

PEOPLES BANCORP OF NORTH CAROLINA INC  
Form DEF 14A  
March 24, 2017

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 14A

(Rule 14a-101)

Proxy Statement Pursuant to Section 14(a)  
of the Securities Exchange Act of 1934

Filed by the  
Registrant  [X]

Filed by a  
Party other  
than the  [ ]  
Registrant

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box:

- [ ] Preliminary Proxy Statement     [ ] Confidential, for Use of the Commission  
 [X] Definitive Proxy Statement        Only (as permitted by Rule 14a-6(e)(2))  
 [ ] Definitive Additional Materials  
 [ ] Soliciting Material Pursuant to  
§240.14a-12

Peoples  
Bancorp of  
North  
Carolina,  
Inc.

(Name of  
Registrant  
as Specified  
In Its  
Charter)

(Name of  
Person(s)  
Filing Proxy  
Statement,

if other than  
the  
Registrant)

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(1) Amount Previously Paid:

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(3) Filing Party:

(4) Date Filed:

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PEOPLES BANCORP  
OF NORTH CAROLINA, INC.

Notice of 2017 Annual Meeting,  
Proxy Statement and  
Annual Report

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PEOPLES BANCORP OF NORTH CAROLINA, INC.

PROXY STATEMENT

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PEOPLES BANCORP OF NORTH CAROLINA, INC.

Post Office Box 467

518 West C Street

Newton, North Carolina 28658-0467

(828) 464-5620

NOTICE OF 2017 ANNUAL MEETING OF SHAREHOLDERS

To Be Held On May 4, 2017

NOTICE IS HEREBY GIVEN that the 2017 Annual Meeting of Shareholders of Peoples Bancorp of North Carolina, Inc. (the "Company") will be held as follows:

Place: Catawba Country Club

1154 Country Club Road

Newton, North Carolina

Date: May 4, 2017

Time: 11:00 a.m., Eastern Time

The purposes of the Annual Meeting are to consider and vote upon the following matters:

To elect ten persons who will serve as members of the Board of Directors until the 2018 Annual Meeting of Shareholders or until their successors are duly elected and qualified;

To ratify the appointment of Elliott Davis Decosimo PLLC ("Elliott Davis") as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2017; and

To consider and act on any other matters that may properly come before the Annual Meeting or any adjournment.

The Board of Directors has established March 9, 2017, as the record date for the determination of shareholders entitled to notice of and to vote at the Annual Meeting. If an insufficient number of shares is present in person or by proxy to constitute a quorum at the time of the Annual Meeting, the Annual Meeting may be adjourned in order to permit further solicitation of proxies by the Company.

Your vote is important. We urge you to vote as soon as possible so that your shares may be voted in accordance with your wishes. You may vote by executing and returning your proxy card in the accompanying envelope, or by voting electronically over the Internet or by telephone. Please refer to the proxy card enclosed for information on voting electronically. If you attend the Annual Meeting, you may vote in person and the proxy will not be used.

By Order of the Board of Directors,

/s/ Lance A. Sellers

Lance A. Sellers

President and Chief Executive Officer

Newton, North Carolina

March 24, 2017

PEOPLES BANCORP OF NORTH CAROLINA, INC.

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PROXY STATEMENT

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Annual Meeting of Shareholders  
To Be Held On May 4, 2017

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This Proxy Statement is being mailed to our shareholders on or about March 24, 2017, for solicitation of proxies by the Board of Directors of Peoples Bancorp of North Carolina, Inc. Our principal executive offices are located at 518 West C Street, Newton, North Carolina 28658. Our telephone number is (828) 464-5620.

In this Proxy Statement, the terms "we," "us," "our" and the "Company" refer to Peoples Bancorp of North Carolina, Inc. The term "Bank" means Peoples Bank, our wholly-owned, North Carolina-chartered bank subsidiary. The terms "you" and "your" refer to the shareholders of the Company.

Important Notice Regarding the Availability of Proxy Materials for the Shareholder Meeting to Be Held on May 4, 2017. The Notice, Proxy Statement and the Annual Report to Shareholders for the year ended December 31, 2016 are also available at <https://www.sn1.com/IRWebLinkX/GenPage.aspx?IID=4050385&GKP=202713>

You may also access the above off-site website by going to [www.peoplesbanknc.com](http://www.peoplesbanknc.com) and click on the link.

INFORMATION ABOUT THE ANNUAL MEETING

Your vote is very important. For this reason, our Board of Directors is requesting that you allow your common stock to be represented at the 2017 Annual Meeting of Shareholders by the proxies named on the enclosed proxy card.

When is the Annual Meeting? May 4, 2017, at 11 a.m., Eastern Time.

Where will the Annual Meeting be held? At the Catawba Country Club, 1154 Country Club Road, Newton, North Carolina.

What items will be voted on at the

Annual Meeting? 1. ELECTION OF DIRECTORS. To elect ten directors to serve until the 2018 Annual Meeting of Shareholders;

2. RATIFICATION OF SELECTION OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM. To ratify the appointment of Elliott Davis Decosimo, PLLC ("Elliott Davis") as the Company's independent registered public accounting firm for fiscal year 2017.

3. OTHER BUSINESS. To consider any other business as may properly come before the Annual Meeting or any adjournment.



Who can vote? Only holders of record of our common stock at the close of business on March 9, 2017 (the "Record Date") will be entitled to notice of and to vote at the Annual Meeting and any adjournment of the Annual Meeting. On the Record Date, there were 5,426,188 shares of our common stock outstanding and entitled to vote and 672 shareholders of record.

How do I vote by proxy? You may vote your shares by marking, signing and dating the enclosed proxy card and returning it in the enclosed postage-paid envelope or by voting electronically over the Internet or by telephone using the information on the proxy card. If you return your signed proxy card before the Annual Meeting, the proxies will vote your shares as you direct. The Board of Directors has appointed proxies to represent shareholders who cannot attend the Annual Meeting in person.

For the election of directors, you may vote for (1) all of the nominees, (2) none of the nominees, or (3) all of the nominees except those you designate. If a nominee for election as a director becomes unavailable for election at any time at or before the Annual Meeting, the proxies will vote your shares for a substitute nominee. For each other item of business, you may vote "FOR" or "AGAINST" or you may "ABSTAIN" from voting.

If you return your signed proxy card but do not specify how you want to vote your shares, the proxies will vote them "FOR" the election of all of our nominees for directors and "FOR" all other proposals presented in this Proxy Statement in accordance with recommendations from the Board of Directors.

If your shares are held in the name of a broker or other nominee (i.e., held in "street name"), you will need to obtain a proxy instruction card from the broker holding your shares and return the card as directed by your broker. Your broker is not permitted to vote on your behalf on the election of directors unless you provide specific instructions by following the instructions from your broker about voting your shares by telephone or Internet or completing and returning the voting instruction card provided by your broker. For your vote to be counted in the election of directors you will need to communicate your voting decision to your bank, broker or other holder of record before the date of the Annual Meeting.

We are not aware of any other matters to be brought before the Annual Meeting. If matters other than those discussed above are properly brought before the Annual Meeting, the proxies may vote your shares in accordance with their best judgment.

How do I change or revoke my proxy?

You can change or revoke your proxy at any time before it is voted at the Annual Meeting in any of three ways: (1) by delivering a written notice of revocation to the Secretary of the Company; (2) by delivering another properly signed proxy card to the Secretary of the Company with a more recent date than your first proxy card or by changing your vote by telephone or the Internet; or (3) by attending the Annual Meeting and voting in person. You should deliver your written notice or superseding proxy to the Secretary of the Company at our principal executive offices listed above.

How many votes can I cast?

You are entitled to one vote for each share held as of the Record Date on each nominee for election and each other matter presented for a vote at the Annual Meeting. You may not vote your shares cumulatively in the election of directors.

How many votes are required to approve the proposals?

If a quorum is present at the Annual Meeting, each director nominee will be elected by a plurality of the votes cast in person or by proxy. If you withhold your vote on a nominee, your shares will not be counted as having voted for that nominee. The proposal to ratify the appointment of the Company's independent registered public accounting firm for 2017 will be approved if the votes cast in favor exceed the votes cast in opposition.

Any other matters properly coming before the Annual Meeting for a vote will require the affirmative vote of the holders of a majority of the shares represented in person or by proxy at the Annual Meeting and entitled to vote on that matter.

Abstentions and broker non-votes are not treated as votes cast on any proposal. As a result, neither will have an effect on the vote for the election of any director or the ratification of our independent registered public accounting firm. A broker non-vote occurs when a broker does not vote on a particular matter because the broker does not have discretionary authority on that matter and has not received instructions from the owner of the shares.

In the event there are insufficient votes present at the Annual Meeting for a quorum or to approve or ratify any proposal, the Annual Meeting may be adjourned in order to permit the further solicitation of proxies.

What constitutes a "quorum" for the Annual Meeting? A majority of the outstanding shares of our common stock entitled to vote at the Annual Meeting, present in person or represented by proxy, constitutes a quorum (a quorum is necessary to conduct business at the Annual Meeting). Your shares will be considered part of the quorum if you have voted your shares by proxy or by telephone or Internet. Abstentions, broker non-votes and votes withheld from any director nominee count as shares present at the Annual Meeting for purposes of determining a quorum.

Who pays for the solicitation of proxies? We will pay the cost of preparing, printing and mailing materials in connection with this solicitation of proxies. In addition to solicitation by mail, our officers, directors and regular employees, as well as those of the Bank, may make solicitations personally, by telephone or otherwise without additional compensation for doing so. We reserve the right to engage a proxy solicitation firm to assist in the solicitation of proxies for the Annual Meeting. We will, upon request, reimburse brokerage firms, banks and others for their reasonable out-of-pocket expenses in forwarding proxy materials to beneficial owners of stock or otherwise in connection with this solicitation of proxies.

## SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The Exchange Act requires that any person who acquires the beneficial ownership of more than five percent (5%) of the Company's common stock notify the Securities and Exchange Commission (the "SEC") and the Company. Following is certain information, as of the Record Date, regarding those persons or groups who held of record, or who are known to the Company to own beneficially, more than five percent (5%) of the Company's outstanding common stock.

Name and Address of Beneficial Owner	Amount and Nature of <u>Beneficial Ownership</u> <sup>1</sup>	Percent of Class <sup>2</sup>
Christine S. Abernethy P.O. Box 386 Newton, NC 28658	660,495 <sup>3</sup>	12.17%
Tontine Financial Partners, LP 55 Railroad Avenue, 3rd Floor Greenwich, CT 06830-6378	376,704 <sup>4</sup>	6.94%
Tontine Management, LLC 55 Railroad Avenue Greenwich, CT 06830	376,704 <sup>4</sup>	6.94%
Tontine Asset Associates, LLC 55 Railroad Avenue Greenwich, CT 06830	141,361 <sup>4</sup>	2.61%
Jeffrey L. Gendell 55 Railroad Avenue Greenwich, CT 06830	518,065 <sup>4</sup>	9.55%

<sup>1</sup> Unless otherwise noted, all shares are owned directly of record by the named individuals, by their spouses and minor children, or by other entities controlled by the named individuals. Voting and investment power is not shared unless otherwise indicated.

<sup>2</sup> Based upon a total of 5,426,188 shares of common stock outstanding as of the Record Date.

Carolina Glove Company, Inc. owns 107,604 shares of common stock. These shares are included in the calculation of Ms. Abernethy's total beneficial ownership interest. Ms. Abernethy owns approximately 50% of the stock of Carolina Glove Company, Inc. The business is operated by a family committee. Ms. Abernethy has no active day-to-day participation in the business affairs of Carolina Glove Company, Inc.

<sup>3</sup> Based on a Schedule 13G/A (Amendment No. 8) filed by Tontine Financial Partners, LP, Tontine Management, LLC, Tontine Overseas Associates, LLC, Tontine Asset Associates, LLC and Jeffrey L. Gendell with the SEC on <sup>4</sup> February 10, 2017 and represents the total number of shares controlled by Jeffrey Gendell and the related Tontine entities.

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Set forth below is certain information, as of the Record Date (unless otherwise indicated), regarding those shares of common stock owned beneficially by each of the persons who currently serves as a member of the Board of Directors, is a nominee for election to the Board of Directors at the Annual Meeting, or is a named executive officer of the Company. Also shown is the number of shares of common stock owned by the directors and executive officers of the Company as a group.

<u>Name and Address</u>	<u>Amount and Nature of Beneficial Ownership<sup>1</sup></u>	<u>Percentage of Class<sup>2</sup></u>
James S. Abernethy Post Office Box 327 Newton, NC 28658	152,262 <sup>3</sup>	2.81%
Robert C. Abernethy Post Office Box 366 Newton, NC 28658	156,845 <sup>4</sup>	2.89%
William D. Cable, Sr. Post Office Box 467 Newton, NC 28658	20,915	*
Douglas S. Howard Post Office Box 587 Denver, NC 28037	15,235 <sup>5</sup>	*
A. Joseph Lampron, Jr. Post Office Box 467 Newton, NC 28658	9,383	*
John W. Lineberger, Jr. Post Office Box 481 Lincolnton, NC 28092	2,773	*
Gary E. Matthews 210 First Avenue South Conover, NC 28613	22,164	*
Billy L. Price, Jr., M.D. 540 11th Ave. Place NW Hickory, NC 28601	6,285	*
Larry E. Robinson Post Office Box 723 Newton, NC 28658	50,755 <sup>6</sup>	*
Lance A. Sellers Post Office Box 467 Newton, NC 28658	14,052	*

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William Gregory Terry	19,258	*
Post Office Box 395		
Conover, NC 28613		
Dan Ray Timmerman, Sr.	89,380 <sup>7</sup>	1.65%
Post Office Box 1148		
Conover, NC 28613		
Benjamin I. Zachary	95,110 <sup>8</sup>	1.75%
Post Office Box 277		
Taylorsville, NC 28681		

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All current directors and nominees and executive officers as a group (13 people) 590,379<sup>9</sup> 10.88%

\*Does not exceed one percent of the common stock outstanding.

<sup>1</sup> Unless otherwise noted, all shares are owned directly of record by the named individuals, by their spouses and minor children, or by other entities controlled by the named individuals. Voting and investment power is not shared unless otherwise indicated.

<sup>2</sup> Based upon a total of 5,426,188 shares of common stock outstanding as of the Record Date.

<sup>3</sup> Includes 64,038 shares of common stock owned by Alexander Railroad Company. Mr. J. Abernethy is Vice President, Secretary and Chairman of the Board of Directors of Alexander Railroad Company.

<sup>4</sup> Includes 6,130 shares of common stock owned by Mr. R. Abernethy's spouse, for which Mr. R. Abernethy disclaims beneficial ownership.

<sup>5</sup> Includes 450 shares of common stock owned by Mr. Howard's spouse, for which Mr. Howard disclaims beneficial ownership.

<sup>6</sup> Includes 8,835 shares of common stock owned by Mr. Robinson's spouse, for which Mr. Robinson disclaims beneficial ownership.

<sup>7</sup> Includes 2,722 shares of common stock owned by Timmerman Manufacturing, Inc. Mr. Timmerman is a shareholder, director, Chairman of the Board and the Chief Executive Officer of Timmerman Manufacturing, Inc.

<sup>8</sup> Includes 64,038 shares of common stock owned by Alexander Railroad Company. Mr. Zachary is President, Treasurer, General Manager and a Director of Alexander Railroad Company.

<sup>9</sup> The 64,038 shares owned by Alexander Railroad Company and attributed to Mr. J. Abernethy and Mr. Zachary are only included once in calculating this total.

Directors James S. Abernethy and Robert C. Abernethy are brothers and are sons of Christine S. Abernethy, who owns in excess of ten percent (10%) of the common stock of the Company.

## SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires the Company's executive officers and directors, and persons who own more than ten percent (10%) of the common stock, to file reports of ownership and changes in ownership with the SEC. Executive officers, directors and greater than ten percent (10%) beneficial owners are required by SEC regulations to furnish the Company with copies of all Section 16(a) forms they file.

Based solely on a review of the copies of such forms furnished to the Company and written representations from the Company's executive officers and directors, the Company believes that during the fiscal year ended December 31, 2016, its executive officers and directors and greater than ten percent (10%) beneficial owners complied with all applicable Section 16(a) filing requirements.

## PROPOSAL 1

## ELECTION OF DIRECTORS

Our Board of Directors has set its number at ten members. Our current Bylaws provide that in order to be eligible for consideration at the Annual Meeting of Shareholders, all nominations of directors, other than those made by the Governance Committee or the Board of Directors, must be in writing and must be delivered to the Secretary of the Company not less than 50 days nor more than 90 days prior to the meeting at which such nominations will be made; provided, however, that if less than 60 days' notice of the meeting is given to the shareholders, such nominations must be delivered to the Secretary of the Company not later than the close of business on the tenth day following the day on which the notice of meeting was mailed.



Information about the nominees for election to the Board of Directors for a one-year term until the 2018 Annual Meeting of Shareholders appears below. All of the nominees are currently serving on the Board of Directors.

#### Director Nominees

James S. Abernethy, age 62 (as of February 1, 2017), is employed by Carolina Glove Company, Inc., a glove manufacturing company as its Vice President. Mr. Abernethy continues to serve as President and Assistant Secretary of Midstate Contractors, Inc., a paving company and also as Vice President, Secretary and Chairman of the Board of Directors of Alexander Railroad Company. He has served as a director of the Company since 1992. Mr. Abernethy has a total of 24 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the North Carolina Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Abernethy earned a business administration degree from Gardner Webb University in North Carolina. Over his 24 years of service on the Board of Directors, Mr. Abernethy has served on all the Bank's and the Company's committees.

Robert C. Abernethy, age 66 (as of February 1, 2017), is employed by Carolina Glove Company, Inc., a glove manufacturing company, as its President, Secretary and Treasurer. Mr. Abernethy continues to serve as Secretary and Assistant Treasurer of Midstate Contractors, Inc., a paving company. He has served as a director of the Company since 1976 and as Chairman since 1991. Mr. Abernethy has a total of 40 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the North Carolina Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Abernethy earned a B.S. degree from Gardner Webb University in North Carolina. He serves on the Finance Committee and Investment Committee of Grace United Church of Christ. Mr. Abernethy also serves on the board of directors of Carolina Glove Company, Inc. and Midstate Contractors, Inc. both privately held companies.

Douglas S. Howard, age 58 (as of February 1, 2017), is employed by Denver Equipment of Charlotte, Inc. as Vice President, Secretary and Treasurer. Mr. Howard is currently serving as the Chairman of the Catawba Valley Medical Group. He has served as a director of the Company since 2004. Mr. Howard has a total of 18 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Howard also serves on the Board of Trustees of Catawba Valley Medical Center and as Chairman of the Finance Committee at Catawba Valley Medical Center.

John W. Lineberger, Jr., age 66 (as of February 1, 2017), is employed by Lincoln Bonded Warehouse Company, a commercial warehousing facility, as President. He has served as a director of the Company since 2004. Mr. Lineberger has a total of 12 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Lineberger earned a B.S. degree in business administration from Western Carolina University.

Gary E. Matthews, age 61 (as of February 1, 2017), is employed by Matthews Construction Company, Inc. as its President and a Director. He has served as a director of the Company since 2001. Mr. Matthews has a total of 15 years of banking experience, is a graduate of the North Carolina Bank Directors' College, and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Matthews is also a director of Conover Metal Products, a privately held company. Mr. Matthews earned a B.S. degree in civil engineering/construction from North Carolina State University.

Billy L. Price, Jr., M.D., age 60 (as of February 1, 2017), is a Practitioner of Internal Medicine at BL Price Medical Consultants, PLLC. Dr. Price also serves on the Board of Trustees of Catawba Valley Medical Center. He has served as a director of the Company since 2004. Dr. Price has a total of 12 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Dr. Price was previously the owner/pharmacist of Conover Drug Company. He is also a Medical Director of Healthgram Medical, a private company. Dr. Price earned a B.S. degree in pharmacy from the University of North Carolina at Chapel Hill and his MD from East Carolina University School of Medicine. He serves as Medical Director and Assistant Professor to Lenoir Rhyne University Physician Assistants Master of Science Program.

Larry E. Robinson, age 71 (as of February 1, 2017), is a shareholder, director, Chairman of the Board of Directors and Chief Executive Officer of The Blue Ridge Distributing Company, Inc., a beer and wine distributor. He is also a director and member of the Board of Directors of United Beverages of North Carolina, LLC, a malt beverage beer distributor. He has served as a director of the Company since 1993. Mr. Robinson has a total of 23 years of banking experience and is a graduate of the North Carolina Bank Directors' College. Mr. Robinson attended Western Carolina University and received an Associate Degree in Business and Accounting from Catawba Valley Community College in North Carolina.

William Gregory Terry, age 49 (as of February 1, 2017), is President of DFH Holdings and Operator/General Manager of Drum & Willis-Reynolds Funeral Homes and Crematory. He has served as a director of the Company since 2004. Mr. Terry has a total of 12 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Terry graduated with a B.S. degree in business management from Clemson University in South Carolina. Mr. Terry serves on numerous civic and community boards.

Dan Ray Timmerman, Sr., age 69 (as of February 1, 2017), is a shareholder, director, Chairman of the Board of Directors and the Chief Executive Officer of Timmerman Manufacturing, Inc., a wrought iron furniture, railings and gates manufacturer. He has served as a director of the Company since 1995. Mr. Timmerman has a total of 21 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Timmerman earned a B.S. degree in business administration with a concentration in accounting from Lenoir-Rhyne University in North Carolina. Mr. Timmerman serves as Chairman of the Board of the Catawba County Economic Development Commission.

Benjamin I. Zachary, age 60 (as of February 1, 2017), is employed by Alexander Railroad Company as its President, Treasurer, General Manager and Director. He has served as a director of the Company since 1995. Mr. Zachary has a total of 21 years of banking experience and is a graduate of the North Carolina Bank Directors' College. Mr. Zachary earned a B.S. degree in business administration with a concentration in accounting from the University of North Carolina at Chapel Hill. He worked as a CPA for a national accounting firm for eight years following graduation where his assignments included financial statement audits of several banks. Mr. Zachary is a member of the Taylorsville Rotary Club and has served as Treasurer for the Taylorsville Rotary Club and its Foundation.

We have no reason to believe that any of the nominees for election will be unable or will decline to serve if elected. In the event of death or disqualification of any nominee or the refusal or inability of any nominee to serve as a director, however, the proxies will vote for the election of another person as they determine in their discretion or may allow the vacancy to remain open until filled by the Board of Directors. In no circumstance will any proxy be voted for more than two nominees who are not named in this Proxy Statement. Properly executed and returned proxies, unless revoked, will be voted as directed by you or, in the absence of direction, will be voted in favor of the election of the recommended nominees. An affirmative vote of a plurality of votes cast at the Annual Meeting is necessary to

elect a nominee as a director.

THE BOARD OF DIRECTORS RECOMMENDS YOU VOTE "FOR" ALL OF THE NOMINEES NAMED ABOVE AS DIRECTORS

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## Executive Officers of the Company

During 2016, our executive officers were:

Lance A. Sellers, age 54 (as of February 1, 2017), serves as the President and Chief Executive Officer of the Company and the Bank. Prior to becoming the President and Chief Executive Officer of the Company and the Bank, Mr. Sellers served as Executive Vice President and Assistant Corporate Secretary of the Company and Executive Vice President and Chief Credit Officer of the Bank. He has been employed by the Company and the Bank since 1998. Mr. Sellers has a total of 32 years of banking experience. He is a graduate of the University of North Carolina at Chapel Hill and upon graduation served as a senior credit officer at a regional bank headquartered in North Carolina.

William D. Cable, Sr., age 48 (as of February 1, 2017), serves as Executive Vice President, Assistant Corporate Treasurer and Corporate Secretary of the Company and Executive Vice President and Chief Operating Officer of the Bank. He has been employed by the Company and the Bank since 1995, where he has served as Senior Vice President-Information Services. Mr. Cable has a total of 25 years of banking experience. Prior to joining the Company, Mr. Cable was a regulatory examiner with the Federal Deposit Insurance Corporation. He is a graduate of Western Carolina University and the School of Banking of the South at Louisiana State University.

A. Joseph Lampron, Jr., age 62 (as of February 1, 2017), serves as Executive Vice President, Chief Financial Officer, Corporate Treasurer and Assistant Corporate Secretary of the Company and Executive Vice President and Chief Financial Officer of the Bank. He has been employed by the Company and the Bank since 2001. Mr. Lampron is a graduate of the University of North Carolina at Chapel Hill and upon graduation worked as a certified public accountant with a national accounting firm. His work with the firm included audits of banks and thrift institutions. Mr. Lampron has also served as Chief Financial Officer of a thrift institution and as a senior change manager in the finance group of a large North Carolina bank. Mr. Lampron has a total of 37 years of banking experience.

How often did our Board of Directors meet during 2016?

Our Board of Directors held 15 meetings during 2016. All incumbent directors attended more than 75% of the total number of meetings of the Board of Directors and its committees on which they served during the year.

What is our policy for director attendance at Annual Meetings?

Although it is customary for all of our directors to attend Annual Meetings of Shareholders, we have no formal policy in place requiring attendance. All members of the Board of Directors attended our 2016 Annual Meeting of Shareholders held on May 5, 2016.

How can you communicate with the Board or its members?

We do not have formal procedures for shareholder communication with our Board of Directors. In general, our directors and officers are easily accessible by telephone, postal mail or e-mail. Any matter intended for your Board of Directors, or any individual director, can be directed to Lance Sellers, our President and Chief Executive Officer, or Joe Lampron, our Chief Financial Officer, at our principal executive offices at 518 West C Street, Newton, North Carolina 28658. You also may direct correspondence to our Board of Directors, or any of its members, in care of the Company at the foregoing address. Your communication will be forwarded to the intended recipient unopened.

## Board Leadership Structure and Risk Oversight

Our Company and the Bank have traditionally operated with separate Chief Executive Officer and Chairman of the Board of Directors positions. We believe it is our Chief Executive Officer's responsibility to manage the Company and the Chairman's responsibility to lead the Board of Directors. Robert Abernethy is currently serving as Chairman of the Board of Directors, and James Abernethy is currently serving as the Vice Chairman of the Board of Directors. Other than Director Lineberger, all of the members of the Board of Directors are independent under applicable NASDAQ listing requirements. The Company has five standing committees: Executive, Loan Sub-Committee, Governance, Audit and Compensation. The Chief Executive Officer serves on the Executive Committee. The Bank in addition to the above-named committees has a Loan Committee and a Loan Sub-Committee. The duties of the Company's committees and the qualifications of the independent directors have been described above. Each of the Company's and the Bank's committees considers risk within its area of responsibility. The Audit Committee and the full Board of Directors focus on the Company's most significant risks in the areas of liquidity, credit, interest rate and general risk management strategy. The Board of Directors sets policy guidelines in the areas of loans and asset/liability management which are reviewed on an on-going basis. While the Board of Directors oversees the Company's risk management, the Company's and the Bank's management are responsible for day-to-day risk management following the dictates of the policy decisions set by the Board of Directors.

The Governance Committee, as part of its annual review, evaluates the Board of Directors leadership structure and performance and reports its findings to the whole Board of Directors. The Board of Directors believes that having separate persons serving as Chief Executive Officer and Chairman and all independent directors provides the optimal board leadership structure for the Company and its shareholders.

## Code of Business Conduct and Ethics

The Company and the Bank have a Code of Business Conduct and Ethics for its directors, officers and employees. The Code of Business Conduct and Ethics requires that individuals avoid conflicts of interest, comply with all laws and other legal requirements, conduct business in an honest and ethical manner and otherwise act with integrity and in the best interests of the Company and the Bank. The Code of Business Conduct and Ethics is a guide to help ensure that all employees live up to the highest ethical standards of behavior.

A copy of the Code of Business Conduct and Ethics is available on the Bank's website ([www.peoplesbanknc.com](http://www.peoplesbanknc.com)) under Investor Relations.

As is permitted by SEC rules, the Company intends to post on its website any amendment to or waiver from any provision in the Code of Business Conduct and Ethics that applies to the Chief Executive Officer, the Chief Financial Officer, the Controller, or persons performing similar functions, and that relates to any element of the standards enumerated in the rules of the SEC.

## Diversity of the Board of Directors

The Governance Committee has no written diversity policy; however, the Governance Committee defines diversity broadly to include, in addition to race, gender, ethnicity and age, differences in professional experience, educational background, geographic mix within the Company's market area, skills and other individual qualities and attributes that foster board heterogeneity in order to encourage and maintain board effectiveness. While there are currently no women or minorities serving on the Board of Directors, any qualified candidate receives consideration regardless of race, gender or national origin.

How can a shareholder nominate someone for election to the Board of Directors?

Our Bylaws provide that in order to be eligible for consideration at the Annual Meeting of Shareholders, all nominations of directors, other than those made by the Governance Committee or the Board of Directors, must be in writing and must be delivered to the Secretary of the Company not less than 50 days nor more than 90 days prior to the meeting at which such nominations will be made. However, if less than 60 days' notice of the meeting is given to the shareholders, such nominations must be delivered to the Secretary of the Company not later than the close of business on the tenth day following the day on which the notice of meeting was mailed.

The Board of Directors may disregard any nominations that do not comply with these requirements. Upon the instruction of the Board of Directors, the inspector of voting for the Annual Meeting may disregard all votes cast for a nominee if the nomination does not comply with these requirements. Written notice of nominations should be directed to the Secretary of the Company.

Who serves on the Board of Directors of the Bank?

The Bank has ten directors currently serving on its Board of Directors, who are the same people who are currently directors of the Company.

#### Board Committees

During 2016, our Board of Directors had five standing committees, the Audit and Enterprise Risk Committee, the Governance Committee, the Compensation Committee, the Executive Committee and the Loan Sub-Committee. The voting members of these Committees are appointed by the Board of Directors annually from among its members. Certain of our executive officers also serve as non-voting, advisory members of these committees.

**Executive Committee.** The Executive Committee performs duties as assigned by the full Board of Directors. Actions taken by the Executive Committee must be approved by the full Board of Directors. The following persons currently serve on the Executive Committee: Directors R. Abernethy, J. Abernethy, Lineberger, Robinson and Terry, as well as the President and Chief Executive Officer of the Company in a non-voting capacity. It meets on an "as needed" basis and met once during 2016.

**Governance Committee.** The Governance Committee is responsible for developing and maintaining the corporate governance policy, as well as acting as the nominating committee for the Board of Directors. The following persons currently serve on the Governance Committee: Directors R. Abernethy, J. Abernethy, Howard, Terry, and Timmerman. All of the members of the Governance Committee are independent as defined in the applicable NASDAQ listing standards. The Board of Directors determines on an annual basis each director's independence.

The Governance Committee, serving as the nominating committee of the Board of Directors, interviews candidates for membership to the Board of Directors, recommends candidates to the full Board of Directors, slates candidates for shareholder votes, and fills any vacancies on the Board of Directors which occur between shareholder meetings. The Governance Committee's identification of candidates for director typically results from the business interactions of the members of the Governance Committee or from recommendations received from other directors or from the Company's management.

If a shareholder recommends a director candidate to the Governance Committee in accordance with the Company's Bylaws, the Governance Committee will consider the candidate and apply the same considerations that it would to its own candidates. The recommendation of a candidate by a shareholder should be made in writing, addressed to the attention of the Governance Committee at the Company's corporate headquarters. The recommendation should include a description of the candidate's background, his or her contact information, and any other information the

shareholder considers useful and appropriate for the Governance Committee's consideration of the candidate. The criteria which have been established by the Governance Committee as bearing on the consideration of a candidate's qualification to serve as a director include the following: the candidate's ethics, integrity, involvement in the community,

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success in business, relationship with the Bank, investment in the Company, place of residence (i.e., proximity to the Bank's market area), and financial expertise.

The Governance Committee met twice during the year ended December 31, 2016.

The Governance Committee has a written charter which is reviewed annually, and amended as needed, by the Governance Committee. A copy of the Governance Committee Charter is available on the Bank's website ([www.peoplesbanknc.com](http://www.peoplesbanknc.com)) under Investor Relations.

**Audit and Enterprise Risk Committee.** The Company has a separately designated standing Audit and Risk Enterprise Committee (the "Audit Committee") which was established in accordance with Section 3(a)(58)(A) of the Exchange Act. The Audit Committee's responsibilities include oversight of enterprise risk. The Audit Committee has a written charter which is reviewed annually, and amended as needed, by the Audit Committee. A copy of the Audit Committee Charter is available on the Bank's website ([www.peoplesbanknc.com](http://www.peoplesbanknc.com)) under Investor Relations. The following persons currently serve on the Audit Committee: Directors R. Abernethy, J. Abernethy, Howard, Price, Timmerman and Zachary. The Board of Directors has determined that these members are independent as that term is defined in the applicable NASDAQ listing standards and the SEC's regulations. The Board of Directors determines on an annual basis each director's independence.

The Board of Directors has determined that each member of the Audit Committee qualifies as an "audit committee financial expert" based on each of the member's educational background and business experience.

The Audit Committee meets at least quarterly and, among other responsibilities, oversees (i) the independent auditing of the Company; (ii) the system of internal controls that management has established; and (iii) the quarterly and annual financial information to be provided to shareholders and the SEC. The Audit Committee met nine times during the year ended December 31, 2016.

**Audit Committee Report.** The Audit Committee has reviewed and discussed the audited financial statements with management of the Company and has discussed with the independent auditors the matters required to be discussed by Auditing Standards No. 16 as amended, as adopted by the Public Company Accounting Oversight Board in Rule 3200T. In addition, the Audit Committee has received the written disclosures and the letter from the independent accountants required by the applicable requirements of the Public Company Accounting Oversight Board regarding the independent accountant's communications with the Audit Committee concerning independence, and has discussed with the independent accountant the independent accountant's independence. Based upon these reviews and discussions, the Audit Committee recommended to the Board of Directors that the audited financial statements be included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2016.

Robert C. Abernethy  
Benjamin I. Zachary  
Douglas S. Howard  
Dan R. Timmerman, Sr.  
James S. Abernethy  
Billy L Price, Jr. MD, Committee Chair

**Compensation Committee.** The Company's Compensation Committee is responsible for developing, reviewing, implementing and maintaining the Bank's salary, bonus, and incentive award programs and for making recommendations to the Company's and the Bank's Board of Directors regarding compensation of the executive officers. Upon recommendation from the Compensation Committee, the Company's Board of Directors ultimately determines such compensation.

All of the members of the Compensation Committee are independent as defined in the applicable NASDAQ's listing standards. The Board of Directors determines on an annual basis each director's independence. The following persons currently serve on the Compensation Committee: Directors R. Abernethy, J. Abernethy, Howard, Terry and Timmerman. The Compensation Committee met twice during the year ended December 31, 2016.





The Compensation Committee has a written charter which is reviewed annually, and amended as needed, by the Compensation Committee. A copy of the Compensation Committee's Charter is available on the Bank's website ([www.peoplesbanknc.com](http://www.peoplesbanknc.com)) under Investor Relations.

Compensation Committee Interlocks and Insider Participation. No member of the Compensation Committee is now, or formerly was, an officer or employee of the Company or the Bank. None of the NEOs serve as a member of the board of directors of another entity whose executive officers or directors serve on the Company's Board of Directors.

Compensation Committee Report. The Compensation Committee has reviewed and discussed the Compensation Discussion and Analysis in this Proxy Statement with management and has recommended that it be included in this Proxy Statement and our Annual Report on Form 10-K filed with the SEC for the year ended December 31, 2016.

#### Compensation Committee

Robert C. Abernethy

James S. Abernethy

Douglas S. Howard

William Gregory Terry

Dan R. Timmerman, Sr., Committee Chair

#### Compensation Discussion and Analysis

The following Compensation Discussion and Analysis provides information with respect to the compensation paid during the year ended December 31, 2016 to our President and Chief Executive Officer, Lance A. Sellers, our Chief Financial Officer, A. Joseph Lampron, Jr. and William D. Cable, Sr. (together, our "named executive officers"). Compensation Committee Processes and Procedures. The Compensation Committee assists the Board of Directors in determining appropriate compensation levels for the members of the Board of Directors and our named executive officers. It also has strategic and administrative responsibility for a broad range of compensation issues. It seeks to ensure that we compensate key management employees effectively and in a manner consistent with the Compensation Committee's stated compensation strategy and relevant requirements of various regulatory entities. A part of these responsibilities is overseeing the administration of executive compensation and employee benefit plans, including the design, selection of participants, establishment of performance measures, and evaluation of awards pursuant to our annual and long-term incentive programs.

Compensation Philosophy. The overall objective of our executive compensation program is to align total compensation so that the individual executive believes it is fair and equitable and provides the highest perceived value to our shareholders and to that individual. In order to accomplish this overall objective, our executive compensation program is designed to: (i) attract qualified executives necessary to meet our needs as defined by the Company's strategic plans, and (ii) retain and motivate executives whose performance supports the achievement of our long-term plans and short-term goals. The executive compensation program is founded upon the idea that a strong, performance-oriented compensation program, which is generally consistent with the practices of our peers, is a key ingredient in becoming a leading performer among financial institutions of similar size, and is, therefore, in the best interests of our shareholders.

The Compensation Committee considers a number of factors specific to each executive's role when determining the amount and mix of compensation to be paid. These factors are:

- compensation of the comparable executives at comparable financial institutions;
- financial performance of the Company (especially on a "net operating" basis, which excludes the effect of one-time gains and expenses) over the most recent fiscal year and the prior three years;
- composition of earnings;
- asset quality relative to the banking industry;
- responsiveness to the economic environment;



the Company's achievement compared to its corporate, financial, strategic and operational objectives and business plans; and  
·cumulative shareholder return.

Elements of the Executive Compensation Program. The Company's and the Bank's compensation program consists of the following elements:

Base Salary. The salaries of our named executive officers are designed to provide a reasonable level of compensation that is affordable to the Company and fair to the executive. Salaries are reviewed annually, and adjustments, if any, are made based on the review of competitive salaries in our peer group, as well as an evaluation of the individual officer's responsibilities, job scope, and individual performance. For example, we assess each officer's success in achieving budgeted earnings and return ratios, business conduct and integrity, and leadership and team building skills.

Annual Cash Incentive Awards. We believe that annual cash incentive awards encourage our named executive officers to achieve short-term targets that are critical to achievement of our long-term strategic plan. The Bank has a Management Incentive Plan for officers of the Bank. Participants in the Management Incentive Plan are recommended annually by the President and Chief Executive Officer to the Bank's Board of Directors. Each individual's incentive pool is determined by a formula which links attainment of corporate budget with attainment of individual goals and objectives. Incentives under the Management Incentive Plan are paid annually. No named executive officer earned or was paid a cash incentive under the Management Incentive Plan during the fiscal year ended December 31, 2016.

Discretionary Bonus and Service Awards. From time to time the Compensation Committee may recommend to the Board of Directors that additional bonuses be paid based on accomplishments that significantly exceed expectations during the fiscal year. These bonuses are totally discretionary as to who will receive a bonus and the amount of any such bonus. In 2016, the Compensation Committee recommended, and the Board of Directors approved, discretionary bonuses as follows: \$50,000 for Mr. Sellers; \$40,000 for Mr. Lampron; and \$40,000 for Mr. Cable. These discretionary bonuses were paid in January of 2017. Under the Service Recognition Program, the Bank gives service awards to each employee and director for every five years of service with the Bank to promote longevity of service for both directors and employees. Service awards are made in the form of shares of the Company's common stock plus cash in the amount necessary to pay taxes on the award. The number of shares awarded increases with the number of years of service to the Bank. On December 20, 2016, Mr. Lampron was awarded 42 shares of the Company's common stock plus \$288 in cash under the Service Recognition Program.

Long-Term Equity Incentive Awards. The Company maintains the 2009 Omnibus Stock Ownership and Long Term Incentive Plan ("Omnibus Plan"), under which it is permitted to grant incentive stock options, restricted stock, restricted stock units, stock appreciation rights, book value shares, and performance units. The purpose of the Omnibus Plan is to promote the interests of the Company by attracting and retaining directors and employees of outstanding ability and to provide executives of the Company greater incentive to make material contributions to the success of the Company by providing them with stock-based compensation which will increase in value based upon the market performance of the common stock and/or the corporate achievement of financial and other performance objectives.

In making its decision to grant awards to the Company's named executive officers under the Omnibus Plan, the Compensation Committee considers all elements of such named executive officer's compensation. In considering the number of awards to grant to the Company's named executive officers, the Compensation Committee considers each named executive officer's contribution to the Company's performance.

The Company did not grant any plan-based awards to its named executive officers during the fiscal year ended December 31, 2016. See "Outstanding equity Awards at Fiscal Year-End" on page 19 of this Proxy Statement for

information on grants of restricted stock units to the named executed officers during the fiscal years ended December 31, 2012, 2013, 2014 and 2015. See "Omnibus Plan and Long Term Incentive Plan" starting on page 22 of this Proxy Statement for additional information on the Omnibus Plan.

Supplemental Executive Retirement Agreements. The Bank provides non-qualified supplemental executive retirement benefit in the form of Executive Salary Continuation Agreements with Messrs. Sellers, Lampron and Cable. The Committee's goal is to provide competitive retirement benefits given the restrictions on executives within tax-qualified plans. In prior years, the Compensation Committee worked with a compensation consultant in analyzing the possible benefits of using supplemental retirement benefits to address the issues of internal and external equity in terms of retirement benefits offered to all employees at the Company as a percentage of final average pay and executives in our peer group. In connection with the non-qualified supplemental executive retirement benefits, the Bank purchased life insurance contracts on the lives of the named executive officers. The increase in cash surrender value of the life insurance contracts constitutes the Bank's contribution to the plan each year. The Bank will pay benefits to participating officers for a period between 13 years and the life of the officer. The Bank is the sole owner of all of the insurance contracts.

Profit Sharing Plan and 401(k) Plan. The Bank has a Profit Sharing Plan and 401(k) Plan for all eligible employees. The Bank made no contribution to the Profit Sharing Plan for the year ended December 31, 2016. No investments in Bank stock have been made by the plan. Under the Bank's 401(k) Plan, the Bank matches employee contributions to a maximum of 4.00% of annual compensation. The Bank's 2016 contribution to the 401(k) Plan pursuant to this formula was approximately \$565,300. All contributions to the 401(k) Plan are tax deferred. The Profit Sharing Plan and 401(k) Plan permit participants to choose from investment funds which are selected by a committee comprised of senior management. Employees are eligible to participate in both the 401(k) Plan and Profit Sharing Plan beginning in the second month of employment. Both plans are now "safe harbor" plans, and all participants are immediately 100% vested in all employer contributions.

Deferred Compensation Plan. The Bank maintains a non-qualified deferred compensation plan for directors and certain officers. Eligible officers selected by the Bank's Board of Directors may elect to contribute a percentage of their compensation to the plan. Participating officers may elect to invest their deferred compensation in a restricted list of investment funds. The Bank may make matching or other contributions to the plan as well, in amounts determined at the discretion of the Bank. Participants are fully vested in all amounts contributed to the plan by them or on their behalf. The Bank has established a Rabbi Trust to hold the accrued benefits of the participants under the plan. There are no "above-market" returns provided for in this plan. The Bank made no contributions to the plan in 2016. Benefits under the plan are payable in the event of the participant's retirement, death, termination, or as a result of hardship. Benefit payments may be made in a lump sum or in installments, as selected by the participant.

Employment Agreements. The Company has employment agreements with each named executive officer, which the Board of Directors believes serve a number of functions, including (i) retention of the executive team; (ii) mitigation of any uncertainty about future employment and continuity of management in the event of a change in control; and (iii) protection of the Company and customers through non-compete and non-solicitation covenants. Additional information regarding the employment agreements, including a description of key terms may be found starting on page 21 of this Proxy Statement.

Other Benefits. Executive officers are entitled to participate in fringe benefit plans offered to employees including health and dental insurance plans and life, accidental death and dismemberment and long-term disability plans. In addition, the Bank has paid country club dues for each named executive officer.

The above elements of each named executive officer's compensation are not inter-related. For example, if vesting standards on restricted stock awards are not achieved, the executive's base salary is not increased to make up the difference. Similarly, the value of previously granted options is not considered by the Compensation Committee in recommending the other elements of the compensation package.

The Compensation Committee did not engage a compensation consultant during the year ended December 31, 2016. The President and Chief Executive Officer of the Company and the Bank makes recommendations to the Committee

regarding the compensation of the executive officers other than his own. The President and Chief Executive Officer participates in the deliberations, but not in the decisions, of the Compensation Committee regarding compensation of executive officers. He does not participate in the Compensation Committee's discussion or decisions regarding his own compensation. The Compensation Committee reports its actions to the Board of Directors and keeps written minutes of its meetings, which minutes are maintained with the books and records of the Company.

The Compensation Committee also considers the results of the shareholders' non-binding vote on executive compensation. At the 2013 Annual Meeting of Shareholders, 52% of the shareholders who voted at the 2013 Annual Meeting of Shareholders elected to review the executive compensation of the Company's named executive officers once every three years. As a result, the Company submitted, in a non-binding advisory proposal, the executive compensation of the Company's named executive officers at the 2016 Annual Meeting of Shareholders. At the 2016 Annual Meeting of Shareholders, 94% of the shareholders who voted at the 2016 Annual Meeting of Shareholders approved the executive compensation of the Company's named executive officers as presented to the shareholders in the 2016 proxy statement. The Company will submit a vote to the shareholders on the compensation of its named executive officers at its 2019 Annual Meeting of Shareholders.

#### Summary Compensation Table

The executive officers of the Company are not paid any cash compensation by the Company. However, the executive officers of the Company also are executive officers of the Bank and receive compensation from the Bank. The table on the following page show, for the fiscal years ended December 31, 2016, 2015 and 2014, the cash compensation received by, as well as certain other compensation paid or accrued for those years, to each named executive officer.



## SUMMARY COMPENSATION TABLE

<u>Name and Principal Position</u>	<u>Year</u>	<u>Salary(\$)</u>	<u>Bonus(\$)</u>	<u>Stock Awards(\$)</u> <sup>1</sup>	<u>Change in Pension Value and Nonqualified Deferred Compensation Earnings(\$)</u>	<u>All Other Compensation(\$)</u> <sup>2</sup>	<u>Total(\$)</u>
Lance A. Sellers	2016	319,185	50,000	-	57,312	31,775	458,271
President and Chief Executive Officer	2015	311,400	30,000	39,893	52,507	31,861	465,661
	2014	311,400	30,000	61,230	54,638	26,990	484,258
A. Joseph Lampron, Jr.	2016	197,653	40,000	-	102,893	24,307	365,153
Executive Vice President, Chief Financial Officer	2015	193,125	30,000	29,920	93,827	23,105	369,977
	2014	187,500	30,000	42,830	57,767	18,468	336,565
William D. Cable, Sr.	2016	203,179	40,000	-	22,540	25,500	291,759
Executive Vice President, Chief Operating Officer	2015	198,750	30,000	29,920	20,619	27,403	306,692
	2014	187,500	30,000	42,830	20,599	19,777	300,706

<sup>1</sup> Amount represents the aggregate grant date fair value computed in accordance with FASB ASC Topic 718. See Note 1 in the Notes to the Company's Consolidated Financial Statements included in the Company's Annual Report, which Annual Report is attached here to as Appendix A.

<sup>2</sup> All other compensation is comprised of the following:

<u>Name and Principal Position</u>	<u>Year</u>	<u>Employer Match(\$)</u>	<u>Car Allowance(\$)</u>	<u>Country Club Dues(\$)</u>	<u>Split Dollar Death Benefit(\$)</u>	<u>Group Term Life(\$)</u> <sup>(a)</sup>	<u>Disability and LTC Premiums(\$)</u> <sup>(b)</sup>	<u>Dividends Accrued on Restricted Stock Units(\$)</u>	<u>Other(\$)</u>
Lance A. Sellers	2016	10,600	4,113	3,576	480	2,376	5,628	5,002	0
President and Chief Executive Officer	2015	10,600	4,113	3,506	454	4,104	5,398	3,686	0
	2014	10,400	4,113	3,455	418	1,242	5,392	1,970	0
A. Joseph Lampron, Jr.	2016	9,096	0	3,380	1,139	3,863	1,984	3,570	1,275 <sup>(d)</sup>
Executive Vice President, Chief Financial Officer	2015	8,628	0	3,300	1,056	5,506	1,984	2,631	0
	2014	8,279	0	3,280	978	2,555	1,984	1,392	0
William D. Cable, Sr.	2016	8,699	0	4,676	405	1,775	6,375	3,570	0
Executive Vice President,	2015	9,150	0	3,452	377	3,477	5,816	2,631	2,500 <sup>(c)</sup>
	2014	8,279	0	3,360		581	5,816	1,392	0

Chief Operating  
Officer

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<sup>(a)</sup>Represents amounts paid by the Bank for premiums on group term life insurance in excess of \$50,000 for each named executive officer.

<sup>(b)</sup>Represents amounts paid by the Bank for premiums on disability and long-term care insurance for each NEO.

<sup>(c)</sup>In 2015, Mr. Cable received 106 shares for 20 years of service with the Bank and \$513 in cash to pay the taxes associated with the award under the Bank's Service Recognition Program.

<sup>(d)</sup>In 2016, Mr. Lampron received 42 shares for 15 years of service with the Bank and \$288 in cash to pay the taxes associated with the award under the Bank's Service Recognition Program.

## Grants of Plan-Based Awards

The Company did not grant any plan-based awards to the named executive officers during the fiscal year ended December 31, 2016.

## Outstanding Equity Awards at Fiscal Year End

The following table shows certain information for those outstanding equity awards at December 31, 2016.

## OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END

## Stock Awards

<u>Name</u>	<u>Number of Shares or Units Have Not Vested (#)</u>	<u>Market Value of Stock That Have Not Vested (\$)</u>	<u>Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)</u>	<u>Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested<sup>(3)</sup> (\$)</u>
Lance A. Sellers	--	--	19,669 <sup>(1)</sup>	493,102
A. Joseph Lampron, Jr.	--	--	14,173 <sup>(2)</sup>	355,317
William D. Cable, Sr.	--	--	14,173 <sup>(2)</sup>	355,317

Includes 6,505 restricted stock units that were granted on March 22, 2012 (with a grant date fair value for each restricted stock unit of \$7.90 on March 22, 2012) and vest on March 22, 2017; 2,169 restricted stock units that were granted on July 26, 2012 (with a grant date fair value for each restricted stock unit of \$8.25 on July 26, 2012) and vest on July 26, 2017; 4,875 restricted stock units that were granted on May 23, 2013 (with a grant date fair value for each restricted stock unit of \$11.90 on May 23, 2013) and vest on May 23, 2017; 3,900 restricted stock units that were granted on February 20, 2014 (with a grant date fair value for each restricted stock unit of \$15.70 on February 20, 2014) and vest on February 20, 2017; and 2,200 restricted stock units that were granted on February 19, 2015 (with a grant date fair value for each restricted stock unit of \$17.97 on February 19, 2015) and vest on February 19, 2019.

Includes 4,777 restricted stock units that were granted on March 22, 2012 (with a grant date fair value for each restricted stock unit of \$7.90 on March 22, 2012) and vest on March 22, 2017; 1,593 restricted stock units that were granted on July 26, 2012 (with a grant date fair value for each restricted stock unit of \$8.25 on July 26, 2012) and vest on July 26, 2017; 3,410 restricted stock units that were granted on May 23, 2013 (with a grant date fair value for each restricted stock unit of \$11.90 on May 23, 2013) and vest on May 23, 2017; 2,728 restricted stock units that were granted on February 20, 2014 (with a grant date fair value for each restricted stock unit of \$15.70 on February 20, 2014) and vest on February 20, 2017; and 1,665 restricted stock units that were granted on February 19, 2015 (with a grant date fair value for each restricted stock unit of \$17.97 on February 19, 2015) and vest on February 19, 2019.

<sup>(3)</sup>Based on a stock price of \$25.07 per share on December 31, 2016.

## Option Exercises and Stock Vested

During the fiscal year ended December 31, 2016, no options were exercised by the named executive officers and no restricted stock units granted to the named executive officers vested.

## Pension Benefits

The following table shows, for the fiscal year ended December 31, 2016, the pension benefits paid or earned by Messrs. Sellers, Lampron and Cable.

## PENSION BENEFITS TABLE

<u>Name</u>	<u>Plan Name</u>	<u>Number of Present Years Credited Service</u>	<u>Value of Accumulated Benefit(\$)</u>	<u>Payments During Last Fiscal Year(\$)</u>
Lance A. Sellers	Executive Salary Continuation Agreement <sup>1</sup>	15	370,614	--
A. Joseph Lampron, Jr.	Executive Salary Continuation Agreement <sup>1,2</sup>	15	525,074	--
William D. Cable, Sr.	Executive Salary Continuation Agreement <sup>1</sup>	15	137,145	--

<sup>1</sup> The Bank entered into an Executive Salary Continuation Agreement with Messrs. Sellers, Lampron and Cable effective on January 1, 2002. Each Executive Salary Continuation Agreement was amended on December 31, 2003 and December 18, 2008. The Executive Salary Continuation Agreements for Messrs. Sellers, Lampron and Cable were further amended on December 10, 2014. Unless a separation from service or a change in control (as defined in the Executive Salary Continuation Agreements) occurs before the retirement age set forth in each Executive Salary Continuation Agreement, the Executive Salary Continuation Agreements provide for an annual supplemental retirement benefit to be paid to each of the named executive officers in 12 equal monthly installments payable on the first day of each month, beginning with the month immediately after the month in which the named executive officer attains the normal retirement age and for the named executive officer's lifetime, or if longer, a 13-year term. Under the terms of the Executive Salary Continuation Agreements, Mr. Sellers will receive an annual supplemental retirement benefit of \$130,495, Mr. Lampron will receive an annual supplemental retirement benefit of \$76,554 and Mr. Cable will receive an annual supplemental retirement benefit of \$93,872.

<sup>2</sup> As of December 31, 2016, Mr. Lampron was the only named executive officer eligible to withdraw funds from the plan. Mr. Lampron, if he elected, could withdrawal 80% of the annual benefit of \$76,554 (or \$61,243 per year).

## Nonqualified Deferred Compensation

The below table shows the compensation deferred by Messrs. Lampron and Cable during the year ended December 31, 2016. Mr. Sellers elected not to defer any portion of his compensation during the year ended December 31, 2016.

## NONQUALIFIED DEFERRED COMPENSATION

<u>Name</u>	<u>Executive Contributions in the Last FY (\$) <sup>(1)</sup></u>	<u>Registrant Contributions In Last FY (\$) <sup>(2)</sup></u>	<u>Aggregate Earnings in Last FY (\$) <sup>(2)</sup></u>	<u>Aggregate Withdrawals/ Distributions (\$) <sup>(3)</sup></u>	<u>Aggregate Balance at Last FYE (\$) <sup>(3)</sup></u>
A. Joseph Lampron, Jr.	5,922	--	43,664	0	182,353
William D. Cable, Sr.	16,252	--	76,767	0	414,653

<sup>(1)</sup> The above contributions were based on the named executive officer's deferral elections and the salaries shown in the Summary Compensation Table. The salaries in the Summary Compensation Table include these contributions.

This column reflects earnings or losses on plan balances in 2016. Earnings may increase or decrease depending on the performance of the elected hypothetical investment options. Earnings on these plans are not "above-market"

<sup>(2)</sup> and thus are not reported in the Summary Compensation Table. Plan balances may be hypothetically invested in various mutual funds and common stock as described below. Investment returns on those funds and common stock ranged from -2.30% to 31.59% for the year ended December 31, 2016.

This column represents the year-end balances of the named executive officer's nonqualified deferred compensation accounts. These balances include contributions that were included in the Summary Compensation Tables in <sup>(3)</sup> previous years. Amounts in this column include earnings that were not previously reported in the Summary Compensation Table because they were not "above-market" earnings.

## Employment Agreements

On January 22, 2015, the Company, the Bank and each of (i) Lance A. Sellers, the President and Chief Executive Officer of the Company and the Bank, (ii) A. Joseph Lampron, Jr., Executive Vice President and Chief Financial Officer of the Bank and Executive Vice President, Chief Financial Officer and Corporate Treasurer of the Company and (iii) William D. Cable, Sr., Executive Vice President and Chief Operating Officer of the Bank and Executive Vice President, Assistant Corporate Treasurer and Assistant Corporate Secretary of the Company executed an Employment Agreement which replaced and superseded such executive's prior employment agreement (collectively, the "Employment Agreements").

Each Employment Agreement provides for an initial term of 36 months beginning on January 22, 2015 (the "Effective Date"). On the first anniversary of the Effective Date and on each anniversary thereafter (the "Renewal Date"), each Employment Agreement shall be extended automatically for one additional year unless the Board of Directors of the Company (or the executive determines, and prior to the Renewal Date sends to the other party written notice, that the term shall not be extended. If the Board of Directors of the Company decides not to extend the term, the Employment Agreement shall nevertheless remain in force until its existing term expires. Under the Employment Agreements, the Bank will pay Mr. Sellers a base salary at the rate of at least \$311,400 per year, Mr. Lampron a base salary at the rate of at least \$193,125 per year and Mr. Cable a base salary at the rate of at least \$198,750 per year ("Base Salary"). The Bank will review each executive's total compensation at least annually and in its sole discretion may adjust an executive's total compensation from year to year, but during the term of the Employment Agreement, Mr. Sellers's Base Salary may not decrease below \$319,185, Mr. Lampron's Base Salary may not decrease below \$193,125 and Mr. Cable's Base Salary may not decrease below \$198,750; provided, however, that periodic increases in Base Salary,

once granted, may not be subject to revocation. In addition, the Employment Agreements provide for discretionary bonuses and participation in other management incentive, pension, profit-sharing, medical and retirement plans maintained by the Bank, as well as fringe benefits normally associated with such executive's office.

Under the Employment Agreements, each executive's employment will terminate automatically upon death. Otherwise, the Company and the Bank may terminate each executive's employment for "cause", "without cause" or in the event of a "disability" (each as defined in the Employment Agreements). In addition, each executive may voluntarily terminate his employment upon 60 days prior written notice to the Company and the Bank or for "good reason" (as

defined in the Employment Agreement). Under the Employment Agreements, if the Company and the Bank terminate an executive's employment "without cause", or an executive terminates his employment for "good reason", in each case, other than in connection with a change of control, then in each case, the executive would be entitled to receive certain severance payments and access to welfare benefit plans as more particularly set forth in the Employment Agreements. Under the Employment Agreements, in the event that the Company and the Bank terminate an executive's employment "without cause", or an executive terminates his employment for "good reason", in any such case at the time of or within one year after a Change of Control, then the executive will be entitled to receive certain change in control payments as more particularly set forth in the Employment Agreements.

In addition, each Employment Agreement contains certain restrictive covenants prohibiting the executive from competing against the Company and the Bank or soliciting the Company's or the Bank's customers for a period of time following termination of employment, all as more particularly set forth in the Employment Agreements.

#### Potential Payments upon Termination or Change in Control

Each of the Employment Agreements provide that in the event the Company terminates the employment of a named executive officers Without Cause (as defined in the Employment Agreements), or the officer terminates his or her employment for Good Reason (as defined in the Employment Agreements), in any such case during the employment and at the time of or within one year after a "change of control" (as defined in the Employment Agreements), the officer will be entitled to receive the following payments and benefits: (1) the Company will pay the officer the aggregate of the following amounts: (a) the sum of his accrued obligations; (b) the greater of his base salary, divided by 365 and multiplied by the number of days remaining in the employment period, or an amount equal to 2.99 times his base salary; and (c) the product of his aggregate cash bonus for the last completed fiscal year, and a fraction, the numerator of which is the number of days in the current fiscal year through the date of termination, and the denominator of which is 365; (2) all restricted stock or restricted stock unit awards previously granted to the executive and which have not already become vested and released from restrictions on transfer and repurchase and forfeiture rights, either as a result of the change of control or otherwise, shall immediately vest and be released from such restrictions as of the change of control termination date; and (3) all options previously granted to the officer that are unvested as of the change of control termination date will be deemed vested, fully exercisable and non-forfeitable as of the change of control termination date (other than transfer restrictions applicable to incentive stock options) and all previously granted options that are vested, but unexercised, on the change of control termination date will remain exercisable, in each case for the period during which they would have been exercisable absent the termination of his or her employment, except as otherwise specifically provided by the Internal Revenue Code; and (4) his benefits under all benefit plans that are non-qualified plans will be 100% vested, regardless of his age or years of service, as of the change of control termination date.

If the named executive officers were terminated on December 31, 2016, "without cause" or for "good reason" at the time of or within one year after a "change of control", Mr. Sellers, Mr. Lampron and Mr. Cable would have been entitled to receive compensation of approximately \$1,084,000, \$713,000 and \$730,000, respectively, pursuant to their Employment Agreements. These amounts are calculated based on each officer's 2016 base salary and bonus as shown in the Summary Compensation Table. In addition, if a "change in control" (as defined in the Omnibus Plan) had occurred on December 31, 2016, all unvested restricted stock units previously granted to each of Mr. Sellers, Mr. Lampron and Mr. Cable would have vest immediately. On December 31, 2016, these unvested restricted stock units had a fair market value of \$493,102, \$355,317 and \$355,317, respectively.

#### Omnibus Stock Option and Long Term Incentive Plan

The purpose of the Omnibus Plan is to promote the interests of the Company by attracting and retaining directors and employees of outstanding ability and to provide executive and other key employees of the Company and its subsidiaries greater incentive to make material contributions to the success of the Company by providing them with

stock-based compensation which will increase in value based upon the market performance of the common stock and/or the corporate achievement of financial and other performance objectives.

Rights Which May Be Granted. Under the Omnibus Plan, the Committee may grant or award eligible participants stock options, rights to receive restricted shares of common stock, restricted stock units, performance units (each equivalent to one share of common stock), SARs, and/or book value shares. These grants and awards are referred



to herein as "Rights." All Rights must be granted or awarded by February 19, 2019, the tenth anniversary of the date the Board of Directors adopted the Omnibus Plan. The Board of Directors has provided for 360,000 shares of the Company's common stock to be included in the Omnibus Plan to underlie Rights which may be granted thereunder.

Options. Options granted under the Omnibus Plan to eligible directors and employees may be either incentive stock options ("ISOs") or non-qualified stock options ("NSOs"). The exercise price of an ISO or NSO may not be less than 100% of the last-transaction price for the common stock quoted by the NASDAQ Stock Market on the date of grant.

Restricted Stock and Restricted Stock Units. The Committee may award Rights to acquire shares of common stock or restricted stock units, subject to certain transfer restrictions ("Restricted Stock" or "Restricted Stock Unit") to eligible participants under the Omnibus Plan for such purchase price per share, if any, as the Committee, in its discretion, may determine appropriate. The Committee will determine the expiration date for each Restricted Stock or Restricted Stock Unit award, up to a maximum of ten years from the date of grant. In the Committee's discretion, it may specify the period or periods of time within which each Restricted Stock or Restricted Stock Unit award will first become exercisable, which period or periods may be accelerated or shortened by the Committee. Under the terms of the Omnibus Plan, the Committee also has the discretion to pay out awards of Restricted Stock or Restricted Stock Units in the Company's common stock, cash or a combination of stock and cash.

Performance Units. Under the Omnibus Plan, the Committee may grant to eligible directors and employees awards of long term incentive performance units, each equivalent in value to one share of common stock ("Units"). Except as otherwise provided, Units awarded may be distributed only after the end of a performance period of two or more years, as determined by the Committee, beginning with the year in which the awards are granted.

The percentage of the Units awarded that are to be distributed will depend on the level of financial and other performance goals achieved by the Company during the performance period. The Committee may adopt one or more performance categories in addition to, or in substitution for, a performance category or may eliminate all performance categories other than financial performance.

As soon as practicable after each performance period, the percentage of Units awarded that are to be distributed, based on the levels of performance achieved, will be determined and distributed to the recipients of such awards in the form of a combination of shares of common stock and cash or cash only. Units awarded, but which the recipients are not entitled to receive, will be cancelled.

In the event of the death or disability of a Unit recipient prior to the end of any performance period, the number of Units awarded for such performance period will be reduced in proportion to the number of months remaining in the performance period after the date of death or disability. The remaining portion of the award, if any, may, in the discretion of the Committee, be adjusted based upon the levels of performance achieved prior to the date of death or disability, and distributed within a reasonable time after death or disability. In the event a recipient of Units ceases to be an eligible director or employee for any reason other than death or disability, all Units awarded, but not yet distributed, will be cancelled.

In the event of a change in control (as that term is defined in the Omnibus Plan), any outstanding Units will immediately and automatically be reduced as appropriate to reflect a shorter performance period.

An amount equal to the dividend payable on one share of common stock (a "dividend equivalent credit") will be determined and credited on the payment date to each Unit recipient's account for each Unit awarded and not yet distributed or cancelled. Such amount will be converted within the account to an additional number of Units equal to the number of shares of common stock which could be purchased at the last-transaction price of the common stock on the NASDAQ Market on the dividend payment date.

No dividend equivalent credits or distribution of Units may be credited or made if, at the time of crediting or distribution, (i) the regular quarterly dividend on the common stock has been omitted and not subsequently paid or there exists any default in payment of dividends on any such outstanding shares of common stock; (ii) the rate of dividends on the common stock is lower than at the time the Units to which the dividend equivalent credit relates were awarded,

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adjusted for certain changes; (iii) estimated consolidated net income of the Company for the twelve-month period preceding the month the dividend equivalent credit or distribution would otherwise have been made is less than the sum of the amount of the dividend equivalent credits and Units eligible for distribution under the Omnibus Plan in that month plus all dividends applicable to such period on an accrual basis, either paid, declared or accrued at the most recently paid rate, on all outstanding shares of common stock; or (iv) the dividend equivalent credit or distribution would result in a default in any agreement by which the Company is bound.

If an extraordinary event occurs during a performance period which significantly alters the basis upon which the performance levels were established, the Committee may make adjustments which it deems appropriate in the performance levels. Such events may include changes in accounting practices, tax, financial institution laws or regulations or other laws or regulations, economic changes not in the ordinary course of business cycles, or compliance with judicial decrees or other legal requirements.

Stock Appreciation Rights. The Omnibus Plan provides that the Committee may award to eligible directors and employees Rights to receive cash based upon increases in the market price of common stock over the last transaction price of the common stock on the NASDAQ Stock Market (the "Base Price") on the date of the award. The Committee may adjust the Base Price of a stock appreciation right ("SAR") based upon the market value performance of the common stock in comparison with the aggregate market value performance of a selected index or at a stated annual percentage rate. The expiration date of a SAR may be no more than ten years from the date of award.

Each SAR awarded by the Committee may be exercisable immediately or may become vested over such period or periods as the Committee may establish, which periods may be accelerated or shortened in the Committee's discretion. Each SAR awarded will terminate upon the expiration date established by the Committee, termination of the employment or directorship of the SAR recipient, or in the event of a change in control, as described above in connection with the termination of Options.

Book Value Shares. The Omnibus Plan provides that the Committee may award to eligible directors and eligible employees long term incentive units, each equivalent in value to the book value of one share of common stock on the date of award ("Book Value Shares"). The Committee will specify the period or periods of time within which each Book Value Share will vest, which period or periods may be accelerated or shortened by the Committee. Upon redemption, the holder of a Book Value Share will receive an amount equal to the difference between the book value of the common stock at the time the Book Value Share is awarded and the book value of the common stock at the time the Book Value Share is redeemed, adjusted for the effects of dividends, new share issuances, and mark-to-market valuations of the Company's investment securities portfolio in accordance with generally accepted accounting principles.

The expiration date of each Book Value Share awarded will be established by the Committee, up to a maximum of ten years from the date of award. However, awards of Book Value Shares will terminate earlier in the same manner as described above in connection with the termination of Options.

Adjustments. In the event the outstanding shares of the common stock are increased, decreased, changed into or exchanged for a different number or kind of securities as a result of a stock split, reverse stock split, stock dividend, recapitalization, merger, share exchange acquisition, or reclassification, appropriate proportionate adjustments will be made in (i) the aggregate number or kind of shares which may be issued pursuant to exercise of, or which underlie, Rights; (ii) the exercise or other purchase price, or Base Price, and the number and/or kind of shares acquirable under, or underlying, Rights; and (iii) rights and matters determined on a per share basis under the Omnibus Plan. Any such adjustment will be made by the Committee, subject to ratification by the Board of Directors. As described above, the Base Price of a SAR may also be adjusted by the Committee to reflect changes in a selected index. Except with regard to Units and Book Value Shares awarded under the Omnibus Plan, no adjustment in the Rights will be required by reason of the issuance of common stock, or securities convertible into common stock, by the Company for cash or

the issuance of shares of common stock by the Company in exchange for shares of the capital stock of any corporation, financial institution or other organization acquired by the Company or a subsidiary thereof in connection therewith.

Any shares of common stock allocated to Rights granted under the Omnibus Plan which are subsequently cancelled or forfeited will be available for further allocation upon such cancellation or forfeiture.

## Director Compensation

**Directors' Fees.** Members of the Company's Board of Directors receive no fees or compensation for their service. However, all members of the Board of Directors are also directors of the Bank and are compensated for that service.

During the year ended December 31, 2016, each director received a fee of \$1,000 for each Bank Board of Directors meeting attended, an additional fee of \$500 for each committee meeting attended and a retainer of \$12,000. In addition, the Chairman of the Bank's Board of Directors received an additional \$250 per meeting attended and the chairpersons of each committee received an additional \$150 per meeting attended. Directors receive \$375 for special meetings held via conference call in lieu of the Board of Director and committee meeting fees set forth above.

Directors who are members of the Board of Directors of Real Estate Advisory Services, Inc., Peoples Investment Services, Inc. and PB Real Estate Holdings, LLC, and Community Bank Real Estate Solutions, LLC, subsidiaries of the Bank, receive \$500 per meeting.

The Bank maintains a Service Recognition Program, under which directors, officers and employees are eligible for awards. Under the Service Recognition Program, directors, officers and employees are awarded a combination of common stock of the Company and cash in the amount necessary to pay taxes on the award, with the amount of the award based upon the length of service to the Bank. Any common stock awarded under the Service Recognition Program is purchased by the Bank on the open market, and no new shares are issued by the Company under the Service Recognition Program.

**Directors' Stock Benefits Plan.** Members of the Board of Directors are eligible to participate in the Company's Omnibus Plan. On March 22, 2012, the Company granted 810 restricted stock units to each director, with each unit being comprised of the right to receive one share of the Company's common stock and having a grant date fair value of \$7.90. The restricted stock units awarded to directors on March 22, 2012 vested in full on March 22, 2017. On May 23, 2013, the Company granted 810 restricted stock units to each director, with each unit being comprised of the right to receive one share of the Company's common stock and having a grant date fair value of \$11.90. The restricted stock units awarded to directors on May 23, 2013 will vest in full on May 23, 2017. On February 20, 2014, the Company granted 650 restricted stock units to each director, with each unit being comprised of the right to receive one share of the Company's common stock and having a grant date fair value of \$15.70. The restricted stock units awarded to directors on February 20, 2014 vested in full on February 20, 2017. On February 19, 2015, the Company granted 375 restricted stock units to each director, with each unit being comprised of the right to receive one share of the Company's common stock and having a grant date fair value of \$17.97. The restricted stock units awarded to directors on February 19, 2015 will vest in full on February 19, 2019. The Company did not grant any plan-based awards to directors during the fiscal year ended December 31, 2016.

**Directors' Deferred Compensation Plan.** The Bank maintains a non-qualified deferred compensation plan for all of its directors. The Bank's directors are also directors of the Company. Under the deferred compensation plan, each director may defer all or a portion of his fees to the plan each year. The director may elect to invest the deferred compensation in a restricted list of investment funds. The Bank may make matching contributions to the plan for the benefit of the director from time to time at the discretion of the Bank. Directors are fully vested in all amounts they contribute to the plan and in any amounts contributed by the Bank. The Bank has established a Rabbi Trust to hold the directors' accrued benefits under the plan. There are no "above-market" returns provided for in the deferred compensation plan. The Bank made no contributions to this plan in 2016.

Benefits under the plan are payable in the event of the director's death, resignation, removal, failure to be re-elected, retirement or in cases of hardship. Directors may elect to receive deferred compensation payments in one lump sum or in installments.

Directors' Supplemental Retirement Plan. The Bank maintains a non-qualified supplemental retirement benefits plan for all its directors. The supplemental retirement benefits plan is designed to provide a retirement benefit to the directors while at the same time minimizing the financial impact on the Bank's earnings. Under the supplemental retirement benefits plan, the Company purchased life insurance contracts on the lives of each director. The increase in

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cash surrender value of the contracts constitutes the Company's contribution to the supplemental retirement benefits plan each year. The Bank will pay annual benefits to each director for 15 years beginning upon retirement from the Board of Directors. The Bank is the sole owner of all of the insurance contracts.

The following table reports all forms of compensation paid to or accrued for the benefit of each director during the 2016 fiscal year.

**DIRECTOR COMPENSATION**

<u>Name</u>	Fees		Option	Non-Equity	Change in Pension Value and Nonqualified Deferred Compensation	All Other	Total (\$)
	Earned or Paid in Cash (\$)	Stock Awards <sup>1</sup> (\$)					
James S. Abernethy	28,950	0	0	0	6,869	0	35,819
Robert C. Abernethy	45,200	0	0	0	10,400	5,000 <sup>3</sup>	60,600
Douglas S. Howard	37,800	0	0	0	4,264	0	42,064
John W. Lineberger, Jr.	27,300	0	0	0	10,129	0	37,429
Gary E. Matthews	27,300	0	0	0	6,228	1,275 <sup>3</sup>	34,803
Billy L. Price, Jr., M.D.	37,650	0	0	0	5,632	0	43,282
Larry E. Robinson	27,800	0	0	0	6,625	0	34,425
William Gregory Terry	28,300	0	0	0	2,087	0	30,387
Dan Ray Timmerman, Sr.	34,300	0	0	0	14,655	0	48,955
Benjamin I. Zachary	31,300	0	0	0	5,657	0	36,957

<sup>1</sup> The Company did not grant any plan-based awards to directors during the fiscal year ended December 31, 2016. At December 31, 2016, each director had an aggregate of 2,645 restricted stock units outstanding. See information above under the heading "Directors Stock Benefit Plan" for information on each individual grant of restricted stock units.

<sup>2</sup> Change in Pension Value and Nonqualified Deferred Compensation Earnings represents the expense accrued by the Bank for each director under the Directors' Supplemental Retirement Plan as described above.

<sup>3</sup> In 2016, Director R. Abernethy received 171 shares of the Company's stock and \$981.50 in cash for his 40 years of service as a director under the Bank's Service Recognition Program, and Director Matthews received 42 shares of the Company's stock and \$288.00 in cash for his 15 years of service as a director under the Bank's Service Recognition Program.

Indebtedness of and Transactions with Management and Directors

The Company is a "listed issuer" under the rules and regulations of the Exchange Act whose common stock is listed on NASDAQ. The Company uses the definition of independence contained in NASDAQ's listing standards to determine the independence of its directors and that the Board of Directors and each standing committee of the Board of Directors is in compliance with NASDAQ listing standards for independence.

Certain directors and executive officers of the Bank and their immediate families and associates were customers of and had transactions with the Bank in the ordinary course of business during 2016. All outstanding loans, extensions of credit or overdrafts, endorsements and guarantees outstanding at any time during 2016 to the Bank's executive officers and directors and their family members were made in the ordinary course of its business. These loans are currently made on substantially the same terms, including interest rates and collateral, as those then prevailing for comparable transactions with persons not related to the lender, and did not involve more than the normal risk of collectability or present any other unfavorable features.

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The Board of Directors routinely, and no less than annually, reviews all transactions, direct and indirect, between the Company or the Bank and any employee or director, or any of such person's immediate family members. Transactions are reviewed as to comparable market values for similar transactions. All material facts of the transactions and the director's interest are discussed by all disinterested directors and a decision is made about whether the transaction is fair to the Company and the Bank. A majority vote of all disinterested directors is required to approve the transaction.

The Bank leases two of its facilities from Shortgrass Associates, L.L.C. ("Shortgrass"). Director John W. Lineberger, Jr. owns 25% of the membership interests in Shortgrass. Pursuant to the terms of the leases for the two facilities leased by the Bank, during 2016 the Bank paid a total of \$229,310 to Shortgrass in lease payments for these facilities. Each of the facilities is subject to a 20-year lease between the Bank and Shortgrass.

The Bank engaged Matthews Construction Company, Inc. ("Matthews Construction") to renovate the Bank's Corporate Center located at 518 West C Street, Newton, North Carolina 28658. Director Gary E. Matthews owns 18.43% of the issued and outstanding capital stock in Matthews Construction. During 2016 the Bank paid a total of \$208,770 to Matthews Construction for such renovation work.

The Board of Directors also evaluates the influence family relationships may have on the independence of directors who are related by blood or marriage. Christine S. Abernethy, a greater than ten percent (10%) shareholder of the Company, has two sons, Robert C. Abernethy and James S. Abernethy, who serve on the Board of Directors. All of the non-related directors have determined that the family relationships among Christine S. Abernethy, James S. Abernethy and Robert C. Abernethy do not affect the brothers' independence as directors.

## Equity Compensation Plan Information

The following table sets forth certain information regarding outstanding options and shares for future issuance under the Equity Compensation Plans as of December 31, 2016. Individual equity compensation arrangements are aggregated and included within this table. This table excludes any plan, contract or arrangement that provides for the issuance of options, warrants or other rights that are given to our shareholders on a pro rata basis and any employee benefit plan that is intended to meet the qualification requirements of Section 401(a) of the Internal Revenue Code.

Plan Category	Number of securities to be issued upon exercise of outstanding option, warrants and rights (1), (2), (3), (4), (5) (a)	Weighted-average exercise price of outstanding options, warrants and rights (6) (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (7) (c)
Equity compensation plans approved by security holders	97,480	\$ 25.07	262,520
Equity compensation plans not approved by security holders	-	-	-
Total	97,480	\$ 25.07	262,520

(1) Includes 24,159 restricted stock units granted on March 22, 2012 and 5,355 restricted stock units granted on July 26, 2012 under the February 19, 2009 Omnibus Stock Ownership and Long Term Incentive Plan (the "Omnibus Plan"). These restricted stock grants vest five years after issuance.

(2) Includes 26,795 restricted stock units granted on May 23, 2013 under the Omnibus Plan. These restricted stock grants vest on May 23, 2017.

(3) Includes 21,056 restricted stock units granted on February 20, 2014 under the Omnibus Plan. These restricted stock grants vest on February 20, 2017.

(4) Includes 15,075 restricted stock units granted on February 19, 2015 under the Omnibus Plan. These restricted stock grants vest on February 19, 2019.

(5) Includes 5,040 restricted stock units granted on February 18, 2016 under the Omnibus Plan. These restricted stock grants vest on February 20, 2020.

(6) The exercise price used for the grants of restricted stock units under the Omnibus Plan is \$25.07, the closing price for the Company's stock on December 31, 2016.

(7) Reflects shares currently reserved for possible issuance under the Omnibus Plan.

## STOCK PERFORMANCE GRAPH

The following graph compares the Company's cumulative shareholder return on its common stock with a NASDAQ index and with a southeastern bank index. The graph was prepared by SNL Securities, L.C., Charlottesville, Virginia, using data as of December 31, 2016.

## COMPARISON OF SIX-YEAR CUMULATIVE TOTAL RETURNS

Performance Report for  
Peoples Bancorp of North Carolina, Inc.

## PROPOSAL 2

## RATIFICATION OF SELECTION OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Elliott Davis Decosimo, PLLC ("Elliott Davis"), our registered independent public accounting firm for the fiscal year ended December 31, 2016, has been appointed by the Audit Committee as our registered independent public accounting firm for the fiscal year ending December 31, 2017, and you are being asked to ratify this appointment. Fees charged by this firm are at rates and upon terms that are customarily charged by other registered independent public accounting firms. A representative of the firm will be present at the Annual Meeting and will have an opportunity to make a statement if he or she desires to do so and to respond to appropriate questions.

On June 19, 2015, we advised Porter Keadle Moore, LLC ("PKM"), our registered independent accounting firm for the fiscal year ended December 31, 2014, that it was dismissed as our registered independent public accounting firm. PKM's reports on our financial statements for the fiscal years ended December 31, 2013 and 2014, did not contain an adverse opinion or a disclaimer of opinion, and were not qualified or modified as to uncertainty, audit scope or accounting principles. The decision to change accountants was recommended and approved by the Audit Committee. During fiscal years ended December 31, 2013 and December 31, 2014 and through the period ended June 19, 2015, there were no disagreements with PKM on any matter of accounting principles or practices, financial statement disclosures, or auditing scope or procedures which disagreements, if not resolved to PKM's satisfaction, would have caused PKM to make reference thereto in their reports on the financial statements for such periods.

In addition, on June 19, 2015, we appointed Elliott Davis as our independent registered public accounting firm for the fiscal year ended December 31, 2015. We did not consult with Elliott Davis during the fiscal years ended December 31, 2013 and 2014, nor during any subsequent interim period preceding such appointment, on the application of accounting principles to a specific contemplated or completed transaction, the type of audit opinion that might be rendered on our consolidated financial statements, or any matter that was the subject of a "disagreement" or a "reportable event" as such terms are described in Item 304(a)(1)(iv) and (v) of Regulation S-K.

## Audit Fees Paid to Independent Auditors

The following table represents the approximate fees for professional services rendered by Elliott Davis and PKM for the audit of our annual financial statements and review of our financial statements included in our Forms 10-Q for the fiscal years ended December 31, 2016 and 2015 and fees billed for audit-related services, tax services and all other services rendered, for each of such years.

	<u>Year Ended</u>	
	<u>December 31</u>	
	<u>2016</u>	<u>2015</u>
Audit Fees <sup>1</sup>	\$ 178,500	\$ 193,000
Audit-Related Fees <sup>2</sup>	\$ 10,000	\$ 19,000
Tax Fees <sup>3</sup>	\$ 25,100	\$ 45,000
All Other Fees	--	--

<sup>1</sup> Of the 2015 amount, \$163,000 was for Elliott Davis and \$30,000 was for PKM. The \$163,000 for Elliott Davis includes amounts for the testing of management's assertions regarding internal controls in accordance with the Federal Deposit Insurance Corporation Improvement Act. Audit Fees for Elliott Davis and PKM include amounts for the integrated audit of the consolidated financial statements and internal control over financial reporting (Sarbanes-Oxley

Section 404).

<sup>2</sup> Represents amounts for the audit of the Company's Profit Sharing and 401(k) Plan and the testing of management's assertions regarding internal controls in accordance with the Federal Deposit Insurance Corporation Improvement Act. Of the 2015 amount, all was for PKM.

<sup>3</sup> Represents amounts for assistance in the preparation of our various federal, state and local tax returns. Of the 2015 amount, \$20,000 was for Elliott Davis and \$25,000 was for PKM.

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All audit related services, tax services and other services giving rise to the fees listed under "Audit-Related Fees", "Tax Fees" and "All Other Fees" in the table above were pre-approved by the Audit Committee, which concluded that the provision of such services was compatible with the maintenance of that firm's independence in the conduct of its auditing functions. The Audit Committee's Charter provides for pre-approval of all audit and non-audit services to be provided by our independent auditors. The Charter authorizes the Audit Committee to delegate to one or more of its members pre-approval authority with respect to permitted services, provided that any such approvals are presented to the Audit Committee at its next scheduled meeting.

THE BOARD OF DIRECTORS RECOMMENDS THAT THE SHAREHOLDERS VOTE FOR RATIFICATION OF THE APPOINTMENT OF ELLIOTT DAVIS AS THE COMPANY'S INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE FISCAL YEAR ENDING DECEMBER 31, 2016.

#### DATE FOR RECEIPT OF SHAREHOLDER PROPOSALS

It is presently anticipated that the 2018 Annual Meeting of Shareholders of the Company will be held on May 3, 2018. In order for shareholder proposals to be included in the Company's proxy materials for that meeting, such proposals must be received by the Secretary of the Company at the Company's principal executive office no later than November 27, 2017 and meet all other applicable requirements for inclusion in the Proxy Statement.

In the alternative, a shareholder may commence his or her own proxy solicitation and present a proposal from the floor at the 2018 Annual Meeting of Shareholders of the Company. In order to do so, the shareholder must notify the Secretary of the Company in writing, at the Company's principal executive office no later than February 9, 2018, of his or her proposal. If the Secretary of the Company is not notified of the shareholder's proposal by February 9, 2018, the Board of Directors may vote on the proposal pursuant to the discretionary authority granted by the proxies solicited by the Board of Directors for the 2018 Annual Meeting of Shareholders.

#### OTHER MATTERS

Management knows of no other matters to be presented for consideration at the Annual Meeting or any adjournments thereof. If any other matters shall properly come before the Annual Meeting, it is intended that the proxyholders named in the enclosed form of proxy will vote the shares represented thereby in accordance with their judgment, pursuant to the discretionary authority granted therein.

#### MISCELLANEOUS

The Annual Report of the Company for the year ended December 31, 2016, which includes financial statements audited and reported upon by the Company's registered independent public accounting firm, is being mailed as Appendix A to this Proxy Statement; however, it is not intended that the Annual Report be deemed a part of this Proxy Statement or a solicitation of proxies.

THE FORM 10-K FILED BY THE COMPANY WITH THE SEC, INCLUDING THE FINANCIAL STATEMENTS AND SCHEDULES THERETO, WILL BE PROVIDED FREE OF CHARGE UPON WRITTEN REQUEST DIRECTED TO: PEOPLES BANCORP OF NORTH CAROLINA, INC., POST OFFICE BOX 467, 518 WEST C STREET, NEWTON, NORTH CAROLINA 28658-0467, ATTENTION: A. JOSEPH LAMPRON, JR.

By Order of the Board of Directors,

/s/ Lance A. Sellers

Lance A. Sellers  
President and Chief Executive Officer  
Newton, North Carolina  
March 24, 2017

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APPENDIX A

ANNUAL REPORT  
OF  
PEOPLES BANCORP OF NORTH CAROLINA, INC.

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## PEOPLES BANCORP OF NORTH CAROLINA, INC.

### General Description of Business

Peoples Bancorp of North Carolina, Inc. ("Bancorp"), was formed in 1999 to serve as the holding company for Peoples Bank (the "Bank"). Bancorp is 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 "BHCA"). Bancorp's principal source of income is dividends declared and paid by the Bank on its capital stock, if any. Bancorp has no operations and conducts no business of its own other than owning the Bank. Accordingly, the discussion of the business which follows concerns the business conducted by the Bank, unless otherwise indicated. Bancorp and its wholly owned subsidiary, the Bank, along with the Bank's wholly owned subsidiaries are collectively called the "Company".

The Bank, founded in 1912, is a state-chartered commercial bank serving the citizens and business interests of the Catawba Valley and surrounding communities through 20 banking offices, as of December 31, 2016, located in Lincolnton, Newton, Denver, Catawba, Conover, Maiden, Claremont, Hiddenite, Hickory, Charlotte, Monroe, Cornelius, Mooresville and Raleigh, North Carolina. The Bank also operates loan production offices in Denver, Durham and Winston-Salem, North Carolina. At December 31, 2016, the Company had total assets of \$1.1 billion, net loans of \$716.3 million, deposits of \$892.9 million, total securities of \$252.6 million, and shareholders' equity of \$107.4 million.

The Bank operates four banking offices focused on the Latino population under the name Banco de la Gente ("Banco"). These offices are operated as a division of the Bank. Banco offers normal and customary banking services as are offered in the Bank's other branches such as the taking of deposits and the making of loans and therefore is not considered a reportable segment of the Company. The Bank operates one Banco loan production office in Durham County, North Carolina and one Banco loan production office in Forsyth County, North Carolina specifically designed to serve the growing Latino market.

The Bank has a diversified loan portfolio, with no foreign loans and few agricultural loans. Real estate loans are predominately variable rate and fixed rate commercial property loans, which include residential development loans to commercial customers. Commercial loans are spread throughout a variety of industries with no one particular industry or group of related industries accounting for a significant portion of the commercial loan portfolio. The majority of the Bank's deposit and loan customers are individuals and small to medium-sized businesses located in the Bank's market area. The Bank's loan portfolio also includes Individual Taxpayer Identification Number (ITIN) mortgage loans generated through the Bank's Banco offices. Additional discussion of the Bank's loan portfolio and sources of funds for loans can be found in "Management's Discussion and Analysis of Financial Condition and Results of Operations" on pages A-4 through A-23 of the Annual Report, which is included in this Form 10-K as Exhibit (13).

The operations of the Bank and depository institutions in general are significantly influenced by general economic conditions and by related monetary and fiscal policies of depository institution regulatory agencies, including the Federal Reserve, the Federal Deposit Insurance Corporation (the "FDIC") and the North Carolina Commissioner of Banks (the "Commissioner").

The Company's fiscal year ends December 31. This Form 10-K is also being used as the Bank's Annual Disclosure Statement under FDIC Regulations. This Form 10-K has not been reviewed, or confirmed for accuracy or relevance by the FDIC.

At December 31, 2016, the Company employed 294 full-time employees and 37 part-time employees, which equated to 318 full-time equivalent employees.

### Subsidiaries

The Bank is a subsidiary of the Company. At December 31, 2016, the Bank had four subsidiaries, Peoples Investment Services, Inc., Real Estate Advisory Services, Inc., Community Bank Real Estate Solutions, LLC ("CBRES") and PB Real Estate Holdings, LLC. Through a relationship with Raymond James Financial Services, Inc., Peoples Investment Services, Inc. provides the Bank's customers access to investment counseling and non-deposit investment products such as stocks, bonds, mutual funds, tax deferred annuities, and related brokerage services. Real Estate Advisory Services, Inc. provides real estate appraisal and real estate brokerage services. CBRES serves as a "clearing-house" for appraisal services for community banks. Other banks are able to contract with CBRES to find and engage appropriate appraisal companies in the area where the property to be appraised is located. This type of service ensures that the appraisal process remains independent from the financing process within the Bank. PB Real Estate Holdings, LLC acquires, manages and disposes of real property, other collateral and other assets obtained in the ordinary course of collecting debts previously contracted.

In June 2006, the Company formed a wholly owned Delaware statutory trust, PEBK Capital Trust II ("PEBK Trust II"), which issued \$20.0 million of guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures. All of the common securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase \$20.6 million of junior subordinated debentures of the Company, which pay a floating rate equal to three-month LIBOR plus 163 basis points.

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The proceeds received by the Company from the sale of the junior subordinated debentures were used in December 2006 to repay the trust preferred securities issued in December 2001 by PEBK Capital Trust, a wholly owned Delaware statutory trust of the Company, and for general purposes. The debentures represent the sole asset of PEBK Trust II. PEBK Trust II is not included in the consolidated financial statements.

The trust preferred securities issued by PEBK Trust II accrue and pay quarterly at a floating rate of three-month LIBOR plus 163 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust II does not have funds with which to make the distributions and other payments. The net combined effect of the trust preferred securities transaction is that the Company is obligated to make the distributions and other payments required on the trust preferred securities.

These trust preferred securities are mandatorily redeemable upon maturity of the debentures on June 28, 2036, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust II, in whole or in part, which became effective on June 28, 2011. As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be the principal amount plus any accrued but unpaid interest.

This report contains certain forward-looking statements with respect to the financial condition, results of operations and business of the Company. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Company and on the information available to management at the time that these disclosures were prepared. These statements can be identified by the use of words like "expect," "anticipate," "estimate" and "believe," variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by the Bank, (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environment and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in the Company's other filings with the Securities and Exchange Commission. The Company undertakes no obligation to update any forward-looking statements.

## SELECTED FINANCIAL DATA

Dollars in Thousands Except Per Share Amounts

	2016	2015	2014	2013	2012	
<b>Summary of Operations</b>						
Interest income	\$39,809	38,666	38,420	36,696	39,245	
Interest expense	3,271	3,484	4,287	5,353	7,696	
Net interest income	36,538	35,182	34,133	31,343	31,549	
Provision for loan losses	(1,206 )	(17 )	(699 )	2,584	4,924	
Net interest income after provision for loan losses	37,744	35,199	34,832	28,759	26,625	
Non-interest income	13,976	13,312	12,164	12,652	12,537	
Non-interest expense	39,982	35,778	35,671	32,841	31,782	
Earnings before income taxes	11,738	12,733	11,325	8,570	7,380	
Income tax expense	2,561	3,100	1,937	1,879	1,587	
Net earnings	9,177	9,633	9,388	6,691	5,793	
Dividends and accretion of preferred stock	-	-	-	656	1,010	
Net earnings available to common shareholders	\$9,177	9,633	9,388	6,035	4,783	
<b>Selected Year-End Balances</b>						
Assets	\$1,087,991	1,038,481	1,040,494	1,034,684	1,013,516	
Investment securities available for sale	249,946	268,530	281,099	297,890	297,823	
Net loans	716,261	679,502	640,809	607,459	605,551	
Mortgage loans held for sale	5,709	4,149	1,375	497	6,922	
Interest-earning assets	1,019,661	977,079	956,900	925,736	931,738	
Deposits	892,918	832,175	814,700	799,361	781,525	
Interest-bearing liabilities	698,120	679,937	722,991	735,111	745,140	
Shareholders' equity	\$107,428	104,864	98,665	83,719	97,747	
Shares outstanding	5,417,800	5,510,538	5,612,588	5,613,495	5,613,495	
<b>Selected Average Balances</b>						
Assets	\$1,076,604	1,038,594	1,036,486	1,023,609	1,029,612	
Investment securities available for sale	252,725	266,830	287,371	293,770	289,010	
Net loans	703,484	669,628	631,025	614,532	648,595	
Interest-earning assets	985,236	952,251	949,537	950,451	965,994	
Deposits	856,313	816,628	808,399	787,640	786,976	
Interest-bearing liabilities	705,291	707,611	731,786	741,228	770,546	
Shareholders' equity	\$113,196	106,644	96,877	100,241	103,805	
Shares outstanding	5,477,245	5,559,235	5,615,666	5,613,495	5,559,401	
<b>Profitability Ratios</b>						
Return on average total assets	0.85	% 0.93	% 0.91	% 0.65	% 0.56	%
Return on average shareholders' equity	8.11	% 9.03	% 9.69	% 6.67	% 5.58	%
Dividend payout ratio*	22.95	% 16.34	% 10.89	% 11.17	% 20.96	%
<b>Liquidity and Capital Ratios (averages)</b>						
Loan to deposit	82.15	% 82.00	% 78.06	% 78.02	% 82.42	%
Shareholders' equity to total assets	10.51	% 10.27	% 9.35	% 9.79	% 10.08	%

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Per share of Common Stock

Basic net earnings	\$1.68	1.73	1.67	1.08	0.86
Diluted net earnings	\$1.65	1.72	1.66	1.07	0.86
Cash dividends	\$0.38	0.28	0.18	0.12	0.18
Book value	\$19.83	19.03	17.58	14.91	15.18

\*As a percentage of net earnings available to common shareholders.

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## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of our financial position and results of operations and should be read in conjunction with the information set forth under Item 1A Risk Factors in the Company's annual report on Form 10-K and the Company's consolidated financial statements and notes thereto on pages A-24 through A-67.

### Introduction

Management's discussion and analysis of earnings and related data are presented to assist in understanding the consolidated financial condition and results of operations of Peoples Bancorp of North Carolina, Inc. ("Bancorp"), for the years ended December 31, 2016, 2015 and 2014. Bancorp is a registered bank holding company operating under the supervision of the Federal Reserve Board (the "FRB") and the parent company of Peoples Bank (the "Bank"). The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander, Mecklenburg, Iredell, Union, Wake, Durham and Forsyth counties, operating under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation (the "FDIC").

### Overview

Our business consists principally of attracting deposits from the general public and investing these funds in commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. Our profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment securities portfolios and our cost of funds, which consists of interest paid on deposits and borrowed funds. Net interest income also is affected by the relative amounts of our interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, a positive interest rate spread will generate net interest income. Our profitability is also affected by the level of other income and operating expenses. Other income consists primarily of miscellaneous fees related to our loans and deposits, mortgage banking income and commissions from sales of annuities and mutual funds. Operating expenses consist of compensation and benefits, occupancy related expenses, federal deposit and other insurance premiums, data processing, advertising and other expenses.

Our operations are influenced significantly by local economic conditions and by policies of financial institution regulatory authorities. The earnings on our assets are influenced by the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System (the "Federal Reserve"), inflation, interest rates, market and monetary fluctuations. Lending activities are affected by the demand for commercial and other types of loans, which in turn is affected by the interest rates at which such financing may be offered. Our cost of funds is influenced by interest rates on competing investments and by rates offered on similar investments by competing financial institutions in our market area, as well as general market interest rates. These factors can cause fluctuations in our net interest income and other income. In addition, local economic conditions can impact the credit risk of our loan portfolio, in that (1) local employers may be required to eliminate employment positions of individual borrowers, and (2) small businesses and commercial borrowers may experience a downturn in their operating performance and become unable to make timely payments on their loans. Management evaluates these factors in estimating the allowance for loan losses and changes in these economic factors could result in increases or decreases to the provision for loan losses.

Current economic conditions, while not as robust as those experienced in the pre-crisis period from 2004 to 2007, have stabilized such that businesses in our market area are growing and investing again. The uncertainty expressed in the local, national and in international markets through the primary economic indicators of activity, however, continues to limit the level of activity in our markets.

Although we are unable to control the external factors that influence our business, by maintaining high levels of balance sheet liquidity, managing our interest rate exposures and by actively monitoring asset quality, we seek to

minimize the potentially adverse risks of unforeseen and unfavorable economic trends.

Our business emphasis has been and continues to be to operate as a well-capitalized, profitable and independent community-oriented financial institution dedicated to providing quality customer service. We are committed to meeting the financial needs of the communities in which we operate. We expect growth to be achieved in our local markets and through expansion opportunities in contiguous or nearby markets. While we would be willing to consider growth by acquisition in certain circumstances, we do not consider the acquisition of another company to be necessary for our continued ability to provide a reasonable return to our shareholders. We believe that we can be more effective in serving our customers than many of our non-local competitors because of our ability to quickly and effectively provide senior management responses to customer needs and inquiries. Our ability to provide these services is enhanced by the stability and experience of our Bank officers and managers.

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The Federal Reserve maintained the Federal Funds rate at 0.25% from December 2008 to December 2015 before increasing the Fed Funds rate to 0.50% on December 16, 2015 and to 0.75% on December 14, 2016. This continued period of very low interest rates has presented a challenge to the Company to maintain its net interest margin as loan rates fell and remained low, primarily because of competition for credit worthy customers. The cost of deposits has also fallen but has reached the point where there is little room left to reduce this cost. While the 0.25% Fed Funds rate increases in December 2015 and December 2016 will be helpful, the negative impact of such low interest rates will remain until the Fed Funds rate increases to levels approaching historical norms.

The Company does not have specific plans for additional offices in 2017 but will continue to look for growth opportunities in nearby markets and may expand if considered a worthwhile opportunity.

On August 31, 2015, the FDIC and the North Carolina Office of the Commissioner of Banks ("Commissioner") issued a Consent Order (the "Order") in connection with compliance by the Bank with the Bank Secrecy Act and its implementing regulations (collectively, the "BSA"). The Order was issued pursuant to the consent of the Bank. In consenting to the issuance of the Order, the Bank did not admit or deny any unsafe or unsound banking practices or violations of law or regulation.

The Order requires the Bank to take certain affirmative actions to comply with its obligations under the BSA, including, without limitation, strengthening its Board of Directors' oversight of BSA activities; reviewing, enhancing, adopting and implementing a revised BSA compliance program; completing a BSA risk assessment; developing a revised system of internal controls designed to ensure full compliance with the BSA; reviewing and revising customer due diligence and risk assessment processes, policies and procedures; developing, adopting and implementing effective BSA training programs; assessing BSA staffing needs and resources and appointing a qualified BSA officer; establishing an independent BSA testing program; ensuring that all reports required by the BSA are accurately and properly filed and engaging an independent firm to review past account activity to determine whether suspicious activity was properly identified and reported.

Prior to implementation, certain of the actions described above are subject to review by and approval or non-objection from the FDIC and the Commissioner. The Order will remain in effect and be enforceable until it is modified, terminated, suspended or set aside by the FDIC and the Commissioner.

The Bank continues to make progress in addressing the issues identified in the Order and expects that it will be able to undertake and implement all required actions within the time period specified in the Order. The Bank has incurred and will continue to incur additional non-interest expenses associated with the implementation of corrective actions; however, these expenses are not expected to have a significant impact on the results of operations or financial position of the Bank or Bancorp. Operating under the Order will limit the Bank's and Bancorp's ability to participate in acquisitions, to open new branches, and to allocate funds to Bancorp's stock repurchase plan until such time as the Order has been modified, terminated, suspended or set aside by the FDIC and the Commissioner.

#### Summary of Significant and Critical Accounting Policies

The consolidated financial statements include the financial statements of Bancorp and its wholly owned subsidiary, the Bank, along with the Bank's wholly owned subsidiaries, Peoples Investment Services, Inc., Real Estate Advisory Services, Inc. ("REAS"), Community Bank Real Estate Solutions, LLC ("CBRES") and PB Real Estate Holdings, LLC (collectively called the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation. CBRES was moved from a wholly owned subsidiary of Bancorp to a wholly owned subsidiary of the Bank effective August 31, 2016.

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of specific accounting guidance. The



following is a summary of some of the more subjective and complex accounting policies of the Company. A more complete description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2016 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 4, 2017 Annual Meeting of Shareholders.

The allowance for loan losses reflects management's assessment and estimate of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. The Bank periodically analyzes the loan portfolio in an effort to review asset quality and to establish an allowance for loan losses that management believes will be adequate in light of anticipated risks and loan losses.

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Many of the Company's assets and liabilities are recorded using various techniques that require significant judgment as to recoverability. The collectability of loans is reflected through the Company's estimate of the allowance for loan losses. The Company performs periodic and systematic detailed reviews of its lending portfolio to assess overall collectability. In addition, certain assets and liabilities are reflected at their estimated fair value in the consolidated financial statements. Such amounts are based on either quoted market prices or estimated values derived from dealer quotes used by the Company, market comparisons or internally generated modeling techniques. The Company's internal models generally involve present value of cash flow techniques. The various techniques are discussed in greater detail elsewhere in this management's discussion and analysis and the Notes to Consolidated Financial Statements.

There are other complex accounting standards that require the Company to employ significant judgment in interpreting and applying certain of the principles prescribed by those standards. These judgments include, but are not limited to, the determination of whether a financial instrument or other contract meets the definition of a derivative in accordance with U.S. Generally Accepted Accounting Principles ("GAAP").

The disclosure requirements for derivatives and hedging activities are intended to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of, and gains and losses, on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company has an overall interest rate risk management strategy that has, in prior years, incorporated the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. When using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimized the credit risk in derivative instruments by entering into transactions with high-quality counterparties that were reviewed periodically by the Company. The Company did not have any interest rate derivatives outstanding as of December 31, 2016 or 2015.

Management of the Company has made a number of estimates and assumptions relating to reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare the accompanying consolidated financial statements in conformity with GAAP. Actual results could differ from those estimates.

#### Results of Operations

Summary. The Company reported earnings of \$9.2 million or \$1.68 basic net earnings per share and \$1.65 diluted net earnings per share, as compared to \$9.6 million or \$1.73 basic net earnings per share and \$1.72 diluted net earnings per share for the same period one year ago. The decrease in year-to-date net earnings is primarily attributable to an increase in non-interest expense, which was partially offset by an increase in net interest income, an increase in the credit to the provision for loan losses and an increase in non-interest income, as discussed below.

The Company reported earnings of \$9.6 million, or \$1.73 basic net earnings per share and \$1.72 diluted net earnings per share for the year ended December 31, 2015, as compared to \$9.4 million, or \$1.67 basic net earnings per share and \$1.66 diluted net earnings per share for the year ended December 31, 2014. The increase in year-to-date earnings is primarily attributable to an increase in net interest income and an increase in non-interest income, which were partially offset by a decrease in the credit to the provision for loan losses and an increase in non-interest expense, as discussed below.

The return on average assets in 2016 was 0.85%, compared to 0.93% in 2015 and 0.91% in 2014. The return on average shareholders' equity was 8.11% in 2016 compared to 9.03% in 2015 and 9.69% in 2014.

**Net Interest Income.** Net interest income, the major component of the Company's net income, is the amount by which interest and fees generated by interest-earning assets exceed the total cost of funds used to carry them. Net interest income is affected by changes in the volume and mix of interest-earning assets and interest-bearing liabilities, as well as changes in the yields earned and rates paid. Net interest margin is calculated by dividing tax-equivalent net interest income by average interest-earning assets, and represents the Company's net yield on its interest-earning assets.

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Net interest income for 2016 was \$36.5 million compared to \$35.2 million in 2015. The increase in net interest income was primarily due to a \$1.1 million increase in interest income, which was primarily attributable to an increase in the average outstanding balance of loans and a 0.25% increase in the prime rate in December 2015, combined with a \$213,000 decrease in interest expense, which was primarily attributable to a decrease in the average outstanding balance of time deposits and Federal Home Loan Bank ("FHLB") borrowings during the year ended December 31, 2016, as compared to the year ended December 31, 2015. Net interest income increased to \$35.2 million in 2015 from \$34.8 million in 2014.

Table 1 sets forth for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest incurred on such amounts and the average rate earned or incurred for the years ended December 31, 2016, 2015 and 2014. The table also sets forth the average rate earned on total interest-earning assets, the average rate paid on total interest-bearing liabilities, and the net yield on total average interest-earning assets for the same periods. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields and interest income on tax-exempt investments have been adjusted to a tax equivalent basis using an effective tax rate of 36.64% for securities that are both federal and state tax exempt and an effective tax rate of 32.64% for federal tax exempt securities. Non-accrual loans and the interest income that was recorded on non-accrual loans, if any, are included in the yield calculations for loans in all periods reported.

Table 1- Average Balance Table

	December 31, 2016			December 31, 2015			December 31, 2014		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
(Dollars in thousands)									
Interest-earning assets:									
Interest and fees on loans	\$703,484	32,452	4.61 %	669,628	31,098	4.64 %	631,025	30,305	4.80 %
Investments - taxable	78,575	1,925	2.45 %	89,998	2,240	2.49 %	120,038	2,840	2.37 %
Investments - nontaxable*	178,379	7,577	4.25 %	181,382	7,634	4.21 %	172,662	7,561	4.38 %
Other	24,798	123	0.50 %	11,243	26	0.23 %	25,812	65	0.25 %
Total interest-earning assets	985,236	42,077	4.27 %	952,251	40,998	4.31 %	949,537	40,771	4.29 %
Cash and due from banks	44,732			42,483			47,614		
Other assets	59,537			59,222			56,571		
Allowance for loan losses	(8,884 )			(10,678 )			(12,905 )		
Total assets	\$1,080,621			1,043,278			1,040,817		
Interest-bearing liabilities:									
NOW, MMDA & savings deposits	\$447,582	495	0.11 %	418,358	432	0.10 %	392,822	499	0.13 %
Time deposits	150,641	586	0.39 %	173,622	870	0.50 %	208,194	1,188	0.57 %
FHLB borrowings	42,903	1,661	3.87 %	49,840	1,735	3.48 %	63,712	2,166	3.40 %
Trust preferred securities	20,619	485	2.35 %	20,619	402	1.95 %	20,619	389	1.89 %

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Other	43,546	44	0.10 %	45,172	45	0.10 %	46,439	45	0.10 %
Total interest-bearing liabilities	705,291	3,271	0.46 %	707,611	3,484	0.49 %	731,786	4,287	0.59 %
Demand deposits	258,091			224,648			207,383		
Other liabilities	4,043			4,375			4,771		
Shareholders' equity	113,196			106,644			96,877		
Total liabilities and shareholder's equity	\$1,080,621			1,043,278			1,040,817		
Net interest spread		\$38,806	3.81 %		\$37,514	3.82 %		36,484	3.70 %
Net yield on interest-earning assets			3.94 %			3.94 %			3.84 %
Taxable equivalent adjustment									
Investment securities		\$2,268			\$2,332			2,351	
Net interest income		\$36,538			\$35,182			34,133	

\*Includes U.S. Government agency securities that are non-taxable for state income tax purposes of \$38.7 million in 2016, \$37.3 million in 2015 and \$26.0 million in 2014. The tax rates of 4.00%, 5.00% and 6.00% were used to calculate the tax equivalent yields on these securities in 2016, 2015 and 2014, respectively.

Changes in interest income and interest expense can result from variances in both volume and rates. Table 2 describes the impact on the Company's tax equivalent net interest income resulting from changes in average balances and average rates for the periods indicated. The changes in interest due to both volume and rate have been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the changes in each.

Table 2 - Rate/Volume Variance Analysis-Tax  
Equivalent Basis

(Dollars in thousands)	December 31, 2016			December 31, 2015		
	Changes in average volume	Changes in average rates	Total Increase (Decrease)	Changes in average volume	Changes in average rates	Total Increase (Decrease)
<b>Interest income:</b>						
Loans: Net of unearned income	\$ 1,566	(212 )	1,354	1,823	(1,031 )	792
Investments - taxable	(282 )	(33 )	(315 )	(729 )	129	(600 )
Investments - nontaxable	(127 )	70	(57 )	375	(302 )	73
Other	50	47	97	(35 )	(4 )	(39 )
Total interest income	1,207	(128 )	1,079	1,434	(1,208 )	226
<b>Interest expense:</b>						
NOW, MMDA & savings deposits	31	32	63	29	(96 )	(67 )
Time deposits	(103 )	(181 )	(284 )	(185 )	(133 )	(318 )
FHLB / FRB Borrowings	(255 )	181	(74 )	(477 )	46	(431 )
Trust Preferred Securities	-	83	83	0	13	13
Other	(1 )	0	(1 )	(1 )	1	-
Total interest expense	(328 )	115	(213 )	(634 )	(169 )	(803 )
Net interest income	\$ 1,535	(243 )	1,292	2,068	(1,039 )	1,029

Net interest income on a tax equivalent basis totaled \$38.8 million in 2016 as compared to \$37.5 million in 2015. The interest rate spread, which represents the rate earned on interest-earning assets less the rate paid on interest-bearing liabilities, was 3.81% in 2016, as compared to a net interest spread of 3.82% in 2015. The net yield on interest-earning assets was 3.94% in 2016 and 2015.

Tax equivalent interest income increased \$1.1 million in 2016 primarily due to an increase in interest income resulting from an increase in the average outstanding principal balance of loans, which was partially offset by a decrease in the average outstanding balance of investment securities. The average outstanding principal balance of loans increased \$33.9 million to \$703.5 million in 2016 compared to \$669.6 million in 2015. The average outstanding balance of investment securities decreased \$14.4 million to \$257.0 million in 2016 compared to \$271.4 million in 2015. The yield on interest-earning assets was 4.27% in 2016 compared to 4.31% in 2015.

Interest expense decreased \$213,000 in 2016 compared to 2015. The decrease in interest expense is primarily due to a decrease in the average outstanding balance of FHLB borrowings and time deposits. Average interest-bearing liabilities decreased by \$2.3 million to \$705.3 million in 2016 compared to \$707.6 million in 2015. The cost of funds decreased to 0.46% in 2016 from 0.49% in 2015.

In 2015 net interest income on a tax equivalent basis was \$37.5 million compared to \$36.5 million in 2014. The net interest spread was 3.82% in 2015 compared to 3.70% in 2014. The net yield on interest-earning assets in 2015 increased to 3.94% from the 2014 net yield on interest-earning assets of 3.84%.

Provision for Loan Losses. Provisions for loan losses are charged to income in order to bring the total allowance for loan losses to a level deemed appropriate by management of the Company based on factors such as management's judgment as to losses within the Bank's loan portfolio, including the valuation of impaired loans, loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies and management's assessment of the

quality of the loan portfolio and general economic climate.

The provision for loan losses for the year ended December 31, 2016 was a credit of \$1.2 million, as compared to a credit of \$17,000 for the year ended December 31, 2015. The credits to provision for loan losses for the years ended December 31, 2016, 2015 and 2014 resulted from, and were considered appropriate as part of, management's assessment and estimate of the risks in the total loan portfolio and determination of the total allowance for loan losses. The primary factors contributing to the decrease in the allowance for loan losses at December 31, 2016 to \$7.6 million from \$9.6 million at December 31, 2015 were the continuing positive trends in indicators of potential losses on loans, primarily non-accrual loans and the reduction in net charge-offs since 2012, as shown in Table 3 below:

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Table 3 - Net Charge-off Analysis

(Dollars in thousands)	Net charge-offs					Net charge-offs/(recoveries) as a percent of average loans outstanding				
	Years ended December 31,					Years ended December 31,				
	2016	2015	2014	2013	2012	2016	2015	2014	2013	2012
Real estate loans										
Construction and land development	\$(3 )	153	456	400	4,200	(0.01 %)	0.25 %	0.78 %	0.58 %	4.99 %
Single-family residential	220	584	237	1,613	814	0.09 %	0.27 %	0.12 %	0.82 %	0.39 %
Single-family residential - Banco de la Gente stated income	-	95	174	131	668	0.00 %	0.21 %	0.36 %	0.26 %	1.25 %
Commercial Multifamily and farmland	299	308	119	395	563	0.12 %	0.13 %	0.05 %	0.20 %	0.27 %
Total real estate loans	-	-	-	-	-	0.00 %	0.00 %	0.00 %	0.00 %	0.00 %
Loans not secured by real estate										
Commercial loans	(25 )	(64 )	376	458	451	(0.03 %)	(0.07 %)	0.53 %	0.73 %	0.75 %
Farm loans	-	-	-	-	-	0.00 %	0.00 %	0.00 %	0.00 %	0.00 %
Consumer loans (1)	342	400	358	509	409	3.38 %	4.00 %	3.63 %	5.27 %	4.00 %
All other loans	-	-	-	-	-	0.00 %	0.00 %	0.00 %	0.00 %	0.00 %
Total loans	\$833	1,476	1,720	3,506	7,105	0.12 %	0.22 %	0.27 %	0.57 %	1.10 %
(Reduction of) provision for loan losses for the period	\$(1,206 )	(17 )	(699 )	2,584	4,924					
Allowance for loan losses at end of period	\$7,550	9,589	11,082	13,501	14,423					
Total loans at end of period	\$723,811	689,091	651,891	620,960	619,974					



Non-accrual loans at end of period	\$3,825	8,432	10,728	13,836	17,630	
Allowance for loan losses as a percent of total loans outstanding at end of period	1.04	% 1.39	% 1.70	% 2.17	% 2.33	%
Non-accrual loans as a percent of total loans outstanding at end of period	0.53	% 1.22	% 1.65	% 2.23	% 2.84	%

(1) The loss ratio for consumer loans is elevated because overdraft charge-offs related to DDA and NOW accounts are reported in consumer loan charge-offs and recoveries. The net overdraft charge-offs are not considered material and are therefore not shown separately.

Another factor considered in taking a credit to provision expense in the years ended December 31, 2016, 2015 and 2014 was the decline in the construction and land development portfolio. This portfolio experienced the highest percentage of loss in 2012 as shown in Table 3 above. The balance outstanding was \$61.7 million at December 31, 2016 and \$65.8 million at December 31, 2015, compared to the maximum balance of \$213.7 million at December 31, 2008. Please see the section below entitled "Allowance for Loan Losses" for a more complete discussion of the Bank's policy for addressing potential loan losses.

Non-Interest Income. Non-interest income was \$14.0 million for the year ended December 31, 2016, compared to \$13.3 million for the year ended December 31, 2015. The increase in non-interest income is primarily attributable to \$729,000 in gains on the sale of securities during the year ended December 31, 2016 and a \$298,000 increase in mortgage banking income during the year ended December 31, 2016, as compared to the year ended December 31, 2015.

Non-interest income was \$13.3 million for the year ended December 31, 2015, compared to \$12.2 million for the year ended December 31, 2014. The increase in non-interest income is primarily attributable to a \$867,000 change in gain/(loss) on sales and write-downs of other real estate, a \$671,000 increase in miscellaneous non-interest income and a \$326,000 increase in mortgage banking income, which were partially offset by a \$463,000 decrease in service charges and fees. The \$671,000 increase in miscellaneous non-interest income is primarily due to a \$282,000 increase in debit card income for the year ended December 31, 2015, as compared to the year ended December 31, 2014, and \$263,000 in net MasterCard debit card incentives recognized in the fourth quarter of 2015.

The Company periodically evaluates its investments for any impairment which would be deemed other-than-temporary. No investment impairments were deemed other-than-temporary in 2016, 2015 or 2014.

Table 4 presents a summary of non-interest income for the years ended December 31, 2016, 2015 and 2014.

Table 4 - Non-Interest Income

(Dollars in thousands)	2016	2015	2014
Service charges	\$4,497	4,647	4,961
Other service charges and fees	890	931	1,080
Gain on sale of securities	729	-	266
Mortgage banking income	1,428	1,130	804
Insurance and brokerage commissions	632	714	701
Gain/(loss) on sale and write-down of other real estate	64	245	(622 )
Visa debit card income	3,589	3,452	3,170
Net appraisal management fee income	886	635	525
Miscellaneous	1,261	1,558	1,279
Total non-interest income	\$13,976	13,312	12,164

Non-Interest Expense. Non-interest expense was \$40.0 million for the year ended December 31, 2016, as compared to \$35.8 million for the year ended December 31, 2015. The increase in non-interest expense included: (1) a \$979,000 increase in salaries and benefits expense resulting primarily from an increase in the number of full-time equivalent employees, salary increases and an increase in compensation expense for restricted stock units, (2) a \$971,000 increase in professional fees primarily due to a \$1.2 million increase in consulting fees due to expenses associated with the Order issued in August 2015, (3) a \$477,000 increase in occupancy expense primarily due to a \$588,000 increase in equipment maintenance expense and (4) a \$1.5 million increase in non-interest expenses other than salary, employee benefits and occupancy expenses primarily due to a \$756,000 increase in penalties associated with the prepayment of FHLB borrowings during the year ended December 31, 2016, as compared to the year ended December 31, 2015.

Non-interest expense was \$35.8 million for the year ended December 31, 2015, as compared to \$35.8 million for the year ended December 31, 2014. Salaries and benefits expense increased by \$755,000 resulting primarily from an increase in the number of full-time equivalent employees and annual salary increases, and such increase was offset by a \$757,000 decrease in other non-interest expenses during the year ended December 31, 2015, as compared to the year ended December 31, 2014. The decrease in other non-interest expenses is primarily due to \$870,000 amortization expense incurred during 2014 that was associated with North Carolina income tax credits purchased in 2014.

Table 5 presents a summary of non-interest expense for the years ended December 31, 2016, 2015 and 2014.

Table 5 - Non-Interest Expense

(Dollars in thousands)	2016	2015	2014
Salaries and employee benefits	\$19,264	18,285	17,530
Occupancy expense	6,765	6,288	6,251
Office supplies	465	422	448
FDIC deposit insurance	494	681	739
Visa debit card expense	1,141	988	905
Professional services	182	564	798
Postage	224	249	280
Telephone	754	588	574
Director fees and expense	326	304	237
Advertising	1,136	784	804
Consulting fees	2,257	904	609
Taxes and licenses	272	301	301

Foreclosure/OREO expense	120	398	317
Internet banking expense	710	671	644
FHLB advance prepayment penalty	1,260	504	869
Other operating expense	4,612	3,847	4,365
Total non-interest expense	\$39,982	35,778	35,671

Income Taxes. The Company reported income tax expense of \$2.6 million, \$3.1 million and \$1.9 million for the years ended December 31, 2016, 2015 and 2014, respectively. The Company's effective tax rates were 21.82%, 24.35% and 17.10% in 2016, 2015 and 2014, respectively. The lower effective tax rate for 2014 is primarily due to North Carolina income tax credits purchased during 2014.

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Liquidity. The objectives of the Company's liquidity policy are to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities and to satisfy regulatory requirements. Both deposit and loan customer cash needs can fluctuate significantly depending upon business cycles, economic conditions and yields and returns available from alternative investment opportunities. In addition, the Company's liquidity is affected by off-balance sheet commitments to lend in the form of unfunded commitments to extend credit and standby letters of credit. As of December 31, 2016, such unfunded commitments to extend credit were \$195.5 million, while commitments in the form of standby letters of credit totaled \$3.7 million.

The Company uses several funding sources to meet its liquidity requirements. The primary funding source is core deposits, which includes demand deposits, savings accounts and non-brokered certificates of deposits of denominations less than \$250,000. The Company considers these to be a stable portion of the Company's liability mix and the result of on-going consumer and commercial banking relationships. As of December 31, 2016, the Company's core deposits totaled \$865.4 million, or 97% of total deposits.

The other sources of funding for the Company are through large denomination certificates of deposit, including brokered deposits, federal funds purchased, securities under agreement to repurchase and FHLB borrowings. The Bank is also able to borrow from the FRB on a short-term basis. The Bank's policies include the ability to access wholesale funding up to 40% of total assets. The Bank's wholesale funding includes FHLB borrowings, FRB borrowings, brokered deposits and internet certificates of deposit. The Company's ratio of wholesale funding to total assets was 2.50% as of December 31, 2016.

At December 31, 2016, the Bank had a significant amount of deposits in amounts greater than \$250,000. Brokered deposits, of \$7.2 million at December 31, 2016, are comprised of certificates of deposit participated through the Certificate of Deposit Account Registry Service ("CDARS") on behalf of local customers. The balance and cost of brokered deposits are more susceptible to changes in the interest rate environment than other deposits. Access to the brokered deposit market could be restricted if the Bank were to fall below the well capitalized level. For additional information, please see the section below entitled "Deposits."

The Bank has a line of credit with the FHLB equal to 20% of the Bank's total assets, with an outstanding balance of \$20.0 million at December 31, 2016. At December 31, 2016, the carrying value of loans pledged as collateral totaled approximately \$128.3 million. The remaining availability under the line of credit with the FHLB was \$66.8 million at December 31, 2016. The Bank had no borrowings from the FRB at December 31, 2016. The FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At December 31, 2016, the carrying value of loans pledged as collateral to the FRB totaled approximately \$374.5 million.

The Bank also had the ability to borrow up to \$59.5 million for the purchase of overnight federal funds from five correspondent financial institutions as of December 31, 2016.

The liquidity ratio for the Bank, which is defined as net cash, interest-bearing deposits with banks, federal funds sold and certain investment securities, as a percentage of net deposits and short-term liabilities was 24.78%, 26.10%, and 31.76% at December 31, 2016, 2015 and 2014, respectively. The minimum required liquidity ratio as defined in the Bank's Asset/Liability and Interest Rate Risk Management Policy for on balance sheet liquidity was 10% at December 31, 2016, 2015 and 2014.

As disclosed in the Company's Consolidated Statements of Cash Flows included elsewhere herein, net cash provided by operating activities was approximately \$12.2 million during 2016. Net cash used in investing activities was \$23.6 million during 2016 and net cash provided by financing activities was \$41.7 million during 2016.

Asset Liability and Interest Rate Risk Management. The objective of the Company's Asset Liability and Interest Rate Risk strategies is to identify and manage the sensitivity of net interest income to changing interest rates and to minimize the interest rate risk between interest-earning assets and interest-bearing liabilities at various maturities. This is done in conjunction with the need to maintain adequate liquidity and the overall goal of maximizing net interest income. Table 6 presents an interest rate sensitivity analysis for the interest-earning assets and interest-bearing liabilities for the year ended December 31, 2016.

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Table 6 - Interest Sensitivity Analysis

(Dollars in thousands)	Immediate	1-3 months	4-12 months	Total Within One Year	Over One Year & Non- sensitive	Total
Interest-earning assets:						
Loans	\$307,490	22,764	15,584	345,838	377,973	723,811
Mortgage loans held for sale	5,709	-	-	5,709	-	5,709
Investment securities available for sale	-	6,602	14,625	21,227	228,719	249,946
Interest-bearing deposit accounts	16,481	-	-	16,481	-	16,481
Other interest-earning assets	-	-	-	-	3,254	3,254
Total interest-earning assets	329,680	29,366	30,209	389,255	609,946	999,201
Interest-bearing liabilities:						
NOW, savings, and money market deposits	477,054	-	-	477,054	-	477,054
Time deposits	15,313	17,946	53,558	86,817	57,196	144,013
FHLB borrowings	-	20,000	-	20,000	-	20,000
Securities sold under agreement to repurchase	36,434	-	-	36,434	-	36,434
Trust preferred securities	-	20,619	-	20,619	-	20,619
Total interest-bearing liabilities	528,801	58,565	53,558	640,924	57,196	698,120
Interest-sensitive gap	\$(199,121)	(29,199)	(23,349)	(251,669)	552,750	301,081
Cumulative interest-sensitive gap	\$(199,121)	(228,320)	(251,669)	(251,669)	301,081	
Interest-earning assets as a percentage of interest-bearing liabilities	62.34	% 50.14	% 56.40	% 60.73	% 1066.41	%

The Company manages its exposure to fluctuations in interest rates through policies established by the Asset/Liability Committee ("ALCO") of the Bank. The ALCO meets quarterly and has the responsibility for approving asset/liability management policies, formulating and implementing strategies to improve balance sheet positioning and/or earnings and reviewing the interest rate sensitivity of the Company. ALCO tries to minimize interest rate risk between interest-earning assets and interest-bearing liabilities by attempting to minimize wide fluctuations in net interest income due to interest rate movements. The ability to control these fluctuations has a direct impact on the profitability of the Company. Management monitors this activity on a regular basis through analysis of its portfolios to determine the difference between rate sensitive assets and rate sensitive liabilities.

The Company's rate sensitive assets are those earning interest at variable rates and those with contractual maturities within one year. Rate sensitive assets therefore include both loans and available for sale ("AFS") securities. Rate sensitive liabilities include interest-bearing checking accounts, money market deposit accounts, savings accounts, time deposits and borrowed funds. At December 31, 2016, rate sensitive assets and rate sensitive liabilities totaled \$999.2 million and \$698.1 million, respectively.

Included in the rate sensitive assets are \$288.9 million in variable rate loans indexed to prime rate subject to immediate repricing upon changes by the Federal Open Market Committee ("FOMC"). The Bank utilizes interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At December 31, 2016, the Bank had \$182.1 million in loans with interest rate floors. The floors were in effect on \$108.9 million of

these loans pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 0.62% higher than the indexed rate on the promissory notes without interest rate floors.

An analysis of the Company's financial condition and growth can be made by examining the changes and trends in interest-earning assets and interest-bearing liabilities. A discussion of these changes and trends follows.

#### Analysis of Financial Condition

**Investment Securities.** The composition of the investment securities portfolio reflects the Company's investment strategy of maintaining an appropriate level of liquidity while providing a relatively stable source of income. The investment portfolio also provides a balance to interest rate risk and credit risk in other categories of the balance sheet while providing a vehicle for the investment of available funds, furnishing liquidity, and supplying securities to pledge as required collateral for certain deposits.

All of the Company's investment securities are held in the AFS category. At December 31, 2016, the market value of AFS securities totaled \$249.9 million, compared to \$268.5 million and \$281.1 million at December 31, 2015 and 2014, respectively. Table 7 presents the fair value of the AFS securities held at December 31, 2016, 2015 and 2014.

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Table 7 - Summary of Investment Portfolio

(Dollars in thousands)	2016	2015	2014
U. S. Government sponsored enterprises	\$38,222	38,417	34,048
State and political subdivisions	141,856	148,245	152,246
Mortgage-backed securities	67,585	77,887	90,210
Corporate bonds	1,533	1,906	2,467
Trust preferred securities	750	750	750
Equity securities	-	1,325	1,378
Total securities	\$249,946	268,530	281,099

The Company's investment portfolio consists of U.S. Government sponsored enterprise securities, municipal securities, U.S. Government sponsored enterprise mortgage-backed securities, corporate bonds, trust preferred securities and equity securities. AFS securities averaged \$252.7 million in 2016, \$266.8 million in 2015 and \$287.4 million in 2014. Table 8 presents the market value of AFS securities held by the Company by maturity category at December 31, 2016. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields are calculated on a tax equivalent basis. Yields and interest income on tax-exempt investments have been adjusted to a tax equivalent basis using an effective tax rate of 36.64% for securities that are both federal and state tax exempt and an effective tax rate of 32.64% for federal tax exempt securities.

Table 8 - Maturity Distribution and Weighted Average Yield on Investments

(Dollars in thousands)	One Year or Less		After One Year Through 5 Years		After 5 Years Through 10 Years		After 10 Years		Totals	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Book value:										
U.S. Government sponsored enterprises	\$1,381	1.88 %	7,644	2.13 %	22,553	2.57 %	6,610	2.41 %	38,188	1.74 %
State and political subdivisions	5,423	3.44 %	73,223	3.11 %	53,944	3.19 %	5,242	3.82 %	137,832	3.40 %
Mortgage-backed securities	12,023	2.89 %	26,622	2.92 %	13,907	2.85 %	14,102	3.00 %	66,654	2.81 %
Corporate bonds	500	5.58 %	-	0.00 %	1,000	1.96 %	-	-	1,500	1.48 %
Trust preferred securities	-	-	-	-	500	4.75 %	250	8.13 %	750	5.88 %
Equity securities	-	-	-	-	-	-	-	0.00 %	-	0.00 %
Total securities	\$19,327	2.91 %	107,489	2.90 %	91,904	2.82 %	26,204	3.33 %	244,924	2.55 %

Loans. The loan portfolio is the largest category of the Company's earning assets and is comprised of commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. The Bank grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg, Union, Wake, Durham and Forsyth counties in North Carolina.

Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by real estate, which is dependent upon the real estate market. Real estate mortgage loans include both commercial and residential mortgage loans. At December 31, 2016, the Bank had \$115.7 million in residential mortgage loans, \$99.8 million in home equity loans and \$330.6 million in commercial mortgage loans, which include \$266.5 million using



commercial property as collateral and \$64.1 million using residential property as collateral. Residential mortgage loans include \$75.5 million made to customers in the Bank's traditional banking offices and \$40.2 million in mortgage loans originated in the Bank's Banco de la Gente offices. All residential mortgage loans are originated as fully amortizing loans, with no negative amortization.

At December 31, 2016, the Bank had \$61.7 million in construction and land development loans. Table 9 presents a breakout of these loans.

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Table 9 - Construction and Land Development Loans

(Dollars in thousands)	Number of Loans	Balance Outstanding	Non-accrual Balance
Land acquisition and development - commercial purposes	56	\$ 9,355	-
Land acquisition and development - residential purposes	223	24,040	22
1 to 4 family residential construction	92	18,218	-
Commercial construction	18	10,136	-
Total acquisition, development and construction	389	\$ 61,749	22

The mortgage loans originated in the traditional banking offices are generally 15 to 30 year fixed rate loans with attributes that prevent the loans from being sellable in the secondary market. These factors may include higher loan-to-value ratio, limited documentation on income, non-conforming appraisal or non-conforming property type. These loans are generally made to existing Bank customers and have been originated throughout the Bank's nine county service area, with no geographic concentration.

Banco de la Gente single family residential stated income loans originated from 2005 to 2009 were primarily adjustable rate mortgage loans that adjust annually after the end of the first five years of the loan. The loans are tied to the one-year T-Bill index and, if they were to adjust at December 31, 2016, would have a reduction in the interest rate on the loan. The underwriting on these loans includes both full income verification and no income verification, with loan-to-value ratios of up to 95% without private mortgage insurance. A majority of these loans would be considered subprime loans, as they were underwritten using stated income rather than fully documented income verification. No other loans in the Bank's portfolio would be considered subprime. The majority of these loans have been originated within the Charlotte, North Carolina metro area (Mecklenburg County). Total losses on this portfolio, since the first loans were originated in 2004, have amounted to approximately \$3.7 million through December 31, 2016.

The composition of the Bank's loan portfolio at December 31 is presented in Table 10.

Table 10 -  
Loan  
Portfolio

(Dollars in thousands)	2016		2015		2014		2013		2012	
	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans	Amount	% of Loans
Real estate loans										
Construction and land development	\$61,749	8.53 %	65,791	9.55 %	57,617	8.84 %	63,742	10.27 %	73,176	11.80 %
Single-family residential	240,700	33.25 %	220,690	32.03 %	206,417	31.66 %	195,975	31.56 %	195,003	31.45 %
Single-family residential-Banco de la Gente stated income	40,189	5.55 %	43,733	6.35 %	47,015	7.21 %	49,463	7.97 %	52,019	8.39 %
Commercial	247,521	34.20 %	228,526	33.16 %	228,558	35.06 %	209,287	33.70 %	200,633	32.36 %
	21,047	2.91 %	18,080	2.62 %	12,400	1.90 %	11,801	1.90 %	8,951	1.44 %

Multifamily and farmland												
Total real estate loans	611,206	84.44 %	576,820	83.71 %	552,007	84.68 %	530,268	85.39 %	529,782	85.45 %		
Loans not secured by real estate												
Commercial loans	87,596	12.11 %	91,010	13.22 %	76,262	11.71 %	68,047	10.97 %	64,295	10.38 %		
Farm loans	-	0.00 %	3	0.00 %	7	0.00 %	19	0.00 %	11	0.00 %		
Consumer loans	9,832	1.36 %	10,027	1.46 %	10,060	1.54 %	9,593	1.54 %	10,148	1.64 %		
All other loans	15,177	2.10 %	11,231	1.63 %	13,555	2.08 %	13,033	2.10 %	15,738	2.54 %		
Total loans	723,811	100.00 %	689,091	100.00 %	651,891	100.00 %	620,960	100.00 %	619,974	100.00 %		
Less:												
Allowance for loan losses	7,550		9,589		11,082		13,501		14,423			
Net loans	\$716,261		679,502		640,809		607,459		605,551			

As of December 31, 2016, gross loans outstanding were \$723.8 million, compared to \$689.1 million at December 31, 2015. Average loans represented 71% and 70% of total earning assets for the years ended December 31, 2016 and 2015, respectively. The Bank had \$5.7 million and \$4.1 million in mortgage loans held for sale as of December 31, 2016 and 2015, respectively.

Troubled debt restructured ("TDR") loans modified in 2016, past due TDR loans and non-accrual TDR loans totaled \$5.9 million and \$8.8 million at December 31, 2016 and December 31, 2015, respectively. The terms of these loans have been renegotiated to provide a concession to original terms, including a reduction in principal or interest as a result of the deteriorating financial position of the borrower. There were \$81,000 and \$354,000 in performing loans classified as TDR loans at December 31, 2016 and December 31, 2015, respectively.

Table 11 identifies the maturities of all loans as of December 31, 2016 and addresses the sensitivity of these loans to changes in interest rates.

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Table 11 - Maturity and Repricing Data for Loans

(Dollars in thousands)	Within one year or less	After one year through five years	After five years	Total loans
Real estate loans				
Construction and land development	\$40,674	12,626	8,449	61,749
Single-family residential	112,279	73,957	54,464	240,700
Single-family residential- Banco de la Gente stated income	17,402	-	22,787	40,189
Commercial	99,527	106,413	41,581	247,521
Multifamily and farmland	6,172	5,167	9,708	21,047
Total real estate loans	276,054	198,163	136,989	611,206
Loans not secured by real estate				
Commercial loans	56,373	17,907	13,316	87,596
Farm loans	-	-	-	-
Consumer loans	4,748	4,880	204	9,832
All other loans	8,663	4,727	1,787	15,177
Total loans	\$345,838	225,677	152,296	723,811
Total fixed rate loans	\$4,924	196,665	152,296	353,885
Total floating rate loans	340,914	29,012	-	369,926
Total loans	\$345,838	225,677	152,296	723,811

In the normal course of business, there are various commitments outstanding to extend credit that are not reflected in the financial statements. At December 31, 2016, outstanding loan commitments totaled \$199.3 million. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the commitment contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Additional information regarding commitments is provided below in the section entitled "Contractual Obligations and Off-Balance Sheet Arrangements" and in Note 10 to the Consolidated Financial Statements.

**Allowance for Loan Losses.** The allowance for loan losses reflects management's assessment and estimate of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. The Bank periodically analyzes the loan portfolio in an effort to review asset quality and to establish an allowance for loan losses that management believes will be adequate in light of anticipated risks and loan losses. In assessing the adequacy of the allowance, size, quality and risk of loans in the portfolio are reviewed. Other factors considered are:

- the Bank's loan loss experience;
  - the amount of past due and non-performing loans;
- specific known risks;
- the status and amount of other past due and non-performing assets;
- underlying estimated values of collateral securing loans;
- current and anticipated economic conditions; and
- other factors which management believes affect the allowance for potential credit losses.

Management uses several measures to assess and monitor the credit risks in the loan portfolio, including a loan grading system that begins upon loan origination and continues until the loan is collected or collectability becomes doubtful. Upon loan origination, the Bank's originating loan officer evaluates the quality of the loan and assigns one of eight risk grades. The loan officer monitors the loan's performance and credit quality and makes changes to the credit grade as conditions warrant. When originated or renewed, all loans over a certain dollar amount receive in-depth reviews and risk assessments by the Bank's Credit Administration. Before making any changes in these risk grades, management considers assessments as determined by the third party credit review firm (as described below), regulatory examiners and the Bank's Credit Administration. Any issues regarding the risk assessments are addressed by the Bank's senior credit administrators and factored into management's decision to originate or renew the loan. The Bank's Board of Directors reviews, on a monthly basis, an analysis of the Bank's reserves relative to the range of reserves estimated by the Bank's Credit Administration.

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As an additional measure, the Bank engages an independent third party to review the underwriting, documentation and risk grading analyses. This independent third party reviews and evaluates loan relationships greater than \$1.0 million, excluding loans in default, and loans in process of litigation or liquidation. The third party's evaluation and report is shared with management and the Bank's Board of Directors.

Management considers certain commercial loans with weak credit risk grades to be individually impaired and measures such impairment based upon available cash flows and the value of the collateral. Allowance or reserve levels are estimated for all other graded loans in the portfolio based on their assigned credit risk grade, type of loan and other matters related to credit risk.

Management uses the information developed from the procedures described above in evaluating and grading the loan portfolio. This continual grading process is used to monitor the credit quality of the loan portfolio and to assist management in estimating the allowance for loan losses. The provision for loan losses charged or credited to earnings is based upon management's judgment of the amount necessary to maintain the allowance at a level appropriate to absorb probable incurred losses in the loan portfolio at the balance sheet date. The amount each quarter is dependent upon many factors, including growth and changes in the composition of the loan portfolio, net charge-offs, delinquencies, management's assessment of loan portfolio quality, the value of collateral, and other macro-economic factors and trends. The evaluation of these factors is performed quarterly by management through an analysis of the appropriateness of the allowance for loan losses.

The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment. When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Bank's loss exposure for each credit, given the appraised value of any underlying collateral. Loans for which specific reserves are provided are excluded from the general allowance calculations as described below.

The general allowance reflects reserves established under GAAP for collective loan impairment. These reserves are based upon historical net charge-offs using the greater of the last two, three, four or five years' loss experience. This charge-off experience may be adjusted to reflect the effects of current conditions. The Bank considers information derived from its loan risk ratings and external data related to industry and general economic trends in establishing reserves.

The unallocated allowance is determined through management's assessment of probable losses that are in the portfolio but are not adequately captured by the other two components of the allowance, including consideration of current economic and business conditions and regulatory requirements. The unallocated allowance also reflects management's acknowledgement of the imprecision and subjectivity that underlie the modeling of credit risk. Due to the subjectivity involved in determining the overall allowance, including the unallocated portion, the unallocated portion may fluctuate from period to period based on management's evaluation of the factors affecting the assumptions used in calculating the allowance.

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the year ended December 31, 2016 as compared to the year ended December 31, 2015. Revisions, estimates and assumptions may be made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

Effective December 31, 2012, stated income mortgage loans from the Banco de la Gente division of the Bank were analyzed separately from other single family residential loans in the Bank's loan portfolio. These loans are first mortgage loans made to the Latino market, primarily in Mecklenburg and surrounding counties. These loans are non-traditional mortgages in that the customer normally did not have a credit history, so all credit information was

accumulated by the loan officers. These loans were made as stated income loans rather than full documentation loans because the customer may not have had complete documentation on the income supporting the loan.

Various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require adjustments to the allowance based on their judgments of information available to them at the time of their examinations. Management believes it has established the allowance for credit losses pursuant to GAAP, and has taken into account the views of its regulators and the current economic environment. Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Bank's loan portfolio as of the date of the financial statements. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

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Net charge-offs for 2016 and 2015 were \$833,000 and \$1.5 million, respectively. The ratio of net charge-offs to average total loans was 0.12% in 2016, 0.22% in 2015 and 0.27% in 2014. The Bank strives to proactively work with its customers to identify potential problems. If found, the Bank works to quickly recognize identifiable losses and to establish a plan, with the borrower, if possible, to have the loans paid off. This process of early identification increased the levels of charge-offs and provision for loan losses in 2009 through 2013 as compared to historical periods prior to 2009. The years ended December 31, 2014, 2015 and 2016 saw a return of net charge-offs to pre-crisis levels. Management expects this to continue in 2017. The allowance for loan losses was \$7.6 million or 1.0% of total loans outstanding at December 31, 2016. For December 31, 2015 and 2014, the allowance for loan losses amounted to \$9.6 million or 1.4% of total loans outstanding and \$11.1 million, or 1.7% of total loans outstanding, respectively.

Table 12 presents the percentage of loans assigned to each risk grade at December 31, 2016 and 2015.

Table 12 - Loan Risk Grade Analysis

Risk Grade	Percentage of Loans By Risk Grade	
	2016	2015
Risk Grade 1 (Excellent Quality)	2.28%	2.46%
Risk Grade 2 (High Quality)	26.82%	24.40%
Risk Grade 3 (Good Quality)	54.43%	53.08%
Risk Grade 4 (Management Attention)	11.99%	14.26%
Risk Grade 5 (Watch)	3.07%	3.27%
Risk Grade 6 (Substandard)	1.41%	2.53%
Risk Grade 7 (Doubtful)	0.00%	0.00%
Risk Grade 8 (Loss)	0.00%	0.00%

Table 13 presents an analysis of the allowance for loan losses, including charge-off activity.

Table 13 - Analysis of Allowance for Loan Losses

(Dollars in thousands)	2016	2015	2014	2013	2012
Allowance for loan losses at beginning	\$9,589	11,082	13,501	14,423	16,604
Loans charged off:					
Commercial	146	38	430	502	555
Real estate - mortgage	593	1,064	789	2,441	2,491
Real estate - construction	7	197	884	777	4,728
Consumer	492	545	534	652	557
Total loans charged off	1,238	1,844	2,637	4,372	8,331
Recoveries of losses previously charged off:					
Commercial	170	101	54	44	104
Real estate - mortgage	74	77	259	302	446
Real estate - construction	10	45	428	377	528
Consumer	151	145	176	143	148
Total recoveries	405	368	917	866	1,226
Net loans charged off	833	1,476	1,720	3,506	7,105
Provision for loan losses	(1,206)	(17 )	(699 )	2,584	4,924



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Allowance for loan losses at end of year	\$7,550	9,589	11,082	13,501	14,423
Loans charged off net of recoveries, as a percent of average loans outstanding	0.12 %	0.22 %	0.27 %	0.57 %	1.10 %
Allowance for loan losses as a percent of total loans outstanding at end of year	1.04 %	1.39 %	1.70 %	2.17 %	2.33 %

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Non-performing Assets. Non-performing assets declined to \$4.1 million or 0.4% of total assets at December 31, 2016, compared to \$9.2 million or 0.9% of total assets at December 31, 2015. The decline in non-performing assets is due to a \$4.6 million decrease in non-accrual loans and a \$456,000 decrease in other real estate owned properties. Non-performing loans include \$22,000 in construction and land development loans, \$3.7 million in commercial and residential mortgage loans and \$54,000 in other loans at December 31, 2016, as compared to \$146,000 in construction and land development loans, \$8.1 million in commercial and residential mortgage loans and \$181,000 in other loans at December 31, 2015. Other real estate owned totaled \$283,000 and \$739,000 as of December 31, 2016 and 2015, respectively. The Bank had no repossessed assets as of December 31, 2016 and 2015.

At December 31, 2016, the Bank had non-performing loans, defined as non-accrual and accruing loans past due more than 90 days, of \$3.8 million or 0.53% of total loans. Non-performing loans at December 31, 2015 were \$8.4 million or 1.23% of total loans.

Management continually monitors the loan portfolio to ensure that all loans potentially having a material adverse impact on future operating results, liquidity or capital resources have been classified as non-performing. Should economic conditions deteriorate, the inability of distressed customers to service their existing debt could cause higher levels of non-performing loans. Management expects the level of non-accrual loans to be more in-line with the levels at December 31, 2016 as opposed to the level of non-accruals experienced in 2012.

It is the general policy of the Bank to stop accruing interest income when a loan is placed on non-accrual status and any interest previously accrued but not collected is reversed against current income. Generally a loan is placed on non-accrual status when it is over 90 days past due and there is reasonable doubt that all principal will be collected.

A summary of non-performing assets at December 31 for each of the years presented is shown in Table 14.

Table 14 - Non-performing Assets

(Dollars in thousands)	2016	2015	2014	2013	2012
Non-accrual loans	\$3,825	8,432	10,728	13,836	17,630
Loans 90 days or more past due and still accruing	-	17	-	882	2,403
Total non-performing loans	3,825	8,449	10,728	14,718	20,033
All other real estate owned	283	739	2,016	1,679	6,254
Repossessed assets	-	-	-	-	10
Total non-performing assets	\$4,108	9,188	12,744	16,397	26,297
TDR loans not included in above, (not 90 days past due or on nonaccrual)	3,337	5,102	7,217	7,953	10,864
As a percent of total loans at year end					
Non-accrual loans	0.53 %	1.22 %	1.65 %	2.23 %	2.84 %
Loans 90 days or more past due and still accruing	0.00 %	0.00 %	0.00 %	0.14 %	0.39 %
Total non-performing assets as a percent of total assets at year end	0.38 %	0.88 %	1.22 %	1.58 %	2.60 %
Total non-performing loans as a percent of total loans at year-end	0.53 %	1.23 %	1.65 %	2.37 %	3.23 %

Deposits. The Company primarily uses deposits to fund its loan and investment portfolios. The Company offers a variety of deposit accounts to individuals and businesses. Deposit accounts include checking, savings, money market

and time deposits. As of December 31, 2016, total deposits were \$892.9 million, compared to \$832.2 million at December 31, 2015. Core deposits, which include demand deposits, savings accounts and non-brokered certificates of deposits of denominations less than \$250,000, amounted to \$865.4 million at December 31, 2016, compared to \$805.0 million at December 31, 2015.

Time deposits in amounts of \$250,000 or more totaled \$26.8 million and \$26.9 million at December 31, 2016 and 2015, respectively. At December 31, 2016, brokered deposits amounted to \$7.2 million as compared to \$4.3 million at December 31, 2015. CDARS balances included in brokered deposits amounted to \$7.2 million and \$4.1 million as of December 31, 2016 and 2015, respectively. Brokered deposits are generally considered to be more susceptible to withdrawal as a result of interest rate changes and to be a less stable source of funds, as compared to deposits from the local market. Brokered deposits outstanding as of December 31, 2016 have a weighted average rate of 0.53% with a weighted average original term of 23 months.

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Table 15 is a summary of the maturity distribution of time deposits in amounts of \$250,000 or more as of December 31, 2016.

Table 15 - Maturities of Time Deposits of \$250,000 or greater

(Dollars in thousands)	2016
Three months or less	\$7,001
Over three months through six months	4,619
Over six months through twelve months	3,971
Over twelve months	11,180
Total	\$26,771

**Borrowed Funds.** The Company has access to various short-term borrowings, including the purchase of federal funds and borrowing arrangements from the FHLB and other financial institutions. At December 31, 2016 and 2015, FHLB borrowings totaled \$20.0 million and \$43.5 million, respectively. Average FHLB borrowings for 2016 and 2015 were \$42.9 million and \$49.8 million, respectively. The maximum amount of outstanding FHLB borrowings was \$43.5 million in 2016 and \$50.0 million in 2015. The FHLB borrowings outstanding at December 31, 2016 had interest rates ranging from 2.68% to 4.12% and all mature in 2018. The weighted average rate on FHLB borrowings was 3.87% and 3.48% at December 31, 2016 and 2015, respectively. Additional information regarding FHLB borrowings is provided in Note 6 to the Consolidated Financial Statements.

The Bank had no borrowings from the FRB at December 31, 2016 and 2015. FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At December 31, 2016, the carrying value of loans pledged as collateral totaled approximately \$374.5 million.

Securities sold under agreements to repurchase were \$36.4 million at December 31, 2016, as compared to \$27.9 million at December 31, 2015.

Junior subordinated debentures were \$20.6 million as of December 31, 2016 and 2015.

**Contractual Obligations and Off-Balance Sheet Arrangements.** The Company's contractual obligations and other commitments as of December 31, 2016 are summarized in Table 16 below. The Company's contractual obligations include the repayment of principal and interest related to FHLB advances and junior subordinated debentures, as well as certain payments under current lease agreements. Other commitments include commitments to extend credit. Because not all of these commitments to extend credit will be drawn upon, the actual cash requirements are likely to be significantly less than the amounts reported for other commitments below.

Table 16 - Contractual Obligations and Other Commitments

(Dollars in thousands)	Within One Year	One to Three Years	Three to Five Years	Five Years or More	Total
Contractual Cash Obligations					
Long-term borrowings	\$-	20,000	-	-	20,000
Junior subordinated debentures	-	-	-	20,619	20,619
Corporate Center renovation	2,170	-	-	-	2,170
Operating lease obligations	632	1,212	1,193	1,611	4,648
Total	\$2,802	21,212	1,193	22,230	47,437

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Other Commitments

Commitments to extend credit	\$70,204	20,389	18,833	86,102	195,528
Standby letters of credit and financial guarantees written	3,728	-	-	-	3,728
Income tax credits	639	2,025	81	119	2,864
Total	\$74,571	22,414	18,914	86,221	202,120

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The Company enters into derivative contracts to manage various financial risks. A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index or referenced interest rate. Derivative contracts are carried at fair value on the consolidated balance sheet with the fair value representing the net present value of expected future cash receipts or payments based on market interest rates as of the balance sheet date. Derivative contracts are written in amounts referred to as notional amounts, which only provide the basis for calculating payments between counterparties and are not a measure of financial risk. Therefore, the derivative amounts recorded on the balance sheet do not represent the amounts that may ultimately be paid under these contracts. Further discussions of derivative instruments are included above in the section entitled "Asset Liability and Interest Rate Risk Management" beginning on page A-11 and in Notes 1, 10 and 15 to the Consolidated Financial Statements.

Capital Resources. Shareholders' equity was \$107.4 million, or 9.9% of total assets, as of December 31, 2016, compared to \$104.9 million, or 10.1% of total assets, as of December 31, 2015. The increase in shareholders' equity is primarily due to an increase in retained earnings due to net income, which was partially offset by a decrease in accumulated other comprehensive income resulting from a decrease in the unrealized gain on investment securities and a \$2.0 million decrease in common stock due to 92,738 shares of common stock being repurchased under the Company's stock repurchase program implemented during the second quarter of 2016.

Average shareholders' equity as a percentage of total average assets is one measure used to determine capital strength. Average shareholders' equity as a percentage of total average assets was 10.51%, 10.27% and 9.35% for 2016, 2015 and 2014, respectively. The return on average shareholders' equity was 8.11% at December 31, 2016 as compared to 9.03% and 9.69% at December 31, 2015 and December 31, 2014, respectively. Total cash dividends paid on common stock were \$2.1 million, \$1.6 million and \$1.0 million during 2016, 2015 and 2014, respectively. The Company did not pay any dividends on preferred stock during 2016 and 2015.

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights.

In 2014, the Company's Board of Directors authorized a stock repurchase program ("the 2014 Stock Repurchase Program"), pursuant to which up to \$2 million was allocated to repurchase the Company's common stock. All purchases under the 2014 Stock Repurchase Program were made periodically as permitted by securities laws and other legal requirements in the open market or in privately negotiated transactions. The timing and amount of the repurchase of shares was determined by the Company's management, based on its evaluation of market conditions and other factors. The Company had repurchased approximately \$2.0 million, or 106,587 shares of its common stock, under the 2014 Stock Repurchase Program as of December 31, 2015.

In the second quarter of 2016, the Company's Board of Directors authorized another stock repurchase program ("the 2016 Stock Repurchase Program"), pursuant to which up to \$2 million was allocated to repurchase the Company's common stock. All purchases under the 2016 Stock Repurchase Program were made periodically as permitted by securities laws and other legal requirements in the open market or in privately negotiated transactions. The timing and amount of the repurchase of shares was determined by the Company's management, based on its evaluation of market conditions and other factors. The Company repurchased approximately \$2.0 million, or 92,738 shares of its common stock, under the 2016 Stock Repurchase Program during 2016.

In 2013, the Federal Reserve Board approved its final rule on the Basel III capital standards, which implement changes to the regulatory capital framework for banking organizations. The Basel III capital standards, which became effective January 1, 2015, include new risk-based capital and leverage ratios, which will be phased in from 2015 to 2019. The new minimum capital level requirements applicable to the Company and the Bank under the final rules are as follows: (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 risk based capital ratio of 8% (unchanged from previous rules); and (iv) a Tier 1 leverage ratio of 4% (unchanged from previous rules). An additional capital conservation buffer will be added to the minimum requirements for capital adequacy purposes beginning on January 1, 2016 at 0.625% and will be phased in through 2019 (increasing by 0.625% on each subsequent January 1, until it reaches 2.5% on January 1, 2019). This will result in the following minimum ratios beginning in 2019: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. Under the final rules, an institution is 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 earnings that could be utilized for such actions.

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Under the regulatory capital guidelines, financial institutions are currently required to maintain a total risk-based capital ratio of 8.0% or greater, with a Tier 1 risk-based capital ratio of 6.0% or greater and a common equity Tier 1 capital ratio of 4.5% or greater, as required by Basel III capital standards referenced above. Tier 1 capital is generally defined as shareholders' equity and trust preferred securities less all intangible assets and goodwill. Tier 1 capital at December 31, 2016 and December 31, 2015 includes \$20.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 15.20% and 15.37% at December 31, 2016 and December 31, 2015, respectively. Total risk-based capital is defined as Tier 1 capital plus supplementary capital. Supplementary capital, or Tier 2 capital, consists of the Company's allowance for loan losses, not exceeding 1.25% of the Company's risk-weighted assets. Total risk-based capital ratio is therefore defined as the ratio of total capital (Tier 1 capital and Tier 2 capital) to risk-weighted assets. The Company's total risk-based capital ratio was 16.12% and 16.63% at December 31, 2016 and December 31, 2015, respectively. The Company's common equity Tier 1 capital consists of common stock and retained earnings. The Company's common equity Tier 1 capital ratio was 12.75% and 12.79% at December 31, 2016 and December 31, 2015, respectively. Financial institutions are also required to maintain a leverage ratio of Tier 1 capital to total average assets of 4.0% or greater. The Company's Tier 1 leverage capital ratio was 11.19% and 11.44% at December 31, 2016 and December 31, 2015, respectively.

The Bank's Tier 1 risk-based capital ratio was 14.85% at December 31, 2016 and 2015. The total risk-based capital ratio for the Bank was 15.78% and 16.11% at December 31, 2016 and December 31, 2015, respectively. The Bank's common equity Tier 1 capital ratio was 14.85% at December 31, 2016 and 2015. The Bank's Tier 1 leverage capital ratio was 10.88% and 11.03% at December 31, 2016 and December 31, 2015, respectively.

A bank is considered to be "well capitalized" if it has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 8.0% or greater, a common equity Tier 1 capital ratio of 6.5% or greater and a leverage ratio of 5.0% or greater. Based upon these guidelines, the Bank was considered to be "well capitalized" at December 31, 2016.

The Company's key equity ratios as of December 31, 2016, 2015 and 2014 are presented in Table 17.

Table 17 - Equity Ratios

	2016	2015	2014
Return on average assets	0.85%	0.93%	0.91%
Return on average equity	8.11%	9.03%	9.69%
Dividend payout ratio *	22.95%	16.34%	10.89%
Average equity to average assets	10.51%	10.27%	9.35%

\* As a percentage of net earnings available to common shareholders.

Quarterly Financial Data. The Company's consolidated quarterly operating results for the years ended December 31, 2016 and 2015 are presented in Table 18.

Table 18 - Quarterly Financial Data

(Dollars in thousands, except per share amounts)	2016				2015			
	First	Second	Third	Fourth	First	Second	Third	Fourth
Total interest income	\$9,905	9,815	9,982	10,107	\$9,567	9,191	9,947	9,961
Total interest expense	809	813	828	821	884	875	874	851
Net interest income	9,096	9,002	9,154	9,286	8,683	8,316	9,073	9,110



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(Reduction of) provision for loan losses	(216 )	(531 )	(360 )	(99 )	173	(214 )	235	(211 )
Other income	3,324	3,572	3,414	3,666	3,245	3,297	3,266	3,504
Other expense	9,492	9,109	9,598	11,783	8,748	8,337	8,669	10,024
Income before income taxes	3,144	3,996	3,330	1,268	3,007	3,490	3,435	2,801
Income taxes (benefit)	691	1,032	872	(34 )	679	866	942	613
Net earnings	2,453	2,964	2,458	1,302	2,328	2,624	2,493	2,188
Basic net earnings per share	0.45	0.54	0.45	0.24	\$0.41	0.47	0.45	0.40
Diluted net earnings per share	\$0.44	0.53	0.44	0.24	\$0.41	0.47	0.45	0.39

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## QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk reflects the risk of economic loss resulting from adverse changes in market prices and interest rates. This risk of loss can be reflected in either diminished current market values or reduced potential net interest income in future periods.

The Company's market risk arises primarily from interest rate risk inherent in its lending and deposit taking activities. The structure of the Company's loan and deposit portfolios is such that a significant decline (increase) in interest rates may adversely (positively) impact net market values and interest income. Management seeks to manage the risk through the utilization of its investment securities and off-balance sheet derivative instruments. During the years ended December 31, 2016, 2015 and 2014, the Company used interest rate contracts to manage market risk as discussed above in the section entitled "Asset Liability and Interest Rate Risk Management."

Table 19 presents in tabular form the contractual balances and the estimated fair value of the Company's on-balance sheet financial instruments at their expected maturity dates for the period ended December 31, 2016. The expected maturity categories take into consideration historical prepayment experience as well as management's expectations based on the interest rate environment at December 31, 2016. For core deposits without contractual maturity (i.e. interest-bearing checking, savings, and money market accounts), the table presents principal cash flows based on management's judgment concerning their most likely runoff or repricing behaviors.

Table 19 - Market Risk Table

(Dollars in thousands)

	2017	2018	2019	2020	2021	Thereafter	Total	Fair Value
<b>Loans Receivable</b>								
Fixed rate	\$44,846	59,309	45,286	53,841	56,949	116,964	377,195	375,900
Average interest rate	4.89 %	4.65 %	4.75 %	4.76 %	4.58 %	5.44 %		
Variable rate	\$75,294	38,558	45,379	35,034	36,069	121,991	352,325	352,325
Average interest rate	4.66 %	4.51 %	4.28 %	4.36 %	4.45 %	3.93 %		
<b>Total</b>							<b>729,520</b>	<b>728,225</b>
<b>Investment Securities</b>								
Interest bearing cash	\$16,481	-	-	-	-	-	16,481	16,481
Average interest rate	0.59 %	-	-	-	-	-		
Securities available for sale	\$44,217	20,188	22,762	23,691	31,668	107,420	249,946	249,946
Average interest rate	4.06 %	4.51 %	4.39 %	4.20 %	4.59 %	4.30 %		
Nonmarketable equity securities	\$-	-	-	-	-	2,635	2,635	2,635
Average interest rate	-	-	-	-	-	3.38 %		
<b>Debt Obligations</b>								
Deposits	\$86,781	33,212	15,117	5,384	3,519	748,905	892,918	884,510
Average interest rate	0.33 %	0.56 %	0.61 %	0.75 %	0.75 %	0.07 %		
Advances from FHLB	\$-	20,000	-	-	-	-	20,000	18,864
Average interest rate	-	3.73 %	-	-	-	-		
Securities sold under agreement to repurchase	\$36,434	-	-	-	-	-	36,434	36,434
Average interest rate	0.10 %	-	-	-	-	-		
	\$-	-	-	-	-	20,619	20,619	20,619

Junior subordinated  
debentures

Average interest rate	-	-	-	-	-	2.47	%
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Table 20 presents the simulated impact to net interest income under varying interest rate scenarios and the theoretical impact of rate changes over a twelve-month period referred to as "rate ramps." The table shows the estimated theoretical impact on the Company's tax equivalent net interest income from hypothetical rate changes of plus and minus 1%, 2% and 3% as compared to the estimated theoretical impact of rates remaining unchanged. The table also shows the simulated impact to market value of equity under varying interest rate scenarios and the theoretical impact of immediate and sustained rate changes referred to as "rate shocks" of plus and minus 1%, 2% and 3% as compared to the theoretical impact of rates remaining unchanged. The prospective effects of the hypothetical interest rate changes are based upon various assumptions, including relative and estimated levels of key interest rates. This type of modeling has limited usefulness because it does not allow for the strategies management would utilize in response to sudden and sustained rate changes. Also, management does not believe that rate changes of the magnitude presented are likely in the forecast period presented.

Table 20 - Interest Rate Risk

(Dollars in thousands)

Hypothetical rate change (ramp over 12 months)	Estimated Resulting Theoretical Net Interest Income	
	Amount	% Change
+3%	\$41,807	4.92%
+2%	\$41,635	4.49%
+1%	\$40,839	2.49%
0%	\$39,847	0.00%
-1%	\$39,177	-1.68%
-2%	\$38,936	-2.29%
-3%	\$38,900	-2.38%

Hypothetical rate change (immediate shock)	Estimated Resulting Theoretical Market Value of Equity	
	Amount	% Change
+3%	\$154,428	6.03%
+2%	\$161,219	10.70%
+1%	\$158,700	8.97%
0%	\$145,641	0.00%
-1%	\$122,977	-15.56%
-2%	\$83,648	-42.57%
-3%	\$70,407	-51.66%

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Financial Statements

December 31, 2016, 2015 and 2014

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## PEOPLES BANCORP OF NORTH CAROLINA, INC.

## Consolidated Balance Sheets

December 31, 2016 and December 31, 2015

(Dollars in thousands)

	December 31, <u>2016</u>	December 31, <u>2015</u>
<u>Assets</u>		
Cash and due from banks, including reserve requirements of \$16,576 at 12/31/16 and \$14,587 at 12/31/15	\$53,613	29,194
Interest-bearing deposits	16,481	10,569
Cash and cash equivalents	70,094	39,763
Investment securities available for sale	249,946	268,530
Other investments	2,635	3,636
Total securities	252,581	272,166
Mortgage loans held for sale	5,709	4,149
Loans	723,811	689,091
Less allowance for loan losses	(7,550 )	(9,589 )
Net loans	716,261	679,502
Premises and equipment, net	16,452	16,976
Cash surrender value of life insurance	14,952	14,546
Other real estate	283	739
Accrued interest receivable and other assets	11,659	10,640
Total assets	\$1,087,991	1,038,481
<u>Liabilities and Shareholders' Equity</u>		
Deposits:		
Noninterest-bearing demand	\$271,851	244,231
NOW, MMDA & savings	477,054	431,052
Time, \$250,000 or more	26,771	26,891
Other time	117,242	130,001
Total deposits	892,918	832,175
Securities sold under agreements to repurchase	36,434	27,874
FHLB borrowings	20,000	43,500
Junior subordinated debentures	20,619	20,619
Accrued interest payable and other liabilities	10,592	9,449
Total liabilities	980,563	933,617

Commitments (Note 10)

Shareholders' equity:

Series A preferred stock, \$1,000 stated value; authorized 5,000,000 shares; no shares issued and outstanding	-	-
Common stock, no par value; authorized 20,000,000 shares; issued and outstanding 5,417,800 shares at December 31, 2016 and 5,510,538 shares at December 31, 2015	44,187	46,171
Retained earnings	60,254	53,183
Accumulated other comprehensive income	2,987	5,510
Total shareholders' equity	107,428	104,864
 Total liabilities and shareholders' equity	 \$1,087,991	 1,038,481

See accompanying Notes to Consolidated Financial Statements.

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## PEOPLES BANCORP OF NORTH CAROLINA, INC.

## Consolidated Statements of Earnings

For the Years Ended December 31, 2016, 2015 and 2014

(Dollars in thousands, except per share amounts)

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Interest income:			
Interest and fees on loans	\$32,452	31,098	30,305
Interest on due from banks	123	26	65
Interest on investment securities:			
U.S. Government sponsored enterprises	2,531	2,616	2,995
States and political subdivisions	4,454	4,600	4,677
Other	249	326	378
Total interest income	39,809	38,666	38,420
Interest expense:			
NOW, MMDA & savings deposits	495	432	499
Time deposits	586	870	1,188
FHLB borrowings	1,661	1,735	2,166
Junior subordinated debentures	485	402	389
Other	44	45	45
Total interest expense	3,271	3,484	4,287
Net interest income	36,538	35,182	34,133
(Reduction of) provision for loan losses	(1,206 )	(17 )	(699 )
Net interest income after provision for loan losses	37,744	35,199	34,832
Non-interest income:			
Service charges	4,497	4,647	4,961
Other service charges and fees	890	931	1,080
Gain on sale of securities	729	-	266
Mortgage banking income	1,428	1,130	804
Insurance and brokerage commissions	632	714	701
Gain (loss) on sales and write-downs of other real estate	64	245	(622 )
Miscellaneous	5,736	5,645	4,974
Total non-interest income	13,976	13,312	12,164
Non-interest expense:			
Salaries and employee benefits	19,264	18,285	17,530
Occupancy	6,765	6,288	6,251
Professional fees	2,439	1,468	1,401
Advertising	1,136	784	804
Debit card expense	1,141	988	905

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FDIC insurance	494	681	739
Other	8,743	7,284	8,041
Total non-interest expense	39,982	35,778	35,671
Earnings before income taxes	11,738	12,733	11,325
Income tax expense	2,561	3,100	1,937
Net earnings	\$9,177	9,633	9,388
Basic net earnings per common share	\$1.68	1.73	1.67
Diluted net earnings per common share	\$1.65	1.72	1.66
Cash dividends declared per common share	\$0.38	0.28	0.18

See accompanying Notes to Consolidated Financial Statements.

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## PEOPLES BANCORP OF NORTH CAROLINA, INC.

## Consolidated Statements of Comprehensive Income

For the Years Ended December 31, 2016, 2015 and 2014

(Dollars in thousands)

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Net earnings	\$9,177	9,633	9,388
Other comprehensive income (loss):			
Unrealized holding gains (losses) on securities available for sale	(3,274)	93	11,117
Reclassification adjustment for gains on securities available for sale included in net earnings	(729 )	-	(266 )
Total other comprehensive income (loss), before income taxes	(4,003)	93	10,851
Income tax (benefit) expense related to other comprehensive (loss) income:			
Unrealized holding gains (losses) on securities available for sale	(1,196)	36	4,330
Reclassification adjustment for gains on securities available for sale included in net earnings	(284 )	-	(104 )
Total income tax expense (benefit) related to other comprehensive income (loss)	(1,480)	36	4,226
Total other comprehensive income (loss), net of tax	(2,523)	57	6,625
Total comprehensive income	\$6,654	9,690	16,013

See accompanying Notes to Consolidated Financial Statements.

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## PEOPLES BANCORP OF NORTH CAROLINA, INC.

## Consolidated Statements of Changes in Shareholders' Equity

For the Years Ended December 31, 2016, 2015 and 2014

(Dollars in thousands)

	Common Stock <u>Shares</u>	Common Stock <u>Amount</u>	Retained <u>Earnings</u>	Accumulated Other Comprehensive <u>Income (loss)</u>	<u>Total</u>
Balance, December 31, 2013	5,613,495	\$ 48,133	36,758	(1,172 )	83,719
Common stock repurchase	(4,537 )	(82 )	-	-	(82 )
Cash dividends declared on common stock	-	-	(1,022 )	-	(1,022 )
Stock options exercised	3,630	37	-	-	37
Net earnings	-	-	9,388	-	9,388
Change in accumulated other comprehensive income, net of tax	-	-	-	6,625	6,625
Balance, December 31, 2014	5,612,588	\$ 48,088	45,124	5,453	98,665
Common stock repurchase	(102,050 )	(1,917 )	-	-	(1,917 )
Cash dividends declared on common stock	-	-	(1,574 )	-	(1,574 )
Net earnings	-	-	9,633	-	9,633
Change in accumulated other comprehensive income, net of tax	-	-	-	57	57
Balance, December 31, 2015	5,510,538	\$ 46,171	53,183	5,510	104,864
Common stock repurchase	(92,738 )	(1,984 )	-	-	(1,984 )
Cash dividends declared on common stock	-	-	(2,106 )	-	(2,106 )
Net earnings	-	-	9,177	-	9,177
Change in accumulated other comprehensive income, net of tax	-	-	-	(2,523 )	(2,523 )
Balance, December 31, 2016	5,417,800	\$ 44,187	60,254	2,987	107,428

See accompanying Notes to Consolidated Financial Statements.

## PEOPLES BANCORP OF NORTH CAROLINA, INC.

## Consolidated Statements of Cash Flows

For the Years Ended December 31, 2016, 2015 and 2014

(Dollars in thousands)

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Cash flows from operating activities:			
Net earnings	\$9,177	9,633	9,388
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation, amortization and accretion	5,423	6,053	6,889
Reduction of provision for loan losses	(1,206 )	(17 )	(699 )
Deferred income taxes	(547 )	673	178
Gain on sale of investment securities	1,097	-	(266 )
Gain on sale of other real estate	(81 )	(363 )	(5 )
Write-down of other real estate	17	118	627
Restricted stock expense	932	487	389
Proceeds from sales of loans held for sale	67,764	50,770	40,898
Origination of loans held for sale	(69,324)	(53,544)	(40,020)
Change in:			
Cash surrender value of life insurance	(406 )	(421 )	(419 )
Other assets	(818 )	(408 )	(2,534 )
Other liabilities	211	882	(12,509)
Net cash provided by operating activities	12,239	13,863	1,917
Cash flows from investing activities:			
Purchases of investment securities available for sale	(12,707)	(19,220)	(32,851)
Proceeds from sales, calls and maturities of investment securities available for sale	4,053	5,475	36,148
Proceeds from paydowns of investment securities available for sale	20,675	22,732	20,202
Purchases of other investments	(255 )	(6 )	-
FHLB stock redemption	1,256	401	959
Net change in loans	(36,116)	(43,441)	(36,692)
Purchases of premises and equipment	(1,610 )	(2,354 )	(3,120 )
Proceeds from sale of other real estate and repossessions	1,083	6,287	3,456
Net cash used by investing activities	(23,621)	(30,126)	(11,898)
Cash flows from financing activities:			
Net change in deposits	60,743	17,475	15,339
Net change in securities sold under agreement to repurchase	8,560	(20,556)	3,034
Proceeds from FHLB borrowings	6,000	20,001	-
Repayments of FHLB borrowings	(29,500)	(26,501)	(15,000)
Proceeds from FRB borrowings	1	1	1
Repayments of FRB borrowings	(1 )	(1 )	(1 )



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Proceeds from Fed Funds Purchased	9,112	5,192	2,602
Repayments of Fed Funds Purchased	(9,112 )	(5,192 )	(2,602 )
Stock options exercised	-	-	37
Common stock repurchased	(1,984 )	(1,917 )	(82 )
Cash dividends paid on common stock	(2,106 )	(1,574 )	(1,022 )
Net cash (used) provided by financing activities	41,713	(13,072)	2,306
Net change in cash and cash equivalents	30,331	(29,335)	(7,675 )
Cash and cash equivalents at beginning of period	39,763	69,098	76,773
Cash and cash equivalents at end of period	\$70,094	39,763	69,098

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## PEOPLES BANCORP OF NORTH CAROLINA, INC.

## Consolidated Statements of Cash Flows, continued

For the Years Ended December 31, 2016, 2015 and 2014

(Dollars in thousands)

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Supplemental disclosures of cash flow information:			
Cash paid during the year for:			
Interest	\$ 3,415	3,518	4,388
Income taxes	\$ 2,028	2,278	1,939
Noncash investing and financing activities:			
Change in unrealized (loss) gain on investment securities available for sale, net	\$(2,523)	57	6,625
Transfer of loans to other real estate and repossessions	\$ 563	4,825	4,415
Financed portion of sale of other real estate	\$ -	60	374
Accrued redemption of Series A Preferred Stock	\$ -	-	(12,524)

See accompanying Notes to Consolidated Financial Statements.

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PEOPLES BANCORP OF NORTH CAROLINA, INC.

Notes to Consolidated Financial Statements

(1) Summary of Significant Accounting Policies

Organization

Peoples Bancorp of North Carolina, Inc. ("Bancorp") received regulatory approval to operate as a bank holding company on July 22, 1999, and became effective August 31, 1999. Bancorp is primarily regulated by the Board of Governors of the Federal Reserve System, and serves as the one-bank holding company for Peoples Bank (the "Bank").

The Bank commenced business in 1912 upon receipt of its banking charter from the North Carolina Commissioner of Banks (the "Commissioner"). The Bank is primarily regulated by the Commissioner and the Federal Deposit Insurance Corporation (the "FDIC") and undergoes periodic examinations by these regulatory agencies. The Bank, whose main office is in Newton, North Carolina, provides a full range of commercial and consumer banking services primarily in Catawba, Alexander, Lincoln, Mecklenburg, Iredell, Union, Wake, Durham and Forsyth counties in North Carolina.

Peoples Investment Services, Inc. is a wholly owned subsidiary of the Bank and began operations in 1996 to provide investment and trust services through agreements with an outside party.

Real Estate Advisory Services, Inc. ("REAS") is a wholly owned subsidiary of the Bank and began operations in 1997 to provide real estate appraisal and property management services to individuals and commercial customers of the Bank.

Community Bank Real Estate Solutions, LLC ("CBRES") is a wholly owned subsidiary of the Bank and began operations in 2009 as a "clearing house" for appraisal services for community banks. Other banks are able to contract with CBRES to find and engage appropriate appraisal companies in the area where the property is located. CBRES was moved from a wholly owned subsidiary of Peoples Bancorp of North Carolina, Inc. to a wholly owned subsidiary of the Bank effective August 31, 2016.

PB Real Estate Holdings, LLC ("PBREH") is a wholly owned subsidiary of the Bank and began operation in 2015. PBREH acquires, manages and disposes of real property, other collateral and other assets obtained in the ordinary course of collecting debts previously contracted.

The Bank operates four offices focused on the Latino population under the name Banco de la Gente. These offices are operated as a division of the Bank. Banco de la Gente offers normal and customary banking services as are offered in the Bank's other branches such as the taking of deposits and the making of loans and therefore is not considered a reportable segment of the Company (as defined below).

Principles of Consolidation

The consolidated financial statements include the financial statements of Bancorp and its wholly owned subsidiary, the Bank, along with the Bank's wholly owned subsidiaries, Peoples Investment Services, Inc., REAS, CBRES and PBREH (collectively called the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation.

Basis of Presentation

The accounting principles followed by the Company, and the methods of applying these principles, conform with accounting principles generally accepted in the United States of America ("GAAP") and with general practices in the banking industry. In preparing the financial statements in conformity with GAAP, management is required to make

estimates and assumptions that affect the reported amounts in the financial statements. Actual results could differ significantly from these estimates. Material estimates common to the banking industry that are particularly susceptible to significant change in the near term include, but are not limited to, the determination of the allowance for loan losses and valuation of real estate acquired in connection with or in lieu of foreclosure on loans.

Cash and Cash Equivalents

Cash, due from banks and interest-bearing deposits are considered cash and cash equivalents for cash flow reporting purposes.

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### Investment Securities

There are three classifications the Company is able to classify its investment securities: trading, available for sale, or held to maturity. Trading securities are bought and held principally for sale in the near term. Held to maturity securities are those securities for which the Company has the ability and intent to hold until maturity. All other securities not included in trading or held to maturity are classified as available for sale. At December 31, 2016 and 2015, the Company classified all of its investment securities as available for sale.

Available for sale securities are recorded at fair value. Unrealized holding gains and losses, net of the related tax effect, are excluded from earnings and are reported as a separate component of shareholders' equity until realized.

Management evaluates investment securities for other-than-temporary impairment on an annual basis. A decline in the market value of any investment below cost that is deemed other-than-temporary is charged to earnings for the decline in value deemed to be credit related and a new cost basis in the security is established. The decline in value attributed to non-credit related factors is recognized in comprehensive income.

Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to the yield. Realized gains and losses for securities classified as available for sale are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

### Other Investments

Other investments include equity securities with no readily determinable fair value. These investments are carried at cost.

### Mortgage Loans Held for Sale

Mortgage loans held for sale are carried at lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value.

### Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are reported at the principal amount outstanding, net of the allowance for loan losses. Interest on loans is calculated by using the simple interest method on daily balances of the principal amount outstanding. The recognition of certain loan origination fee income and certain loan origination costs is deferred when such loans are originated and amortized over the life of the loan.

A loan is impaired when, based on current information and events, it is probable that all amounts due according to the contractual terms of the loan will not be collected. Impaired loans are measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or at the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent.

Accrual of interest is discontinued on a loan when management believes, after considering economic conditions and collection efforts, that the borrower's financial condition is such that collection of interest is doubtful. Interest previously accrued but not collected is reversed against current period earnings.

### Allowance for Loan Losses

The allowance for loan losses reflects management's assessment and estimate of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. The Bank periodically analyzes the loan portfolio in an effort to review asset quality and to establish an allowance for loan losses that management believes will be adequate in light of anticipated risks and loan losses. In assessing the adequacy of the allowance, size, quality and risk of loans in the portfolio are reviewed. Other factors considered are:

- the Bank's loan loss experience;
  - the amount of past due and non-performing loans;
- specific known risks;
- the status and amount of other past due and non-performing assets;
- underlying estimated values of collateral securing loans;
- current and anticipated economic conditions; and
- other factors which management believes affect the allowance for potential credit losses.

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Management uses several measures to assess and monitor the credit risks in the loan portfolio, including a loan grading system that begins upon loan origination and continues until the loan is collected or collectability becomes doubtful. Upon loan origination, the Bank's originating loan officer evaluates the quality of the loan and assigns one of eight risk grades. The loan officer monitors the loan's performance and credit quality and makes changes to the credit grade as conditions warrant. When originated or renewed, all loans over a certain dollar amount receive in-depth reviews and risk assessments by the Bank's Credit Administration. Before making any changes in these risk grades, management considers assessments as determined by the third party credit review firm (as described below), regulatory examiners and the Bank's Credit Administration. Any issues regarding the risk assessments are addressed by the Bank's senior credit administrators and factored into management's decision to originate or renew the loan. The Bank's Board of Directors reviews, on a monthly basis, an analysis of the Bank's reserves relative to the range of reserves estimated by the Bank's Credit Administration.

As an additional measure, the Bank engages an independent third party to review the underwriting, documentation and risk grading analyses. This independent third party reviews and evaluates loan relationships greater than \$1.0 million, excluding loans in default, and loans in process of litigation or liquidation. The third party's evaluation and report is shared with management and the Bank's Board of Directors.

Management considers certain commercial loans with weak credit risk grades to be individually impaired and measures such impairment based upon available cash flows and the value of the collateral. Allowance or reserve levels are estimated for all other graded loans in the portfolio based on their assigned credit risk grade, type of loan and other matters related to credit risk.

Management uses the information developed from the procedures described above in evaluating and grading the loan portfolio. This continual grading process is used to monitor the credit quality of the loan portfolio and to assist management in estimating the allowance for loan losses. The provision for loan losses charged or credited to earnings is based upon management's judgment of the amount necessary to maintain the allowance at a level appropriate to absorb probable incurred losses in the loan portfolio at the balance sheet date. The amount each quarter is dependent upon many factors, including growth and changes in the composition of the loan portfolio, net charge-offs, delinquencies, management's assessment of loan portfolio quality, the value of collateral, and other macro-economic factors and trends. The evaluation of these factors is performed quarterly by management through an analysis of the appropriateness of the allowance for loan losses.

The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment. When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Bank's loss exposure for each credit, given the appraised value of any underlying collateral. Loans for which specific reserves are provided are excluded from the general allowance calculations as described below.

The general allowance reflects reserves established under GAAP for collective loan impairment. These reserves are based upon historical net charge-offs using the greater of the last two, three, four or five years' loss experience. This charge-off experience may be adjusted to reflect the effects of current conditions. The Bank considers information derived from its loan risk ratings and external data related to industry and general economic trends in establishing reserves.

The unallocated allowance is determined through management's assessment of probable losses that are in the portfolio but are not adequately captured by the other two components of the allowance, including consideration of current economic and business conditions and regulatory requirements. The unallocated allowance also reflects management's acknowledgement of the imprecision and subjectivity that underlie the modeling of credit risk. Due to the subjectivity involved in determining the overall allowance, including the unallocated portion, the unallocated portion may

fluctuate from period to period based on management's evaluation of the factors affecting the assumptions used in calculating the allowance.

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the year ended December 31, 2016 as compared to the year ended December 31, 2015. Revisions, estimates and assumptions may be made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

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Effective December 31, 2012, stated income mortgage loans from the Banco de la Gente division of the Bank were analyzed separately from other single family residential loans in the Bank's loan portfolio. These loans are first mortgage loans

made to the Latino market, primarily in Mecklenburg and surrounding counties. These loans are non-traditional mortgages in that the customer normally did not have a credit history, so all credit information was accumulated by the loan officers. These loans were made as stated income loans rather than full documentation loans because the customer may not have had complete documentation on the income supporting the loan.

Various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require adjustments to the allowance based on their judgments of information available to them at the time of their examinations. Management believes it has established the allowance for credit losses pursuant to GAAP, and has taken into account the views of its regulators and the current economic environment. Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Bank's loan portfolio as of the date of the financial statements. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

#### Mortgage Banking Activities

Mortgage banking income represents net gains from the sale of mortgage loans and fees received from borrowers and loan investors related to the Bank's origination of single-family residential mortgage loans.

Mortgage loans serviced for others are not included in the accompanying balance sheets. The unpaid principal balances of mortgage loans serviced for others was approximately \$1.4 million, \$1.6 million and \$2.1 million at December 31, 2016, 2015 and 2014, respectively.

The Bank originates certain fixed rate mortgage loans and commits these loans for sale. The commitments to originate fixed rate mortgage loans and the commitments to sell these loans to a third party are both derivative contracts. The fair value of these derivative contracts is immaterial and has no effect on the recorded amounts in the financial statements.

#### Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed primarily using the straight-line method over the estimated useful lives of the assets. When assets are retired or otherwise disposed, the cost and related accumulated depreciation are removed from the accounts, and any gain or loss is reflected in earnings for that period. The cost of maintenance and repairs that do not improve or extend the useful life of the respective asset is charged to earnings as incurred, whereas significant renewals and improvements are capitalized. The range of estimated useful lives for premises and equipment are generally as follows:

Buildings	10 - 50
and	years
improvements	
Furniture	3 - 10
and equipment	years

#### Other Real Estate

Foreclosed assets include all assets received in full or partial satisfaction of a loan. Foreclosed assets are reported at fair value less estimated selling costs. Any write-downs at the time of foreclosure are charged to the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management, and a valuation allowance is established if fair value less estimated selling costs declines below carrying value. Costs relating to the development and improvement of the property are capitalized. Revenues and expenses from operations are included

in other expenses. Changes in the valuation allowance are included in loss on sale and write-down of other real estate.

Income Taxes

Deferred tax assets and liabilities 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. Additionally, the recognition of future tax benefits, such as net operating loss carryforwards, is required to the extent that the realization of such benefits is more likely than not to occur. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which the assets and liabilities are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expense in the period that includes the enactment date.

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In the event the future tax consequences of differences between the financial reporting bases and the tax bases of the Company's assets and liabilities results in a deferred tax asset, an evaluation of the probability of being able to realize the future benefits indicated by such asset is required. A valuation allowance is provided for the portion of the deferred tax asset when it is more likely than not that some portion or all of the deferred tax asset will not be realized. In assessing the realizability of a deferred tax asset, management considers the scheduled reversals of deferred tax liabilities, projected future taxable income, and tax planning strategies.

Tax effects from an uncertain tax position can be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more likely than not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Previously recognized tax positions that no longer meet the more likely than not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. The Company assessed the impact of this guidance and determined that it did not have a material impact on the Company's financial position, results of operations or disclosures.

#### Derivative Financial Instruments and Hedging Activities

In the normal course of business, the Company enters into derivative contracts to manage interest rate risk by modifying the characteristics of the related balance sheet instruments in order to reduce the adverse effect of changes in interest rates. All material derivative financial instruments are recorded at fair value in the financial statements. The fair value of derivative contracts related to the origination of fixed rate mortgage loans and the commitments to sell these loans to a third party is immaterial and has no effect on the recorded amounts in the financial statements.

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of, and gains and losses on, derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

On the date a derivative contract is entered into, the Company designates the derivative as a fair value hedge, a cash flow hedge, or a trading instrument. Changes in the fair value of instruments used as fair value hedges are accounted for in the earnings of the period simultaneous with accounting for the fair value change of the item being hedged. Changes in the fair value of the effective portion of cash flow hedges are accounted for in other comprehensive income rather than earnings. Changes in fair value of instruments that are not intended as a hedge are accounted for in the earnings of the period of the change.

If a derivative instrument designated as a fair value hedge is terminated or the hedge designation removed, the difference between a hedged item's then carrying amount and its face amount is recognized into income over the original hedge period. Likewise, if a derivative instrument designated as a cash flow hedge is terminated or the hedge designation removed, related amounts accumulated in other accumulated comprehensive income are reclassified into earnings over the original hedge period during which the hedged item affects income.

The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are

considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

The Company formally documents all hedging relationships, including an assessment that the derivative instruments are expected to be highly effective in offsetting the changes in fair values or cash flows of the hedged items.

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Advertising Costs

Advertising costs are expensed as incurred.

Stock-Based Compensation

The Company has an Omnibus Stock Ownership and Long Term Incentive Plan that was approved by shareholders on May 7, 2009 (the "Plan") whereby certain stock-based rights, such as stock options, restricted stock, restricted stock units, performance units, stock appreciation rights or book value shares, may be granted to eligible directors and employees. A total of 262,520 shares are currently reserved for possible issuance under the Plan. All stock-based rights under the Plan must be granted or awarded by May 7, 2019 (i.e. ten years from the Plan effective date).

The Company granted 29,514 restricted stock units under the Plan at a grant date fair value of \$7.90 per share during the first quarter of 2012, of which 5,355 restricted stock units were forfeited by the executive officers of the Company as required by the agreement with the U.S. Department of the Treasury ("UST") in conjunction with the Company's participation in the Capital Purchase Program ("CPP") under the Troubled Asset Relief Program ("TARP"). In July 2012, the Company granted 5,355 restricted stock units at a grant date fair value of \$8.25 per share. The Company granted 26,795 restricted stock units under the Plan at a grant date fair value of \$11.90 per share during the second quarter of 2013. The Company granted 21,056 restricted stock units under the Plan at a grant date fair value of \$15.70 per share during the first quarter of 2014. The Company granted 15,075 restricted stock units under the Plan at a grant date fair value of \$17.97 per share during the first quarter of 2015. The Company granted 5,040 restricted stock units under the Plan at a grant date fair value of \$18.60 per share during the first quarter of 2016. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (five years from the grant date for the 2012 grants, four years from the grant date for the 2013, 2015 and 2016 grants and three years from the grant date for the 2014 grants). The amount of expense recorded each period reflects the changes in the Company's stock price during such period. As of December 31, 2016, the total unrecognized compensation expense related to the restricted stock unit grants under the Plan was \$396,000.

The Company recognized compensation expense for restricted stock units granted under the Plan of \$932,000, \$487,000 and \$389,000 for the years ended December 31, 2016, 2015 and 2014, respectively.

Net Earnings Per Share

Net earnings per common share is based on the weighted average number of common shares outstanding during the period while the effects of potential common shares outstanding during the period are included in diluted earnings per common share. The average market price during the year is used to compute equivalent shares.

The reconciliations of the amounts used in the computation of both "basic earnings per common share" and "diluted earnings per common share" for the years ended December 31, 2016, 2015 and 2014 are as follows:

For the year ended December 31, 2016

	Net Earnings (Dollars in thousands)	Weighted Average Number of Shares	Per Share Amount
Basic earnings per share	\$ 9,177	5,477,245	\$ 1.68
Effect of dilutive securities:			
Restricted stock units	-	70,734	
Diluted earnings per share	\$ 9,177	5,547,979	\$ 1.65

For the year ended December 31, 2015

Weighted

	Net Earnings (Dollars in thousands)	Average Number of Shares	Per Share Amount
Basic earnings per share	\$ 9,633	5,559,235	\$ 1.73
Effect of dilutive securities:			
Restricted stock units	-	47,954	
Diluted earnings per share	\$ 9,633	5,607,189	\$ 1.72

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For the year ended December 31, 2014

	Net Earnings (Dollars in thousands)	Weighted Average Number of Shares	Per Share Amount
Basic earnings per share	\$ 9,388	5,615,666	\$ 1.67
Effect of dilutive securities:			
Restricted stock units	-	26,326	
Diluted earnings per share	\$ 9,388	5,641,992	\$ 1.66

### Recent Accounting Pronouncements

In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-02, (Topic 842): Leases. ASU No. 2016-02 increases transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. ASU No. 2016-02 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In June 2016, FASB issued ASU No. 2016-13, (Topic 326): Measurement of Credit Losses on Financial Instruments. ASU No. 2016-13 provides guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. ASU No. 2016-13 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2019. The Company is currently evaluating the effect that implementation of the new standard will have on its results of operations, financial position and disclosures.

In October 2016, FASB issued ASU No. 2016-16, (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory. ASU No. 2016-16 eliminates the exception for all intra-entity sales of assets other than inventory. ASU No. 2016-16 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In October 2016, FASB issued ASU No. 2016-17, (Topic 810): Interests Held through Related Parties That Are under Common Control. ASU No. 2016-17 amends the consolidation guidance on how a reporting entity that is the single decision maker of a variable interest entity should treat indirect interests in the entity held through related parties that are under common control with the reporting entity when determining whether it is the primary beneficiary of that variable interest entity. ASU No. 2016-17 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2016. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In November 2016, FASB issued ASU No. 2016-18, (Topic 230): Restricted Cash. ASU No. 2016-18 clarifies guidance on the classification and presentation of restricted cash in the statement of cash flows. ASU No. 2016-18 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

In December 2016, FASB issued ASU No. 2016-20, (Topic 606): Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers. ASU No. 2016-20 make a limited number of revisions to several pieces of the revenue recognition standard issued in 2014. ASU No. 2016-20 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures.

Other accounting standards that have been issued or proposed by FASB or other standards-setting bodies are not expected to have a material impact on the Company's results of operations, financial position or disclosures.

Reclassification

Certain amounts in the 2014 and 2015 consolidated financial statements have been reclassified to conform to the 2016 presentation.

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## (2) Investment Securities

Investment securities available for sale at December 31, 2016 and 2015 are as follows:

(Dollars in thousands)

	December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Mortgage-backed securities	\$66,654	1,221	290	67,585
U.S. Government sponsored enterprises	38,188	308	274	38,222
State and political subdivisions	137,832	4,176	152	141,856
Corporate bonds	1,500	33	-	1,533
Trust preferred securities	750	-	-	750
Total	\$244,924	5,738	716	249,946

(Dollars in thousands)

	December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Mortgage-backed securities	\$76,406	1,526	45	77,887
U.S. Government sponsored enterprises	38,173	399	155	38,417
State and political subdivisions	141,500	6,817	72	148,245
Corporate bonds	1,928	-	22	1,906
Trust preferred securities	750	-	-	750
Equity securities	748	577	-	1,325
Total	\$259,505	9,319	294	268,530

The current fair value and associated unrealized losses on investments in debt securities with unrealized losses at December 31, 2016 and 2015 are summarized in the tables below, with the length of time the individual securities have been in a continuous loss position.

(Dollars in thousands)

	December 31, 2016					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	\$15,594	290	-	-	15,594	290
U.S. Government sponsored enterprises	10,120	94	9,562	180	19,682	274
State and political subdivisions	10,441	123	561	29	11,002	152
Total	\$36,155	507	10,123	209	46,278	716

(Dollars in thousands)

	December 31, 2015		
	Less than 12 Months	12 Months or More	Total
	Unrealized	Unrealized	Unrealized

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	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
Mortgage-backed securities	\$7,891	45	-	-	7,891	45
U.S. Government sponsored enterprises	3,074	13	10,828	142	13,902	155
State and political subdivisions	2,198	4	3,930	68	6,128	72
Corporate bonds	1,500	22	-	-	1,500	22
Total	\$14,663	84	14,758	210	29,421	294

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At December 31, 2016, unrealized losses in the investment securities portfolio relating to debt securities totaled \$716,000. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the December 31, 2016 tables above, one out of 168 securities issued by state and political subdivisions contained unrealized losses and five out of 80 securities issued by U.S. Government sponsored enterprises, including mortgage-backed securities, contained unrealized losses. These unrealized losses are considered temporary because of acceptable financial condition and results of operations on each security and the repayment sources of principal and interest on U.S. Government sponsored enterprises, including mortgage-backed securities, are government backed.

The Company periodically evaluates its investments for any impairment which would be deemed other-than-temporary. No investment impairments were deemed other-than-temporary in 2016, 2015 or 2014.

The amortized cost and estimated fair value of investment securities available for sale at December 31, 2016, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

December 31, 2016  
(Dollars in thousands)

	Amortized Cost	Estimated Fair Value
Due within one year	\$ 7,304	7,341
Due from one to five years	81,366	84,100
Due from five to ten years	77,498	78,751
Due after ten years	12,102	12,169
Mortgage-backed securities	66,654	67,585
Equity securities	-	-
Total	\$ 244,924	249,946

During 2016, proceeds from sales of securities available for sale were \$1.5 million and resulted in gross gains of \$729,000. No securities available for sale were sold during the year ended December 31, 2015. During 2014, proceeds from sales of securities available for sale were \$20.2 million and resulted in gross gains of \$291,000 and gross losses of \$25,000.

Securities with a fair value of approximately \$95.6 million and \$91.0 million at December 31, 2016 and 2015, respectively, were pledged to secure public deposits, Federal Home Loan Bank of Atlanta ("FHLB") borrowings and for other purposes as required by law.

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. There is a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The table below presents the balance of securities available for sale, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of December 31, 2016 and 2015.

(Dollars in thousands)

	December 31, 2016		
Fair Value	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation

	Measurements			
Mortgage-backed securities	\$67,585	-	67,585	-
U.S. Government sponsored enterprises	\$38,222	-	38,222	-
State and political subdivisions	\$141,856	-	141,856	-
Corporate bonds	\$1,533	-	1,533	-
Trust preferred securities	\$750	-	-	750

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(Dollars in thousands)

	December 31, 2015			
	Fair Value Measurement	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$77,887	-	77,887	-
U.S. Government sponsored enterprises	\$38,417	-	38,417	-
State and political subdivisions	\$148,245	-	148,245	-
Corporate bonds	\$1,906	-	1,906	-
Trust preferred securities	\$750	-	-	750
Equity securities	\$1,325	1,325	-	-

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities.

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the year ended December 31, 2016.

(Dollars in thousands)

	Investment Securities Available for Sale Level 3 Valuation
Balance, beginning of period	\$ 750
Change in book value	-
Change in gain/(loss) realized and unrealized	-
Purchases/(sales and calls)	-
Transfers in and/or (out) of Level 3	-
Balance, end of period	\$ 750

Change in unrealized gain/(loss) for assets still held in Level 3 \$ -

## (3) Loans

Major classifications of loans at December 31, 2016 and 2015 are summarized as follows:

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(Dollars in thousands)

	December 31, 2016	December 31, 2015
Real estate loans:		
Construction and land development	\$61,749	65,791
Single-family residential	240,700	220,690
Single-family residential - Banco de la Gente stated income	40,189	43,733
Commercial	247,521	228,526
Multifamily and farmland	21,047	18,080
Total real estate loans	611,206	576,820
Loans not secured by real estate:		
Commercial loans	87,596	91,010
Farm loans	-	3
Consumer loans	9,832	10,027
All other loans	15,177	11,231
Total loans	723,811	689,091
Less allowance for loan losses	7,550	9,589
Total net loans	\$716,261	679,502

The above table includes deferred costs, net of deferred fees, totaling \$1.4 million and \$488,000 at December 31, 2016 and 2015, respectively.

The Bank grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg, Union, Wake, Durham and Forsyth counties of North Carolina. Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by improved and unimproved real estate, the value of which is dependent upon the real estate market. Risk characteristics of the major components of the Bank's loan portfolio are discussed below:

**Construction and land development loans** – The risk of loss is largely dependent on the initial estimate of whether the property's value at completion equals or exceeds the cost of property construction and the availability of take-out financing. During the construction phase, a number of factors can result in delays or cost overruns. If the estimate is inaccurate or if actual construction costs exceed estimates, the value of the property securing the loan may be insufficient to ensure full repayment when completed through a permanent loan, sale of the property, or by seizure of collateral. As of December 31, 2016, construction and land development loans comprised approximately 9% of the Bank's total loan portfolio.

**Single-family residential loans** – Declining home sales volumes, decreased real estate values and higher than normal levels of unemployment could contribute to losses on these loans. As of December 31, 2016, single-family residential loans comprised approximately 39% of the Bank's total loan portfolio, including Banco de la Gente single-family residential stated income loans which were approximately 6% of the Bank's total loan portfolio.

**Commercial real estate loans** – Repayment is dependent on income being generated in amounts sufficient to cover operating expenses and debt service. These loans also involve greater risk because they are generally not fully amortizing over a loan period, but rather have a balloon payment due at maturity. A borrower's ability to make a balloon payment typically will depend on being able to either refinance the loan or timely sell the underlying

property. As of December 31, 2016, commercial real estate loans comprised approximately 34% of the Bank's total loan portfolio.

Commercial loans – Repayment is generally dependent upon the successful operation of the borrower's business. In addition, the collateral securing the loans may depreciate over time, be difficult to appraise, be illiquid, or fluctuate in value based on the success of the business. As of December 31, 2016, commercial loans comprised approximately 12% of the Bank's total loan portfolio.

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Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The following tables present an age analysis of past due loans, by loan type, as of December 31, 2016 and 2015:

December 31, 2016

(Dollars in thousands)

	Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Total Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Real estate loans:						
Construction and land development	\$-	10	10	61,739	61,749	-
Single-family residential	4,890	80	4,970	235,730	240,700	-
Single-family residential - Banco de la Gente stated income	5,250	249	5,499	34,690	40,189	-
Commercial	342	126	468	247,053	247,521	-
Multifamily and farmland	471	-	471	20,576	21,047	-
Total real estate loans	10,953	465	11,418	599,788	611,206	-
Loans not secured by real estate:						
Commercial loans	273	-	273	87,323	87,596	-
Farm loans	-	-	-	-	-	-
Consumer loans	68	6	74	9,758	9,832	-
All other loans	3	-	3	15,174	15,177	-
Total loans	\$11,297	471	11,768	712,043	723,811	-

December 31, 2015

(Dollars in thousands)

	Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Total Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Real estate loans:						
Construction and land development	\$330	17	347	65,444	65,791	-
Single-family residential	2,822	1,385	4,207	216,483	220,690	-
Single-family residential - Banco de la Gente stated income	7,021	114	7,135	36,598	43,733	-
Commercial	2,619	157	2,776	225,750	228,526	-
Multifamily and farmland	-	-	-	18,080	18,080	-
Total real estate loans	12,792	1,673	14,465	562,355	576,820	-



Loans not secured by real estate:

Commercial loans	185	40	225	90,785	91,010	17
Farm loans	-	-	-	3	3	-
Consumer loans	136	8	144	9,883	10,027	-
All other loans	-	-	-	11,231	11,231	-
Total loans	\$13,113	1,721	14,834	674,257	689,091	17

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The following table presents the Bank's non-accrual loans as of December 31, 2016 and 2015:

(Dollars in thousands)

	December 31, 2016	December 31, 2015
Real estate loans:		
Construction and land development	\$ 22	146
Single-family residential	1,662	4,023
Single-family residential - Banco de la Gente stated income	1,340	1,106
Commercial	669	2,992
Multifamily and farmland	78	-
Total real estate loans	3,771	8,267
Loans not secured by real estate:		
Commercial loans	21	113
Consumer loans	33	52
Total	\$ 3,825	8,432

At each reporting period, the Bank determines which loans are impaired. Accordingly, the Bank's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan that is collateral-dependent is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by REAS, a subsidiary of the Bank. REAS is staffed by certified appraisers that also perform appraisals for other companies. Factors, including the assumptions and techniques utilized by the appraiser, are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. An allowance for each impaired loan that is not collateral dependent is calculated based on the present value of projected cash flows. If the recorded investment in the impaired loan exceeds the present value of projected cash flows, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under \$250,000 are not individually evaluated for impairment with the exception of the Bank's troubled debt restructured ("TDR") loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Impaired loans collectively evaluated for impairment totaled \$5.9 million and \$8.4 million at December 31, 2016 and 2015, respectively. Accruing impaired loans were \$23.5 million and \$25.0 million at December 31, 2016 and December 31, 2015, respectively. Interest income recognized on accruing impaired loans was \$1.2 million and \$1.3 million for the years ended December 31, 2016 and 2015, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as non-accrual.

The following tables present the Bank's impaired loans as of December 31, 2016, 2015 and 2014:

December 31, 2016

(Dollars in thousands)

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Recorded Investment in Impaired Loans	Recorded Investment Related Allowance	Average Outstanding Impaired Loans	YTD Interest Income Recognized
Real estate loans:							
Construction and land development	\$ 282	-	278	278	11	330	13

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Single-family residential	5,354	703	4,323	5,026	47	7,247	164
Single-family residential - Banco de la Gente stated income	18,611	-	18,074	18,074	1,182	17,673	861
Commercial	3,750	1,299	2,197	3,496	166	4,657	152
Multifamily and farmland	78	-	78	78	-	78	-
Total impaired real estate loans	28,075	2,002	24,950	26,952	1,406	29,985	1,190
Loans not secured by real estate:							
Commercial loans	27	-	27	27	-	95	-
Consumer loans	211	-	202	202	3	222	8
Total impaired loans	\$ 28,313	2,002	25,179	27,181	1,409	30,302	1,198

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December 31, 2015  
(Dollars in thousands)

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Recorded Investment in Impaired Loans	Related Allowance	Average Outstanding Impaired Loans	YTD Interest Income Recognized
Real estate loans:							
Construction and land development	\$ 643	216	226	442	12	705	18
Single-family residential	8,828	1,489	6,805	8,294	189	10,852	224
Single-family residential - Banco de la Gente stated income	20,375	-	19,215	19,215	1,143	18,414	921
Commercial	4,556	-	4,893	4,893	179	5,497	89
Multifamily and farmland	96	-	83	83	-	93	6
Total impaired real estate loans	34,498	1,705	31,222	32,927	1,523	35,561	1,258
Loans not secured by real estate:							
Commercial loans	180	-	161	161	3	132	5
Consumer loans	286	-	260	260	4	283	11
Total impaired loans	\$ 34,964	1,705	31,643	33,348	1,530	35,976	1,274

December 31, 2014  
(Dollars in thousands)

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Recorded Investment in Impaired Loans	Related Allowance	Average Outstanding Impaired Loans	YTD Interest Income Recognized
Real estate loans:							
Construction and land development	\$ 5,481	3,639	555	4,194	31	5,248	20
Single-family residential	6,717	933	5,540	6,473	154	7,430	214
Single-family residential - Banco de la Gente stated income	21,243	-	20,649	20,649	1,191	19,964	952
Commercial	4,752	1,485	2,866	4,351	272	4,399	76
Multifamily and farmland	111	-	110	110	1	154	-
Total impaired real estate loans	38,304	6,057	29,720	35,777	1,649	37,195	1,262
Loans not secured by real estate:							
Commercial loans	218	-	201	201	4	641	2
Farm loans (non RE)			-				
Consumer loans	318	-	313	313	5	309	12
Total impaired loans	\$ 38,840	6,057	30,234	36,291	1,658	38,145	1,276

The fair value measurements for mortgage loans held for sale, impaired loans and other real estate on a non-recurring basis at December 31, 2016 and 2015 are presented below. The Company's valuation methodology is discussed in Note 15.

(Dollars in thousands)

	Fair Value Measurements			
	December 31, 2016	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage loans held for sale	\$ 5,709	-	-	5,709
Impaired loans	\$ 25,931	-	-	25,931
Other real estate	\$ 283	-	-	283

(Dollars in thousands)

	Fair Value Measurements			
	December 31, 2015	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage loans held for sale	\$ 4,149	-	-	4,149
Impaired loans	\$ 31,818	-	-	31,818
Other real estate	\$ 739	-	-	739

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(Dollars in thousands)

	Fair Value December 31, 2016	Fair Value December 31, 2015	Valuation Technique	Significant Unobservable Inputs	General Range of Significant Unobservable Input Values
Mortgage loans held for sale	\$ 5,709	4,149	Rate lock commitment	N/A	N/A
Impaired loans	\$ 25,931	31,818	Appraised value and discounted cash flows	Discounts to reflect current market conditions and ultimate collectability	0 - 25%
Other real estate	\$ 283	739	Appraised value	Discounts to reflect current market conditions and estimated costs to sell	0 - 25%

Changes in the allowance for loan losses for the year ended December 31, 2016 were as follows:

(Dollars in thousands)

	Real Estate Loans									Unallocated	Total
	Construction and Land Development	Single-Family Residential	Single-Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer and All Other			
Allowance for loan losses:											
Beginning balance	\$2,185	2,534	1,460	1,917	-	842	-	172	479		9,589
Charge-offs	(7)	(275)	-	(318)	-	(146)	-	(492)	-		(1,238)
Recoveries	10	55	-	19	-	170	-	151	-		405
Provision	(1,036)	(188)	(83)	(25)	52	(191)	-	373	(108)		(1,206)
Ending balance	\$1,152	2,126	1,377	1,593	52	675	-	204	371		7,550
Ending balance: individually evaluated for impairment	\$-	-	1,160	159	-	-	-	-	-		1,319

Ending balance:  
collectively  
evaluated

for impairment	1,152	2,126	217	1,434	52	675	-	204	371	6,231
Ending balance	\$1,152	2,126	1,377	1,593	52	675	-	204	371	7,550

Loans:

Ending balance	\$61,749	240,700	40,189	247,521	21,047	87,596	-	25,009	-	723,811
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Ending balance:  
individually  
evaluated

for impairment	\$-	935	16,718	3,648	-	-	-	-	-	21,301
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Ending balance:

collectively  
evaluated

for impairment	\$61,749	239,765	23,471	243,873	21,047	87,596	-	25,009	-	702,510
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Changes in the allowance for loan losses for the year ended December 31, 2015 were as follows:

(Dollars in thousands)

	Real Estate Loans									
	Construction and Land Development	Single-Family Residential	Single-Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer and All Other	Unallocated	Total
Allowance for loan losses:										
Beginning balance	\$2,785	2,566	1,610	1,902	7	1,098	-	233	881	11,082
Charge-offs	(198)	(618)	(117)	(329)	-	(37)	-	(545)	-	(1,844)
Recoveries	45	34	22	21	-	101	-	145	-	368
Provision	(447)	552	(55)	323	(7)	(320)	-	339	(402)	(17)
Ending balance	\$2,185	2,534	1,460	1,917	-	842	-	172	479	9,589
Ending balance: individually evaluated for impairment	\$-	96	1,115	171	-	-	-	-	-	1,382
Ending balance: collectively evaluated for impairment	2,185	2,438	345	1,746	-	842	-	172	479	8,207
Ending balance	\$2,185	2,534	1,460	1,917	-	842	-	172	479	9,589
Loans:										
Ending balance	\$65,791	220,690	43,733	228,526	18,080	91,010	3	21,258	-	689,091
Ending balance: individually evaluated for impairment	\$216	2,636	17,850	4,212	-	-	-	-	-	24,914



Ending  
balance:  
collectively  
evaluated  
for  
impairment

\$65,575	218,054	25,883	224,314	18,080	91,010	3	21,258	-	664,177
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Changes in the allowance for loan losses for the year ended December 31, 2014 were as follows:

(Dollars in  
thousands)

	Real Estate Loans									
	Construction and Land Development	Single- Family Residential	Single- Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm and All Other	Consumer and All Other	Unallocated	Total
Allowance for loan losses: Beginning balance	\$3,218	3,123	1,863	2,219	37	1,069	-	245	1,727	13,501
Charge-offs	(884)	(309)	(190)	(290)	-	(430)	-	(534)	-	(2,637)
Recoveries	428	72	16	171	-	54	-	176	-	917
Provision	23	(320)	(79)	(198)	(30)	405	-	346	(846)	(699)
Ending balance	\$2,785	2,566	1,610	1,902	7	1,098	-	233	881	11,082
Ending balance: individually evaluated for impairment	\$-	82	1,155	260	-	-	-	-	-	1,497
Ending balance: collectively evaluated for impairment	2,785	2,484	455	1,642	7	1,098	-	233	881	9,585
Ending balance	\$2,785	2,566	1,610	1,902	7	1,098	-	233	881	11,082
Loans: Ending balance	\$57,617	206,417	47,015	228,558	12,400	76,262	7	23,615	-	651,890

Ending  
balance:  
individually  
evaluated

for impairment	\$3,639	2,298	18,884	3,345	-	-	-	-	-	28,166
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Ending  
balance:  
collectively  
evaluated

for impairment	\$53,978	204,119	28,131	225,213	12,400	76,262	7	23,615	-	623,723
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The Bank utilizes an internal risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 1 to 8. These risk grades are evaluated on an ongoing basis. A description of the general characteristics of the eight risk grades is as follows:

- Risk Grade 1 – Excellent Quality: Loans are well above average quality and a minimal amount of credit risk exists. CD or cash secured loans or properly margined actively traded stock or bond secured loans would fall in this grade.
- Risk Grade 2 – High Quality: Loans are of good quality with risk levels well within the Company's range of acceptability. The organization or individual is established with a history of successful performance though somewhat susceptible to economic changes.

Risk Grade 3 – Good Quality: Loans of average quality with risk levels within the Company's range of acceptability but higher than normal. This may be a new organization or an existing organization in a transitional phase (e.g. expansion, acquisition, market change).

Risk Grade 4 – Management Attention: These loans have higher risk and servicing needs but still are acceptable. Evidence of marginal performance or deteriorating trends is observed. These are not problem credits presently, but may be in the future if the borrower is unable to change its present course.

Risk Grade 5 – Watch: These loans are currently performing satisfactorily, but there has been some recent past due history on repayment and there are potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Company's position at some future date.

Risk Grade 6 – Substandard: A Substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or the collateral pledged (if there is any). There is a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. There is a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Risk Grade 7 – Doubtful: Loans classified as Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.

Risk Grade 8 – Loss: Loans classified as Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be realized in the future. Loss is a temporary grade until the appropriate authority is obtained to charge the loan off.

The following tables present the credit risk profile of each loan type based on internally assigned risk grades as of December 31, 2016 and 2015.

December  
31, 2016  
(Dollars in  
thousands)

	Real Estate Loans									Total
	Construction and Land Development	Single-Family Residential	Single-Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer	All Other	
1- Excellent Quality	\$-	14,996	-	-	-	541	-	959	-	16,496
2- High Quality	9,784	109,809	-	39,769	2,884	26,006	-	3,335	2,507	194,094
3- Good Quality	33,633	82,147	16,703	176,109	14,529	55,155	-	4,842	10,921	394,039
4- Management Attention	10,892	25,219	15,580	24,753	2,355	5,586	-	619	1,749	86,753
5- Watch	7,229	4,682	3,943	4,906	1,201	246	-	31	-	22,238

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6-Substandard	211	3,847	3,963	1,984	78	62	-	42	-	10,187
7- Doubtful	-	-	-	-	-	-	-	-	-	-
8- Loss	-	-	-	-	-	-	-	4	-	4
Total	\$61,749	240,700	40,189	247,521	21,047	87,596	-	9,832	15,177	723,811

December  
31, 2015  
(Dollars in  
thousands)

Real Estate Loans

	Construction and Land Development	Single- Family Residential	Single- Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer	All Other	Total
1- Excellent Quality	\$-	15,189	-	-	-	700	-	1,091	-	16,980
2- High Quality	10,144	86,061	-	38,647	2,998	24,955	-	3,647	1,665	168,117
3- Good Quality	35,535	78,843	19,223	148,805	12,058	58,936	3	4,571	7,828	365,802
4- Management Attention	12,544	30,259	15,029	31,824	335	5,905	-	620	1,738	98,254
5- Watch	7,265	4,322	3,308	4,561	2,689	332	-	43	-	22,520
6- Substandard	303	6,016	6,173	4,689	-	182	-	55	-	17,418
7- Doubtful	-	-	-	-	-	-	-	-	-	-
8- Loss	-	-	-	-	-	-	-	-	-	-
Total	\$65,791	220,690	43,733	228,526	18,080	91,010	3	10,027	11,231	689,091

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TDR loans modified in 2016, past due TDR loans and non-accrual TDR loans totaled \$5.9 million and \$8.8 million at December 31, 2016 and December 31, 2015, respectively. The terms of these loans have been renegotiated to provide a concession to original terms, including a reduction in principal or interest as a result of the deteriorating financial position of the borrower. There were \$81,000 and \$354,000 in performing loans classified as TDR loans at December 31, 2016 and December 31, 2015, respectively.

The following table presents an analysis of loan modifications during the year ended December 31, 2016:

Year ended December 31, 2016  
(Dollars in thousands)

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans:			
Single-family residential	3	\$ 124	121
Total TDR loans	3	\$ 124	121

During the year ended December 31, 2016, three loans were modified that were considered to be new TDR loans. The interest rate was modified on these TDR loans.

The following table presents an analysis of loan modifications during the year ended December 31, 2015:

Year ended December 31, 2015  
(Dollars in thousands)

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans:			
Construction and land development	1	\$ 216	216
Single-family residential	3	288	271
Total TDR loans	4	\$ 504	487

During the year ended December 31, 2015, four loans were modified that were considered to be new TDR loans. The interest rate was modified on these TDR loans.

There were no TDR loans with a payment default occurring within 12 months of the restructure date, and the payment default occurring during the years ended December 31, 2016 and 2015. TDR loans are deemed to be in default if they become past due by 90 days or more.

#### (4) Premises and Equipment

Major classifications of premises and equipment at December 31, 2016 and 2015 are summarized as follows:

(Dollars in thousands)

	2016	2015
Land	\$3,670	3,669

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Buildings and improvements	16,398	15,889
Furniture and equipment	19,996	19,462
Total premises and equipment	40,064	39,020
Less accumulated depreciation	23,612	22,044
Total net premises and equipment	\$ 16,452	16,976

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The Company recognized approximately \$2.1 million in depreciation expense for the year ended December 31, 2016. Depreciation expense was approximately \$2.4 million and \$2.5 million for the years ended December 31, 2015 and 2014, respectively.

(5) Time Deposits

At December 31, 2016, the scheduled maturities of time deposits are as follows:

(Dollars in thousands)

2017	\$86,817
2018	33,184
2019	15,207
2020	5,287
2021 and thereafter	3,518
Total	\$144,013

At December 31, 2016 and 2015, the Bank had approximately \$7.2 million and \$4.3 million, respectively, in time deposits purchased through third party brokers, including certificates of deposit participated through the Certificate of Deposit Account Registry Service ("CDARS") on behalf of local customers. CDARS balances totaled \$7.2 million and \$4.1 million as of December 31, 2016 and 2015, respectively. The weighted average rate of brokered deposits as of December 31, 2016 and 2015 was 0.05% and 0.10%, respectively.

(6) Federal Home Loan Bank and Federal Reserve Bank Borrowings

The Bank has borrowings from the FHLB with monthly or quarterly interest payments at December 31, 2016. The FHLB borrowings are collateralized by a blanket assignment on all residential first mortgage loans, home equity lines of credit and loans secured by multi-family real estate that the Bank owns. At December 31, 2016, the carrying value of loans pledged as collateral totaled approximately \$128.3 million. The remaining availability under the line of credit with the FHLB was \$66.8 million at December 31, 2016.

Borrowings from the FHLB outstanding at December 31, 2016 and 2015 consist of the following:

December 31, 2016

(Dollars in thousands)

<u>Maturity Date</u>	<u>Call Date</u>	<u>Rate</u>	<u>Rate Type</u>	<u>Amount</u>
October 17, 2018	N/A	4.050%	Adjustable Rate Hybrid	\$5,000
October 17, 2018	N/A	4.065%	Adjustable Rate Hybrid	5,000
October 17, 2018	N/A	4.120%	Adjustable Rate Hybrid	5,000
May 8, 2018	N/A	2.683%	Adjustable Rate Hybrid	5,000
				\$20,000

December 31, 2015

(Dollars in thousands)

<u>Maturity Date</u>	<u>Call Date</u>	<u>Rate</u>	<u>Rate Type</u>	<u>Amount</u>
October 17, 2018	N/A	3.485%	Adjustable Rate Hybrid	\$5,000
October 17, 2018	N/A	3.725%	Adjustable Rate Hybrid	15,000
October 17, 2018	N/A	3.500%	Adjustable Rate Hybrid	5,000
October 17, 2018	N/A	3.555%	Adjustable Rate Hybrid	5,000
May 8, 2018	N/A	2.144%	Adjustable Rate Hybrid	5,000
May 8, 2018	N/A	3.734%	Floating to Fixed	8,500
				\$43,500

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The Bank is required to purchase and hold certain amounts of FHLB stock in order to obtain FHLB borrowings. No ready market exists for the FHLB stock, and it has no quoted market value. The stock is redeemable at \$100 per share subject to certain limitations set by the FHLB. The Bank owned \$1.8 million and \$2.8 million of FHLB stock, included in other investments, at December 31, 2016 and 2015, respectively.

The Bank prepaid FHLB borrowings totaling \$23.5 million in 2016 with prepayment penalties totaling \$1.3 million. The Bank prepaid FHLB borrowings totaling \$6.5 million in 2015 with prepayment penalties totaling \$504,000.

As of December 31, 2016 and 2015, the Bank had no borrowings from the Federal Reserve Bank ("FRB"). FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At December 31, 2016, the carrying value of loans pledged as collateral totaled approximately \$374.5 million. Availability under the line of credit with the FRB was \$289.7 million at December 31, 2016.

(7) Junior Subordinated Debentures

In June 2006, the Company formed a second wholly owned Delaware statutory trust, PEBK Capital Trust II ("PEBK Trust II"), which issued \$20.0 million of guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures. All of the common securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase \$20.6 million of junior subordinated debentures of the Company. The proceeds received by the Company from the sale of the junior subordinated debentures were used to repay in December 2006 the trust preferred securities issued in December 2001 by PEBK Capital Trust, a wholly owned Delaware statutory trust of the Company, and for general purposes. The debentures represent the sole assets of PEBK Trust II. PEBK Trust II is not included in the consolidated financial statements.

The trust preferred securities issued by PEBK Trust II accrue and pay interest quarterly at a floating rate of three-month LIBOR plus 163 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust II does not have funds with which to make the distributions and other payments. The net combined effect of all the documents entered into in connection with the trust preferred securities is that the Company is liable to make the distributions and other payments required on the trust preferred securities.

These trust preferred securities are mandatorily redeemable upon maturity of the debentures on June 28, 2036, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust II, in whole or in part, which became effective on June 28, 2011. As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be the principal amount plus any accrued but unpaid interest.

(8) Income Taxes

The provision for income taxes is summarized as follows:

(Dollars in thousands)

	2016	2015	2014
Current expense	\$1,464	2,427	1,759
Deferred income tax expense	1,097	673	178
Total income tax	\$2,561	3,100	1,937

The differences between the provision for income taxes and the amount computed by applying the statutory federal income tax rate to earnings before income taxes are as follows:

(Dollars in thousands)

	2016	2015	2014
Tax expense at statutory rate (34%)	\$3,991	4,329	3,851
State income tax, net of federal income tax effect	339	494	(283 )
Tax-exempt interest income	(1,681)	(1,682)	(1,630)
Increase in cash surrender value of life insurance	(138 )	(143 )	(143 )
Nondeductible interest and other expense	78	103	119
Other	(28 )	(1 )	23
Total	\$2,561	3,100	1,937

The following summarizes the tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities. The net deferred tax asset is included as a component of other assets at December 31, 2016 and 2015.

(Dollars in thousands)

	2016	2015
Deferred tax assets:		
Allowance for loan losses	\$2,717	3,513
Accrued retirement expense	1,616	1,574
Other real estate	-	33
Federal credit carryforward	326	-
State credit carryforward	14	-
Restricted stock	745	417
Accrued bonuses	216	238
Interest income on nonaccrual loans	27	88
Other than temporary impairment	14	374
Other	23	16
Total gross deferred tax assets	5,698	6,253
Deferred tax liabilities:		
Deferred loan fees	797	588
Accumulated depreciation	532	172
Prepaid expenses	78	59
Other	23	70
Unrealized gain on available for sale securities	1,807	3,308
Total gross deferred tax liabilities	3,237	4,197
Net deferred tax asset	\$2,461	2,056

The Company has analyzed the tax positions taken or expected to be taken in its tax returns and has concluded that it has no liability related to uncertain tax positions.

The Company's tax filings for years 2013 through 2016 were at year end 2016 open to audit under statutes of limitations by the Internal Revenue Service and State taxing authorities.

(9) Related Party Transactions

The Company conducts transactions with its directors and executive officers, including companies in which they have beneficial interests, in the normal course of business. It is the policy of the Company that loan transactions with directors and officers are made on substantially the same terms as those prevailing at the time made for comparable loans to other persons. The following is a summary of activity for related party loans for 2016 and 2015:

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(Dollars in thousands)

	2016	2015
Beginning balance	\$5,674	6,055
New loans	6,048	7,857
Repayments	(7,219)	(8,238)
Ending balance	\$4,503	5,674

At December 31, 2016 and 2015, the Company had deposit relationships with related parties of approximately \$27.8 million and \$22.1 million, respectively.

A Director of the Company is an officer and partial owner of the construction company engaged to renovate the Bank's Corporate Center located at 518 West C Street, Newton, North Carolina. During 2016 the Company paid a total of approximately \$209,000 to this construction company for such renovation work. At December 31, 2016, the remaining commitment to this construction company for renovation work not yet completed was approximately \$2.2 million.

#### (10) Commitments and Contingencies

The Company leases various office spaces for banking and operational facilities and equipment under operating lease arrangements. Future minimum lease payments required for all operating leases having a remaining term in excess of one year at December 31, 2016 are as follows:

(Dollars in thousands)

Year ending December 31,	
2017	\$632
2018	611
2019	601
2020	602
2021	591
Thereafter	1,611
Total minimum obligation	\$4,648

Total rent expense was approximately \$752,000, \$702,000 and \$691,000 for the years ended December 31, 2016, 2015 and 2014, respectively.

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and financial guarantees. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

The exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit and financial guarantees written is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

In most cases, the Bank requires collateral or other security to support financial instruments with credit risk.

(Dollars in thousands)

	Contractual Amount	
	2016	2015
Financial instruments whose contract amount represent credit risk:		
Commitments to extend credit	\$195,528	189,351
Standby letters of credit and financial guarantees written	\$3,728	3,872

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Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and because they may expire without being drawn upon, the total commitment amount of \$199.3 million does not necessarily represent future cash requirements.

Standby letters of credit and financial guarantees written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to businesses in the Bank's delineated market area. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds real estate, equipment, automobiles and customer deposits as collateral supporting those commitments for which collateral is deemed necessary.

In the normal course of business, the Company is a party (both as plaintiff and defendant) to a number of lawsuits. In the opinion of management and counsel, none of these cases should have a material adverse effect on the financial position of the Company.

Bancorp and the Bank have employment agreements with certain key employees. The agreements, among other things, include salary, bonus, incentive compensation, and change in control provisions.

The Company has \$59.5 million available for the purchase of overnight federal funds from five correspondent financial institutions as of December 31, 2016.

At December 31, 2016, the Bank has a commitment to invest \$3 million in an income tax credit partnership owning and developing two multifamily housing developments in Charlotte, North Carolina, with \$1.5 million allocated to each property. The Bank funded \$136,000 of this commitment in 2016.

#### (11) Employee and Director Benefit Programs

The Company has a profit sharing and 401(k) plan for the benefit of substantially all employees subject to certain minimum age and service requirements. Under the 401(k) plan, the Company matched employee contributions to a maximum of 4.00% of annual compensation in 2014, 2015 and 2016. The Company's contribution pursuant to this formula was approximately \$565,000, \$539,000 and \$439,000 for the years 2016, 2015 and 2014, respectively. Investments of the 401(k) plan are determined by a committee comprised of senior management. No investments in Company stock have been made by the 401(k) plan. Prior to January 1, 2015, the vesting schedule for the 401(k) plan began at 20 percent after two years of employment and graduated 20 percent each year until reaching 100 percent after six years of employment. Effective January 1, 2015, contributions to the 401(k) plan are vested immediately.

In December 2001, the Company initiated a postretirement benefit plan to provide retirement benefits to key officers and its Board of Directors and to provide death benefits for their designated beneficiaries. Under the postretirement benefit plan, the Company purchased life insurance contracts on the lives of the key officers and each director. The increase in cash surrender value of the contracts constitutes the Company's contribution to the postretirement benefit plan each year. Postretirement benefit plan participants are to be paid annual benefits for a specified number of years commencing upon retirement. Expenses incurred for benefits relating to the postretirement benefit plan were approximately \$428,000, \$413,000 and \$422,000 for the years 2016, 2015 and 2014, respectively.

The Company is currently paying medical benefits for certain retired employees. The Company did not incur any postretirement medical benefits expense in 2016, 2015 and 2014 due to an excess accrual balance.

The following table sets forth the change in the accumulated benefit obligation for the Company's two postretirement benefit plans described above:

(Dollars in thousands)

	2016	2015
Benefit obligation at beginning of period	\$3,993	3,812
Service cost	346	334
Interest cost	67	65
Benefits paid	(232 )	(218 )
Benefit obligation at end of period	\$4,174	3,993

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The amounts recognized in the Company's Consolidated Balance Sheet as of December 31, 2016 and 2015 are shown in the following two tables:

(Dollars in thousands)

	2016	2015
Benefit obligation	\$4,174	3,993
Fair value of plan assets	-	-

(Dollars in thousands)

	2016	2015
Funded status	\$(4,174)	(3,993)
Unrecognized prior service cost/benefit	-	-
Unrecognized net actuarial loss	-	-
Net amount recognized	\$(4,174)	(3,993)
Unfunded accrued liability	\$(4,174)	(3,993)
Intangible assets	-	-
Net amount recognized	\$(4,174)	(3,993)

Net periodic benefit cost of the Company's postretirement benefit plans for the years ended December 31, 2016, 2015 and 2014 consisted of the following:

(Dollars in thousands)

	2016	2015	2014
Service cost	\$346	334	348
Interest cost	67	65	67
Net periodic cost	\$413	399	415

Weighted average discount rate assumption

used to determine benefit obligation 5.47% 5.47% 5.47%

The Company paid benefits under the two postretirement plans totaling \$232,000 and \$218,000 during the years ended December 31, 2016 and 2015, respectively. Information about the expected benefit payments for the Company's two postretirement benefit plans is as follows:

(Dollars in thousands)

Year ending December 31,	
2017	\$263
2018	\$275
2019	\$310
2020	\$363
2021	\$364
Thereafter	\$9,077



(12) Regulatory Matters

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

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Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios of capital in relation to both on- and off-balance sheet items at various risk weights. Total capital consists of two tiers of capital. Tier 1 Capital includes common shareholders' equity and trust preferred securities less adjustments for intangible assets. Tier 2 Capital consists of the allowance for loan losses, up to 1.25% of risk-weighted assets and other adjustments. Management believes, as of December 31, 2016, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2016, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the table below. There have been no conditions or events since that notification that management believes have changed the Bank's category.

In 2013, the Federal Reserve Board approved its final rule on the Basel III capital standards, which implement changes to the regulatory capital framework for banking organizations. The Basel III capital standards, which became effective January 1, 2015, include new risk-based capital and leverage ratios, which will be phased in from 2015 to 2019. The new minimum capital level requirements applicable to the Company and the Bank under the final rules are as follows: (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 risk based capital ratio of 8% (unchanged from previous rules); and (iv) a Tier 1 leverage ratio of 4% (unchanged from previous rules). An additional capital conservation buffer will be added to the minimum requirements for capital adequacy purposes beginning on January 1, 2016 at 0.625% and will be phased in through 2019 (increasing by 0.625% on each subsequent January 1, until it reaches 2.5% on January 1, 2019). This will result in the following minimum ratios beginning in 2019: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. Under the final rules, institutions would be 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 earnings that could be utilized for such actions.

The Company's and the Bank's actual capital amounts and ratios are presented below:

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(Dollars in thousands)

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2016:						
Total Capital (to Risk-Weighted Assets)						
Consolidated	\$ 131,991	16.12%	65,508	8.00%	N/A	N/A
Bank	\$ 129,035	15.78%	65,426	8.00%	81,782	10.00%
Tier 1 Capital (to Risk-Weighted Assets)						
Consolidated	\$ 124,441	15.20%	49,131	6.00%	N/A	N/A
Bank	\$ 121,485	14.85%	49,069	6.00%	65,426	8.00%
Tier 1 Capital (to Average Assets)						
Consolidated	\$ 124,441	11.19%	44,488	4.00%	N/A	N/A
Bank	\$ 121,485	10.88%	44,677	4.00%	55,846	5.00%
Common Equity Tier 1 (to Risk-Weighted Assets)						
Consolidated	\$ 104,441	12.75%	36,848	4.50%	N/A	N/A
Bank	\$ 121,485	14.85%	36,802	4.50%	53,158	6.50%

As of December 31, 2015:

Total Capital (to Risk-Weighted Assets)						
Consolidated	\$ 129,203	16.63%	62,137	8.00%	N/A	N/A
Bank	\$ 124,910	16.11%	62,026	8.00%	77,532	10.00%
Tier 1 Capital (to Risk-Weighted Assets)						
Consolidated	\$ 119,354	15.37%	46,603	6.00%	N/A	N/A
Bank	\$ 115,160	14.85%	46,519	6.00%	62,026	8.00%
Tier 1 Capital (to Average Assets)						
Consolidated	\$ 119,354	11.44%	41,743	4.00%	N/A	N/A
Bank	\$ 115,160	11.03%	41,776	4.00%	52,220	5.00%
Common Equity Tier 1 (to Risk-Weighted Assets)						
Consolidated	\$ 99,354	12.79%	34,952	4.50%	N/A	N/A
Bank	\$ 115,160	14.85%	34,890	4.50%	50,396	6.50%

On August 31, 2015, the FDIC and the Commissioner issued a Consent Order (the "Order") in connection with compliance by the Bank with the Bank Secrecy Act and its implementing regulations (collectively, the "BSA"). The Order was issued pursuant to the consent of the Bank. In consenting to the issuance of the Order, the Bank did not admit or deny any unsafe or unsound banking practices or violations of law or regulation.

The Order requires the Bank to take certain affirmative actions to comply with its obligations under the BSA, including, without limitation, strengthening its Board of Directors' oversight of BSA activities; reviewing, enhancing, adopting and implementing a revised BSA compliance program; completing a BSA risk assessment; developing a

revised system of internal controls designed to ensure full compliance with the BSA; reviewing and revising customer due diligence and risk assessment processes, policies and procedures; developing, adopting and implementing effective BSA training programs; assessing BSA staffing needs and resources and appointing a qualified BSA officer; establishing an independent BSA testing program; ensuring that all reports required by the BSA are accurately and properly filed and engaging an independent firm to review past account activity to determine whether suspicious activity was properly identified and reported.

Prior to implementation, certain of the actions described above are subject to review by and approval or non-objection from the FDIC and the Commissioner. The Order will remain in effect and be enforceable until it is modified, terminated, suspended or set aside by the FDIC and the Commissioner.

The Bank continues to make progress in addressing the issues identified in the Order and expects that it will be able to undertake and implement all required actions within the time period specified in the Order. The Bank has incurred and will continue to incur additional non-interest expenses associated with the implementation of corrective actions; however, these expenses are not expected to have a significant impact on the results of operations or financial position of the Company. Operating under the Order will limit the Company's ability to participate in acquisitions, to open new branches, and to allocate funds to its stock repurchase plan until such time as the Order has been modified, terminated, suspended or set aside by the FDIC and the Commissioner.

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## (13) Shareholders' Equity

Shareholders' equity was \$107.4 million, or 9.9% of total assets, as of December 31, 2016, compared to \$104.9 million, or 10.1% of total assets, as of December 31, 2015. The increase in shareholders' equity is primarily due to an increase in retained earnings due to net income, which was partially offset by a decrease in accumulated other comprehensive income resulting from a decrease in the unrealized gain on investment securities and a \$2.0 million decrease in common stock due to 92,738 shares of common stock being repurchased under the Company's stock repurchase program implemented during the second quarter of 2016.

Annualized return on average equity for the year ended December 31, 2016 was 8.11% compared to 9.03% for the year ended December 31, 2015. Total cash dividends paid on common stock were \$2.1 million and \$1.6 million for the years ended December 31, 2016 and 2015, respectively.

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights. The Board of Directors does not currently anticipate issuing any additional series of preferred stock.

In 2014, the Company's Board of Directors authorized a stock repurchase program ("the 2014 Stock Repurchase Program"), pursuant to which up to \$2 million was allocated to repurchase the Company's common stock. All purchases under the 2014 Stock Repurchase Program were made periodically as permitted by securities laws and other legal requirements in the open market or in privately negotiated transactions. The timing and amount of the repurchase of shares was determined by the Company's management, based on its evaluation of market conditions and other factors. The Company had repurchased approximately \$2.0 million, or 106,587 shares of its common stock, under the 2014 Stock Repurchase Program as of December 31, 2015.

In the second quarter of 2016, the Company's Board of Directors authorized another stock repurchase program ("the 2016 Stock Repurchase Program"), pursuant to which up to \$2 million was allocated to repurchase the Company's common stock. All purchases under the 2016 Stock Repurchase Program were made periodically as permitted by securities laws and other legal requirements in the open market or in privately negotiated transactions. The timing and amount of any repurchase of shares was determined by the Company's management, based on its evaluation of market conditions and other factors. The Company repurchased approximately \$2.0 million, or 92,738 shares of its common stock, under the 2016 Stock Repurchase Program during 2016.

## (14) Other Operating Income and Expense

Miscellaneous non-interest income for the years ended December 31, 2016, 2015 and 2014 included the following items that exceeded one percent of total revenues at some point during the following three-year period:

(Dollars in thousands)

	2016	2015	2014
Visa debit card income	\$3,589	3,452	3,170
Net appraisal management fee income	\$886	635	525
Insurance and brokerage commissions	\$631	713	701

Other non-interest expense for the years ended December 31, 2016, 2015 and 2014 included the following items that exceeded one percent of total revenues at some point during the following three-year period:

(Dollars in thousands)

	2016	2015	2014
Advertising	\$1,136	784	804

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FDIC insurance	\$494	681	739
Visa debit card expense	\$1,140	988	905
Telephone	\$754	588	574
Foreclosure/OREO expense	\$120	398	317
Internet banking expense	\$710	671	644
FHLB advance prepayment penalty	\$1,260	504	869
Consulting	\$2,257	904	609
NC Tax Credit Amortization	\$-	-	870

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(15) Fair Value of Financial Instruments

The Company is required to disclose fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company's financial instruments are detailed below. Where quoted prices are not available, fair values are based on estimates using discounted cash flows and other valuation techniques. The use of discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following disclosures should not be considered a surrogate of the liquidation value of the Company, but rather a good faith estimate of the increase or decrease in the value of financial instruments held by the Company since purchase, origination, or issuance.

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Cash and Cash Equivalents

For cash, due from banks and interest-bearing deposits, the carrying amount is a reasonable estimate of fair value. Cash and cash equivalents are reported in the Level 1 fair value category.

Investment Securities Available for Sale

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Fair values for investment securities with quoted market prices are reported in the Level 1 fair value category. Fair value measurements obtained from independent pricing services are reported in the Level 2 fair value category. All other fair value measurements are reported in the Level 3 fair value category.

Other Investments

For other investments, the carrying value is a reasonable estimate of fair value. Other investments are reported in the Level 3 fair value category.

Mortgage Loans Held for Sale

Mortgage loans held for sale are carried at lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value. Mortgage loans held for sale are reported in the Level 3 fair value category.

Loans

The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. For variable rate loans, the carrying amount is a reasonable estimate of fair value. Loans are reported in the Level 3 fair value category, as the pricing of loans is more subjective than the pricing of other financial instruments.

Cash Surrender Value of Life Insurance

For cash surrender value of life insurance, the carrying value is a reasonable estimate of fair value. Cash surrender value of life insurance is reported in the Level 2 fair value category.

Other Real Estate

The fair value of other real estate is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. Other real estate is reported in the Level 3 fair value category.

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### Deposits

The fair value of demand deposits, interest-bearing demand deposits and savings is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. Deposits are reported in the Level 2 fair value category.

### Securities Sold Under Agreements to Repurchase

For securities sold under agreements to repurchase, the carrying value is a reasonable estimate of fair value. Securities sold under agreements to repurchase are reported in the Level 2 fair value category.

### FHLB Borrowings

The fair value of FHLB borrowings is estimated based upon discounted future cash flows using a discount rate comparable to the current market rate for such borrowings. FHLB borrowings are reported in the Level 2 fair value category.

### Junior Subordinated Debentures

Because the Company's junior subordinated debentures were issued at a floating rate, the carrying amount is a reasonable estimate of fair value. Junior subordinated debentures are reported in the Level 2 fair value category.

### Commitments to Extend Credit and Standby Letters of Credit

Commitments to extend credit and standby letters of credit are generally short-term and at variable interest rates. Therefore, both the carrying value and estimated fair value associated with these instruments are immaterial.

### Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on many judgments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial instruments include deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

The fair value presentation for recurring assets is presented in Note 2. There were no recurring liabilities at December 31, 2016 and 2015. The fair value presentation for non-recurring assets is presented in Note 3. There were no non-recurring liabilities at December 31, 2016 and 2015. The carrying amount and estimated fair value of the Company's financial instruments at December 31, 2016 and 2015 are as follows:

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(Dollars in thousands)

	Carrying Amount	Fair Value Measurements at December 31, 2016			
		Level 1	Level 2	Level 3	Total
Assets:					
Cash and cash equivalents	\$70,094	70,094	-	-	70,094
Investment securities available for sale	\$249,946	-	249,196	750	249,946
Other investments	\$2,635	-	-	2,635	2,635
Mortgage loans held for sale	\$5,709	-	-	5,709	5,709
Loans, net	\$716,261	-	-	720,675	720,675
Cash surrender value of life insurance	\$14,952	-	14,952	-	14,952
Liabilities:					
Deposits	\$892,918	-	-	884,510	884,510
Securities sold under agreements to repurchase	\$36,434	-	36,434	-	36,434
FHLB borrowings	\$20,000	-	18,864	-	18,864
Junior subordinated debentures	\$20,619	-	20,619	-	20,619

(Dollars in thousands)

	Carrying Amount	Fair Value Measurements at December 31, 2015			
		Level 1	Level 2	Level 3	Total
Assets:					
Cash and cash equivalents	\$39,763	39,763	-	-	39,763
Investment securities available for sale	\$268,530	1,325	266,455	750	268,530
Other investments	\$3,636	-	-	3,636	3,636
Mortgage loans held for sale	\$4,149	-	-	4,149	4,149
Loans, net	\$679,502	-	-	683,540	683,540
Cash surrender value of life insurance	\$14,546	-	14,546	-	14,546
Liabilities:					
Deposits	\$832,175	-	-	827,874	827,874
Securities sold under agreements to repurchase	\$27,874	-	27,874	-	27,874
FHLB borrowings	\$43,500	-	43,144	-	43,144
Junior subordinated debentures	\$20,619	-	20,619	-	20,619

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## (16) Peoples Bancorp of North Carolina, Inc. (Parent Company Only) Condensed Financial Statements

## Balance Sheets

December 31, 2016 and 2015  
(Dollars in thousands)

<u>Assets</u>	<u>2016</u>	<u>2015</u>
Cash	\$957	553
Interest-bearing time deposit	1,000	1,000
Investment in subsidiaries	124,471	121,848
Investment in PEBK Capital Trust II	619	619
Investment securities available for sale	750	1,234
Other assets	275	249
Total assets	\$128,072	125,503

Liabilities and Shareholders' Equity

Junior subordinated debentures	\$20,619	20,619
Liabilities	25	20
Shareholders' equity	107,428	104,864
Total liabilities and shareholders' equity	\$128,072	125,503

## Statements of Earnings

For the Years Ended December 31, 2016, 2015 and 2014  
(Dollars in thousands)

Revenues:	<u>2016</u>	<u>2015</u>	<u>2014</u>
Interest and dividend income	\$4,569	3,979	2,718
Gain on sale of securities	405	-	-
Total revenues	4,974	3,979	2,718
Expenses:			
Interest	485	403	389
Other operating expenses	513	538	527
Total expenses	998	941	916
Income before income tax benefit and equity in undistributed earnings of subsidiaries	3,976	3,038	1,802
Income tax benefit	178	262	239

Income before equity in undistributed earnings of subsidiaries	4,154	3,300	2,041
Equity in undistributed earnings of subsidiaries	5,023	6,333	7,347
Net earnings	\$9,177	9,633	9,388

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Statements of Cash  
Flows

For the Years Ended  
December 31, 2016,  
2015 and 2014  
(Dollars in  
thousands)

2016&#1