they detect certain known or suspected violations of federal law or suspicious transactions related to a money laundering activity or a violation of the BSA.

In addition to complying with the BSA, the Bank is subject to the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “USA Patriot Act”). The USA Patriot Act is designed to deny terrorists and criminals the ability to obtain access to the United States’ financial system and has significant implications for depository institutions, brokers, dealers, and other businesses involved in the transfer of money. The USA Patriot Act mandates that financial service companies implement additional policies and procedures and take heightened measures designed to address any or all of the following matters: customer identification programs, money laundering, terrorist financing, identifying and reporting suspicious activities and currency transactions, currency crimes, and cooperation between financial institutions and law enforcement authorities.

### **Mortgage Lending and Servicing**

In January 2013, the CFPB issued eight final regulations governing mainly consumer mortgage lending. These regulations became effective in January 2014.

One of these rules, effective on January 10, 2014, requires mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. This rule also defines “qualified mortgages.” In general, a “qualified mortgage” is a mortgage loan without negative amortization, interest-only payments, balloon payments, or a term exceeding 30 years, where the lender determines that the borrower has the ability to repay, and where the borrower’s points and fees do not exceed 3% of the total loan amount. Qualified mortgages that are not “higher-priced” are afforded a safe harbor presumption of compliance with the ability to repay rules. Qualified mortgages that are “higher-priced” garner a rebuttable presumption of compliance with the ability to repay rules.

The CFPB regulations also: (i) require that “higher-priced” mortgages must have escrow accounts for taxes and insurance and similar recurring expenses; (ii) expand the scope of the high-rate, high-cost mortgage provisions by, among other provisions, lowering the rates and fees that lead to coverage and including home equity lines of credit; (iii) revise rules for mortgage loan originator compensation; (iv) add prohibitions against mandatory arbitration provisions and financing single premium credit insurances; and (v) impose a broader requirement for providing borrowers with copies of all appraisals on first-lien dwelling secured loans.

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Effective January 10, 2014, the CFPB's final Truth-in-Lending Act rules relating to mortgage servicing impose new obligations to credit payments and provide payoff statements within certain time periods and provide new notices prior to interest rate and payment adjustments. Effective on that same date, the CFPB's final Real Estate Settlement Procedures Act rules add new obligations on the servicer when a mortgage loan is default.

On November 20, 2013, the CFPB issued a final rule on integrated mortgage disclosures under the Truth-in-Lending Act and the Real Estate Settlement Procedures Act, for which compliance was required by October 3, 2015. As of December 31, 2016, we believe that we are in compliance with this new rule.

### **Consumer Lending – Military Lending Act**

The Military Lending Act (the "MLA"), which was initially implemented in 2007, was amended and its coverage significantly expanded in 2015. The Department of Defense (the "DOD") issued a final rule under the MLA that took effect on October 15, 2015, but financial institutions were not required to take action until October 3, 2016. The types of credit covered under the MLA were expanded to include virtually all consumer loan and credit card products (except for loans secured by residential real property and certain purchase-money motor vehicle/personal property secured transactions). Lenders must now provide specific written and oral disclosures concerning the protections of the MLA to active duty members of the military and dependents of active duty members of the military ("covered borrowers"). The rule imposes a 36% "Military Annual Percentage Rate" cap that includes costs associated with credit insurance premiums, fees for ancillary products, finance charges associated with the transactions, and application and participation charges. In addition, loan terms cannot include (i) a mandatory arbitration provision, (ii) a waiver of consumer protection laws, (iii) mandatory allotments from military benefits, or (iv) a prepayment penalty. The revised rule also prohibits "roll-over" or refinances of the same loan unless the new loan provides more favorable terms for the covered borrower. Lenders may verify covered borrower status using a DOD database or information provided by credit bureaus. We believe that we are in compliance with the revised rule.

### **Federal Securities Laws and NASDAQ Rules**

The shares of the Corporation's common stock are registered with the SEC under Section 12(b) of the Exchange and listed on the NASDAQ Global Select Market. The Corporation is subject to information reporting requirements, proxy solicitation requirements, insider trading restrictions and other requirements of the Exchange Act, including the requirements imposed under the federal Sarbanes-Oxley Act of 2002, and rules adopted by NASDAQ. Among other things, loans to and other transactions with insiders are subject to restrictions and heightened disclosure, directors and certain committees of the Board must satisfy certain independence requirements, the Corporation must comply with certain enhanced corporate governance requirements, and various issuances of securities by the Corporation require shareholder approval.

## **Governmental Monetary and Credit Policies and Economic Controls**

The earnings and growth of the banking industry and ultimately of the Bank are affected by the monetary and credit policies of governmental authorities, including the Federal Reserve. An important function of the Federal Reserve is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the Federal Reserve to implement these objectives are open market operations in U.S. Government securities, changes in the federal funds rate, changes in the discount rate of member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans, investments and deposits and may also affect interest rates charged on loans or paid on deposits. The monetary policies of the Federal Reserve authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future. In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the Federal Reserve, no prediction can be made as to possible future changes in interest rates, deposit levels, loan demand or their effect on our businesses and earnings.

## **SEASONALITY**

Management does not believe that our business activities are seasonal in nature. Deposit and loan demand may vary depending on local and national economic conditions, but management believes that any variation will not have a material impact on our planning or policy-making strategies.

## **EMPLOYEES**

At December 31, 2016, we employed 356 individuals, of whom 296 were full-time employees.

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## **ITEM 1A. RISK FACTORS**

The significant risks and uncertainties related to us, our business and our securities of which we are aware are discussed below. You should carefully consider these risks and uncertainties before making investment decisions in respect of our securities. Any of these factors could materially and adversely affect our business, financial condition, operating results and prospects and could negatively impact the market price of our securities. If any of these risks materialize, you could lose all or part of your investment in the Corporation. Additional risks and uncertainties that we do not yet know of, or that we currently think are immaterial, may also impair our business operations. You should also consider the other information contained in this annual report, including our financial statements and the related notes, before making investment decisions in respect of our securities.

### ***Risks Relating to First United Corporation and its Affiliates***

#### **First United Corporation's future success depends on the successful growth of its subsidiaries.**

The Corporation's primary business activity for the foreseeable future will be to act as the holding company of the Bank and its other direct and indirect subsidiaries. Therefore, the Corporation's future profitability will depend on the success and growth of these subsidiaries. In the future, part of our growth may come from buying other banks and buying or establishing other companies. Such entities may not be profitable after they are purchased or established, and they may lose money, particularly at first. A new bank or company may bring with it unexpected liabilities, bad loans, or bad employee relations, or the new bank or company may lose customers.

#### **Interest rates and other economic conditions will impact our results of operations.**

Our results of operations may be materially and adversely affected by changes in prevailing economic conditions, including declines in real estate values, rapid changes in interest rates and the monetary and fiscal policies of the federal government. Our profitability is in part a function of the spread between the interest rates earned on assets and the interest rates paid on deposits and other interest-bearing liabilities (*i.e.*, net interest income), including advances from FHLB. Interest rate risk arises from mismatches (*i.e.*, the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities. If more assets reprice or mature than liabilities during a falling interest rate environment, then our earnings could be negatively impacted. Conversely, if more liabilities reprice or mature than assets during a rising interest rate environment, then our earnings could be negatively impacted. Fluctuations in interest rates are not predictable or controllable. There can be no assurance that our attempts to structure our asset and liability management strategies to mitigate the impact on net interest income of changes in market interest rates will be successful in the event of such changes.

**The majority of our business is concentrated in Maryland and West Virginia, much of which involves real estate lending, so a decline in the real estate and credit markets could materially and adversely impact our financial condition and results of operations.**

Most of the Bank's loans are made to borrowers located in Western Maryland and Northeastern West Virginia, and many of these loans, including construction and land development loans, are secured by real estate. At December 31, 2016, approximately 12%, or \$104.3 million, of our total loans were real estate acquisition, construction and development loans that were secured by real estate. Accordingly, a decline in local economic conditions would likely have an adverse impact on our financial condition and results of operations, and the impact on us would likely be greater than the impact felt by larger financial institutions whose loan portfolios are geographically diverse. We cannot guarantee that any risk management practices we implement to address our geographic and loan concentrations will be effective to prevent losses relating to our loan portfolio.

**The Bank's concentrations of commercial real estate loans could subject it to increased regulatory scrutiny and directives, which could force us to preserve or raise capital and/or limit future commercial lending activities.**

The Federal Reserve, the FDIC, and the other federal banking regulators issued guidance in December 2006 entitled "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" directed at institutions who have particularly high concentrations of CRE loans within their lending portfolios. This guidance suggests that these institutions face a heightened risk of financial difficulties in the event of adverse changes in the economy and CRE markets. Accordingly, the guidance suggests that institutions whose concentrations exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk. The guidance provides that banking regulators may require such institutions to reduce their concentrations and/or maintain higher capital ratios than institutions with lower concentrations in CRE. At December 31, 2016, the Corporation's concentrations were below the regulatory guidelines.

**The Bank may experience loan losses in excess of its allowance, which would reduce our earnings.**

The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loans being made, the creditworthiness of the borrowers over the term of the loans and, in the case of collateralized loans, the value and marketability of the collateral for the loans. Management of the Bank maintains an allowance for loan losses based upon, among other things, historical experience, an evaluation of economic conditions and regular reviews of delinquencies and loan portfolio quality. Based upon such factors, management makes various assumptions and judgments about the ultimate collectability of the loan portfolio and provides an allowance for loan losses based upon a percentage of the outstanding balances and for specific loans when their ultimate collectability is considered questionable. If management's assumptions and judgments prove to be incorrect and the allowance for loan losses is inadequate to absorb future losses, or if the bank regulatory authorities require us to increase the allowance for loan losses as a part of its examination process, our earnings and capital could be significantly and adversely affected. Although management continually monitors our loan portfolio and makes determinations with respect to the

allowance for loan losses, future adjustments may be necessary if economic conditions differ substantially from the assumptions used or adverse developments arise with respect to our non-performing or performing loans. Material additions to the allowance for loan losses could result in a material decrease in our net income and capital, and could have a material adverse effect on our financial condition.

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**The market value of our investments could decline.**

As of December 31, 2016, investment securities in our investment portfolio having a cost basis of \$149.6 million and a market value of \$140.0 million were classified as available-for-sale pursuant to FASB Accounting Standards Codification (“ASC”) Topic 320, *Investments – Debt and Equity Securities*, relating to accounting for investments. Topic 320 requires that unrealized gains and losses in the estimated value of the available-for-sale portfolio be “marked to market” and reflected as a separate item in shareholders’ equity (net of tax) as accumulated other comprehensive loss. There can be no assurance that future market performance of our investment portfolio will enable us to realize income from sales of securities. Shareholders’ equity will continue to reflect the unrealized gains and losses (net of tax) of these investments. Moreover, there can be no assurance that the market value of our investment portfolio will not decline, causing a corresponding decline in shareholders’ equity.

Management believes that several factors could affect the market value of our investment portfolio. These include, but are not limited to, changes in interest rates or expectations of changes, the degree of volatility in the securities markets, inflation rates or expectations of inflation and the slope of the interest rate yield curve (the yield curve refers to the differences between shorter-term and longer-term interest rates; a positively sloped yield curve means shorter-term rates are lower than longer-term rates). Also, the passage of time will affect the market values of our investment securities, in that the closer they are to maturing, the closer the market price should be to par value. These and other factors may impact specific categories of the portfolio differently, and management cannot predict the effect these factors may have on any specific category.

**The Volcker Rule may require the Bank to dispose of certain investments, which could result in a significant charge to earnings.**

On December 10, 2013, the SEC, the Federal Reserve, the FDIC and other financial regulatory agencies issued final regulations to implement the Volcker Rule. Among other things, these regulations prohibit banking entities from acquiring or retaining an “ownership interest” in a “covered fund”, as such terms are defined in the regulations. A banking entity that owns such an interest was required to dispose of it no later than July 21, 2015. Although the final rule release provides that, in general, debt securities evidencing typical extensions of credit (*i.e.*, those that provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate) do not meet the definition of an “ownership interest”, it also contains a statement to the effect that all CDOs backed by trust preferred securities are prohibited by the Volcker Rule. Subsequently, on January 14, 2014, the agencies issued an interim final rule that exempts a CDO if (i) the issuer was established, and the CDO was originally issued, before May 19, 2010 (ii) the banking entity investor reasonably believes that the offering proceeds received by the issuer were invested primarily in trust preferred securities or subordinated debt instruments issued prior to May 19, 2010 by a depository institution holding company that satisfied certain criteria at the time of issuance and (iii) the banking entity investor acquired the CDO on or before December 10, 2013. The agencies’ rule releases create significant uncertainty with respect to whether the Volcker Rule will be applied to CDOs that are backed by non-bank trust preferred securities but that take the form of debt securities evidencing typical extensions of credit, because the

agencies did not, in making the statement that CDOs backed by trust preferred securities are generally prohibited investments, acknowledge or otherwise address the fact that an investment must, as a threshold matter, meet the definition of “ownership interest” before it can be characterized as a prohibited investment.

At December 31, 2016, the Bank owned two debt securities, in the principal amount of \$8.0 million, that are collateralized primarily by trust preferred securities and/or subordinated debt instruments issued by insurance entities and that provide for the payment of stated principal and interest at rates tied to LIBOR. These securities are held in the Bank’s investment portfolio and, as of December 31, 2016, were classified as available-for-sale. The Bank has analyzed these securities under the final Volcker Rule regulations and has concluded that it is not a prohibited investment because it does not exhibit, on a current, future, or contingent basis, any of the characteristics of an equity, partnership or other similar interest in the issuers identified in the Volcker Rule’s definition of “ownership interest”. If the FDIC were to disagree with the Bank’s analysis, then the Bank would be required to dispose of these securities, likely at a considerable loss due to their current market values.

**Impairment of investment securities, goodwill, or deferred tax assets could require charges to earnings, which could result in a negative impact on our results of operations.**

In assessing whether the impairment of investment securities is other-than-temporary, management considers the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability to retain our investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value in the near term. See the discussion under the heading “Estimates and Critical Accounting Policies – Other-Than-Temporary Impairment of Investment Securities” in Item 7 of Part II of this annual report for further information.

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Under current accounting standards, goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. A decline in the price of the Corporation's common stock or occurrence of a triggering event following any of our quarterly earnings releases and prior to the filing of the periodic report for that period could, under certain circumstances, cause us to perform a goodwill impairment test and result in an impairment charge being recorded for that period which was not reflected in such earnings release. In the event that we conclude that all or a portion of our goodwill may be impaired, a non-cash charge for the amount of such impairment would be recorded to earnings. Such a charge would have no impact on tangible capital. At December 31, 2016, we had recorded goodwill of \$11.0 million, representing approximately 9.7% of shareholders' equity. See the discussion under the heading "Estimates and Critical Accounting Policies – Goodwill" in Item 7 of Part II of this annual report for further information.

At December 31, 2016, our net deferred tax assets were valued at \$19.3 million, which included \$2.8 million associated with a federal net operating loss carryforward which we expect to be substantially utilized in 2017. Also included in that total is \$2.1 million of state net operating loss carryforwards associated with separate company tax filings of the Corporation, which we do not expect to use and, thus, we have established a \$1.9 million valuation allowance. A deferred tax asset is reduced by a valuation allowance if, based on the weight of the evidence available, both negative and positive, including the recent trend of quarterly earnings, management believes that it is more likely than not that some portion or all of the total deferred tax asset will not be realized. Moreover, our ability to utilize our net operating loss carryforwards to offset future taxable income may be significantly limited if we experience an "ownership change," as determined under Section 382 of the Code. If an ownership change were to occur, the limitations imposed by Section 382 of the Code could result in a portion of our net operating loss carryforwards expiring unused, thereby impairing their value. Section 382's provisions are complex, and we cannot predict any circumstances surrounding the future ownership of the common stock. Accordingly, we cannot provide any assurance that we will not experience an ownership change in the future.

The impact of each of these impairment matters could have a material adverse effect on our business, results of operations, and financial condition.

**We could have a material write down related to our deferred tax asset as a result of a decrease in our corporate tax rate.**

Since the 2016 presidential election, there has been a great deal of discussion relating to possible changes to the IRC and corporate tax rates. A number of proposals for broad reform of the corporate tax system are under evaluation by various legislative and administrative bodies, but it is not possible to accurately determine the overall impact of such proposals on our tax rate at this time. As of December 31, 2016, the balance of our net deferred tax asset was \$19.3 million. Any decrease in our corporate tax rate would result in an immediate decrease in the deferred tax asset and a related charge to earnings that could materially affect our financial results.

**We operate in a competitive environment, and our inability to effectively compete could adversely and materially impact our financial condition and results of operations.**

We operate in a competitive environment, competing for loans, deposits, and customers with commercial banks, savings associations and other financial entities. Competition for deposits comes primarily from other commercial banks, savings associations, credit unions, money market and mutual funds and other investment alternatives. Competition for loans comes primarily from other commercial banks, savings associations, mortgage banking firms, credit unions and other financial intermediaries. Competition for other products, such as securities products, comes from other banks, securities and brokerage companies, and other non-bank financial service providers in our market area. Many of these competitors are much larger in terms of total assets and capitalization, have greater access to capital markets, and/or offer a broader range of financial services than those that we offer. In addition, banks with a larger capitalization and financial intermediaries not subject to bank regulatory restrictions have larger lending limits and are thereby able to serve the needs of larger customers.

In addition, changes to the banking laws over the last several years have facilitated interstate branching, merger and expanded activities by banks and holding companies. For example, the federal Gramm-Leach-Bliley Act (the “GLB Act”) revised the BHC Act and repealed the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities and other non-banking activities of any company that controls an FDIC insured financial institution. As a result, the ability of financial institutions to branch across state lines and the ability of these institutions to engage in previously-prohibited activities are now accepted elements of competition in the banking industry. These changes may bring us into competition with more and a wider array of institutions, which may reduce our ability to attract or retain customers. Management cannot predict the extent to which we will face such additional competition or the degree to which such competition will impact our financial conditions or results of operations.

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**The banking industry is heavily regulated; significant regulatory changes could adversely affect our operations.**

Our operations will be impacted by current and future legislation and by the policies established from time to time by various federal and state regulatory authorities. The Corporation is subject to supervision by the Federal Reserve. The Bank is subject to supervision and periodic examination by the Maryland Commissioner of Financial Regulation, the West Virginia Division of Banking, and the FDIC. Banking regulations, designed primarily for the safety of depositors, may limit a financial institution's growth and the return to its investors by restricting such activities as the payment of dividends, mergers with or acquisitions by other institutions, investments, loans and interest rates, interest rates paid on deposits, expansion of branch offices, and the offering of securities or trust services. The Corporation and the Bank are also subject to capitalization guidelines established by federal law and could be subject to enforcement actions to the extent that either is found by regulatory examiners to be undercapitalized. It is not possible to predict what changes, if any, will be made to existing federal and state legislation and regulations or the effect that such changes may have on our future business and earnings prospects. Management also cannot predict the nature or the extent of the effect on our business and earnings of future fiscal or monetary policies, economic controls, or new federal or state legislation. Further, the cost of compliance with regulatory requirements may adversely affect our ability to operate profitably.

**The full impact of the Dodd-Frank Act is unknown because significant rule making efforts are still required to fully implement all of its requirements, but it will likely materially increase our regulatory expenses.**

The Dodd-Frank Act represents a comprehensive overhaul of the financial services industry within the United States and affects the lending, investment, trading and operating activities of all financial institutions. Significantly, the Dodd-Frank Act includes the following provisions that affect the Bank:

It established the CFPB, which has rulemaking authority over many of the statutes governing products and services offered to Bank customers. The creation of the CFPB will directly impact the scope and cost of products and services offered to consumers by the Bank and may have a significant effect on its financial performance.

It revised the FDIC's insurance assessment methodology so that premiums are assessed based upon the average consolidated total assets of the Bank less tangible equity capital.

It permanently increased deposit insurance coverage to \$250,000.

It authorized the Federal Reserve to set debit interchange fees in an amount that is "reasonable and proportional" to the costs incurred by processors and card issuers. Under the final rule issued by the Federal Reserve, there is a cap of \$0.21 per transaction (with a maximum of \$.24 per transaction permitted if certain requirements are met).

Implementation of these caps went into effect on October 1, 2011.

It imposes proprietary trading restrictions on insured depository institutions and their holding companies that prohibit them from engaging in proprietary trading except in limited circumstances, and prevents them from owning equity interests in excess of three percent (3%) of a bank's Tier 1 capital in private equity and hedge funds.

Based on the text of the Dodd-Frank Act and the implementing regulations, it is anticipated that the costs to banks may increase or fee income may decrease significantly, which could adversely affect our results of operations, financial condition and/or liquidity.

**The Consumer Financial Protection Bureau may reshape the consumer financial laws through rulemaking and enforcement of the prohibitions against unfair, deceptive and abusive business practices. Compliance with any such change may impact our business operations.**

The CFPB has broad rulemaking authority to administer and carry out the provisions of the Dodd-Frank Act with respect to financial institutions that offer covered financial products and services to consumers. The CFPB has also been directed to adopt rules identifying practices or acts that are unfair, deceptive or abusive in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service. The concept of what may be considered to be an “abusive” practice is new under the law. The full scope of the impact of this authority has not yet been determined as the CFPB has not yet released significant supervisory guidance.

As discussed above, the CFPB issued several rules in 2013 relating to mortgage operations and servicing, including a rule requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms, or to originate “qualified mortgages” that meet specific requirements with respect to terms, pricing and fees. These new rules have required the Bank to dedicate significant personnel resources and could have a material adverse effect on our operations.

**Bank regulators and other regulations, including the Basel III Capital Rules, may require higher capital levels, impacting our ability to pay dividends or repurchase our stock.**

The capital standards to which we are subject, including the standards created by the Basel III Capital Rules, may materially limit our ability to use our capital resources and/or could require us to raise additional capital by issuing common stock. The issuance of additional shares of common stock could dilute existing stockholders.

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**A material weakness or significant deficiency in our disclosure or internal controls could have an adverse effect on us.**

The Corporation is required by the Sarbanes-Oxley Act of 2002 to establish and maintain disclosure controls and procedures and internal control over financial reporting. These control systems are intended to provide reasonable assurance that material information relating to the Corporation is made known to our management and reported as required by the Exchange Act, to provide reasonable assurance regarding the reliability and preparation of our financial statements, and to provide reasonable assurance that fraud and other unauthorized uses of our assets are detected and prevented. We may not be able to maintain controls and procedures that are effective at the reasonable assurance level. If that were to happen, our ability to provide timely and accurate information about the Corporation, including financial information, to investors could be compromised and our results of operations could be harmed. Moreover, if the Corporation or its independent registered public accounting firm were to identify a material weakness or significant deficiency in any of those control systems, our reputation could be harmed and investors could lose confidence in us, which could cause the market price of the Corporation's stock to decline and/or limit the trading market for the common stock.

**We may be adversely affected by other recent legislation and rule-making efforts.**

In November 2009, the Federal Reserve announced amendments to Regulation E that prohibit financial institutions from charging fees to consumers for paying overdrafts on automated teller machine and one-time debit card transactions unless a consumer consents, or opts-in, to the overdraft service for those types of transactions. These amendments became effective on July 1, 2010 for new consumer accounts and August 15, 2010 for existing consumer accounts.

In addition, the Federal Reserve has issued rules pursuant to the Dodd-Frank Act governing debit card interchange fees that apply to institutions with greater than \$10 billion in assets. Although we are not subject to these rules, market forces may effectively require the Bank to adopt a debit card interchange fee structure that complies with these rules, in which case our non-interest income for future periods could be materially and adversely affected.

As discussed above, the GLB Act repealed restrictions on banks affiliating with securities firms and it also permitted certain bank holding companies to become financial holding companies. Financial holding companies are permitted to engage in a host of financial activities, and activities that are incidental to financial activities, that are not permitted for bank holding companies who have not elected to become financial holding companies, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities. The Corporation terminated its financial holding company election in September 2014, and this election and the GLB Act may increase the competition that we face from other entities that provide financial products and services. It is not possible to predict the full effect that the GLB Act will have on us.

The USA Patriot Act requires certain financial institutions, such as the Bank, to maintain and prepare additional records and reports that are designed to assist the government's efforts to combat terrorism. This law includes sweeping anti-money laundering and financial transparency laws and required additional regulations, including, among other things, standards for verifying client identification when opening an account and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. If we fail to comply with this law, we could be exposed to adverse publicity as well as fines and penalties assessed by regulatory agencies.

**The Bank's funding sources may prove insufficient to replace deposits and support our future growth.**

The Bank relies on customer deposits, advances from the FHLB, lines of credit at other financial institutions and brokered funds to fund our operations. Although the Bank has historically been able to replace maturing deposits and advances if desired, no assurance can be given that the Bank would be able to replace such funds in the future if our financial condition or the financial condition of the FHLB or market conditions were to change. Our financial flexibility will be severely constrained and/or our cost of funds will increase if we are unable to maintain our access to funding or if financing necessary to accommodate future growth is not available at favorable interest rates. Finally, if we are required to rely more heavily on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In that case, our profitability would be adversely affected.

**The loss of key personnel could disrupt our operations and result in reduced earnings.**

Our growth and profitability will depend upon our ability to attract and retain skilled managerial, marketing and technical personnel. Competition for qualified personnel in the financial services industry is intense, and there can be no assurance that we will be successful in attracting and retaining such personnel. Our current executive officers provide valuable services based on their many years of experience and in-depth knowledge of the banking industry and the market areas we serve. Due to the intense competition for financial professionals, these key personnel would be difficult to replace and an unexpected loss of their services could result in a disruption to the continuity of operations and a possible reduction in earnings.

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**The Bank's lending activities subject the Bank to the risk of environmental liabilities.**

A significant portion of the Bank's loan portfolio is secured by real property. During the ordinary course of business, the Bank may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, the Bank may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require the Bank to incur substantial expenses and may materially reduce the affected property's value or limit the Bank's ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase the Bank's exposure to environmental liability. Although the Bank has policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

**We may be subject to claims and the costs of defensive actions, and such claims and costs could materially and adversely impact our financial condition and results of operations.**

Our customers may sue us for losses due to alleged breaches of fiduciary duties, errors and omissions of employees, officers and agents, incomplete documentation, our failure to comply with applicable laws and regulations, or many other reasons. Also, our employees may knowingly or unknowingly violate laws and regulations. Management may not be aware of any violations until after their occurrence. This lack of knowledge may not insulate us from liability. Claims and legal actions will result in legal expenses and could subject us to liabilities that may reduce our profitability and hurt our financial condition.

**We may not be able to keep pace with developments in technology.**

We use various technologies in conducting our businesses, including telecommunication, data processing, computers, automation, internet-based banking, and debit cards. Technology changes rapidly. Our ability to compete successfully with other financial institutions may depend on whether we can exploit technological changes. We may not be able to exploit technological changes, and any investment we do make may not make us more profitable.

**Safeguarding our business and customer information increases our cost of operations. To the extent that we, or our third party vendors, are unable to prevent the theft of or unauthorized access to this information, our operations may become disrupted, we may be subject to claims, and our net income may be adversely affected.**

Our business depends heavily on the use of computer systems, the Internet and other means of electronic communication and recordkeeping. Accordingly, we must protect our computer systems and network from break-ins, security breaches, and other risks that could disrupt our operations or jeopardize the security of our business and customer information. Moreover, we use third party vendors to provide products and services necessary to conduct our day-to-day operations, which exposes us to risk that these vendors will not perform in accordance with the service arrangements, including by failing to protect the confidential information we entrust to them. Any security measures that we or our vendors implement, including encryption and authentication technology that we use to effect secure transmissions of confidential information, may not be effective to prevent the loss or theft of our information or to prevent risks associated with the Internet, such as cyber-fraud. Advances in computer capabilities, new discoveries in the field of cryptography, or other developments could permit unauthorized persons to gain access to our confidential information in spite of the use of security measures that we believe are adequate. Any compromise of our security measures or of the security measures employed by our vendors of our third party could disrupt our business and/or could subject us to claims from our customers, either of which could have a material adverse effect on our business, financial condition and results of operations.

***Risks Relating to First United Corporation's Securities***

**The shares of common stock and Series A Preferred Stock are not insured.**

The shares of the Corporation's common stock and of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the "Series A Preferred Stock") are not deposits and are not insured against loss by the FDIC or any other governmental or private agency.

**There is no market for the Series A Preferred Stock, and the common stock is not heavily traded.**

There is no established trading market for the shares of the Series A Preferred Stock. The Corporation does not intend to apply for listing of the Series A Preferred Stock on any securities exchange or for inclusion of the Series A Preferred Stock in any automated quotation system. The Corporation's common stock is listed on the NASDAQ Global Select Market, but shares of the common stock are not heavily traded. Securities that are not heavily traded can be more volatile than stock trading in an active public market. Factors such as our financial results, the introduction of new products and services by us or our competitors, and various factors affecting the banking industry generally may have a significant impact on the market price of the shares the common stock. Management cannot predict the extent to which an active public market for any of the Corporation's securities will develop or be sustained in the future. Accordingly, holders of the Corporation's securities may not be able to sell such securities at the volumes, prices, or times that they desire.

**Significant sales of the common stock, or the perception that significant sales may occur in the future, could adversely affect the market price for the common stock.**

The sale of substantial amounts of the Corporation's common stock could adversely affect the price of the shares. The availability of shares for future sale could adversely affect the prevailing market price of the common stock and could cause the market price of the common stock to remain low for a substantial amount of time. In addition, we may grant equity awards under our equity compensation plan, including fully-vested shares of common stock. It is possible that if a significant percentage of such available shares were attempted to be sold within a short period of time, the market for the shares would be adversely affected. It is unclear whether or not the market for the common stock could absorb a large number of attempted sales in a short period of time, regardless of the price at which they might be offered. Even if a substantial number of sales do not occur within a short period of time, the mere existence of this "market overhang" could have a negative impact on the market for the common stock and our ability to raise capital in the future.

**The common stock's inclusion in The NASDAQ Stock Market's "Tick Size Pilot Program" may limit your ability to sell your shares at the volumes, prices or times that you desire.**

Effective October 31, 2016, the Corporation's common stock was randomly selected by The NASDAQ Stock Market for inclusion in "Test Group 3" of its "Tick Size Pilot Program". The program will last for two years and imposes wider minimum quoting and/or trading increments, or "tick sizes", for certain securities with small market capitalization. Specifically, subject to certain exceptions, the minimum quotation price and minimum trading price for securities in Test Group 3, like the common stock, have been widened to \$0.05 per share, which means that the common stock must now be quoted in \$0.05 minimum increments and must now trade at \$0.05 minimum increments. In addition, securities in Test Group 3 are subject to a "trade-at" requirement that prevents price matching by a trading center that is not displaying a protected bid or protected offer, subject to certain exceptions. As a result, brokerage firms are now required to ensure that your orders with respect to shares of the common stock are priced in nickel increments. This means that the "limit" or "stop" prices that you may place on your order can no longer be in pennies and instead must be in increments of \$0.05. We cannot predict the impact, if any, of the common stock's inclusion in this Tick Size Pilot Program. This program could adversely affect the market for the Corporation's common stock and could limit your ability to sell your shares at the prices, times and/or volumes that you desire.

**The Corporation has entered into an informal agreement with its federal banking regulator that limits its ability to pay dividends and make other distributions on outstanding securities.**

The Corporation has entered into an informal agreement with the Federal Reserve Bank of Richmond (the "Reserve Bank") that prohibits the Corporation, without the Reserve Bank's prior consent, from paying dividends on outstanding shares of its common stock or Series A Preferred Stock, making interest payments under the Corporation's junior

subordinated debentures (“TPS Debentures”) underlying the trust preferred securities that were issued by the Trusts, or taking any other action that would reduce regulatory capital. As a result, the Corporation may be prohibited from making a dividend payment or any other distribution with respect to outstanding securities, including the repurchase of stock, at a time or times when applicable banking and corporate laws would otherwise permit such a dividend or distribution. This agreement increases the likelihood that we will realize the other risks discussed below relating to our ability to pay dividends and make other distributions.

**The terms of the Series A Preferred Stock may, under certain circumstances, prohibit the Corporation from paying dividends on and/or repurchasing shares of the Corporation’s common stock.**

The terms of the Series A Preferred Stock prohibit the Corporation from declaring or paying any dividends or making other distributions on the outstanding shares of its common stock, and from repurchasing, redeeming or otherwise acquiring shares of its common stock, if the Corporation is in arrears on any quarterly cash dividend due on the Series A Preferred Stock. Unless and until the Corporation is advised otherwise by the Reserve Bank, the Corporation’s ability to make each future quarterly dividend payment due under the Series A Preferred Stock will depend on its receipt of an approval from the Reserve Bank. In addition, it should be noted that the Corporation’s ability to make future quarterly dividend payments will depend in large part on its receipt of cash dividends from the Bank, and the Bank’s ability to pay dividends is subject to various statutory and regulatory limitations. As a result of these limitations, no assurance can be given that the Corporation will pay dividends on any of its outstanding capital securities. The Corporation has received approvals to pay all subsequent quarterly dividends through February 2017.

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**The Corporation's ability to pay dividends on its capital securities is also subject to the terms of the outstanding TPS Debentures, which prohibit the Corporation from paying dividends during an interest deferral period.**

In March 2004, the Corporation issued approximately \$30.9 million of TPS Debentures to Trust I and Trust II in connection with the sales by those Trusts of \$30.0 in mandatorily redeemable preferred capital securities to third party investors. Between December 2009 and January 2010, the Corporation issued approximately \$10.8 million of TPS Debentures to Trust III in connection with the sale by Trust III of approximately \$10.5 million in mandatorily redeemable preferred capital securities to third party investors. The terms of the TPS Debentures require the Corporation to make quarterly payments of interest to the Trusts, as the holders of the TPS Debentures, although the Corporation has the right to defer payments of interest for up to 20 consecutive quarterly periods. An election to defer interest payments does not constitute an event of default under the terms of the TPS Debentures. The terms of the TPS Debentures prohibit the Corporation from declaring or paying any dividends or making other distributions on, or from repurchasing, redeeming or otherwise acquiring, any shares of its common stock or shares of its Series A Preferred Stock if the Corporation elects to defer quarterly interest payments under the TPS Debentures. In addition, a deferral election will require the Trusts to likewise defer the payment of quarterly dividends on their related trust preferred securities.

Unless and until the Corporation is advised otherwise by the Reserve Bank, the Corporation's ability to make each future quarterly interest payment due under the TPS Debentures will depend on its receipt of an approval from the Reserve Bank. As a result, and in light of the fact that the Corporation relies primarily on cash dividends from the Bank to make interest payments, no assurance can be given that the Corporation will make regularly-scheduled quarterly interest payments under its TPS Debentures. If the Corporation were to defer interest payments, then it would be prohibited from paying dividends on its outstanding equity securities until the termination of such termination. The Corporation has received approvals to pay all subsequent quarterly dividends through March 2017.

**If the Corporation fails to make six quarterly dividend payments on the Series A Preferred Stock, then the holders thereof would have the right to elect up to two additional directors to the Corporation's Board of Directors.**

The terms of the Series A Preferred Stock permit the Corporation to defer the payment of quarterly dividends, but, in that case, undeclared dividends will continue to accrue and must be paid in full at the time the Corporation terminates the dividend deferral. The terms provide further that whenever, at any time or times, dividends payable on the outstanding shares of the Series A Preferred Stock have not been paid for an aggregate of six quarterly dividend periods or more, whether or not consecutive, the authorized number of directors then constituting the Corporation's Board of Directors will automatically be increased by two. Thereafter, holders of the Series A Preferred Stock, together with holders of any outstanding stock having voting rights similar to the Series A Preferred Stock, voting as a single class, will be entitled to fill the vacancies created by the automatic increase by electing up to two additional directors (the "Preferred Stock Directors") at the next annual meeting (or at a special meeting called for the purpose of electing the Preferred Stock Directors prior to the next annual meeting) and at each subsequent annual meeting until

all accrued and unpaid dividends for all past dividend periods have been paid in full. Currently, the Corporation does not have any outstanding capital stock with voting rights that are on par with the Series A Preferred Stock.

**Applicable banking and Maryland laws impose additional restrictions on the ability of the Corporation and the Bank to pay dividends and make other distributions on their capital securities, and, in any event, the payment of dividends is at the discretion of the boards of directors of the Corporation and the Bank.**

In the past, the Corporation has funded dividends on its capital securities using cash received from the Bank, and this will likely be the case for the foreseeable future. No assurance can be given that the Bank will be able to pay dividends to the Corporation for these purposes at times and/or in amounts requested by the Corporation. Both federal and state laws impose restrictions on the ability of the Bank to pay dividends. Under Maryland law, a state-chartered commercial bank may pay dividends only out of undivided profits or, with the prior approval of the Maryland Commissioner, from surplus in excess of 100% of required capital stock. If, however, the surplus of a Maryland bank is less than 100% of its required capital stock, cash dividends may not be paid in excess of 90% of net earnings. In addition to these specific restrictions, bank regulatory agencies have the ability to prohibit proposed dividends by a financial institution which would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice. Banks that are considered “troubled institution” are prohibited by federal law from paying dividends altogether. Notwithstanding the foregoing, shareholders must understand that the declaration and payment of dividends and the amounts thereof are at the discretion of the Corporation’s Board of Directors. Thus, even at times when the Corporation is not prohibited from paying cash dividends on its capital securities, neither the payment of such dividends nor the amounts thereof can be guaranteed.

**The Corporation’s Articles of Incorporation and Bylaws and Maryland law may discourage a corporate takeover.**

The Corporation’s Amended and Restated Articles of Incorporation (the “Charter”) and its Amended and Restated Bylaws, as amended (the “Bylaws”) contain certain provisions designed to enhance the ability of the Corporation’s Board of Directors to deal with attempts to acquire control of the Corporation. First, the Board of Directors is classified into three classes. Directors of each class serve for staggered three-year periods, and no director may be removed except for cause, and then only by the affirmative vote of either a majority of the entire Board of Directors or a majority of the outstanding voting stock. Second, the board has the authority to classify and reclassify unissued shares of stock of any class or series of stock by setting, fixing, eliminating, or altering in any one or more respects the preferences, rights, voting powers, restrictions and qualifications of, dividends on, and redemption, conversion, exchange, and other rights of, such securities. The board could use this authority, along with its authority to authorize the issuance of securities of any class or series, to issue shares having terms favorable to management to a person or persons affiliated with or otherwise friendly to management. In addition, the Bylaws require any shareholder who desires to nominate a director to abide by strict notice requirements.

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Maryland law also contains anti-takeover provisions that apply to the Corporation. The Maryland Business Combination Act generally prohibits, subject to certain limited exceptions, corporations from being involved in any “business combination” (defined as a variety of transactions, including a merger, consolidation, share exchange, asset transfer or issuance or reclassification of equity securities) with any “interested shareholder” for a period of five years following the most recent date on which the interested shareholder became an interested shareholder. An interested shareholder is defined generally as a person who is the beneficial owner of 10% or more of the voting power of the outstanding voting stock of the corporation after the date on which the corporation had 100 or more beneficial owners of its stock or who is an affiliate or associate of the corporation and was the beneficial owner, directly or indirectly, of 10% percent or more of the voting power of the then outstanding stock of the corporation at any time within the two-year period immediately prior to the date in question and after the date on which the corporation had 100 or more beneficial owners of its stock. The Maryland Control Share Acquisition Act applies to acquisitions of “control shares”, which, subject to certain exceptions, are shares the acquisition of which entitle the holder, directly or indirectly, to exercise or direct the exercise of the voting power of shares of stock of the corporation in the election of directors within any of the following ranges of voting power: one-tenth or more, but less than one-third of all voting power; one-third or more, but less than a majority of all voting power or a majority or more of all voting power. Control shares have limited voting rights.

Although these provisions do not preclude a takeover, they may have the effect of discouraging, delaying or deferring a tender offer or takeover attempt that a shareholder might consider in his or her best interest, including those attempts that might result in a premium over the market price for the common stock. Such provisions will also render the removal of the Board of Directors and of management more difficult and, therefore, may serve to perpetuate current management. These provisions could potentially adversely affect the market prices of the Corporation’s securities.

#### **ITEM 1B.UNRESOLVED STAFF COMMENTS**

This Item 1B is not applicable because the Corporation is a “smaller reporting company”.

#### **ITEM 2.PROPERTIES**

The headquarters of the Corporation and the Bank occupies approximately 29,000 square feet at 19 South Second Street, Oakland, Maryland, a 30,000 square feet operations center located at 12892 Garrett Highway, Oakland Maryland and 8,500 square feet at 102 South Second Street, Oakland, Maryland. These premises are owned by the Corporation. The Bank owns 19 of its banking offices and leases five. The Bank also leases one office that is used for disaster recovery purposes. Total rent expense on the leased offices and properties was \$.5 million in 2016.

#### **ITEM 3.LEGAL PROCEEDINGS**

We are at times, in the ordinary course of business, subject to legal actions. Management, upon the advice of counsel, believes that losses, if any, resulting from current legal actions will not have a material adverse effect on our financial condition or results of operations.

**ITEM 4.MINE SAFETY DISCLOSURES**

Not applicable.

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**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Shares of the Corporation's common stock are listed on the NASDAQ Global Select Market under the symbol "FUNC". As of February 27, 2017, the Corporation had 1,502 shareholders of record. The high and low sales prices for the shares of the Corporation's common stock for each quarterly period of 2016 and 2015 are set forth below. On March 7, 2017, the closing sales price of the common stock as reported on the NASDAQ Global Select Market was \$13.50 per share. During 2016 and 2015, the Corporation did not declare any dividends on its common stock.

	High	Low
2016		
1 <sup>st</sup> Quarter	\$11.70	\$8.82
2 <sup>nd</sup> Quarter	11.34	9.65
3 <sup>rd</sup> Quarter	12.38	9.58
4 <sup>th</sup> Quarter	16.95	11.06
2015		
1 <sup>st</sup> Quarter	\$9.50	\$8.21
2 <sup>nd</sup> Quarter	9.46	8.36
3 <sup>rd</sup> Quarter	8.83	8.01
4 <sup>th</sup> Quarter	11.89	7.91

The ability of the Corporation to declare dividends is limited by federal banking laws and Maryland corporation laws. Subject to these and the terms of its other securities, including the Series A Preferred Stock and the TPS Debentures, the payment of dividends on the shares of common stock and the amounts thereof are at the discretion of the Corporation's Board of Directors. Prior to November 2010, cash dividends were typically declared on a quarterly basis. When paid, dividends to shareholders have historically been dependent on the ability of the Corporation's subsidiaries, especially the Bank, to declare dividends to the Corporation. Like the Corporation, the Bank's ability to declare and pay dividends is subject to limitations imposed by federal and Maryland banking and Maryland corporation laws. A complete discussion of these and other dividend restrictions is contained in Item 1A of Part I of this annual report under the heading "*Risks Relating to First United Corporation's Securities*" and in Note 21 to the Consolidated Financial Statements, both of which are incorporated herein by reference. Accordingly, there can be no assurance that dividends will be declared on the shares of common stock in any future fiscal quarter.

The Corporation's Board of Directors periodically evaluates the Corporation's dividend policy both internally and in consultation with the Federal Reserve.

### **Issuer Repurchases**

Neither the Corporation nor any of its affiliates (as defined by Exchange Act Rule 10b-18) repurchased any shares of the Corporation's common stock during 2016.

### **Equity Compensation Plan Information**

Pursuant to the SEC's Regulation S-K Compliance and Disclosure Interpretation 106.01, the information regarding the Corporation's equity compensation plans required by this Item pursuant to Item 201(d) of Regulation S-K is located in Item 12 of Part III of this annual report and is incorporated herein by reference.

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**ITEM 6. SELECTED FINANCIAL DATA**

The following table sets forth certain selected financial data for each of the last five calendar years and is qualified in its entirety by the detailed information and financial statements, including notes thereto, included elsewhere or incorporated by reference in this annual report.

(Dollars in thousands, except for share data)	2016	2015	2014	2013	2012	
<b>Balance Sheet Data</b>						
Total Assets	\$ 1,318,190	\$ 1,323,458	\$ 1,332,296	\$ 1,334,046	\$ 1,321,296	
Net Loans	882,008	867,101	827,926	796,646	858,782	
Investment Securities	237,169	275,792	330,566	340,489	227,313	
Deposits	1,014,229	998,794	981,323	977,403	976,884	
Long-term Borrowings	131,737	147,537	182,606	182,672	182,735	
Shareholders' Equity	113,698	120,771	108,999	101,883	99,418	
<b>Operating Data</b>						
Interest Income	\$45,863	\$45,032	\$46,386	\$49,914	\$53,111	
Interest Expense	8,223	9,407	10,870	11,732	13,965	
Net Interest Income	37,640	35,625	35,516	38,182	39,146	
Provision for Loan Losses	3,122	1,054	2,513	380	9,390	
Other Operating Income	14,127	24,992	12,907	13,137	13,658	
Net Gains	526	1,016	1,053	229	1,708	
Other Operating Expense	39,107	41,115	40,095	42,471	39,518	
Income Before Taxes	10,064	19,464	6,868	8,697	5,604	
Income Tax expense	2,783	6,473	1,271	2,222	913	
Net Income	\$7,281	\$12,991	\$5,597	\$6,475	\$4,691	
Accumulated preferred stock dividend and discount accretion	(2,025 )	(2,700 )	(2,601 )	(1,778 )	(1,691 )	
Net income available to common shareholders	\$5,256	\$10,291	\$2,996	\$4,697	\$3,000	
<b>Per Share Data</b>						
Basic and diluted net income per common share	\$0.84	\$1.65	\$0.48	\$0.76	\$0.48	
Book Value	14.95	14.51	13.30	11.49	11.14	
<b>Significant Ratios</b>						
Return on Average Assets	0.55	% 0.98	% 0.42	% 0.49	% 0.34	%
Return on Average Equity	6.38	% 11.40	% 5.07	% 6.48	% 4.79	%
Average Equity to Average Assets	8.62	% 8.69	% 8.26	% 7.52	% 7.19	%
Total Risk-based Capital Ratio	16.71	% 17.21	% 15.40	% 15.33	% 14.13	%
Tier I Capital to Risk Weighted Assets	14.76	% 15.24	% 14.23	% 13.71	% 12.54	%
Tier I Capital to Average Assets	10.95	% 11.64	% 11.29	% 11.02	% 10.32	%
	10.74	% 9.99	%			

Common Equity Tier I to Risk Weighted  
Assets

[24]

## **ITEM 7: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This discussion and analysis should be read in conjunction with the Consolidated Financial Statements and notes thereto for the years ended December 31, 2016 and 2015, which are included in Item 8 of Part II of this annual report.

### **Recent Development**

On November 7, 2016, the Corporation announced that it had filed a Registration Statement on Form S-1 with the SEC in connection with a proposed common stock rights offering (the "Registration Statement"). On February 8, 2017, the Registration Statement was declared effective by the SEC. Shortly thereafter, the Corporation distributed, at no charge and on a pro-rata basis, non-transferable rights to purchase an aggregate of 783,626 shares of the Corporation's common stock at a subscription price of \$11.93 per share. Rights were distributed to each person who held shares of the common stock as of 5:00 p.m., Eastern Standard Time, on November 28, 2016. The offering period is scheduled to expire at 5:00 pm on March 17, 2017 unless the Corporation extends the offering for an additional 30-day period, until April 16, 2017. To facilitate the offering, the Corporation entered into standby purchase agreements (the "Standby Agreements") with third-party accredited investors (the "Standby Purchasers") pursuant to which they agreed to purchase, at the same subscription price of \$11.93 per share, up to an aggregate of 570,304 the shares of common stock being offered in the rights offering to the extent that such shares are not purchased by rights holders. Any sale of shares to the Standby Purchasers will be effected in a private placement transaction in reliance on the exemption from the registration requirements of the Securities Act afforded by Section 4(a)(2) thereof and Regulation D promulgated thereunder. The closing of the transactions contemplated by the Standby Agreements is subject to various terms and conditions. No assurance can be given with respect to whether the Corporation will sell any shares to the Standby Purchasers or the number of shares that may be sold in connection with any such sales. The Corporation intends to use the proceeds of the foregoing offerings, after paying its offering expenses, to offset the impact of its planned redemption of \$10.0 million of Series A Preferred Stock and its planned repayment of \$10.8 million of junior subordinated debentures issued to Trust III.

### **Overview**

First United Corporation is a bank holding company that, through the Bank and its non-bank subsidiaries, provides an array of financial products and services primarily to customers in four Western Maryland counties and three Northeastern West Virginia counties. Its principal operating subsidiary is the Bank, which consists of a community banking network of 23 branch offices located throughout its market areas. Our primary sources of revenue are interest income earned from our loan and investment securities portfolios and fees earned from financial services provided to customers.

Consolidated net income available to common shareholders was \$5.3 million for the year ended December 31, 2016, compared to \$10.3 million for 2015. Basic and diluted net income per common share for the year ended December 31, 2016 were both \$.84, compared to basic and diluted net income per common share of \$1.65 for 2015. The decrease in earnings for 2016 was primarily attributable to an \$11.6 million arbitration award received in November 2015 that was recorded in other income. The reduction was offset by increases of \$.2 million in trust department earnings, \$.3 million in service charge income, and \$.3 million in Bank Owned Life Insurance (“BOLI”) income and decreases in operating expenses such as salaries and employee benefits, FDIC premiums, data processing expenses, professional services expenses associated with the arbitration award and Other Real Estate Owned (“OREO”) expenses. The net interest margin for the year ended December 31, 2016, on a fully tax equivalent (“FTE”) basis, increased to 3.19% from 3.04% for the year ended December 31, 2015.

The provision for loan losses increased to \$3.1 million for the year ended December 31, 2016 compared to \$1.1 million for the year ended December 31, 2015. The increase was driven by higher net charge-offs, particularly charge-offs of \$2.5 million on a mall in Pennsylvania. Specific allocations have been made for impaired loans where management has determined that the collateral supporting the loans is not adequate to cover the loan balance, and the qualitative factors affecting the allowance for loan losses (the “ALL”) have been adjusted based on the current economic environment and the characteristics of the loan portfolio.

Other operating income decreased \$11.4 million for the year ended December 31, 2016 when compared to 2015. This decrease was primarily attributable to the \$11.6 million arbitration award discussed above. As compared to 2015, the Company experienced increases in trust department earnings of \$.2 million, service charge income of \$.3 million, and BOLI income of \$.3 million for 2016. The increase in BOLI was a result of a one-time death benefit received in the second quarter of 2016.

Operating expenses decreased \$2.0 million for the year ended December 31, 2016 when compared to the same period of 2015. This decrease was due to a decrease of \$.3 million in salaries and benefits primarily due to decreased health care costs, a decrease of \$.5 million in professional services due to a decrease in legal expenses incurred for litigation in 2015, a \$.9 million decrease in FDIC premiums, \$.4 million in data processing expense and a decrease of \$1.1 million in OREO expenses due to reductions in valuation write-downs on properties. The decreases were offset by an increase of \$1.2 million in other miscellaneous expenses due to increased trust expenses, reserves for litigation claims, miscellaneous loan fees and debit card fraud expenses.

[25]

Comparing December 31, 2016 to December 31, 2015, loans outstanding increased \$12.9 million (1.5%). CRE loans increased \$17.5 million as a result of several new relationships booked during 2016. Acquisition and development (“A&D”) loans decreased \$6.7 million due to payoffs in the third quarter 2016. Commercial and industrial (“C&I”) loans decreased \$1.6 million due to regularly scheduled amortization. Residential mortgage loans increased \$4.7 million due to increased production primarily in our 5/1 and 7/1 ARM programs. The Bank continues to sell new, longer term, fixed-rate residential loan originations to Fannie Mae. The consumer loan portfolio decreased slightly by \$1.0 million due to our decision to discontinue indirect auto lending. Approximately 39% of the commercial loan portfolio was collateralized by real estate at both December 31, 2016 and December 31, 2015.

Interest income on loans increased by \$1.8 million (on a FTE basis) in 2016 when compared to 2015 due to loan growth early in 2016. Interest income on our investment securities decreased by \$1.3 million (on a FTE basis) in 2016 when compared to 2015 due to sales and calls on the investment portfolio. This shift in interest income was due to our strategic focus to change the asset mix to higher earning assets by utilizing cash flows from the investment portfolio to fund loan growth. Additional information on the composition of interest income is available in Table 1 that appears on page 31 of this report.

Total deposits increased \$15.4 million at December 31, 2016 when compared to December 31, 2015. During 2016, we continued our focus on changing the mix of our deposit portfolio from higher cost certificates of deposit to lower cost core accounts. Non-interest bearing deposits increased \$14.6 million. Traditional savings accounts increased \$8.9 million due to continued growth in our Prime Saver product. Total demand deposits decreased \$4.0 million and total money market accounts increased \$9.4 million. Time deposits less than \$100,000 declined \$12.6 million and time deposits greater than \$100,000 decreased \$.9 million. The growth in the brokered/ICS money market balances was primarily due to the shift of balances for retail customers to this product to maintain liquidity as well as insurance protection.

Interest expense on our interest-bearing liabilities decreased \$1.2 million for the year ended December 31, 2016 when compared to 2015 due to a decrease of \$18.4 million in average long-term borrowings as a result of the repayment of a \$30.0 million FHLB advance in July 2015 and a \$30.4 million decrease in average time deposits. The increase of 12 basis points on the average rate paid on long-term borrowings was offset by a 22 basis point decrease in time deposits. Our retail staff continued their focus on shifting the mix of deposits from higher cost certificates of deposit to lower cost core accounts.

**Dividends** - The Corporation’s Board of Directors suspended the payment of dividends on outstanding shares of common stock in December 2010.

**Looking Forward** - We will continue to face risks and challenges in the future, including, without limitation, changes in local economic conditions in our core geographic markets, potential yield compression on loan and deposit products

from existing competitors and potential new entrants in our markets, fluctuations in interest rates, and changes to existing federal and state laws and regulations that apply to banks and financial holding companies. For a more complete discussion of these and other risk factors, see Item 1A of Part I of this annual report.

## **Estimates and Critical Accounting Policies**

This discussion and analysis of our financial condition and results of operations is based upon our Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. (See Note 1 to the Consolidated Financial Statements.) On an on-going basis, management evaluates estimates and bases those estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Management believes the following critical accounting policies affect our more significant judgments and estimates used in the preparation of the Consolidated Financial Statements.

### *Allowance for Loan Losses*

One of our most important accounting policies is that related to the monitoring of the loan portfolio. A variety of estimates impact the carrying value of the loan portfolio and resulting interest income, including the calculation of the ALL, the valuation of underlying collateral, and the timing of loan charge-offs. The ALL is established and maintained at a level that management believes is adequate to cover losses resulting from the inability of borrowers to make required payments on loans. Estimates for loan losses are arrived at by analyzing risks associated with specific loans and the loan portfolio, current and historical trends in delinquencies and charge-offs, and changes in the size and composition of the loan portfolio. The analysis also requires consideration of the economic climate and direction, changes in lending rates, political conditions, legislation impacting the banking industry and economic conditions specific to Western Maryland and Northeastern West Virginia. Because the calculation of the ALL relies on management's estimates and judgments relating to inherently uncertain events, actual results may differ from management's estimates.

[26]



The ALL is also discussed below in Item 7 under the heading “Allowance for Loan Losses” and in Note 7 to the Consolidated Financial Statements.

### *Goodwill*

Accounting Standards Codification (“ASC”) Topic 350, *Intangibles - Goodwill and Other*, establishes standards for the amortization of acquired intangible assets and impairment assessment of goodwill. The \$11.0 million in recorded goodwill at December 31, 2016 is related to the Bank’s 2003 acquisition of Huntington National Bank branches and is not subject to periodic amortization.

Goodwill arising from business combinations represents the value attributable to unidentifiable intangible elements in the business acquired. Goodwill is not amortized but is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Impairment testing requires that the fair value of each of an entity’s reporting units be compared to the carrying amount of its net assets, including goodwill. If the estimated current fair value of the reporting unit exceeds its carrying value, then no additional testing is required and an impairment loss is not recorded. Otherwise, additional testing is performed and, to the extent such additional testing results in a conclusion that the carrying value of goodwill exceeds its implied fair value, an impairment loss is recognized.

For evaluation purposes, the Corporation is considered to be a single reporting unit. Accordingly, our goodwill relates to value inherent in the banking business and the value is dependent upon our ability to provide quality, cost effective services in a highly competitive local market. This ability relies upon continuing investments in processing systems, the development of value-added service features and the ease of use of our services. As such, goodwill value is supported ultimately by revenue that is driven by the volume of business transacted. A decline in earnings as a result of a lack of growth or the inability to deliver cost effective services over sustained periods can lead to impairment of goodwill, which could adversely impact earnings in future periods. ASC Topic 350 requires an annual evaluation of goodwill for impairment. The determination of whether or not these assets are impaired involves significant judgments and estimates.

At December 31, 2016, the date of the Corporation’s annual impairment test, the fair value of the Corporation as determined by the price of its common stock exceeded the carrying amount of the Corporation’s common equity.

Based on the results of the evaluation, management concluded that the recorded value of goodwill at December 31, 2016 was not impaired. However, future changes in strategy and/or market conditions could significantly impact these judgments and require adjustments to recorded asset balances. Management will continue to evaluate goodwill

for impairment on an annual basis and as events occur or circumstances change.

*Accounting for Income Taxes*

We account for income taxes in accordance with ASC Topic 740, “*Income Taxes*”. Under this guidance, deferred taxes are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates that will apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized as income or expense in the period that includes the enactment date.

We regularly review the carrying amount of our net deferred tax assets to determine if the establishment of a valuation allowance is necessary. If based on the available evidence, it is more likely than not that all or a portion of our net deferred tax assets will not be realized in future periods, then a deferred tax valuation allowance must be established. Consideration is given to various positive and negative factors that could affect the realization of the deferred tax assets. In evaluating this available evidence, management considers, among other things, historical performance, expectations of future earnings, the ability to carry back losses to recoup taxes previously paid, length of statutory carry forward periods, experience with utilization of operating loss and tax credit carry forwards not expiring, tax planning strategies and timing of reversals of temporary differences. Significant judgment is required in assessing future earnings trends and the timing of reversals of temporary differences. Our evaluation is based on current tax laws as well as management’s expectations of future performance.

Management expects that the Corporation’s adherence to the required accounting guidance may result in increased volatility in quarterly and annual effective income tax rates because of changes in judgment or measurement including changes in actual and forecasted income before taxes, tax laws and regulations, and tax planning strategies.

[27]

### *Other-Than-Temporary Impairment of Investment Securities*

Management systematically evaluates the securities in our investment portfolio for impairment on a quarterly basis. Based upon the application of accounting guidance for subsequent measurement in ASC Topic 320 (Section 320-10-35), management assesses whether (i) we have the intent to sell a security being evaluated and (ii) it is more likely than not that we 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 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 (a) the length of time and the extent to which the fair value has been less than cost, (b) adverse conditions specifically related to the security, an industry, or a geographic area, (c) the historic and implied volatility of the fair value of the security, (d) changes in the rating of the security by a rating agency, (e) recoveries or additional declines in fair value subsequent to the balance sheet date, (f) failure of the issuer of the security to make scheduled interest or principal payments, and (g) 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). This process is described more fully in the section of the Consolidated Balance Sheet Review entitled “Investment Securities”.

### *Fair Value of Investments*

We have determined the fair value of our investment securities in accordance with the requirements 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. We measure the fair market values of our investments based on the fair value hierarchy established in Topic 820. The determination of fair value of investments and other assets is discussed further in Note 24 to the Consolidated Financial Statements.

### *Pension Plan Assumptions*

Our pension plan costs are calculated using actuarial concepts, as discussed within the requirements of ASC Topic 715, *Compensation – Retirement Benefits*. Pension expense and the determination of our projected pension liability are based upon two critical assumptions: the discount rate and the expected return on plan assets. We evaluate each of these critical assumptions annually. Other assumptions impact the determination of pension expense and the projected liability including the primary employee demographics, such as retirement patterns, employee turnover, mortality rates, and estimated employer compensation increases. These factors, along with the critical assumptions, are carefully

reviewed by management each year in consultation with our pension plan consultants and actuaries. Further information about our pension plan assumptions, the plan's funded status, and other plan information is included in Note 18 to the Consolidated Financial Statements.

Other than as discussed above, management does not believe that any material changes in our critical accounting policies have occurred since December 31, 2016.

*Adoption of New Accounting Standards and Effects of New Accounting Pronouncements*

Note 1 to the Consolidated Financial Statements discusses new accounting pronouncements that, when adopted, could affect our future consolidated financial statements.

**CONSOLIDATED STATEMENT OF INCOME REVIEW**

**Net Interest Income**

Net interest income is our largest source of operating revenue. Net interest income is the difference between the interest that we earn on our interest-earning assets and the interest expense we incur on our interest-bearing liabilities. For analytical and discussion purposes, net interest income is adjusted to an FTE basis to facilitate performance comparisons between taxable and tax-exempt assets by increasing tax-exempt income by an amount equal to the federal income taxes that would have been paid if this income were taxable at the statutorily applicable rate. This is a Non-GAAP disclosure and management believes it is not materially different than GAAP.

The table below summarizes net interest income (on an FTE basis) for 2016 and 2015.

(Dollars in thousands)	2016	2015
Interest income	\$46,418	45,827
Interest expense	8,223	9,407
Net interest income	\$38,195	\$36,420
Net interest margin %	3.19 %	3.04 %

Net interest income on an FTE basis increased \$1.8 million (4.9%) for the year ended December 31, 2016 when compared to 2015 due to a \$.6 million (1.3%) increase in interest income and a \$1.2 million (12.6%) decrease in

interest expense. The slight increase in interest income was primarily due to an increase of \$53.1 million in the average balance of loans offset by a decrease in interest income on investments due to a decline in average investments of \$61.9 million. The decline in interest expense was due to the reduction of \$18.3 million in average balances of long-term borrowings due to the payoff of a \$30.0 million FHLB advance in July 2015 and the continued shift in deposits from higher cost certificates of deposit to lower cost core accounts. We saw an increase in the net interest margin for the year ended December 31, 2016 to 3.19% when compared to 3.04% for the year ended December 31, 2015.

[28]

When comparing the year ended December 31, 2016 to the year ended December 31, 2015, there was a slight increase of \$1.1 million in average interest-earning assets, driven by an increase of \$53.1 million in average loan balances and an increase of \$12.6 million in fed funds sold, offset by a decrease of \$61.9 million in investment securities.

Interest expense decreased for the year ended December 31, 2016 when compared to the year ended December 31, 2015. This decrease was primarily due to the continued shift of higher cost certificates of deposit to lower cost core deposits. The effect of this shift was a decrease in average balances in certificates of deposit of \$30.4 million and a decrease of 22 basis points in the average rate paid on certificates of deposit and a decrease of 13 basis points in the average rate paid on core deposits, even though the average balance on core deposits increased \$61.3 million. Although the average balance in long-term borrowings decreased \$18.4 million, due primarily to the payoff of a \$30.0 million FHLB advance in July 2015, the effective rate paid on long-term borrowings increased 12 basis points due to the increase in rates paid on off-balance sheet interest rate swaps compared to 2015. The effect on the average rate paid on total interest-bearing liabilities was a 13 basis point decrease from .97% for 2015 to .84% for 2016.

As shown below, the composition of total interest income between 2016 and 2015 remained relatively stable between interest and fees on loans and investment securities with a slight increase in interest and fees on loans offset by a decrease in interest on investment securities. This shift is due to our strategic focus to change the asset mix to higher earning assets.

	% of Total Interest Income			
	2016		2015	
Interest and fees on loans	85	%	82	%
Interest on investment securities	14	%	17	%
Other	1	%	1	%

[29]

Table 1 sets forth the average balances, net interest income and expense, and average yields and rates for our interest-earning assets and interest-bearing liabilities for 2016, 2015 and 2014. Table 2 sets forth an analysis of volume and rate changes in interest income and interest expense of our average interest-earning assets and average interest-bearing liabilities for 2016, 2015 and 2014. Table 2 distinguishes between the changes related to average outstanding balances (changes in volume created by holding the interest rate constant) and the changes related to average interest rates (changes in interest income or expense attributed to average rates created by holding the outstanding balance constant).

### Distribution of Assets, Liabilities and Shareholders' Equity

#### Interest Rates and Interest Differential – Tax Equivalent Basis

**Table 1**

(Dollars in thousands)	For the Years Ended December 31								
	2016 Average Balance	Interest	Average Yield/Rate	2015 Average Balance	Interest	Average Yield/Rate	2014 Average Balance	Interest	Average Yield/Rate
<b>Assets</b>									
Loans	\$899,516	\$38,981	4.33%	\$846,391	\$37,201	4.40%	\$820,076	\$37,525	4.58%
<b>Investment Securities:</b>									
Taxable	228,174	5,611	2.46	276,063	6,248	2.26	288,022	6,981	2.42
Non taxable	20,840	1,391	6.67	34,820	2,023	5.81	52,408	2,467	4.71
Total	249,014	7,002	2.81	310,883	8,271	2.66	340,430	9,448	2.78
Federal funds sold	40,011	161	0.40	27,411	49	0.18	37,069	84	0.23
<b>Interest-bearing deposits with other banks</b>									
Other interest earning assets	2,032	4	0.20	4,022	4	0.10	7,931	2	0.03
Total earning assets	1,196,428	46,418	3.88%	1,195,348	45,827	3.83%	1,213,105	47,350	3.90%
Allowance for loan losses	(12,183 )			(12,072 )			(12,558 )		
Non-earning assets	140,819			127,851			140,666		
<b>Total Assets</b>	<b>\$1,325,064</b>			<b>\$1,311,127</b>			<b>\$1,341,213</b>		
<b>Liabilities and Shareholders' Equity</b>									
	\$176,049	\$137	0.08%	\$149,214	\$104	0.07%	\$139,875	\$127	0.09%

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Interest-bearing demand deposits									
Interest-bearing money markets	234,075	349	0.15	210,109	477	0.23	214,268	501	0.23
Savings deposits	147,428	168	0.11	136,946	228	0.17	123,756	234	0.19
Time deposits:									
Less than \$100k	124,129	1,245	1.00	142,188	1,471	1.03	163,100	1,769	1.08
\$100k or more	120,253	1,251	1.04	132,579	1,625	1.23	145,024	1,972	1.36
Short-term borrowings	31,007	60	0.19	36,048	58	0.16	45,997	63	0.14
Long-term borrowings	146,315	5,013	3.43	164,693	5,444	3.31	182,637	6,204	3.40
Total interest-bearing liabilities	979,256	8,223	0.84%	971,777	9,407	0.97%	1,014,657	10,870	1.07%
Non-interest-bearing deposits	209,948			204,453			196,468		
Other liabilities	21,703			20,925			19,254		
Shareholders' Equity	114,157			113,972			110,834		
Total Liabilities and Shareholders' Equity	\$1,325,064			\$1,311,127			\$1,341,213		
Net interest income and spread		\$38,195	3.04%		\$36,420	2.86%		\$36,480	2.83%
Net interest margin			3.19%			3.04%			3.00%

**Notes:**

The above table reflects the average rates earned or paid stated on a FTE basis assuming a tax rate of 35% for (1) 2016, 2015 and 2014. Non-GAAP interest income on a fully taxable equivalent basis for the years ended December 31, 2016, 2015 and 2014 were \$555, \$795 and \$964, respectively.

(2) The average balances of non-accrual loans for the years ended December 31, 2016, 2015 and 2014, which were reported in the average loan balances for these years, were \$14,953, \$11,952 and \$15,093, respectively.

(3) Net interest margin is calculated as net interest income divided by average earning assets.

(4) The average yields on investments are based on amortized cost.

[30]



**Interest Variance Analysis (1)****Table 2**

(In thousands and tax equivalent basis)	2016 Compared to 2015			2015 Compared to 2014		
	Volume	Rate	Net	Volume	Rate	Net
<b>Interest Income:</b>						
Loans	\$2,302	\$(522)	\$1,780	\$1,157	\$(1,481)	\$(324 )
Taxable Investments	(1,178)	541	(637 )	(271 )	(462 )	(733 )
Non-taxable Investments	(933 )	301	(632 )	(1,022)	578	(444 )
Federal funds sold	51	61	112	(17 )	(18 )	(35 )
Other interest earning assets	(134 )	102	(32 )	(226 )	239	13
Total interest income	108	483	591	(379 )	(1,144)	(1,523)
<b>Interest Expense:</b>						
Interest-bearing demand deposits	21	12	33	7	(30 )	(23 )
Interest-bearing money markets	36	(164)	(128 )	(9 )	(15 )	(24 )
Savings deposits	12	(72 )	(60 )	22	(28 )	(6 )
Time deposits less than \$100	(181 )	(45 )	(226 )	(216 )	(82 )	(298 )
Time deposits \$100 or more	(128 )	(246)	(374 )	(152 )	(195 )	(347 )
Short-term borrowings	(10 )	12	2	(16 )	11	(5 )
Long-term borrowings	(630 )	199	(431 )	(593 )	(167 )	(760 )
Total interest expense	(880 )	(304)	(1,184)	(957 )	(506 )	(1,463)
Net interest income	\$988	\$787	\$1,775	\$578	\$(638 )	\$(60 )

**Note:**

(1) The change in interest income/expense due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

**Provision for Loan Losses**

The provision for loan losses was \$3.1 million for the year ended December 31, 2016 compared to \$1.1 million for the year ended December 31, 2015. The increase in net charge-offs and loan growth during 2016 (discussed below in the section entitled "FINANCIAL CONDITION" under the heading "Allowance and Provision for Loan Losses"), were contributing factors to the increased provision expense. Management believes that the ALL reflects a level commensurate with the risk inherent in our loan portfolio.

**Other Operating Income**

The following table shows the major components of other operating income for the past two years, exclusive of net gains, and the percentage changes during these years:

(Dollars in thousands)	2016	2015	% Change	
Service charges on deposit accounts	\$2,428	\$2,231	8.83	%
Other service charge income	853	764	11.65	%
Debit card income	2,112	2,300	-8.17	%
Trust department income	5,837	5,641	3.47	%
Bank owned life insurance (BOLI) income	1,426	1,146	24.43	%
Brokerage commissions	849	887	-4.28	%
Other income- recovery	0	11,572	-100.00	%
Other income	622	451	37.92	%
Total other operating income	\$14,127	\$24,992	-43.47	%

Other operating income, exclusive of net gains, decreased \$10.9 million for the year ended December 31, 2016 when compared to 2015. This decrease in 2016 was primarily attributable to the \$11.6 million arbitration award received in November 2015. As compared to 2015, the Company experienced increases in trust department earnings of \$.2 million, service charge income of \$.3 million, and BOLI income of \$.3 million for 2016. The increase in BOLI was a result of a one-time death benefit received in the second quarter of 2016. Trust assets under management were \$740 million at December 31, 2016 and \$718 million at December 31, 2015.

[31]

Net gains of \$.5 million were reported through other income for the year ended December 31, 2016, compared to net gains of \$1.0 million for 2015. The reduction in gains realized in 2016 was due to reduced sales of investment securities.

### Other Operating Expense

The following table compares the major components of other operating expense for 2016 and 2015:

(Dollars in thousands)	2016	2015	% Change	
Salaries and employee benefits	\$20,595	\$20,912	-1.52	%
Other expenses	6,309	5,068	24.49	%
FDIC premiums	940	1,870	-49.73	%
Equipment	2,437	2,544	-4.21	%
Occupancy	2,499	2,479	0.81	%
Data processing	3,065	3,429	-10.62	%
Professional services	1,127	1,674	-32.68	%
Other real estate owned expense	802	1,899	-57.77	%
Contract labor	718	607	18.29	%
Line rentals	615	633	-2.84	%
Total other operating expense	\$39,107	\$41,115	-4.88	%

Operating expenses decreased \$2.0 million for the year ended December 31, 2016 when compared to the same period of 2015. This decrease was due to a decrease of \$.3 million in salaries and benefits primarily due to decreased health care costs, a decrease of \$.5 million in professional services due to a decrease in legal expenses incurred for litigation in 2015, a \$.9 million decrease in FDIC premiums, \$.4 million in data processing expense and a decrease of \$1.1 million in OREO expenses due to reductions in valuation write-downs on properties. The decreases were offset by an increase of \$1.2 million in other miscellaneous expenses due to increased trust expenses, reserves for litigation claims, miscellaneous loan fees and debit card fraud expenses.

### Applicable Income Taxes

We recognized a tax expense of \$2.8 million in 2016, compared to a net tax expense of \$6.5 million in 2015. See the discussion under "Income Taxes" in Note 17 to the Consolidated Financial Statements presented elsewhere in this annual report for a detailed analysis of our deferred tax assets and liabilities. A valuation allowance has been provided for the \$1.9 million in state tax loss carry forwards included in deferred tax assets, which will expire commencing in 2030.

At December 31, 2016, we had federal net operating losses (“NOLs”) of approximately \$8.0 million and West Virginia NOLs of approximately \$4.7 million for which deferred tax assets of \$2.8 million and \$.2 million, respectively, have been recorded at December 31, 2016. The federal and West Virginia NOLs were created in 2010, 2012, 2014 and 2016 and will begin expiring in 2030. Management has determined that a deferred tax valuation allowance for these NOLs is not required for 2016 because we believe it is more likely than not that these deferred tax assets will be realized prior to expiration of their carry-forward periods.

At December 31, 2016, the Corporation had Maryland NOLs of \$38.3 million for which a deferred tax asset of \$1.9 million has been recorded. There has been and continues to be a full valuation allowance on these NOLs based on the fact that it is more likely than not that this deferred tax asset will not be realized because the Corporation files a separate Maryland income tax return, has recurring tax losses and will not generate sufficient taxable income in the future to utilize them before they expire. The valuation allowance of \$1.9 million at December 31, 2016 reflects an increase of \$.1 million from the level at December 31, 2015.

We have concluded that no valuation allowance is deemed necessary for our remaining federal and state deferred tax assets at December 31, 2016, as it is more likely than not (defined a level of likelihood that is more than 50%) that they will be realized based on the expected reversal of deferred tax liabilities, the generation of future income sufficient to realize the deferred tax assets as they reverse, and the ability to implement tax planning strategies to prevent the expiration of any carry-forward periods. In making this determination, management considered the following:

the expected reversal of \$.6 million of the total \$4.3 million of deferred tax liabilities at December 31, 2016 in such a manner so as to substantially utilize the dollar for dollar impact against the deferred tax assets at December 31, 2016;

[32]

for the remaining excess deferred tax assets that will not be utilized by the reversal of deferred tax liabilities, our expected future income will be sufficient to utilize the deferred tax assets as they reverse or before any net operating loss, if created, would expire; and tax planning strategies that can provide both one-time increases to taxable income of up to approximately \$13.2 million and recurring annual decreases in unfavorable permanent items.

We will need to generate future taxable income of approximately \$27.5 million to fully utilize the Maryland net deferred tax assets in the years in which they are expected to reverse. Management estimates that we can fully utilize the deferred tax assets in approximately seven years based on the historical pre-tax income and forecasts of estimated future pre-tax income as adjusted for permanent book to tax differences.

## CONSOLIDATED BALANCE SHEET REVIEW

### Overview

Total assets remained stable at \$1.3 billion at December 31, 2016 when compared to assets at December 31, 2015. Comparing 2016 to 2015, cash and interest-bearing deposits in other banks increased \$11.2 million, the investment portfolio decreased \$38.6 million, and gross loans increased \$12.9 million. OREO balances increased \$4.0 million due to the addition of properties during 2016. BOLI increased \$.8 million due to earnings of \$1.4 million, offset by a reduction of \$.6 million from the one-time death benefit received in second quarter of 2016. Total liabilities increased by \$1.8 million for the year ended December 31, 2016 when compared to 2015 due primarily to an increase of \$15.4 million in deposits, offset by a decrease of \$15.8 million in long-term borrowings as a result of the repayment of a \$15.0 million FHLB advance in December 2016. Comparing December 31, 2016 to December 31, 2015, shareholders' equity decreased \$7.1 million as a result of the Corporation's redemption of \$10.0 million of outstanding shares of Series A Preferred Stock in February 2016, and the increase of \$2.5 million in accumulated other comprehensive loss, partially offset by the \$5.3 million in net income recorded for 2016.

The total interest-earning asset mix remained relatively stable at December 31, 2016 and December 31, 2015. The mix for each year is illustrated below:

	Year End Percentage of Total Assets			
	2016		2015	
Cash and cash equivalents	5	%	4	%
Net loans	67	%	66	%
Investments	18	%	21	%

The year-end total liability mix has remained consistent during the two-year period as illustrated below.

	Year End Percentage of Total Liabilities			
	2016		2015	
Total deposits	84	%	83	%
Total borrowings	14	%	15	%

### Loan Portfolio

The Bank is actively engaged in originating loans to customers primarily in Allegany County, Frederick County, Garrett County, and Washington County in Maryland, and in Berkeley County, Mineral County, and Monongalia County in West Virginia; and the surrounding regions of West Virginia and Pennsylvania. We have policies and procedures designed to mitigate credit risk and to maintain the quality of our loan portfolio. These policies include underwriting standards for new credits as well as continuous monitoring and reporting policies for asset quality and the adequacy of the allowance for loan losses. These policies, coupled with ongoing training efforts, have provided effective checks and balances for the risk associated with the lending process. Lending authority is based on the type of the loan, and the experience of the lending officer.

Commercial loans are collateralized primarily by real estate and, to a lesser extent, equipment and vehicles. Unsecured commercial loans represent an insignificant portion of total commercial loans. Residential mortgage loans are collateralized by the related property. Generally, a residential mortgage loan exceeding a specified internal loan-to-value ratio requires private mortgage insurance. Installment loans are typically collateralized, with loan-to-value ratios which are established based on the financial condition of the borrower. We also have made unsecured consumer loans to qualified borrowers meeting our underwriting standards. Additional information about our loans and underwriting policies can be found in Item 1 of Part I of this annual report under the heading “Banking Products and Services”.

[33]

Table 3 sets forth the composition of our loan portfolio. Historically, our policy has been to make the majority of our loan commitments in our market areas. We had no foreign loans in our portfolio as of December 31 for any of the years presented.

### Summary of Loan Portfolio

**Table 3**

The following table presents the composition of our loan portfolio as of December 31 for the past five years:

(In millions)	2016	2015	2014	2013	2012
Commercial real estate	\$298.0	\$280.5	\$256.1	\$268.0	\$298.8
Acquisition and development	104.3	111.0	99.3	107.2	128.4
Commercial and industrial	72.3	73.9	93.3	59.8	69.0
Residential mortgage	393.4	388.7	367.6	350.9	346.9
Consumer	23.9	24.9	23.7	24.3	31.7
Total Loans	\$891.9	\$879.0	\$840.0	\$810.2	\$874.8

Comparing December 31, 2016 to December 31, 2015, loans outstanding increased \$12.9 million (1.5%). CRE loans increased \$17.5 million as a result of several new relationships booked during 2016. Acquisition and development (“A&D”) loans decreased \$6.7 million due to payoffs in the third quarter 2016. Commercial and industrial (“C&I”) loans decreased \$1.6 million due to regularly scheduled amortization. Residential mortgage loans increased \$4.7 million due to increased production primarily in our 5/1 and 7/1 ARM programs. The Bank continues to sell new, longer term, fixed-rate residential loan originations to Fannie Mae. The consumer loan portfolio decreased slightly by \$1.0 million due to our decision to discontinue indirect auto lending. Approximately 39% of the commercial loan portfolio was collateralized by real estate at both December 31, 2016 and December 31, 2015. Adjustable interest rate loans made up 60% of total loans at December 31, 2016 and 62% at December 31, 2015, with the balance being fixed-interest rate loans.

Comparing December 31, 2015 to December 31, 2014, loans outstanding increased \$39.0 million (4.6%). CRE loans increased \$24.4 million as a result new relationships in the fourth quarter 2015. A&D loans increased \$11.7 million primarily due to large relationships booked in the fourth quarter of 2015. C&I loans decreased \$19.4 million due to the payoff of one large loan in the third quarter of 2015. Residential mortgage loans increased \$21.1 million due to increased production of loans in our adjustable and fixed rate mortgage programs. The consumer loan portfolio increased slightly by \$1.2 million.

[34]



The following table sets forth the maturities, based upon contractual dates, for selected loan categories as of December 31, 2016:

#### Maturities of Loan Portfolio at December 31, 2016

**Table 4**

(In thousands)	Maturing Within One Year	Maturing After One Year But Within Five Years	Maturing After Five Years	Total
Commercial Real Estate	\$ 28,182	\$ 91,508	\$ 178,269	\$297,959
Acquisition and Development	41,605	21,366	41,311	104,282
Commercial and Industrial	18,080	34,011	20,255	72,346
Residential Mortgage	7,174	8,067	378,175	393,416
Consumer	3,742	17,526	2,655	23,923
Total Loans	\$ 98,783	\$ 172,478	\$ 620,665	\$891,926
Classified by Sensitivity to Change in Interest Rates				
Fixed-Interest Rate Loans	50,698	137,197	169,582	357,477
Adjustable-Interest Rate Loans	48,085	35,281	451,083	534,449
Total Loans	\$ 98,783	\$ 172,478	\$ 620,665	\$891,926

Management 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 required payment is past due. A loan is considered to be past due when a scheduled 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. Our policy for recognizing interest income on impaired loans does not differ from our overall policy for interest recognition.

[35]

Table 5 sets forth the amounts of non-accrual, past-due and restructured loans for the past five years:

## Risk Elements of Loan Portfolio

**Table 5**

(In thousands)	At December 31,				
	2016	2015	2014	2013	2012
<b>Non-accrual loans:</b>					
Commercial real estate	\$12,211	\$11,282	\$5,762	\$7,433	\$6,194
Acquisition and development	45	1,817	3,609	5,632	10,778
Commercial and industrial	0	185	171	191	176
Residential mortgage	1,690	2,214	2,009	4,126	2,731
Consumer	0	0	0	14	36
<b>Total non-accrual loans</b>	<b>\$13,946</b>	<b>\$15,498</b>	<b>\$11,551</b>	<b>\$17,396</b>	<b>\$19,915</b>
<b>Accruing Loans Past Due 90 days or more:</b>					
Commercial real estate	\$0	\$0	\$0	\$65	\$0
Acquisition and development	0	0	1	282	200
Commercial and industrial	11	0	4	133	0
Residential mortgage	382	998	485	730	1,888
Consumer	27	27	39	24	58
<b>Total accruing loans past due 90 days or more</b>	<b>\$420</b>	<b>\$1,025</b>	<b>\$529</b>	<b>\$1,234</b>	<b>\$2,146</b>
<b>Total non-accrual and past due 90 days or more</b>	<b>\$14,366</b>	<b>\$16,523</b>	<b>\$12,080</b>	<b>\$18,630</b>	<b>\$22,061</b>
<b>Restructured Loans (TDRs):</b>					
Performing	\$7,336	\$8,168	\$7,621	\$10,567	\$12,134
Non-accrual (included above)	1,987	5,851	6,063	7,380	5,540
<b>Total TDRs</b>	<b>\$9,323</b>	<b>\$14,019</b>	<b>\$13,684</b>	<b>\$17,947</b>	<b>\$17,674</b>
<b>Other Real Estate Owned</b>	<b>\$10,910</b>	<b>\$6,883</b>	<b>\$12,932</b>	<b>\$17,031</b>	<b>\$17,513</b>
<b>Impaired loans without a valuation allowance</b>	<b>\$23,131</b>	<b>\$20,940</b>	<b>\$19,937</b>	<b>\$24,296</b>	<b>\$39,361</b>
<b>Impaired loans with a valuation allowance</b>	<b>869</b>	<b>3,868</b>	<b>4,844</b>	<b>9,013</b>	<b>8,481</b>
<b>Total impaired loans</b>	<b>\$24,000</b>	<b>\$24,808</b>	<b>\$24,781</b>	<b>\$33,309</b>	<b>\$47,842</b>
<b>Valuation allowance related to impaired loans</b>	<b>\$260</b>	<b>\$1,157</b>	<b>\$1,236</b>	<b>\$2,283</b>	<b>\$1,632</b>

## Non-Accrual Loans as a % of Applicable Portfolio

	2016	2015	2014	2013	2012
Commercial real estate	4.1 %	4.0 %	2.3 %	2.8 %	2.1 %

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Acquisition and development	0.1 %	1.6 %	3.6 %	5.3 %	8.4 %
Commercial and industrial	0.0 %	0.3 %	0.2 %	0.3 %	0.3 %
Residential mortgage	0.4 %	0.6 %	0.5 %	1.2 %	0.8 %
Consumer	0.0 %	0.0 %	0.0 %	0.1 %	0.1 %

Interest income not recognized as a result of placing loans on non-accrual status was \$.6 million for the year ended December 31, 2016, and we recognized, on a cash basis, \$24 thousand of interest income during 2016.

[36]

Performing loans considered to be impaired (including performing troubled debt restructurings, or TDRs), as defined and identified by management, amounted to \$10.3 million at December 31, 2016 and \$9.3 million at December 31, 2015. Loans are identified as impaired when, based on current information and events, management determines that we will be unable to collect all amounts due according to contractual terms. These loans consist primarily of A&D loans and CRE loans. The fair values are generally determined based upon independent third party appraisals of the collateral or discounted cash flows based upon the expected proceeds. Specific allocations have been made where management believes there is insufficient collateral to repay the loan balance if liquidated and there is no secondary source of repayment available.

The level of performing impaired loans (other than performing TDRs) increased \$1.8 million during the year ended December 31, 2016 due to the addition of a single relationship with two CRE loans totaling \$1.6 million and one \$.3 million C&I loan.

The following table presents the details of TDRs by loan class at December 31, 2016 and December 31, 2015:

(Dollars in thousands)	December 31, 2016		December 31, 2015	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
<b>Performing</b>				
<b>Commercial real estate</b>				
Non owner-occupied	3	\$ 385	3	\$ 399
All other CRE	3	3,044	2	2,965
<b>Acquisition and development</b>				
1-4 family residential construction	1	582	1	700
All other A&D	2	1,898	2	1,980
Commercial and industrial	0	0	2	890
<b>Residential mortgage</b>				
Residential mortgage – term	9	1,427	5	1,234
Residential mortgage – home equity	0	0	0	0
Consumer	0	0	0	0
<b>Total performing</b>	<b>18</b>	<b>\$ 7,336</b>	<b>15</b>	<b>\$ 8,168</b>
<b>Non-accrual</b>				
<b>Commercial real estate</b>				
Non owner-occupied	0	\$ 0	0	\$ 0
All other CRE	3	1,594	5	3,520
<b>Acquisition and development</b>				
1-4 family residential construction	0	0	0	0
All other A&D	0	0	4	1,721
Commercial and industrial	0	0	1	169
<b>Residential mortgage</b>				

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Residential mortgage – term	3	393	4	441
Residential mortgage – home equity	0	0	0	0
Consumer	0	0	0	0
Total non-accrual	6	1,987	14	5,851
Total TDRs	24	\$ 9,323	29	\$ 14,019

The level of TDRs decreased \$4.7 million during the year ended December 31, 2016. Six loans totaling \$.6 million were added to performing TDRs, and one \$.2 million loan was added to non-performing TDRs, and five loans already in performing TDRs were re-modified. During the year ended December 31, 2016, there were ten non-performing loans totaling \$3.6 million that were transferred to OREO. One previously accruing TDR totaling \$.1 million was transferred to non-performing status during 2016. Two performing TDRs totaling \$.9 million paid off and net principal payments totaling \$1.0 million were received during the same time period.

At December 31, 2016, there were no additional funds committed to be advanced in connection with TDRs. Interest income not recognized due to rate modifications of TDRs was \$.1 million and interest income recognized on all TDRs was \$.4 million in 2016.

[37]

## Allowance for Loan Losses

The ALL is maintained to absorb losses from the loan portfolio. The ALL is based on management's continuing evaluation of the 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 ALL is also based on estimates, and actual losses will vary from current estimates. These estimates are reviewed quarterly, and as adjustments, either positive or negative, become necessary, a corresponding increase or decrease is made in the ALL. The methodology used to determine the adequacy of the ALL is consistent with prior years. An estimate for probable losses related to unfunded lending commitments, such as letters of credit and binding but unfunded loan commitments is also prepared. This estimate is computed in a manner similar to the methodology described above, adjusted for the probability of actually funding the commitment.

The ALL decreased to \$9.9 million at December 31, 2016, compared to \$11.9 million at December 31, 2015. The provision for loan losses for the year ended December 31, 2016 increased to \$3.1 million from \$1.1 million for the year ended December 31, 2015. The increased provision expense was primarily due to increased net charge-offs of \$5.1 million in 2016, compared to net charge-offs of \$1.2 million in 2015. The ratio of the ALL to loans outstanding at December 31, 2016 was 1.11% compared to 1.36% at December 31, 2015.

The ratio of net charge-offs to average loans for the year ended December 31, 2016 was .57%, compared to .14% for the year ended December 31, 2015. The CRE portfolio had an annualized net charge-off rate of 1.80% as of December 31, 2016, compared to .05% as of December 31, 2015. This increase in charge-offs is related to a \$1.7 million charge-off on one loan due to reduced appraised value on the property and a \$2.5 million charge-off on one large participation loan in Pennsylvania. The A&D loan portfolio had an annualized net recovery rate of .98% as of December 31, 2016 compared to an annualized net charge-off rate of .79% as of December 31, 2015 due primarily to obtaining new appraisals on properties that secure a large loan relationship. The annualized net charge-off ratio for C&I loans was 0.69% as of December 31, 2016, compared to no charge-offs as of December 31, 2015. The residential mortgage loan charge-off ratios were .07% and .02% for December 31, 2016 and December 31, 2015, respectively, and the consumer loan charge-off ratios were .77% and .40% for December 31, 2016 and December 31, 2015, respectively.

Accruing loans past due 30 days or more improved slightly to .67% of the loan portfolio at December 31, 2016, compared to .75% at December 31, 2015. Non-accrual loans totaled \$13.9 million at December 31, 2016, compared to \$15.5 million at December 31, 2015. Non-accrual loans which have been subject to a partial charge-off totaled \$11.1 million at December 31, 2016, compared to \$4.1 million at December 31, 2015. The increase in charge-offs during 2016 is related to a partial charge-off of \$2.5 million on one large participation loan in Pennsylvania.

Management believes that the ALL at December 31, 2016 is adequate to provide for probable losses inherent in our loan portfolio. Amounts that will be recorded for the provision for loan losses in future periods will depend upon trends in the loan balances, including the composition of the loan portfolio, changes in loan quality and loss experience trends, potential recoveries on previously charged-off loans and changes in other qualitative factors. Management also applies interest rate risk, collateral value and debt service sensitivity analyses to the CRE loan portfolio and obtains new appraisals on specific loans under defined parameters to assist in the determination of the periodic provision for loan losses.

The ALL at December 31, 2015 decreased to \$11.9 million from \$12.1 million at December 31, 2014. The provision for loan losses for the year ended December 31, 2015 decreased to \$1.1 million from \$2.5 million for the year ended December 31, 2014. The lower provision expense was primarily due to lower net charge-offs of \$1.2 million in 2015, compared to net charge-offs of \$4.0 million in 2014. The ratio of the ALL to loans outstanding as of December 31, 2015 was 1.36%, which was lower than the 1.44% at December 31, 2014 due to the higher quality of the loan portfolio.

[38]

Table 6 presents the activity in the allowance for loan losses by major loan category for the past five years.

### Analysis of Activity in the Allowance for Loan Losses

**Table 6**

(In thousands)	For the Years Ended December 31,				
	2016	2015	2014	2013	2012
Balance, January 1	\$ 11,922	\$ 12,065	\$ 13,594	\$ 16,047	\$ 19,480
Charge-offs:					
Commercial real estate	(5,301 )	(420 )	(485 )	(233 )	(2,289 )
Acquisition and development	(248 )	(1,261 )	(2,673 )	(2,200 )	(809 )
Commercial and industrial	(558 )	(26 )	(266 )	(1,066 )	(9,402 )
Residential mortgage	(737 )	(300 )	(847 )	(485 )	(1,314 )
Consumer	(333 )	(307 )	(512 )	(590 )	(650 )
Total charge-offs	(7,177 )	(2,314 )	(4,783 )	(4,574 )	(14,464 )
Recoveries:					
Commercial real estate	90	283	11	1,004	156
Acquisition and development	1,303	382	133	100	420
Commercial and industrial	52	26	26	79	464
Residential mortgage	461	217	229	199	177
Consumer	145	209	342	359	424
Total recoveries	2,051	1,117	741	1,741	1,641
Net credit losses	(5,126 )	(1,197 )	(4,042 )	(2,833 )	(12,823 )
Provision for loan losses	3,122	1,054	2,513	380	9,390
Balance at end of period	\$ 9,918	\$ 11,922	\$ 12,065	\$ 13,594	\$ 16,047
Allowance for loan losses to loans outstanding (as %)	1.11 %	1.36 %	1.44 %	1.68 %	1.83 %
Net charge-offs to average loans outstanding during the period (as %)	0.57 %	0.14 %	0.49 %	0.34 %	1.41 %

Table 7 presents management's allocation of the ALL by major loan category in comparison to that loan category's percentage of total loans. Changes in the allocation over time reflect changes in the composition of the loan portfolio risk profile and refinements to the methodology of determining the ALL. Specific allocations in any particular category may be reallocated in the future as needed to reflect current conditions. Accordingly, the entire ALL is considered available to absorb losses in any category.

### Allocation of the Allowance for Loan Losses

**Table 7**



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(In thousands)	For the Years Ended December 31,														
	2016	% of Total Loans		2015	% of Total Loans		2014	% of Total Loans		2013	% of Total Loans		2012	% of Total Loans	
Commercial real estate	\$3,913	33	%	\$2,580	32	%	\$2,424	30	%	\$4,052	33	%	\$5,206	34	%
Acquisition and development	871	12	%	4,129	13	%	3,912	12	%	4,172	13	%	5,029	15	%
Commercial and industrial	858	8	%	722	8	%	1,680	11	%	766	8	%	906	8	%
Residential mortgage	3,588	44	%	3,785	44	%	3,862	44	%	4,320	43	%	4,507	39	%
Consumer	188	3	%	206	3	%	187	3	%	284	3	%	399	4	%
Unallocated	500	0	%	500	0	%	0	0	%	0	0	%	0	0	%
Total	\$9,918	100	%	\$11,922	100	%	\$12,065	100	%	\$13,594	100	%	\$16,047	100	%

[39]

## Investment Securities

The following table sets forth the composition of our securities portfolio by major category as of the indicated dates:

**Table 8**

(In thousands)	At December 31, 2016		2015		2014					
	Amortized Cost	Fair Value (FV)	FV As % of Total	Amortized Cost	Fair Value (FV)	FV As % of Total	Amortized Cost	Fair Value (FV)	FV AS % of Total	
Securities										
Available-for-Sale:										
U.S. treasuries	\$0	\$0	0 %	\$0	\$0	0 %	\$29,607	\$29,596	13 %	
U.S. government agencies	25,000	24,253	17 %	34,079	33,964	20 %	39,077	38,941	18 %	
Residential mortgage-backed agencies	0	0	0 %	14,285	14,170	8 %	45,175	45,273	21 %	
Commercial mortgage-backed agencies	52,978	52,222	37 %	43,780	43,636	26 %	26,007	25,957	12 %	
Collateralized mortgage obligations	19,953	19,567	14 %	9,690	9,610	6 %	8,611	8,707	4 %	
Obligations of states and political subdivisions	23,700	23,704	17 %	45,949	46,641	27 %	46,151	47,304	21 %	
Collateralized debt obligations	27,930	20,254	15 %	29,287	22,211	13 %	37,117	25,339	11 %	
Total available for sale	\$149,561	\$140,000	100 %	\$177,070	\$170,232	100 %	\$231,745	\$221,117	100 %	
Securities Held to Maturity:										
U.S. government agencies	\$15,738	\$16,250	17 %	\$24,704	\$25,338	24 %	\$24,520	\$25,034	23 %	
Residential mortgage-backed agencies	50,384	50,265	51 %	53,734	53,912	51 %	58,400	59,008	53 %	
Commercial mortgage-backed agencies	17,584	17,832	18 %	18,078	18,232	17 %	16,425	16,737	15 %	
Collateralized mortgage obligations	4,833	4,684	5 %	6,419	6,297	6 %	7,379	7,384	7 %	

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Obligations of states and political subdivisions	8,630	8,950	9 %	2,625	2,963	2 %	2,725	2,608	2 %
Total held to maturity	\$97,169	\$97,981	100 %	\$105,560	\$106,742	100 %	\$109,449	\$110,771	100 %

Total fair value of investment securities available-for-sale at December 31, 2016 decreased \$30.2 million when compared to December 31, 2015 due to calls and sales in 2016. At December 31, 2016, the securities classified as available-for-sale included a net unrealized loss of \$9.6 million, which represents the difference between the fair value and amortized cost of securities in the portfolio and is primarily attributable to our CDOs. On June 1, 2014, management reclassified an amortized cost basis of \$107.6 million of available-for-sale securities to held to maturity. The unrealized loss of approximately \$4.0 million, at the date of transfer, will continue to be reported in a separate component of shareholders' equity as accumulated other comprehensive income and will be amortized over the remaining life of the securities as an adjustment of yield in a manner consistent with the amortization of any premium or discount.

As discussed in Note 24 to the Consolidated Financial Statements, we measure fair market values based on the fair value hierarchy established in ASC Topic 820, *Fair Value Measurements and Disclosures*. 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). Level 3 prices or valuation techniques require inputs that are both significant to the valuation assumptions and are not readily observable in the market (i.e. supported with little or no market activity). These Level 3 instruments are valued based on both observable and unobservable inputs derived from the best available data, some of which is internally developed, and considers risk premiums that a market participant would require.

Approximately \$119.7 million of the available-for-sale portfolio was valued using Level 2 pricing and had net unrealized losses of \$1.9 million at December 31, 2016. The remaining \$20.3 million of the securities available-for-sale represents the entire CDO portfolio, which was valued using significant unobservable inputs, or Level 3 pricing. The \$7.7 million in net unrealized losses associated with the CDO portfolio relates to 12 pooled trust preferred securities. Unrealized losses of \$4.0 million represent non-credit related OTTI charges on eight of the securities, while \$3.7 million of unrealized losses relates to four securities which have no credit related OTTI. The unrealized losses on these securities are primarily attributable to continued depression in the marketability and liquidity associated with CDOs.

[40]

The following table provides a summary of the trust preferred securities in the CDO portfolio and the credit status of the securities as of December 31, 2016.

**Level 3 Investment Securities Available for Sale**

**(Dollars in Thousands)**

Deal	Claw	United Level 3 Investments				Lowest Credit Rating	security Credit Status				
		Amortized Cost	Fair Market Value	Unrealized Gain (Loss)	Original Collateral		Deferrals/ Defaults as % of Original Collateral	Performing Collateral	Collateral Support	Collateral Support as % of Performing Collateral	Number of Performing Issuers/Total Issuers
Preferred Term Security XI*	B-1	1,342	946	(396 )	C	635,775	14.08 %	372,925	(20,761 )	-5.57 %	43/53
Preferred Term Security XVIII*	C	1,979	1,226	(753 )	C	676,565	14.83 %	364,686	(5,412 )	-1.48 %	46/62
Preferred Term Security XVIII	C	2,821	1,840	(981 )	C	676,565	14.83 %	364,686	(5,412 )	-1.48 %	46/62
Preferred Term Security XIX*	C	1,836	1,482	(354 )	C	700,535	5.42 %	514,706	13,077	2.54 %	54/61
Preferred Term Security XIX*	C	1,092	889	(203 )	C	700,535	5.42 %	514,706	13,077	2.54 %	54/61
Preferred Term Security XIX*	C	2,518	2,074	(444 )	C	700,535	5.42 %	514,703	13,077	2.54 %	54/61
Preferred Term Security XIX*	C	1,094	889	(205 )	C	700,535	5.42 %	514,706	13,077	2.54 %	54/61
	C-1	1,537	1,143	(394 )	C	1,386,600	15.29 %	921,324	14,267	1.55 %	64/83

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Preferred Term Security XXII*	C-1	3,841	2,858	(983 )	C	1,386,600	15.29 %	921,324	14,267	1.55 %	64/83
Preferred Term Security XXII*	C-1	1,870	1,097	(773 )	C	1,467,000	16.84 %	852,685	45,346	5.39 %	84/101
Preferred Term Security I-P-IV	B-1	3,000	2,179	(821 )	CCC-	325,000	0.00 %	141,950	38,534	27.15 %	15/15
Preferred Term Security I-P-IV	B-1	5,000	3,631	(1,369 )	CCC-	325,000	0.00 %	141,950	38,534	27.15 %	15/15
Total Level 3 Securities Available for Sale		27,930	20,254	(7,676)							

\* Security has been deemed other-than-temporarily impaired and loss has been recognized in accordance with ASC Section 320-10-35.

The terms of the debentures underlying trust preferred securities allow the issuer of the debentures to defer interest payments for up to 20 quarters, and, in such case, the terms of the related trust preferred securities require their issuers to contemporaneously defer dividend payments. The issuers of the trust preferred securities in our investment portfolio have defaulted and/or deferred payments, ranging from 0.00% to 16.84% of the total collateral balances underlying the securities. The securities were designed to include structural features that provide investors with credit enhancement or support to provide default protection by subordinated tranches. These features include over-collateralization of the notes or subordination, excess interest or spread which will redirect funds in situations where collateral is insufficient, and a specified order of principal payments. There are securities in our portfolio that are under-collateralized, which does represent additional stress on our tranche. However, in these cases, the terms of the securities require excess interest to be redirected from subordinate tranches as credit support, which provides additional support to our investment.

Management systematically evaluates securities for impairment on a quarterly basis. Based upon application of ASC Topic 320 (Section 320-10-35), management must assess whether (i) we have the intent to sell the security and (ii) it is more likely than not that we will be required to sell the security prior to its anticipated recovery. If neither applies, then declines in the fair value of securities below their cost that are considered other-than-temporary declines are split

into two components. The first 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. The other losses are recognized in other comprehensive income. In estimating OTTI charges, management considers (a) the length of time and the extent to which the fair value has been less than cost, (b) adverse conditions specifically related to the security, an industry, or a geographic area, (c) the historic and implied volatility of the security, (d) changes in the rating of a security by a rating agency, (e) recoveries or additional declines in fair value subsequent to the balance sheet date, (f) failure of the issuer of the security to make scheduled interest payments, and (g) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future. Due to the duration and the significant market value decline in the pooled trust preferred securities held in our portfolio, we performed more extensive testing on these securities for purposes of evaluating whether or not an OTTI has occurred.

The market for these securities as of December 31, 2016 as well as the market for similar securities saw limited activity. The inactivity was evidenced by a decrease in the volume of trades relative to historical levels due to limited supply. In addition, the securities that traded were typically more senior in the capital structure. The new issue market is also inactive, as no new 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 Treasury, are depressed relative to historical levels. 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 (i) the few observable transactions and market quotations that are available are not reliable for the purpose of obtaining fair value at either December 31, 2015 or December 31, 2016, (ii) an income valuation approach technique (i.e. present value) that maximizes the use of relevant unobservable inputs and minimizes the use of observable inputs will be equally or more representative of fair value than a market approach, and (iii) 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.

[41]

Management utilizes an independent third party to prepare both the evaluations of OTTI and the fair value determinations for the CDO portfolio. Management does not believe that there were any material differences in the OTTI evaluations and pricing between December 31, 2015 and December 31, 2016.

The approach used by the third party to determine fair value involved several steps, which included detailed credit and structural evaluation of each piece of collateral in each bond, projection of 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, with a limited market for highly-rated CDO securities that are more senior in the capital structure than the securities in the CDO portfolio. Therefore, adjustments to the baseline discount rate are also made to reflect the additional leverage found in structured instruments.

Based upon a review of credit quality and the cash flow tests performed by the independent third party, management determined that no additional credit-related OTTI was required during 2016.

On December 10, 2013, to implement Section 619 of the Dodd-Frank Act, the four federal banking regulatory agencies and the SEC adopted the Volcker Rule. The Volcker Rule prohibits a banking institution from acquiring or retaining an “ownership interest” in a “covered fund”. A “covered fund” is (i) an entity that would be an investment company under the Investment Company Act of 1940, as amended, but for the exemptions contained in Section 3(c)(1) or Section 3(c)(7) of that Act, (ii) a commodity pool with certain characteristics, and/or (iii) a non-US entity with certain characteristics that is sponsored or owned by a banking entity located or organized in the US. The term “ownership interest” is defined as “any equity, partnership, or other similar interest.”

On January 14, 2014, the federal banking agencies adopted a final interim rule that exempts CDOs from the scope of the Volcker Rule if they were issued in offerings in which, among other things, the proceeds were used primarily to purchase securities issued by depository institutions and their affiliates. In connection with that final interim rule, the agencies published a non-exclusive list of exempt offerings. Of the 12 CDOs held by the Corporation, 10 were issued in exempt offerings. The remaining CDOs are collateralized primarily by securities issued by insurance companies and are not included in the agencies’ list of exempt offerings, which fact required management to make a determination as to whether the CDOs constitute an “ownership interest” in a “covered fund”, such that the Corporation would be required to dispose of them pursuant to the Volcker Rule. To make this determination, management conducted a thorough review of the Indentures that govern the CDOs and the other offering materials used by the issuers to offer and sell the CDOs.

The Volcker Rule defines an “ownership interest” as an equity, partnership or other similar interest. The CDOs are debt securities (promissory notes) issued by corporations that call for regularly-scheduled payments of principal and interest, with interest calculated either at a fixed-rate or at a rate that is tied to LIBOR. Accordingly, none of the CDOs represent an equity or partnership interest in the issuers. In their adopting rule release, the agencies stated that debt securities evidencing “typical extensions of credit” – those that “provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate” – do not generally meet the definition of “other similar interest”. To be considered an “other similar interest”, a debt security must exhibit one or more of seven specified characteristics identified in the Volcker Rule on a current, future, or contingent basis:

Based on its review, management concluded that the two CDOs evidence “typical extensions of credit” and do not exhibit any of these seven characteristics. Accordingly, management concluded that the CDOs do not constitute an “ownership interest” as defined by the Volcker Rule and that, therefore, as of December 31, 2016, the Corporation has the current intent and ability to hold the CDOs until maturity.

During the first quarter of 2014 and following the promulgation of the Volcker Rule, the fair value of the CDO portfolio improved significantly. The improvement was due to several factors including improved financial condition of the issuers, improved cash flows and a lower discount rate. As the issuers resumed payments of previously deferred interest during the quarter, cash flow projections for the securities increased. In addition, the discount rate utilized in the cash flow models was reduced as the base line current market yield for comparable corporate and structured products improved and the projected credit performance of the CDOs improved with favorable market conditions. The resulting increase in cash flow projections over the remaining life of the securities yielded a higher fair market value.

[42]



Table 9 sets forth the contractual or estimated maturities of the components of our securities portfolio as of December 31, 2016 and the weighted average yields on a tax-equivalent basis.

### Investment Security Maturities, Yields, and Fair Values at December 31, 2016

**Table 9**

(In thousands)	Within 1 Year	1 Year To 5 Years	5 Years To 10 Years	Over 10 Years	Total Fair Value
<b>Securities Available-for-Sale:</b>					
U.S. government agencies	\$ 0	\$ 9,857	\$ 14,396	\$ 0	\$ 24,253
Commercial mortgage-backed agencies	618	44,382	7,222	0	52,222
Collateralized mortgage obligations	990	8,567	10,010	0	19,567
Obligations of states and political subdivisions	0	666	4,632	18,406	23,704
Collateralized debt obligations	0	0	0	20,254	20,254
Total available for sale	\$ 1,608	\$ 63,472	\$ 36,260	\$ 38,660	\$ 140,000
Percentage of total	1.15	% 45.34	% 25.90	% 27.61	% 100.00
Weighted average yield	0.86	% 2.26	% 1.88	% 4.49	% 2.76
<b>Held to Maturity:</b>					
U.S. government agencies	\$ 0	\$ 0	\$ 16,250	\$ 0	\$ 16,250
Residential mortgage-backed agencies	1,021	29,753	0	19,491	50,265
Commercial mortgage-backed agencies	0	0	17,832	0	17,832
Collateralized mortgage obligations	0	4,684	0	0	4,684
Obligations of states and political subdivisions	0	0	0	8,950	8,950
Total held to maturity	\$ 1,021	\$ 34,437	\$ 34,082	\$ 28,441	\$ 97,981
Percentage of total	1.04	% 35.15	% 34.78	% 29.03	% 100.00
Weighted average yield	-3.16	% 2.65	% 2.86	% 3.34	% 2.87

The weighted average yield was calculated using historical cost balances and does not give effect to changes in fair value. The negative weighted average yield was due to increased paydowns on mortgage-backed securities which impacted their factors and three-month conditional prepayment rate (“CPR”). At December 31, 2016, we did not hold any securities in the name of any one issuer exceeding 10% of shareholders’ equity.

[43]

## Deposits

Table 10 sets forth the actual and average deposit balances by major category for 2016, 2015 and 2014:

### Deposit Balances

**Table 10**

(In thousands)	Actual Balance	2016		2015		2014		Average Yield	
		Average Balance	Average Yield	Average Balance	Average Yield	Average Balance	Average Yield		
Non-interest-bearing demand deposits	\$219,158	\$209,948	0.00%	\$204,569	\$204,453	0.00%	\$201,188	\$196,468	0.00%
Interest-bearing deposits:									
Demand	172,071	176,049	0.08%	176,084	149,214	0.07%	134,302	139,875	0.09%
Money Market:									
Retail	161,812	163,021	0.15%	160,597	203,214	0.23%	224,699	214,268	0.23%
Brokered/ICS	70,425	71,054	0.15%	62,197	6,895	0.20%	0	0	0.00%
Savings deposits	149,653	147,428	0.11%	140,772	136,946	0.16%	129,392	123,756	0.19%
Time deposits less than \$100K:									
Retail	116,651	123,751	1.00%	129,324	141,738	1.22%	146,764	163,100	1.08%
Brokered/CDARS	520	378	0.10%	434	450	0.16%	0	0	0.00%
Time deposits \$100K or more:									
Retail	120,341	117,641	1.04%	122,123	128,928	1.22%	141,455	140,489	1.36%
Brokered/CDARS	3,598	2,612	0.15%	2,694	3,651	0.16%	3,523	4,535	0.11%
Total Deposits	\$1,014,229	\$1,011,882		\$998,794	\$975,489		\$981,323	\$982,491	

Total deposits increased \$15.4 million at December 31, 2016 when compared to December 31, 2015. During 2016, we continued our focus on changing the mix of our deposit portfolio from higher cost certificates of deposit to lower cost core accounts. Non-interest bearing deposits increased \$14.6 million. Traditional savings accounts increased \$8.9 million due to continued growth in our Prime Saver product. Total demand deposits decreased \$4.0 million and total money market accounts increased \$9.4 million. Time deposits less than \$100,000 declined \$12.6 million and time deposits greater than \$100,000 decreased \$.9 million. The growth in the brokered/ICS money market balances was primarily due to the shift of balances for retail customers to this product to maintain liquidity as well as insurance protection.

The following table sets forth the maturities of time deposits of \$100,000 or more:

**Maturity of Time Deposits of \$100,000 or More**

**Table 11**

(In thousands)	December 31, 2016
Maturities	
3 Months or Less	\$ 26,816
3-6 Months	14,353
6-12 Months	12,835
Over 1 Year	69,935
Total	\$ 123,939

[44]

**Borrowed Funds**

The following shows the composition of our borrowings at December 31:

(In thousands)	2016	2015	2014
Securities sold under agreements to repurchase	\$36,000	\$35,828	\$39,801
Total short-term borrowings	\$36,000	\$35,828	\$39,801
Long-term FHLB advances	\$90,007	\$105,807	\$135,876
Junior subordinated debentures	41,730	41,730	46,730
Total long-term borrowings	\$131,737	\$147,537	\$182,606
Total borrowings	\$167,737	\$183,365	\$222,407
Average balance (from Table 1)	\$177,322	\$200,741	\$228,634

The following is a summary of short-term borrowings at December 31 with original maturities of less than one year:

(Dollars in thousands)	2016	2015	2014
Securities sold under agreements to repurchase:			
Outstanding at end of year	\$36,000	\$35,828	\$39,801
Weighted average interest rate at year end	0.16 %	0.16 %	0.15 %
Maximum amount outstanding as of any month end	\$39,456	\$47,131	\$53,819
Average amount outstanding	30,899	35,908	45,702
Approximate weighted average rate during the year	0.19 %	0.16 %	0.13 %

Total borrowings decreased by \$15.6 million, or 8.5%, in 2016 when compared to 2015, while the average balance of borrowings decreased by \$23.4 million during the same period. These decreases were due to a \$15.8 million decrease in long-term borrowings due primarily to the repayment of a \$15.0 million FHLB advance in December 2016. Short-term borrowings increased \$.2 million due to a slight increase in our Treasury Management product.

Total borrowings decreased by \$39.0 million, or 17.6%, in 2015 when compared to 2014, while the average balance of borrowings decreased by \$27.9 million during the same period. These decreases were due to a \$35.1 million decrease in long-term borrowings due to the repayment of \$5.0 million in junior subordinated debentures in March 2015 and a

\$30.0 million FHLB advance in July 2015. Short-term borrowings decreased \$4.0 million due to a decline in our Treasury Management product.

Management will continue to closely monitor interest rates within the context of its overall asset-liability management process. See the discussion under the heading “Interest Rate Sensitivity” in this Item 7 for further information on this topic.

As of December 31, 2016, we had additional borrowing capacity with the FHLB totaling \$172.4 million, an additional \$70.0 million of unused lines of credit with various financial institutions, \$10.6 million of an unused secured line of credit with the Federal Reserve Bank and approximately \$95.7 million available through wholesale money market funds. See Note 12 to the Consolidated Financial Statements presented elsewhere in this annual report for further details about our borrowings and additional borrowing capacity, which is incorporated herein by reference.

### **Capital Resources**

We require capital to fund loans, satisfy our obligations under the Bank’s letters of credit, meet the deposit withdraw demands of the Bank’s customers, and satisfy our other monetary obligations. To the extent that deposits are not adequate to fund our capital requirements, we can rely on the funding sources identified below under the heading “Liquidity Management”. At December 31, 2016, the Bank had \$70.0 million available through unsecured lines of credit with correspondent banks, \$10.6 million available through a secured line of credit with the Fed Discount Window and approximately \$172.4 million available through the FHLB. Management is not aware of any demands, commitments, events or uncertainties that are likely to materially affect our ability to meet our future capital requirements.

[45]

In addition to operational requirements, the Bank and the Corporation are subject to risk-based capital regulations, which were adopted and are monitored by federal banking regulators. These regulations are used to evaluate capital adequacy and require an analysis of an institution's asset risk profile and off-balance sheet exposures, such as unused loan commitments and stand-by letters of credit.

On July 2, 2013, the Federal Reserve approved final rules that substantially amended the regulatory risk-based capital rules applicable to the Corporation. The FDIC subsequently approved the same rules which apply to the Bank. The final rules implement the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act and were implemented as of March 31, 2015.

The Basel III capital rules include new risk-based capital and leverage ratios, which will be phased in from 2015 to 2019, and which refine the definition of what constitutes "capital" for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Corporation under the final rules are: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The final rules also establish a "capital conservation buffer" above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital. The capital conservation buffer will be phased-in over four years beginning on January 1, 2016, as follows: the maximum buffer will be 0.625% of risk-weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. This will result in the following minimum ratios beginning in 2019: (a) a common equity Tier 1 capital ratio of 7.0%, (b) a Tier 1 capital ratio of 8.5%, and (c) a total capital ratio of 10.5%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions.

The Basel III capital final rules also implement revisions and clarifications consistent with Basel III regarding the various components of Tier 1 capital, including common equity, unrealized gains and losses, as well as certain instruments that no longer qualify as Tier 1 capital, some of which will be phased out over time. Under the final rules, the effects of certain accumulated other comprehensive items are not excluded; however, banking organizations like the Corporation and the Bank that are not considered "advanced approaches" banking organizations may make a one-time permanent election to continue to exclude these items. The Corporation and the Bank made this election in their first quarter 2015 regulatory filings in order to avoid significant variations in the level of capital depending upon the impact of interest rate fluctuations on the fair value of the Corporation's available-for-sale securities portfolio. Additionally, the final rules provide that small depository institution holding companies with less than \$15 billion in total assets as of December 31, 2009 (which includes the Corporation) will be able to permanently include non-qualifying instruments that were issued and included in Tier 1 or Tier 2 capital prior to May 19, 2010 (such as the Corporation's TPS Debentures) in additional Tier 1 or Tier 2 capital until they redeem such instruments or until the instruments mature.

The Basel III capital rules also contain revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions if their capital levels begin to show signs of weakness. These revisions were effective January 1, 2015. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions are required to meet the following capital level requirements in order to qualify as “well capitalized”: (i) a new common equity Tier 1 capital ratio of 6.5%; (ii) a Tier 1 capital ratio of 8% (increased from 6%); (iii) a total capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (increased from 4%).

The Basel III capital rules set forth certain changes for the calculation of risk-weighted assets. These changes include (i) an increased number of credit risk exposure categories and risk weights; (ii) an alternative standard of creditworthiness consistent with Section 939A of the Dodd-Frank Act; (iii) revisions to recognition of credit risk mitigation; (iv) rules for risk weighting of equity exposures and past due loans, and (v) revised capital treatment for derivatives and repo-style transactions.

Regulators may require higher capital ratios when warranted by the particular circumstances or risk profile of a given banking organization. In the current regulatory environment, banking organizations must stay well capitalized in order to receive favorable regulatory treatment on acquisition and other expansion activities and favorable risk-based deposit insurance assessments. Our capital policy establishes guidelines meeting these regulatory requirements and takes into consideration current or anticipated risks as well as potential future growth opportunities.

At December 31, 2016, the Corporation’s total risk-based capital ratio was 16.71% and the Bank’s total risk-based capital ratio was 16.70%, both of which were well above the regulatory minimum of 8%. The total risk-based capital ratios of the Corporation and the Bank at December 31, 2015 were 17.21% and 16.29%, respectively. The decrease for the Corporation in 2016 was due to a change in the composition of risk based assets and the repayment of \$10.0 million of Series A Preferred Stock, offset by the effect of current period net income.

At the Bank level, the ratios increased from December 31, 2015 to December 31, 2016 because of the Bank’s current period earnings for 2016.

[46]



As of December 31, 2016, the most recent notification from the regulators categorizes the Corporation and the Bank as “well capitalized” under the regulatory framework for prompt corrective action. See Note 4 to the Consolidated Financial Statements presented elsewhere in this annual report for additional information regarding regulatory capital ratios.

## Liquidity Management

Liquidity is a financial institution’s capability to meet customer demands for deposit withdrawals while funding all credit-worthy loans. The factors that determine the institution’s liquidity are:

Reliability and stability of core deposits;  
Cash flow structure and pledging status of investments; and  
Potential for unexpected loan demand.

We actively manage our liquidity position through weekly meetings of a sub-committee of executive management, known as the internal treasury team, which looks forward 12 months at 30-day intervals. The measurement is based upon the projection of funds sold or purchased position, along with ratios and trends developed to measure dependence on purchased funds and core growth. Monthly reviews by management and quarterly reviews by the Asset and Liability Committee under prescribed policies and procedures are designed to ensure that we will maintain adequate levels of available funds.

It is our policy to manage our affairs so that liquidity needs are fully satisfied through normal Bank operations. That is, the Bank will manage its liquidity to minimize the need to make unplanned sales of assets or to borrow funds under emergency conditions. The Bank will use funding sources where the interest cost is relatively insensitive to market changes in the short run (periods of one year or less) to satisfy operating cash needs. The remaining normal funding will come from interest-sensitive liabilities, either deposits or borrowed funds. When the marginal cost of needed wholesale funding is lower than the cost of raising this funding in the retail markets, the Corporation may supplement retail funding with external funding sources such as:

Unsecured Fed Funds lines of credit with upstream correspondent banks (M&T Bank, Atlantic Community Banker’s Bank, Community Banker’s Bank, PNC Financial Services (“PNC”), SunTrust and Zions Bancorp).

Secured advances with the FHLB of Atlanta, which are collateralized by eligible one to four family residential mortgage loans, home equity lines of credit, commercial real estate loans. Cash and various securities may also be pledged as collateral.

Secured line of credit with the Fed Discount Window for use in borrowing funds up to 90 days, using municipal securities as collateral.

Brokered deposits, including CDs and money market funds, provide a method to generate deposits quickly. These deposits are strictly rate driven but often provide the most cost effective means of funding growth.

One Way Buy CDARS/ICS funding – a form of brokered deposits that has become a viable supplement to brokered deposits obtained directly.

Management believes that we have adequate liquidity available to respond to current and anticipated liquidity demands and is not aware of any trends or demands, commitments, events or uncertainties that are likely to materially affect our ability to maintain liquidity at satisfactory levels.

### **Market Risk and Interest Sensitivity**

Our primary market risk is interest rate fluctuation. Interest rate risk results primarily from the traditional banking activities that we engage in, such as gathering deposits and extending loans. Many factors, including economic and financial conditions, movements in interest rates and consumer preferences affect the difference between the interest earned on our assets and the interest paid on our liabilities. Interest rate sensitivity refers to the degree that earnings will be impacted by changes in the prevailing level of interest rates. Interest rate risk arises from mismatches in the repricing or maturity characteristics between interest-bearing assets and liabilities. Management seeks to minimize fluctuating net interest margins, and to enhance consistent growth of net interest income through periods of changing interest rates. Management uses interest sensitivity gap analysis and simulation models to measure and manage these risks. The interest rate sensitivity gap analysis assigns each interest-earning asset and interest-bearing liability to a time frame reflecting its next repricing or maturity date. The differences between total interest-sensitive assets and liabilities at each time interval represent the interest sensitivity gap for that interval. A positive gap generally indicates that rising interest rates during a given interval will increase net interest income, as more assets than liabilities will reprice. A negative gap position would benefit us during a period of declining interest rates.

As of December 31, 2016, we were asset sensitive.

Our interest rate risk management goals are:

Ensure that the Board of Directors and senior management will provide effective oversight and ensure that risks are adequately identified, measured, monitored and controlled;

Enable dynamic measurement and management of interest rate risk;

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- Select strategies that optimize our ability to meet our long-range financial goals while maintaining interest rate risk within policy limits established by the Board of Directors;
- Use both income and market value oriented techniques to select strategies that optimize the relationship between risk and return; and
- Establish interest rate risk exposure limits for fluctuation in net interest income (“NII”), net income and economic value of equity.

In order to manage interest sensitivity risk, management formulates guidelines regarding asset generation and pricing, funding sources and pricing, and off-balance sheet commitments. These guidelines are based on management’s outlook regarding future interest rate movements, the state of the regional and national economy, and other financial and business risk factors. Management uses computer simulations to measure the effect on net interest income of various interest rate scenarios. Key assumptions used in the computer simulations include cash flows and maturities of interest rate sensitive assets and liabilities, changes in asset volumes and pricing, and management’s capital plans. This modeling reflects interest rate changes and the related impact on net interest income over specified periods.

We evaluate the effect of a change in interest rates of +/-100 basis points to +/-400 basis points on both NII and Net Portfolio Value (“NPV”) / Economic Value of Equity (“EVE”). We concentrate on NII rather than net income as long as NII remains the significant contributor to net income.

NII modeling allows management to view how changes in interest rates will affect the spread between the yield paid on assets and the cost of deposits and borrowed funds. Unlike traditional Gap modeling, NII modeling takes into account the different degree to which installments in the same repricing period will adjust to a change in interest rates. It also allows the use of different assumptions in a falling versus a rising rate environment. The period considered by the NII modeling is the next eight quarters.

NPV / EVE modeling focuses on the change in the market value of equity. NPV / EVE is defined as the market value of assets less the market value of liabilities plus/minus the market value of any off-balance sheet positions. By effectively looking at the present value of all future cash flows on or off the balance sheet, NPV / EVE modeling takes a longer-term view of interest rate risk. This complements the shorter-term view of the NII modeling.

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

Based on the simulation analysis performed at December 31, 2016 and 2015, management estimated the following changes in net interest income, assuming the indicated rate changes:

(Dollars in thousands)	2016	2015
+400 basis points	\$4,569	\$2,363
+300 basis points	\$3,617	\$2,092
+200 basis points	\$2,623	\$1,962
+100 basis points	\$1,501	\$1,298
-100 basis points	\$(3,175)	\$(2,364)

This estimate is based on assumptions that may be affected by unforeseeable changes in the general interest rate environment and any number of unforeseeable factors. Rates on different assets and liabilities within a single maturity category adjust to changes in interest rates to varying degrees and over varying periods of time. The relationships between lending rates and rates paid on purchased funds are not constant over time. Management can respond to current or anticipated market conditions by lengthening or shortening the Bank's sensitivity through loan repricings or changing its funding mix. The rate of growth in interest-free sources of funds will influence the level of interest-sensitive funding sources. In addition, the absolute level of interest rates will affect the volume of earning assets and funding sources. As a result of these limitations, the interest-sensitive gap is only one factor to be considered in estimating the net interest margin.

*Impact of Inflation* – Our assets and liabilities are primarily monetary in nature, and as such, future changes in prices do not affect the obligations to pay or receive fixed and determinable amounts of money. During inflationary periods, monetary assets lose value in terms of purchasing power and monetary liabilities have corresponding purchasing power gains. The concept of purchasing power is not an adequate indicator of the impact of inflation on financial institutions because it does not incorporate changes in our earnings.

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**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information called for by this item is incorporated herein by reference to Item 7 of Part II of this annual report under the heading “Market Risk and Interest Sensitivity”.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders

First United Corporation

Oakland, Maryland

We have audited the accompanying consolidated statement of financial condition of First United Corporation and Subsidiaries as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of First United Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First United Corporation and Subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ Baker Tilly Virchow Krause, LLP

Pittsburgh, Pennsylvania  
March 8, 2017

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**First United Corporation and Subsidiaries****Consolidated Statement of Financial Condition****(In thousands, except per share amounts)**

	December 31,	
	2016	2015
<b>Assets</b>		
Cash and due from banks	\$60,707	\$50,188
Interest bearing deposits in banks	2,603	1,953
Cash and cash equivalents	63,310	52,141
Investment securities – available-for-sale (at fair value)	140,000	170,232
Investment securities – held to maturity (fair value of \$97,981 at December 31, 2016 and \$106,742 at December 31, 2015)	97,169	105,560
Restricted investment in bank stock, at cost	5,209	5,904
Loans	891,926	879,023
Allowance for loan losses	(9,918 )	(11,922 )
Net loans	882,008	867,101
Premises and equipment, net	27,160	25,198
Goodwill	11,004	11,004
Bank owned life insurance	40,968	40,150
Deferred tax assets	19,337	19,790
Other real estate owned	10,910	6,883
Accrued interest receivable and other assets	21,115	19,495
<b>Total Assets</b>	<b>\$1,318,190</b>	<b>\$1,323,458</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities:</b>		
Non-interest bearing deposits	\$219,158	\$204,569
Interest bearing deposits	795,071	794,225
Total deposits	1,014,229	998,794
Short-term borrowings	36,000	35,828
Long-term borrowings	131,737	147,537
Accrued interest payable and other liabilities	22,526	20,528
<b>Total Liabilities</b>	<b>1,204,492</b>	<b>1,202,687</b>
<b>Shareholders' Equity:</b>		
Preferred stock – no par value; Authorized 2,000 shares of which 30 shares of Series A, \$1,000 per share liquidation preference, 9% cumulative, issued and outstanding 20 shares at December 31, 2016 and 30 shares at December 31, 2015	20,000	30,000
Common Stock – par value \$.01 per share; Authorized 25,000 shares; issued and outstanding 6,269 shares at December 31, 2016 and 6,255 shares at December 31, 2015	63	63

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Surplus	22,178	21,986
Retained earnings	92,922	87,666
Accumulated other comprehensive loss	(21,465 )	(18,944 )
Total Shareholders' Equity	113,698	120,771
Total Liabilities and Shareholders' Equity	\$1,318,190	\$1,323,458

*See notes to consolidated financial statements*

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**First United Corporation and Subsidiaries****Consolidated Statement of Income****(In thousands, except per share data)**

	Year ended December 31,	
	2016	2015
Interest income		
Interest and fees on loans	\$38,948	\$37,165
Interest on investment securities		
Taxable	5,611	6,248
Exempt from federal income tax	869	1,264
Total investment income	6,480	7,512
Other	435	355
Total interest income	45,863	45,032
Interest expense		
Interest on deposits	3,150	3,905
Interest on short-term borrowings	60	58
Interest on long-term borrowings	5,013	5,444
Total interest expense	8,223	9,407
Net interest income	37,640	35,625
Provision for loan losses	3,122	1,054
Net interest income after provision for loan losses	34,518	34,571
Other operating income		
Net gains	526	1,016
Service charges	3,281	2,995
Trust department	5,837	5,641
Debit card income	2,112	2,300
Bank owned life insurance	1,426	1,146
Brokerage commissions	849	887
Other Income- recovery	0	11,572
Other	622	451
Total other income	14,127	24,992
Total other operating income	14,653	26,008
Other operating expenses		
Salaries and employee benefits	20,595	20,912
FDIC premiums	940	1,870
Equipment	2,437	2,544
Occupancy	2,499	2,479
Data processing	3,065	3,429
Professional services	1,127	1,674
Other real estate owned expenses	802	1,899
Contract labor	718	607
Line rentals	615	633

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Other	6,309	5,068
Total other operating expenses	39,107	41,115
Income before income tax expense	10,064	19,464
Provision for income tax expense	2,783	6,473
Net Income	7,281	12,991
Accumulated preferred stock dividends	(2,025 )	(2,700 )
Net Income Available to Common Shareholders	\$5,256	\$10,291
Basic and diluted net income per common share	\$0.84	\$1.65
Weighted average number of basic and diluted shares outstanding	6,264,209	6,248,830

*See notes to consolidated financial statements*

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**First United Corporation and Subsidiaries****Consolidated Statement of Comprehensive Income****(In thousands)**

	Year Ended December 31,	
	2016	2015
Comprehensive Income		
Net Income	\$7,281	\$12,991
Other comprehensive (loss)/income, net of tax and reclassification adjustments:		
Net unrealized (losses)/gains on investments with OTTI	(426 )	1,737
Net unrealized (losses)/gains on all other AFS securities	(1,194)	531
Net unrealized gains on HTM securities	617	284
Net unrealized gains on cash flow hedges	461	80
Net unrealized losses on pension plan liability	(1,569)	(1,271 )
Net unrealized losses on SERP liability	(410 )	(72 )
Other comprehensive (loss)/income, net of tax	(2,521)	1,289
Comprehensive Income	\$4,760	\$14,280

*See notes to consolidated financial statements*

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**First United Corporation and Subsidiaries****Consolidated Statement of Changes in Shareholders' Equity****(In thousands)**

	Preferred Stock	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss, net of tax	Total Shareholders' Equity
Balance at January 1, 2015	\$30,000	\$ 62	\$21,795	\$77,375	\$ (20,233	) \$ 108,999
Net income				12,991		12,991
Other comprehensive income, net of tax					1,289	1,289
Stock based compensation		1	191			192
Preferred stock dividends paid				(2,700 )		(2,700 )
Balance at December 31, 2015	30,000	63	21,986	87,666	(18,944	) 120,771
Net income				7,281		7,281
Other comprehensive loss, net of tax					(2,521	) (2,521 )
Stock based compensation			192			192
Preferred stock redemption	(10,000)					(10,000 )
Preferred stock dividends paid				(2,025 )		(2,025 )
Balance at December 31, 2016	\$20,000	\$ 63	\$22,178	\$92,922	\$ (21,465	) \$ 113,698

*See notes to consolidated financial statements*

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**First United Corporation and Subsidiaries****Consolidated Statement of Cash Flows****(In thousands)**

	Year ended December 31,	
	2016	2015
Operating activities		
Net income	\$7,281	\$12,991
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	3,122	1,054
Depreciation	1,693	1,768
Stock compensation	192	191
Gain on sales of other real estate owned	(189 )	(753 )
Write-downs of other real estate owned	486	1,997
Gain on loan sales	(95 )	(57 )
Loss on disposal of fixed assets	9	3
Net amortization of investment securities discounts and premiums- AFS	365	659
Net amortization of investment securities discounts and premiums- HTM	142	73
Net gain on sales of investment securities – available-for-sale	(440 )	(962 )
Amortization of deferred loan fees	(494 )	(554 )
(Increase)/decrease in accrued interest receivable and other assets	(5,472 )	4,223
Deferred tax expense	2,117	3,855
Increase/(decrease) in accrued interest payable and other liabilities	4,388	(1,143 )
Earnings on bank owned life insurance	(1,426 )	(1,146 )
Net cash provided by operating activities	11,679	22,199
Investing activities		
Proceeds from maturities/calls of investment securities available-for-sale	38,387	42,020
Proceeds from maturities/calls of investment securities held-to-maturity	19,334	7,525
Proceeds from sales of investment securities available-for-sale	43,782	60,598
Purchases of investment securities available-for-sale	(54,585)	(47,640)
Purchases of investment securities held-to-maturity	(11,085)	(3,709 )
Proceeds from sales of other real estate owned	2,614	6,190
Proceeds from loan sales	8,838	6,433
Proceeds from disposal of fixed assets	260	31
Purchase of BOLI policy	0	(5,500 )
Proceeds from BOLI death benefit	608	0
Net decrease in FHLB stock	695	1,620
Net increase in loans	(33,216)	(47,436)
Purchases of premises and equipment	(3,924 )	(1,371 )
Net cash provided by investing activities	11,708	18,761

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Financing activities		
Net increase in deposits	15,435	17,471
Preferred stock dividends paid	(2,025 )	(2,700 )
Preferred stock redemption	(10,000)	0
Common Stock grants	0	1
Net increase/(decrease) in short-term borrowings	172	(3,973 )
Payments on long-term borrowings	(15,800)	(35,069)
Net cash used in financing activities	(12,218)	(24,270)
Increase in cash and cash equivalents	11,169	16,690
Cash and cash equivalents at beginning of the year	52,141	35,451
Cash and cash equivalents at end of period	\$63,310	\$52,141
Supplemental information		
Interest paid	\$8,321	\$9,811
Taxes paid	\$540	\$125
Non-cash investing activities:		
Transfers from loans to other real estate owned	\$6,938	\$1,385

*See notes to consolidated financial statements*

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## **First United Corporation and Subsidiaries**

### **Notes to Consolidated Financial Statements**

#### **1. Summary of Significant Accounting Policies**

##### **Business**

First United Corporation is a Maryland corporation chartered in 1985 and a bank holding company registered under the federal Bank Holding Company Act of 1956, as amended. First United Corporation's primary business is serving as the parent company of First United Bank & Trust, a Maryland trust company with commercial banking powers (the "Bank"), First United Statutory Trust I ("Trust I") and First United Statutory Trust II ("Trust II"), both Connecticut statutory business trusts, and First United Statutory Trust III, a Delaware statutory business trust ("Trust III" and together with Trust I and Trust II, the "Trusts"). The Trusts were formed for the purpose of selling trust preferred securities that qualified as Tier 1 capital. The Bank has four wholly-owned subsidiaries: OakFirst Loan Center, Inc., a West Virginia finance company; OakFirst Loan Center, LLC, a Maryland finance company (collectively, the "OakFirst Loan Centers"); First OREO Trust, a Maryland statutory trust; and FUBT OREO I, LLC, a Maryland limited liability company. The OakFirst Loan Centers are engaged in the consumer finance business, and First OREO Trust and FUBT OREO I, LLC were formed for the purposes of holding, servicing and disposing of the real estate that the Bank acquires through foreclosure or by deed in lieu of foreclosure. The Bank also owns 99.9% of the limited partnership interests in Liberty Mews Limited Partnership, a Maryland limited partnership formed for the purpose of acquiring, developing and operating low-income housing units in Garrett County, Maryland ("Liberty Mews").

First United Corporation and its subsidiaries operate principally in four counties in Western Maryland and three counties in West Virginia.

As used in these Notes, the terms "the Corporation", "we", "us", and "our" mean First United Corporation and, unless the context clearly suggests otherwise, its consolidated subsidiaries.

##### **Basis of Presentation**

The accompanying consolidated financial statements of the Corporation have been prepared in accordance with United States generally accepted accounting principles ("GAAP") as required by the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") that require management to make estimates and

assumptions that affect the reported amounts of certain assets and liabilities at the date of the financial statements as well as the reported amount of revenues and expenses during the reporting period. Actual results could differ from these estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the assessment of other-than-temporary impairment (“OTTI”) pertaining to investment securities, potential impairment of goodwill, and the valuation of deferred tax assets. For purposes of comparability, certain prior period amounts have been reclassified to conform to the 2015 presentation. Such reclassifications had no impact on net income or equity.

The Corporation has evaluated events and transactions occurring subsequent to the statement of financial condition date of December 31, 2016 for items that should potentially be recognized or disclosed in these financial statements as prescribed by ASC Topic 855, *Subsequent Events*.

### **Principles of Consolidation**

The consolidated financial statements of the Corporation include the accounts of First United Corporation, the Bank, the OakFirst Loan Centers, First OREO Trust and FUBT OREO I, LLC. All significant inter-company accounts and transactions have been eliminated.

First United Corporation determines whether it has a controlling financial interest in an entity by first evaluating whether the entity is a voting interest entity or a variable interest entity (“VIE”) in accordance with GAAP. Voting interest entities are entities in which the total equity investment at risk is sufficient to enable the entity to finance itself independently and provides the equity holders with the obligation to absorb losses, the right to receive residual returns and the right to make financial and operating decisions. The Corporation consolidates voting interest entities in which it has 100%, or at least a majority, of the voting interest. As defined in applicable accounting standards, a VIE is an entity that either (i) does not have equity investors with voting rights or (ii) has equity investors that do not provide sufficient financial resources for the entity to support its activities. A controlling financial interest in an entity exists when an enterprise has a variable interest, or a combination of variable interests that will absorb a majority of an entity’s expected losses, receive a majority of an entity’s expected residual returns, or both. The enterprise with a controlling financial interest, known as the primary beneficiary, consolidates the VIE.

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The Corporation accounts for its investment in Liberty Mews utilizing the effective yield method under guidance that applies specifically to investments in limited partnerships that operate qualified affordable housing projects. Under the effective yield method, the investor recognizes tax credits as they are allocated and amortizes the initial cost of the investment to provide a constant effective yield over the period that tax credits are allocated to the investor. The effective yield is the internal rate of return on the investment, based on the cost of the investment and the guaranteed tax credits allocated to the investor. The tax credit allocated, net of the amortization of the investment in the limited partnership, is recognized in the income statement as a component of income taxes attributable to continuing operations.

### **Significant Concentrations of Credit Risk**

Most of the Corporation's relationships are with customers located in Western Maryland and Northeastern West Virginia. At December 31, 2016, approximately 12%, or \$104.3 million, of total loans were secured by real estate acquisition, construction and development projects, with \$101.8 million performing according to their contractual terms and \$2.5 million considered to be impaired based on management's concerns about the borrowers' ability to comply with present repayment terms. The \$2.5 million in impaired loans were classified as troubled debt restructurings ("TDRs") performing in accordance with their modified terms, and \$45 thousand were classified as non-performing loans at December 31, 2016. Additionally, loans collateralized by commercial rental properties represented 19% of the total loan portfolio as of December 31, 2016. Note 6 discusses the types of securities in which the Corporation invests and Note 7 discusses the Corporation's lending activities.

### **Investments**

The investment portfolio is classified and accounted for based on the guidance of ASC Topic 320, *Investments – Debt and Equity Securities*. Securities bought and held principally for the purpose of selling them in the near term are classified as trading account securities and reported at fair value with unrealized gains and losses included in net gains/losses in other operating income. Securities purchased with the intent and ability to hold the securities to maturity are classified as held-to-maturity securities and are recorded at amortized cost. All other investment securities are classified as available-for-sale. These securities are held for an indefinite period of time and may be sold in response to changing market and interest rate conditions or for liquidity purposes as part of our overall asset/liability management strategy. Available-for-sale securities are reported at market value, with unrealized gains and losses excluded from earnings and reported as a separate component of other comprehensive income included in consolidated statement of comprehensive income, net of applicable income taxes.

The amortized cost of debt securities 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.

### **Restricted Investment in Bank Stock**

Restricted stock, which represents required investments in the common stock of the Federal Home Loan Bank (“FHLB”) of Atlanta, Atlantic Community Bankers Bank (“ACBB”) and Community Bankers Bank (“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*, (942-325-35). Management’s evaluation of potential impairment is based on its 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 (i) 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, (ii) 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 (iii) 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 December 31, 2016 or 2015.

The Corporation recognizes dividends on a cash basis. For the years ended December 31, 2016 and December 31, 2015, dividends of \$269,694 and \$302,227, respectively, were recorded in income.

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## **Loans**

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or full repayment by the borrower are reported at their unpaid principal balance outstanding, adjusted for any deferred fees or costs pertaining to origination. Loans that management has the intent to sell are reported at the lower of cost or fair value determined on an individual basis.

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 further disaggregated into two classes. Non-owner occupied CRE loans, which include loans secured by non-owner occupied nonfarm 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 further disaggregated 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. These loans have a higher risk profile because the ultimate buyer, once development is completed, is generally not known at the time of the A&D loan. 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 further disaggregated into two classes: amortizing term loans, which are primarily first liens, and home equity lines of credit, which are generally second liens. The consumer loan segment consists primarily of installment loans (direct and indirect) and overdraft lines of credit connected with customer deposit accounts.

## **Interest and Fees on Loans**

Interest on loans (other than those on non-accrual status) is recognized based upon the principal amount outstanding. Loan fees in excess of the costs incurred to originate the loan are recognized as income over the life of the loan utilizing either the interest method or the straight-line method, depending on the type of loan. Generally, fees on loans with a specified maturity date, such as residential mortgages, are recognized using the interest method. Loan fees for lines of credit are recognized using the straight-line method.

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.

Generally, consumer installment loans are not placed on non-accrual status, but are charged off after they are 120 days contractually past due. Loans other than consumer loans are charged-off based on an evaluation of the facts and circumstances of each individual loan.

### **Allowance for Loan Losses**

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 Corporation’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 Statements 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 Corporation maintains an ALL on unfunded commercial lending commitments and letters of credit to provide for the risk of loss inherent in these arrangements. The allowance is determined utilizing a methodology that is similar to that used to determine the ALL, modified to take into account the probability of a draw down on the commitment. This allowance is reported as a liability on the balance sheet within accrued interest payable and other liabilities. The balance in the liability account was \$61,174 at December 31, 2016 and \$65,332 at December 31, 2015.

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## **Premises and Equipment**

Land is carried at cost. Premises and equipment are carried at cost, less accumulated depreciation. The provision for depreciation for financial reporting has been made by using the straight-line method based on the estimated useful lives of the assets, which range from 10 to 31.6 years for buildings and three to 20 years for furniture and equipment. Accelerated depreciation methods are used for income tax purposes.

## **Goodwill**

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired in business combinations. In accordance with ASC Topic 350, *Intangibles - Goodwill and Other*, goodwill is not amortized but is subject to an annual impairment test.

## **Bank-Owned Life Insurance (“BOLI”)**

BOLI policies are recorded at their cash surrender values. Changes in the cash surrender values are recorded as other operating income.

## **Other Real Estate Owned**

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less the cost to sell at the date of foreclosure, with any losses charged to the ALL, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Changes in the valuation allowance, sales gains and losses, and revenue and expenses from holding and operating properties are all included in net expenses from other real estate owned (“OREO”).

## **Income Taxes**

First United Corporation and its subsidiaries file a consolidated federal income tax return. Income taxes are accounted for using the asset and liability method. Under the asset and liability method, the deferred tax liability or asset is determined based on the difference between the financial statement and tax bases of assets and liabilities (temporary differences) and is measured at the enacted tax rates that will be in effect when these differences reverse. Deferred tax expense is determined by the change in the net liability or asset for deferred taxes adjusted for changes in any deferred tax asset valuation allowance.

ASC Topic 740, *Taxes*, provides clarification on accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We have not identified any income tax uncertainties.

State corporate income tax returns are filed annually. Federal and state returns may be selected for examination by the Internal Revenue Service and the states where we file, subject to statutes of limitations. At any given point in time, the Corporation may have several years of filed tax returns that may be selected for examination or review by taxing authorities.

Interest and penalties on income taxes are recognized as a component of income tax expense.

### **Defined Benefit Plans**

The defined benefit pension plan and supplemental executive retirement plan are accounted for in accordance with ASC Topic 715, *Compensation – Retirement Benefits*. Under the provisions of Topic 715, the defined benefit pension plan and the supplemental executive retirement plan are recognized as liabilities in the Consolidated Statement of Financial Condition, and unrecognized net actuarial losses, prior service costs and a net transition asset are recognized as a separate component of other comprehensive loss, net of tax. Actuarial gains and losses in excess of 10 percent of the greater of plan assets or the pension benefit obligation are amortized over a blend of future service of active employees and life expectancy of inactive participants. Refer to Note 18 for a further discussion of the pension plan and supplemental executive retirement plan obligations.

### **Statement of Cash Flows**

Cash and cash equivalents are defined as cash and due from banks and interest bearing deposits in banks in the Consolidated Statement of Cash Flows.

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## **Trust Assets and Income**

Assets held in an agency or fiduciary capacity are not the Bank's assets and, accordingly, are not included in the Consolidated Statement of Financial Condition. Income from the Bank's trust department represents fees charged to customers and is recorded on an accrual basis.

## **Business Segments**

The Corporation operates in one segment, community banking, as defined by ASC Topic 280, *Segment Reporting*. The Corporation in its entirety is managed and evaluated on an ongoing basis by First United Corporation's Board of Directors and executive management, with no division or subsidiary receiving separate analysis regarding performance or resource allocation.

## **Equity Compensation Plan**

At the 2007 Annual Meeting of Shareholders, First United Corporation's shareholders approved the First United Corporation Omnibus Equity Compensation Plan (the "Omnibus Plan"), which authorizes the issuance of up to 185,000 shares of common stock pursuant to the grant of stock options, stock appreciation rights, stock awards, stock units, performance units, dividend equivalents, and other stock-based awards to employees or directors.

On June 18, 2008, the Board of Directors of First United Corporation adopted a Long-Term Incentive Program (the "LTIP"). This program was adopted as a sub-plan of the Omnibus Plan to reward participants for increasing shareholder value, align executive interests with those of shareholders, and serve as a retention tool for key executives. Under the LTIP, participants are granted shares of restricted common stock of First United Corporation. The amount of an award is based on a specified percentage of the participant's salary as of the date of grant. These shares will vest if the Corporation meets or exceeds certain performance thresholds.

The Corporation applies the provisions of ASC Topic 718, *Compensation-Stock Compensation*, in measuring and disclosing stock compensation cost. The measurement objective in ASC Paragraph 718-10-30-6 requires public companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. The cost is recognized in expense over the period in which an employee is



required to provide service in exchange for the award (the vesting period).

Stock-based awards were made to non-employee directors in May 2016 pursuant to First United Corporation's director compensation policy. Each director receives an annual retainer of 1,000 shares of First United Corporation common stock, plus \$10,000 to be paid, at the director's election, in cash or additional shares of common stock. In 2016 and 2015, a total of 14,384 and 16,022, respectively, fully-vested shares of common stock were issued to directors, which had a fair market value of \$10.34 and \$8.96 per share, respectively. Director stock compensation expense was \$147,006 for the year ended December 31, 2016 and \$147,738 for the year ended December 31, 2015.

In January 2015, a one-time stock grant was awarded to one executive officer in the amount of 4,845 shares at a fair market value of \$8.63. In February 2015, a one-time stock grant was awarded to one executive officer in the amount of 5,387 shares at a fair market value of \$8.76. These shares have a two-year vesting period. Executive stock compensation expense related to these awards was \$45,527 for the year ended December 31, 2016 and \$43,475 for the year ended December 31, 2015. There was no executive stock compensation expense remaining at December 31, 2016.

### **Stock Repurchases**

Under the Maryland General Corporation Law, shares of capital stock that are repurchased are cancelled and treated as authorized but unissued shares. When a share of capital stock is repurchased, the payment of the repurchase price reduces stated capital by the par value of that share (currently, \$0.01 for common stock and \$0.00 for preferred stock), and any excess over par value reduces capital surplus. There were no stock repurchases in 2016 and 2015.

### **Adoption of New Accounting Standards and Effects of New Accounting Pronouncements**

In January 2017, the FASB issued Accounting Standards Update ("ASU") 2017-04, *Intangibles- Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. ASU 2017-04 simplifies the accounting for goodwill impairments by eliminating step 2 from the goodwill impairment test. Instead, if "the carrying amount of a reporting unit exceeds its fair value, an impairment loss shall be recognized in an amount equal to that excess, limited to the total amount of goodwill allocated to that reporting unit." The ASU does not change the qualitative assessment, however, it removes the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform step 2 of the goodwill impairment test. ASU 2017-04 is effective for public business entities that are SEC filers for annual periods beginning after December 15, 2019, and interim periods within those annual periods, for public entities that are not SEC filers for annual periods beginning after December 15, 2020 and for all other entities for annual periods beginning after December 15, 2021 with early adoption permitted. The Corporation is evaluating the provisions of ASU 2017-04 but believes that its adoption will not have a material impact on the Corporation's financial condition or results of operations.

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In August 2016, the FASB issued Accounting Standards Update (“ASU”) 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*. ASU 2016-15 addresses the following eight specific cash flow issues: (a) debt prepayment or debt extinguishment costs; (b) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; (c) contingent consideration payments made after a business combination; (d) proceeds from the settlement of insurance claims; (e) proceeds from the settlement of corporate-owned life insurance policies (COLIs) (including bank-owned life insurance policies (BOLIs)); (f) distributions received from equity method investees; (g) beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominance principle. The amendments in this Update apply to all entities, including both business entities and not-for-profit entities that are required to present a statement of cash flows under Topic 230. ASU 2016-15 is effective for public business entities for annual periods beginning after December 15, 2017, and interim periods within those annual periods, and for all other entities for annual periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 15, 2019 with early adoption permitted. The Corporation is evaluating the provisions of ASU 2016-15 but believes that its adoption will not have a material impact on the Corporation’s financial condition or results of operations.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments- Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. ASU 2016-13 introduces an approach based on expected losses to estimate credit losses on certain types of financial instruments. It also modifies the impairment model for available-for-sale (“AFS”) debt securities and provides for a simplified accounting model for purchases financial assets with credit deterioration since their origination. The new model referred to as current expected credit losses (“CECL”) model, will apply to: (a) financial assets subject to credit losses and measured at amortized cost, and (b) certain off-balance sheet credit exposures. This includes loans, held to maturity debt securities, loan commitments, financial guarantees and net investments in leases as well as reinsurance and trade receivables. The estimate of expected credit losses (“ECL”) should consider historical information, current information, and supportable forecasts, including estimates of prepayments. ASU 2016-13 is effective for public business entities for annual periods beginning after December 15, 2019, and interim periods within those annual periods, and for all other entities for annual periods beginning after December 15, 2020 and interim periods within annual periods beginning after December 15, 2018 with early adoption permitted. Management currently intends to adopt the guidance on January 1, 2020 and is assessing the impact of this guidance on the Corporation’s financial condition and results of operations. Management has formed a focus group consisting of multiple members from areas including credit, finance, and information systems. The focus group is evaluating the requirements of the new standard and the impact it will have on our processes. The Corporation is still in the process of determining the impact on the Corporation’s financial condition or results of operations.

In March 2016, the FASB issued ASU 2016-09, *Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*. ASU 2016-09 introduces amendments intended to simplify the accounting for stock compensation. ASU 2016-09 requires all excess tax benefits and tax deficiencies to be recognized as income tax expense or benefit in the income statement. The tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. An entity should also recognize excess tax benefits, and assess the need for a valuation allowance, regardless of whether the benefit reduces taxes payable in the current period. The ASU also requires excess tax benefits be classified along with other income tax cash flows as an operating activity in the statement of cash flows. ASU 2016-09 is effective for public business entities for annual periods beginning after December 15, 2016, and interim periods within those annual periods, and for all other entities

for annual periods beginning after December 15, 2017 and interim periods within annual periods beginning after December 15, 2018 with early adoption permitted. The Corporation is evaluating the provisions of ASU 2016-09, but believes that its adoption will not have a material impact on the Corporation's financial condition or results of operations.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. ASU 2016-02 is intended to improve financial reporting about leasing transactions by requiring organizations that lease assets – referred to as “lessees” – to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases. Under the new guidance, a lessee will be required to recognize assets and liabilities related to certain operating leases on the balance sheet. The amendments will require disclosures to help investors and other financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 applies to all public business entities for annual and interim periods after December 15, 2018, and for all other entities for annual periods beginning after December 15, 2019 and interim periods beginning after December 15, 2020 with early adoption permitted. Management is currently assessing the impact of the new guidance but expects to report higher assets and liabilities as a result of including additional leases on the consolidated balance sheet.

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In January 2016, the FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10)*. The update requires all equity investments to be measured at fair value with changes in the fair value recognized through net income (other than those accounted for under equity method of accounting or those that result in consolidation of the investee). The update also requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. In addition, the update eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities and the requirement for to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measure at amortized cost on the balance sheet for public entities. For public business entities, the amendments are effective for annual periods beginning after December 15, 2017, including interim periods within the annual period, and for all other entities, effective for annual periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 15, 2019. Early application is permitted. The Corporation is evaluating the provisions of ASU 2016-01, but believes that its adoption will not have a material impact on the Corporation's financial condition or results of operations.

In November 2015, the FASB issued ASU 2015-17, *Income Taxes (Topic 874): Balance Sheet Classification of Deferred Taxes*. ASU 2015-17 eliminates the guidance in Topic 740, Income Taxes, that required an entity to separate deferred tax liabilities and assets between current and noncurrent amounts in a classified balance sheet. The amendments require that all deferred tax liabilities and assets of the same tax jurisdiction or a tax filing group, as well as any related valuation allowance, be offset and presented as a single noncurrent amount in a classified balance sheet. Prior U.S. GAAP required that in a classified balance sheet, deferred tax liabilities and assets be separated into a current and a noncurrent amount on the basis of the classification of the related asset or liability. If deferred tax liabilities and assets did not relate to a specific asset or liability, such as a carryforward, they were classified according to the expected reversal date of the temporary difference. ASU 2015-17 applies to all public business entities for annual and interim periods beginning after December 15, 2016, and for all other entities for annual periods beginning after December 15, 2017 and for interim periods beginning after December 15, 2018. The Corporation is evaluating the provisions of ASU 2015-17, but believes that its adoption will not have a material impact on the Corporation's financial condition or results of operations.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*, which establishes a comprehensive revenue recognition standard for virtually all industries under U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. ASU 2014-09 specifies that an entity shall recognize revenue when, or as, the entity satisfies a performance obligation by transferring a promised good or service (i.e. an asset) to a customer. An asset is transferred when, or as, the customer obtains control of the asset. Entities are required to disclose qualitative and quantitative information on the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. ASU 2014-09 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017. Because the guidance does not apply to revenue associated with financial instruments, including loans and securities, the new guidance is not expected to have a material impact on the components of the consolidated statement of income related to financial instruments, including securities gains/losses and interest income. However, we do believe the new standard will result in new disclosure requirements. The Corporation is currently evaluating this guidance on other components of non-interest income such as service charges, payment processing fees, trust services fees, and

brokerage services fees. The new guidance is not expected to have a material impact on the Corporation's financial condition or results of operations.

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## 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. There were no common stock equivalents at December 31, 2016 or December 31, 2015.

The following table sets forth the calculation of basic and diluted earnings per common share for the years ended December 31, 2016 and 2015:

(in thousands, except for per share amount)	2016			2015		
	Income	Average Shares	Per Share Amount	Income	Average Shares	Per Share Amount
Basic and Diluted Earnings Per Share:						
Net income	\$7,281			\$12,991		
Preferred stock dividends paid	(2,025)			(2,700)		
Net income available to common shareholders	\$5,256	6,264	\$ 0.84	\$10,291	6,249	\$ 1.65

## 3. Net Gains

The following table summarizes the gain/(loss) activity for the years ended December 31, 2016 and 2015:

(in thousands)	2016	2015
Net gains/(losses):		
Available-for-sale securities:		
Realized gains	\$688	\$1,609
Realized losses	(248)	(647)
Gain on sale of consumer loans	95	57
Loss on disposal of fixed assets	(9)	(3)
Net gains	\$526	\$1,016

## 4. Regulatory Capital Requirements

We require capital to fund loans, satisfy our obligations under the Bank's letters of credit, meet the deposit withdrawal demands of the Bank's customers, and satisfy our other monetary obligations. To the extent that deposits are not adequate to fund our capital requirements, we can rely on a number of funding sources, including an unsecured Fed Funds lines of credit with upstream correspondent banks; secured advances with the FHLB of Atlanta, which are collateralized by eligible one to four family residential mortgage loans, home equity lines of credit, commercial real estate loans, and various securities. Cash may also be pledged as collateral. In addition, First United Corporation has a secured line of credit with the Fed Discount Window for use in borrowing funds up to 90 days, using municipal securities as collateral; brokered deposits, including CDs and money market funds; and One Way Buy CDARS/ ICS funding, which is a form of brokered deposits that has become a viable supplement to brokered deposits obtained directly. At December 31, 2016, the Bank had \$70.0 million available through unsecured lines of credit with correspondent banks, \$10.6 million through a secured line of credit with the Fed Discount Window and approximately \$172.4 million at the FHLB. Management is not aware of any demands, commitments, events or uncertainties that are likely to materially affect our ability to meet our future capital requirements.

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(in thousands)	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions			
	Amount	Ratio	Amount	Ratio	Amount	Ratio		
December 31, 2016								
Total Capital (to risk-weighted assets)								
Consolidated	\$ 164,081	16.71 %	\$ 78,577	8.00 %	\$ 98,221	10.00	%	
First United Bank & Trust	155,992	16.70 %	74,733	8.00 %	93,416	10.00	%	
Tier 1 Capital (to risk-weighted assets)								
Consolidated	145,008	14.76 %	58,933	6.00 %	78,577	8.00	%	
First United Bank & Trust	146,013	15.63 %	56,050	6.00 %	74,733	8.00	%	
Common Equity Tier 1 Capital (to risk-weighted assets)								
Consolidated	105,523	10.74 %	44,200	4.50 %	63,844	6.50	%	
First United Bank & Trust	146,013	15.63 %	42,037	4.50 %	60,721	6.50	%	
Tier 1 Capital (to average assets)								
Consolidated	145,008	10.95 %	53,124	4.00 %	66,404	5.00	%	
First United Bank & Trust	146,013	11.11 %	52,321	4.00 %	65,401	5.00	%	
December 31, 2015								
Total Capital (to risk-weighted assets)								
Consolidated	\$ 173,124	17.21 %	\$ 79,276	8.00 %	\$ 99,095	10.00	%	
First United Bank & Trust	149,775	16.29 %	73,714	8.00 %	92,143	10.00	%	
Tier 1 Capital (to risk-weighted assets)								
Consolidated	153,283	15.24 %	59,457	6.00 %	79,276	8.00	%	
First United Bank & Trust	138,243	15.03 %	55,286	6.00 %	73,714	8.00	%	
Common Equity Tier 1 Capital (to risk-weighted assets)								
Consolidated	100,485	9.99 %	44,593	4.50 %	64,412	6.50	%	
First United Bank & Trust	138,243	15.03 %	41,464	4.50 %	59,893	6.50	%	
Tier 1 Capital (to average assets)								
Consolidated	153,283	11.64 %	52,833	4.00 %	66,041	5.00	%	
First United Bank & Trust	138,243	10.53 %	52,346	4.00 %	65,432	5.00	%	

As of December 31, 2016 and 2015, the most recent notifications from the regulators categorized First United Corporation and the Bank as “well capitalized” under the regulatory framework for prompt corrective action. On a consolidated basis, there was a slight decline in the capital ratios when comparing December 31, 2016 to December 31, 2015 due to the dividend of \$10.0 million from the Bank to the holding company in December 2015 and the Corporation’s subsequent repayment of \$10.0 million of its outstanding Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the “Series A Preferred Stock”) in February 2016. The consolidated total risk-based capital ratios

include \$40.3 million of First United Corporation's junior subordinated debentures ("TPS Debentures") which qualified as Tier 1 capital at December 31, 2016 under guidance issued by the Board of Governors of the Federal Reserve System (the "Federal Reserve").

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At the Bank level, the ratios increased from December 31, 2015 to December 31, 2016. As of December 31, 2016, we were in compliance with the requirements as set forth in the final rules.

First United Corporation's Board of Directors suspended the payment of dividends on the common stock in December 2010.

## 5. 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)	December 31, 2016	December 31, 2015
Cash and due from banks, weighted average interest rate of 0.29% (at December 31, 2016)	\$ 60,707	\$ 50,188

Interest bearing deposits in banks, which represent funds invested at a correspondent bank, are carried at fair value and, as of December 31, 2016 and 2015, consisted of daily funds invested at the FHLB of Atlanta, First Tennessee Bank ("FTN"), and M&T Bank ("M&T").

(in thousands)	December 31, 2016	December 31, 2015
FHLB daily investments, interest rate of 0.57% (at December 31, 2016)	\$ 1,590	\$ 742
FTN daily investments, interest rate of 0.00% (at December 31, 2016)	0	200
M&T daily investments, interest rate of 0.15% (at December 31, 2016)	1,013	1,011
	\$ 2,603	\$ 1,953

[65]

## 6. Investment Securities

The following table shows a comparison of amortized cost and fair values of investment securities at December 31, 2016 and 2015:

(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	OTTI in AOCL
December 31, 2016					
Available for Sale:					
U.S. government agencies	\$ 25,000	\$ 0	747	\$ 24,253	\$ 0
Commercial mortgage-backed agencies	52,978	1	757	52,222	0
Collateralized mortgage obligations	19,953	13	399	19,567	0
Obligations of states and political subdivisions	23,700	255	251	23,704	0
Collateralized debt obligations	27,930	0	7,676	20,254	(3,961 )
Total available for sale	\$ 149,561	\$ 269	\$ 9,830	\$ 140,000	\$ (3,961 )
Held to Maturity:					
U.S. government agencies	\$ 15,738	\$ 512	\$ 0	\$ 16,250	\$ 0
Residential mortgage-backed agencies	50,384	160	279	50,265	0
Commercial mortgage-backed agencies	17,584	248	0	17,832	0
Collateralized mortgage obligations	4,833	0	149	4,684	0
Obligations of states and political subdivisions	8,630	490	170	8,950	0
Total held to maturity	\$ 97,169	\$ 1,410	\$ 598	\$ 97,981	\$ 0
December 31, 2015					
Available for Sale:					
U.S. government agencies	34,079	14	129	33,964	0
Residential mortgage-backed agencies	14,285	105	220	14,170	0
Commercial mortgage-backed agencies	43,780	52	196	43,636	0
Collateralized mortgage obligations	9,690	43	123	9,610	0
Obligations of states and political subdivisions	45,949	915	223	46,641	0
Collateralized debt obligations	29,287	0	7,076	22,211	(4,320 )
Total available for sale	\$ 177,070	1,129	7,967	170,232	(4,320 )
Held to Maturity:					
U.S. government agencies	\$ 24,704	\$ 634	\$ 0	\$ 25,338	\$ 0
Residential mortgage-backed agencies	53,734	276	98	53,912	0
Commercial mortgage-backed agencies	18,078	171	17	18,232	0
Collateralized mortgage obligations	6,419	0	122	6,297	0
Obligations of states and political subdivisions	2,625	338	0	2,963	0
Total held to maturity	\$ 105,560	\$ 1,419	\$ 237	\$ 106,742	\$ 0

[66]

Proceeds from sales of available-for-sale securities and the realized gains and losses for the years ended December 31, 2016 and 2015 are as follows:

(in thousands)	2016	2015
Proceeds	\$43,782	\$60,598
Realized gains	688	1,609
Realized losses	248	647

The following table shows the Corporation's securities with gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized position, at December 31, 2016 and 2015:

(in thousands)	Less than 12 months		12 months or more	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2016				
Available for Sale:				
U.S. government agencies	\$ 24,253	\$ 747	\$ 0	\$ 0
Commercial mortgage-backed agencies	51,604	757	0	0
Collateralized mortgage obligations	14,706	399	0	0
Obligations of states and political subdivisions	8,079	160	2,934	91
Collateralized debt obligations	0	0	20,254	7,676
Total available for sale	\$ 98,642	\$ 2,063	\$ 23,188	\$ 7,767
Held to Maturity:				
Residential mortgage-backed agencies	20,899	279	0	0
Commercial mortgage-backed agencies	4,684	149	0	0
Obligations of states and political subdivisions	2,335	170	0	0
Total held to maturity	\$ 27,918	\$ 598	\$ 0	\$ 0
December 31, 2015				
Available for Sale:				
U.S. government agencies	23,929	129	0	0
Residential mortgage-backed agencies	0	0	8,051	220
Commercial mortgage-backed agencies	25,858	196	0	0
Collateralized mortgage obligations	5,299	123	0	0
Obligations of states and political subdivisions	11,537	104	4,048	119
Collateralized debt obligations	0	0	22,211	7,076
Total available for sale	\$ 66,623	\$ 552	\$ 34,310	\$ 7,415
Held to Maturity:				
Residential mortgage-backed agencies	11,085	98	0	0
Commercial mortgage-backed agencies	9,518	17	0	0
Collateralized mortgage obligations	6,297	122	0	0

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Obligations of states and political subdivisions	0	0	0	0
Total held to maturity	\$ 26,900	\$ 237	\$ 0	\$ 0

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Management systematically evaluates securities for impairment on a quarterly basis. Based upon application of accounting guidance for subsequent measurement in ASC Topic 320 (ASC Section 320-10-35), management assesses whether (i) the Corporation has the intent to sell a security being evaluated and (ii) 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 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 OTTI losses, management considers (a) the length of time and the extent to which the fair value has been less than cost, (b) adverse conditions specifically related to the security, an industry, or a geographic area, (c) the historic and implied volatility of the fair value of the security, (d) changes in the rating of the security by a rating agency, (e) recoveries or additional declines in fair value subsequent to the balance sheet date, (f) failure of the issuer of the security to make scheduled interest or principal payments, and (g) 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).

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. Management performs due diligence on the third party processes and believes that it has an adequate understanding of the analysis, assumptions and methodology used by the third party to prepare the fair value determination and the OTTI evaluation. Management reviews the qualifications of the third party and believes they are qualified to provide the analysis and pricing determinations. Quarterly, management reviews the third party’s detailed assumptions and analyzes its projected discounted present value results for reasonableness and consistency with the trend of prior projections. Annually, management performs stress tests of the assumptions used in the third party models and performs back tests of the assumptions and prepayment projections to validate the impairment model results. As a result of its due diligence process, management believes that the fair value presented and the OTTI recognized are appropriate. A total of \$3.2 million in impairment losses was realized during the time period 2009 through 2011 on the CDO portfolio remaining at December 31, 2016. Due to the prior credit impairment, the securities in this portfolio have continued to be evaluated to determine whether any additional OTTI has occurred. Based on management’s review of the third party evaluations, management believes that there were no material differences in the relative valuations between December 31, 2016 and December 31, 2015.

U.S. Government Agencies – Available for Sale – There were four U.S. government agencies in an unrealized loss position for less than 12 months as of December 31, 2016. There were no 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 December 31, 2016.



Residential Mortgage-Backed Agencies – Available for Sale - There were no residential mortgage-backed agencies in an unrealized loss position as of December 31, 2016.

Commercial Mortgage-Backed Agencies – Available for Sale – There were nine commercial mortgage-backed agencies in an unrealized loss position for less than 12 months as of December 31, 2016. 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 December 31, 2016. There were no commercial mortgage-backed agency securities in an unrealized loss position for 12 months or more.

Collateralized Mortgage Obligations – Available for Sale – There were three collateralized mortgage obligations in an unrealized loss position for less than 12 months as of December 31, 2016. 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 the amortized cost basis, which may be at maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at December 31, 2016. There were no collateralized mortgage obligations in an unrealized loss position for 12 months or more.

Obligations of State and Political Subdivisions – Available for Sale – There were five obligations of state and political subdivisions that have been in an unrealized loss position for less than 12 months at December 31, 2016. There was one security that has 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 and performs an in-depth credit analysis on the securities. Management believes that this portfolio is well-diversified throughout the United States, and all 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 December 31, 2016.

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Collateralized Debt Obligations – Available for Sale - The \$7.7 million in unrealized losses greater than 12 months at December 31, 2016 relates to twelve pooled trust preferred securities that are included in the CDO portfolio. See Note 24 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 2016. 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.

U.S. Government Agencies – Held to Maturity – There were no U.S. government agencies in an unrealized loss position as of December 31, 2016.

Residential Mortgage-Backed Agencies – Held to Maturity – There were 15 residential mortgage-backed agencies have been in an unrealized loss position for less than 12 months as of December 31, 2016. The securities are of the highest investment grade and the Corporation has the intent and ability to hold the investments to maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at December 31, 2016. There were no residential mortgage-backed agencies in an unrealized loss position for 12 months or more.

Commercial Mortgage-Backed Agencies – Held to Maturity – There were no commercial mortgage-backed agencies in an unrealized loss position as of December 31, 2016.

Collateralized Mortgage Obligations – Held to Maturity – There was one collateralized mortgage obligation in an unrealized loss position for less than 12 months as of December 31, 2016. The security is of the highest investment grade and the Corporation has the intent and ability to hold the investment to maturity. Accordingly, management does not consider this investment to be other-than-temporarily impaired at December 31, 2016. There were no collateralized mortgage obligations in an unrealized loss position for 12 months or more.

Obligations of State and Political Subdivisions – Held to Maturity – There was one obligations of state and political subdivision in an unrealized loss position for less than 12 months as of December 31, 2016. This bond is a Tax Increment Fund (TIF) bond. Management performs an in-depth credit analysis on this security. The Corporation has the intent and ability to hold the investment to maturity. Accordingly, management does not consider this investment to be other-than-temporarily impaired at December 31, 2016. There were no obligations of state and political subdivisions in an unrealized loss position for 12 months for more.

Due to the duration and market value decline in the pooled trust preferred securities held in our portfolio, we performed more extensive testing on these securities for purposes of evaluating whether or not OTTI has occurred.

The market for these securities as of December 31, 2016 as well as the market for similar securities saw limited activity. The inactivity was evidenced by a decrease in the volume of trades relative to historical levels due to limited supply. In addition, the securities that traded were typically more senior in the capital structure. The new issue market is also inactive, as no new 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 Treasury, are depressed relative to historical levels. 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 (i) the few observable transactions and market quotations that are available are not reliable for the purpose of obtaining fair value at either December 31, 2015 or 2016, (ii) an income valuation approach technique (i.e. present value) that maximizes the use of relevant unobservable inputs and minimizes the use of observable inputs will be equally or more representative of fair value than a market approach, and (iii) 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 and the fair value determinations for the CDO portfolio. Management does not believe that there were any material differences in the OTTI evaluations and pricing between December 31, 2015 and December 31, 2016.

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The approach used by the third party to determine fair value involved several steps, which included detailed credit and structural evaluation of each piece of collateral in each bond, projection of 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, with a limited market for highly-rated CDO securities that are more senior in the capital structure than the securities in the CDO portfolio. Therefore, adjustments to the baseline discount rate are also made to reflect the additional leverage found in structured instruments.

On December 10, 2013, to implement Section 619 of the Dodd-Frank Act, the Treasury, the federal banking regulators including FDIC, and the Securities and Exchange Commission (the “SEC”) adopted the Volcker Rule. The Volcker Rule prohibits a banking institution from acquiring or retaining an “ownership interest” in a “covered fund”. A “covered fund” is (a) an entity that would be an investment company under the Investment Company Act of 1940, as amended, but for the exemptions contained in Section 3(c)(1) or Section 3(c)(7) of that Act, (b) a commodity pool with certain characteristics, and/or (c) a non-US entity with certain characteristics that is sponsored or owned by a banking entity located or organized in the US. The term “ownership interest” is defined as “any equity, partnership, or other similar interest.”

On January 14, 2014, the federal banking agencies adopted a final interim rule that exempts CDOs from the scope of the Volcker Rule if they were issued in offerings in which, among other things, the proceeds were used primarily to purchase securities issued by depository institutions and their affiliates. In connection with that final interim rule, the agencies published a non-exclusive list of exempt offerings.

Of the 12 CDOs held by the Corporation, 10 were issued in exempt offerings. The two remaining CDOs are collateralized primarily by securities issued by insurance companies and are not included in the agencies’ list of exempt offerings, which fact required management to make a determination as to whether the CDOs constituted an “ownership interest” in a “covered fund”, such that the Corporation would be required to dispose of them pursuant to the Volcker Rule. To make this determination, management conducted a thorough review of the Indentures that govern the CDOs and the other offering materials used by the issuers to offer and sell the CDOs.

The Volcker Rule defines an “ownership interest” as an equity, partnership or other similar interest. The CDOs are debt securities (promissory notes) issued by corporations that call for regularly-scheduled payments of principal and interest, with interest calculated either at a fixed-rate or at a rate that is tied to LIBOR. Accordingly, none of the CDOs represent an equity or partnership interest in the issuers. In their adopting rule release, the agencies stated that debt securities evidencing “typical extensions of credit” – those that “provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate” – do not generally meet the definition of “other similar interest”. To be considered an “other similar interest”, a debt security must exhibit one or more of seven

specified characteristics identified in the Volcker Rule on a current, future, or contingent basis.

Based on its review, management concluded that the two CDOs evidences “typical extensions of credit” and do not exhibit any of these seven characteristics. Accordingly, management concluded that the two CDOs constitutes an “ownership interest” as defined by the Volcker Rule and that, therefore, as of December 31, 2016, the Corporation has the current intent and ability to hold these CDOs until maturity.

During the first quarter of 2014 and following the promulgation of the Volcker Rule, the fair value of the CDO portfolio improved significantly. The improvement was due to several factors including improved financial condition of the issuers, improved cash flows and a lower discount rate. As the issuers resumed payments of previously deferred interest during the quarter, cash flow projections for the securities increased. In addition, the discount rate utilized in the cash flow models was reduced as the base line current market yield for comparable corporate and structured products improved and the projected credit performance of the CDOs improved with favorable market conditions. The resulting increase in cash flow projections over the remaining life of the securities yielded a higher fair market value.

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 years ended December 31, 2016 and 2015:

(in thousands)	2016	2015
Balance of credit-related OTTI at January 1	\$3,133	\$12,583
Decreases for previously recognized credit-related OTTI because there was an intent to sell	0	(10,029)
Additions for decreases in cash flows expected to be collected	0	602
Reduction for increases in cash flows expected to be collected	(9 )	(23 )
Balance of credit-related OTTI at December 31	\$3,124	\$3,133

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The amortized cost and estimated fair value of securities by contractual maturity at December 31, 2016 are shown in the following table. Actual maturities will 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.

(in thousands)	Amortized Cost	Fair Value
<b>Contractual Maturity</b>		
Available for sale:		
Due after one year through five years	\$ 10,667	\$ 10,524
Due after five years through ten years	19,576	19,027
Due after ten years	46,387	38,660
	76,630	68,211
Commercial mortgage-backed agencies	52,978	52,222
Collateralized mortgage obligations	19,953	19,567
Total available for sale	\$ 149,561	\$ 140,000
Held to Maturity:		
Due after five years through ten years	\$ 15,738	\$ 16,250
Due after ten years	8,630	8,950
	24,368	25,200
Residential mortgage-backed agencies	50,384	50,265
Commercial mortgage-backed agencies	17,584	17,832
Collateralized mortgage obligations	4,833	4,684
Total held to maturity	\$ 97,169	\$ 97,981

At December 31, 2016 and 2015, investment securities with a value of \$121.8 million and \$140.0 million, respectively, were pledged as permitted or required to secure public deposits, for securities sold under agreements to repurchase as required or permitted by law and as collateral for borrowing capacity.

## 7. Loans and Related Allowance for Loan Losses

The following table summarizes the primary segments of the loan portfolio as of December 31, 2016 and December 31, 2015:

(in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Consumer	Total
December 31, 2016						
Individually evaluated for impairment	\$ 17,210	\$ 2,525	\$ 290	\$ 3,975	\$ 0	\$ 24,000
	\$ 280,749	\$ 101,757	\$ 72,056	\$ 389,441	\$ 23,923	\$ 867,926

Collectively evaluated for  
impairment

Total loans	\$ 297,959	\$ 104,282	\$ 72,346	\$ 393,416	\$ 23,923	\$ 891,926
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December 31, 2015

Individually evaluated for  
impairment

	\$ 14,646	\$ 4,496	\$ 1,076	\$ 4,590	\$ 0	\$ 24,808
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Collectively evaluated for  
impairment

	\$ 265,859	\$ 106,490	\$ 72,777	\$ 384,149	\$ 24,940	\$ 854,215
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Total loans

	\$ 280,505	\$ 110,986	\$ 73,853	\$ 388,739	\$ 24,940	\$ 879,023
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The segments of the Bank's loan portfolio are disaggregated to a level that allows management to monitor risk and performance. The CRE loan segment is further disaggregated into two classes. Non-owner occupied CRE loans, which include loans secured by non-owner occupied nonfarm 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 A&D loan segment is further disaggregated 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. These loans have a higher risk profile because the ultimate buyer, once development is completed, is generally not known at the time of the A&D loan. The C&I loan segment consists of loans made for the purpose of financing the activities of commercial customers. The residential mortgage loan segment is further disaggregated into two classes: amortizing term loans, which are primarily first liens, and home equity lines of credit, which are generally second liens. The consumer loan segment consists primarily of installment loans (direct and indirect) and overdraft lines of credit connected with customer deposit accounts.

In the ordinary course of business, executive officers and directors of the Corporation, including their families and companies in which certain directors are principal owners, were loan customers of the Bank. Pursuant to the Bank's lending policies, such loans were made on the same terms, including collateral, as those prevailing at the time for comparable transactions with persons who are not related to the Corporation and do not involve more than the normal risk of collectability. Changes in the dollar amount of loans outstanding to officers, directors and their associates were as follows for the year ended December 31:

(in thousands)	2016
Balance at January 1	\$ 11,393
Loans or advances	915
Repayments	(2,016 )
Balance at December 31	\$ 10,292

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. Only 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 is classified in the Doubtful category. Any portion of a loan that has been charged off is placed in the Loss category. It is possible for a loan to be classified as Substandard in the internal risk rating system, but not considered impaired under GAAP, due to the broader reach of "well-defined weaknesses" in the application of the Substandard definition.



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 \$1,000,000 and/or criticized non-consumer loans 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.

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The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention and Substandard. There were no loans classified as Doubtful within the internal risk rating system as of December 31, 2016 and 2015:

(in thousands)	Pass	Special Mention	Substandard	Total
December 31, 2016				
Commercial real estate				
Non owner-occupied	\$ 137,181	\$ 10,620	\$ 9,357	\$ 157,158
All other CRE	125,720	3,121	11,960	140,801
Acquisition and development				
1-4 family residential construction	15,845	0	0	15,845
All other A&D	87,135	65	1,237	88,437
Commercial and industrial	70,613	593	1,140	72,346
Residential mortgage				
Residential mortgage - term	308,734	113	7,618	316,465
Residential mortgage – home equity	75,710	0	1,241	76,951
Consumer	23,794	0	129	23,923
Total	\$844,732	\$ 14,512	\$ 32,682	\$891,926
December 31, 2015				
Commercial real estate				
Non owner-occupied	\$ 140,378	\$ 11,574	\$ 7,378	\$ 159,330
All other CRE	103,811	1,184	16,180	121,175
Acquisition and development				
1-4 family residential construction	15,011	0	700	15,711
All other A&D	89,963	74	5,238	95,275
Commercial and industrial	69,420	1,212	3,221	73,853
Residential mortgage				
Residential mortgage - term	300,558	167	10,744	311,469
Residential mortgage – home equity	75,491	0	1,779	77,270
Consumer	24,881	0	59	24,940
Total	\$819,513	\$ 14,211	\$ 45,299	\$879,023

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.

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The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and non-accrual loans as of December 31, 2016 and December 31, 2015:

(in thousands)	Current	30-59 Day Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due and still accruing	Non-Accrual	Total Loans
December 31, 2016							
Commercial real estate							
Non owner-occupied	\$ 150,595	\$ 182	\$ 0	\$ 0	\$ 182	\$ 6,381	\$ 157,158
All other CRE	134,931	40	0	0	40	5,830	140,801
Acquisition and development							
1-4 family residential construction	15,845	0	0	0	0	0	15,845
All other A&D	88,353	0	39	0	39	45	88,437
Commercial and industrial	72,324	9	2	11	22	0	72,346
Residential mortgage							
Residential mortgage - term	310,721	517	3,376	312	4,205	1,539	316,465
Residential mortgage – home equity	75,558	974	198	70	1,242	151	76,951
Consumer	23,662	186	48	27	261	0	23,923
Total	\$ 871,989	\$ 1,908	\$ 3,663	\$ 420	\$ 5,991	\$ 13,946	\$ 891,926
December 31, 2015							
Commercial real estate							
Non owner-occupied	\$ 157,217	\$ 634	\$ 171	\$ 0	\$ 805	\$ 1,308	\$ 159,330
All other CRE	110,022	1,179	0	0	1,179	9,974	121,175
Acquisition and development							
1-4 family residential construction	15,711	0	0	0	0	0	15,711
All other A&D	93,284	0	174	0	174	1,817	95,275
Commercial and industrial	73,619	13	36	0	49	185	73,853
Residential mortgage							
Residential mortgage - term	306,248	227	2,149	907	3,283	1,938	311,469
Residential mortgage – home equity	76,195	505	203	91	799	276	77,270
Consumer	24,604	224	85	27	336	0	24,940
Total	\$ 856,900	\$ 2,782	\$ 2,818	\$ 1,025	\$ 6,625	\$ 15,498	\$ 879,023

Non-accrual loans which have been subject to a partial charge-off totaled \$11.1 million as of December 31, 2016, compared to \$4.1 million as of December 31, 2015. Loans secured by 1-4 family residential real estate properties in the process of foreclosure was \$0.5 million at December 31, 2016 and \$1.8 million at December 31, 2015.

The 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 Statements on the Allowance for Loan and Lease Losses and other bank regulatory guidance. The total of the two components represents the Bank's ALL.

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The following table summarizes the primary segments of the ALL, segregated into the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment as of December 31, 2016 and December 31, 2015.

(in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Consumer	Unallocated	Total
December 31, 2016							
Individually evaluated for impairment	\$ 177	\$ 40	\$ 0	\$ 43	\$ 0	\$ 0	\$260
Collectively evaluated for impairment	\$ 3,736	\$ 831	\$ 858	\$ 3,545	\$ 188	\$ 500	\$9,658
Total ALL	\$ 3,913	\$ 871	\$ 858	\$ 3,588	\$ 188	\$ 500	\$9,918
December 31, 2015							
Individually evaluated for impairment	\$ 144	\$ 867	\$ 16	\$ 130	\$ 0	\$ 0	\$1,157
Collectively evaluated for impairment	\$ 2,436	\$ 3,262	\$ 706	\$ 3,655	\$ 206	\$ 500	\$10,765
Total ALL	\$ 2,580	\$ 4,129	\$ 722	\$ 3,785	\$ 206	\$ 500	\$11,922

Management evaluates individual loans in all of the commercial segments for possible impairment if the loan is greater than \$500,000 or is part of a relationship that is greater than \$750,000 and (i) is either in non-accrual status or (ii) is risk-rated Substandard and is 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 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: (i) the present value of expected future cash flows discounted at the loan's effective interest rate; (ii) the loan's observable market price; or (iii) the fair value of the collateral less selling costs. The method is selected on a loan-by-loan basis, with management utilizing the fair value of collateral method for all of the analyses. 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 the loan balance is less than \$500,000, 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. The discount rates in the appraisal discount grid are updated at least annually 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, 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. 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. 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.

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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 December 31, 2016 and December 31, 2015:

(in thousands)	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance	Total Impaired Loans	
	Recorded Investment	Related Allowances	Recorded Investment	Recorded Investment	Unpaid Principal Balance
December 31, 2016					
Commercial real estate					
Non owner-occupied	\$ 131	\$ 23	\$ 6,635	\$ 6,766	\$ 9,372
All other CRE	432	154	10,012	10,444	11,057
Acquisition and development					
1-4 family residential construction	0	0	582	582	628
All other A&D	245	40	1,698	1,943	2,213
Commercial and industrial	0	0	290	290	2,504
Residential mortgage					
Residential mortgage - term	61	43	3,763	3,824	4,249
Residential mortgage – home equity	0	0	151	151	168
Consumer	0	0	0	0	0
Total impaired loans	\$ 869	\$ 260	\$ 23,131	\$ 24,000	\$ 30,191
December 31, 2015					
Commercial real estate					
Non owner-occupied	\$ 676	\$ 144	\$ 1,031	\$ 1,707	\$ 1,842
All other CRE	0	0	12,939	12,939	13,302
Acquisition and development					
1-4 family residential construction	700	178	0	700	746
All other A&D	1,979	689	1,817	3,796	8,362
Commercial and industrial	16	16	1,060	1,076	3,343
Residential mortgage					
Residential mortgage - term	440	112	3,874	4,314	4,808
Residential mortgage – home equity	57	18	219	276	297
Consumer	0	0	0	0	0
Total impaired loans	\$ 3,868	\$ 1,157	\$ 20,940	\$ 24,808	\$ 32,700

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. The un-criticized (“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.

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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: (i) national and local economic trends and conditions; (ii) levels of and trends in delinquency rates and non-accrual loans; (iii) trends in volumes and terms of loans; (iv) effects of changes in lending policies; (v) experience, ability, and depth of lending staff; (vi) value of underlying collateral; and (vii) 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. In most cases, 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 years ended December 31, 2016 and December 31, 2015:

(in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Consumer	Unallocated	Total
ALL balance at January 1, 2016	\$ 2,580	\$ 4,129	\$ 722	\$ 3,785	\$ 206	\$ 500	\$11,922
Charge-offs	(5,301 )	(248 )	(558 )	(737 )	(333 )	0	(7,177 )
Recoveries	90	1,303	52	461	145	0	2,051
Provision	6,544	(4,313 )	642	79	170	0	3,122
ALL balance at December 31, 2016	\$ 3,913	\$ 871	\$ 858	\$ 3,588	\$ 188	\$ 500	\$9,918
ALL balance at January 1, 2015	\$ 2,424	\$ 3,912	\$ 1,680	\$ 3,862	\$ 187	\$ 0	\$12,065
Charge-offs	(420 )	(1,261 )	(26 )	(300 )	(307 )	0	(2,314 )
Recoveries	283	382	26	217	209	0	1,117

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Provision	293	1,096	(958	)	6	117	500	1,054
ALL balance at December 31, 2015	\$ 2,580	\$ 4,129	\$ 722		\$ 3,785	\$ 206	\$ 500	\$11,922

The ALL is based on estimates, and actual losses will 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.

[77]

The following table presents the average recorded investment in impaired loans and related interest income recognized for the years ended December 31, 2016 and 2015:

(in thousands)	2016			2015		
	Average investment	Interest income recognized on an accrual basis	Interest income recognized on a cash basis	Average investment	Interest income recognized on an accrual basis	Interest income recognized on a cash basis
Commercial real estate						
Non owner-occupied	\$6,076	\$ 131	\$ 0	\$3,792	\$ 144	\$ 0
All other CRE	11,802	187	8	8,688	124	106
Acquisition and development						
1-4 family residential construction	629	27	0	736	33	0
All other A&D	2,735	95	0	5,008	119	0
Commercial and industrial	934	37	0	1,392	69	18
Residential mortgage						
Residential mortgage - term	4,580	163	16	4,258	164	10
Residential mortgage – home equity	272	0	0	334	0	2
Consumer	0	0	0	6	0	0
Total	\$27,028	\$ 640	\$ 24	\$24,214	\$ 653	\$ 136

In the normal course of business, the Bank modifies loan terms for various reasons. These reasons may include as a retention strategy to compete in the current interest rate environment, and to re-amortize or extend 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 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 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, amortization period and/or maturity date) are modified in such a way 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. TDRs are considered to be in payment default if, subsequent to modification, the loans are transferred to non-accrual status or to foreclosure. A loan may be removed from being reported as a TDR 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. Further, a loan that has been removed from TDR reporting status and has been subsequently re-modified at standard market terms, may be removed from impaired status as well.

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

[78]

There were 24 loans totaling \$9.3 million and 29 loans totaling \$14.0 million that were classified as TDRs at December 31, 2016 and December 31, 2015, respectively. The following table presents the volume and recorded investment at the time of modification of TDRs by class and type of modification that occurred during the periods indicated:

(Dollars in thousands)	Temporary Rate Modification		Extension of Maturity		Modification of Payment and Other Terms	
	Number of Recorded Contracts	Investment	Number of Recorded Contracts	Investment	Number of Recorded Contracts	Investment
For the year ended December 31, 2016						
Commercial real estate						
Non owner-occupied	0	\$ 0	0	\$ 0	0	\$ 0
All other CRE	0	0	1	203	0	0
Acquisition and development						
1-4 family residential construction	0	0	1	582	0	0
All other A&D	0	0	1	1,664	0	0
Commercial and industrial	0	0	1	482	1	486
Residential mortgage						
Residential mortgage – term	3	260	1	61	3	469
Residential mortgage – home equity	0	0	0	0	0	0
Consumer	0	0	0	0	0	0
Total	3	\$ 260	5	\$ 2,992	4	\$ 955
For the year ended December 31, 2015						
Commercial real estate						
Non owner-occupied	0	\$ 0	1	\$ 3,097	2	\$ 260
All other CRE	0	0	1	237	5	3,847
Acquisition and development						
1-4 family residential construction	0	0	0	0	1	700
All other A&D	0	0	3	372	1	1,746
Commercial and industrial	0	0	1	930	0	0
Residential mortgage						
Residential mortgage – term	1	156	3	741	1	116
Residential mortgage – home equity	0	0	0	0	0	0
Consumer	0	0	0	0	0	0
Total	1	\$ 156	9	\$ 5,377	10	\$ 6,669

During the year ended December 31, 2016, there were seven new TDRs. In addition, five existing TDRs which had reached their original modification maturity were re-modified. A \$7 thousand reduction of the ALL resulted from a change to the impairment evaluation of the seven new TDRs, from evaluated collectively to being evaluated individually. There was no impact to the recorded investment relating to the transfer of these loans.

During the year ended December 31, 2016, activity relating to payment defaults included two mortgage loans totaling \$.2 million, one C&I loan totaling \$.2 million, four A&D loans totaling \$1.7 million and three CRE loans totaling \$1.5 million that were transferred to OREO during the year; and one mortgage loan totaling \$.1 million that was transferred to non-accrual. During the year ended December 31, 2015, activity relating to payment defaults included one mortgage loan totaling \$.1 million that was transferred to OREO during the year; and two mortgage loans totaling \$.2 million that were transferred to non-accrual.

At December 31, 2016, there were no additional funds committed and at December 31, 2015 up to \$11,200 were committed to be advanced in connection with TDRs.

[79]

**8. Other Real Estate Owned**

The following table presents the components of OREO as of December 31, 2016 and 2015:

(in thousands)	2016	2015
Commercial real estate	\$3,803	\$1,520
Acquisition and development	5,944	4,167
Residential mortgage	1,163	1,196
Total OREO	\$10,910	\$6,883

The following table presents the activity in the OREO valuation allowance for the years ended December 31, 2016 and 2015:

(in thousands)	2016	2015
Balance January 1	\$4,430	\$3,440
Fair value write-down	486	1,997
Sales of OREO	(1,381)	(1,007)
Balance December 31	\$3,535	\$4,430

The following table presents the components of OREO expenses, net for the years ended December 31, 2016 and 2015:

(in thousands)	2016	2015
Gains on real estate, net	\$(189)	\$(753)
Fair value write-down	486	1,997
Expenses, net	603	885
Rental and other income	(98)	(230)
Total OREO expenses, net	\$802	\$1,899

**9. Premises and Equipment**

The following table presents the components of premises and equipment at December 31, 2016 and 2015:

(in thousands)	2016	2015
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Land	\$7,383	\$7,304
Land Improvements	1,201	1,210
Premises	25,696	25,272
Furniture and Equipment	17,506	16,824
Capital Lease	534	534
	52,320	51,144
Less accumulated depreciation	(25,160)	(25,946)
Total	\$27,160	\$25,198

The Corporation recorded depreciation expense of \$1.7 million in 2016 and \$1.8 million in 2015.

Pursuant to the terms of non-cancelable operating lease agreements for banking and subsidiaries' offices and for data processing and telecommunications equipment in effect at December 31, 2016, future minimum rent commitments under these leases for future years are as follows: (i) \$3.4 million for 2017; (ii) \$3.4 million for 2018; (iii) \$3.1 million for 2019; (iv) \$3.1 million for 2020; (v) \$3.1 million for 2021; and (vi) \$9.0 million thereafter. The leases contain options to extend for periods from one to five years, which are not included in the aforementioned amounts.

Total building and land rental expense amounted to \$.5 million in 2016 and 2015.

[80]

## 10. Goodwill

ASC Topic 350, *Intangibles - Goodwill and Other*, establishes standards for the amortization of acquired intangible assets and impairment assessment of goodwill. The \$11.0 million in recorded goodwill at December 31, 2016 is related to the Bank's 2003 acquisition of Huntington National Bank branches and is not subject to periodic amortization.

Goodwill arising from business combinations represents the value attributable to unidentifiable intangible elements in the business acquired. Goodwill is not amortized but is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Impairment testing requires that the fair value of each of an entity's reporting units be compared to the carrying amount of its net assets, including goodwill. If the estimated current fair value of the reporting unit exceeds its carrying value, then no additional testing is required and an impairment loss is not recorded. Otherwise, additional testing is performed and, to the extent such additional testing results in a conclusion that the carrying value of goodwill exceeds its implied fair value, an impairment loss is recognized.

For evaluation purposes, the Corporation is considered to be a single reporting unit. Accordingly, our goodwill relates to value inherent in the banking business and the value is dependent upon our ability to provide quality, cost effective services in a highly competitive local market. This ability relies upon continuing investments in processing systems, the development of value-added service features and the ease of use of our services. As such, goodwill value is supported ultimately by revenue that is driven by the volume of business transacted. A decline in earnings as a result of a lack of growth or the inability to deliver cost effective services over sustained periods can lead to impairment of goodwill, which could adversely impact earnings in future periods. ASC Topic 350 requires an annual evaluation of goodwill for impairment. The determination of whether or not these assets are impaired involves significant judgments and estimates.

At December 31, 2016, the date of the Corporation's annual impairment evaluation, the estimated fair value of the Corporation, as determined by the price of its common stock, exceeded the carrying amount of the Corporation's common equity. Based on this analysis, management concluded that the recorded value of goodwill at December 31, 2016 was not impaired. However, future changes in strategy and/or market conditions could significantly impact this conclusion and require adjustments to recorded asset balances. Management will continue to evaluate goodwill for impairment on an annual basis and as events occur or circumstances change.

The significant components of goodwill at December 31, 2016 and 2015 are as follows:

(In thousands) Gross Carrying Amount   Accumulated Amortization   Net Carrying Amount

Goodwill:      \$ 14,812                      \$ (3,808                      ) \$ 11,004

**11. Deposits**

The aggregate amount of time deposits in denomination of \$250,000 or more was \$45.6 million at December 31, 2016 and \$32.6 million at December 31, 2015. The aggregate amount of time deposits with a minimum denomination of \$100,000 was \$123.9 million and \$124.8 million at December 31, 2016 and 2015, respectively. At December 31, 2016, \$.2 million of deposit overdrafts were re-classified as loans.

The following is a summary of the scheduled maturities of all time deposits as of December 31, 2016 (in thousands):

2017	\$93,433
2018	52,321
2019	27,605
2020	22,336
2021	45,415
Thereafter	0
<b>Total</b>	<b>\$241,110</b>

[81]

In the ordinary course of business, executive officers and directors of the Corporation, including their families and companies in which certain directors are principal owners, were deposit customers of the Bank. Pursuant to the Bank's policies, such deposits are on the same terms as those prevailing at the time for comparable deposits with persons who are not related to the Corporation. At December 31, 2016, executive officers and directors had approximately \$5.2 million in deposits with the Bank.

## 12. Borrowed Funds

The following is a summary of short-term borrowings at December 31, 2016 and 2015 with original maturities of less than one year:

(Dollars in thousands)	2016	2015
Securities sold under agreements to repurchase:		
Outstanding at end of year	\$36,000	\$35,828
Weighted average interest rate at year end	0.16 %	0.16 %
Maximum amount outstanding as of any month end	\$39,456	\$47,131
Average amount outstanding	\$30,899	\$35,908
Approximate weighted average rate during the year	0.19 %	0.16 %

At December 31, 2016, the repurchase agreements were secured by \$49.8 million in investment securities.

The following is a summary of long-term borrowings at December 31, 2016 and 2015 with original maturities exceeding one year:

(In thousands)	2016	2015
FHLB advances, bearing fixed interest rates ranging from 1.54% to 3.69% at December 31, 2016	\$90,007	\$105,807
Junior subordinated debt, bearing variable interest rate of 3.74% at December 31, 2016	30,929	30,929
Junior subordinated debt, bearing fixed interest rate of 9.88% at December 31, 2016	10,801	10,801
Total long-term debt	\$131,737	\$147,537

At December 31, 2016, the long-term FHLB advances were secured by \$262.4 million in loans.

The contractual maturities of long-term borrowings at December 31, 2016 and 2015 are as follows:

(in thousands)	2016		Total	2015 Total
	Fixed Rate	Floating Rate		
Due in 2018	20,000	0	20,000	20,000
Due in 2019	20,000	0	20,000	0
Due in 2020	30,000	0	30,000	30,000
Due in 2021	20,000	0	20,000	35,000
Thereafter	10,808	30,929	41,737	62,537
Total long-term debt	\$ 100,808	\$ 30,929	\$ 131,737	\$ 147,537

[82]

The Bank has a borrowing capacity agreement with the FHLB in an amount equal to 30% of the Bank's assets. At December 31, 2016, the available line of credit equaled \$389.1 million. This line of credit, which can be used for both short and long-term funding, can only be utilized to the extent of available collateral. The line is secured by certain qualified mortgage, commercial and home equity loans and investment securities as follows (in thousands):

1-4 family mortgage loans	\$ 199,577
Commercial loans	29,263
Multi-family loans	827
Home equity loans	32,760
	\$262,427

At December 31, 2016, \$172.4 million was available for additional borrowings.

The Bank also has various unsecured lines of credit totaling \$70.0 million with various financial institutions and a \$10.6 million secured line with the Federal Reserve to meet daily liquidity requirements. As of December 31, 2016, there were no borrowings under these credit facilities. In addition, there was approximately \$95.7 million of available funding through brokered money market funds at December 31, 2016.

**Repurchase Agreements** - The Bank has retail repurchase agreements with customers within its local market areas. Repurchase agreements generally have maturities of one to four days from the transaction date. These borrowings are collateralized with securities that we own and are held in safekeeping at independent correspondent banks.

**FHLB Advances** - The FHLB advances consist of various borrowings with maturities generally ranging from five to 10 years with initial fixed rate periods of one, two or three years. After the initial fixed rate period, the FHLB has one or more options to convert each advance to a LIBOR based, variable rate advance, but the Bank may repay the advance in whole or in part, without a penalty, if the FHLB exercises its option. At all other times, the Bank's early repayment of any advance could be subject to a prepayment penalty.

### 13. Junior Subordinated Debentures and Restrictions on Dividends

In March 2004, Trust I and Trust II issued preferred securities with an aggregate liquidation amount of \$30.0 million to third-party investors and issued common equity with an aggregate liquidation amount of \$.9 million to First United Corporation. Trust I and Trust II used the proceeds of these offerings to purchase an equal amount of TPS Debentures, as follows:

\$20.6 million—floating rate payable quarterly based on three-month LIBOR plus 275 basis points (3.74% at December 31, 2016), maturing in 2034, became redeemable five years after issuance at First United Corporation's option.

\$10.3 million—floating rate payable quarterly based on three-month LIBOR plus 275 basis points (3.74% at December 31, 2016) maturing in 2034, became redeemable five years after issuance at First United Corporation's option.

In December 2009, Trust III issued 9.875% fixed-rate preferred securities with an aggregate liquidation amount of approximately \$7.0 million to private investors and issued common securities to First United Corporation with an aggregate liquidation amount of approximately \$.2 million. Trust III used the proceeds of the offering to purchase approximately \$7.2 million of 9.875% fixed-rate TPS Debentures. Interest on these TPS Debentures are payable quarterly, and the TPS Debentures mature in 2040 but are redeemable five years after issuance at First United Corporation's option.

In January 2010, Trust III issued an additional \$3.5 million of 9.875% fixed-rate preferred securities to private investors and issued common securities to First United Corporation with an aggregate liquidation amount of \$.1 million. Trust III used the proceeds of the offering to purchase \$3.6 million of 9.875% fixed-rate TPS Debentures. Interest on these TPS Debentures are payable quarterly, and the TPS Debentures mature in 2040 but are redeemable five years after issuance at First United Corporation's option.

The TPS Debentures issued to each of the Trusts represent the sole assets of that Trust, and payments of the TPS Debentures by First United Corporation are the only sources of cash flow for the Trust. First United Corporation has the right, without triggering a default, to defer interest on all of the TPS Debentures for up to 20 quarterly periods, in which case distributions on the preferred securities will also be deferred. Should this occur, the Corporation may not pay dividends or distributions on, or repurchase, redeem or acquire any shares of its capital stock. Refer to Note 4 for further details.

[83]

On February 22, 2017, the Corporation notified the trustee of Trust III that the Corporation intends to repay all of the TPS Debentures issued to Trust III on March 24, 2017. Following that repayment, Trust III is required to redeem all of Trust III's outstanding securities. The Corporation's ability to effect this repayment is subject to its receipt of at least \$7.0 million in gross proceeds from its pending common stock rights offering and/or the standby purchases transactions related thereto.

#### **14. Preferred Stock**

On January 30, 2009, pursuant to the Troubled Asset Relief program Capital Purchase Program adopted by the U.S. Department of the Treasury (the "Treasury"), First United Corporation issued to the Treasury 30,000 shares of its Series A Preferred Stock and a Warrant to purchase 326,323 shares of common stock at an exercise price of \$13.79 per share, for an aggregate consideration of \$30.0 million. The proceeds from this transaction qualify as Tier 1 capital and the Warrant qualified as tangible common equity.

The holders of the Series A Preferred Stock are entitled to receive, if and when declared by the Board of Directors, out of assets legally available for payment, cumulative cash dividends at a rate per annum of 5% per share on a liquidation amount of \$1,000 per share of Series A Preferred Stock with respect to each dividend period from January 30, 2009 to, but excluding, February 15, 2014. From and after February 15, 2014, holders of Series A Preferred Stock are entitled to receive cumulative cash dividends at a rate per annum of 9% per share on a liquidation amount of \$1,000 per share with respect to each dividend period thereafter. In 2014, the Corporation paid \$7.9 million in dividends, including all deferred dividends, to holders of the Series A Preferred Stock. Under the terms of the Series A Preferred Stock, on and after February 15, 2012, the Corporation may, at its option and after consulting with the Reserve Bank, redeem shares of Series A Preferred Stock, in whole or in part, at any time and from time to time, for cash at a per share amount equal to the sum of the liquidation preference per share plus any accrued and unpaid dividends to but excluding the redemption date.

On December 4, 2014, the Treasury sold all of its shares of Series A Preferred stock to third-party investors.

On May 26, 2015, the Corporation repurchased the warrant from the Treasury for \$120,786, which is included in other expense. The warrant was canceled and as a result of the repurchase, the Treasury has no remaining equity investment in the Corporation.

On February 15, 2016, the Corporation redeemed 10,000 shares of the Series A Preferred Stock, having an aggregate liquidation amount of \$10.0 million, on a pro rata basis from each of the holders. On February 17, 2017, the Corporation notified the holders of the remaining 20,000 shares of Series A Preferred Stock that it had called an additional 10,000 shares, having an aggregate liquidation amount of \$10.0 million, for redemption on March 21, 2017.



The Corporation's ability to effect the March 21, 2017 redemption is subject to its receipt of at least \$7.0 million in gross proceeds from its pending common stock rights offering and/or the standby purchase transactions related thereto.

## **15. Variable Interest Entities**

As noted in Note 14, First United Corporation created the Trusts for the purposes of raising regulatory capital through the sale of mandatorily redeemable preferred capital securities to third party investors and common equity interests to First United Corporation. The Trusts are considered VIEs, but are not consolidated because First United Corporation is not the primary beneficiary of the Trusts. At December 31, 2016, the Corporation reported all of the \$41.7 million of TPS Debentures issued in connection with these offerings as long-term borrowings, and it reported its \$1.3 million equity interest in the Trusts as "Other Assets".

In November 2009, the Bank became a 99.99% limited partner in Liberty Mews. Liberty Mews was financed with a total of \$10.6 million of funding, including a \$6.1 million equity contribution from the Bank as the limited partner. Liberty Mews used the proceeds from these sources to purchase land and construct thereon a 36-unit low income housing rental complex at a total cost of \$10.6 million. The total assets of Liberty Mews were \$8.8 million at December 31, 2016 and \$9.1 million at December 31, 2015.

Through December 31, 2016, the Bank had made contributions to Liberty Mews totaling \$6.1 million. The project for which Liberty Mews was formed was completed in June 2011, and the Bank is entitled to \$8.4 million in federal investment tax credits over a 10-year period as long as certain qualifying hurdles are maintained. The Bank will also receive the benefit of tax operating losses from Liberty Mews the extent of its capital contribution. The investment in Liberty Mews assists the Bank in achieving its community reinvestment initiatives.

[84]

Because Liberty Mews is considered to be a VIE, management performed an analysis to determine whether its involvement with Liberty Mews would lead it to determine that it must consolidate Liberty Mews. In performing its analysis, management evaluated the risks creating the variability in Liberty Mews and identified which activities most significantly impact the VIE's economic performance. Finally, it examined each of the variable interest holders to determine which, if any, of the holders was the primary beneficiary based on their power to direct the most significant activities and their obligation to absorb potentially significant losses of Liberty Mews.

The Bank, as a limited partner, generally has no voting rights. The Bank is not in any way involved in the daily management of Liberty Mews and has no other rights that provide it with the power to direct the activities that most significantly impact Liberty Mews' economic performance, which are to develop and operate the housing project in such a manner that complies with specific tax credit guidelines. As a limited partner, there is no recourse to the Bank by the creditors of Liberty Mews. The tax credits that result from the Bank's investment in Liberty Mews are generally subject to recapture should the partnership fail to comply with the applicable government regulations. The Bank has not provided any financial or other support to Liberty Mews beyond its required capital contributions and does not anticipate providing such support in the future. Management currently believes that no material losses are probable as a result of the Bank's investment in Liberty Mews.

On the basis of management's analysis, the general partner is deemed to be the primary beneficiary of Liberty Mews. Because the Bank is not the primary beneficiary, Liberty Mews has not been included in the Corporation's consolidated financial statements.

The Corporation accounts for the Bank's investment in Liberty Mews utilizing the effective yield method under guidance that applies specifically to investments in limited partnerships that operate qualified affordable housing projects. Under the effective yield method, the investor recognizes tax credits as they are allocated and amortizes the initial cost of the investment to provide a constant effective yield over the period that tax credits are allocated to the investor. The effective yield is the internal rate of return on the investment, based on the cost of the investment and the guaranteed tax credits allocated to the investor. The tax credit allocated, net of the amortization of the investment in the limited partnership, is recognized in the income statement as a component of income taxes attributable to continuing operations.

The Corporation's tax expense for the year ended December 31, 2016 was approximately \$.4 million lower as a result of the impact of the tax credits and the tax losses relating to the partnership.

At December 31, 2016 and December 31, 2015, the Corporation included the Bank's total investment in Liberty Mews in "Other Assets" in its Consolidated Statements of Financial Condition. As of December 31, 2016 the Corporation's commitment in Liberty Mews is fully funded. The following table presents details of the Bank's involvement with Liberty Mews at the dates indicated:

(In thousands)	2016	2015
Investment in LIHTC Partnership		
Carrying amount on Balance Sheet of:		
Investment (Other Assets)	\$3,223	\$3,844
Maximum exposure to loss	3,223	3,844

[85]

**16. Accumulated Other Comprehensive Loss (“AOCL”)**

The following table presents the changes in each component of accumulated other comprehensive loss for the years ended December 31, 2016 and 2015:

(in thousands)	Investment securities- with OTTI AFS	Investment securities- all other AFS	Investment securities- HTM	Cash Flow Hedge	Pension Plan	SERP	Total
Accumulated OCL, net:							
Balance - January 1, 2015	\$ (3,679 )	\$ (2,555 )	\$ (2,255 )	\$ (119 )	\$ (11,392 )	\$ (233 )	\$ (20,233 )
Other comprehensive income/(loss) before reclassifications	1,793	705	0	80	(1,736 )	(113)	729
Amounts reclassified from accumulated other comprehensive loss	(56 )	(174 )	284	0	465	41	560
Balance - December 31, 2015	\$ (1,942 )	\$ (2,024 )	\$ (1,971 )	\$ (39 )	\$ (12,663 )	\$ (305 )	\$ (18,944 )
Other comprehensive income/(loss) before reclassifications	(421 )	(929 )	0	461	(2,086 )	(466)	(3,441 )
Amounts reclassified from accumulated other comprehensive loss	(5 )	(265 )	617	0	517	56	920
Balance - December 31, 2016	\$ (2,368 )	\$ (3,218 )	\$ (1,354 )	\$ 422	\$ (14,232 )	\$ (715 )	\$ (21,465 )

[86]

The following tables present the components of other comprehensive income/(loss) for the years ended December 31, 2016 and 2015:

<b>Components of Other Comprehensive Loss (in thousands)</b>	<b>Before Tax Amount</b>	<b>Tax (Expense) Benefit</b>	<b>Net</b>
For the year ended December 31, 2016			
Available for sale (AFS) securities with OTTI:			
Unrealized holding losses	\$ (700	) \$ 279	\$(421 )
Less: accretable yield recognized in income	9	(4	) 5
Net unrealized losses on investments with OTTI	(709	) 283	(426 )
Available for sale securities – all other:			
Unrealized holding losses	(1,545	) 616	(929 )
Plus: gains recognized in income	440	(175	) 265
Net unrealized losses on all other AFS securities	(1,985	) 791	(1,194)
Held to maturity securities:			
Unrealized holding gains	0	0	0
Less: amortization recognized in income	(1,026	) 409	(617 )
Net unrealized gains on HTM securities	1,026	(409	) 617
Cash flow hedges:			
Unrealized holding gains	766	(305	) 461
Pension Plan:			
Unrealized net actuarial loss	(3,468	) 1,382	(2,086)
Less: amortization of unrecognized loss	(848	) 338	(510 )
Less: amortization of transition asset	0	0	0
Less: amortization of prior service costs	(12	) 5	(7 )
Net pension plan liability adjustment	(2,608	) 1,039	(1,569)
SERP:			
Unrealized net actuarial loss	(775	) 309	(466 )
Less: amortization of unrecognized loss	(73	) 29	(44 )
Less: amortization of prior service costs	(20	) 8	(12 )
Net SERP liability adjustment	(682	) 272	(410 )
Other comprehensive loss	\$ (4,192	) \$ 1,671	\$(2,521)

[87]

<b>Components of Other Comprehensive Income (in thousands)</b>	Before Tax Amount	Tax (Expense) Benefit	Net
For the year ended December 31, 2015			
Available for sale (AFS) securities with OTTI:			
Unrealized holding gains	\$ 2,985	\$ (1,192 )	\$1,793
Less: losses recognized in income	672	(268 )	404
Less: accretable yield recognized in income	(580 )	232 )	(348 )
Net unrealized gains on investments with OTTI	2,893	(1,156 )	1,737
Available for sale securities – all other:			
Unrealized holding gains	1,174	(469 )	705
Plus: gains recognized in income	290	(116 )	174
Net unrealized gains on all other AFS securities	884	(353 )	531
Held to maturity securities:			
Unrealized holding gains	0	0	0
Less: amortization recognized in income	(473 )	189 )	(284 )
Net unrealized gains on HTM securities	473	(189 )	284
Cash flow hedges:			
Unrealized holding gains	133	(53 )	80
Pension Plan:			
Unrealized net actuarial loss	(2,890 )	1,154 )	(1,736)
Less: amortization of unrecognized loss	(781 )	312 )	(469 )
Less: amortization of transition asset	19	(8 )	11
Less: amortization of prior service costs	(12 )	5 )	(7 )
Net pension plan liability adjustment	(2,116 )	845 )	(1,271)
SERP:			
Unrealized net actuarial loss	(188 )	75 )	(113 )
Less: amortization of unrecognized loss	(49 )	20 )	(29 )
Less: amortization of prior service costs	(20 )	8 )	(12 )
Net SERP liability adjustment	(119 )	47 )	(72 )
Other comprehensive income	\$ 2,148	\$ (859 )	\$1,289

[88]

The following tables present the details of accumulated other comprehensive income components for the years ended December 31, 2016 and 2015:

Details of Accumulated Other Comprehensive Income Components (in thousands)	Amount Reclassified from Accumulated Other Comprehensive Income	
	2016	Affected Line Item in the Statement Where Net Income is Presented
Net unrealized losses on investment securities with OTTI:		
Accretable Yield	\$ 9	Interest income on taxable investment securities
Taxes	(4)	) Tax expense
	\$ 5	Net of tax
Net unrealized losses on available for sale investment securities - all other:		
Gains on sales	\$ 440	Net gains - other
Taxes	(175)	) Tax expense
	\$ 265	Net of tax
Net unrealized gains on held to maturity investment securities:		
Amortization	\$ (1,026)	) Interest income on taxable investment securities
Taxes	409	Tax benefit
	\$ (617)	) Net of tax
Net pension plan liability adjustment:		
Amortization of unrecognized loss	(848)	) Salaries and employee benefits
Amortization of transition asset	0	Salaries and employee benefits
Amortization of prior service costs	(12)	) Salaries and employee benefits
Taxes	343	Tax benefit
	\$ (517)	) Net of tax
Net SERP liability adjustment:		
Amortization of unrecognized loss	(73)	) Salaries and employee benefits
Amortization of prior service costs	(20)	) Salaries and employee benefits
Taxes	37	Tax benefit
	\$ (56)	) Net of tax
Total reclassifications for the period	\$ (920)	) Net of tax

[89]

Details of Accumulated Other Comprehensive Income Components (in thousands)	Amount Reclassified from Accumulated Other Comprehensive Income	
	2015	Affected Line Item in the Statement Where Net Income is Presented
Net unrealized gains on investment securities with OTTI:		
Losses recognized	\$ 672	Net losses - other
Accretable Yield reversal	(580)	) Interest income on taxable investment securities
Taxes	(36)	) Tax benefit
	\$ 56	Net of tax
Net unrealized gains on available for sale investment securities - all other:		
Gain on Sales	\$ 290	Net gains - other
Taxes	(116)	) Tax benefit
	\$ 174	Net of tax
Net unrealized gains on held to maturity investment securities:		
Amortization	\$ (473)	) Interest income on taxable investment securities
Taxes	189	) Tax benefit
	\$ (284)	) Net of tax
Net pension plan liability adjustment:		
Amortization of unrecognized loss	(781)	) Salaries and employee benefits
Amortization of transition asset	19	) Salaries and employee benefits
Amortization of prior service costs	(12)	) Salaries and employee benefits
Taxes	309	) Tax benefit
	\$ (465)	) Net of tax
Net SERP liability adjustment:		
Amortization of unrecognized loss	(49)	) Salaries and employee benefits
Amortization of prior service costs	(20)	) Salaries and employee benefits
Taxes	28	) Tax benefit
	\$ (41)	) Net of tax
Total reclassifications for the period	\$ (560)	) Net of tax

[90]



**17. Income Taxes**

The provision for income taxes consists of the following for the years ended December 31, 2016 and 2015:

(In thousands)	2016	2015
Current Tax expense:		
Federal	\$622	\$585
State	44	627
	\$666	\$1,212
Deferred tax expense:		
Federal	\$1,694	\$4,715
State	423	546
	\$2,117	\$5,261
Income tax expense for the year	\$2,783	\$6,473

The reconciliation between the statutory federal income tax rate and effective income tax rate for the years ended December 31, 2016 and 2015 is as follows:

	2016	2015
Federal statutory rate	35.0%	35.0%
Tax-exempt income on securities and loans	(2.9)	(2.4)
Tax-exempt BOLI income	(5.0)	(2.1)
State income tax, net of federal tax benefit	4.5	4.9
Tax credits	(4.4)	(2.4)
Other	0.4	0.2
	27.6%	33.2%

[91]

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Corporation's temporary differences as of December 31, 2016 and 2015 are as follows:

(In thousands)	2016	2015
Deferred tax assets:		
Allowance for loan losses	\$3,952	\$4,760
Deferred loan fees	164	137
Deferred compensation	912	901
Federal and state tax loss carry forwards	4,849	4,165
AMT and other carry forwards	5,147	4,304
Unrealized loss on investment securities	4,705	4,039
Pension/SERP	2,883	2,598
Other than temporary impairment on investment securities	1,244	1,251
Other real estate owned	1,408	1,769
Other	222	1,481
Total deferred tax assets	25,486	25,405
Valuation allowance	(1,856 )	(1,794 )
Total deferred tax assets less valuation allowance	23,630	23,611
Deferred tax liabilities:		
Amortization of goodwill	(3,197 )	(2,986 )
Depreciation	(730 )	(653 )
Other	(366 )	(182 )
Total deferred tax liabilities	(4,293 )	(3,821 )
Net deferred tax assets	\$19,337	\$19,790

In assessing the ability to realize deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of the deferred tax assets is dependent upon the generation of future taxable income of the appropriate character (for example, ordinary income or capital gain) within the carry-back or carry-forward period available under the tax law during the periods in which temporary differences are deductible. The Corporation has considered future market growth, forecasted earnings, future taxable income, and feasible and permissible tax planning strategies in determining whether it will be able to realize the deferred tax asset. If the Corporation were to determine that it will not be able to realize a portion of its net deferred tax asset in the future for which there is currently no valuation allowance, an adjustment to the net deferred tax asset would be charged to earnings in the period such determination was made. Conversely, if the Corporation were to make a determination that it is more likely than not that the deferred tax assets for which there is a valuation allowance will be realized, the related valuation allowance would be reduced and a benefit would be recorded.

At December 31, 2016, the Corporation had federal net operating losses ("NOLs") of approximately \$8.0 million and West Virginia NOLs of approximately \$4.7 million for which deferred tax assets of \$2.8 million and \$0.2 million, respectively, have been recorded at December 31, 2016. The federal and West Virginia NOLs were created in 2010, 2012, 2014 and 2016 and will begin expiring in 2030. Based on our evaluation of the four sources of taxable income,

Management has determined that a deferred tax valuation allowance for 2016 is not required on the Federal and West Virginia NOLs because we believe it is more likely than not that these deferred tax assets can be realized prior to expiration of their carry-forward periods based on the expected reversal of deferred tax liabilities, the generation of future income sufficient to realize the deferred tax assets as they reverse.

The Corporation has Maryland NOL carry-forwards of \$38.3 million relating to a Parent Company (First United Corporation) NOL for which a deferred tax asset of \$1.9 million has been recorded at December 31, 2016. There has been and continues to be a full valuation allowance on this NOL based on the fact that it is more likely than not that this deferred tax asset will not be realized because First United Corporation files a separate Maryland income tax return, has recurring tax losses and is not expected to generate sufficient taxable income in the future to utilize the NOL carry-forwards before they expire. The valuation allowance of \$1.9 million at December 31, 2016 reflects an increase of \$.1 million from the level at December 31, 2015.

[92]

## 18. Employee Benefit Plans

First United Corporation sponsors a noncontributory defined benefit pension plan (the “Pension Plan”) covering the employees who were hired prior to the freeze and others who were grandfathered into the plan. The benefits are based on years of service and the employees’ compensation during the last five years of employment.

Effective April 30, 2010, the Pension Plan was amended, resulting in a “soft freeze”, the effect of which prohibits new entrants into the plan and ceases crediting of additional years of service, after that date. Effective January 1, 2013, the Pension Plan was amended to unfreeze it for those employees for whom the sum of (i) their ages, at their closest birthday, plus (ii) years of service for vesting purposes equals 80 or greater. The “soft freeze” continues to apply to all other plan participants. Pension benefits for these participants will be managed through discretionary contributions to the First United Corporation 401(k) Profit Sharing Plan (the “401(k) Plan”).

During 2001, the Bank established an unfunded supplemental executive retirement plan (the “SERP”). The SERP is available only to a select group of management or highly compensated employees to provide supplemental retirement benefits in excess of limits imposed on qualified plans by federal tax law. Concurrent with the establishment of the SERP, the Bank acquired BOLI policies on the senior management personnel and officers of the Bank. The benefits resulting from the favorable tax treatment accorded the earnings on the BOLI policies are intended to provide a source of funds for the future payment of the SERP benefits as well as other employee benefit costs.

The benefit obligation activity for both the Pension Plan and SERP was calculated using an actuarial measurement date of January 1. Plan assets and the benefit obligations were calculated using an actuarial measurement date of December 31.

On January 9, 2015, First United Corporation and members of management who do not participate in the SERP entered into participation agreements under the Deferred Compensation Plan, each styled as a SERP Alternative Participation Agreement (the “Participation Agreement”). Pursuant to each Participation Agreement, First United Corporation agreed, for each Plan Year (as defined in the Deferred Compensation Plan) in which it determines that it has been Profitable (as defined in the Participation Agreement), to make a discretionary contribution to the participant’s Employer Account in an amount equal to 15% of the participant’s base salary level for such Plan Year, with the first Plan Year being the year ending December 31, 2015. The Participation Agreement provides that the participant will become 100% vested in the amount maintained in his or her Employer Account upon the earliest to occur of the following events: (i) Normal Retirement (as defined in the Participation Agreement); (ii) Separation from Service (as defined in the Participation Agreement) following a Change of Control (as defined in the Deferred Compensation Plan) and subsequent Triggering Event (as defined in the Participation Agreement); (iii) Separation from Service due to a Disability (as defined in the Participation Agreement); (iv) with respect to a particular award of Employer Contribution Credits, the participant’s completion of two consecutive Years of Service (as defined in the Participation Agreement) immediately following the Plan Year for which such award was made; or (v) death.

Notwithstanding the foregoing, however, a participant will lose entitlement to the amount maintained in his or her Employer Account in the event employment is terminated for Cause (as defined in the Participation Agreement). In addition, the Participation Agreement conditions entitlement to the amounts held in the Employer Account on the participant (a) refraining from engaging in Competitive Employment (as defined in the Participation Agreement) for three years following his or her Separation from Service, (b) refraining from injurious disclosure of confidential information concerning the Corporation, and (c) remaining available, at the First United Corporation's reasonable request, to provide at least six hours of transition services per month for 12 months following his or her Separation from Service (except in the case of death or Disability), except that only item (b) will apply in the event of a Separation from Service following a Change of Control and subsequent Triggering Event.

In January 2016, the Board of Directors of First United Corporation approved a discretionary contribution in the amount of \$63,500 on two participants. The contribution has a two-year vesting period and \$31,770 of SERP Alternative expense was recorded in 2016. In January 2017, a discretionary contribution in the amount of \$112,708, on four participants, was approved by the Board of Directors of First United Corporation. This contribution will be expensed through 2018.

[93]

The following tables summarize benefit obligation and funded status, plan asset activity, components of net pension cost, and weighted average assumptions for the Pension Plan and the SERP:

(in thousands)	Pension		SERP	
	2016	2015	2016	2015
Change in Benefit Obligation				
Obligation at the beginning of the year	\$39,416	\$39,348	\$6,289	\$5,827
Service cost	305	316	100	121
Interest cost	1,740	1,579	279	239
Change in discount rate and mortality assumptions	3,127	(1,207 )	0	0
Actuarial losses	149	841	775	190
Settlement losses	(268 )	0	0	0
Benefits paid	(3,383 )	(1,461 )	(141 )	(88 )
Obligation at the end of the year	41,086	39,416	7,302	6,289
Change in Plan Assets				
Fair value at the beginning of the year	39,200	38,967	0	0
Actual return on plan assets	2,172	(306 )	0	0
Employer contribution	3,000	2,000	141	88
Benefits paid	(3,383 )	(1,461 )	(141 )	(88 )
Fair value at the end of the year	40,989	39,200	0	0
Unfunded Status	\$(97 )	\$(216 )	\$(7,302)	\$(6,289)

(in thousands)	Pension		SERP	
	2016	2015	2016	2015
Components of Net Pension Cost				
Service cost	\$305	\$316	\$100	\$121
Interest cost	1,740	1,579	279	239
Expected return on assets	(2,796 )	(2,965 )	0	0
Amortization of transition asset	0	(19 )	0	0
Amortization of recognized loss	848	781	73	49
Amortization of prior service cost	12	12	20	20
Net pension expense/(income) in employee benefits	\$109	\$(296 )	\$472	\$429

Weighted Average Assumptions used to determine benefit obligations:

Discount rate for benefit obligations	4.10	%	4.50	%	4.00	%	4.00	%
Discount rate for net pension cost	4.50	%	4.00	%	0	%	0	%
Expected long-term return on assets	7.00	%	7.00	%	0	%	0	%
Rate of compensation increase	3.00	%	3.00	%	3.00	%	3.00	%
Mortality tables	RP-2014		RP-2014		N/A		N/A	

The accumulated benefit obligation for the Pension Plan was \$38.2 million and \$36.1 million at December 31, 2016 and 2015, respectively. The accumulated benefit obligation for the SERP was \$6.3 million and \$5.4 million at December 31, 2016 and 2015, respectively.

During the fourth quarter of 2016, the Company instituted a temporary lump sum window in its defined benefit pension plan. This window gave terminated employees, who had not yet started receiving their pension benefits, the opportunity to elect a single lump sum payment in lieu of any future pension benefits. Approximately 90 participants accepted the Company's offer and \$1.7 million in lump sums were paid from the plan. The lump sum window closed on December 1, 2016.

[94]

The investment assets of a defined benefit plan are managed with the goal of providing for retiree distributions while also supporting long-term plan obligations with a moderate level of portfolio risk. In order to address the variability over time of both risk and return, the plan investment strategy entails a dynamic approach to asset allocation, providing for normalized targets for major asset classes, with the ability to tactically adjust within the following specified ranges around those targets.

Asset Class	Normalized Target	Range
Cash	5%	0% - 20%
Fixed Income	40%	30% - 50%
Equities	55%	45% - 65%

Decisions regarding tactical adjustments within the above noted ranges for asset classes are based on a top down review of factors expected to have material impact on the risk and reward dynamics of the portfolio as a whole. Such factors include, but are not limited to, the following:

- Anticipated domestic and international economic growth as a whole;
- The position of the economy within its longer term economic cycle; and
- The expected impact of economic vitality, cycle positioning, financial market risks, industry/demographic trends and political forces on the various market sectors and investment styles.

With respect to individual company securities, additional company specific matters are considered, which could include management track record and guidance, future earnings expectations, current relative price expectations and the impact of identified risks on expected performance, among others. A core equity position of large cap stocks will be maintained, with more aggressive or volatile sectors meaningfully represented in the asset mix in pursuit of higher returns.

Strategic and specific investment decisions are guided by an in-house investment committee as well as a number of outside institutional resources that provide economic, industry and company data and analytics. It is management's intent to give the Plan's investment managers flexibility with respect to investment decisions and their timing within the overall guidelines. However, certain investments require specific review and approval by management. Management is also informed of anticipated changes in nonproprietary investment managers, significant modifications of any previously approved investment, or the anticipated use of derivatives to execute investment strategies.

Portfolio risk is managed in large part by a focus on diversification across multiple levels as well as an emphasis on financial strength. For example, current investment policies restrict initial investments in debt securities to be rated investment grade at the time of purchase. Also, with the exception of the highest rated securities (e.g. - U.S. Treasury or government-backed agency securities), no more than 10% of the portfolio may be invested in a single entity's



securities. As a result of the previously noted approaches to controlling portfolio risk, any concentrations of risk would be associated with general systemic risks faced by industry sectors or the portfolio as a whole.

Assets in the Pension Plan are valued by the Corporation's accounting system provider who utilizes a third party pricing service. Valuation data is based on actual market data for stocks and mutual funds (Level 1) and matrix pricing for bonds (Level 2). Cash and cash equivalents are also considered Level 1 within the fair value hierarchy.

[95]

As of December 31, 2016 and 2015, the value of Pension Plan investments was as follows:

December 31, 2016		Fair Value Hierarchy		
(Dollars in thousands)	Assets at Fair Value	% of Portfolio	Level 1	Level 2
Cash and cash equivalents	\$ 1,951	4.8	% \$ 1,951	\$ 0
Fixed income securities:				
U.S. Government and Agencies	227	0.5	% 0	227
Taxable municipal bonds and notes	3,630	8.9	% 0	3,630
Corporate bonds and notes	9,500	23.2	% 0	9,500
Preferred stock	492	1.2	% 0	492
Fixed income mutual funds	2,682	6.5	% 2,682	0
Total fixed income	16,531	40.3	% 2,682	13,849
Equities:				
Large Cap	16,917	41.3	% 16,917	0
Mid Cap	2,477	6.0	% 2,477	0
Small Cap	1,199	2.9	% 1,199	0
International	1,914	4.7	% 1,914	0
Total equities	22,507	54.9	% 22,507	0
Total market value	\$ 40,989	100.0	% \$ 27,140	\$ 13,849

December 31, 2015		Fair Value Hierarchy		
(Dollars in thousands)	Assets at Fair Value	% of Portfolio	Level 1	Level 2
Cash and cash equivalents	\$ 2,260	5.8	% \$ 2,260	\$ 0
Fixed income securities:				
U.S. Government and Agencies	131	0.3	% 0	131
Taxable municipal bonds and notes	2,869	7.3	% 0	2,869
Corporate bonds and notes	8,774	22.4	% 0	8,774
Preferred stock	542	1.4	% 0	542
Fixed income mutual funds	2,736	7.0	% 2,736	0
Total fixed income	15,052	38.5	% 2,736	12,316
Equities:				
Large Cap	16,364	41.7	% 16,364	0
Mid Cap	2,775	7.0	% 2,775	0
Small Cap	1,061	2.7	% 1,061	0
International	1,688	4.3	% 1,688	0
Total equities	21,888	55.7	% 21,888	0
Total market value	\$ 39,200	100.0	% \$ 26,884	\$ 12,316

The expected rate of return on Pension Plan assets is based on a combination of the following:

Historical returns of the portfolio of assets;  
Monte Carlo simulations of expected returns for a portfolio with strategic asset targets similar to the normalized targets; and  
Market impact adjustments to reflect expected future investment environment considerations.

At December 31, 2016, the 25-year average return on pension portfolio assets was 7.68%, exceeding the expected long-term return of 7.00% utilized for 2016. Based on the actual performance experience noted above and long-term returns of relevant indices, a case could be built for retaining the expected returns at the existing level. However, there are a number of reasons that would support a lowering of the expected return. For example, since the early 1980s, there has been a general trend of lower interest rates that have supported bond market performance in a positive manner. Such support would likely be reversed if the general trend in rates reverses for an extended period. Since bond market exposure represents a significant portion of pension plan assets, weaker performance from bonds would be reflected in pension returns. Also, expectations from global economic growth continue to be muted, despite the efforts of the efforts of central banks around the world. Further, long-term average returns of benchmark indices are impacted by favorable markets during the 1990s that may or may not be repeated in the foreseeable future.

[96]

The Pension Plan did not hold any shares of First United Corporation common stock at December 31, 2016 or 2015.

Estimated cash flows related to expected future benefit payments from the Pension Plan and SERP are as follows:

(In thousands)	Pension Plan	SERP
2017	\$ 1,689	\$215
2018	1,745	257
2019	1,908	319
2020	1,998	315
2021	2,127	371
2022-2026	11,995	1,999

First United Corporation funded an annual contribution of \$3.0 million to the pension plan in the second quarter of 2016. First United Corporation made a contribution of \$3.0 million in first quarter of 2017 and will continue to evaluate future annual contributions to the Pension Plan based upon its funded status and an evaluation of the future benefits to be provided thereunder. The Bank expects to fund the annual projected benefit payments for the SERP from operations.

Amounts included in accumulated other comprehensive loss as of December 31, 2016 and 2015, net of tax, are as follows:

(In thousands)	2016		2015	
	Pension	SERP	Pension	SERP
Unrecognized net actuarial loss	\$ 14,335	\$ 729	\$ 12,641	\$ 306
Unrecognized prior service costs	13	(8 )	20	4
	\$ 14,348	\$ 721	\$ 12,661	\$ 310

The estimated costs that will be amortized from accumulated other comprehensive loss into net periodic pension cost during the next fiscal year are as follows:

(In thousands)	Pension	SERP
Prior service costs	\$ 12	\$(3 )
Net actuarial loss	1,057	146

\$ 1,069 \$ 143

**19.401(k) Profit Sharing Plan**

In furtherance of First United Corporation's belief that every employee should have the ability to accrue retirement benefits, it adopted the 401(k) Profit Sharing Plan, which is available to all employees, including executive officers. Employees are automatically entered in the plan on the first of the month following completion of 30 days of service to First United Corporation and/or its subsidiaries. Employees have the opportunity to opt out of participation or change their deferral amounts under the plan at any time. In addition to contributions by participants, the plan contemplates employer matching and the potential of discretionary contributions to the accounts of participants. First United Corporation believes that matching contributions encourage employees to participate and thereby plan for their post-retirement financial future. Beginning with the 2008 plan year, First United Corporation enhanced the match formula to 100% on the first 1% of salary reduction and 50% on the next 5% of salary reduction. This match is accrued for all participants, including executive officers, immediately upon entering the plan on the first day of the month following the completion of 30 days of employment. The employee must be a plan participant and be actively employed on the last day of the plan year to share in the employer matching contribution, except in the case of death, disability or retirement of the participant. Additionally, First United Corporation accrued a non-elective employer contribution during 2016 for all employees other than employees who participate in the SERP and SERP Alternative and those employees meeting the age plus service requirement in the Pension Plan equal to 4.0% of each employee's salary, and .5% of each employee's salary hired before January 1, 2010, which will be paid in the first quarter of 2017. Expense charged to operations for the 401(k) Plan was \$1.0 million in 2016 and 2015.

[97]

## **20. Federal Reserve Requirements**

During 2013, the Federal Reserve modified its structure for institutions to calculate their reserve requirements with the Reserve Bank. Under these new calculations, the Bank was not required to maintain certain cash reserve levels as its vault cash exceeded the levels for reserve.

## **21. Restrictions on Dividend Payments**

First United Corporation is subject to an informal agreement with the Federal Reserve Bank of Richmond (the “Reserve Bank”), which requires it to seek the prior approval of the Reserve Bank before making any dividend payment or other distribution on its capital securities or other securities that qualify as Tier 1 capital. The Board of Directors elected to pay no dividend to common shareholders during 2016.

## **22. Restrictions on Subsidiary Dividends, Loans or Advances**

Federal and state banking regulations place certain restrictions on the amount of dividends paid and loans or advances made by the Bank to First United Corporation. The total amount of dividends that may be paid at any date is generally limited to the retained earnings of the Bank, and loans or advances are limited to 10% of the Bank’s capital stock and surplus on a secured basis. In addition, dividends paid by the Bank to First United Corporation would be prohibited if the effect thereof would cause the Bank’s capital to be reduced below applicable minimum capital requirements.

## **23. Commitments and Contingent Liabilities**

We are at times, and in the ordinary course of business, subject to legal actions. Management believes that losses, if any, resulting from current legal actions will not have a material adverse effect on our financial condition or results of operations.

Loan commitments are made to accommodate the financial needs of our customers. Loan commitments have credit risk essentially the same as that involved in extending loans to customers and are subject to normal credit policies. Commitments to extend credit generally have fixed expiration dates, may require payment of a fee, and contain cancellation clauses in the event of an adverse change in the customer’s credit quality.

We do not issue any guarantees that would require liability recognition or disclosure other than the standby letters of credit issued by the Bank. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party to support contractual obligations and to ensure job performance. Generally, the Bank's letters of credit are issued with expiration dates within one year. Historically, most letters of credit expire unfunded, and therefore, cash requirements are substantially less than the total commitment. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral and/or personal guarantees supporting letters of credit. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payment required by the letters of credit. Management does not believe that the amount of the liability associated with guarantees under standby letters of credit outstanding at December 31, 2016 and December 31, 2015 is material.

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The following table is a summary of commitments as of December 31, 2016 and 2015:

(In thousands)	2016	2015
Loan commitments	\$ 120,786	\$ 129,076
Commercial letters of credit	1,562	1,587
Total	\$ 122,348	\$ 130,663

## 24. 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. Transfers in and out of Level 1, 2 or 3 are recorded at fair value at the beginning of the reporting period.

Management believes that the Corporation's 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 following valuation techniques were used to measure the fair value of assets in the table below which are measured on a recurring and non-recurring basis as of December 31, 2016.

***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 December 31, 2016, the U.S. Government agencies and treasuries, residential and commercial mortgage-backed securities, private label residential 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 we have historically transacted both purchases and sales of investment securities.

[99]

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 December 31, 2016, the Corporation owned 12 pooled trust preferred securities with an amortized cost of \$27.9 million and a fair value of \$20.3 million. The market for these securities at December 31, 2016 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 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 (i) the few observable transactions and market quotations that are available are not reliable for the purpose of obtaining fair value at December 31, 2016, (ii) 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 (iii) 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 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. Management performs due diligence on the third party processes and believes that it has an adequate understanding of the analysis, assumptions and methodology used by the third party to prepare the fair value determination and the OTTI evaluation. Management reviews the qualifications of the third party and believes they are qualified to provide the analysis and pricing determinations. Quarterly, management reviews the third party’s detailed assumptions and analyzes its projected discounted present value results for reasonableness and consistency with the trend of prior projections. Annually, management performs stress tests of the assumptions used in the third party models and performs back tests of the assumptions and prepayment projections to validate the impairment model results. As a result of its due diligence process, management believes that the fair value presented and the OTTI recognized are appropriate. A total of \$3.2 million in impairment losses were realized during the time period 2009 through 2011 on the CDO portfolio remaining at December 31, 2016. Due to the prior credit impairment, the securities in this portfolio have continued to be evaluated to determine whether any additional OTTI has occurred. Based on management’s review of the third party evaluations, management believes that there were no material differences in the valuations between December 31, 2016 and December 31, 2015.

The approach used by the third party to determine fair value involved several steps, which included detailed credit and structural evaluation of each piece of collateral in each bond, projection of 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, with a limited market for

highly-rated CDO securities that are more senior in the capital structure than the securities in the CDO portfolio. 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 swap agreements. Those classified as Level 2 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 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.

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**Other real estate owned** – Fair value of other real estate owned was 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 December 31, 2016 and 2015, the significant unobservable inputs used in the fair value measurements were as follows:

(in thousands)	Fair Value at December 31, 2016	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Value
Recurring:				
Investment Securities – available for sale - CDO	\$ 20,254	Discounted Cash Flow	Discount Rate	Range of Libor+ 4.5% to 5.5%
Non-recurring:				
Impaired Loans	\$ 14,537	Market Comparable Properties	Marketability Discount	4.6% to 31.0% <sup>(1)</sup> (weighted avg 6.5%)
OREO	\$ 1,201	Market Comparable Properties	Marketability Discount	15%
(in thousands)	Fair Value at December 31, 2015	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Value
Recurring:				
Investment Securities – available for sale - CDO	\$ 22,211	Discounted Cash Flow	Discount Rate	Range of Libor+ 4.5% to 5.5%
Cash Flow Hedge	\$ (66	) Discounted Cash Flow	Reuters Third Party Market Quote	99.9% (weighted avg 99.9%)
Non-recurring:				
Impaired Loans	\$ 6,247	Market Comparable Properties	Marketability Discount	3% to 15% <sup>(1)</sup> (weighted avg

				11.3%)
OREO	\$ 4,133	Market Comparable Properties	Marketability Discount	10% to 15% <sup>(1)</sup> (weighted avg 12.5%)

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

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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 December 31, 2016 and 2015 are as follows:

Description	Fair Value Measurements at December 31, 2016 Using (In Thousands)			
	Assets Measured at 12/31/2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Recurring:				
Investment securities available-for-sale:				
U.S. government agencies	\$ 24,253	\$ 24,253		
Commercial mortgage-backed agencies	\$ 52,222	\$ 52,222		
Collateralized mortgage obligations	\$ 19,567	\$ 19,567		
Obligations of states and political subdivisions	\$ 23,704	\$ 23,704		
Collateralized debt obligations	\$ 20,254			\$ 20,254
Financial Derivative	\$ 700	\$ 700		
Non-recurring:				
Impaired loans	\$ 14,537			\$ 14,537
Other real estate owned	\$ 1,201			\$ 1,201

Description	Fair Value Measurements at December 31, 2015 Using (In Thousands)			
	Assets Measured at 12/31/2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Recurring:				
Investment securities available-for-sale:				
U.S. government agencies	\$ 33,964	\$ 33,964		
Residential mortgage-backed agencies	\$ 14,170	\$ 14,170		
Commercial mortgage-backed agencies	\$ 43,636	\$ 43,636		
Collateralized mortgage obligations	\$ 9,610	\$ 9,610		
Obligations of states and political subdivisions	\$ 46,641	\$ 46,641		
Collateralized debt obligations	\$ 22,211			\$ 22,211
Financial Derivative	\$ (66 )			\$ (66 )
Non-recurring:				
Impaired loans	\$ 6,247			\$ 6,247
Other real estate owned	\$ 4,133			\$ 4,133

There were no transfers of assets between any of the levels of the fair value hierarchy for the years ended December 31, 2016 or December 31, 2015.

[102]

The following tables show a reconciliation of the beginning and ending balances for fair valued assets measured using Level 3 significant unobservable inputs for the years ended December 31, 2016 and 2015:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)	
	Investment Securities Available for Sale	Cash Flow Hedge
Beginning balance January 1, 2016	\$ 22,211	\$ (66 )
Total gains/(losses) realized/unrealized:		
Included in earnings	0	0
Included in other comprehensive loss	(1,957 )	66
Ending balance December 31, 2016	\$ 20,254	\$ 0

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
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	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)	
	Investment Securities Available for Sale	Cash Flow Hedge
Beginning balance January 1, 2015	\$ 25,339	\$ (199 )
Total gains/(losses) realized/unrealized:		
Included in earnings	818	0
Included in other comprehensive income	(3,946 )	133
Ending balance December 31, 2015	\$ 22,211	\$ (66 )

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
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Gains and losses (realized and unrealized) included in earnings for the periods above are reported in the Consolidated Statement of Income in other operating income.

The fair values disclosed 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.

We use the following methods and assumptions in estimating fair value disclosures for financial instruments:

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**Cash and due from banks:** The carrying amounts as reported in the statement of financial condition for cash and due from banks approximate their fair values.

**Interest bearing deposits in banks:** The carrying amount of interest bearing deposits approximates their fair values.

**Restricted investment in Bank stock:** The carrying value of stock issued by the FHLB of Atlanta, ACBB and CBB approximates fair value based on the redemption provisions of the stock.

**Loans (excluding impaired loans with specific loss allowances):** For variable-rate loans that reprice frequently or “in one year or less”, and with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed-rate loans that do not reprice frequently are estimated using a discounted cash flow calculation that applies current market interest rates being offered on the various loan products.

**Deposits:** The fair values disclosed for demand deposits (e.g., interest and non-interest checking, savings, and certain types of money market accounts, etc.) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on the various certificates of deposit to the cash flow stream.

**Short-term borrowings:** The carrying amount of short-term borrowings approximates their fair values.

**Borrowed funds:** The fair value of the Bank’s FHLB borrowings and First United Corporation’s TPS Debentures is calculated based on the discounted value of contractual cash flows, using rates currently existing for borrowings with similar remaining maturities. The carrying amounts of federal funds purchased and securities sold under agreements to repurchase approximate their fair values.

**Accrued interest:** The carrying amount of accrued interest receivable and payable approximates their fair values.

**Off-balance-sheet financial instruments:** In the normal course of business, the Bank makes commitments to extend credit and issues standby letters of credit. The Bank expects most of these commitments to expire without being drawn upon; therefore, the commitment amounts do not necessarily represent future cash requirements. Due to the

uncertainty of cash flows and difficulty in the predicting the timing of such cash flows, fair values were not estimated for these instruments.

[104]

The following table presents fair value information about financial instruments, whether or not recognized in the statement of financial condition, for which it is practicable to estimate that value. The actual carrying amounts and estimated fair values of the Corporation's financial instruments that are included in the statement of financial condition are as follows:

(in thousands)	December 31, 2016		Fair Value Measurements		Significant Unobservable Inputs (Level 3)
	Carrying Amount	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	
<b>Financial Assets:</b>					
Cash and due from banks	\$60,707	\$ 60,707	\$60,707		
Interest bearing deposits in banks	2,603	2,603	2,603		
Investment securities - AFS	140,000	140,000		\$ 119,746	\$ 20,254
Investment securities - HTM	97,169	97,981		89,031	8,950
Restricted Bank stock	5,209	5,209		5,209	
Loans, net	882,008	886,712			886,712
Financial derivative	700	700		700	
Accrued interest receivable	3,862	3,862		3,862	
<b>Financial Liabilities:</b>					
Deposits – non-maturity	773,120	773,120		773,120	
Deposits – time deposits	241,110	245,762		245,762	
Short-term borrowed funds	36,000	36,000		36,000	
Long-term borrowed funds	131,737	133,397		133,397	
Accrued interest payable	380	380		380	
Off balance sheet financial instruments	0	0	0		

[105]

	December 31, 2015		Fair Value Measurements		
	Carrying		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(In thousands)	Amount	Fair Value			
<b>Financial Assets:</b>					
Cash and due from banks	\$50,188	\$ 50,188	\$50,188		
Interest bearing deposits in banks	1,953	1,953	1,953		
Investment securities - AFS	170,232	170,232		\$ 148,021	\$ 22,211
Investment securities - HTM	105,560	106,742		103,779	2,963
Restricted Bank stock	5,904	5,904		5,904	
Loans, net	867,101	872,991			872,991
Accrued interest receivable	4,218	4,218		4,218	
<b>Financial Liabilities:</b>					
Deposits – non-maturity	744,219	744,219		744,219	
Deposits – time deposits	254,575	258,267		258,267	
Short-term borrowed funds	35,828	35,828		35,828	
Long-term borrowed funds	147,537	151,562		151,562	
Accrued interest payable	478	478		478	
Financial derivative	66	66			66
Off balance sheet financial instruments	0	0	0		

## 25. Derivative Financial Instruments

As a part of managing interest rate risk, the Corporation entered into interest rate swap agreements to modify the re-pricing characteristics of certain interest-bearing liabilities. The Corporation has designated its interest rate swap agreements as cash flow hedges under the guidance of ASC Subtopic 815-30, *Derivatives and Hedging – Cash Flow Hedges*. Cash flow hedges have the effective portion of changes in the fair value of the derivative, net of taxes, recorded in net accumulated other comprehensive income.

In July 2009, the Corporation entered into three interest rate swap contracts totaling \$20.0 million notional amount, hedging future cash flows associated with floating rate trust preferred debt. The final contract matured on June 17, 2016, ending the agreement.

In March 2016, the Corporation entered into four new interest rate swap contracts totaling \$30.0 million notional amount, hedging future cash flows associated with floating rate trust preferred debt. These contracts are a three-year \$5.0 million contract maturing June 17, 2019, a five-year \$5.0 million contract maturing March 17, 2021, a seven-year \$5.0 million contract maturing March 17, 2023 and a 10-year \$15.0 million contract maturing March 17, 2026.

The fair value of the interest rate swap contracts was \$.7 million at December 31, 2016 and was reported in Other Assets on the Consolidated Statement of Financial Condition. The fair value at December 31, 2015 was (\$66) thousand and was reported in Other Liabilities on the Consolidated Statement of Financial Condition.

For the year ended December 31, 2016, the Corporation recorded an increase in the value of the derivatives of \$766 thousand and the related deferred tax of \$305 thousand in net accumulated other comprehensive loss to reflect the effective portion of cash flow hedges. ASC Subtopic 815-30 requires this amount to be reclassified to earnings if the hedge becomes ineffective or is terminated. There was no hedge ineffectiveness recorded for the twelve months ending December 31, 2016. The Corporation does not expect any losses relating to these hedges to be reclassified into earnings within the next 12 months.

[106]

Interest rate swap agreements are entered into with counterparties that meet established credit standards and the Corporation believes that the credit risk inherent in these contracts is not significant as of December 31, 2016.

The table below discloses the impact of derivative financial instruments on the Corporation's Consolidated Financial Statements for the years ended December 31, 2016 and December 31, 2015.

Derivative in Cash Flow  
Hedging Relationships

(In thousands)	Amount of gain (loss) recognized in OCI on derivative (effective portion)	Amount of gain or (loss) reclassified from accumulated OCI into income (effective portion) <sup>(1)</sup>	Amount of gain or (loss) recognized in income on derivative (ineffective portion and amount excluded from effectiveness testing) <sup>(2)</sup>
Interest rate contracts:			
December 31, 2016	\$ 461	\$ 0	\$ 0
December 31, 2015	\$ 80	\$ 0	\$ 0

Notes:

- (1) Reported as interest expense  
(2) Reported as other income

**26. Assets and Liabilities Subject to Enforceable Master Netting Arrangements**

*Interest Rate Swap Agreements ("Swap Agreements")*

The Corporation has entered into interest rate swap agreements to modify the re-pricing characteristics of certain interest-bearing liabilities as a part of managing interest rate risk. The swap agreements have been designated as cash flow hedges, and accordingly, the fair value of the interest rate swap contracts is reported in Other Liabilities on the Consolidated Statement of Financial Condition. The swap agreements were entered into with a third party financial institution. The Corporation is party to master netting arrangements with its financial institution counterparty; however the Corporation does not offset assets and liabilities under these arrangements for financial statement presentation purposes. The master netting arrangements provide for a single net settlement of all swap agreements, as well as collateral, in the event of default on, or termination of, any one contract. Collateral, in the form of cash, is posted by the Corporation as the counterparty with net liability positions in accordance with contract thresholds. See Note 25 to the Consolidated Financial Statements for more information.

***Securities Sold Under Agreements to Repurchase (“Repurchase Agreements”)***

The Bank enters into agreements under which it sells interests in U.S. Securities to certain customers subject to an obligation to repurchase, and on the part of the customers to resell, such interests. Under these arrangements, the Bank may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Bank to repurchase the assets. As a result, these repurchase agreements are accounted for as collateralized financing arrangements (i.e. secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the consolidated statement of condition, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. There is no offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Bank does not enter into reverse repurchase agreements, there is no such offsetting to be done with the repurchase agreements. The right of setoff for a repurchase agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the repurchase agreement should the Bank be in default (i.e. fails to repurchase the U.S. Securities on the maturity date of the agreement). The investment security collateral is held by a third party financial institution in the counterparty’s custodial account.

[107]



The following table presents the liabilities subject to an enforceable master netting arrangement or repurchase agreements as of December 31, 2016 and December 31, 2015.

(In thousands)	Gross Amounts of		Net Amounts of		Gross Amounts Not Offset in		Cash Collateral Pledged	Net Amount
	Recognized	Offset in the	(Assets)/Liabilities	Presented in the	Financial	the Statement of Condition		
	(Assets)/Liabilities	Statement of	(Assets)/Liabilities	Statement of	Instruments			
		Condition		Condition				
December 31, 2016								
Interest Rate Swap Agreements	\$ (700 )	\$ 0	\$ (700 )	\$ 700		\$ 0	\$ 0	
Repurchase Agreements	\$ 36,000	\$ 0	\$ 36,000	\$ (36,000 )		\$ 0	\$ 0	
December 31, 2015								
Interest Rate Swap Agreements	\$ 66	\$ 0	\$ 66	\$ (66 )		\$ 0	\$ 0	
Repurchase Agreements	\$ 35,828	\$ 0	\$ 35,828	\$ (35,828 )		\$ 0	\$ 0	

## 27. Parent Company Only Financial Information

### Condensed Statement of Financial Condition

(In thousands)	December 31,	
	2016	2015
Assets		
Cash	\$541	\$11,102
Investment securities	12,401	14,522
Investment in bank subsidiary	137,831	132,809
Investment in non-bank subsidiaries	1,255	1,255
Other assets	7,618	5,403
Total Assets	\$159,646	\$165,091
Liabilities and Shareholders' Equity		
Accrued interest and other liabilities	\$4,218	\$2,590
Junior subordinated debt	41,730	41,730
Shareholders' equity	113,698	120,771
Total Liabilities and Shareholders' Equity	\$159,646	\$165,091

[108]

## Condensed Statement of Income

(In thousands)	Year Ended	
	December 31,	
	2016	2015
<b>Income:</b>		
Dividend income from bank subsidiary	\$1,000	\$33,658
Interest income on investments	573	0
Gain on Investments	0	3,521
Other income	128	69
Total other income	701	3,590
Total Income	1,701	37,248
<b>Expenses:</b>		
Interest expense	2,429	2,192
Other expenses	207	365
Total Expenses	2,636	2,557
(Loss)/Income before income taxes and equity in undistributed net (loss)/income of subsidiaries	(935 )	34,691
Applicable income tax benefit/(expense)	693	(975 )
Net (loss)/income before equity in undistributed net income/(loss) of subsidiaries	(242 )	33,716
Equity in undistributed net income/(loss) of subsidiaries:		
Bank	7,523	(20,725)
Net Income	\$7,281	\$12,991

## Condensed Statement of Comprehensive Income

<b>Components of Comprehensive Income (in thousands)</b>	Year Ended	
	December 31,	
	2016	2015
Net Income	\$7,281	\$12,991
Unrealized losses on AFS Securities, net of tax	(478 )	(2,115 )
Unrealized gains on cash flow hedges, net of tax	461	80
Other comprehensive loss, net of tax	(17 )	(2,035 )
Comprehensive income	\$7,264	\$10,956

[109]

## Condensed Statement of Cash Flows

(In thousands)	Year Ended	
	December 31, 2016	2015
<b>Operating Activities</b>		
Net Income	\$7,281	\$12,991
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed net income of subsidiaries	(7,523 )	6,203
(Increase)/Decrease in other assets	(575 )	470
Increase/(decrease) in accrued interest payable and other liabilities	2,089	(2,089 )
Stock Compensation	192	191
Net cash provided by operating activities	1,464	17,766
<b>Investing Activities</b>		
Net investment in subsidiaries	0	0
Net cash provided by investing activities	0	0
<b>Financing Activities</b>		
Dividends – common stock	0	0
Repayment of Long-term debt	0	(5,000 )
Preferred Stock Redemption	(10,000)	0
Dividends - preferred stock paid	(2,025 )	(2,700 )
Net cash used in financing activities	(12,025)	(7,700 )
(Decrease)/increase in cash and cash equivalents	(10,561)	10,066
Cash and cash equivalents at beginning of year	11,102	1,036
Cash and cash equivalents at end of year	\$541	\$11,102

## Accumulated Other Comprehensive Loss

<b>Components of Comprehensive Loss (in thousands)</b>	Before Tax Amount	Tax (Expense) Benefit	Net
For the period ended December 31, 2016			
Available for Sale Securities:			
Unrealized holding losses	\$ (795 )	\$ 317	\$(478 )
Cash flow hedges:			
Unrealized holding gains	\$ 766	\$ (305 )	\$461
Other comprehensive loss	\$ (29 )	\$ 12	\$(17 )

## For the period ended December 31, 2015

Available for Sale Securities:

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Unrealized holding losses	(3,521	)	1,406	(2,115)
Cash flow hedges:				
Unrealized holding gains	\$ 133		\$ (53	) \$80
Other comprehensive loss	\$ (3,388	)	\$ 1,353	\$(2,035)

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

The Corporation maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Corporation's reports filed under the Exchange Act with the SEC, such as this annual report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to the Corporation's management, including the principal executive officer ("PEO") and the principal accounting officer ("PAO"), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, a control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls as of December 31, 2016 was carried out under the supervision and with the participation of the Corporation's management, including the PEO and the PAO. Based on that evaluation, the Corporation's management, including the PEO and the PAO, has concluded that the Corporation's disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

As discussed in the Corporation's Current Report on Form 8-K filed with the SEC on December 19, 2016, the Corporation's Board of Directors concluded on that date, after consulting with management and the Corporation's independent registered public accounting firm, that the Corporation's consolidated financial statements for the year ended December 31, 2015 that were included in the Company's Annual Report on Form 10-K for the year then ended should no longer be relied upon because of an error therein relating to the Corporation's accounting for the transfer of eight pooled trust preferred securities in the fourth quarter of 2015 from the Bank to the Corporation. During the fourth quarter of 2016, the Corporation updated its system of internal control over financial reporting to ensure, to the extent reasonably possible, that such error will not occur in the future. In particular, the Corporation's system of internal control over financial reporting now requires an additional level of review over all consolidating entries between the Corporation and the Bank. Otherwise, there was no change in the Corporation's internal control over

financial reporting during the fourth quarter of 2016 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

As required by Section 404 of the Sarbanes-Oxley Act of 2002, management has performed an evaluation and testing of the Corporation's internal control over financial reporting as of December 31, 2016. Management's report on the Corporation's internal control over financial reporting is included on the following page. The Corporation is a "smaller reporting company" as defined by Rule 12b-2 under the Exchange Act and, accordingly, its independent registered public accounting firm is not required to attest to the foregoing management report.

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## Management's Report on Internal Control Over Financial Reporting

The Board of Directors and Shareholders

First United Corporation

First United Corporation's management is responsible for establishing and maintaining adequate internal control over financial reporting. This internal control system was designed to provide reasonable assurance to management and the Board of Directors as to the reliability of First United Corporation's financial reporting and the preparation and presentation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States, as well as to safeguard assets from unauthorized use or disposition.

An internal control system, no matter how well designed, has inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation and may not prevent or detect misstatements in the financial statements or the unauthorized use or disposition of First United Corporation's assets. Also, projections of any evaluation of effectiveness of internal controls to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies and procedures may deteriorate.

An error relating to the Corporation's accounting for the transfer of eight pooled trust preferred securities in the fourth quarter of 2015 from the Bank to the Corporation led to the restatement of the Company's 2015 Annual Report on Form 10-K. During the fourth quarter of 2016, the Corporation updated its system of internal control over financial reporting to ensure, to the extent reasonably possible, that such error will not occur in the future. In particular, the Corporation's system of internal control over financial reporting now requires an additional level of review over all consolidating entries between the Corporation and the Bank. Otherwise, there was no change in the Corporation's internal control over financial reporting during the fourth quarter of 2016 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

Management assessed the effectiveness of First United Corporation's internal control over financial reporting as of December 31, 2016, based on the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework (2013 Framework). Based on this assessment and on the foregoing criteria, management has concluded that, as of December 31, 2016, First United Corporation's internal control over financial reporting is effective.

Dated: March 8, 2017

/s/ Carissa L. Rodeheaver	/s/ Tonya K. Sturm
Carissa L. Rodeheaver, CPA, CFP	Tonya K. Sturm
Chairman of the Board, President	Senior Vice President and
And Chief Executive Officer	Chief Financial Officer
(Principal Executive Officer)	(Principal Accounting Officer)

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## ITEM 9B. OTHER INFORMATION

None.

## PART III

## ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The Corporation has adopted a Code of Ethics applicable to its principal executive officer, principal financial officer, principal accounting officer, or controller, or persons performing similar functions, a Code of Ethics applicable to all employees, and a Code of Ethics applicable to members of the Board of Directors. Copies of these Codes of Ethics are available free of charge upon request to Mr. Jason B. Rush, Senior Vice President and Chief Operating Officer, First United Corporation, c/o First United Bank & Trust, 19 S. Second Street, Oakland, MD 21550-0009. Copies are also available on the Corporation's website at [www.mybank.com](http://www.mybank.com) in the "Governance Documents" tab under "Investor Relations".

All other information required by this item is incorporated herein by reference to the following sections of the Corporation's definitive Proxy Statement for the 2017 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A:

Election of Directors (Proposal 1);  
Continuing Directors;  
Qualifications of Director Nominees and Current Directors;  
Executive Officers;  
Section 16(a) Beneficial Ownership and Reporting Compliance; and  
Corporate Governance Matters (under Audit Committee).

## ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is incorporated herein by reference to the sections of the Corporation's definitive Proxy Statement for the 2017 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A entitled "Director Compensation" and "Remuneration of Executive Officers."

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ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

At the 2007 Annual Meeting of Shareholders, the Corporation's shareholders approved the First United Corporation Omnibus Equity Compensation Plan (the "Omnibus Plan"), which authorizes the grant of stock options, stock appreciation rights, stock awards, stock units, performance units, dividend equivalents, and other stock-based awards. The following table contains information about the Omnibus Plan as of December 31, 2016:

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights		Weighted-average exercise price of outstanding options, warrants, and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
	(a)	(b)		
Equity compensation plans approved by security holders	0	N/A		60,168 (1)
Equity compensation plans not approved by security holders	0	N/A		N/A
Total	0	N/A		60,168

**Note:**

(1) In addition to stock options and stock appreciation rights, the Omnibus Plan permits the grant of stock awards, stock units, performance units, dividend equivalents, and other stock-based awards. Subject to the anti-dilution provisions of the Omnibus Plan, the maximum number of shares for which awards may be granted to any one participant in any calendar year is 20,000, without regard to whether an award is paid in cash or shares.

All other information required by this item is incorporated herein by reference to the section of the Corporation's definitive Proxy Statement for the 2017 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A entitled "Beneficial Ownership of Common Stock by Principal Shareholders and Management".

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item is incorporated herein by reference to the following sections of the Corporation's definitive Proxy Statement for the 2017 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A entitled "Certain Relationships and Related Transactions" and "Corporate Governance Matters" (under "Director Independence").

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated herein by reference to the section of the Corporation's definitive Proxy Statement for the 2017 Annual Meeting of Shareholders to be filed with the SEC pursuant to Regulation 14A entitled "Audit Fees and Services".

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1), (2) and (c) Financial Statements.

Report of Independent Registered Public Accounting Firm	50
Consolidated Statement of Financial Condition as of December 31, 2016 and 2015	51
Consolidated Statement of Income for the years ended December 31, 2016 and 2015	52
Consolidated Statement of Comprehensive Income for the years ended December 31, 2016 and 2015	53
Consolidated Statement of Changes in Shareholders' Equity for the years ended December 31, 2016 and 2015	54
Consolidated Statement of Cash Flows for the years ended December 31, 2016 and 2015	55
Notes to Consolidated Financial Statements for the years ended December 31, 2016 and 2015	56

(a)(3) and (b) Exhibits.

The exhibits filed or furnished with this annual report are listed on the Exhibit Index that follows the signatures to this annual report, which list is incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST UNITED CORPORATION

Dated: March 8, 2017 By: /s/ Carissa L. Rodeheaver  
Carissa L. Rodeheaver, CPA, CFP  
Chairman of the Board, President  
and Chief Executive Officer  
(Principal Executive Officer)

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Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated.

/s/ John F. Barr  
John F. Barr – Director  
March 8, 2017

/s/ Brian R. Boal  
Brian R. Boal - Director  
March 8, 2017

/s/ M. Kathryn Burkey  
M. Kathryn Burkey - Director  
March 8, 2017

/s/ Robert W. Kurtz  
Robert W. Kurtz - Director  
March 8, 2017

/s/ John W. McCullough  
John W. McCullough – Director  
March 8, 2017

/s/ Elaine L. McDonald  
Elaine L. McDonald – Director  
March 8, 2017

/s/ Carissa L. Rodeheaver  
Carissa L. Rodeheaver – Director, President  
and Chief Executive Officer  
(Principal Executive Officer)  
March 8, 2017

/s/ Gary R. Ruddell  
Gary R. Ruddell - Director  
March 8, 2017

/s/ I. Robert Rudy  
I. Robert Rudy - Director  
March 8, 2017

/s/ Marisa A. Shockley  
Marisa A. Shockley - Director  
March 8, 2017

/s/ Robert G. Stuck  
Robert G. Stuck – Director  
March 8, 2017

/s/ H. Andrew Walls, III  
H. Andrew Walls, III - Director  
March 8, 2017

/s/ Tonya K. Sturm  
Tonya K. Sturm – Senior Vice President and  
Chief Financial Officer  
(Principal Accounting Officer)  
March 8, 2017

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EXHIBIT INDEX

**Exhibit Description**

- 3.1(i) Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 to First United Corporation's Quarterly Report on Form 10-Q for the period ended June 30, 1998)
- 3.2(i) Amended and Restated Bylaws (incorporated by reference to Exhibit 3.2(i) to First United Corporation's Annual Report on Form 10-K for the year ended December 31, 2007)
- 3.2(ii) First Amendment to Amended and Restated Bylaws (incorporated by reference to Exhibit 3.2(ii) to First United Corporation's Annual Report on Form 10-K for the year ended December 31, 2007)
- 3.2(iii) Second Amendment to Amended and Restated Bylaws (incorporated by reference to Exhibit 3.2 to First United Corporation's Current Report on Form 8-K filed on February 9, 2009)
- 4.1 Letter Agreement, including the related Securities Purchase Agreement – Standard Terms, dated January 30, 2009 by and between First United Corporation and the U.S. Department of Treasury (incorporated by reference to Exhibit 10.1 to First United Corporation's Form 8-K filed on February 2, 2009)
- 4.2 Certificate of Notice, including the Certificate of Designations incorporated therein, relating to the Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference Exhibit 4.1 to First United Corporation's Form 8-K filed on February 2, 2009)
- 4.3 Sample Stock Certificate for Series A Preferred Stock for the Series A Preferred Stock (incorporated by reference Exhibit 4.3 to First United Corporation's Form 8-K filed on February 2, 2009)
- 4.4 Common Stock Purchase Warrant dated January 30, 2009 issued to the U.S. Department of Treasury (incorporated by reference to Exhibit 4.2 to First United Corporation's Form 8-K filed on February 2, 2009)
- 4.5 Amended and Restated Declaration of Trust, dated as of December 30, 2009 (incorporated by reference to Exhibit 4.1 to First United Corporation's Current Report on Form 8-K filed on December 30, 2009)
- 4.6 Indenture, dated as of December 30, 2009 (incorporated by reference to Exhibit 4.2 to First United Corporation's Current Report on Form 8-K filed on December 30, 2009)
- 4.7 Preferred Securities Guarantee Agreement, dated as of December 30, 2009 (incorporated by reference to Exhibit 4.3 to First United Corporation's Current Report on Form 8-K filed on December 30, 2009)
- 4.8 Form of Preferred Security Certificate of First United Statutory Trust III (included as Exhibit C to Exhibit 4.5)
- 4.9 Form of Common Security Certificate of First United Statutory Trust III (included as Exhibit B to Exhibit 4.5)
- 4.10 Form of Junior Subordinated Debenture of First United Corporation (included as Exhibit A to Exhibit 4.6)

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- 10.1 First United Bank & Trust Amended and Restated Supplemental Executive Retirement Plan (“SERP”) (incorporated by reference to Exhibit 10.4 to First United Corporation’s Current Report on Form 8-K filed on February 21, 2007)
- 10.2 Second Amended and Restated Participation Agreement, dated as of August 12, 2011, under the SERP between First United Bank & Trust and William B. Grant (incorporated by reference to Exhibit 10.1 to the Corporation’s Quarterly Report on Form 10-Q for the period ended September 30, 2011)
- 10.3 Form of Second Amended and Restated Participation Agreement, dated as of August 12, 2011, under the SERP between First United Bank & Trust and executive officers other than William B. Grant (incorporated by reference to Exhibit 10.2 to First United Corporation’s Quarterly Report on Form 10-Q for the period ended September 30, 2011)
- 10.4 Form of Endorsement Split Dollar Agreement between the Bank and each of William B. Grant, Robert W. Kurtz, Jeannette R. Fitzwater, Phillip D. Frantz, Eugene D. Helbig, Jr., Steven M. Lantz, Robin M. Murray, Carissa L. Rodeheaver, and Frederick A. Thayer, IV (incorporated by reference to Exhibit 10.3 to First United Corporation’s Quarterly Report on Form 10-Q for the period ended September 30, 2003)
- 10.5 Amended and Restated First United Corporation Executive and Director Deferred Compensation Plan (incorporated by reference to Exhibit 10.1 to First United Corporation’s Current Report on Form 8-K filed on November 24, 2008)
- 10.6 SERP Alternative Participation Agreement under the First United Corporation Executive and Director Deferred Compensation Plan, dated as of January 9, 2015, between First United Corporation and Keith R. Sanders (incorporated by reference to Exhibit 10.2 to First United Corporation’s Current Report on Form 8-K filed on January 9, 2015)

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- 10.7 Amended and Restated First United Corporation Change in Control Severance Plan (incorporated by reference to Exhibit 10.5 to First United Corporation's Current Report on Form 8-K filed on June 23, 2008)
- 10.8 Change in Control Severance Plan Agreement, dated as of February 14, 2007, with William B. Grant (incorporated by reference to Exhibit 10.2 to First United Corporation's Current Report on Form 8-K filed on February 21, 2007)
- 10.9 First Amendment to Change in Control Severance Plan Agreement, dated as of December 28, 2012, with William B. Grant (incorporated by reference to Exhibit 10.8 to First United Corporation's Annual Report on Form 10-K for the year ended December 31, 2012)
- 10.10 Second Amendment to Agreement Under the First United Corporation Change in Control Severance Plan, dated as of January 5, 2015, between First United Corporation and William B. Grant (incorporated by reference to Exhibit 10.1 to First United Corporation's Current Report on Form 8-K filed on January 9, 2015)
- 10.11 Form of Agreement Under the First United Corporation Change in Control Severance Plan, dated as of February 14, 2007, with executive officers other than William B. Grant (incorporated by reference to Exhibit 10.3 to First United Corporation's Current Report on Form 8-K filed on February 21, 2007)
- 10.12 Form of First Amendment to Agreement Under the First United Corporation Change in Control Severance Plan, dated as of December 28, 2012, with executive officers other than William B. Grant (incorporated by reference to Exhibit 10.10 to First United Corporation's Annual Report on Form 10-K for the year ended December 31, 2012)
- 10.13 Form of Agreement Under the First United Corporation Change in Control Severance Plan, dated as of January 9, 2015, between First United Corporation and Keith R. Sanders (incorporated by reference to Exhibit 10.3 to First United Corporation's Current Report on Form 8-K filed on January 9, 2015)
- 10.14 First United Corporation Omnibus Equity Compensation Plan (incorporated by reference to Appendix B to First United Corporation's 2007 definitive proxy statement filed on March 23, 2007)
- 10.15 First United Corporation Long-Term Incentive Plan (incorporated by reference to Exhibit 10.1 to First United Corporation's Current Report on Form 8-K filed on June 23, 2008)
- 10.16 Form of Restricted Stock Agreement under the First United Corporation Long-Term Incentive Plan (incorporated by reference to Exhibit 10.3 to First United Corporation's Current Report on Form 8-K filed on June 23, 2008)
- 10.17 Restricted Stock Agreement, dated as of January 9, 2015, between First United Corporation and Keith R. Sanders (incorporated by reference to Exhibit 10.4 to First United Corporation's Current Report on Form 8-K filed on January 9, 2015)
- 10.18 First United Corporation Executive Pay for Performance Plan (incorporated by reference to Exhibit 10.4 to First United Corporation's Current Report on Form 8-K filed on June 23, 2008)
- 10.19 Form of Standby Purchase Agreement (incorporated by reference to Exhibit 10.1 to First United Corporation's Registration Statement on Form S-1, File No. 333-214477, filed on November 7, 2016)

- 21 Subsidiaries (filed herewith)
- 23.1 Consent of Baker Tilly Virchow Krause, LLP, Independent Registered Public Accounting Firm (filed herewith)
- 31.1 Certifications of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)
- 31.2 Certifications of Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)
- 32.1 Certifications pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith)
- 101.INS XBRL Instance Document (filed herewith)
- 101.SCHXBRL Taxonomy Extension Schema (filed herewith)
- 101.CALXBRL Taxonomy Extension Calculation Linkbase (filed herewith)
- 101.DEF XBRL Taxonomy Extension Definition Linkbase (filed herewith)
- 101.LABXBRL Taxonomy Extension Label Linkbase (filed herewith)
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase (filed herewith)

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