# 2018

# ANNUAL REPORT


*Beaver Creek Plantation Corporate Headquarters*

## Proud of the Past Focused on the Future

Carter Bank & Trust

Carter Bank & Trust

## To Our Shareholders:

Midway through 2017, when much of the current senior management team was newly in place, we outlined a strategic plan to address the many issues that were negatively impacting the financial performance of your Bank. These issues included an inordinately high level of nonperforming and problem assets, an inadequate technology infrastructure, regulatory non-compliance with the requirements of the Bank Secrecy Act ("BSA"), poorly structured segments of the balance sheet, and a net interest margin well below our peers. At that time we set in motion several strategic initiatives designed to address these and other issues. We also communicated back then that it was our belief that our plan would take 36 months to fully unfold and allow the financial performance of Carter Bank & Trust to begin to normalize. The end of 2018 marked the halfway point of that 36 month period. It is the belief of management and the Board of Directors ("the Board") that we are very much on track with our plan. While there is still much work to be done, there are many positives that can be highlighted that support the excitement we have for the future of Carter Bank & Trust.

Credit quality metrics showed marked improvement in 2018. Nonperforming loans decreased by $42.2 million during 2018 from $92.9 million at the end of 2017 to $50.7 million at the end of 2018. As a percentage of portfolio loans this is a reduction from 3.46% at year-end 2017 to 1.88% at year-end 2018. Total adversely classified loans were reduced by $344.5 million in 2018 from $816.1 million at year-end 2017 to $471.6 million at year-end 2018. While this number remains elevated, we expect the positive trending to continue. The allowance for loan losses (ALL) was 1.45% of total loans as of December 31, 2018 as compared to 1.32% as of December 31, 2017. The ALL was 77.3% of nonperforming loans as of year-end 2018. This figure is up from 38.0% as of year-end 2017. While trending positively, the risk profile of the loan portfolio remains high and improving the credit quality of our loan portfolio remains one of our highest priorities.

On the technology front, 2018 was an extremely active year. Nearly every system was either upgraded or completely replaced during the year: accounting systems, a document imaging platform, data and phone infrastructure, and risk management systems. These efforts culminated in November of 2018 when we converted our core operating system. This was a significant event in our efforts to transform your Bank into one that can operate efficiently and effectively in today's competitive banking environment. Thousands of man hours – much of which was outside of normal business hours – went into making all of these conversions successful with minimal disruption to both our customers and our employees. We are now better positioned to offer a more competitive array of products and services and more convenient access for our customers. We are also more operationally sound than ever. Examples of the enhancements that have resulted from our improved technology infrastructure are our Mobile & Online platform which went live in February of 2019 and our Customer Contact Center which went live in August of 2018. To date, we have had over 22,000 customers enroll in our Mobile & Online platform and enrollment continues to be brisk. The Customer Contact Center serves our customer base by handling over 800 calls daily. In 2019, look for more enhancements to come as we roll out commercial cash management, online account opening, automated debit card controls, and more.

The improved technology infrastructure also improves our ability to meet the industry regulatory compliance requirements. Along with our core conversion in November of 2018, we also implemented a new automated Bank Secrecy Act /Anti-Money Laundering monitoring system. This system allows us to effectively track and monitor all transactions conducted in the Bank. We believe this system is the final component that will enable us to achieve full compliance with the Consent Order for BSA non-compliance. The feedback thus far from our regulators has been very positive. We will know more regarding any movement on the Consent Order once we receive the results of our safety and soundness exam later this year.

In addition to the improvement in the risk profile of our loan portfolio mentioned earlier, other efforts to improve the composition of the balance sheet also yielded success. Our bond portfolio composition continued to improve with more diversity in terms of bond type as compared to year-end 2017. In addition, the rate structures have been diversified as evidenced by the fact that now 20% of our portfolio is on a floating rate structure. A year ago 100% of our portfolio had a fixed rate structure. Overall, we were also successful in shifting our asset mix into higher yielding assets such as loans. Even with the significant reduction in problem loans during 2018, we were able to grow our loan portfolio in 2018 by $19.3 million. Portfolio loans represented 72.4% of earning assets as of December 31, 2018 as compared to 69.9% as of December 31, 2017. Our goal is to eventually increase loans as a percentage of earning assets to 80%.

Our deposit mix also continues to be a key focus. Our ability to offer our customers a more diverse array of products and services will allow us to reduce our significant reliance on higher cost funding. Now that our Mobile & Online platform is live, we can put greater emphasis on the acquisition of transaction accounts – a more cost effective funding source. Currently certificates of deposits represent 58.4% of our total deposits and noninterest bearing deposits represent 14.6% of total deposits. Our ability to now offer Mobile & Online access will enable us to be better equipped to achieve our goal of 35% and 25% for certificates of deposits and noninterest bearing accounts, respectively.

Improvement in the net interest margin continued during 2018. The net interest margin for 2018 was 3.10%. This is a 30 basis points increase over the 2.80% margin in 2017. This improvement was a result of our focused efforts to deploy excess cash in higher yielding assets as well as our controlled runoff of higher cost deposits. Changing the mix of our deposits, as discussed earlier, is critical to our goal of achieving a net income margin comparable to that of our high performing peer banks. With approximately 90% of our revenue coming from our net interest income, continued improvement in our net interest margin is critical to the overall profitability of your Bank.

From an earnings perspective, the financial performance of your Bank in 2018 fell short of where we strive to be. Net income was negatively impacted by additional write-downs in the loan portfolio and other real estate owned. It is important to note that pre-tax pre-provision earnings were solid at $31.2 million during 2018. The core earning power of your Bank continues to be sound. These significant write-downs are, for the most part, behind us and you will begin to see normalized earnings as the many initiatives that I have highlighted in this letter begin to gain traction.

The Bank remains well capitalized. The Bank's Tier 1 Capital ratio increased to 13.97% as of December 31, 2018 as compared to 12.93% as of December 31, 2017. The Bank's leverage ratio was 9.69% as of December 31, 2018 as compared to 9.33% as of December 31, 2017. The Bank's Total Risk-Based Capital ratio was 15.22% as of December 31, 2018 as compared to 14.15% as of December 31, 2017. While the capital levels of the Bank remain strong, management and the Board continue to believe that a strategy of capital retention remains the appropriate strategy for the foreseeable future given the Bank's level of problem assets and overall risk profile.

Thank you for your investment in Carter Bank & Trust. We trust that you find this letter informative and you are pleased with the progress we are making. We also trust you are pleased with your investment in Carter Bank & Trust. Overall the market has responded favorably to our efforts as reflected in the fact that our market capitalization recently exceeded $500 million. Our transition to the Nasdaq Global Select Market ("Nasdaq") has been a success. Volume and price trends for our common stock are both positive since the move to Nasdaq on March 25th, 2019. If you are a customer of Carter Bank & Trust, thank you for your patronage. I hope that you have taken advantage of the convenience of "Carter on the Go" – our new online/mobile platform. If you have not enrolled, I encourage you to do so. You will find this platform very user friendly and it will allow you to conduct banking business anytime and anywhere. If you are not a customer of your Bank, I encourage you to visit one of our many convenient offices and become a customer. I believe that you will find our product offerings very competitive and our employees willing and able to make it easy to switch to Carter Bank & Trust.

Overall, we believe 2018 was a successful year. While there is much work to be done, we have made progress on several fronts. Management and the Board believe that your Bank is better prepared now than ever before to be successful in today's banking environment. There was a lot of work that went into achieving many of the successes I have mentioned. Many thanks to the hard working and dedicated employees that made this happen. There is no doubt that one of our continuing competitive advantages is our excellent staff. I feel very blessed to be able to come to work every day with such a fine group of people who are committed to honoring the over 45 year legacy of this Bank. We are confident that 2019 and beyond will be exciting and successful for your Bank. We all continue to be **Proud of the Past and Focused on the Future!**

Litz H. Van Dyke
Chief Executive Officer

Phyllis Q. Karavatakis
President & Chief Banking Officer
Vice Chairman of the Board

James W. Haskins
Chairman of the Board

**NOTICE TO HOLDERS OF SHARES OF COMMON STOCK OF**

**Carter Bank & Trust**

1300 KINGS MOUNTAIN ROAD
MARTINSVILLE, VIRGINIA 24112



NOTICE IS HEREBY GIVEN that pursuant to its Bylaws and call of its Directors, the 2019 Annual Meeting of Shareholders of CARTER BANK & TRUST, Martinsville, Virginia will be held at the **Frith Center at Patrick Henry Community College, 645 Patriot Ave., Martinsville, Virginia 24112, Wednesday, June 26, 2019 at 10:00 a.m.**, for the purposes of considering and voting upon the following matters:

1. To elect the 13 persons listed in the proxy statement dated May 24, 2019 to serve as Directors of the Bank until the 2020 Annual Meeting of Shareholders.
2. To ratify the appointment of the independent registered public accounting firm of Crowe LLP as the independent auditors of the Bank for the fiscal year ending December 31, 2019.
3. To transact such other business as may be properly brought before the meeting or any adjournment thereof. The Board of Directors at the present knows of no other business to be presented at the Annual Meeting.

Only those shareholders of record at the close of business on April 30, 2019 shall be entitled to notice of the meeting and to vote at the meeting or any adjournment thereof.

**Important Notice Regarding the Availability of Proxy Materials for the Shareholders' Meeting to be held June 26, 2019.** The 2019 Proxy Statement, Proxy Card, and Annual Report to Shareholders for the year ended December 31, 2018, are also available at www.carterbankandtrust.com.

By Order of the Board of Directors

James W. Haskins

**James W. Haskins**
**Chairman of the Board**

May 24, 2019

**CARTER BANK & TRUST**
**1300 Kings Mountain Road**
**Martinsville, Virginia 24112**
**PROXY STATEMENT**

**FIRST MAILED ON OR ABOUT MAY 24, 2019**
**FOR THE 2019 ANNUAL MEETING OF SHAREHOLDERS**

This proxy statement is furnished in connection with the solicitation of the proxies to be used at the 2019 Annual Meeting of Shareholders (the "Annual Meeting") of Carter Bank & Trust, Martinsville, Virginia (the "Bank") to be held June 26, 2019. The Bank is a banking institution, incorporated under Virginia law.

Proxies in the form enclosed herewith are solicited by the Board of Directors (or the "Board") of the Bank. In addition to the solicitation of proxies by this proxy statement, officers and regular employees of the Bank may solicit proxies from shareholders in person, by telephone, or by mail, acting without any compensation other than their regular compensation. The cost of soliciting proxies will be borne by the Bank. To obtain directions to attend the Annual Meeting and vote in person, please contact Tammy C. Ingram, Vice President & Accounting Operations Manager of the Bank, at 276-226-2097.

If the enclosed proxy is properly signed and returned to the Bank, the shares represented thereby will be voted at the Annual Meeting in accordance with the specifications made on the proxy. When no choice is indicated, the proxy will be voted "FOR" all Director nominees in Proposal 1, "FOR" Proposal 2 and according to the recommendations of the Board of Directors on any other matter that may properly come before the meeting or any adjournment thereof. Any proxy given pursuant to this solicitation may be revoked at any time prior to the voting by submitting a subsequently dated proxy or by delivering a notification of revocation in writing to the Board, or by attending the meeting and requesting to vote the shares in person.

The number of shares of common stock outstanding and entitled to vote at the 2019 Annual Meeting of Shareholders is 26,333,929 as of the record date. Only those shareholders of record at the close of business April 30, 2019 shall be entitled to vote at the meeting.

A majority of the shares entitled to be voted, represented in person or by proxy, will constitute a quorum for the transaction of business at the meeting. Each share is entitled to one vote upon each matter to be presented at the meeting.

With regard to the election of Directors, votes may be cast in favor of any given Director or withheld. If a quorum is present, the nominees receiving the greatest number of the votes cast (even if less than a majority) will be elected Directors; therefore, votes withheld will have no effect.

For the ratification of the selection of independent registered public accounting firm Crowe LLP as the independent auditors of the Bank for the 2019 fiscal year votes may be cast in favor or against, or you may abstain from voting. If a quorum is present, the proposal to ratify the selection of Crowe LLP as the Bank's independent registered public accounting firm will be approved if the votes cast in favor of the proposal exceed the votes cast against the proposal.

An abstention does not constitute a vote "for" or "against." "Broker non-votes" (i.e., shares held by brokers or nominees as to which (i) instructions have not been received from the beneficial owner or the persons entitled to vote the shares, and (ii) the broker does not have discretionary voting power on a particular matter) will be treated in the same manner as abstentions. The election of directors is not considered a routine matter and, therefore, brokers do not have discretionary voting power with respect to this proposal. The ratification of the selection of Crowe LLP as the Bank's independent registered public accounting firm for the 2019 fiscal year is considered a routine matter and, therefore, brokers do have discretionary voting power with respect to this proposal. Although abstentions and broker non-votes are counted for purposes of determining the presence or absence of a quorum for the transaction of business, they will have no effect on the outcome of any of the proposals.

## PROPOSAL 1

## ELECTION OF DIRECTORS

The exact size of the Board of Directors shall be fixed by the Board of Directors prior to each annual meeting. As established in the Bylaws, the number of Directors shall at no time be less than 5 nor more than 30. The Board of Directors set the size of the Board at 13 Directors. The Nominating, Governance and Compensation Committee (previously known as the Governance and Compensation Committee) has recommended and the Board of Directors has nominated the 13 persons named below to the Board of Directors to serve until the 2020 Annual Meeting of Shareholders or until their successors have been elected and qualified. Each of the nominees is a current member of the Board of Directors. The Bank's Board of Directors believes that the nominees will be available and able to serve as Directors if elected, but if any of these nominees becomes unavailable or unable to serve, the persons named in the proxy may exercise discretionary authority to vote for a substitute proposed by the Bank's Board of Directors. In no event will a proxy be voted for more than 13 Directors.

It is the intent of the persons named in the proxy, unless otherwise directed therein, to vote "FOR" the election of the following nominees:

| | | | | Committee Memberships | | | |
|---|---|---|---|---|---|---|---|
| **Name**<br>**Current Position** | **Age** | **Director Since** | **Independence** | **Audit & Compliance** | **Investment/ Interest Rate Risk** | **Credit Risk** | **Nominating, Governance & Compensation** |
| **Michael R. Bird**<br>CFO of Virginia Lutheran Homes, Inc. | 64 | 2018 | YES | Chair | | | |
| **Robert W. Conner**<br>Retired Clerk of Circuit Court of Halifax County, Virginia | 79 | 1985* | YES | | | Chair | ✓ |
| **Gregory W. Feldmann**<br>President of Skyline Capital Strategies, LLC | 62 | 2017 | YES | | Chair | | ✓ |
| **Chester A. Gallimore**<br>President Wills Ridge Supply | 82 | 1978* | YES | ✓ | | | |
| **Charles E. Hall**<br>Farmer | 77 | 1978* | YES | | | ✓ | |
| **James W. Haskins**<br>Chairman of the Board of Directors; Attorney and Principal of Young, Haskins, Mann, Gregory, McGarry and Wall, P.C. | 78 | 1982* | NO | | | | Chair |
| **Phyllis Q. Karavatakis**<br>Vice Chairman of the Board of Directors; President and Chief Banking Officer of Carter Bank & Trust | 63 | 2017 | NO | | | ✓ | |
| **Lanny A. Kyle, O.D.**<br>Retired Optometrist | 65 | 2003* | YES | | | | ✓ |
| **George W. Lester, II**<br>Chairman of Lester Group, Inc. | 80 | 1976* | YES | ✓ | | | |
| **E. Warren Matthews**<br>Attorney at Harris, Matthews & Crowder, P.C. | 78 | 1998* | YES | ✓ | | | |
| **Catharine L. Midkiff**<br>Retired Executive from General Electric Capital Corporation | 59 | 2018 | YES | ✓ | ✓ | | |
| **Joseph E. Pigg**<br>President of Millard's Machinery, Inc. | 83 | 1976* | YES | | ✓ | | |
| **Litz H. Van Dyke**<br>CEO of Carter Bank & Trust | 55 | 2017 | NO | | ✓ | ✓ | |

* Indicates year first served as a director of one of the 10 banking institutions that were merged into and created Carter Bank & Trust in 2006 (each a "Merged Bank" and collectively, the "Merged Banks"). The Merged Banks were Blue Ridge Bank, N.A., Central National Bank, Community National Bank, First National Bank, First National Exchange Bank, Mountain National Bank, Patrick Henry National Bank, Patriot Bank, N.A., Peoples National Bank and Shenandoah National Bank.

The Board of Directors is not aware of any family relationship between any Director, executive officer or person nominated by the Bank to become a Director; nor is the Board of Directors aware of any involvement in legal proceedings that would be material to an evaluation of the ability or integrity of any Director, executive officer or person nominated to become a Director.

The following paragraphs provide information regarding each nominee's specific experience, qualifications, attributes and skills that led to the conclusion that he or she should serve as a Director. We also believe that all of our Director nominees have a reputation for honesty and adherence to high ethical standards.

**Michael R. Bird** has more than 30 years of experience in the long-term care industry. He is the Chief Financial Officer of Virginia Lutheran Homes Inc., which owns and operates a continuing care retirement community and nursing and rehabilitation center in Roanoke, Virginia and subsidized apartments with supportive services in New Market, Virginia. Prior to this, he served as Chief Financial Officer of Waveny Care Network, a provider of long-term care, assisted living, independent living and home healthcare in New Canaan, Connecticut. He earned his Bachelor's Degree in Accounting from Central Connecticut State University in New Britain, Connecticut and MBA from Sacred Heart University in Fairfield, Connecticut. Mr. Bird chairs the Board's Audit and Compliance Committee. Mr. Bird was appointed to the Board of Directors of the Bank in January 2018. Mr. Bird is qualified to serve as a Director and Chair of the Audit and Compliance Committee due to his broad experience in finance and accounting.

**Robert W. Conner** is retired Clerk of Circuit Court of Halifax County. Mr. Conner is a long-time farmer in Halifax County. He also served as an organizing director of Community National Bank from 1985 until the merger into Carter Bank & Trust and as a director of Bank Building Corporation from 1995 until its merger with Carter Bank & Trust. He served as a director of CB&T Real Estate Holdings, Inc. from 2008 to 2016. Mr. Conner is a qualified candidate as a Director, as well as Chair of the Credit Risk Committee and member of the Nominating, Governance and Compensation Committee, due to his skills and knowledge of the business community.

**Gregory W. Feldmann** is President of Skyline Capital Strategies, LLC, a management consultancy group providing advisory services in the areas of corporate finance, private equity, business and financial strategy, mergers and acquisitions, and performance related studies. He is former President and Director of StellarOne Bank. Mr. Feldmann was appointed to the Board of Directors of the Bank in February 2017. Mr. Feldmann is qualified to serve as a Director and Chair of the Investment/Interest Rate Risk Committee and member of the Nominating, Governance and Compensation Committee due to his business and banking background in commercial banking, investment banking and brokerage and private equity and experience in other executive and leadership roles, both in private and public companies.

**Chester A. Gallimore** is President of Wills Ridge Supply. He also served as an organizing director of Blue Ridge Bank, N. A. from 1978 until the merger into Carter Bank & Trust. Mr. Gallimore is a qualified candidate to serve on the Board, as well as the Audit and Compliance Committee, due to his strong business background, knowledge and service as a Director of the Bank and its predecessors for over 40 years.

**Charles E. Hall** is a farmer. He also served as an organizing director of Blue Ridge Bank, N.A. from 1978 until the merger into Carter Bank & Trust and of Bank Building Corporation since 1995 until its merger with Carter Bank & Trust. He served as a director of CB&T Real Estate Holdings, Inc. from 2008 to 2016. Mr. Hall is qualified to serve as a Director and member of the Credit Risk Committee due to his knowledge of the banking industry and the business community.

**James W. Haskins** is an attorney and principal in the law firm of Young, Haskins, Mann, Gregory, McGarry, and Wall, P. C., Martinsville, Virginia. He also served as a director of Mountain National Bank from 1996 until the merger into Carter Bank & Trust and of Patrick Henry National Bank from 1982 until the merger into Carter Bank & Trust. Mr. Haskins was appointed as Chairman of the Board of Directors in April 2017; prior to that he served as Vice Chairman. Mr. Haskins is qualified to serve on the Board as well as Chair of the Nominating, Governance and Compensation Committee, due to his legal expertise and his prominence in the Bank's market area.

**Phyllis Q. Karavatakis** is President and Chief Banking Officer of Carter Bank & Trust. Prior to serving in this role, she served as Executive Vice President and Chief Lending Officer and various other roles in her over 40 years employed with the Bank. Ms. Karavatakis was appointed to the Board of Directors of the Bank in February 2017 and appointed Vice Chairman in April 2017. Ms. Karavatakis is qualified to serve as a Director and member of the Credit Risk Committee due to her business experience along with in-depth knowledge of the banking industry.

**Lanny A. Kyle, O. D.** is a retired Optometrist. He formerly was Owner and President of Piedmont Optometric Association. He also served as a director of Mountain National Bank from 2003 until the merger into Carter Bank & Trust. Dr. Kyle is qualified to serve as a Director and member of the Nominating, Governance and Compensation Committee due to his management and financial skills.

**George W. Lester, II** is Chairman of the Lester Group, Inc., a forest products company in Martinsville, Virginia. He also served as an organizing director of Patrick Henry National Bank from 1976 until the merger into Carter Bank & Trust and Shenandoah National Bank from 1996 until the merger into Carter Bank & Trust. He served as a director of CB&T Real Estate Holdings Inc. from 2008 to 2016. Mr. Lester is considered to be a qualified candidate to serve on the Board, as well as the Audit and Compliance Committee, due to his strong business background and knowledge, broad community development, and service as a Director of the Bank and its predecessors for over 42 years.

**E. Warren Matthews** is an attorney in the firm of Harris, Matthews & Crowder, P.C. He also served as a director of Community National Bank from 1998 until the merger into Carter Bank & Trust. Mr. Matthews is considered to be a qualified candidate for service on the Board, as well as the Audit and Compliance Committee, due to his legal expertise and his prominence in the Bank's market area.

**Catharine L. Midkiff** worked for more than 20 years as an Executive with General Electric Capital Corporation in risk management, operations, and finance in its Asia, Europe, and United States markets. Prior to this, she served as Vice President and Director in other General Electric entities located in the United States, Japan, Korea, Thailand and Hong Kong. A Certified Public Accountant, Ms. Midkiff has a Bachelor's Degree in Commerce with a specialization in Finance and Accounting from the University of Virginia. She is certified in Six Sigma as a master black belt, the highest level credential in management techniques to improve business processes, primarily by reducing risks, and has completed numerous specialty programs, such as an asset-based finance program from the University of Pennsylvania's Wharton School and the Commercial Finance Association. Ms. Midkiff serves on the Board's Audit and Compliance and Investment/Interest Rate Risk Committees. Ms. Midkiff was appointed to the Board of Directors of the Bank in January 2018. Ms. Midkiff is qualified to serve as a Director and member of the Audit and Compliance and Investment/Interest Rate Risk Committees due to her broad based experience in accounting, risk management and finance with executive roles in public companies.

**Joseph E. Pigg** is President of Millard's Machinery, Inc., an industrial and logging equipment sales and service business. He also served as an organizing director of Patrick Henry National Bank from 1976 until the merger into Carter Bank & Trust and Shenandoah National Bank from 1996 until the merger into Carter Bank & Trust. His financial experience and prior service of over 42 years as a bank board member qualifies him to be a Director and member of the Investment/Interest Rate Risk Committee.

**Litz H. Van Dyke** is Chief Executive Officer of Carter Bank & Trust and previously served as Executive Vice President. Prior to joining Carter Bank & Trust in 2016, Mr. Van Dyke was a Practice Manager for CCG Catalyst Consulting Group based in Phoenix, Arizona, assisting banks with strategic advisory services. He served as Chief Operating Officer for StellarOne Corporation from 2008 to 2012. Mr. Van Dyke is a qualified candidate as a Director and member of the Investment/Interest Rate Risk and Credit Risk Committees due to his prior experience in senior executive roles with a number of Virginia-based banking institutions with responsibilities including credit administration, regulatory risk management, information technology, operations, marketing, and facilities as well as extensive work with commercial, retail, and mortgage lines of business.

**THE BOARD OF DIRECTORS RECOMMENDS THAT THE SHAREHOLDERS VOTE FOR THE DIRECTOR NOMINEES LISTED ABOVE.**

**Executive Officers of the Registrant**

The following individuals are executive officers of Carter Bank & Trust. Ages are given as of April 30, 2019:

| Name | Age | Position | Business Experience During Past Five Years |
|---|---|---|---|
| A. Loran Adams | 58 | Executive Vice President and Director of Regulatory Risk Management since 2018 | Prior to 2018, Senior Vice President and Director of Regulatory Risk Management since 2017, Director of Internal Audit, Georgia Bank & Trust from 2009 to 2016. |
| Wendy S. Bell | 55 | Executive Vice President and Chief Financial Officer since 2017 | Prior to 2017, Senior Vice President and Senior Finance Officer, First Commonwealth Financial Corporation from 2010 to 2017. |
| Jane Ann Davis | 56 | Executive Vice President and Chief Administrative Officer since 2017 | Prior to 2017, Executive Vice President and Chief Financial Officer and Chief Operating Officer. |
| Tony E. Kallsen | 51 | Executive Vice President and Chief Credit Officer since 2018 | Prior to 2018, Senior Vice President and Senior Credit Officer, First Commonwealth Financial Corporation from 2010 to 2017. |
| Phyllis Q. Karavatakis | 63 | President and Chief Banking Officer since 2017 | Prior to 2017, President and Chief Administrative Officer since 2016, Executive Vice President and Chief Lending Officer since 2014. |
| Bradford N. Langs | 53 | Executive Vice President and Chief Strategy Officer since 2017 | Prior to 2017, Chief Risk Officer, Chief Credit Officer and Treasurer, Coastal States Bank from 2009 to 2017. |
| Matthew M. Speare | 52 | Executive Vice President and Chief Information Officer since 2017 | Prior to 2017, Executive Vice President and Chief Information Officer, Regions Bank from 2013 to 2017. |
| Litz H. Van Dyke | 55 | Chief Executive Officer since 2017 | Prior to 2017, Executive Vice President since July 2016; prior to joining Carter Bank & Trust, Practice Manager, CCG Catalyst Group from 2012 to 2016 and Chief Operating Officer, StellarOne Corporation from 2008 to 2012. |

**PRINCIPAL BENEFICAL OWNERS OF CARTER BANK & TRUST COMMON STOCK**

The following table sets forth certain information concerning the persons known by us to be the beneficial owners of more than 5% of the outstanding shares of the Bank's common stock.

| Name and Address | Number of Shares Beneficially Owned | Percentage of Class(1) |
|---|---|---|
| First Citizens BancShares, Inc.<br>4300 Six Forks Road<br>Raleigh, NC 27609 | 2,055,994(2) | 7.83% |

(1) Percentage is based on 26,270,174 shares of common stock issued and outstanding at December 31, 2018.

(2) Based on the information provided by First Citizens BancShares, Inc. as of December 31, 2018.

## BENEFICIAL OWNERSHIP OF CARTER BANK & TRUST COMMON STOCK BY DIRECTORS AND OFFICERS

The following table sets forth, as of April 15, 2019, the beneficial ownership of the Bank's common stock of each Director, the executive officers identified in the Summary Compensation Table (referred to as our "named executive officers") and the Bank's current Directors and executive officers as a group. For purposes of the table below, beneficial ownership has been determined in accordance with the provisions of Rule 13d-3 of the Securities Exchange Act of 1934 (the "Exchange Act") under which, in general, a person is deemed to be the beneficial owner of a security if he/she has or shares the power to vote or direct the voting of the security or the power to dispose of or direct the disposition of the security, or if he/she has the right to acquire beneficial ownership of the security within sixty days. Unless otherwise indicated, all persons listed below have sole voting and investment power over all the shares of common stock.

| Name | Amount and Nature of Beneficial Ownership(1) | Ownership as a Percentage of Common Stock Outstanding(2) |
|---|---|---|
| Bell, Wendy S. | 12,462 | * |
| Bird, Michael R. | 2,059 | * |
| Conner, Robert W. | 68,424 | * |
| Feldmann, Gregory W. | 2,759 | * |
| Gallimore, Chester A. | 116,284 | * |
| Hall, Charles E. | 32,400 | * |
| Haskins, James W.(3) | 56,456 | * |
| Karavatakis, Phyllis Q. | 15,637 | * |
| Kyle, Lanny A., O.D. | 64,946 | * |
| Langs, Bradford N. | 2,327 | * |
| Lester, George W., II(4) | 1,187,409 | 4.51% |
| Matthews, E. Warren | 5,216 | * |
| Midkiff, Catharine L. | 7,359 | * |
| Pigg, Joseph E.(5) | 226,747 | * |
| Speare, Matthew M. | 16,617 | * |
| Van Dyke, Litz H. | 4,879 | * |
| All Directors and Executive Officers as a Group (19 Persons) | 1,827,624 | 6.94% |

(1) May include shares held by spouse, other family members, as trustee or through a corporation.
(2) Percentages are based on 26,333,929 shares of common stock issued and outstanding.
(3) Shares reported include 20,000 shares of common stock pledged as security.
(4) Shares reported include 620,199 shares of common stock pledged as security.
(5) Shares reported include 135,977 shares of common stock pledged as security.
* Less than 1% of the outstanding common stock.

## SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires that Directors and executive officers, and persons who beneficially own more than 10% of the Bank's equity securities, file reports of ownership and reports of changes in ownership of the Bank's outstanding equity securities. Based on a review of these reports filed by the Bank's officers and Directors, the Bank believes that its officers and Directors complied with all filing requirements under Section 16(a) of the Exchange Act during 2018.

## EXECUTIVE COMPENSATION

### Compensation Discussion & Analysis

The Bank's compensation program is designed to offer competitive compensation to employees based on each individual's contribution to the Bank's overall success. As such, the program provides a competitive compensation package to attract and retain capable employees.

The compensation and benefits program consists of salary, annual incentive opportunity, equity compensation, a profit sharing plan, life, health and disability insurance and limited perquisites. In 2017, the Bank entered into employee agreements with its named executive officers, which are further described under "Employment Agreements," and in connection therewith granted phantom stock incentive awards to the named executive officers.

The Nominating, Governance and Compensation Committee has the responsibility for administering the Bank's overall compensation program and for setting the salaries and incentive opportunities for the Bank's senior officers. In setting the compensation of the Bank's senior officers, the Committee has generally relied on the recommendations of the Chairman and Chief Executive Officer and the Board members' own significant personal knowledge of the compensation provided to other, similarly situated, executives in banking and other industries in the local area. The Committee established the compensation paid to the Bank's non-employee directors in 2018; beginning in December 2018, however, the Committee will review and recommend to the Board of Directors for approval the compensation of the Bank's non-employee directors. In 2017, the Compensation Committee engaged Matthews, Young & Associates, Inc. as an independent compensation consultant to assist in the development of our executive compensation program and to provide information on executive compensation at banks similar to Carter Bank & Trust including market trends and developments in executive compensation. The Committee also will review each individual's performance and contribution to the overall Bank goals in determining the level of salary for the coming year.

When setting compensation for fiscal 2018 and in determining compensation policies, the Committee took into account the results of the shareholder advisory vote on executive compensation that took place in June 2017. In that vote, which is advisory and non-binding, shareholders approved the compensation of our named executive officers as disclosed in the proxy statement for the 2017 Annual Meeting of Shareholders. A substantial majority (96%) of votes cast approved the compensation program described in the Bank's proxy statement for the 2017 Annual Meeting of Shareholders. The vote results were taken into consideration when setting the compensation for 2018 and the new say-on-pay vote results will be taken into consideration by the Board when setting the compensation for 2019. The next advisory vote to approve executive compensation will occur at our 2020 Annual Meeting of Shareholders.

## Employment Agreements

On September 29, 2017, the Bank entered into employment agreements with Mr. Van Dyke and Ms. Karavatakis. The Bank entered into an employment agreement with Mr. Langs on May 31, 2017, with Mr. Speare on June 15, 2017, and with Ms. Bell on June 19, 2017. Prior to entering into these agreements, the Bank did not have any employment agreements with any Bank officers or employees. The terms of the agreements are substantially similar to each other as described below.

*Van Dyke Employment Agreement*

Mr. Van Dyke and the Bank entered into an employment agreement, dated as of September 29, 2017 (the "Van Dyke Agreement"), pursuant to which Mr. Van Dyke continues to serve as Chief Executive Officer of the Bank for an initial term of two years, beginning October 1, 2017. The employment term automatically renews on October 1, 2019 and on each subsequent two-year anniversary for an additional two-year term unless either party provides at least 60 days' advance notice of non-renewal.

Pursuant to the Van Dyke Agreement, Mr. Van Dyke's initial annual base salary is $500,000, subject to increase by the Bank's Board of Directors at its discretion. Mr. Van Dyke received a phantom stock award with an initial value of $150,000 to be settled in cash, which vests on the third anniversary of the grant date, subject to continued employment by Mr. Van Dyke. He also receives $700 per month as an automobile allowance. Mr. Van Dyke is eligible to participate in the Bank's annual bonus plan, employee benefit plans and programs on terms offered to similarly situated employees.

The Bank may terminate Mr. Van Dyke's employment with or without cause (as defined in the Van Dyke Agreement), with or without notice. Mr. Van Dyke also may voluntarily terminate his employment with the Bank at any time for Good Reason (as defined in the Van Dyke Agreement). In the event the Bank terminates Mr. Van Dyke's employment without cause or Mr. Van Dyke terminates his employment for

Good Reason, Mr. Van Dyke will receive any unpaid base salary, any annual bonus compensation earned and awarded but not yet paid, and any vested benefits (collectively, the "Accrued Obligations"). He will also receive a monthly severance payment equal to one-twelfth of his annual base salary for 18 months and continued employee health insurance coverage for 18 months. Payment of these severance benefits is subject to receipt by the Bank of a signed release and waiver of claims and satisfaction of other requirements, conditions, and limitations set forth in the Van Dyke Agreement, including covenants regarding confidentiality, non-competition, non-piracy and non-solicitation.

In the event the Bank terminates Mr. Van Dyke's employment without cause or Mr. Van Dyke terminates his employment for Good Reason within two years after a Change of Control (as defined in the Van Dyke Agreement), Mr. Van Dyke will receive the Accrued Obligations, plus a lump sum severance payment equal to 2.99 times his annual base salary, continued employee health insurance coverage for 18 months and a lump sum payment equal to Mr. Van Dyke's highest annual bonus earned from the Bank for the three years prior to termination. Payment of these severance benefits is subject to receipt by the Bank of a signed release and waiver of claims and satisfaction of other requirements, conditions, and limitations set forth in the Van Dyke Agreement, including covenants regarding confidentiality, non-competition, non-piracy and non-solicitation.

In the event of a termination for Cause, Mr. Van Dyke will be entitled to receive his Accrued Obligations. If he dies while employed by the Bank, the Bank will pay Mr. Van Dyke's spouse, if his spouse survives him, or, if not, his estate, his Accrued Obligations and an amount equal to his base salary from the date of his death through the end of the month in which his death occurs.



*Bell Employment Agreement*

On June 19, 2017, the Bank and Ms. Bell entered into an employment agreement pursuant to which Ms. Bell serves as Executive Vice President and Chief Financial Officer of the Bank (the "Bell Agreement"). The terms of the Bell Agreement are substantially the same as the Van Dyke Agreement, except as follows. The initial term of the Bell Agreement is two years, beginning on July 27, 2017. The employment term automatically renews on July 24, 2019 and on each subsequent anniversary for an additional one-year term unless either party provides at least 60 days' advance notice of non-renewal.

Pursuant to the Bell Agreement, Ms. Bell's initial annual base salary is $330,000, subject to increase by the Bank's Board of Directors in its discretion. She also received a signing bonus in the amount of $80,000, which is payable $50,000 in 2017 and $30,000 in 2018 and is subject to repayment to the Bank if Ms. Bell is terminated for Cause (as defined in the Bell Agreement) or resigns without Good Reason (as defined in the Bell Agreement) within 12 months of receipt. Ms. Bell also received a phantom stock award with an initial value of $99,000 to be settled in cash, which vests on the third anniversary of the grant date, subject to continued employment by Ms. Bell. Ms. Bell was entitled to up to $20,000 in relocation expenses and up to $1,500 per month for up to six months in temporary housing expenses. She was also entitled to a real estate commission reimbursement of up to $35,000 in connection with the sale of her existing current residence and reimbursement of legal expenses of up to $3,500 in connection with the review and negotiation of the Bell Agreement. She will also receive $500 per month as an automobile allowance.

In the event the Bank terminates Ms. Bell's employment without cause or Ms. Bell terminates her employment for Good Reason, in addition to the Accrued Obligations, she will also receive a monthly severance payment equal to one-twelfth of her annual base salary for 12 months and continued employee health insurance coverage for 12 months. In the event the Bank terminates Ms. Bell's employment without cause or Ms. Bell terminates her employment for Good Reason within two years after a Change of Control (as defined in the Bell Agreement), Ms. Bell will receive the Accrued Obligations, plus a lump sum severance payment equal to 24 months of her annual base salary, continued employee health insurance coverage for 18 months and a lump sum payment equal to Ms. Bell's highest annual bonus earned from the Bank for the three years prior to termination.

*Karavatakis Employment Agreement*

On September 29, 2017, the Bank and Ms. Karavatakis entered into an employment agreement pursuant to which Ms. Karavatakis continues to serve as President of the Bank (the "Karavatakis Agreement"). The terms of the Karavatakis Agreement are substantially the same as the Van Dyke

Agreement, except as follows. The initial term of the Karavatakis Agreement is one year, beginning on October 1, 2017. The employment term automatically renews on October 1, 2018 and on each subsequent anniversary for an additional one-year term unless either party provides at least 60 days' advance notice of non-renewal.

Pursuant to the Karavatakis Agreement, Ms. Karavatakis' initial annual base salary is $325,000, subject to increase by the Bank's Board of Directors in its discretion. She also received a signing bonus in the amount of $80,000, which is payable in two equal installments in 2017 and 2018 and is subject to repayment to the Bank if Ms. Karavatakis is terminated for Cause (as defined in the Karavatakis Agreement) or resigns without Good Reason (as defined in the Karavatakis Agreement) within 12 months of receipt. Ms. Karavatakis also received a phantom stock award with an initial value of $97,500 to be settled in cash, which vests on the third anniversary of the grant date, subject to continued employment by Ms. Karavatakis. She also received $500 per month as an automobile allowance.

In the event the Bank terminates Ms. Karavatakis' employment without cause or Ms. Karavatakis terminates her employment for Good Reason, in addition to the Accrued Obligations, she will receive a monthly severance payment equal to one-twelfth of her annual base salary for 12 months and continued employee health insurance coverage for 12 months. In the event the Bank terminates Ms. Karavatakis' employment without Cause or she terminates her employment for Good Reason within two years after a Change of Control (as defined in the Karavatakis Agreement), Ms. Karavatakis will receive the Accrued Obligations, plus a lump sum severance payment equal to two times her annual base salary, continued employee health insurance coverage for 18 months and a lump sum payment equal to Ms. Karavatakis' highest annual bonus earned from the Bank for the three years prior to termination.

*Speare Employment Agreement*

On June 15, 2017, the Bank and Mr. Speare entered into an employment agreement pursuant to which Mr. Speare serves as Executive Vice President and Chief Information Officer of the Bank (the "Speare Agreement"). The terms of the Speare Agreement are substantially the same as the Van Dyke Agreement, except as follows. The initial term of the Speare Agreement is one year, beginning on July 3, 2017. The employment term automatically renews on July 3, 2018 and on each subsequent anniversary for an additional one-year term unless either party provides at least 60 days' advance notice of non-renewal.

Pursuant to the Speare Agreement, Mr. Speare's initial annual base salary is $325,000, subject to increase by the Bank's Board of Directors in its discretion. He also received a signing bonus in the amount of $50,000, which is payable $25,000 in 2017 and $25,000 in 2018 and is subject to repayment to the Bank if Mr. Speare is terminated for Cause (as defined in the Speare Agreement) or resigns without Good Reason (as defined in the Speare Agreement) within 12 months of receipt. Mr. Speare also received a phantom stock award with an initial value of $97,500 to be settled in cash, which vests on the third anniversary of the grant date, subject to continued employment by Mr. Speare. Mr. Speare was entitled to up to $20,000 in relocation expenses and up to $1,500 per month for up to six months in temporary housing expenses. He was also entitled to a real estate commission reimbursement of up to $35,000 in connection with the sale of his existing current residence and reimbursement of legal expenses of up to $2,500 in connection with the review and negotiation of the Speare Agreement. He also receives $500 per month as an automobile allowance.

In the event the Bank terminates Mr. Speare's employment without Cause or Mr. Speare terminates his employment for Good Reason, in addition to the Accrued Obligations, he will also receive a monthly severance payment equal to one-twelfth of his annual base salary for 12 months and continued employee health insurance coverage for 12 months. In the event the Bank terminates Mr. Speare's employment without Cause or Mr. Speare terminates his employment for Good Reason within two years after a Change of Control (as defined in the Speare Agreement), Mr. Speare will receive the Accrued Obligations, plus a lump sum severance payment equal to 24 months of his annual base salary, continued employee health insurance coverage for 18 months and a lump sum payment equal to Mr. Speare's highest annual bonus earned from the Bank for the three years prior to termination.

*Langs Employment Agreement*

On May 31, 2017, the Bank and Mr. Langs entered into an employment agreement pursuant to which Mr. Langs serves as Chief Strategy Officer of the Bank (the "Langs Agreement"). The terms of the Langs

Agreement are substantially the same as the Van Dyke Agreement, except as follows. The initial term of the Langs Agreement is one year, beginning on June 19, 2017. The employment term automatically renews on June 19, 2018 and on each subsequent anniversary for an additional one-year term unless either party provides at least 60 days' advance notice of non-renewal.

Pursuant to the Langs Agreement, Mr. Langs' initial annual base salary is $297,500, subject to increase by the Bank's Board of Directors in its discretion. He also received a signing bonus in the amount of $125,000, which is payable $50,000 in 2017 and $75,000 in 2018 and is subject to repayment to the Bank if Mr. Langs is terminated for Cause (as defined in the Langs Agreement) or resigns without Good Reason (as defined in the Langs Agreement) within 12 months of receipt. Mr. Langs also received a phantom stock award with an initial value of $85,500 to be settled in cash, which vests on the third anniversary of the grant date, subject to continued employment by Mr. Langs. Mr. Langs was entitled to up to $20,000 in relocation expenses and up to $1,500 per month for up to six months in temporary housing expenses. He also receives $500 per month as an automobile allowance.

In the event the Bank terminates Mr. Langs' employment without cause or Mr. Langs terminates his employment for Good Reason, in addition to the Accrued Obligations, he will also receive a monthly severance payment equal to one-twelfth of his annual base salary for 12 months and continued employee health insurance coverage for 12 months. In the event the Bank terminates Mr. Langs' employment without Cause or Mr. Langs terminates his employment for Good Reason within two years after a Change of Control (as defined in the Langs Agreement), Mr. Langs will receive the Accrued Obligations, plus a lump sum severance payment equal to 24 months of his annual base salary, continued employee health insurance coverage for 18 months and a lump sum payment equal to Mr. Langs' highest annual bonus earned from the Bank for the three years prior to termination.



### Base Salaries

Base salaries provide appropriate fixed cash compensation necessary to attract and retain executive talent. Base salaries are intended to be competitive. The Nominating, Governance and Compensation Committee reviews the base salaries of our named executive officers on an annual basis as well as at the time of any promotion or other material change in responsibilities. In addition to engaging independent consultant, Matthews, Young & Associates on base salaries, our Nominating, Governance and Compensation Committee also considers the following when setting base salaries: (a) the individual executive's overall performance and contribution to the Bank's performance, (b) overall Bank performance and (c) the individual's base salary relative to other executive officers.

| Executive | 2017 Base Salary ($) | 2018 Base Salary ($)[1] | % Increase |
|---|---|---|---|
| Litz H. Van Dyke | 500,000 | 570,000 | 14% |
| Wendy S. Bell | 330,000 | 350,000 | 6% |
| Phyllis Q. Karavatakis | 325,000 | 335,000 | 3% |
| Matthew M. Speare | 325,000 | 345,000 | 6% |
| Bradford N. Langs | 297,500 | 335,000 | 13% |

(1) Base Salaries for all named executive officers were effective as of November 26, 2018.

### Annual Incentive Plan

On November 15, 2018, with assistance from its independent compensation consultant, the Governance & Compensation Committee (which became the "Nominating, Governance and Compensation Committee" in December 2018) adopted an annual incentive plan for the purpose of awarding annual bonuses to certain employees of the Bank based upon the achievement of annual performance objectives established each year under the plan. The annual incentive plan covers the Bank's executive officers and certain executive vice presidents (each, a Participant), which includes all of the Bank's named executive officers. The goal of the annual incentive plan is to motivate Participants to maximize shareholder value by achieving performance while limiting risk appropriately and maintaining the safety and soundness of the Bank.

The plan is an annual incentive plan that is approved each year with a performance year running from January 1 through December 31. The Nominating, Governance and Compensation Committee will oversee the administration of the plan, as well as plan design, determination of performance measures, goals and weightings and award payouts, partly based on input from the Bank's CEO.

At the beginning of each year (except for 2018), the Nominating, Governance and Compensation Committee will develop a bonus template for each Participant. The primary elements of each template are:

- Percentage of base salary opportunity,
- Performance measures and goals selected from the Bank's approved budget numbers for the year or other objective measure, and
- Weightings assigned to the selected performance measures.

Under the annual incentive plan, a Participant can earn a bonus of up to a specific percentage of the Participant's base salary. For 2018, these percentages are as follows:

| Participant | % of Base Salary |
|---|---|
| CEO, CFO, CBO, CSO | 50% |
| All Other Participants | 35% |

Performance measures under the plan are determined each year, in the categories of profitability, capital effectiveness and safety and soundness. The performance measures, goals and weightings assigned to them may change from year to year, and will probably be the same for all participants in any given year, although that is subject to change.

The amount of bonus earned by a Participant each year will depend on the Bank's achievement with respect to the performance measure goals selected for that year, multiplied by the applicable weightings, multiplied by the Participant's base salary and percentage of base salary opportunity.

Bonus amounts earned based on the Bank's performance for a year will be reviewed and certified by the Nominating, Governance and Compensation Committee and paid to the Participant between January 1 and March 15 of the following year, generally shortly after the year's results have been finalized and the Bank's earnings for the year have been announced. The plan has both short-term and long-term elements to it, as the bonus amounts will be paid 2/3 in cash and 1/3 in shares of restricted common stock of the Bank, with time-based vesting in three annual installments.

For 2018, the Nominating, Governance and Compensation Committee selected the same performance measure goals and weightings for each of the named executive officers. The following table shows the performance measure goals for the annual incentive plan for 2018, as well as the weightings of these goals and the achievement with respect to each goal:

| Performance Measure | Weighting | Maximum Performance Goal | Performance Achieved |
|---|---|---|---|
| Core ROAA(1) | 35% | 0.73% | 41% |
| Core ROATCE(1) | 35% | 8.58% | 33% |
| Regulatory Rating | 30% | *confidential* | 0% |
| **Weighted Average Bonus Amount Earned** | | | **74%** |

(1) Core return on average assets and core return on average tangible common equity are calculated excluding all extraordinary items, whether positive or negative.

The Nominating, Governance and Compensation Committee reviewed the Bank's performance with respect to these goals for 2018, and bonus amounts were determined under the plan based on the achievement of the performance goals, multiplied by the named executive officer's base salary and percentage of base salary opportunity. As noted above, the bonus amounts were paid in early 2019, 2/3 in cash and 1/3 in shares of restricted common stock of the Bank, with time-based vesting in three annual installments, granted under the Carter Bank & Trust 2018 Omnibus Equity Incentive Plan, which is discussed further below. The bonus amounts earned by the named executive officers for 2018 performance under this plan are reported as "Non-Equity Incentive Plan Compensation" for 2018 in the Summary Compensation Table.

## Equity Compensation

On June 27, 2018, the Bank's shareholders approved the Carter Bank & Trust 2018 Omnibus Equity Incentive Plan (the "Equity Plan"). The Equity Plan authorizes the issuance of up to 2,000,000 shares of common stock for awards to key employees and non-employee directors as determined by the Nominating, Governance and Compensation Committee, which has been appointed by the Board of Directors to administer the Equity Plan. The Equity Plan authorizes the grant of stock options, restricted stock, restricted stock units, stock appreciation rights, stock awards, performance units and performance cash awards. With respect to executive compensation, the purpose of the Equity Plan is to provide incentive to certain key employees and non-employee directors to associate their personal interests with the long-term financial success of the Bank and with growth in shareholder value, consistent with the Bank's risk management practices. In November 2018, the Bank granted restricted stock awards to several employees, including Mr. Speare, in connection with their contributions to the successful conversion of the Bank's core systems. The restricted stock granted in November 2018 vests in equal installments on each of the first, second and third anniversaries of the grant date, subject to accelerated vesting in certain circumstances.

As discussed above, the Nominating, Governance and Compensation Committee has granted during 2019 and anticipates granting in the future awards of restricted stock to employees, including the named executive officers, in connection with the annual incentive plan adopted in November 2018 and may also grant other equity awards under the Equity Plan as part of the Bank's compensation program.

## CEO Pay Ratio

The Bank determined that the 2018 annual total compensation of the median compensated employee of all its employees, other than the CEO, as of December 31, 2018 was $23,656; the CEO's 2018 annual total compensation was $735,445; and the ratio of these amounts was 31:1.

The Bank identified a new median employee for 2018 due to changes in the Bank's compensation program since 2017. As of December 31, 2018, the Bank's total population consisted of 1,012 employees, all of whom work in the United States. This population consisted of all of its full-time and part-time employees. To identify the median compensated employee, we used a Consistently Applied Compensation Measure defined as gross wages as reported on each employee's 2018 IRS Form W-2. We further annualized pay for those individuals not employed for a full year in 2018, but who were employed as of December 31, 2018.

Once we identified our median compensated employee, we calculated the median compensated employee's and our CEO's 2018 annual total compensation in accordance with the requirements of the Summary Compensation Table.

This pay ratio is a reasonable estimate calculated in a manner consistent with Securities Exchange Commission ("SEC") rules based on our payroll and employment records and the methodology described above. The SEC rules for identifying the median compensated employee and calculating the pay ratio based on that employee's annual total compensation allow companies to adopt a variety of methodologies, to apply certain exclusions, and to make reasonable estimates and assumptions that reflect their compensation practices. As such, the pay ratio reported by other companies may not be comparable to the pay ratio reported above, as other companies may have different employment and compensation practices and may utilize different methodologies, exclusions, estimates and assumptions in calculating their own pay ratios.

## SUMMARY COMPENSATION TABLE

Fiscal 2016 – 2018

The table below reflects compensation received by each named executive officer.

| Name and Principal Position with Carter Bank & Trust | Year | Salary ($) | Bonus[(1)] ($) | Stock Awards[(2)] ($) | Option Awards ($) | Non-equity Incentive Plan Compensation[(3)] ($) | Change in Pension Value and Non-Qualified Deferred Comp. Earn. ($) | All Other Comp.[(4)] ($) | Total ($) |
|---|---|---|---|---|---|---|---|---|---|
| Litz H. Van Dyke | 2018 | $497,051 | $25,000 | — | — | $185,483 | — | $27,911 | $735,445 |
| *Chief Executive Officer[(5)]* | 2017 | $440,000 | $25,000 | — | — | $150,000 | — | $16,353 | $631,353 |
| | 2016 | $133,974 | — | — | — | — | — | $ 207 | $134,181 |
| Wendy S. Bell | 2018 | $326,039 | $30,000 | — | — | $122,419 | — | $22,715 | $501,173 |
| *Executive Vice President and Chief Financial Officer[(6)]* | 2017 | $145,962 | $50,000 | — | — | $ 99,000 | — | $18,709 | $313,671 |
| Phyllis Q. Karavatakis | 2018 | $320,353 | $40,000 | — | — | $120,564 | — | $22,149 | $503,066 |
| *President and Chief Banking Officer* | 2017 | $280,000 | $40,000 | — | — | $ 97,500 | — | $ 9,734 | $427,234 |
| | 2016 | $250,000 | — | — | — | — | — | $34,619 | $284,619 |
| Matthew M. Speare | 2018 | $320,353 | $41,250 | $29,255 | — | $ 84,395 | — | $19,027 | $494,280 |
| *Executive Vice President and Chief Information Officer[(7)]* | 2017 | $162,500 | $25,000 | — | — | $ 97,500 | — | $58,649 | $343,649 |
| Bradford N. Langs | 2018 | $315,769 | $75,000 | — | — | $120,564 | — | $21,035 | $532,368 |
| *Executive Vice President and Chief Strategy Officer[(8)]* | 2017 | $162,099 | $50,000 | — | — | $ 85,500 | — | $20,878 | $318,477 |

(1) The amounts in the "Bonus" column represent the first installment (paid in 2017) and second installment (paid in 2018) of the sign-on bonuses granted to the named executive officer in connection with entering into an employment agreement with the Bank.

(2) The amounts in this column reflect the grant date fair value for restricted stock granted during 2018 pursuant to the Equity Plan, calculated in accordance with ASC Topic 718, based on the closing price of the Bank's common stock on the date of grant. These amounts do not include the portion of the annual incentive plan bonus payout for 2018 performance paid in restricted stock, which was granted in February 2019.

(3) The amounts in this column for 2018 reflect the bonus amounts earned for 2018 performance under the annual incentive plan and include both the portion of the bonus paid in cash and the portion paid in shares of restricted stock that was granted in February 2019. In each case, the cash portion and the portion paid in restricted shares of these bonus amounts were paid in the year following the year in which the performance criteria was achieved. The amounts in this column for 2017 reflect the starting value of the phantom stock awarded to the named executive officers in connection with the entering into of employment agreements with the Bank. Each phantom stock award will be settled in cash in an amount equal to the product of the following: (A) the total number of shares of the Bank's common stock that could be purchased for the target amount stated on the grant date, based on the average of the closing price for the Bank's common stock during the 30-day period preceding the grant date, multiplied by (B) the average of the closing price for the Bank's common stock during the 30-day period immediately preceding the third anniversary of the grant date.

(4) The amount of compensation properly categorized in this column, including perquisites and other personal benefits that total more than $10,000, is listed in the chart below for 2018.

The following table shows information on all other compensation to the named executive officers during 2018:

| Name | Medical | Disability Insurance | Life Insurance | Car Allowance | Gross Ups Car Allowance | Total |
|---|---|---|---|---|---|---|
| Litz H. Van Dyke | $9,064 | $806 | $5,885 | $8,400 | $3,756 | $27,911 |
| Wendy S. Bell | $9,064 | $806 | $4,113 | $6,000 | $2,732 | $22,715 |
| Phyllis Q. Karavatakis | $7,032 | $806 | $5,693 | $6,000 | $2,618 | $22,149 |
| Matthew M. Speare | $7,032 | $806 | $2,629 | $6,000 | $2,560 | $19,027 |
| Bradford N. Langs | $9,064 | $806 | $2,604 | $6,000 | $2,561 | $21,035 |

(5) Mr. Van Dyke transitioned from Executive Vice President to Chief Executive Officer on April 18, 2017.
(6) Ms. Bell became Chief Financial Officer on July 24, 2017.
(7) Mr. Speare became Chief Information Officer on July 3, 2017.
(8) Mr. Langs became Chief Strategy Officer on June 19, 2017.

The table below reflects information regarding the restricted stock awards and annual incentive plan opportunities granted to the named executive officers during or for the year ended December 31, 2018.

## Grants of Plan-Based Awards
## Fiscal 2018

The following table shows information on plan-based awards and restricted stock to the named executive officers during 2018:

| Name | Approval Date | Grant Date | Estimated Possible Payouts Under Non-Equity Incentive Plan Awards[1] | | | All Other Stock Awards: Number of Shares of Stock or Units[2] | Grant Date Fair Value of Stock and Option Awards[3] |
|---|---|---|---|---|---|---|---|
| | | | Threshold ($) | Target ($) | Maximum ($) | (#) | ($) |
| Litz H. Van Dyke | | | | | | | |
| *Annual Incentive Plan* | | | — | — | $285,000 | — | — |
| *Restricted Stock* | | | — | — | — | — | $ — |
| Wendy S. Bell | | | | | | | |
| *Annual Incentive Plan* | | | — | — | $175,000 | — | — |
| *Restricted Stock* | | | — | — | — | — | $ — |
| Phyllis Q. Karavatakis | | | | | | | |
| *Annual Incentive Plan* | | | — | — | $167,500 | — | — |
| *Restricted Stock* | | | — | — | — | — | $ — |
| Matthew M. Speare | | | | | | | |
| *Annual Incentive Plan* | | | — | — | $172,500 | — | — |
| *Restricted Stock* | 11/15/18 | 11/19/18 | — | — | — | 1,638 | $29,255 |
| Bradford N. Langs | | | | | | | |
| *Annual Incentive Plan* | | | — | — | $167,500 | — | — |
| *Restricted Stock* | | | — | — | — | — | $ — |

(1) Reflects the maximum bonus that each named executive officer could earn for 2018 performance under the annual incentive plan. The annual incentive plan does not have threshold or target performance levels. The actual amounts earned by the named executive officers for 2018 performance under this plan, which were paid partly in cash and partly in shares of restricted stock with a three-year vesting period, are reported as "Non-Equity Incentive Plan Compensation" for 2018 in the Summary Compensation Table.

(2) The stock awards in this column represent the number of shares of restricted stock the Nominating, Governance & Compensation Committee granted in 2018 to the named executive officer under the Equity Plan in connection with the core conversion. The restricted stock has a three-year vesting period.

(3) The amounts in this column represent the grant date fair value of the restricted stock award granted on November 19, 2018, calculated in accordance with ASC Topic 718, based on the closing price of the Bank's common stock on the date of grant.

**Outstanding Equity Awards at Fiscal 2018 Year-End**

The table below reflects certain information regarding the phantom stock awards and restricted stock awards held by each named executive officer as of December 31, 2018. None of the named executive officers held any other equity awards as of December 31, 2018.

| | | Stock Awards | | | |
|---|---|---|---|---|---|
| **Name** | **Grant Date** | **Number of Shares or Units of Stock That Have Not Vested (#)[(1)]** | **Market Value of Shares or Units of Stock That Have Not Vested ($)[(2)]** | **Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)** | **Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($)[(3)]** |
| Litz H. Van Dyke | 10/1/17 | | | — | $130,450 |
| Wendy S. Bell | 7/24/17 | | | — | $ 95,489 |
| Phyllis Q. Karavatakis | 10/1/17 | | | — | $ 84,792 |
| Matthew M. Speare | 7/3/17 | | | — | $ 94,958 |
| | 11/19/18 | 1,638 | $24,570 | | |
| Bradford N. Langs | 6/19/17 | | | — | $ 83,442 |

(1) The amounts in this column reflect the number of shares of restricted stock granted during 2018 pursuant to the Equity Plan. The restricted stock vests in equal 1/3 installments on the first, second and third anniversaries of the grant date, subject to accelerated vesting under certain circumstances. This table does not include the portion of the annual incentive plan bonus payout for 2018 performance paid in restricted stock, which was granted in February 2019.

(2) The amounts in this column represent the fair market value of the restricted stock as of December 31, 2018. The closing price of the Bank's common stock was $15.00 on that date.

(3) The amounts in this column reflect the value of each phantom stock award as of December 31, 2018, based on the closing price of the Bank's common stock on December 31, 2018. The phantom stock awards vest on the third anniversary of the grant date, subject to the named executive officer's continued employment on such date and will be settled in cash.

None of our named executive officers exercised any stock options or stock appreciation rights or held any restricted stock or phantom stock that vested during 2018.

### Securities Authorized for Issuance under Equity Compensation Plans

The following table contains summary information as of December 31, 2018 with respect to the Carter Bank & Trust 2018 Omnibus Equity Incentive Plan, the only equity compensation plan under which Bank securities are authorized for issuance.

#### Equity Compensation Plan Information

| Plan Category | Number of Securities to be Issued upon Exercise of Outstanding Options, Rights and Warrants (a) | Weighted-Average Exercise Price of Outstanding Options, Rights and Warrants (b) | Number of Securities Remaining Available for Future Issuance under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c) |
|---|---|---|---|
| Equity compensation plans approved by security holders(1) | — | — | 1,987,587 |
| Equity compensation plans not approved by security holders(2) | — | — | — |
| **Total** | **—** | **—** | **1,987,587** |

(1) Shares available to be granted under the Equity Plan as of December 31, 2018, in the form of stock options, restricted stock, restricted stock units, stock appreciation rights, stock awards, performance units and performance cash awards.

(2) The Bank does not have any equity compensation plans that have not been approved by shareholders.

### Qualified Profit Sharing Plan

The Qualified Profit Sharing Plan covers all full-time employees that have been employed for six (6) months and have reached the age of 20-1/2 as of the first day of the plan year. Persons who have reached the age of 62 are fully vested regardless of length of service. For eligibility and vesting purposes, employees receive credit for previous employment with any of the Merged Banks, the Mortgage Company of Virginia, Bank Services of Virginia, Inc. and Bank Services Insurance, Inc. Vesting is based on the number of Years of Service.

The vesting schedule is as follows:

| Years of Service | Vested Percentage | Forfeitable Percentage |
|---|---|---|
| 1 | 0 | 100% |
| 2 | 20% | 80% |
| 3 | 40% | 60% |
| 4 | 60% | 40% |
| 5 | 100% | 0% |

Each year the Board of Directors determines what amount, if any, is to be allocated to the plan out of accumulated or current earnings of the Bank. The contributions to the plan were $1.7 million in 2018, none in 2017, and $2.4 million in 2016.

None of the named executive officers participated in the plan during 2018. The Bank did not have any deferred compensation plans during 2018.

### Potential Payments upon Termination or Change of Control

The following table shows the estimated payments to or benefits that would have been received by each of the named executive officers upon the following termination events or upon a change of control of the Bank, in each case assuming that each termination event or the change of control occurred on December 31, 2018, and assuming a stock price of $15.00 which was the closing stock price of the Bank's common stock on December 31, 2018. The amounts reflected in the following table are estimates, as the actual amounts that would have been paid to or received by a named executive officer can only be determined at the time of termination or change of control.

The following table reports only amounts that are increased, accelerated or otherwise paid or payable as a result of the applicable termination or change of control event and, as a result, excludes amounts accrued through December 31, 2018, such as accrued but unpaid salary and annual bonus compensation amounts for completed performance periods and vested account balances under the 401(k) Plan and other plans. The table also excludes any amounts that are available generally to all salaried employees and in a manner that does not discriminate in favor of the Bank's executive officers.

| Payments and Benefits | Death | Termination Due to Incapacity | Termination Without Cause or for Good Reason Not in Connection with Change of Control[(1)(2)] | Termination Without Cause or for Good Reason within 2 Years Following a Change of Control[(3)(4)(5)] | Termination For Cause or Without Good Reason | Change of Control with no Related Termination of Employment |
|---|---|---|---|---|---|---|
| **Litz H. Van Dyke** | | | | | | |
| Cash Severance | $ — | $ — | $750,000 | $1,495,000 | $ — | $ — |
| Equity Vesting[(6)] | — | — | — | — | — | — |
| Health Care Coverage | — | — | $ 13,064 | $ 13,064 | — | — |
| **Total** | **$ —** | **$ —** | **$763,064** | **$1,508,064** | **$ —** | **$ —** |
| **Wendy S. Bell** | | | | | | |
| Cash Severance | $ — | $ — | $330,000 | $ 660,000 | $ — | $ —- |
| Equity Vesting[(6)] | — | — | — | — | — | — |
| Health Care Coverage | — | — | $ 8,710 | $ 13,064 | — | — |
| **Total** | **$ —** | **$ —** | **$338,710** | **$ 673,064** | **$ —** | **$ —** |
| **Phyllis Q. Karavatakis** | | | | | | |
| Cash Severance | $ — | $ — | $325,000 | $ 650,000 | $ — | $ — |
| Equity Vesting[(6)] | — | — | — | — | — | — |
| Health Care Coverage | — | — | $ 6,773 | $ 10,160 | — | — |
| **Total** | **$ —** | **$ —** | **$331,773** | **$ 660,160** | **$ —** | **$ —** |
| **Matthew M. Speare** | | | | | | |
| Cash Severance | $ — | $ — | $325,000 | $ 650,000 | $ — | $ — |
| Equity Vesting[(7)] | 24,570 | 24,570 | — | 24,570 | — | 24,570 |
| Health Care Coverage | — | — | $ 6,773 | $ 10,160 | — | — |
| **Total** | **$24,570** | **$24,570** | **$331,773** | **$ 684,730** | **$ —** | **$24,570** |
| **Bradford N. Langs** | | | | | | |
| Cash Severance | $ — | $ — | $297,500 | $ 595,000 | $ — | $ — |
| Equity Vesting[(6)] | — | — | — | — | — | — |
| Health Care Coverage | — | — | $ 6,773 | $ 10,160 | — | — |
| **Total** | **$ —** | **$ —** | **$304,273** | **$ 605,160** | **$ —** | **$ —** |

(1) Under his employment agreement, if Mr. Van Dyke resigns for good reason or his employment is terminated without cause not in connection with a change of control, Mr. Van Dyke will be entitled to receive monthly severance payments equal to one-twelfth of his annual base salary for 18 months and continued employee health insurance coverage for 18 months. Payment

of these severance benefits is subject to receipt by the Bank of a signed release and waiver of claims and satisfaction of other requirements, conditions, and limitations set forth in Mr. Van Dyke's employment agreement, including covenants regarding confidentiality, non-competition, non-piracy and non-solicitation.

(2) For each named executive officer other than Mr. Van Dyke, under his or her employment agreement, if the named executive officer resigns for good reason or his or her employment is terminated without cause not in connection with a change of control, the named executive officer will be entitled to receive monthly severance payments equal to one-twelfth of his or her annual base salary for 12 months and continued employee health insurance coverage for 12 months. Payment of these severance benefits is subject to receipt by the Bank of a signed release and waiver of claims and satisfaction of other requirements, conditions, and limitations set forth in the employment agreement, including covenants regarding confidentiality, non-competition, non-piracy and non-solicitation.

(3) Under his employment agreement, if Mr. Van Dyke resigns for good reason or his employment is terminated without cause within two years after a change of control Mr. Van Dyke will be entitled to receive a lump sum severance payment equal to 2.99 times his annual base salary, continued employee health insurance coverage for 18 months and a lump sum payment equal to Mr. Van Dyke's highest annual bonus earned from the Bank for the three years prior to termination. Payment of these severance benefits is subject to receipt by the Bank of a signed release and waiver of claims and satisfaction of other requirements, conditions, and limitations set forth in Mr. Van Dyke's employment agreement, including covenants regarding confidentiality, non-competition, non-piracy and non-solicitation.

(4) For each named executive officer other than Mr. Van Dyke, under his or her employment agreement, if the named executive officer resigns for good reason or his or her employment is terminated without cause within two years after a change of control, the named executive officer will be entitled to receive to receive a lump sum severance payment equal to 2 times his or her annual base salary, continued employee health insurance coverage for 18 months and a lump sum payment equal to the named executive officer's highest annual bonus earned from the Bank for the three years prior to termination. Payment of these severance benefits is subject to receipt by the Bank of a signed release and waiver of claims and satisfaction of other requirements, conditions, and limitations set forth in the employment agreement, including covenants regarding confidentiality, non-competition, non-piracy and non-solicitation.

(5) Each named executive officer's employment agreement provides for change of control benefits on a "best net" approach, under which the named executive officer's change of control benefits will be reduced to avoid the golden parachute excise tax under Section 280G of the Internal Revenue Code unless without such a reduction the named executive officer would receive more after-tax compensation than with a reduction. The amounts shown in this column do not reflect any reductions that might be made pursuant to these provisions.

(6) None of these named executive officers held any equity awards as of December 31, 2018 that would have experienced accelerated vesting upon any of these termination events or upon a change of control of the Bank.

(7) Restricted shares granted to the named executive officers become fully vested upon termination of the named executive officer's employment due to (a) death, (b) disability, (c) retirement (with the consent of the Nominating, Governance and Compensation Committee) at or after age 59 years and six months, with 7 full years of employment where there is no cause for termination and the named executive officer is subject to a non-competition agreement upon retirement, or (d) a change in control of the Bank. In the event of termination of the named executive officer's employment for good reason or without cause, all then unvested restricted shares would be forfeited in the absence of the Nominating, Governance and Compensation Committee's exercise of discretion to waive such forfeiture. Ms. Karavatakis was the only named executive officer eligible for retirement under these provisions as of December 31, 2018.

## DIRECTOR COMPENSATION

For 2018, the Nominating, Governance and Compensation Committee determines the fees to be paid to non-employee directors based on the recommendation of the Chief Executive Officer, which is based on a review of Director fees paid by comparable community banks in Carter Bank & Trust's trade area. For 2018, the Chairman of the Board received $3,000 for each Board meeting and the chairman for each committee received $750 for each committee meeting attended. For 2018, the non-employee directors were paid $2,000 for each Board meeting regardless of whether they attend or not, and were paid $500 for each committee meeting attended. Carter Bank & Trust did not pay its Directors an annual retainer for 2018.

Effective January 1, 2019, the Nominating, Governance and Compensation Committee approved a change in non-employee director compensation. Beginning in 2019, non-employee directors will no longer receive per-meeting fees and will instead receive an annual cash retainer, payable monthly, and an annual stock retainer in the form of an annual award of time-based restricted stock under the Equity Plan. The Chairman of the Board will receive an annual cash retainer in the amount of $48,000, each committee chair will receive an annual cash retainer in the amount of $40,000, and each other non-employee director will receive an annual cash retainer in the amount of $36,000. The annual stock retainer for each director will be paid in the form of restricted stock in the amount of $24,000 based on the closing price of the Bank's stock on the grant date, which restricted stock will vest in equal installments on each of the first, second and third anniversaries of the grant date, subject to accelerated vesting in certain circumstances.

Beginning in 2019, any changes to non-employee director compensation will be reviewed and recommended by the Nominating, Governance and Compensation Committee and approved by the Board of Directors.

## DIRECTOR COMPENSATION TABLE
## FISCAL 2018

The following table provides compensation information for the year ended December 31, 2018 for each non-employee member of the Board of Directors.

| Name[(1)] | Fees Earned or Paid in Cash ($) | Stock Awards ($) | Option Awards ($) | Non-Equity Incentive Plan Compensation ($) | Change in Pension Value and Nonqualified Deferred Compensation Earnings ($) | All Other Compensation ($) | Total ($) |
|---|---|---|---|---|---|---|---|
| Michael R. Bird | $33,250 | — | — | — | — | — | $33,250 |
| Robert W. Conner | $40,000 | — | — | — | — | — | $40,000 |
| Gregory W. Feldmann | $38,000 | — | — | — | — | — | $38,000 |
| Chester A. Gallimore | $28,000 | — | — | — | — | — | $28,000 |
| Charles E. Hall | $33,000 | — | — | — | — | — | $33,000 |
| James W. Haskins | $55,750 | — | — | — | — | — | $55,750 |
| Lanny A. Kyle, O.D. | $35,000 | — | — | — | — | — | $35,000 |
| George W. Lester, II | $36,750 | — | — | — | — | — | $36,750 |
| E. Warren Matthews | $36,000 | — | | — | — | — | $36,000 |
| Catharine L. Midkiff | $30,500 | — | — | — | — | — | $30,500 |
| Joseph E. Pigg | $25,000 | — | — | — | — | — | $25,000 |

(1) Litz Van Dyke, Chief Executive Officer, and Phyllis Karavatakis, Vice Chairman of the Board and President and Chief Banking Officer, are not included in this table because they are officers of the Bank and did not receive separate compensation for service as a Director. The compensation received by Mr. Van Dyke and Ms. Karavatakis as officers of the Bank in 2018 is included in the Summary Compensation Table on page 20. Sidney D. Mason is also not included in this table because he resigned from the Board effective January 1, 2018 and received no compensation during 2018.

## NOMINATING, GOVERNANCE AND COMPENSATION COMMITTEE REPORT

The Nominating, Governance and Compensation Committee of the Board of Directors has reviewed and discussed with management the Compensation Discussion & Analysis included above. Based upon such review, the related discussions and such other matters deemed relevant and appropriate by the Committee, the Committee has recommended to the Board of Directors the inclusion of the Compensation Discussion & Analysis in this proxy statement.

**MEMBERS OF THE NOMINATING, GOVERNANCE AND COMPENSATION COMMITTEE**

Robert W. Conner
Gregory W. Feldmann
James W. Haskins
Lanny A. Kyle, O.D.

### Nominating, Governance and Compensation Committee Interlocks and Insider Participation

None of the members of the Board of Directors currently serve as an officer or employee of Carter Bank & Trust except Mr. Van Dyke and Ms. Karavatakis and none of the Directors served as an officer or employee of Carter Bank & Trust during 2018 except Mr. Van Dyke and Ms. Karavatakis. None of the executive officers of Carter Bank & Trust have served as a member of a compensation committee of any other entity which has an executive officer serving as a member of the Bank's Board of Directors.

## DIRECTOR INDEPENDENCE

All of the Bank's current Directors, other than the Chief Executive Officer, Mr. Van Dyke, Vice Chairman of the Board and President and Chief Banking Officer, Ms. Karavatakis, and Chairman of the Board, Mr. Haskins, satisfy the director independence requirements of the Nasdaq listing standards. All of the Bank's Directors during 2018, other than Mr. Van Dyke and Ms. Karavatakis, satisfied the director independence requirements of the Nasdaq listing standards.

## MEETINGS AND COMMITTEES OF THE BOARD OF DIRECTORS

The Board of Directors held twelve regular meetings during 2018. During 2018, each member of the Board of Directors attended at least 75% of the aggregate of: (1) the Bank's Board meetings held during the period and (2) the number of meetings of all committees on which he or she served for the Bank.

The Board of Directors meets regularly once a month. Carter Bank & Trust has not adopted a formal policy on Board members' attendance at annual meetings of shareholders, although all Board members are encouraged to attend. Thirteen Directors attended the 2018 Annual Meeting of Shareholders on June 27, 2018.

Carter Bank & Trust has created and designated a separate committee of its Board of Directors as the Audit and Compliance Committee. Current members of the Bank's Audit and Compliance Committee are Messrs. Chester A. Gallimore, George W. Lester, II, E. Warren Matthews, Michael R. Bird (Chairman) and Ms. Catharine Midkiff, each of whom is "independent" for this purpose according to Nasdaq listing standards and the regulations of the "SEC". The Audit and Compliance Committee engages the Bank's independent registered public accounting firm, approves the scope of the independent registered public accounting firm's audit, reviews the reports of examination by the applicable Bank regulatory agencies and the independent registered public accountant, and the internal auditor, and reports to the Board of Directors periodically. The Audit and Compliance Committee met nine times during 2018. The Audit and Compliance Committee operates pursuant to a written charter that has been adopted by the Board and is reviewed periodically by the Audit and Compliance Committee for changes to recommend to the Board for approval. The charter is available on the Bank's website at www.carterbankandtrust.com under "Investor Relations".

The Board of Directors has determined that Mr. George W. Lester II, Catharine L. Midkiff and Michael R. Bird each qualify as an "audit committee financial expert" within the meaning of applicable regulations of the SEC, promulgated pursuant to the Sarbanes-Oxley Act of 2002.

The Nominating, Governance and Compensation Committee consists of four Directors. The current members of the Committee are Chairman James W. Haskins, and Messrs. Robert W. Conner, Gregory W. Feldmann, and Lanny A. Kyle, O.D. Each Director satisfies the independence requirements of the Nasdaq listing standards, except for Mr. Haskins. A company that lists its stock on Nasdaq in connection with transferring from a market that did not have substantially similar corporate governance requirements, such as the OTCQX, is eligible to use applicable Nasdaq transition rules to phase in compliance with certain Nasdaq listing standards over a period of one year from the date of listing its stock on Nasdaq. The Bank is relying on this phase-in period with respect to the independence of members of the Nominating, Governance and Compensation Committee and plans to adjust the composition of the committee such that all members satisfy the independence requirements of the Nasdaq listing standards by the end of the phase-in period. Additional information regarding the function of the Committee is provided on the prior page and in the "Compensation Discussion & Analysis" section.

The Nominating, Governance and Compensation Committee evaluates Director candidates and recommends to the Board of Directors nominees for election to the Board. The Board has no prescribed minimum qualifications for nominees and will consider recommendations to the Board from shareholders as appropriate. The Committee also administers the annual incentive plan discussed above. The Committee also administers the Carter Bank & Trust 2018 Omnibus Equity Incentive Plan (the "Equity Plan") and grants equity awards under the plan. In addition to its compensation-related responsibilities, the Committee also makes recommendations to the Board of Directors regarding individuals to be nominated to serve on the Board of Directors and regarding corporate governance matters. The Nominating, Governance and Compensation Committee operates pursuant to a written charter, most recently approved by the Board of Directors on December 19, 2018. This charter is reviewed periodically by the Nominating, Governance and Compensation Committee for changes to recommend to the Board of Directors for approval. A copy of this charter can be found on the Bank's website at carterbankandtrust.com under "Investor Relations". The Nominating, Governance and Compensation Committee met 10 times during 2018.

Generally, nominees for Director are identified and suggested by the members of the Board or management using their business networks. The Board has not retained any executive search firms or other third parties to identify or evaluate Director candidates in the past and does not intend to in the near future. In evaluating candidates, the Nominating, Governance and Compensation Committee considers all appropriate factors, which may include high level leadership experience, knowledge of issues affecting the Bank, availability for meetings and consultation on Bank matters, strength of character, mature judgment, independence of thought and an ability to work collegially. The Nominating, Governance and Compensation Committee may also consider the extent to which a candidate would fill a present need on the Board.

Although the Bank has no formal policy regarding diversity, as a matter of practice in its evaluation of candidates, the Nominating, Governance and Compensation Committee, may consider whether the Board of Directors, as a whole, is diverse and includes individuals with various backgrounds, career experience, technical skills, industry knowledge and experience financial expertise and local or community ties.

The Board has not established any specific minimum qualifications that a candidate for Director must meet in order to be nominated for Board membership. Rather the Board will evaluate the mix of skills and experience that the candidate offers, consider how a given candidate meets the Board's current expectations and needs and make a determination regarding whether a candidate should be nominated for election by the shareholders as a Director.

The Nominating, Governance and Compensation Committee will evaluate Director recommendations from shareholders if made in writing. Director candidates recommended by shareholders will be considered on the same basis as Director candidates referred from other sources. While there are no formal procedures for shareholders to submit Director candidate recommendations, written recommendations of Director candidates should include the name, address and telephone number of the recommended candidate, along with a brief statement of the candidate's qualifications to serve as a Director. All such shareholder recommendations should be submitted to the Secretary of the Bank at the address provided on the first page of this proxy statement, by January 31, 2020 in order to be considered by the Nominating, Governance and Compensation Committee, for the next annual election of directors. In addition, in accordance with the Bank's Articles of Incorporation and/or Bylaws, nominations for election to the Board of Directors may be made by any shareholder of any outstanding class of capital stock of the Bank entitled to vote for the election of Directors. Notices of nominations, other than those made by or on behalf of the existing Board of Directors of the Bank, must be made in writing and be delivered to the Secretary of the Bank at the address provided on the first page of this proxy statement not less than 90 days or more than 120 days before the first anniversary of the prior year's annual meeting; provided that if the annual meeting is changed by more than 30 days from the first anniversary of the prior year's annual meeting, the notice must be delivered no earlier than 120 days before the annual meeting and no later than 90 days before the annual meeting or the tenth day after notice of the annual meeting was mailed.

Such notice shall contain the following information to the extent known to the notifying shareholder: (a) the name and address of each nominee; (b) the name and residence address of the notifying shareholder; (c) the number of shares of capital stock of the Bank owned by the notifying shareholder; (d) a description of all arrangements or understandings between the notifying shareholder and any other person or persons (including their names) in connection with the nomination and any material interest of the notifying shareholder in the nomination; (e) a brief description of the background and credentials of the person being nominated for Director including name, age, business address and residence address, principal occupation or employment, number of shares of capital stock of the Bank owned by the nominee; (f) any other information relating to such nominee required to be disclosed in solicitations of proxies for election of directors pursuant to Regulation 14A under the Exchange Act, including the nominee's written consent to being named in the proxy statement as a nominee and to serving as a director if elected; and (g) a written representation and agreement by the notifying shareholder that the shareholder is not and will not become a party to any agreement, arrangement or understanding with any other party or shareholder regarding the nomination. Nominations not made in accordance with these requirements may, in his discretion, be disregarded by the chairman of the meeting, and upon his instructions, the judges of election may disregard all votes cast for each such nominee.



## BOARD LEADERSHIP STRUCTURE AND RISK OVERSIGHT

The Board of Directors believes that the Bank and its shareholders are best served by a leadership structure with separate positions for Chairman and Chief Executive Officer, with Mr. James W. Haskins serving as Chairman of the Board and Mr. Litz H. Van Dyke serving as Chief Executive Officer of Carter Bank & Trust. The Board believes that this leadership structure is the most efficient and effective leadership structure for the Bank at this time. The current leadership structure allows Mr. Van Dyke to focus on providing day-to-day leadership and management of the Bank, while Mr. Haskins, who has stepped into the role of Chairman from Vice Chairman, can maintain responsibility for leading the Board in its oversight function and consideration of broader corporate strategy. The Board will continue to evaluate the best leadership structure for the Bank in the future.

The Board of Directors is responsible for consideration and oversight of risk facing the Bank and is responsible for ensuring that material risks are identified and managed appropriately. The Audit and Compliance Committee meets quarterly and reviews the Bank's major financial risk exposures and reviews the steps management is taking to monitor and control such exposures, including results of internal and external audits. Directors also serve on various committees that focus on major areas of risk in the Bank that include, but are not limited to, loans, investments, audit, and governance and compensation. Directors discuss risk and risk reduction strategies with management within those committees. All such discussions are included in committee reports to the full Board of Directors.

## SHAREHOLDER COMMUNICATIONS WITH THE BOARD OF DIRECTORS

The Bank does not have a formal process for shareholders to send communications to the Board of Directors. Shareholders who wish to contact the Board of Directors or any of its members may do so by addressing their written correspondence to Board of Directors, Carter Bank & Trust, c/o Vice President and Accounting Operations Manager, 1300 Kings Mountain Rd, Martinsville, Virginia 24112. Correspondence directed to an individual Board member will be referred, unopened, to that member. Correspondence not directed to a particular Board member will be referred, unopened, to the Chairman of the Board.

## RELATED PERSON TRANSACTIONS

In the ordinary course of business, executive officers and their related interests were customers of, and had transactions with the Bank. Loan transactions with Directors and officers, principal security holders and associates were made in the ordinary course of the Bank's business, on substantially the same terms, including interest rates, collateral and repayment terms, as those prevailing at the time for comparable loans to unrelated parties and did not involve more than normal risk of collectability or present other unfavorable features. These extensions of credit equaled $23.1 million or 5.3% of the equity capital of Carter Bank & Trust as of December 31, 2018 and $17.0 million or 3.9%, as of December 31, 2017. The maximum aggregate amount of such indebtedness outstanding during 2018 was $23.1 million, or 5.3% of total year-end capital. The Bank expects to have similar banking transactions in the future with its Directors, officers, principal security holders and their associates.

### Procedures for Approving Related Party Transactions

The Board of Directors has adopted a written policy with respect to related party transactions that governs the review, approval or ratification of covered related party transactions. The Audit and Compliance Committee oversees this policy. The policy generally provides that the Bank may enter into a related party transaction only if the Audit and Compliance Committee approves or ratifies such transaction in accordance with the guidelines set forth in the policy and if the transaction is on terms comparable to those that could be obtained in arm's length dealings with an unrelated third party, the transaction involves compensation approved by the Nominating, Governance and Compensation Committee or with respect to loans to or similar relationships with related parties, the loan or other relationship has been approved in accordance with the Bank's Regulation O loan policy and procedures.

In the event management determines to recommend a related party transaction, the transaction must be presented to the Audit and Compliance Committee for approval. After review, the Audit and Compliance Committee will approve or disapprove such transaction and management will update the Audit and Compliance Committee as to any material change to the approved related party transaction. If advance approval by the Audit and Compliance Committee is not feasible, management may preliminarily enter into a related party transaction and the related party transaction shall be considered and, if the Audit and Compliance Committee determines it to be appropriate, ratified by the Audit and Compliance Committee at its next meeting. The Audit and Compliance Committee approves only those related party transactions that are in, or are not inconsistent with, the best interests of the Bank and its shareholders, as the Audit and Compliance Committee determines.

For purposes of this policy, a "related party transaction" is a transaction, arrangement or relationship (or any series of similar transactions, arrangements or relationships) in which the Bank is, was or will be a participant and the amount involved exceeds $120,000 and in which any related party had, has or will have a direct or indirect material interest. For purposes of determining whether a transaction is a related party transaction, the Audit and Compliance Committee refers to Item 404 of Regulation S-K.

Carter Bank & Trust is a party to an agreement with Young, Haskins, Mann, Gregory, McGarry and Wall, P.C. to provide legal services of which Chairman and Director James W. Haskins is an Attorney and Principal. During 2018, Carter Bank & Trust paid $228,000 in various legal fees to Young, Haskins, Mann, Gregory, McGarry and Wall, P.C.

A "related party" is (i) any person who is, or at any time since the beginning of the last fiscal year was, an executive officer, Director, or nominee for Director of the Bank, (ii) any person who is known to own more than 5% of the Bank's outstanding equity securities, (iii) any immediate family member of any of the foregoing persons, which means any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law and any person (other than a tenant or employee) sharing the household of any of the foregoing persons, and (iv) any entity owned or controlled by any of the foregoing persons or in which such person has a substantial ownership interest or control.

## CHANGE IN INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

As disclosed in the Bank's Current Report on Form 8-K filed with the FDIC on March 19, 2019, the Bank's Audit and Compliance Committee conducted a competitive process to determine the Bank's independent registered public accounting firm for the fiscal year ending December 31, 2019. The Audit and Compliance Committee invited several independent registered public accounting firms to participate in this process, including Yount, Hyde & Barbour P.C.

On March 13, 2019, the Audit and Compliance Committee approved the dismissal of Yount, Hyde & Barbour P.C. as the Bank's independent registered public accounting firm, effective upon the filing of the Bank's Annual Report on Form 10-K for the year ended December 31, 2018, which was filed with the FDIC on March 14, 2019. Yount, Hyde & Barbour, P.C. audited the Bank's financial statements as of and for the fiscal years ended December 31, 2018 and 2017 and the effectiveness of the Bank's internal control over financial reporting as of December 31, 2018 and 2017.

The audit reports of Yount, Hyde & Barbour P.C. on the Bank's consolidated financial statements for the fiscal years ended December 31, 2018 and 2017 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.

During the fiscal years ended December 31, 2018 and 2017 and the subsequent interim period through March 14, 2019, there have been no "disagreements" (within the meaning of Item 304(a)(1)(iv) of Regulation S-K and the related instructions) between the Bank and Yount, Hyde & Barbour P.C. on any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure, which disagreements if not resolved to the satisfaction of Yount, Hyde & Barbour P.C. would have caused Yount, Hyde & Barbour P.C. to make reference thereto in its reports on the consolidated financial statements for such years. Except as described below, during the fiscal years ended December 31, 2018 and 2017 and through March 14, 2019, there have been no "reportable events" (as defined in Item 304(a)(1)(v) of Regulation S-K). On March 16, 2017, Yount, Hyde & Barbour P.C. issued its audit report (the "YHB Report") regarding the Bank's internal control over financial reporting which stated that, as of December 31, 2016, the Bank had not maintained effective internal control over financial reporting. The YHB Report identified a material weakness in the Bank's internal control over financial reporting based on control deficiencies in the Bank's process of estimating the allowance for loan losses. This material weakness did not affect the unqualified audit report of Yount, Hyde & Barbour P.C. dated March 16, 2017 regarding the Bank's financial statements for the year ended December 31, 2016. As disclosed in Item 9A of the Bank's Annual Report on Form 10-K for the year ended December 31, 2017, the Bank concluded that the material weakness was fully remediated as of December 31, 2017. The Audit and Compliance Committee discussed the YHB Report with Yount, Hyde & Barbour P.C. and the Bank has authorized Yount, Hyde & Barbour P.C. to respond fully to any inquiries of Crowe LLP regarding the material weakness that was fully remediated as of December 31, 2017.

On March 13, 2019, the Audit and Compliance Committee approved the appointment of Crowe LLP as the Bank's new independent registered public accounting firm to perform independent audit services for the fiscal year ending December 31, 2019. During the fiscal years ended December 31, 2018 and 2017 and through March 14, 2019, neither the Bank, nor anyone acting on its behalf, consulted Crowe LLP regarding either (i) the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered with respect to the consolidated financial statements of the Bank, and no written report or oral advice was provided to the Bank by Crowe LLP that was an important factor considered by the Bank in reaching a decision as to any accounting, auditing or financial reporting issue; or (ii) any matter that was the subject of a "disagreement" (within the meaning of Item 304(a)(1)(iv) of Regulation S-K and the related instructions) or a "reportable event" (as defined in Item 304(a)(1)(v) of Regulation S-K).

Representatives of Yount, Hyde & Barbour, P.C. and Crowe LLP are expected to be present at the Annual Meeting and will be given the opportunity to make a statement if they so desire and to respond to appropriate questions.

## PROPOSAL 2

## RATIFICATION OF INDEPENDENT AUDITORS

The Audit and Compliance Committee of Carter Bank & Trust's Board of Directors has appointed Crowe LLP to serve as the Bank's independent registered public accounting firm for 2019 and recommends that the Bank's shareholders vote for the ratification of that appointment. The Audit and Compliance Committee considered the compatibility of proposed permitted non-audit services to be provided by and fees to be paid to Crowe LLP and determined that such services and fees are compatible with the independence of Crowe LLP. In the event the shareholders fail to ratify the appointment, the Audit and Compliance Committee will reconsider this appointment and make such determination as it would be in the Bank's and its shareholders' best interests.

**THE BOARD OF DIRECTORS RECOMMENDS THAT THE SHAREHOLDERS VOTE FOR RATIFICATION OF THE SELECTION OF CROWE LLP AS INDEPENDENT REGISTERED PUBLIC ACCOUNTANTS FOR THE FISCAL YEAR ENDING DECEMBER 31, 2019.**

## REPORT OF THE AUDIT AND COMPLIANCE COMMITTEE

In fulfilling its oversight responsibilities for the financial statements for fiscal year 2018, the Audit and Compliance Committee:

- Monitored the preparation of the annual financial report by the Bank's management;
- Reviewed and discussed the annual audit process and the audited financial statements for the fiscal year ended December 31, 2018 with management and Yount, Hyde & Barbour, P.C.;
- Discussed with management, Yount, Hyde & Barbour, P.C. and the Bank's internal auditor the adequacy of the system of internal controls;
- Discussed with Yount, Hyde & Barbour, P.C. the matters required to be discussed by Statement on Auditing Standards No. 1301, Communications with Audit Committees, relating to the conduct of the audit; and
- Received written disclosures and a letter from Yount, Hyde & Barbour, P.C. regarding its independence as required by the Public Company Accounting Oversight Board (PCAOB) Rule 3526. The Audit and Compliance Committee discussed with Yount, Hyde & Barbour, P.C. its independence.

The Audit and Compliance Committee also considered the status of pending litigation, taxation matters and other areas of oversight relating to the financial reporting and audit process that the Audit and Compliance Committee determined appropriate.

In performing all of these functions, the Audit and Compliance Committee acts only in an oversight capacity. In its oversight role, the Audit and Compliance Committee relies on the work and assurances of the Bank's management, which has the primary responsibility for the financial statements and reports, and of the independent registered public accountant, who, in their report, express an opinion on the conformity of the Bank's annual financial statements to accounting principles generally accepted in the United States of America. Based on the reviews and discussions described above, the Audit and Compliance Committee recommended to the Board that the audited financial statements be included in the Bank's Annual Report on Form 10-K for fiscal year 2018 for filing with the FDIC.

**MEMBERS OF THE AUDIT AND COMPLIANCE COMMITTEE**

Michael R. Bird, Chairman
Chester A. Gallimore
George W. Lester, II
Catharine L. Midkiff
E. Warren Matthews

## INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Yount, Hyde & Barbour, P.C. served as the independent registered public accounting firm for Carter Bank & Trust for the years ended December 31, 2018 and 2017. As discussed above, Crowe LLP has been selected by the Audit and Compliance Committee to serve as the independent registered public accounting firm for Carter Bank & Trust for 2019.

The following table presents the aggregate fees for Carter Bank & Trust and its wholly-owned subsidiaries, for professional audit services rendered by Yount, Hyde & Barbour, P.C. for the audit of the annual financial statements for the years ended December 31, 2018 and 2017 and fees billed for other services rendered by Yount, Hyde & Barbour, P.C. during those periods. Crowe LLP did not perform any accounting or audit services for Carter Bank & Trust during those periods.

| | Years Ended December 31, | |
|---|---|---|
| | 2018 | 2017 |
| Audit fees(1) | $176,748 | $176,900 |
| Tax fees(2) | 5,827 | 4,546 |
| Total Fees | $182,575 | $181,446 |

(1) Audit fees consist of audit and review services, report on internal control over financial reporting and review of documents filed with the FDIC.

(2) Tax fees consist of assistance with 2016 IRS audit during 2018, as well as, research and consultation on various tax matters in 2017.

The Audit and Compliance Committee, considered the compatibility of the non-audit related services performed by and fees paid to Yount, Hyde & Barbour, P.C. in 2018 and determined that such services and fees were compatible with the independence of Yount, Hyde & Barbour, P.C. as the Bank's independent auditors.

Also, the Audit and Compliance Committee of the Board of Directors of the Bank pre-approves all audits (including audit-related) and permitted non-audit services to be performed by the independent auditors. With respect to other permitted services, the Audit and Compliance Committee pre-approves specific engagements, projects and categories of services on a fiscal year basis.

## OTHER BUSINESS

As of the date of this proxy statement, management of the Bank has no knowledge of any matters to be presented for consideration at the Annual Meeting other than the proposals referred to above. If any other matters properly come before the Annual Meeting, the persons named in the accompanying proxy intend to vote such proxy, to the extent entitled, according to the recommendations of the Board of Directors.

## SHAREHOLDER PROPOSALS FOR 2020 ANNUAL MEETING

If any shareholder intends to present a proposal at the 2020 Annual Meeting of Shareholders (including nominations of directors) or have a proposal considered for inclusion in the Bank's proxy materials for the 2020 Annual Meeting of Shareholders pursuant to Rule 14a-8 under the Exchange Act, the proposal must be in proper form in accordance with the federal proxy rules and the Bank's Bylaws as applicable, and must be received by the Secretary of the Bank, at the Bank's main office in Martinsville, Virginia no later than March 28, 2020 and no earlier than February 26, 2020; provided however, if the 2020 Annual Meeting of Shareholders is changed by more than 30 days from the first anniversary date of the 2019 Annual Meeting of Shareholders (June 26, 2019), notice must be delivered no earlier than 120 days before the 2020 Annual Meeting of Shareholders and no later than 90 days before the 2020 Annual Meeting of Shareholders or the tenth day following the day on which notice of the 2020 Annual Meeting of Shareholders is mailed.

The proxy solicited by the Board of Directors for the 2020 Annual Meeting of Shareholders will confer discretionary authority on the persons named in the accompanying proxy to vote on any shareholder proposal presented at the meeting if the Bank has not received proper notice of such proposal.

By Direction of the Board of Directors

James W. Haskins
Chairman of the Board

May 24, 2019

**A copy of the Bank's Annual Report on Form 10-K (including exhibits) as filed with the FDIC for the year ended December 31, 2018, will be furnished without charge to shareholders upon written request to Chief Financial Officer, Carter Bank & Trust, 1300 Kings Mountain Road, Martinsville, Virginia 24112.**

# Carter Bank & Trust

2018 Annual Report

FEDERAL DEPOSIT INSURANCE CORPORATION
Washington, D.C. 20429

# FORM 10-K

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

For the fiscal year ended December 31, 2018

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

For the transition period from to
Commission file number: N/A

# CARTER BANK & TRUST

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Virginia** | **20-5539935** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| **1300 Kings Mountain Road, Martinsville, Virginia** | **24112** |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code: **(276) 656-1776**

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

| Title of each class | Name of each exchange on which registered |
|---|---|
| **n/a** | **n/a** |

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

**Common stock, $1.00 par value per share**

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

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). **Yes** ☐ **No** ☐

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

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

| | | | | | |
|---|---|---|---|---|---|
| Large accelerated filer | ☐ | Accelerated filer | ☒ | Emerging growth company | ☐ |
| Non-accelerated filer | ☐ | Smaller reporting company | ☐ | | |

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

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

The aggregate market value of Carter Bank & Trust's common stock held by non-affiliates, computed by reference to the price at which the common stock was last sold, or the average bid and asked price of such common stock, as of June 30, 2018 was $439,705,161.

There were 26,287,323 shares of common stock of Carter Bank & Trust outstanding as of March 13, 2019.

## DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement of Carter Bank & Trust to be filed pursuant to Regulation 14A for the 2019 Annual Meeting of Shareholders to be held June 26, 2019, are incorporated by reference in Part III of this report on Form 10-K.

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### PART III



### PART IV

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## ITEM 1. BUSINESS

### General

Carter Bank & Trust (the "Bank") is a non-member state Bank headquartered in Martinsville, Virginia with assets of $4.0 billion at December 31, 2018. The Bank operates branches in Virginia and North Carolina and is one of the largest state chartered commercial banks headquartered in Virginia, operating 105 branches in Virginia and North Carolina.

The Bank provides a full range of financial services with retail, and commercial banking products and insurance. Our common stock began trading on the Over the Counter ("OTCQX") Best Market effective April 26, 2018, under the ticker symbol "CARE." On February 28, 2019, Carter Bank and Trust received approval for the Bank's application to have our common stock listed on The Nasdaq Global Select Market. Carter Bank & Trust's common shares are expected to begin trading on Nasdaq at the opening of the market on Monday, March 25, 2019 under the ticker symbol "CARE."

The Bank earns revenue primarily from interest on loans and securities and fees charged for financial services provided to our customers. The Bank incurs expenses for the cost of deposits, provision for loan losses and other operating costs such as salaries and employee benefits, data processing, occupancy and tax expense.

Our mission is that the Bank strives to be the preferred lifetime financial partner for our customers and shareholders, and the employer of choice in the communities the Bank is privileged to serve. Our strategic plan focuses on restructuring the balance sheet to provide more diversification and higher yielding assets to increase net interest margin. Another area of focus is the transformation of our infrastructure through new technology. During 2018, we converted our core systems to a best-in-suite platform that provides a transformative foundation for both our operational efficiency and delivery process including online and mobile channels for our customers.

During 2018 and 2017, the Bank continued to take aggressive steps to deal with legacy problem loans to reduce their lingering impact to our long-term performance. Our focus going forward into 2019 will be on loan and deposit growth with emphasis on an account acquisition strategy and implementation of new opportunities to increase fee income while closely monitoring our operating expenses. The Bank is focused on executing our strategy to successfully build our brand and grow our business in our markets. The Bank benefited from recent increases in short-term interest rates and from the Tax Cuts and Jobs Act ("Tax Act") which lowered the federal corporate tax rate from 35 percent to 21 percent effective January 1, 2018.

The Bank offers a full range of deposit services including LIFETIME FREE CHECKING, interest checking accounts, savings accounts, retirement accounts and other deposit accounts of various types, ranging from money market accounts to longer-term certificates of deposit. The transaction accounts and time certificates are tailored to each of the Bank's principal markets at competitive rates. All deposit accounts are insured by the Federal Deposit Insurance Corporation ("FDIC") up to the maximum amount allowed by law. The Dodd-Frank Act, signed into law on July 21, 2010, makes permanent the $250,000 limit for federal deposit insurance and the coverage limit applies per depositor, per insured depository institution for each account ownership.

The Bank also offers a full range of commercial and personal loans. Commercial loans include both secured and unsecured loans. Consumer loans include secured and unsecured loans for financing automobiles, home improvements, education and personal investments. The Bank also makes real estate construction and acquisition loans, and originates and holds fixed and variable rate mortgage loans.

The Bank's lending activities are subject to a variety of lending limits imposed by federal law. While differing limits apply in certain circumstances based on the type of loan or the nature of the borrower (including the borrower's relationship to the Bank), in general the Bank is subject to a loan-to-one borrower limit of an amount equal to 15% of the Bank's unimpaired capital and surplus. The Bank may not make loans to any director, officer, employee or 10% shareholder of the Bank unless the loan is approved by the Board of Directors and is made on terms not more favorable than are made available to a person not affiliated with the Bank.

Other bank services include safe deposit boxes, direct deposit of payroll and social security checks, and automated drafts for various accounts. The Bank has no current plans to exercise trust powers.

In 2018, the Bank had one direct wholly owned subsidiary operating as The Mortgage Company of Virginia, Inc. (“MCOV”). The business operations of MCOV had been entirely absorbed by Carter Bank & Trust and MCOV had no employees and no separate business of its own in 2018. The subsidiary was terminated and dissolved on December 11, 2018.

In 2018, MCOV owned 100% of Bank Services of Virginia (“BSVA”) which provided courier services to the Bank. The only employees of BSVA were those persons working in the courier operations. This subsidiary was terminated and dissolved on July 10, 2018.

In 2018, MCOV owned 100% of Bank Services Insurance, Inc. which was a fully operational, licensed general insurance agency providing insurance services to bank customers and other third parties. This subsidiary was sold in January of 2018.

## Employees

As of December 31, 2018, Carter Bank & Trust and its subsidiaries had 992 full-time equivalent employees.

## Competition

The Bank experiences significant competition in attracting depositors and borrowers. Competition in lending activities comes principally from other commercial banks, savings associations, insurance companies, governmental agencies, credit unions, and brokerage firms. Competition for deposits comes from other commercial banks, savings associations, money market and mutual funds, credit unions, insurance companies and brokerage firms. Some of the financial organizations competing with the Bank have greater financial resources than the Bank. Certain of these financial organizations also have greater geographic coverage and some offer bank and bank-related services which the Bank does not offer.

## Supervision and Regulation

*General.* Financial institutions are extensively regulated under federal and state law. Consequently, the growth and earnings performance of the Bank can be affected not only by management decisions and general economic conditions, but also by the statutes administered by, and the regulations and policies of, various governmental regulatory authorities including, but not limited to, the Federal Reserve Board (“FRB”), the FDIC, the Internal Revenue Service (“IRS”), federal and state taxing authorities, and the Securities and Exchange Commission (“SEC”). The effect of such statutes, regulations and policies can be significant, and cannot be predicted with a high degree of certainty.

The Bank is subject to supervision, regulation and examination by the Virginia Bureau of Financial Institutions (the “Bureau”) and the Bank’s primary federal regulator, the FDIC. Federal and state laws and regulations generally applicable to financial institutions regulate, among other things, the scope of business, investments, reserves against deposits, capital levels relative to operations, the nature and amount of collateral for loans, the establishment of branches, mergers, consolidations and dividends. The system of supervision and regulation applicable to the Bank establishes a comprehensive framework for its operations and is intended primarily for the protection of the FDIC’s deposit insurance funds and the depositors, rather than the shareholders of the Bank.

Finally, the Bank is subject to the periodic reporting requirements of the Securities Exchange Act of 1934, as amended, including, but not limited to, filing annual, quarterly and other current reports with the FDIC. The Bank is not a member of the Federal Reserve System.

The following references to material statutes and regulations affecting the Bank are brief summaries thereof and do not purport to be complete, and are qualified in their entirety by reference to such statutes and regulations. Any change in applicable law or regulations may have a material effect on the business of the Bank.

*Regulatory Reform.* The financial crisis of 2008, including the downturn of global economic, financial and money markets and the threat of collapse of numerous financial institutions, and other events led to the adoption of numerous laws and regulations that apply to, and focus on, financial institutions. The most significant of these laws is the Dodd-Frank Act Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was enacted on July 21, 2010 and, in part, was intended to implement significant structural reforms to the financial services industry.

In May 2018, the Economic Growth, Regulatory Relief and Consumer Protection Act (the "EGRRCPA") was enacted to reduce the regulatory burden on certain banking organizations, including community banks, by modifying or eliminating certain federal regulatory requirements. While the EGRRCPA maintains most of the regulatory structure established by the Dodd-Frank Act, it amends certain aspects of the regulatory framework for small depository institutions with assets of less than $10 billion as well as for larger banks with assets above $50 billion. In addition, the EGRRCPA included regulatory relief for community banks regarding call reports, application of the Volcker Rule (proprietary trading prohibitions), mortgage disclosures, qualified mortgages, and risk weights for certain high-risk commercial real estate loans. However, federal banking regulators retain broad discretion to impose additional regulatory requirements on banking organizations based on safety and soundness and U.S. financial system stability considerations.

The Bank continues to experience ongoing regulatory reform. These regulatory changes could have a significant effect on how the Bank conducts its business. The specific implications of the Dodd-Frank Act, the EGRRCPA, and other potential regulatory reforms cannot yet be fully predicted and will depend to a large extent on the specific regulations that are to be adopted in the future. Certain aspects of the Dodd-Frank Act and the EGRRCPA are discussed below in more detail.

*Regulatory Capital Requirements.* All financial institutions are required to maintain minimum levels of regulatory capital. The FDIC established risk-based and leveraged capital standards for the financial institutions they regulate. The FDIC also may impose capital requirements in excess of these standards on a case-by-case basis for various reasons, including financial condition or actual or anticipated growth.

As of December 31, 2018 and 2017, Carter Bank & Trust qualified as a "well capitalized" institution (see Note 15 of the Notes to Consolidated Financial Statements filed herewith). Under the risk-based capital requirements, through December 31, 2015, the Bank was required to maintain a minimum ratio of total capital to risk-weighted assets of at least 8%. At least half of the total capital was required to be "Tier 1 capital," which consists principally of common and certain qualifying preferred shareholders' equity, less certain intangibles and other adjustments. The remainder, "Tier 2 capital," consists of a limited amount of subordinated and other qualifying debt (including certain hybrid capital instruments) and a limited amount of the general loan loss reserve.

The federal regulatory agencies established a minimum leveraged capital ratio (Tier 1 capital to period end total average assets). These guidelines provided for a minimum leverage capital ratio of 4%. The guidelines also provided that banking organizations experiencing internal growth or making acquisitions were expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

*Basel III Regulatory Capital Framework.* On July 2, 2013, the Federal Reserve approved certain provisions to not only revise and strengthen risk-based and leverage capital requirements, but to implement certain provisions required by the Dodd-Frank Act. The provisions adopted by the FRB and FDIC contain rules to implement the Basel III capital framework as outlined by the Basel Committee on Banking Supervision and standards for calculating risk-weighted assets and risk-based capital measurements (collectively, the "Basel III Final Rules") that apply to banking institutions they supervise. For the purposes of the Basel III Final Rules, (i) common equity tier 1 capital (CET1) consists principally of common stock (including surplus) and retained earnings; (ii) Tier 1 capital consists principally of CET1 plus non-cumulative preferred stock and related surplus, and certain grandfathered cumulative preferred stocks and trust preferred securities; and (iii) Tier 2 capital consists of other capital instruments, principally qualifying subordinated debt and preferred stock, and limited amounts of an institution's allowance for loan losses. Each regulatory capital classification is subject to certain adjustments and limitations, as implemented by the Basel III Final Rules. The Basel III Final Rules also establish risk weightings that are applied to many classes of assets held by community banks, importantly including applying higher risk weightings to certain commercial real estate loans.

The Basel III Final Rules became effective January 1, 2015, and included a requirement that banks maintain additional capital (the "capital conservation buffer"), which became fully phased-in effective January 1, 2019. The Basel III Final Rules (and the fully phased-in capital conservation buffer) require banks to maintain:

- a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% capital conservation buffer (which is added to the minimum CET1 ratio, effectively resulting in a required ratio of CET1 to risk-weighted assets of at least 7%);
- a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (effectively resulting in a required Tier 1 capital ratio of 8.5%);
- a minimum ratio of total (that is, Tier 1 plus Tier 2) capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (effectively resulting in a required total capital ratio of 10.5%); and
- a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average total assets, subject to certain adjustments and limitations.

The Basel III Final Rules provide deductions from and adjustments to regulatory capital measures, primarily to CET1, including deductions and adjustments that were not applied to reduce CET1 under historical regulatory capital rules. For example, mortgage servicing rights, deferred tax assets dependent upon future taxable income, and significant investments in non-consolidated financial entities must be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1.

The Basel III Final Rules also include changes in the risk weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and nonresidential mortgage loans that are 90 days past due or otherwise on nonaccrual status, a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancelable, a 250% risk weight (up from 100%) for mortgage servicing rights and deferred tax assets that are not deducted from capital, and increased risk-weights (from 0% to up to 600%) for equity exposures.

As of December 31, 2018, the Bank meets all capital adequacy requirements under the Basel III Final Rules, including the capital conservation buffer on a fully phased-in basis as if such requirements were in effect as of that date.

*Community Bank Leverage Ratio*. As a result of the EGRRCPA, the federal banking agencies were required to develop a Community Bank Leverage Ratio (the ratio of a bank's tangible equity capital to average total consolidated assets) for banking organizations with assets of less than $10 billion, such as the Bank. On November 21, 2018, the federal banking agencies invited public comment on their proposal to establish the Community Bank Leverage Ratio framework. Under the proposal, a community banking organization would be eligible to elect the Community Bank Leverage Ratio framework if it has less than $10 billion in total consolidated assets, limited amounts of certain assets and off-balance sheet exposures, and a Community Bank Leverage Ratio greater than 9%.

A qualifying community banking organization that has chosen the proposed framework would be automatically considered in compliance with the Basel III capital requirements and would be exempt from the complex Basel III risk-based capital calculations. Such a community banking organization would be considered to have met the capital ratio requirements to be "well capitalized" for the federal banking agencies' Prompt Corrective Action rules provided it has a Community Bank Leverage Ratio greater than 9%. Because the proposal has not been finalized and a final rule has not been issued, it is difficult at this time to predict when or how this new capital ratio will ultimately be applied to community banking organizations or to predict the specific impacts of the final rule.

*The Dodd-Frank Act*. The Dodd-Frank Act implemented far-reaching changes across the financial regulatory landscape, including changes that have affected all bank holding companies and banks, including the Bank. Provisions that significantly affect the business of the Bank include the following:

- Insurance of Deposit Accounts. The Dodd-Frank Act changed the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible capital. The Dodd-Frank Act also made permanent the $250,000 limit for federal deposit insurance and increased the cash limit of Securities Investor Protection Corporation protection from $100,000 to $250,000.

- Payment of Interest on Demand Deposits. The Dodd-Frank Act repealed the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

- Creation of the Consumer Financial Protection Bureau (the "CFPB"). The Dodd-Frank Act centralized significant aspects of consumer financial protection by creating a new agency, the CFPB (discussed in more detail below).

- Debit Card Interchange Fees. The Dodd-Frank Act imposed limits for debit card interchange fees for issuers that have over $10 billion in assets, which could affect the amount of interchange fees collected by financial institutions with less than $10 billion in assets.

In addition, the Dodd-Frank Act implemented other changes to financial regulations, including provisions that:

- Restrict the preemption of state law by federal law and disallow subsidiaries and affiliates of national banks from availing themselves of such preemption.

- Impose comprehensive regulation of the over-the-counter derivatives market, subject to significant rulemaking processes, which would include certain provisions that would effectively prohibit insured depository institutions from conducting certain derivatives businesses in the institution itself.

- Require loan originators to retain 5% of any loan sold or securitized, unless it is a "qualified residential mortgage," subject to certain exceptions.

- Prohibit banks and their affiliates from engaging in proprietary trading and investing in and sponsoring certain unregistered investment companies (the "Volcker Rule"), as subsequently amended by the EGRRCPA, which provides an exemption from the Volcker Rule for many community banking organizations (discussed in more detail below).

- Implement corporate governance revisions that apply to all public companies (not only financial institutions).

*Insurance of Accounts, Assessments and Regulation by the FDIC.* Deposits with Carter Bank & Trust are insured through the Deposit Insurance Fund ("DIF") of the FDIC. As a DIF-insured institution, the Bank is subject to FDIC rules and regulations as administrator of the DIF. The Dodd-Frank Act made permanent the current standard maximum deposit insurance amount of $250,000. The FDIC coverage applies per depositor, per insured depository institution, for each account ownership category. The FDIC is authorized to conduct examinations of and to require reporting by DIF-insured institutions.

The FDIC is authorized to prohibit any DIF-insured institution from engaging in any activity that the FDIC determines by regulation or order to pose a serious threat to the insurance fund. Also, the FDIC may initiate enforcement actions against banks after first giving the institution's primary regulatory authority an opportunity to take such action. The FDIC may terminate the deposit insurance of any depository institution, including the Bank, if it determines, after a hearing, that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed in writing by the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance, if the institution has no tangible capital. If deposit insurance is terminated, the deposits at the institution at the time of termination, less subsequent withdrawals, shall continue to be insured for a period from six months to two years, as determined by the FDIC. Management is aware of no existing circumstances that could result in termination of the Bank's deposit insurance.

The actual assessment to be paid by each DIF member is based on the institution's assessment risk classification and whether the institution is considered by its supervisory agency to be financially sound or to have supervisory concerns.

The DIF is funded by assessments on banks and other depository institutions calculated based on average consolidated total assets minus average tangible equity (defined as Tier 1 capital). As required by the Dodd-Frank Act, the FDIC has adopted a large-bank pricing assessment scheme, set a target "designated reserve ratio" (described in more detail below) of 2% for the DIF and, in lieu of dividends, provides for a lower assessment rate schedule when the reserve ratio reaches 2% and 2.5%. An institution's assessment rate is based on a statistical analysis of financial ratios that estimates the likelihood of failure over a three-year period, which considers the institution's weighted average CAMELS component rating, and is subject to further adjustments including those related to levels of unsecured debt and brokered deposits (not applicable to banks with less than $10 billion in assets). At December 31, 2018, total base assessment rates for institutions that have been insured for at least five years range from 1.5 to 40 basis points, with rates of 1.5 to 30 basis points applying to banks with less than $10 billion in assets.

The Dodd-Frank Act transferred to the FDIC increased discretion with regard to managing the required amount of reserves for the DIF, or the "designated reserve ratio." Among other changes, the Dodd-Frank Act:

- raised the minimum designated reserve ratio to 1.35% and removed the upper limit on the designated reserve ratio;
- requires that the reserve ratio reach 1.35% by September 2020; and
- requires the FDIC to offset the effect on institutions with total consolidated assets of less than $10 billion of raising the reserve ratio from 1.15% to 1.35% — which requirement was met by rules adopted by the FDIC during 2016.

The FDIC has adopted a DIF restoration plan to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. The FDIA requires that the FDIC consider the appropriate level for the designated reserve ratio on at least an annual basis. On June 30, 2016, the reserve ratio rose to 1.17%, which triggered three major changes to deposit insurance assessments beginning for the third quarter of 2016: (i) the range of initial assessment rates for all institutions declined from 5 to 35 basis points to 3 to 30 basis points (which are included in the total base assessment rates in the above paragraph); (ii) surcharges equal to an annual rate of 4.5 basis points began for insured depository institutions with total consolidated assets of $10 billion or more; and (iii) the revised assessment method described above was implemented.

Banks with less than $10 billion in total consolidated assets (such as the Bank) receive credits to offset the portion of their assessments that help to raise the reserve ratio to 1.35%. When the reserve ratio is at or above 1.38%, the FDIC will automatically apply such a bank's credits to reduce its regular DIF assessment up to the entire amount of the assessment. At September 30, 2018, the reserve ratio was 1.36%.

*CFPB Regulation and Supervision.* The Dodd-Frank Act created the CFPB, which has the power to establish rules and regulations under certain federal consumer protection laws with respect to the conduct of providers of certain consumer financial products and services. The CFPB is the federal regulatory agency responsible for implementing, examining and enforcing compliance with federal consumer financial laws for institutions with more than $10 billion of assets and, to a lesser extent, smaller institutions. The CFPB supervises and regulates providers of consumer financial products and services, and has rulemaking authority in connection with numerous federal consumer financial protection laws (for example, but not limited to, the Truth-in-Lending Act ("TILA") and the Real Estate Settlement Procedures Act ("RESPA")).

Because the Bank is a smaller institution (i.e., with assets of $10 billion or less), most consumer protection aspects of the Dodd-Frank Act will continue to be applied to the Bank by the FDIC. However, the CFPB may include its own examiners in regulatory examinations by a small institution's principal regulators and may require smaller institutions to comply with certain CFPB reporting requirements. In addition, regulatory positions taken by the CFPB and administrative and legal precedents established by CFPB enforcement activities, including in connection with supervision of larger banks, could influence how the FDIC applies consumer protection laws and regulations to financial institutions that are not directly supervised by the CFPB. The precise effect of the CFPB's consumer protection activities on the Bank cannot be determined with certainty.

*Mortgage Banking*. In connection with making mortgage loans, the Bank is subject to rules and regulations that, among other things, establish standards for loan origination, prohibit discrimination, provide for inspections and appraisals of property, require credit reports on prospective borrowers, in some cases restrict certain loan features and fix maximum interest rates and fees, require the disclosure of certain basic information to mortgagors concerning credit and settlement costs, limit payment for settlement services to the reasonable value of the services rendered and require the maintenance and disclosure of information regarding the disposition of mortgage applications based on race, gender, geographical distribution and income level. The Bank's mortgage origination activities are subject to the Equal Credit Opportunity Act ("ECOA"), TILA, the Home Mortgage Disclosure Act, RESPA, the Home Ownership Equity Protection Act, and the regulations promulgated under these acts, among other additional state and federal laws, regulations and rules.

The Bank's mortgage origination activities are also subject to Regulation Z, which implements TILA. Certain provisions of Regulation Z require mortgage lenders to make a reasonable and good faith determination, based on verified and documented information, that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Alternatively, a mortgage lender can originate "qualified mortgages", which are generally defined as mortgage loans without negative amortization, interest-only payments, balloon payments, terms exceeding 30 years, and points and fees paid by a consumer equal to or less than 3% of the total loan amount. Under the EGRRCPA, most residential mortgage loans originated and held in portfolio by a bank with less than $10 billion in assets will be designated as "qualified mortgages." Higher-priced qualified mortgages (e.g., sub-prime loans) receive a rebuttable presumption of compliance with ability-to-repay rules, and other qualified mortgages (e.g., prime loans) are deemed to comply with the ability-to-repay rules.

*Brokered Deposits*. Section 29 of the FDIA and FDIC regulations generally limit the ability of any bank to accept, renew or roll over any brokered deposit unless it is "well capitalized" or, with the FDIC's approval, "adequately capitalized." However, as a result of the EGRRCPA, the FDIC is undertaking a comprehensive review of its regulatory approach to brokered deposits, including reciprocal deposits, and interest rate caps applicable to banks that are less than "well capitalized." At this time, it is difficult to predict the impact, if any, of the FDIC's review of brokered deposit regulations.

*Prompt Corrective Action.* The federal banking agencies have broad powers under current federal law to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institution in question is "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" or "critically undercapitalized." These terms are defined under uniform regulations issued by each of the federal banking agencies regulating these institutions. An insured depository institution which is less than adequately capitalized must adopt an acceptable capital restoration plan, is subject to increased regulatory oversight and is increasingly restricted in the scope of its permissible activities. As of December 31, 2018, the Bank was considered "well capitalized."

*Incentive Compensation.* The federal banking agencies have issued regulatory guidance (the "Incentive Compensation Guidance") intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. Findings related to the Incentive Compensation Guidance from supervisory reviews by a banking organization's primary federal regulator will be included in reports of examination, and deficiencies will be incorporated into the organization's supervisory ratings. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization's safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

In 2016, the SEC and the federal banking agencies proposed rules that prohibit covered financial institutions (including bank holding companies and banks) from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risk taking by providing covered persons (consisting of senior executive officers and significant risk takers, as defined in the rules) with excessive compensation, fees or benefits that could lead to material financial loss to the financial institution. The proposed rules outline factors to be considered when analyzing whether compensation is excessive and whether an incentive-based compensation arrangement encourages inappropriate risks that could lead to material loss to the covered financial institution, and establishes minimum requirements that incentive-based compensation arrangements must meet to be considered to not encourage inappropriate risks and to appropriately balance risk and reward. The proposed rules also impose additional corporate governance requirements on the boards of directors of covered financial institutions and impose additional record-keeping requirements. The comment period for these proposed rules has closed and a final rule has not yet been published.

*Community Reinvestment.* The requirements of the Community Reinvestment Act ("CRA") affect the Bank. The CRA imposes on financial institutions an affirmative obligation to help meet the credit needs of their local communities, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of those institutions. Each financial institution's efforts in helping meet community credit needs currently are evaluated as part of the examination process pursuant to regulations adopted by the banking regulatory agencies. Under the regulation financial institution's efforts in helping meet its community's credit needs are evaluated, based on the particular institution's total assets, according to a lending test, a community development test in addition to the lending test, or the three-pronged (lending, investment and service) test. The grade received by a bank is considered in evaluating mergers, acquisitions and applications to open a branch or facility. To the best knowledge of the Bank, it is meeting its obligations under the CRA. The Bank received a rating of "satisfactory" on its most recent CRA examination dated October 23, 2017.

*Confidentiality and Required Disclosures of Customer Information.* The Bank is subject to various laws and regulations that address the privacy of nonpublic personal financial information of consumers. The Gramm-Leach-Bliley Act and certain regulations issued thereunder protect against the transfer and use by financial institutions of consumer nonpublic personal information. A financial institution must provide to its customers, at the beginning of the customer relationship and annually thereafter, the institution's policies and procedures regarding the handling of customers' nonpublic personal financial information. These privacy provisions generally prohibit a financial institution from providing a customer's personal financial information to unaffiliated third parties unless the institution discloses to the customer that the information may be so provided and the customer is given the opportunity to opt out of such disclosure.

In August 2018, the CFPB published its final rule to update Regulation P pursuant to the amended Gramm-Leach-Bliley Act. Under this rule, certain qualifying financial institutions are not required to provide annual privacy notices to customers. To qualify, a financial institution must not share nonpublic personal information about customers except as described in certain statutory exceptions which do not trigger a customer's statutory opt-out right. In addition, the financial institution must not have changed its disclosure policies and practices from those disclosed in its most recent privacy notice. The rule sets forth timing requirements for delivery of annual privacy notices in the event that a financial institution that qualified for the annual notice exemption later changes its policies or practices in such a way that it no longer qualifies for the exemption.

The Bank is also subject to various laws and regulations that attempt to combat money laundering and terrorist financing. The Bank Secrecy Act requires all financial institutions to, among other things, create a system of controls designed to prevent money laundering and the financing of terrorism, and imposes recordkeeping and reporting requirements. The USA Patriot Act added regulations to facilitate information sharing among governmental entities and financial institutions for the purpose of combating terrorism and money laundering, and requires financial institutions to establish anti-money laundering programs. The Office of Foreign Assets Control ("OFAC"), which is a division of the Treasury, is responsible for helping to ensure that United States entities do not engage in transactions with "enemies" of the United States, as defined by various Executive Orders and Acts of Congress. If the Bank finds a name of an "enemy" of the United States on any transaction, account or wire transfer that is on an OFAC list, it must freeze such account or place transferred funds into a blocked account, and report it to OFAC.

Although these laws and programs impose compliance costs and create privacy obligations and, in some cases, reporting obligations, and compliance with all of the laws, programs, and privacy and reporting obligations may require significant resources of the Bank, these laws and programs do not materially affect the Bank's products, services or other business activities.

*Cybersecurity.* The federal banking agencies have also adopted guidelines for establishing information security standards and cybersecurity programs for implementing safeguards under the supervision of a financial institution's board of directors. These guidelines, along with related regulatory materials, increasingly focus on risk management and processes related to information technology and the use of third parties in the provision of financial products and services. The federal banking agencies expect financial institutions to establish lines of defense and ensure that their risk management processes also address the risk posed by compromised customer credentials, and also expect financial institutions to maintain sufficient business continuity planning processes to ensure rapid recovery, resumption and maintenance of the institution's operations after a cyber-attack. If the Bank fails to meet the expectations set forth in this regulatory guidance, it could be subject to various regulatory actions and any remediation efforts may require significant resources of the Bank.

In October 2016, the federal banking agencies issued proposed rules on enhanced cybersecurity risk-management and resilience standards that would apply to very large financial institutions and to services provided by third parties to these institutions. The comment period for these proposed rules has closed and a final rule has not been published. Although the proposed rules would apply only to bank holding companies and banks with $50 billion or more in total consolidated assets, these rules could influence the federal banking agencies' expectations and supervisory requirements for information security standards and cybersecurity programs of smaller financial institutions, such as the Bank.

*Stress Testing.* As required by the Dodd-Frank Act, the federal banking agencies implemented stress testing requirements for certain financial institutions, including bank holding companies and state-chartered banks, with more than $10 billion in total consolidated assets. The EGRRCPA subsequently raised the asset thresholds for company-run stress testing and mandatory stress testing conducted by the Federal Reserve Board to $50 billion and $100 billion, respectively. Although these requirements do not apply to the Bank, the federal banking agencies emphasize that all banking organizations, regardless of size, should have the capacity to analyze the potential effect of adverse market conditions or outcomes on the organization's financial condition. Based on existing regulatory guidance, the Bank will be expected to consider its interest rate risk management, commercial real estate loan concentrations and other credit-related information, and funding and liquidity management during analysis of adverse market conditions or outcomes.

*Volcker Rule.* The Dodd-Frank Act prohibits bank holding companies and their subsidiary banks from engaging in proprietary trading except in limited circumstances, and places limits on ownership of equity investments in private equity and hedge funds (the "Volcker Rule"). The EGRRCPA exempted all banks with less than $10 billion in assets (including their holding companies and affiliates) from the Volcker Rule, provided that the institution has total trading assets and liabilities of 5% or less of total assets, subject to certain limited exceptions. In December 2018, the federal banking agencies invited public comment on a proposal to exclude community banks from the application of the Volcker Rule. The Bank believes that its financial condition and its operations are not and will not be significantly affected by the Volcker Rule, amendments thereto, or its implementing regulations.

*Call Reports*. All institutions, regardless of size, submit a quarterly call report that includes data used by federal banking agencies to monitor the condition, performance, and risk profile of individual institutions and the industry as a whole. The EGRRCPA contained provisions expanding the number of regulated institutions eligible to use streamlined call report forms. In November 2018, the federal banking agencies issued a proposal to permit insured depository institutions with total assets of less than $5 billion that do not engage in certain complex or international activities to file the most streamlined version of the quarterly call report, and to reduce data reportable on certain streamlined call report submissions. The Bank continues to monitor developments related to this proposal.

*Effect of Governmental Monetary Policies.* As with other financial institutions, the earnings of the Bank are affected by general economic conditions as well as by the monetary policies of the FRB. Such policies, which include regulating the national supply of bank reserves and bank credit, can have a major effect upon the source and cost of funds and the rates of return earned on loans and investments. The Federal Reserve System exerts a substantial influence on interest rates and credit conditions, primarily through establishing target rates for federal funds, open market operations in U.S. Government securities, varying the discount rate on member bank borrowings and setting cash reserve requirements against deposits. Changes in monetary policy, including changes in interest rates, will influence the origination of loans, the purchase of investments, the generation of deposits, and rates received on loans and investment securities and paid on deposits. Fluctuations in the FRB's monetary policies have had a significant impact on the operating results of the Bank and all financial institutions in the past and are expected to continue to do so in the future.

*Dividend Limitations.* The amount of dividends permitted to be paid by the Bank will depend upon its earnings and capital position, and is limited by federal and state law, regulations and policy. Virginia law imposes restrictions on the ability of all banks chartered under Virginia law to pay dividends. Under Virginia law, no dividend may be declared or paid that would impair a bank's paid-in capital and payments must be made from retained earnings.

State and federal regulators have the general authority to limit dividends paid by the Bank if it is, or after making the distribution it would become, "undercapitalized" (as that term is defined in federal law). The FDIC has issued policy statements that provide that insured banks generally should pay dividends only from their current operating earnings, and, under the Federal Deposit Insurance Act, no dividend may be paid by an insured bank while it is in default on any assessment due the FDIC. The Bank's payment of dividends also could be affected or limited by other factors, such as events or circumstances which lead the FDIC to require that the Bank maintain capital in excess of regulatory guidelines, or the Bank's failure to maintain an appropriate capital conservation buffer as discussed above.

*Future Regulation*. From time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and the operating environment of the Bank in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Bank cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on its financial condition or results of operations. A change in statutes, regulations or regulatory policies applicable to the Bank could have a material effect on its business.

**Where You Can Find More Information**

Carter Bank & Trust files quarterly, annual and other reports, proxy statements and other information with the FDIC (rather than the SEC). You may (i) obtain copies of the documents Carter Bank & Trust files with the FDIC by directing a request by telephone or mail to Investor Relations, Carter Bank & Trust, 1300 Kings Mountain Road, Martinsville, Virginia 24112; telephone number: (276) 656-1776, or (ii) obtain copies of these documents directly from the FDIC's website at www.fdic.gov. The annual report and proxy statement will be available through our website at www.carterbankandtrust.com/under "Investor Relations" as of the date of the annual mailing to shareholders.

## ITEM 1A. RISK FACTORS

An investment in the Bank's securities involves risk. In addition to the other information set forth in this report, including the information under the heading "Important Notice Regarding Forward-Looking Statements," investors in the Bank's securities should consider the factors discussed below.

***Carter Bank & Trust's business is subject to interest rate risk and fluctuations in interest rates may adversely affect its earnings and capital levels.***

The majority of Carter Bank & Trust's assets are monetary in nature and, as a result, Carter Bank & Trust is subject to significant risk from changes in interest rates. Changes in interest rates can impact Carter Bank & Trust's net interest income as well as the valuation of its assets and liabilities. Also, Carter Bank & Trust's earnings are significantly dependent on its net interest income, which is the difference between interest income on interest-earning assets, such as loans and securities, and interest expense on interest-bearing liabilities, such as deposits and borrowings. Carter Bank & Trust expects that it will experience "gaps" in the interest rate sensitivities of its assets and liabilities, meaning that either its interest-bearing liabilities will be more sensitive to changes in market interest rates than its interest-earning assets, or vice versa. In either event, if market interest rates should move contrary to Carter Bank & Trust's position, this "gap" will work against it and its earnings may be negatively affected.

On December 19, 2018, the Federal Open Market Committee ("FOMC") announced its fourth increase during 2018 for the federal funds rate, which is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight, to 2.25%. The FOMC's monetary policy remains accommodative after this increase. Financial markets generally expect two more quarter-point rate increases to the federal funds rate in 2019. As short-term market interest rates have risen, however, longer-term market interest rates, including yields on U.S. treasury bonds, remain low.

An increase in the general level of interest rates may also, among other things, reduce the demand for loans and Carter Bank & Trust's ability to originate loans or increase the rate of default on existing loans. Conversely, a decrease in the general level of interest rates may, among other things, lead to an increase in prepayments on loans and increased competition for deposits. Accordingly, changes in the general level of market interest rates may affect net yield on interest-earning assets, loan origination volume, loan portfolios and Carter Bank & Trust's overall results.

Although Carter Bank & Trust's asset-liability management strategy is designed to control its risk from changes in the general level of market interest rates, market interest rates will be affected by many factors outside of its control, including inflation, recession, changes in unemployment, other economic conditions, money supply and international disorder and instability in domestic and foreign financial markets. It is possible that significant or unexpected changes in interest rates may take place in the future, and Carter Bank & Trust cannot always accurately predict the nature or magnitude of such changes or how such changes may affect its business.

***Carter Bank & Trust is subject to extensive government regulation and supervision.***

Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not security holders. These regulations affect our lending practices, capital structure, investment practices, dividend policy and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. The Dodd-Frank Act, enacted in July 2010, instituted major changes to the banking and financial institutions regulatory regimes in light of the financial crisis of 2008 and government intervention in the financial services sector that followed. Other changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect us in substantial and unpredictable ways. Such changes could subject us to additional costs, limit the types of financial services and products we may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations, policies or supervisory guidance could result in enforcement and other legal actions by Federal or state authorities, including criminal and civil penalties, the loss of FDIC insurance, the revocation of a banking charter, other sanctions by regulatory agencies, civil money penalties and/or reputational damage. In this regard, government authorities, including the bank regulatory agencies, are pursuing aggressive enforcement actions with respect to compliance and other legal matters involving financial activities, which heightens the risks associated with actual and perceived compliance failures. See "Supervision and Regulation" included in Item 1. Business of this Report for a more detailed description of the Dodd-Frank Act and other regulatory requirements applicable to Carter Bank & Trust.

***Carter Bank & Trust's profitability depends significantly on local economic conditions.***

Carter Bank & Trust's success depends primarily on the general economic conditions of the geographic markets in which it operates, primarily in Virginia and North Carolina. The local economic conditions in the areas where it operates have a significant impact on its commercial, real estate and construction loans, the ability of its borrowers to repay their loans and the value of the collateral securing these loans and on customer demand for loans, deposits and other bank products. A significant decline in general economic conditions, including a decline caused by inflation, recession, acts of terrorism, outbreak of hostilities or other international or domestic calamities, unemployment or other factors, all of which are beyond the Bank's control, could impact these local economic conditions and negatively affect Carter Bank & Trust's financial results.

***The Basel III Final Rules require higher levels of capital and liquid assets, which could adversely affect the Bank's net income and return on equity.***

The Basel III Final Rules represent the most comprehensive overhaul of the U.S. banking capital framework in over two decades. This new capital framework and related changes to the standardized calculations of risk-weighted assets are complex and create additional compliance burdens, especially for community banks. The Basel III Final Rules require bank holding companies and their subsidiaries, such as the Bank, to maintain significantly more capital as a result of higher required capital levels and more demanding regulatory capital risk weightings and calculations. The stricter capital requirements were fully implemented on January 1, 2019. See "Supervision and Regulation" included in Item 1. Business of this Report for a more detailed description of the Basel III Final Rules applicable to the Bank.

As a result of the Basel III Final Rules, many community banks could be forced to limit banking operations, activities and growth of loan portfolios, in order to focus on retention of earnings to improve capital levels. The Bank believes that it maintains sufficient levels of Tier 1 and Common Equity Tier 1 capital to comply with the Basel III Final Rules. However, the Bank can offer no assurances with regard to the ultimate effect of the Basel III Final Rules, and satisfying increased capital requirements imposed by the Basel III Final Rules may require the Bank to limit its banking operations, raise additional capital, retain net income or reduce dividends to improve regulatory capital levels, which could negatively affect our business, financial condition and results of operations. In addition, the Bank could be subject to regulatory actions if it were unable to comply with such requirements.

***Carter Bank & Trust faces strong competition from financial services companies and other companies that offer banking services which could negatively affect its business.***

Carter Bank & Trust conducts its banking operations primarily in Virginia and North Carolina, including Roanoke, Lynchburg, Danville, Fredericksburg, Northern Virginia, Greensboro, Durham, Wilson and Fayetteville. Increased competition in these markets may result in reduced loans and deposits. Ultimately, Carter Bank & Trust may not be able to compete successfully against current and future competitors. Many competitors offer the same banking services that Carter Bank & Trust offers in its service area. These competitors include national banks, regional banks and other community banks. Carter Bank & Trust also faces competition from many other types of financial institutions, including without limitation, savings and loan institutions, finance companies, brokerage firms, insurance companies, credit unions, mortgage banks and other financial intermediaries. In particular, Carter Bank & Trust's competitors include several major financial companies whose greater resources may afford them a marketplace advantage by enabling them to maintain numerous banking locations and ATMs, conduct extensive promotional and advertising campaigns and offer a wider range of products, services and technologies.

Additionally, banks and other financial institutions with larger capitalization and financial intermediaries not subject to bank regulatory restrictions have larger lending limits and are thereby able to serve the credit needs of larger customers. Areas of competition include interest rates for loans and deposits, efforts to obtain deposits, and range and quality of products and services provided, including new technology-driven products and services. Technological innovation continues to contribute to greater competition in domestic and international financial services markets as technological advances enable more companies to provide financial services. Carter Bank & Trust also faces competition from out-of-state financial intermediaries that have opened low-end production offices or that solicit deposits in its market areas. If Carter Bank & Trust is unable to attract and retain banking customers, it may be unable to continue to grow its loan and deposit portfolios or may be required to increase the rates it pays on deposits or lower the rates it offers on loans and its results of operations and financial condition may otherwise be adversely affected.

***A large percentage of Carter Bank & Trust's loans are secured by real estate, and an adverse change in the real estate market may result in losses and adversely affect Carter Bank & Trust's profitability.***

Approximately 73% of Carter Bank & Trust's loan portfolio as of December 31, 2018, was comprised of loans secured by real estate. An adverse change in the economy affecting values of real estate generally or in the market areas served by Carter Bank & Trust specifically could impair the value of Carter Bank & Trust's collateral and its ability to sell the collateral upon foreclosure. In the event of a default with respect to any of these loans, the amounts Carter Bank & Trust receives upon sale of the collateral may be insufficient to recover outstanding principal and interest on the loan. As a result, Carter Bank & Trust's profitability and financial condition could be negatively impacted by an adverse change in the real estate market. The Bank uses internally developed methods for valuing collateral for impaired loans and other real estate owned. The methods require the use of assumptions that are subject to change based on events impacting real estate values.

***The Bank's level of credit risk is increased due to the level of commercial real estate loans in its portfolio.***

Approximately 51% of the Bank's loan portfolio as of December 31, 2018, was comprised of loans secured by commercial purpose real estate, including loans related to hotels, strip malls and apartments. These loans generally carry larger loan balances and involve a greater degree of financial and credit risk than loans secured by residential real estate. Repayment of these loans is often dependent on the success of the borrower's underlying business and the borrower's ability to generate a positive cash flow sufficient to service its debts. The increased financial and credit risk associated with these loans is a result of several factors, including the concentration of principal in a limited number of loans and to borrowers in similar lines of business, the size of the loan balances, general economic conditions affecting values of real estate, and the existence of a market for the subject collateral.

***Our allowance for loan losses may be insufficient.***

All borrowers carry the potential to default and our remedies to recover may not fully satisfy money previously loaned. We maintain an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate of probable credit losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is adequate to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance for loan losses reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic conditions and unidentified losses in the current loan portfolio. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks using existing qualitative and quantitative information, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for credit losses or the recognition of additional loan charge-offs, based on judgments different than those of management. An increase in the allowance for loan losses results in a decrease in net income or losses, and possibly risk-based capital, and may have a material adverse effect on our financial condition and results of operations.

***Carter Bank & Trust is dependent on its management team, and the loss of its senior executive officers or other key employees could impair its relationship with its customers and adversely affect its business and financial results.***

We believe that our growth and future success will depend in large on the skills of our executive officers. We also depend upon the experience of the senior officers and other key personnel and their relationship with the communities they serve. The loss of the services of one or more of these officers or key personnel could have an adverse impact on the business of the Bank because of their skills, knowledge of the market, years of industry experience and the difficulty promptly finding qualified replacement personnel.

***Our business and reputation may be adversely affected by a failure in or breach of our operational or security systems or infrastructure, or those of third parties.***

Our operational and security systems, infrastructure, including our computer systems, data management, and internal processes, as well as those of third parties, are integral to our business. We handle a substantial volume of customer and other financial transactions every day. Our financial, accounting, data processing, check processing, electronic funds transfer, loan processing, online and mobile banking, backup or other operating or security systems and infrastructure may fail to operate properly or become disabled or damaged as a result of a number of factors including events that are wholly or partially beyond our control. Sudden increases in customer transaction volume, electrical, telecommunications or other major physical infrastructure outages, natural disasters, events arising from local or larger scale political or social matters, including terrorist acts, and cyber-attacks could adversely affect our ability to process these transactions or provide these services. We have taken measures to implement backup systems and other safeguards to support our operations, but our ability to conduct business may be adversely affected by any significant disruptions to us or to third parties with whom we interact. Despite these measures, our systems and infrastructure may fail, may be vulnerable to attacks by hackers or may be breached as a result of human error, misconduct or malfeasance.

In addition, our ability to implement backup systems and other safeguards with respect to third-party systems is more limited than with our own systems. We are dependent on these third-party providers securing their information systems, over which we have limited control, and a failure or breach of their information systems could adversely affect our ability to process transactions, service our clients or manage our exposure to risk and could result in the disclosure of sensitive, personal customer information, which could have a material adverse impact on our business through damage to our reputation, loss of business, remedial costs, additional regulatory scrutiny or exposure to civil litigation and possible financial liability.

We continuously update these systems to support our operations and growth. This updating entails significant costs and creates risks associated with implementing new systems and integrating them with existing ones. Further, as cyber threats continue to evolve and increase, we may be required to expend significant additional financial and operational resources to modify or enhance our protective measures or to investigate and remediate any identified systems or infrastructure vulnerabilities. These risk exposures could adversely impact our results of operations, liquidity and financial condition, and cause reputational harm.

***The trading volume in Carter Bank & Trust's common stock is less than that of other larger financial services companies.***

Carter Bank & Trust began trading on the OTCQX Best Market effective April 26, 2018, under the ticker symbol "CARE." On February 28, 2019, Carter Bank and Trust received approval for the Bank's application to have our common stock listed on The Nasdaq Global Select Market. Carter Bank & Trust's common shares are expected to begin trading on Nasdaq at the opening of the market on Monday, March 25, 2019 under the ticker symbol "CARE."

The trading volume in its common stock is less than that of other, larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of Carter Bank & Trust's common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the lower trading volume of Carter Bank & Trust's common stock, significant sales of Carter Bank & Trust's common stock, or the expectation of these sales, could cause Carter Bank & Trust's stock price to fall.

***Our risk management framework may not be effective in mitigating risk and loss.***

We maintain an enterprise risk management program that is designed to identify, quantify, monitor, report and control the risks we face. These risks include, but are not limited to, interest rate, credit, liquidity, operational, reputation, legal, compliance, economic and litigation risk. Although we assess our risk management program on an ongoing basis and make identified improvements to it, the Bank can offer no assurances that this approach and risk management framework (including related controls) will effectively mitigate the risks listed above or limit losses that we may incur. If our risk management program has flaws or gaps, or if our risk management controls do not function effectively, our results of operations, financial condition or business may be adversely affected.

***We rely on independent appraisals to determine the value of the real estate which secures a significant portion of our loans, and the values indicated by such appraisals may not be realizable if we are forced to foreclose on such loans.***

A significant portion of our loan portfolio consists of loans secured by real estate. We rely on independent appraisers to estimate the value of such real estate. Appraisals are only estimates of value and the independent appraisers may make mistakes of fact or judgment that adversely affect the reliability of their appraisals. In addition, events occurring after the initial appraisal may cause the value of the real estate to increase or decrease. As a result of any of these factors, the real estate securing some of our loans may be more or less valuable than anticipated at the time the loans were made. If a default occurs on a loan secured by real estate that is less valuable than originally estimated, we may not be able to recover the outstanding balance of the loan.

***Our real estate lending business can result in increased costs associated with Other Real Estate Owned ("OREO").***

Because we originate loans secured by real estate, we may have to foreclose on the collateral property to protect our investment and may thereafter own and operate such property, in which case we are exposed to the risks inherent in the ownership of real estate. The amount that we may realize after a default is dependent upon factors outside of our control, including, but not limited to, general or local economic conditions, environmental cleanup liability, neighborhood values, interest rates, real estate tax rates, operating expenses of the mortgaged properties, and supply of and demand for properties. Certain expenditures associated with the ownership of income-producing real estate, principally real estate taxes and maintenance costs, may adversely affect the net cash flows generated by the real estate. Therefore, the cost of operating income-producing real property may exceed the rental income earned from such property, and we may have to advance funds to protect our investment or we may be required to dispose of the real property at a loss.

***We rely substantially on deposits obtained from customers in our target markets to provide liquidity and support growth.***

Our primary funding and liquidity source to support our business strategies is a stable customer deposit base. Deposit levels may be affected by a number of factors, including interest rates paid by competitors, general interest rate levels, returns available to customers on alternative investments and general economic conditions. If our deposit levels fall, we could lose a relatively low-cost source of funding and our interest expense would likely increase as we obtain alternative funding to replace lost deposits. If local customer deposits are not sufficient to fund our normal operations and growth, we will look to outside sources, such as Fed Funds lines with other financial institutions. We may also seek to raise funds through the issuance of shares of our common stock, or other equity or equity-related securities, or debt securities including subordinated notes as additional sources of liquidity. If we are unable to access funding sufficient to support our business operations and growth strategies or are only able to access such funding on unattractive terms, we may not be able to implement our business strategies which may negatively affect our financial performance.

***Our earnings are significantly affected by the fiscal and monetary policies of the federal government and its agencies.***

The policies of the Federal Reserve affect us significantly. The Federal Reserve regulates the supply of money and credit in the United States. Its policies directly and indirectly influence the rate of interest earned on loans and paid on borrowings and interest-bearing deposits and can also affect the value of financial instruments we hold. Those policies determine to a significant extent our cost of funds for lending and investing. Changes in those policies are beyond our control and are difficult to predict. Federal Reserve policies can also affect our borrowers, potentially increasing the risk that they may fail to repay their loans. For example, a tightening of the money supply by the Federal Reserve could reduce the demand for a borrower's products and services. This could adversely affect the borrower's earnings and ability to repay a loan, which could have a material adverse effect on our financial condition and results of operations.

## ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

## ITEM 2. PROPERTIES

Carter Bank & Trust's principal executive office is located at 1300 Kings Mountain Road in Martinsville, Virginia. There are also two other corporate administrative locations that house its operations center and various other corporate functions. We offer our community banking services through 105 combined locations in Virginia and North Carolina at December 31, 2018. Seventy-eight offices are located in Virginia and twenty-seven are located in North Carolina. Three of the banking locations are held under operating leases. Management believes the terms of the various leases are consistent with market standards and were arrived at through arm's length bargaining. The leases are described in Note 7 of the Notes to Consolidated Financial Statements.

## ITEM 3. LEGAL PROCEEDINGS

On August 2, 2016, the FDIC and the Virginia Bureau of Financial Institutions (the "Bureau") issued a Consent Order (the "Order") in connection with compliance by the Bank with the Bank Secrecy Act (the "BSA") and related regulations and other related anti-money laundering regulations (collectively, the "BSA/AML Requirements"). The Order was issued pursuant to the consent of the Bank, and 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 related to weaknesses in the Bank's compliance with the BSA/AML Requirements. The Bank has reviewed, assessed and taken actions to strengthen and enhance compliance programs related to the BSA/AML requirements. The Order was incorporated by reference to the Bank's Current Report on Form 8-K filed with the FDIC on August 8, 2016.

Except as set forth above, as of December 31, 2018 no material legal proceedings were pending or threatened against Carter Bank & Trust.

## ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

## PART II

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

### Market for Common Stock and Dividends

Carter Bank & Trust's common stock began trading on the OTCQX Best Market effective April 26, 2018, under the ticker symbol "CARE." Raymond James and Associates and Boenning and Scattergood are currently quoting a market in Carter Bank & Trust under the symbol CARE on the OTCQX Best Marketplace. Any over-the-counter market quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily reflect actual transactions.

On February 28, 2019, Carter Bank and Trust received approval for the Bank's application to have our common stock listed on The Nasdaq Global Select Market. Carter Bank & Trust's common shares are expected to begin trading on Nasdaq at the opening of the market on Monday, March 25, 2019 under the ticker symbol "CARE."

The Bank's common stock last traded at $17.50 on March 13, 2019 the last completed trading day before the filing of this Report.

As of March 13, 2019, there were 26,287,323 shares of common stock of Carter Bank & Trust outstanding, held by 2,610 shareholders of record.

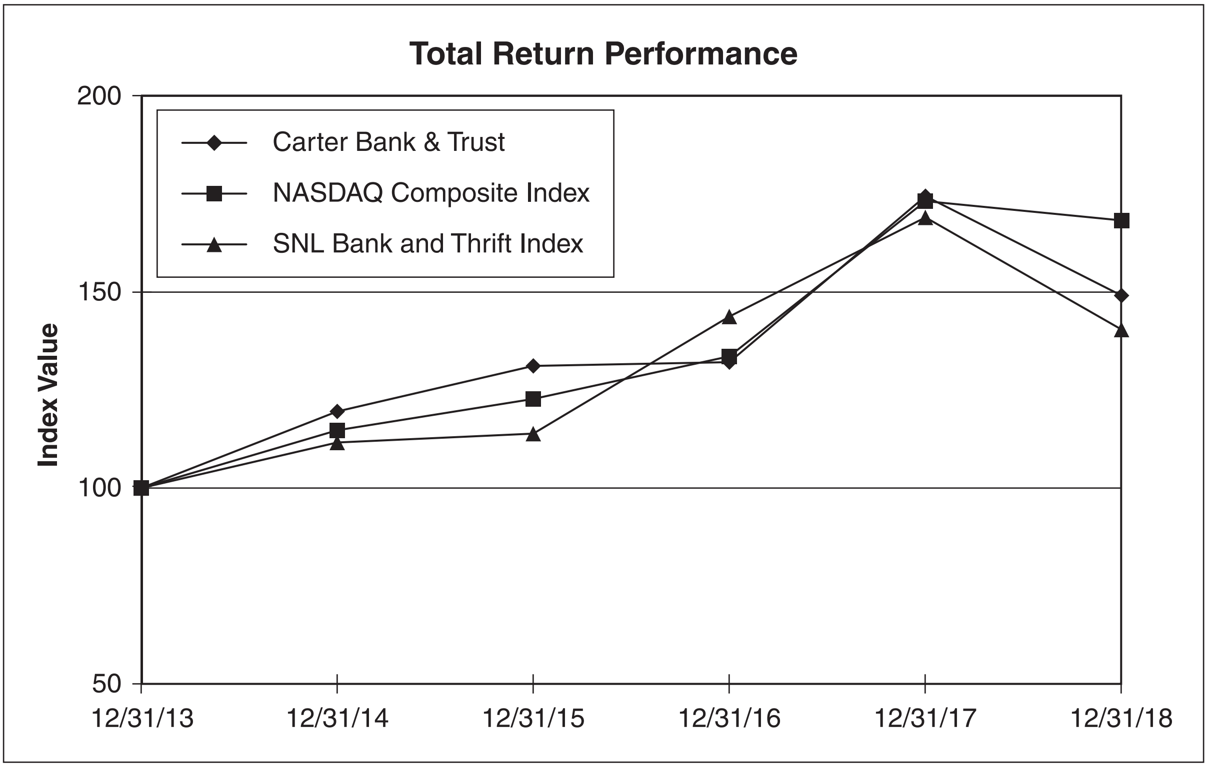
### Dividends

In order to meet and maintain comfortable capital margins in light of increasing regulatory costs and increasing capital requirements, on October 14, 2016, the Board of Directors (the "Board") of Carter Bank & Trust (the "Bank") determined that it was prudent not to declare a cash dividend on the Bank's common stock beginning in the fourth quarter of 2016. Given the Bank's history of paying a quarterly cash dividend on its common stock, this decision was an extremely difficult one and one that the Board did not take lightly. However, the Board believes this decision is necessary and appropriate as the Bank commits additional resources to assist with regulatory compliance and makes significant investments in new technology and human resources, in part to comply with the August 2, 2016 Consent Order issued by the Federal Deposit Insurance Corporation and the Virginia Bureau of Financial Institutions in connection with the Bank's compliance with the Bank Secrecy Act and related regulations and other related anti-money laundering regulations. While recognizing the importance of dividends to the Bank's shareholders, the Board determined that preservation of capital is of paramount importance at this time.

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES (continued)

**Five-Year Cumulative Total Return**

The following chart compares the cumulative total shareholder return on our common stock with the cumulative total return of the NASDAQ Composite Index and SNL Bank and Thrift Index, which includes the stocks of banks, thrifts and bank and financial holding companies listed on all major exchanges (NYSE, AMEX, NASDAQ) S&P Global Market Intelligence's coverage universe.




| | Period Ending | | | | | |
|---|---|---|---|---|---|---|
| **Index** | **12/31/13** | **12/31/14** | **12/31/15** | **12/31/16** | **12/31/17** | **12/31/18** |
| Carter Bank & Trust | 100.00 | 119.55 | 131.17 | 132.13 | 174.48 | 149.13 |
| NASDAQ Composite Index | 100.00 | 114.75 | 122.74 | 133.62 | 173.22 | 168.30 |
| SNL Bank and Thrift Index | 100.00 | 111.63 | 113.89 | 143.78 | 169.07 | 140.45 |

**Repurchases of Shares of Common Stock**

Carter Bank & Trust did not repurchase any shares of its common stock during 2018.

## ITEM 6. SELECTED FINANCIAL DATA

The tables below summarize selected consolidated financial data as of the dates or for the periods presented and should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 and the Consolidated Financial Statements and Supplementary Data in Part II, Item 8 of this Report:

| **(Dollars in Thousands except Per Share Data)** | **At or for the Year Ended December 31,** | | | | |
|---|---|---|---|---|---|
| **Five-Year Selected Financial Data** | **2018** | **2017** | **2016** | **2015** | **2014** |
| **Balance Sheet Summary** | | | | | |
| (At End of Period) | | | | | |
| Total Assets | $4,039,599 | $4,112,292 | $4,505,529 | $4,893,968 | $4,629,941 |
| Securities Available-for-Sale, at Fair Value | 782,758 | 947,201 | — | — | — |
| Securities Held-to-Maturity, at Cost | — | — | 879,694 | 1,422,101 | 1,828,264 |
| Loans Held-for-Sale | 2,559 | 517 | c | — | — |
| Portfolio Loans | 2,703,792 | 2,684,445 | 2,731,783 | 2,638,852 | 2,320,621 |
| Allowance for Loan Losses | (39,199) | (35,318) | (34,500) | (26,990) | (24,142) |
| Goodwill and Other Intangibles | 58,726 | 59,884 | 59,795 | 59,828 | 62,308 |
| Noninterest-Bearing Deposits | 524,614 | 530,242 | 534,923 | 534,005 | 458,266 |
| Interest-Bearing Deposits | 3,066,567 | 3,139,373 | 3,528,916 | 3,920,556 | 3,755,691 |
| **Total Deposits** | **3,591,181** | **3,669,615** | **4,063,839** | **4,454,561** | **4,213,957** |
| Other Liabilities | 12,204 | 10,551 | 7,040 | 12,858 | 18,090 |
| Total Liabilities | 3,603,385 | 3,680,166 | 4,070,879 | 4,467,419 | 4,232,047 |
| Retained Earnings | 277,835 | 265,930 | 266,214 | 258,113 | 229,458 |
| Accumulated Other Comprehensive Loss | (10,066) | (2,240) | — | — | — |
| Total Shareholders' Equity | 436,214 | 432,126 | 434,650 | 426,549 | 397,894 |
| **Summary of Earnings** | | | | | |
| Interest Income | $ 152,019 | $ 144,084 | $ 147,648 | $ 152,479 | $ 146,819 |
| Interest Expense | 38,114 | 37,111 | 46,382 | 47,797 | 45,330 |
| Provision for Loan Losses | 16,870 | 43,197 | 17,717 | 3,300 | 3,000 |
| **Net Interest Income after Provision for Loan Losses** | **97,035** | **63,776** | **83,549** | **101,382** | **98,489** |
| Noninterest Income | 16,986 | 12,591 | 12,494 | 14,685 | 14,473 |
| Noninterest Expense | 99,713 | 94,579 | 78,419 | 66,668 | 69,677 |
| **Net Income (Loss) before Taxes** | **14,308** | **(18,212)** | **17,624** | **49,399** | **43,285** |
| Income Tax (Benefit) Provision | 2,403 | (17,531) | 1,645 | 10,241 | 9,825 |
| **Net Income (Loss)** | **$ 11,905** | **$ (681)** | **$ 15,979** | **$ 39,158** | **$ 33,460** |
| **Earnings (Loss) per Share Basic and Diluted** | **$ 0.45** | **$ (0.03)** | **$ 0.61** | **$ 1.49** | **$ 1.27** |
| Cash Dividends Declared per Share | $ — | $ — | $ 0.30 | $ 0.40 | $ 0.40 |
| **Selected Ratios** | | | | | |
| Return on average assets | 0.29% | -0.02% | 0.33% | 0.82% | 0.73% |
| Return on average equity | 2.75% | -0.15% | 3.63% | 9.51% | 8.80% |
| Average equity to average assets | 10.70% | 10.42% | 9.12% | 8.64% | 8.25% |
| Total Risk-based capital | 15.22% | 14.15% | 13.35% | 12.03% | 12.07% |
| Leverage Ratio | 9.69% | 9.33% | 8.10% | 7.61% | 7.32% |
| Dividend Payout | 0.00% | 0.00% | 49.30% | 26.85% | 31.50% |

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

This section reviews our financial condition for each of the past two years and results of operations for each of the past three years. Certain reclassifications have been made to prior periods to place them on a basis comparable with the current period presentation. Some tables may include additional time periods to illustrate trends within our Consolidated Financial Statements. The results of operations reported in the accompanying Consolidated Financial Statements are not necessarily indicative of results to be expected in future periods.

**Important Note Regarding Forward-Looking Statements**

This Annual Report on Form 10-K contains or incorporates statements that we believe are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements generally relate to our financial condition, results of operations, plans, objectives, outlook for earnings, revenues, expenses, capital and liquidity levels and ratios, asset levels, asset quality, financial position, and other matters regarding or affecting Carter Bank & Trust and its future business and operations. Forward looking statements are typically identified by words or phrases such as "will likely result," "expect," "anticipate," "estimate," "forecast," "project," "intend," "believe," "assume," "strategy," "trend," "plan," "outlook," "outcome," "continue," "remain," "potential," "opportunity," "believe," "comfortable," "current," "position," "maintain," "sustain," "seek," "achieve" and variations of such words and similar expressions, or future or conditional verbs such as will, would, should, could or may. Although we believe the assumptions upon which these forward-looking statements are based are reasonable, any of these assumptions could prove to be inaccurate and the forward-looking statements based on these assumptions could be incorrect. The matters discussed in these forward-looking statements are subject to various risks, uncertainties and other factors that could cause actual results and trends to differ materially from those made, projected, or implied in or by the forward-looking statements depending on a variety of uncertainties or other factors including, but not limited to: credit losses; loan quality; levels of net charge-offs; changes in appraised values of collateral securing loans; rates of customer loan payoffs; cyber-security concerns; rapid technological developments and changes; the impact of the information technology systems upgrade; efforts to restructure the balance sheet; sensitivity to the interest rate environment including a prolonged period of low interest rates, a rapid increase in interest rates or a change in the shape of the yield curve; a change in spreads on interest-earning assets and interest-bearing liabilities; our ability to retain existing deposits and attract new deposits; regulatory supervision and oversight; legislation affecting the financial services industry as a whole, and Carter Bank & Trust in particular; the outcome of pending and future litigation and governmental proceedings; increasing price and product/service competition; the ability to continue to introduce competitive new products and services on a timely, cost-effective basis; containing costs and expenses; reliance on significant customer relationships; general economic or business conditions; deterioration of the housing market and reduced demand for mortgages; deterioration in the overall macroeconomic conditions or the state of the banking industry that could warrant further analysis of the carrying value of goodwill and could result in an adjustment to its carrying value resulting in a non-cash charge to net income; re-emergence of turbulence in significant portions of the global financial and real estate markets that could impact our performance, both directly, by affecting our revenues and the value of our assets and liabilities, and indirectly, by affecting the economy generally and access to capital in the amounts, at the times and on the terms required to support our future businesses; and the risk factors discussed in Part I, Item 1A, Risk Factors of this Report or contained in any of our subsequent filings with the FDIC. Forward-looking statements are based on beliefs and assumptions using information available at the time the statements are made. We caution you not to unduly rely on forward-looking statements because the assumptions, beliefs, expectations and projections about future events may, and often do, differ materially from actual results. Any forward-looking statement speaks only as to the date on which it is made, and we undertake no obligation to update any forward-looking statement to reflect developments occurring after the statement is made.

### Explanation of Use of Non-GAAP Financial Measures

In addition to the results of operations presented in accordance with generally accepted accounting principles ("GAAP") in the United States, management uses, and this annual report references, net interest income on a fully taxable equivalent, or ("FTE"), basis, which is a non-GAAP financial measure. Management believes this measure provides information useful to investors in understanding our underlying business, operational performance trends as it facilitates comparisons with the performance of other companies in the financial services industry. Although management believes that this non-GAAP financial measure enhance investors' understanding of our business and performance, this non-GAAP financial measure should not be considered an alternative to GAAP or considered to be more important than financial results determined in accordance with GAAP, nor is it necessarily comparable with similar non-GAAP measures which may be presented by other companies.

The Bank believes the presentation of net interest income on an FTE basis ensures the comparability of net interest income arising from both taxable and tax-exempt sources and is consistent with industry practice. Interest income per the Consolidated Statements of Income is reconciled to net interest income adjusted to an FTE basis in the Net Interest Income section of the "Results of Operations — Year ended December 31, 2018" and "Results of Operations — Year ended December 31, 2017."

### Critical Accounting Policies and Significant Accounting Estimates

Carter Bank & Trust's accounting and reporting policies conform to GAAP in the United States of America ("GAAP") and predominant practice in the banking industry. The preparation of financial statements in accordance with GAAP requires management to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. Over time, these estimates, assumptions and judgments may prove to be inaccurate or vary from actual results and may significantly affect our reported results and financial position for the period presented or in future periods. We currently view the determination of the allowance for loan losses, fair value measurements, goodwill and income taxes to be critical because they are highly dependent on subjective or complex judgments, assumptions and estimates made by management.

### Allowance for Loan Losses

We account for the credit risk associated with our lending activities through the allowance and provision for loan losses. The allowance represents management's best estimate of probable losses that have been incurred in our existing loan portfolio as of the balance sheet date. The provision is a periodic charge to earnings in an amount necessary to maintain the allowance at a level that is appropriate based on management's assessment of probable estimated losses. Management determines and reviews with the Board of Directors the adequacy of the allowance on a quarterly basis in accordance with the methodology described below.

- Individual loans are selected for review in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 310, "Receivables." These are generally large balance commercial loans and commercial mortgages that are rated less than "satisfactory" based on our internal credit-rating process.
- We assess whether the loans identified for review in step one are "impaired," which means that it is probable that all amounts will not be collected according to the contractual terms of the loan agreement, which generally represents loans that management has placed on nonaccrual status.
- For impaired loans we calculate the estimated fair value of the loans that are selected for review based on observable market prices, discounted cash flows or the value of the underlying collateral less costs to sell and record an allowance if needed.

- We then select pools of homogeneous smaller balance loans, having similar risk characteristics, as well as unimpaired larger commercial loans, that have similar risk characteristics, for evaluation collectively under the provisions of FASB ASC Topic 450, "Contingencies." These smaller balance loans generally include residential mortgages, consumer loans, installment loans and some commercial loans.
- FASB ASC Topic 450 loans are segmented into groups with similar characteristics and an allowance for loan losses is allocated to each segment based on recent loss history and other relevant information.
- We then review the results to determine the appropriate balance of the allowance for credit losses. This review includes consideration of additional factors, such as the mix of loans in the portfolio, the balance of the allowance relative to total loans and nonperforming assets, trends in the overall risk profile in the portfolio, trends in delinquencies and nonaccrual loans, and local and national economic information and industry data, including trends in the industries we believe are higher risk.

There are many factors affecting the allowance for loan losses; some are quantitative, while others require qualitative judgment. These factors require the use of estimates related to the amount and timing of expected future cash flows, appraised values on impaired loans, estimated losses for each loan category based on historical loss experience by category, loss emergence periods for each loan category and consideration of current economic trends and conditions, all of which may be susceptible to significant judgment and change. To the extent that actual outcomes differ from estimates, additional provisions for loan losses could be required that could adversely affect our earnings or financial position in future periods. The loan portfolio represents the largest asset category on our Consolidated Balance Sheets.

**Fair Values Measurements**

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. We use various valuation techniques to determine fair value, including market, income and cost approaches. There are three levels of inputs that may be used to measure fair values:

**Level 1:** Quoted prices (unadjusted) for identical assets or liabilities in active markets that an entity has the ability to access as of the measurement date, or observable inputs.

**Level 2:** Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

**Level 3:** Significant unobservable inputs that reflect an entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. When that occurs, we classify the fair value hierarchy on the lowest level of input that is significant to the fair value measurement. We used the following methods and significant assumptions to estimate fair value:

**Securities:** The fair values of securities available-for-sale are determined by obtaining quoted prices on nationally recognized securities exchanges, if available. This valuation method is classified as Level 1 in the fair value hierarchy. For securities where quoted prices are not available, fair values are calculated on market prices of similar securities, or 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. Matrix pricing relies on the securities' relationship to similarly traded securities, benchmark curves, and the benchmarking of like securities. Matrix pricing utilizes observable market inputs such as benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, reference data, and industry and economic events. In instances where broker quotes are used, these quotes are obtained from market makers or broker-dealers recognized to be market participants. This valuation method is classified as Level 2 in the fair value hierarchy. For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators.

**Impaired Loans:** An impaired loan is evaluated at the time the loan is identified as impaired and is recorded at fair value less costs to sell. Fair value is measured based on the value of the collateral securing the loan and is classified as Level 3 in the fair value hierarchy. Fair value is determined using several methods. Generally, the fair value of real estate is determined based on appraisals by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach.

Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. These routine adjustments are made to adjust the value of a specific property relative to comparable properties for variations in qualities such as location, size, and income production capacity relative to the subject property of the appraisal. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

Impaired loans are evaluated quarterly for additional impairment. We obtain updated appraisals on properties securing our loans when circumstances are warranted such as at the time of renewal or when market conditions have significantly changed. This determination is made on a property-by-property basis in light of circumstances in the broader economic climate and our assessment of deterioration of real estate values in the market in which the property is located. The first stage of our assessment involves management's inspection of the property in question. Management also engages in conversations with local real estate professionals and market participants to determine the likely marketing time and value range for the property. The second stage involves an assessment of current trends in the regional market. After thorough consideration of these factors, management will either internally evaluate fair value or order a new appraisal.

**Other Real Estate Owned ("OREO")**: OREO assets are evaluated at the time of acquisition, and are recorded at fair value as determined by an appraisal or evaluation, less costs to sell. After acquisition, most OREO assets revalued every twelve months, or more frequently when deemed necessary by management based upon changes in market, or collateral, conditions. For smaller OREO assets with existing carrying values less than $0.5 million, management may elect to revalue the assets, at minimum, once every twenty-four months based on the size of the exposure. At December 31, 2018 Carter Bank's OREO assets were in compliance with the Bank's OREO policy as set forth above, and substantially all of the assets were listed for sale with credible third party real estate brokers.

**Goodwill and Other Intangibles**

Goodwill and other intangible assets with indefinite useful lives are tested for impairment at least annually and written down and charged to results of operations only in periods in which the recorded value is more than the estimated fair value. Intangible assets that have finite useful lives will continue to be amortized over their useful lives and are periodically evaluated for impairment.

As of December 31, 2018, goodwill and other intangible assets were not considered impaired; however, changing economic conditions that may adversely affect our performance and stock price could result in impairment, which could adversely affect earnings in future periods. As a result of our Step 2 analysis as of December 31, 2018, it was determined that the fair value of our goodwill exceeded its carrying value.

### Income Taxes

We estimate income tax expense based on amounts expected to be owed to the tax jurisdictions where we conduct business. On a quarterly basis, management assesses the reasonableness of its effective tax rate based upon its current estimate of the amount and components of net income, tax credits and the applicable statutory tax rates expected for the full year.

Deferred income tax assets and liabilities are determined using the asset and liability method and are reported in the Consolidated Balance Sheets. Under this method, 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. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to be applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. Management assesses all available positive and negative evidence on a quarterly basis to estimate if sufficient future taxable income will be generated to utilize the existing deferred tax assets. The amount of future taxable income used in management's valuation is based upon management approved forecasts, evaluation of historical earnings levels, proven ability to raise capital to support growth or during times of economic stress and consideration of prudent and feasible potential tax strategies. If future events differ from our current forecasts, a valuation allowance may be required, which could have a material impact on our financial condition and results of operations.

Accrued taxes payable or receivable represent the net estimated amount due to or due from taxing jurisdictions and are reported in other liabilities and other assets, respectively, in the Consolidated Balance Sheets. Management evaluates and assesses the relative risks and appropriate tax treatment of transactions and filing positions after considering statutes, regulations, judicial precedent and other information and maintains tax accruals consistent with its evaluation of these relative risks and merits. Changes to the estimate of accrued taxes occur periodically due to changes in tax rates, interpretations of tax laws, the status of examinations being conducted by taxing authorities and changes to statutory, judicial and regulatory guidance. These changes, when they occur, can affect deferred taxes and accrued taxes, as well as the current period's income tax expense and can be significant to our operating results.

### Executive Overview

Carter Bank & Trust (the "Bank") is a state non-member Bank headquartered in Martinsville, Virginia with assets of $4.0 billion at December 31, 2018. The Bank operates branches in Virginia and North Carolina. The Bank provides a full range of financial services with retail, and commercial banking products and insurance. Our common stock trades on the OTCQX Best Market effective April 26, 2018, under the ticker symbol "CARE."

The Bank earns revenue primarily from interest on loans and securities and fees charged for financial services provided to our customers. The Bank incurs expenses for the cost of deposits, provision for loan losses and other operating costs such as salaries and employee benefits, data processing, occupancy and tax expense.

Our mission is that the Bank strives to be the preferred lifetime financial partner for our customers and shareholders, and the employer of choice in the communities the Bank is privileged to serve. Our strategic plan focuses on restructuring the balance sheet to provide more diversification and higher yielding assets to increase the net interest margin. Another area of focus is the transformation of our infrastructure of the Bank to provide a foundation for operational efficiency and provide new products and services for our customers that will ultimately increase noninterest income.

During 2018 and 2017, the Bank continued to take aggressive steps to deal with legacy problem loans so they will not have a lingering impact to our long-term performance. Our focus going forward into 2019 will be focused on loan and deposit growth with emphasis on an account acquisition strategy and implementation of new opportunities to increase fee income while closely monitoring our operating expenses. The Bank is focused on executing our strategy to successfully build our brand and grow our business in our markets. The Bank benefited from recent increases in short-term interest rates and from the Tax Cuts and Jobs Act (Tax Act) which lowered the federal corporate tax rate from 35% to 21% effective January 1, 2018.

**Earnings Summary**

Net interest income, on a FTE basis, increased $2.2 million to $117.7 million in 2018 as compared to 2017. The increase in net interest income is driven by a $3.2 million increase in interest income, offset by a $1.0 million increase in interest expense during 2018 as compared to 2017. The increase in interest expense is a result of seven increases by the FRB in short-term interest rates since March of 2017 and additional expense due to recent certificate of deposit promotions, partially offset by the intentional runoff of higher cost certificates of deposit. The net interest margin, on a fully taxable equivalent basis, increased 30 basis points to 3.10% over the past twelve months due to our deployment of excess cash into higher yielding and diversified investment securities and loans as well as the intentional runoff of higher cost deposits. The margin also increased despite the decreased tax benefit from our tax-exempt securities and loans due to the decrease in the federal corporate income tax rate in 2018.

The provision for loan losses decreased $26.3 million to $16.9 million in 2018 compared to $43.2 million in 2017. The decrease in provision expense in 2018 as compared to 2017 is attributable to a reduction in net charge-offs in the loan portfolio. Net charge-offs were $13.0 million in 2018 as compared to $42.4 million in 2017. The most significant loan charge-off in 2018 was for one legacy commercial credit relationship of $10.1 million that experienced deterioration in collateral values as a result of a new appraisal. During 2017, the Bank dealt with significant impairment in several large commercial real estate loan relationships, which resulted in substantial charge-offs in the aggressive resolution of these legacy credits.

Noninterest income increased $4.3 million, or 37.8%, to $15.7 million, excluding net securities gains, in 2018 as compared to $11.4 million in 2017. The increase in noninterest income is attributable to increased service charges of $1.3 million, $1.2 million of earnings from bank owned life insurance and an increase of $2.2 million in income from other real estate owned due to the acquisition of several large commercial properties generating income beginning in the first quarter of 2018, all offset by a decrease of $0.7 million in insurance due to the sale of the insurance agency in the first quarter of 2018. Net securities gains in the amounts of $1.3 million and $1.2 million were realized during 2018 and 2017, respectively, to take advantage of market opportunities and reduce the credit risk of the securities portfolio.

Total noninterest expense increased $5.1 million, or 5.4%, in 2018 to $99.7 million as compared to $94.6 million in 2017. Salaries and employee benefits increased $7.2 million, or 17.0%, in 2018 as compared to 2017. This increase was expected and planned as investments were made in the appropriate infrastructure to support the Bank in the future. Occupancy expense, other taxes, and telephone expense increased $0.5 million, $0.7 million, and $0.8 million, respectively, in 2018 as compared to 2017. Other real estate owned expenses increased $1.3 million for the year ended 2018 over the year ended 2017. The increase in other real estate owned expense is due to the acquisition of several large commercial properties in the first quarter of 2018. Other factors negatively impacting our noninterest expense were one-time charges of $3.5 million and $5.3 million on write-downs of retail branch offices marketed for sale in the fourth quarters of 2018 and 2017, respectively, and $4.1 million of tax credit amortization in 2018. Additional expenses including advertising, automated services, travel and dues and subscriptions, and non-core business administration fees increased in 2018 as compared to 2017 in the amounts of $0.7 million, $0.5 million, $0.3 million, and $0.7 million, respectively. Offsetting the above-referenced increases were decreases in data processing expenses, professional and legal fees, and FDIC insurance expense. Data processing expense decreased $4.4 million in the year-over-year comparison due to the write-off of expenses that were previously capitalized and were fully expensed during 2017. Conversion expenses during 2018 in the amount of $0.8 million were included in data processing license fees. Professional and legal expenses decreased $1.6 million in 2018 as compared to 2017 due to regulatory and compliance reviews that were completed as of June 30, 2018. The decrease in FDIC insurance expense was attributable to lower assessment rates and a decrease in the assessment base. Also decreasing our noninterest expense in the yearly comparison was $3.3 million of impairment on tax credits charged during the fourth quarter of 2017.

The provision for income taxes was a tax provision of $2.4 million for 2018 and pretax income of $14.3 million compared to a tax benefit of $17.5 million in 2017 as a result of a pretax loss of $18.2 million. Year-end 2017 was negatively impacted by a charge of $2.8 million from the write-down of the Bank's deferred tax assets resulting from the recent tax reform legislation.

The effective tax rate was 17% in 2018 and negative 96% in 2017. The Bank ordinarily generates an annual effective tax rate that is less than the federal statutory rate in effect for a fiscal year (which was 21% for 2018 and 35% for 2017 and 2016) due to benefits resulting from tax-exempt interest and tax benefits associated with tax credits, which are relatively consistent regardless of the level of pretax income. The negative annual effective tax rate for 2017 was produced because of the consistent level of tax benefits that reduced our tax rate below the statutory 35% rate in effect at that time and the pretax loss.

## RESULTS OF OPERATIONS
## Year Ended December 31, 2018

### Net Interest Income

Our principal source of revenue is net interest income. Net interest income represents the difference between the interest and fees earned on interest-earning assets and the interest paid on interest-bearing liabilities. Net interest income is affected by changes in the average balance of interest-earning assets and interest-bearing liabilities and changes in interest rates and spreads. The level and mix of interest-earning assets and interest-bearing liabilities is managed by our Asset and Liability Committee, or ("ALCO"), in order to mitigate interest rate and liquidity risks of the balance sheet. A variety of ALCO strategies were implemented, within prescribed ALCO risk parameters, to produce what the Bank believes is an acceptable level of net interest income.

The interest income on interest-earning assets and the net interest margin are presented on a fully taxable equivalent ("FTE") basis. The FTE basis adjusts for the tax benefit of income on certain tax-exempt loans and securities using the applicable federal statutory tax rate for each period (which was 21% for the year ended December 31, 2018 and 35% for the years ended December 31, 2017 and 2016) and the dividend-received deduction for equity securities. The Bank believes this FTE presentation provides a relevant comparison between taxable and non-taxable sources of interest income.

The following table reconciles net interest income per the Consolidated Statements of Income to net interest income on a FTE basis for the periods presented:

| | Years Ended December 31, | | |
|---|---|---|---|
| **(Dollars in Thousands)** | **2018** | **2017** | **2016** |
| Total Interest Income | $152,019 | $144,084 | $147,648 |
| Total Interest Expense | 38,114 | 37,111 | 46,382 |
| Net Interest Income | 113,905 | 106,973 | 101,266 |
| Adjustment to FTE Basis | 3,816 | 8,505 | 7,940 |
| **Net Interest Income (FTE) (non-GAAP)** | **$117,721** | **$115,478** | **$109,206** |
| Net Interest Margin | 3.00% | 2.59% | 2.23% |
| Adjustment to FTE Basis | 0.10 | 0.21 | 0.17 |
| **Net Interest Income (FTE) (non-GAAP)** | **3.10%** | **2.80%** | **2.40%** |

### Average Balance Sheet and Net Interest Income Analysis (FTE)

Net interest income, on a FTE basis, increased $2.2 million, or 1.9%, to $117.7 million in 2018 as compared to 2017. The increase in net interest income is driven by a $3.2 million increase in interest income, offset by a $1.0 million increase in interest expense during 2018 as compared to 2017. The increase in interest expense is a result of seven increases by the FRB in short-term interest rates since March of 2017 and additional expense due to recent certificate of deposit promotions, partially offset by the intentional runoff of higher cost certificates of deposit. The net interest margin, on a fully taxable equivalent basis, increased 30 basis points to 3.10% over the past twelve months due to our deployment of excess cash into higher yielding and diversified investment securities and loans as well as the aforementioned runoff of higher cost deposits. The margin also increased despite the decreased tax benefit from our tax-exempt securities and loans due to the decrease in the federal corporate income tax rate in 2018.

The following table provides information regarding the average balances, interest and rates earned on interest-earning assets and the average balances, interest and rates paid on interest-bearing liabilities for the years ended December 31:

| | 2018 | | | 2017 | | | 2016 | | |
|---|---|---|---|---|---|---|---|---|---|
| (Dollars in Thousands) | Average Balance | Income/ Expense | Rate | Average Balance | Income/ Expense | Rate | Average Balance | Income/ Expense | Rate |
| **ASSETS** | | | | | | | | | |
| Interest-Bearing Deposits with Banks | $ 134,406 | $ 2,682 | 2.00% | $ 481,128 | $ 5,184 | 1.08% | $ 781,593 | $ 4,089 | 0.52% |
| Tax-Free Investment Securities | 153,036 | 5,375 | 3.51% | 126,287 | 7,530 | 5.96% | 123,072 | 7,649 | 6.22% |
| Taxable Investment Securities | 753,023 | 15,421 | 2.05% | 806,353 | 14,911 | 1.85% | 978,193 | 21,343 | 2.18% |
| Tax-Free Loans | 419,981 | 12,794 | 3.05% | 451,100 | 16,771 | 3.72% | 382,889 | 15,035 | 3.93% |
| Taxable Loans, net of Unearned Income | 2,331,165 | 119,563 | 5.13% | 2,259,438 | 108,193 | 4.79% | 2,281,207 | 107,472 | 4.71% |
| **Total Interest-Earning Assets** | **$3,791,611** | **$155,835** | **4.11%** | **$4,124,306** | **$152,589** | **3.70%** | **$4,546,954** | **$155,588** | **3.42%** |
| **LIABILITIES** | | | | | | | | | |
| Deposits | | | | | | | | | |
| Interest-Bearing Demand | $ 246,592 | $ 1,959 | 0.79% | $ 244,919 | $ 1,587 | 0.65% | $ 243,355 | $ 1,487 | 0.61% |
| Money Market | 96,068 | 694 | 0.72% | 141,438 | 788 | 0.56% | 219,775 | 1,649 | 0.75% |
| Savings | 663,801 | 2,027 | 0.31% | 727,182 | 3,568 | 0.49% | 710,493 | 3,617 | 0.51% |
| Certificates of Deposit | 2,090,103 | 33,414 | 1.60% | 2,199,263 | 31,168 | 1.42% | 2,633,535 | 39,629 | 1.50% |
| **Total Interest-Bearing Deposits** | **$3,096,564** | **$ 38,094** | **1.23%** | **$3,312,802** | **$ 37,111** | **1.12%** | **$3,807,158** | **$ 46,382** | **1.22%** |
| Borrowings | | | | | | | | | |
| Federal Funds Purchased | 681 | 20 | 2.94% | — | — | — | — | — | — |
| **Total Borrowings** | **681** | **20** | **2.94%** | — | — | — | — | — | — |
| **Total Interest-Bearing Liabilities** | **$3,097,245** | **$ 38,114** | **1.23%** | **$3,312,802** | **$ 37,111** | **1.12%** | **$3,807,158** | **$ 46,382** | **1.22%** |
| **Net Interest Income** | | **$117,721** | | | **$115,478** | | | **$109,206** | |
| **Net Interest Margin** | | | **3.10%** | | | **2.80%** | | | **2.40%** |

Interest income, on a FTE basis, increased $3.2 million, or 2.1%, in 2018 compared to 2017. The increase in interest income is the result of seven increases by the FRB in short-term interest rates since March of 2017, despite a decline in average total interest-earning assets of $332.7 million in 2018 compared to 2017. The rates earned on interest-earning assets increased 41 basis points in 2018 as compared to 2017. Average interest-bearing deposits with banks, which are primarily cash at the Federal Reserve Bank, decreased $346.7 million and the rates increased 92 basis points due to the Federal Funds rate increases since March of 2017. The decline of Federal Reserve Bank balances was utilized to deploy the excess cash into higher yielding and diversified investment securities, fund loan growth, and also funded the planned decrease in high cost deposits during the last year.

Interest expense increased $1.0 million, or 2.7%, in 2018 compared to 2017. Despite a decrease in average interest-bearing deposits in the amount of $216.2 million for the year ended December 31, 2018 compared to the same period in 2017, total interest expense actually increased year over year primarily as a result of recent certificate of deposit promotions. The cost of interest-bearing deposits increased 11 basis points in 2018 compared to 2017.

The following table sets forth for the periods presented a summary of the changes in interest earned and interest paid resulting from changes in volume and changes in rates:

| | 2018 Compared to 2017 | | | 2017 Compared to 2016 | | |
|---|---|---|---|---|---|---|
| **(Dollars in Thousands)** | **Increase/ (Decrease)** | **Rate** | **Volume** | **Increase/ (Decrease)** | **Rate** | **Volume** |
| **ASSETS** | | | | | | |
| Interest-Bearing Deposits with Banks | $ (2,502) | $ 2,693 | $(5,195) | $ 1,095 | $ 3,110 | $(2,015) |
| Tax-Free Investment Securities | (2,155) | (3,527) | 1,372 | (119) | (316) | 197 |
| Taxable Investment Securities | 510 | 1,536 | (1,026) | (6,432) | (2,989) | (3,443) |
| Tax-Free Loans | (3,977) | (2,878) | (1,099) | 1,736 | (833) | 2,569 |
| Taxable Loans | 11,370 | 7,860 | 3,510 | 721 | 1,753 | (1,032) |
| **Total Interest-Earning Assets** | **$ 3,246** | **$ 5,684** | **$(2,438)** | **$(2,999)** | **$ 725** | **$(3,724)** |
| **LIABILITIES** | | | | | | |
| Deposits | | | | | | |
| Interest-Bearing Demand | $ 372 | $ 361 | $ 11 | $ 100 | $ 90 | $ 10 |
| Money Market | (94) | 198 | (292) | (861) | (361) | (500) |
| Savings | (1,541) | (1,252) | (289) | (49) | (133) | 84 |
| Certificates of Deposit | 2,246 | 3,848 | (1,602) | (8,461) | (2,207) | (6,254) |
| **Total Interest-Bearing Deposits** | **$ 983** | **$ 3,155** | **$(2,172)** | **$(9,271)** | **$(2,611)** | **$(6,660)** |
| Borrowings | | | | | | |
| Federal Funds Purchased | 20 | — | 20 | — | — | — |
| **Total Borrowings** | **20** | **—** | **20** | **—** | **—** | **—** |
| **Total Interest-Bearing Liabilities** | **$ 1,003** | **$ 3,155** | **$(2,152)** | **$(9,271)** | **$(2,611)** | **$(6,660)** |
| **Net Interest Income** | **$ 2,243** | | | **$ 6,272** | | |

### Provision for Loan Losses

The following table summarizes the activity in the ALL for the periods presented:

| (Dollars in Thousands) | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Balance Beginning of Year | $35,318 | $34,500 | $26,990 | $24,142 | $21,392 |
| Provision for Loan Losses | 16,870 | 43,197 | 17,717 | 3,300 | 3,000 |
| Charge-offs: | | | | | |
| Real Estate Loans | 11,924 | 42,813 | 9,687 | 310 | 89 |
| Consumer Loans | 2,710 | 465 | 510 | 177 | 166 |
| Commercial Loans | 20 | 31 | 257 | 20 | 82 |
| **Total Charge-offs** | **14,654** | **43,309** | **10,454** | **507** | **337** |
| Recoveries: | | | | | |
| Real Estate Loans | 1,415 | 720 | 131 | — | 36 |
| Consumer Loans | 250 | 210 | 110 | 55 | 51 |
| Commercial Loans | — | — | 6 | — | — |
| **Total Recoveries** | **1,665** | **930** | **247** | **55** | **87** |
| **Total Net Charge-offs** | **12,989** | **42,379** | **10,207** | **452** | **250** |
| **Balance End of Year** | **$39,199** | **$35,318** | **$34,500** | **$26,990** | **$24,142** |
| **Net Charge-offs to Average Loans** | **0.47%** | **1.56%** | **0.38%** | **0.02%** | **0.01%** |
| **Allowance for Loan Losses to Year-end Loans** | **1.45%** | **1.32%** | **1.26%** | **1.03%** | **1.04%** |

The provision for loan losses is the amount to be added to the allowance for loan losses, or ("ALL"), after considering loan charge-offs and recoveries, to bring the ALL to a level determined to be appropriate in management's judgment to absorb probable losses inherent in the loan portfolio.

The provision for loan losses decreased $26.3 million to $16.9 million in 2018 compared to $43.2 million in 2017. The decrease in provision expense in 2018 as compared to 2017 is attributable to a reduction in net charge-offs in the loan portfolio. Net charge-offs were $13.0 million in 2018 as compared to $42.4 million in 2017. The most significant loan charge-off in 2018 was for one legacy commercial credit relationship of $10.1 million that experienced deterioration in collateral values as a result of a new appraisal. During 2017, the Bank dealt with significant impairment in several large commercial real estate loan relationships, which resulted in substantial charge-offs in the aggressive resolution of these legacy credits.

Net charge-offs decreased $29.4 million to $13.0 million in 2018 compared to $42.4 million for 2017. Annualized net loan charge-offs to average loans were 0.47% and 1.56% in 2018 and 2017, respectively. Specific reserves were $5.2 million at December 31, 2018. The Bank had $32 thousand of specific reserves at December 31, 2017.

Nonperforming loans decreased at December 31, 2018 by $42.2 million, to $50.7 million as compared to $92.9 million at December 31 2017. The allowance for loan losses was 77.3% of nonperforming loans as of December 31, 2018 as compared to 38.0% of nonperforming loans as of December 31, 2017. Management is aggressively taking steps to address problem loan relationships.

The ALL at December 31, 2018 was $39.2 million compared to $35.3 million at December 31, 2017. The ALL as a percentage of total portfolio loans was 1.45% at December 31, 2018 and 1.32% at December 31, 2017.

**Noninterest Income**

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| **(Dollars in Thousands)** | **2018** | **2017** | **$ Change** | **% Change** |
| Gains on Sales of Securities, net | $ 1,271 | $ 1,186 | $ 85 | 7.2% |
| Service Charges, Commissions and Fees | 4,228 | 2,920 | 1,308 | 44.8% |
| Debit Card Interchange Fees | 4,750 | 4,854 | (104) | (2.1)% |
| Insurance | 1,855 | 2,582 | (727) | (28.2)% |
| Bank Owned Life Insurance Income | 1,161 | — | 1,161 | NM |
| Other Real Estate Owned Income | 2,692 | 448 | 2,244 | NM |
| Other | 1,029 | 601 | 428 | 71.2% |
| **Total Noninterest Income** | **$16,986** | **$12,591** | **$4,395** | **34.9%** |

*NM — percentage not meaningful*

Noninterest income increased $4.3 million, or 37.8%, to $15.7 million, excluding net securities gains, in 2018 as compared to $11.4 million in 2017. The increase in noninterest income is attributable to increased service charges of $1.3 million, $1.2 million of earnings from bank owned life insurance and an increase of $2.2 million in income from other real estate owned due to the acquisition of several large commercial properties generating income beginning in the first quarter of 2018, all offset by a decrease of $0.7 million in insurance due to the sale of the insurance agency in the first quarter of 2018. Net securities gains in the amounts of $1.3 million and $1.2 million were realized during 2018 and 2017, respectively, to take advantage of market opportunities and reduce the credit risk of the securities portfolio.

**Noninterest Expense**

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| **(Dollars in Thousands)** | **2018** | **2017** | **$ Change** | **% Change** |
| Salaries and Employee Benefits | $49,958 | $42,711 | $ 7,247 | 17.0% |
| Occupancy Expense, net | 10,312 | 9,780 | 532 | 5.4% |
| FDIC Insurance Expense | 2,985 | 3,890 | (905) | (23.3)% |
| Other Taxes | 2,571 | 1,907 | 664 | 34.8% |
| Telephone Expense | 2,466 | 1,699 | 767 | 45.1% |
| Professional and Legal Fees | 5,288 | 6,856 | (1,568) | (22.9)% |
| Data Processing License Fee | 1,242 | 5,604 | (4,362) | (77.8)% |
| Losses on Sales and Write-downs of Other Real Estate Owned, net | 8,201 | 9,909 | (1,708) | (17.2)% |
| Losses on Sales and Write-downs of Bank Premises, net | 186 | 714 | (528) | (73.9)% |
| Debit Card Expense | 2,785 | 2,436 | 349 | 14.3% |
| Tax Credit Amortization | 4,060 | — | 4,060 | NM |
| Tax Credit Impairment | — | 3,259 | (3,259) | NM |
| Other Real Estate Owned Expense | 2,139 | 791 | 1,348 | NM |
| Other | 7,520 | 5,023 | 2,497 | 49.7% |
| **Total Noninterest Expense** | **$99,713** | **$94,579** | **$ 5,134** | **5.4%** |

*NM — percentage not meaningful*

Total noninterest expense increased $5.1 million, or 5.4%, in 2018 to $99.7 million as compared to $94.6 million in 2017. Salaries and employee benefits increased $7.2 million, or 17.0%, in 2018 as compared to 2017. This increase was expected and planned as investments were made in the appropriate infrastructure to support the Bank in the future. Occupancy expense, other taxes, and telephone expense increased $0.5 million, $0.7 million, and $0.8 million, respectively, in 2018 as compared to 2017. Other real estate owned expenses increased $1.3 million for the year ended 2018 over the year ended 2017. The increase in other real estate owned expense is due to the acquisition of several large commercial properties in the first quarter of 2018. Other factors negatively impacting our noninterest expense were one-time charges of $3.5 million and $5.3 million on write-downs of retail branch offices marketed for sale in the fourth quarters of 2018 and 2017, respectively, and $4.1 million of tax credit amortization in 2018. Additional expenses in the other category including advertising, automated services, travel and dues and subscriptions, and non-core business administration fees increased in 2018 as compared to 2017 in the amounts of $0.7 million, $0.5 million, $0.3 million, and $0.7 million, respectively. Offsetting the above-referenced increases were decreases in data processing expenses, professional and legal fees, and FDIC insurance expense. Data processing expense decreased $4.4 million in the year-over-year comparison due to the write-off of expenses that were previously capitalized and were fully expensed during 2017. Conversion expenses during 2018 in the amount of $0.8 million were included in data processing license fees. Professional and legal expenses decreased $1.6 million in 2018 as compared to 2017 due to regulatory and compliance reviews that were completed as of June 30, 2018. The decrease in FDIC insurance expense was attributable to lower assessment rates and a decrease in the assessment base. Also decreasing our noninterest expense in the yearly comparison was $3.3 million of impairment on tax credits charged during the fourth quarter of 2017.

### Provision for Income Taxes

The provision for income taxes was a tax provision of $2.4 million for 2018 and pretax income of $14.3 million compared to a tax benefit of $17.5 million in 2017 as a result of a pretax loss of $18.2 million. Year-end 2017 was negatively impacted by a charge of $2.8 million from the write-down of the Bank's deferred tax assets resulting from the recent tax reform legislation.

The effective tax rate was 17% in 2018 and negative 96% in 2017. The Bank ordinarily generates an annual effective tax rate that is less than the federal statutory rate in effect for a fiscal year (which was 21% for 2018 and 35% for 2017 and 2016) due to benefits resulting from tax-exempt interest and tax benefits associated with tax credits, which are relatively consistent regardless of the level of pretax income. The negative annual effective tax rate for 2017 was produced because of the consistent level of tax benefits that reduced our tax rate below the statutory 35% rate in effect at that time and the pretax loss.

## RESULTS OF OPERATIONS
### For the Year Ended December 31, 2017

### Net Interest Income

Our principal source of revenue is net interest income. Net interest income represents the difference between the interest and fees earned on interest-earning assets and the interest paid on interest-bearing liabilities. Net interest income is affected by changes in the average balance of interest-earning assets and interest-bearing liabilities and changes in interest rates and spreads. The level and mix of interest-earning assets and interest-bearing liabilities is managed by our Asset and Liability Committee, or ("ALCO"), in order to mitigate interest rate and liquidity risks of the balance sheet. A variety of ALCO strategies were implemented, within prescribed ALCO risk parameters, to produce what the Bank believes is an acceptable level of net interest income.

The interest income on interest-earning assets and the net interest margin are presented on a fully taxable equivalent ("FTE") basis. The FTE basis adjusts for the tax benefit of income on certain tax-exempt loans and securities using the applicable federal statutory tax rate for each period (which was 35% for the years ended December 31, 2017, 2016 and 2015) and the dividend-received deduction for equity securities. The Bank believes this FTE presentation provides a relevant comparison between taxable and non-taxable sources of interest income.

The following table reconciles net interest income per the Consolidated Statements of Income to net interest income and adjusted to a FTE basis for the periods presented:

| | Years Ended December 31, | | |
|---|---|---|---|
| **(Dollars in Thousands)** | **2017** | **2016** | **2015** |
| Total Interest Income | $144,084 | $147,648 | $152,479 |
| Total Interest Expense | 37,111 | 46,382 | 47,797 |
| Net Interest Income | 106,973 | 101,266 | 104,682 |
| Adjustment to FTE Basis | 8,505 | 7,940 | 7,725 |
| **Net Interest Income (FTE) (non-GAAP)** | **$115,478** | **$109,206** | **$112,407** |
| Net Interest Margin | 2.59% | 2.23% | 2.34% |
| Adjustment to FTE Basis | 0.21 | 0.17 | 0.17 |
| **Net Interest Income (FTE) (non-GAAP)** | **2.80%** | **2.40%** | **2.51%** |

### Average Balance Sheet and Net Interest Income Analysis (FTE)

Net interest income, on a FTE basis, increased $6.3 million, or 5.7%, for 2017 compared to 2016. The increase in net interest income is primarily driven by the intentional runoff of higher cost certificates of deposit. The net interest margin, on an FTE basis, increased 40 basis points for 2017 compared to 2016. The increases were primarily due to the deployment of excess cash into higher yielding and diversified investment securities and loans as well as the runoff of higher cost deposits.

The following table provides information regarding the average balances, interest and rates earned on interest-earning assets and the average balances, interest and rates paid on interest-bearing liabilities for the years ended December 31:

| | 2017 | | | 2016 | | | 2015 | | |
|---|---|---|---|---|---|---|---|---|---|
| **(Dollars in Thousands)** | **Average Balance** | **Income/ Expense** | **Rate** | **Average Balance** | **Income/ Expense** | **Rate** | **Average Balance** | **Income/ Expense** | **Rate** |
| **ASSETS** | | | | | | | | | |
| Interest-Bearing Deposits with Banks | $ 481,128 | $ 5,184 | 1.08% | $ 781,593 | $ 4,089 | 0.52% | $ 451,855 | $ 1,205 | 0.27% |
| Tax-Free Investment Securities | 126,287 | 7,530 | 5.96% | 123,072 | 7,649 | 6.22% | 130,084 | 7,981 | 6.14% |
| Taxable Investment Securities | 806,353 | 14,911 | 1.85% | 978,193 | 21,343 | 2.18% | 1,477,925 | 31,851 | 2.16% |
| Tax-Free Loans | 451,100 | 16,771 | 3.72% | 382,889 | 15,035 | 3.93% | 340,899 | 14,091 | 4.13% |
| Taxable Loans | 2,259,438 | 108,193 | 4.79% | 2,281,207 | 107,472 | 4.71% | 2,079,635 | 105,076 | 5.05% |
| **Total Interest-Earning Assets** | **$4,124,306** | **$152,589** | **3.70%** | **$4,546,954** | **$155,588** | **3.42%** | **$4,480,398** | **$160,204** | **3.58%** |
| **LIABILITIES** | | | | | | | | | |
| Deposits | | | | | | | | | |
| Interest-Bearing Demand | $ 244,919 | $ 1,587 | 0.65% | $ 243,355 | $ 1,487 | 0.61% | $ 240,348 | $ 1,127 | 0.47% |
| Money Market | 141,438 | 788 | 0.56% | 219,775 | 1,649 | 0.75% | 223,838 | 2,147 | 0.96% |
| Savings | 727,182 | 3,568 | 0.49% | 710,493 | 3,617 | 0.51% | 736,900 | 6,660 | 0.90% |
| Certificates of Deposit | 2,199,263 | 31,168 | 1.42% | 2,633,535 | 39,629 | 1.50% | 2,667,173 | 37,863 | 1.42% |
| **Total Interest-Bearing Deposits** | **$3,312,802** | **$ 37,111** | **1.12%** | **$3,807,158** | **$ 46,382** | **1.22%** | **$3,868,259** | **$ 47,797** | **1.24%** |
| **Total Interest-Bearing Liabilities** | **$3,312,802** | **$ 37,111** | **1.12%** | **$3,807,158** | **$ 46,382** | **1.22%** | **$3,868,259** | **$ 47,797** | **1.24%** |
| **Net Interest Income** | | **$115,478** | | | **$109,206** | | | **$112,407** | |
| **Net Interest Margin** | | | **2.80%** | | | **2.40%** | | | **2.51%** |

Interest income, on a FTE basis, decreased $3.0 million, or 1.9%, in 2017 compared to 2016. The decrease was primarily a result of a decline in average total interest-earning assets of $422.6 million in 2017 compared to 2016. The rates earned on interest-earning assets increased 28 basis points primarily due to diversification of excess cash and the investment portfolio. Average interest-bearing deposits with banks, which are primarily cash at the Federal Reserve Bank, decreased $300.5 million and the rates increased 56 basis points due to the Federal Funds rate increases since December of 2016. The decline of Federal Reserve Bank balances was utilized to deploy the excess cash into higher yielding and diversified investment securities as well as the intentional runoff of higher cost deposits.

Interest expense decreased $9.3 million, or 20.0%, in 2017 compared to 2016. The decrease was primarily due to decreases in average interest-bearing deposits of $494.4 million for the year ended December 31, 2017 compared to the same period in 2016 primarily a result of the intentional runoff of higher cost certificates of deposits. The cost of interest-bearing deposits decreased 10 basis points in 2017 compared to 2016.

The following table sets forth for the periods presented a summary of the changes in interest earned and interest paid resulting from changes in volume and changes in rates:

| | 2017 Compared to 2016 | | | 2016 Compared to 2015 | | |
|---|---|---|---|---|---|---|
| **(Dollars in Thousands)** | **Increase/ (Decrease)** | **Rate** | **Volume** | **Increase/ (Decrease)** | **Rate** | **Volume** |
| **ASSETS** | | | | | | |
| Interest-Bearing Deposits with Banks | $ 1,095 | $ 3,110 | $(2,015) | $ 2,884 | $ 1,640 | $ 1,244 |
| Tax-Free Investment Securities | (119) | (316) | 197 | (332) | 103 | (435) |
| Taxable Investment Securities | (6,432) | (2,989) | (3,443) | (10,508) | 391 | (10,899) |
| Tax-Free Loans | 1,736 | (833) | 2,569 | 944 | (730) | 1,674 |
| Taxable Loans | 721 | 1,753 | (1,032) | 2,396 | (7,383) | 9,779 |
| **Total Interest-Earning Assets** | **$(2,999)** | **$ 725** | **$(3,724)** | **$ (4,616)** | **$(5,979)** | **$ 1,363** |
| **LIABILITIES** | | | | | | |
| Deposits | | | | | | |
| Interest-Bearing Demand | $ 100 | $ 90 | $ 10 | $ 360 | $ 346 | $ 14 |
| Money Market | (861) | (361) | (500) | (498) | (460) | (38) |
| Savings | (49) | (133) | 84 | (3,043) | (2,812) | (231) |
| Certificates of Deposit | (8,461) | (2,207) | (6,254) | 1,766 | 2,248 | (482) |
| **Total Interest-Bearing Deposits** | **$(9,271)** | **$(2,611)** | **$(6,660)** | **$ (1,415)** | **$ (678)** | **$ (737)** |
| **Total Interest-Bearing Liabilities** | **$(9,271)** | **$(2,611)** | **$(6,660)** | **$ (1,415)** | **$ (678)** | **$ (737)** |
| **Net Interest Income** | **$ 6,272** | | | **$ (3,201)** | | |

### Provision for Loan Losses

The provision for loan losses is the amount to be added to the allowance for loan losses, or ("ALL"), after considering loan charge-offs and recoveries, to bring the ALL to a level determined to be appropriate in management's judgment to absorb probable losses inherent in the loan portfolio.

The provision for loan losses increased $25.5 million to $43.2 million in 2017 compared to $17.7 million in 2016. The increase in provision expense in 2017 as compared to 2016 is attributable to significant impairment in several large commercial real estate loan relationships. This resulted in significant charge-offs as we aggressively worked toward resolution of these legacy credits. The increase in provision expense for 2017 as compared to 2016 is directly attributable to the impairment of these commercial real estate credit relationships.

Net charge-offs increased $32.2 million to $42.4 million in 2017 compared to $10.2 million for 2016. Annualized net loan charge-offs to average loans were 1.56% and 0.38% in 2017 and 2016, respectively. Specific reserves were $32 thousand at December 31, 2017. The Bank had $0.2 million of specific reserves at December 31, 2016.

Nonperforming loans decreased at December 31, 2017 by $26.6 million, to $92.9 as compared to $119.5 million at December 31 2016. The allowance for loan losses was 38.0% of nonperforming loans as of December 31, 2017 as compared to 28.9% of nonperforming loans as of December 31, 2016. Management is aggressively taking steps to address problem loan relationships.

The ALL at December 31, 2017 was $35.3 million compared to $34.5 million at December 31, 2016. The ALL as a percentage of total portfolio loans was 1.32% at December 31, 2017 and 1.26% at December 31, 2016.

**Noninterest Income**

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| **(Dollars in Thousands)** | **2017** | **2016** | **$ Change** | **% Change** |
| Gains on Sales of Securities, net | $ 1,186 | $ — | $1,186 | NM |
| Service Charges, Commissions and Fees | 2,920 | 3,139 | (219) | (7.0)% |
| Debit Card Interchange Fees | 4,854 | 4,718 | 136 | 2.9% |
| Insurance | 2,582 | 2,933 | (351) | (12.0)% |
| Other Real Estate Owned Income | 448 | 1,261 | (813) | (64.5)% |
| Other | 601 | 443 | 158 | 35.7% |
| **Total Noninterest Income** | **$12,591** | **$12,494** | **$ 97** | **0.8%** |

*NM — percentage not meaningful*

Noninterest income decreased $1.1 million, or 8.7%, to $11.4 million, excluding net securities gains, in 2017 as compared to $12.5 million in 2016. The decline in noninterest income is primarily attributable to lower income from other real estate owned due to the disposition of several properties during the period. Debit card income, a key component of the Bank's noninterest income, improved to $4.9 million in 2017 as compared to $4.7 million in 2016. Net securities gains of $1.2 million were realized during 2017 to take advantage of market opportunities and reduce the credit risk of the securities portfolio.

**Noninterest Expense**

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| **(Dollars in Thousands)** | **2017** | **2016** | **$ Change** | **% Change** |
| Salaries and Employee Benefits | $42,711 | $37,527 | $ 5,184 | 13.8% |
| Occupancy Expense, net | 9,780 | 8,577 | 1,203 | 14.0% |
| FDIC Insurance Expense | 3,890 | 4,914 | (1,024) | (20.8)% |
| Other Taxes | 1,907 | 1,760 | 147 | 8.4% |
| Telephone Expense | 1,699 | 1,615 | 84 | 5.2% |
| Professional and Legal Fees | 6,856 | 1,109 | 5,747 | 518.2% |
| Data Processing License Fee | 5,604 | 3,456 | 2,148 | 62.2% |
| Losses on Sales and Write-downs of Other Real Estate Owned, net | 9,909 | 10,747 | (838) | (7.8)% |
| Losses on Sales and Write-downs of Bank Premises | 714 | 10 | 704 | NM |
| Debit Card Expense | 2,436 | 2,735 | (299) | (10.9)% |
| Tax Credit Impairment | 3,259 | — | 3,259 | NM |
| Other Real Estate Owned Expense | 791 | 1,445 | (654) | (45.3)% |
| Other | 5,023 | 4,524 | 499 | 11.0% |
| **Total Noninterest Expense** | **$94,579** | **$78,419** | **$16,160** | **20.6%** |

*NM — percentage not meaningful*

Total noninterest expense increased $16.2 million, or 20.6%, in 2017 to $94.6 million as compared to $78.4 million in 2016. Several nonrecurring items primarily contributed to this increase including $3.3 million of tax credit impairment, $4.9 million for regulatory and compliance reviews, $0.7 million for write-downs on bank premises and $0.1 million for the establishment of a reserve for unfunded loan commitments. Also contributing to the increase was an increase in salaries and employee benefits of $5.2 million, $5.7 million increase in legal and professional consulting fees and $2.1 million of licensing fees for data processing that were fully amortized during 2017. These increases were expected and planned as investments are made in the appropriate infrastructure to support the Bank in the future. Offsetting these increases were decreases of $1.5 million (includes $5.3 million of write-downs on retail branch offices marketed for sale in the fourth quarter of 2017), which were comprised of decreases in losses on sales and write-downs of other real estate owned and expenses due to the aforementioned disposition of several properties during the period and higher losses on sales in 2016. FDIC insurance expense decreased $1.0 million attributable to lower FDIC assessment rates and a decrease in the assessment base.

**Provision for Income Taxes**

The provision for income taxes was a tax benefit of $17.5 million for 2017 as a result of a pretax loss of $18.2 million as compared to a tax provision of $1.6 million in 2016 and pretax income of $17.6 million. Year-end 2017 was negatively impacted by a charge of $2.8 million from the write-down of the Bank's deferred tax assets resulting from the recent tax reform legislation.

The effective tax rate was negative 96% for the tax benefit in 2017 and 9% for the tax expense in 2016. The Bank ordinarily generates an annual effective tax rate that is less than the applicable federal statutory rate for a fiscal year (which was 35% for 2017, 2016 and 2015) due to benefits resulting from tax-exempt interest and tax benefits associated with tax credits, which are relatively consistent regardless of the level of pretax income.

The consistent level of tax benefits that reduce the Bank's tax rate below the applicable statutory rate, coupled with the pretax losses during 2017, produced a negative annual effective tax rate for 2017.

**Financial Condition**
**December 31, 2018**

Total assets were $4.0 billion at December 31, 2018 and $4.1 billion at December 31, 2017. Total portfolio loans increased $19.3 million to $2.7 billion as of December 31, 2018 despite the reduction of several large legacy credits during 2018 totaling $286.4 million, which partially offset new loan growth.

Federal Reserve Bank excess reserves increased $33.1 million at December 31, 2018 as compared to December 31, 2017 primarily due to several legacy credit reductions in the amount of $286.4 million received during 2018. This excess cash was deployed during the twelve-month period into higher yielding and diversified securities, funded loan growth, and also funded the planned decrease in high cost deposits during the past twelve months.

The securities portfolio declined $164.4 million, or 17.4%, to $782.8 million as of December 31, 2018 as compared to December 31, 2017. Investment securities comprise 19.4% of total assets at December 31, 2018 as compared to 23.0% of total assets at December 31, 2017. This decrease is a result of active balance sheet management. The portfolio has been further diversified as to bond types, maturities, and interest rate structures.

Deposits are our primary source of funds. The Bank believes that our deposit base is stable and that the Bank has the ability to attract new deposits. Total deposits at December 31, 2018 decreased $78.4 million, or 2.1%, from December 31, 2017. Noninterest-bearing deposits decreased slightly by $5.6 million, or 1.1%, to $524.6 million as of December 31, 2018 as compared to $530.2 million at December 31, 2017. Money market and savings accounts collectively declined $132.6 million, or 16.1%, at year-end 2018 as compared to year-end 2017. Interest-bearing demand deposits increased $16.2 million, or

6.2%, to $277.2 million at December 31, 2018 as compared to $261.0 million at December 31, 2017. Certificates of deposit increased $43.6 million in the year-over-year comparison, or 2.1%, due to recent special rate promotions during 2018. Noninterest-bearing deposits comprised 14.6% and 14.4% of total deposits at December 31, 2018 and December 31, 2017, respectively.

The allowance for loan losses was 1.45% of total loans as of December 31, 2018 as compared to 1.32% as of December 31, 2017. General reserves as a percentage of total loans were 1.26% at December 31, 2018 as compared to 1.31% as of December 31, 2017. The allowance for loan losses was 77.3% of nonperforming loans as of December 31, 2018 as compared to 38.0% of nonperforming loans as of December 31, 2017. In the view of management, the allowance for loan losses is adequate to meet the loss contingency based on experience factors and a review of the loan portfolio.

The Bank remains well capitalized. The Bank's Tier 1 Capital ratio increased to 13.97% as of December 31, 2018 as compared to 12.93% as of December 31, 2017. The Bank's leverage ratio was 9.69% at December 31, 2018 as compared to 9.33% as of December 31, 2017. The Bank's Total Risk-Based Capital ratio was 15.22% at December 31, 2018 as compared to 14.15% at December 31, 2017.

**Securities Activity**

The balances and average rates of our securities portfolio are presented below as of December 31:

**Available-for-Sale**

| | 2018 | | 2017 | |
|---|---|---|---|---|
| **(Dollars in Thousands)** | **Balance** | **Weighted-Average Yield** | **Balance** | **Weighted-Average Yield** |
| U.S. Government Agency Securities | $270,388 | 1.44% | $298,665 | 1.42% |
| Residential Mortgage-Backed Securities | 70,871 | 2.37% | 60,380 | 1.98% |
| Commercial Mortgage-Backed Securities | 21,792 | 2.59% | 24,908 | 2.58% |
| Asset Backed Securities | 58,861 | 3.46% | 16,867 | 2.28% |
| Collateralized Mortgage Obligations | 76,819 | 2.84% | 61,594 | 2.45% |
| Small Business Administration | 89,238 | 3.59% | 68,260 | 2.73% |
| States and Political Subdivisions | 167,474 | 3.45% | 306,963 | 4.42% |
| Corporate Notes | 27,315 | 3.62% | 109,564 | 1.75% |
| **Total Securities Available-for-Sale** | **$782,758** | **2.49%** | **$947,201** | **2.66%** |

**Held-to-Maturity Securities**

| | 2016 | |
|---|---|---|
| **(Dollars in Thousands)** | **Balance** | **Weighted-Average Yield** |
| U.S. Agency Securities | $302,891 | 1.42% |
| Mortgage-Backed Securities | 228 | 2.77% |
| States and Political Subdivisions | 299,935 | 3.47% |
| Corporate Notes | 276,640 | 2.44% |
| **Total Securities Held-to-Maturity** | **$879,694** | **2.44%** |

The Bank invests in various securities in order to maintain a source of liquidity, to satisfy various pledging requirements, to increase net interest income and as a tool of the ALCO to reposition the balance sheet for interest rate risk purposes. Securities are subject to market risks that could negatively affect the level of liquidity available to us. Security purchases are subject to our investment policy approved annually by our Board of Directors and administered through ALCO and our treasury function.

The securities portfolio decreased by $164.4 million at December 31, 2018 as compared to December 31, 2017. Securities comprise 19.4% of total assets at December 31, 2018 as compared to 23.0% at December 31, 2017. The decrease is a result of active balance sheet management as the Bank has further diversified the securities portfolio as to bond types, maturities and interest rate structures.

On July 26, 2017, the Bank reclassified its entire held-to-maturity portfolio to the available-for-sale portfolio. At the time of reclassification, the investments had an amortized cost of $863.8 million. At December 31, 2018, total gross unrealized gains in the available-for-sale portfolio were $0.5 million offset by $13.2 million of gross unrealized losses. At December 31, 2017, total gross unrealized gains in the available-for-sale portfolio were $4.5 million offset by $7.3 million of gross unrealized losses.

Management evaluates the securities portfolio for other than temporary impairment, or OTTI, on a quarterly basis. During the years ended December 31, 2018 and 2017 the Bank did not record any OTTI. The performance of the debt and equity securities markets could generate impairments in future periods requiring realized losses to be reported.

The following table sets forth the maturities of securities at December 31, 2018 and the weighted average yields of such securities. Taxable-equivalent adjustments (using a 21% federal income tax rate) for 2018 have been made in calculating yields on obligations of state and political subdivisions.

**Available-for-Sale Securities**

| | Maturing | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Within One Year | | After One But Within Five Years | | After Five But Within Ten Years | | After Ten Years | |
| (Dollars in Thousands) | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield |
| **Available-for-Sale** | | | | | | | | |
| U.S. Government Agency Securities | $123,922 | 1.44% | $146,466 | 1.44% | $ — | 0.00% | $ — | 0.00% |
| Residential Mortgage-Backed Securities | — | 0.00% | 2,086 | 2.84% | 12,070 | 2.74% | 56,715 | 2.27% |
| Commercial Mortgage-Backed Securities | — | 0.00% | 1,644 | 2.19% | 19,255 | 2.65% | 893 | 1.89% |
| Asset Backed Securities | — | 0.00% | — | 0.00% | 5,809 | 4.13% | 53,052 | 3.39% |
| Collateralized Mortgage Obligations | — | 0.00% | — | 0.00% | 1,955 | 2.77% | 74,864 | 2.84% |
| Small Business Administration | — | 0.00% | 1,025 | 3.88% | 23,747 | 3.55% | 64,466 | 3.61% |
| States and Political Subdivisions | 12,886 | 2.34% | 25,406 | 2.70% | 16,097 | 4.01% | 113,085 | 3.66% |
| Corporate Notes | 1,248 | 2.51% | 19,065 | 3.07% | 7,002 | 5.32% | — | 0.00% |
| **Total** | **$138,056** | | **$195,692** | | **$85,935** | | **$363,075** | |
| **Weighted Average Yield** | | **1.54%** | | **1.79%** | | **3.48%** | | **3.22%** |

*Weighted-average yields are calculated on a taxable-equivalent basis using the federal statutory tax rate of 21 percent.*

**Loan Composition**

The following table summarizes our loan portfolio as of December 31:

| | December 31, | | | | |
|---|---|---|---|---|---|
| **(Dollars in Thousands)** | **2018** | **2017** | **2016** | **2015** | **2014** |
| **Commercial** | | | | | |
| Commercial Real Estate | $1,381,231 | $1,536,957 | $1,527,552 | $1,363,648 | $1,171,522 |
| Commercial and Industrial | 660,872 | 803,833 | 835,131 | 851,083 | 579,939 |
| Commercial Construction | 238,016 | 118,786 | 199,551 | 248,021 | 350,638 |
| **Total Commercial Loans** | **2,280,119** | **2,459,576** | **2,562,234** | **2,462,752** | **2,102,099** |
| **Consumer** | | | | | |
| Residential Mortgages | 339,307 | 136,895 | 138,657 | 145,331 | 155,294 |
| Other Consumer | 73,058 | 79,980 | 20,724 | 22,810 | 57,743 |
| Consumer Construction | 11,308 | 7,994 | 10,168 | 7,959 | 5,485 |
| **Total Consumer Loans** | **423,673** | **224,869** | **169,549** | **176,100** | **218,522** |
| **Total Portfolio Loans** | **2,703,792** | **2,684,445** | **2,731,783** | **2,638,852** | **2,320,621** |
| Loans Held-for-Sale | 2,559 | 517 | — | — | — |
| **Total Loans** | **$2,706,351** | **$2,684,962** | **$2,731,783** | **$2,638,852** | **$2,320,621** |

Our loan portfolio represents our most significant source of interest income. The risk that borrowers will be unable to pay such obligations is inherent in the loan portfolio. Other conditions such as downturns in the borrower's industry or the overall economic climate can significantly impact the borrower's ability to pay.

Total portfolio loans increased $19.3 million as of December 31, 2018 as compared to December 31, 2017. This increase occurred despite the reduction of several large legacy credits during 2018 in the amount of $286.4 million, which partially offset new loan growth. Commercial loans decreased $179.5 million, or 7.3%. Consumer loans increased $198.8 million, or 88.4%. The increase is a result of the Bank's new mortgage division, which began making a significant impact during 2018. Loans held-for-sale were $2.6 million and $0.5 million as of December 31, 2018 and December 31, 2017, respectively. These loans are purchased mortgage loans from another financial institution with fully executed contracts with an investor. The loans are held until funded by the investor, typically a two-week period.

The following tables present the maturity schedule of selected loan types at December 31, 2018:

| **(Dollars in Thousands)** | **Within One Year** | **Maturity After One But Within Five Years** | **After Five Years** | **Total** |
|---|---|---|---|---|
| Fixed interest rates | $122,988 | $73,791 | $ 4,210 | $200,989 |
| Variable interest rates | 2,502 | 22,835 | 22,998 | 48,335 |
| **Total Construction Loans** | **$125,490** | **$96,626** | **$27,208** | **$249,324** |

| (Dollars in Thousands) | Within One Year | Maturity After One But Within Five Years | After Five Years | Total |
|---|---|---|---|---|
| Fixed interest rates | $18,383 | $ 21,859 | $39,561 | $ 79,803 |
| Variable interest rates | 13,067 | 87,164 | 48,436 | 148,667 |
| **Total Commercial, Industrial & Agricultural** | **$31,450** | **$109,023** | **$87,997** | **$228,470** |

**Credit Quality**

On a monthly basis, a criticized asset committee meets to review all special mention and substandard loans. These loans typically represent the highest risk of loss to us. Action plans are established and these loans are monitored through regular contact with the borrower, review of current financial information and other documentation, review of all loan or potential loan restructures or modifications and the regular re-evaluation of assets held as collateral.

Additional credit risk management practices include periodic review and update of our lending policies and procedures to support sound underwriting practices and portfolio management through portfolio stress testing. Our loan review serves as a mechanism to independently monitor credit quality and assess the effectiveness of credit risk management practices to provide oversight of all corporate lending activities. The loan review function has the primary responsibility for assessing commercial credit administration and credit decision functions of consumer and mortgage underwriting, as well as providing input to the loan risk rating process. Our policy is to place loans in all categories in nonaccrual status when collection of interest or principal is doubtful, or generally when interest or principal payments are 90 days or more past due based on contractual terms.

Nonperforming assets ("NPAs") consist of nonaccrual loans, nonaccrual troubled debt restructurings ("TDRs") and other real estate owned ("OREO"). The following table summarizes nonperforming assets for the dates presented:

| | December 31, | | | | |
|---|---|---|---|---|---|
| **(Dollars in Thousands)** | **2018** | **2017** | **2016** | **2015** | **2014** |
| **Nonperforming Loans** | | | | | |
| Real Estate | $ 3,289 | $ 51,047 | $ 96,143 | $ 92,944 | $ 7,651 |
| Consumer | 65 | 47 | 1 | 40 | 164 |
| Commercial | 606 | — | 1 | — | 40 |
| **Total Nonperforming Loans** | **3,960** | **51,094** | **96,145** | **92,984** | **7,855** |
| **Nonperforming Troubled Debt Restructurings** | | | | | |
| Real Estate | 46,771 | 41,804 | 23,319 | 7,920 | 17,041 |
| Consumer | — | — | — | — | — |
| Commercial | — | — | — | — | — |
| **Total Nonperforming Troubled Debt Restructurings** | **46,771** | **41,804** | **23,319** | **7,920** | **17,041** |
| **Total Nonperforming Loans and Troubled Debt Restructurings** | **50,731** | **92,898** | **119,464** | **100,904** | **24,896** |
| Other Real Estate Owned | 33,681 | 39,793 | 23,558 | 43,422 | 43,829 |
| **Total Nonperforming Assets** | **$84,412** | **$132,691** | **$143,022** | **$144,326** | **$68,725** |
| **Nonperforming Loans to Total Portfolio Loans** | **1.88%** | **3.46%** | **4.37%** | **3.82%** | **1.07%** |
| **Nonperforming Assets to Total Portfolio Loans plus OREO** | **3.08%** | **4.87%** | **5.19%** | **5.38%** | **2.91%** |

Nonperforming assets decreased $48.3 million to $84.4 million at December 31, 2018 compared to $132.7 million at December 31, 2017. The decrease was due to a $42.2 million decline in nonperforming loans and a $6.1 million decrease in OREO. The decrease in nonperforming loans is primarily due to the charge-off of a legacy credit in the amount of $10.1 million in the third quarter of 2018 and nonperforming loans migrating to OREO during the first quarter of 2018. The decrease in OREO is primarily due to the migration of nonperforming loans during the first quarter of 2018, offset by write-downs in the amount of $8.7 million during 2018 and sales of properties with a book value of $28.2 million during 2018. Write-downs include $3.5 million on retail bank offices marketed for sale with a remaining book value of $6.8 million. In addition, retail branch offices marketed for sale were transferred to OREO during 2018 in the amount of $2.2 million.

The following table summarizes past due loans for the dates presented:

| (Dollars in Thousands) | December 31, 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| **Loans 90 Days or More Past Due and Still Accruing** | | | | | |
| Real Estate | $ — | $493 | $592 | $418 | $1,270 |
| Consumer | — | 59 | 26 | 5 | 55 |
| Commercial | — | 4 | — | — | 15 |
| **Total Loans 90 Days or More Past Due** | **$ —** | **$556** | **$618** | **$423** | **$1,340** |

| (Dollars in Thousands) | December 31, 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| **Loans 30 to 89 Days Past Due** | | | | | |
| Real Estate | $6,046 | $5,443 | $9,158 | $43,062 | $5,109 |
| Consumer | 1,510 | 392 | 197 | 329 | 239 |
| Commercial | 62 | 161 | 23 | 75 | 94 |
| **Total Loans 30 to 89 Days Past Due** | **$7,618** | **$5,996** | **$9,378** | **$43,466** | **$5,442** |

Loans past due 90 days or more and still accruing decreased $0.6 million to zero at December 31, 2018 as compared to $0.6 million at December 31, 2017. With the implementation of the Bank's new core system, loans past due 90 days are automatically transferred to nonaccrual status. Loans past due 30 to 89 days or more and still accruing increased $1.6 million to $7.6 million at December 31, 2018 compared to $6.0 million at December 31, 2017.

Closed-end installment loans, amortizing loans secured by real estate and any other loans with payments scheduled monthly are reported past due when the borrower is in arrears two or more monthly payments. Other multi-payment obligations with payments scheduled other than monthly are reported past due when one scheduled payment is due and unpaid for 30 days or more. We monitor delinquency on a monthly basis, including early stage delinquencies of 30 to 89 days past due for early identification of potential problem loans.

TDRs are loans that we, for economic or legal reasons related to a borrower's financial difficulties, grant a concession to the borrower that we would not otherwise grant. The Bank strives to identify borrowers in financial difficulty early and work with them to modify the terms before their loan reaches nonaccrual status. These modified terms generally include extension of maturity dates at a stated interest rate lower than the current market rate for a new loan with similar characteristics, reductions in contractual interest rates or principal deferment. While unusual, there may be instances of principal forgiveness. These modifications are generally for longer term periods that would not be considered insignificant.

An accruing loan that is modified into a TDR can remain in accrual status if, based on a current credit analysis, collection of principal and interest in accordance with the modified terms is reasonably assured, and the borrower has demonstrated sustained historical performance for a reasonable period before the modification. All TDRs are considered to be impaired loans and will be reported as impaired loans for their remaining lives, unless the restructuring agreement specifies an interest rate equal to or greater than the rate that would be accepted at the time of the restructuring for a new loan with comparable risk and we fully expect that the remaining principal and interest will be collected according to the restructured agreement. For all TDRs, regardless of size, as well as all other impaired loans, the Bank conducts further analysis to determine the probable loss and assign a specific reserve to the loan if deemed appropriate. Further, all impaired loans are reported as nonaccrual loans unless the loan is a TDR that has met the requirements noted above to be returned to accruing status. TDRs can be returned to accruing status if the ultimate collectability of all contractual amounts due, according to the restructured agreement, is not in doubt and there is a period of a minimum of six months of satisfactory payment performance by the borrower either immediately before or after the restructuring.

As an example, consider a substandard commercial construction loan that is currently 90 days past due where the loan is restructured to extend the maturity date for a period longer than would be considered an insignificant period of time. The post-modification interest rate given to the borrower is considered to be lower than the current market rate for new debt with similar risk and all other terms remain the same according to the original loan agreement. This loan will be considered a TDR as the borrower is experiencing financial difficulty and a concession has been granted due to the long extension, resulting in payment delay as well as the rate being lower than current market rate for new debt with similar risk. The loan will be reported as a nonaccrual TDR and an impaired loan. In addition, the loan could be charged down to the fair value of the collateral if a confirmed loss exists. If the loan subsequently performs, by means of making on-time principal and interest payments according to the newly restructured terms for a period of six months, and it is expected that all remaining principal and interest will be collected according to the terms of the restructured agreement, the loan will be returned to accrual status and reported as an accruing TDR. The loan will remain an impaired loan for the remaining life of the loan because the interest rate was not adjusted to be equal to or greater than the rate that would be accepted at the time of the restructuring for a new loan with comparable risk.

The following table summarizes the restructured loans as of the dates presented:

| | December 31, 2018 | | | December 31, 2017 | | |
|---|---|---|---|---|---|---|
| **(Dollars in Thousands)** | **Performing TDRs** | **Nonperforming TDRs** | **Total TDRs** | **Performing TDRs** | **Nonperforming TDRs** | **Total TDRs** |
| Real Estate | $114,806 | $46,771 | $161,577 | $121,465 | $41,804 | $163,269 |
| Consumer | — | — | — | — | — | — |
| Commercial | — | — | — | 133,182 | — | 133,182 |
| **Total TDRs** | **$114,806** | **$46,771** | **$161,577** | **$254,647** | **$41,804** | **$296,451** |

TDRs decreased $134.9 million to $161.6 million at December 31, 2018 compared to 296.5 million at December 31, 2017. The decrease is primarily due to principal payoffs and pay-downs totaling $218.8 million, charge-offs in the amount of $10.4 million, transfers to other real estate owned in the amount of $29.9 million, and upgrades in the amount of $13.9 million, all offset by two new performing TDRS in the amount of $90.2 million, five new nonperforming TDRs in the amount of $47.7 million, and draws in the amount of $0.2 million. Total TDRs of $46.8 million and $41.8 million were on nonaccrual at December 31, 2018 and December 31, 2017, respectively. At December 31 2018, there were minimal commitments to lend additional funds on one loan relationship identified as a TDR.

The following tables represent credit exposures by internally assigned grades as of December 31, 2018 and 2017:

| (Dollars in Thousands) December 31, 2018 | Real Estate | Consumers & Other Loans | Commercial & Industrial | Obligations Of States and Political Sub. | Total |
|---|---|---|---|---|---|
| Pass | $1,593,704 | $72,909 | $133,004 | $432,402 | $2,232,019 |
| Special Mention | 10,765 | 45 | 70 | — | 10,880 |
| Substandard | 365,393 | 104 | 95,396 | — | 460,893 |
| Doubtful | — | — | — | — | — |
| Loss | — | — | — | — | — |
| **Total Loans** | **$1,969,862** | **$73,058** | **$228,470** | **$432,402** | **$2,703,792** |
| Performing Loans | $1,919,802 | $72,993 | $227,864 | $432,402 | $2,653,061 |
| Non-Accrual Loans | 50,060 | 65 | 606 | — | 50,731 |
| **Total Loans** | **$1,969,862** | **$73,058** | **$228,470** | **$432,402** | **$2,703,792** |

| (Dollars in Thousands) December 31, 2017 | Real Estate | Consumers & Other Loans | Commercial & Industrial | Obligations Of States and Political Sub. | Total |
|---|---|---|---|---|---|
| Pass | $1,299,705 | $73,921 | $ 24,180 | $470,569 | $1,868,375 |
| Special Mention | 29,989 | 6,000 | 61,019 | — | 97,008 |
| Substandard | 470,938 | 59 | 248,065 | — | 719,062 |
| Doubtful | — | — | — | — | — |
| Loss | — | — | — | — | — |
| **Total Loans** | **$1,800,632** | **$79,980** | **$333,264** | **$470,569** | **$2,684,445** |
| Performing Loans | $1,707,736 | $79,978 | $333,264 | $470,569 | $2,591,547 |
| Non-Accrual Loans | 92,896 | 2 | — | — | 92,898 |
| **Total Loans** | **$1,800,632** | **$79,980** | **$333,264** | **$470,569** | **$2,684,445** |

Special mention, substandard and doubtful loans at December 31, 2018 decreased by $344.3 million to $471.8 million compared to $816.1 million at December 31, 2017, with a decrease of $86.1 million in special mention and a decrease of $258.2 million in substandard.

**Allowance for Loan Losses**

The Bank maintains an ALL at a level determined to be adequate to absorb estimated probable credit losses inherent within the loan portfolio as of the balance sheet date and it is presented as a reserve against loans in the Consolidated Balance Sheets. Determination of an adequate ALL is inherently subjective and may be subject to significant changes from period to period. The methodology for determining the ALL has two main components: evaluation and impairment tests of individual loans and evaluation and impairment tests of certain groups of homogeneous loans with similar risk characteristics.

Our charge-off policy for commercial loans requires that loans and other obligations that are not collectible be promptly charged-off when the loss becomes probable, regardless of the delinquency status of the loan. The Bank may elect to recognize a partial charge-off when management has determined that the value of collateral is less than the remaining investment in the loan. A loan or obligation does not need to be charged-off, regardless of delinquency status, if (i) management has determined there exists sufficient collateral to protect the remaining loan balance and (ii) there exists a strategy to liquidate the collateral.

Management may also consider a number of other factors to determine when a charge-off is appropriate. These factors may include, but are not limited to:

- The status of a bankruptcy proceeding
- The value of collateral and probability of successful liquidation; and/or
- The status of adverse proceedings or litigation that may result in collection

Consumer unsecured loans and secured loans are evaluated for charge-off after the loan becomes 90 days past due. Unsecured loans are fully charged-off and secured loans are charged-off to the estimated fair value of the collateral less the cost to sell.

The following summarizes our allowance for loan loss experience at December 31 for each of the years presented below:

| (Dollars in Thousands) | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Balance Beginning of Year | $35,318 | $34,500 | $26,990 | $24,142 | $21,392 |
| Provision for Loan Losses | 16,870 | 43,197 | 17,717 | 3,300 | 3,000 |
| Charge-offs: | | | | | |
| Real Estate Loans | 11,924 | 42,813 | 9,687 | 310 | 89 |
| Consumer Loans | 2,710 | 465 | 510 | 177 | 166 |
| Commercial Loans | 20 | 31 | 257 | 20 | 82 |
| **Total Charge-offs** | **14,654** | **43,309** | **10,454** | **507** | **337** |
| Recoveries: | | | | | |
| Real Estate Loans | 1,415 | 720 | 131 | — | 36 |
| Consumer Loans | 250 | 210 | 110 | 55 | 51 |
| Commercial Loans | — | — | 6 | — | — |
| **Total Recoveries** | **1,665** | **930** | **247** | **55** | **87** |
| **Total Net Charge-Offs** | **12,989** | **42,379** | **10,207** | **452** | **250** |
| **Balance End of Year** | **$39,199** | **$35,318** | **$34,500** | **$26,990** | **$24,142** |
| **Net Charge-offs to Average Loans** | **0.47%** | **1.56%** | **0.38%** | **0.02%** | **0.01%** |
| **Allowance for Loan Losses to Year-end Loans** | **1.45%** | **1.32%** | **1.26%** | **1.03%** | **1.04%** |

Net charge-offs were $13.0 million in 2018 as compared to $42.4 million in 2017. The most significant loan charge-off in 2018 was for one legacy commercial credit relationship of $10.1 million that experienced deterioration in collateral values as a result of a new appraisal. During 2017, the Bank dealt with significant impairment in several large commercial real estate loan relationships, which resulted in substantial charge-offs in the aggressive resolution of these legacy credits.

An inherent risk to the loan portfolio as a whole is the condition of the economy in our markets. In addition, each loan segment carries with it risks specific to the segment. The Bank develops and documents a systematic ALL methodology based on the following portfolio segments: 1. Commercial Real Estate ("CRE"), 2. Commercial & Industrial ("C&I"), 3. Consumer 4. Obligations of States and Political Subdivisions. The following is a discussion of the key risks by portfolio segment that management assesses in preparing the ALL.

CRE loans are secured by commercial purpose real estate, including both owner occupied properties and investment properties, for various purposes such as hotels, strip malls and apartments. Operations of the individual projects as well as global cash flows of the debtors are the primary sources of repayment for these loans. The condition of the local economy is an important indicator of risk, but there are also more specific risks depending on the collateral type as well as the business.

C&I loans are made to operating companies or manufacturers for the purpose of production, operating capacity, accounts receivable, inventory or equipment financing. Cash flow from the operations of the borrower is the primary source of repayment for these loans. The condition of the local economy is an important indicator of risk, but there are also more specific risks depending on the industry of the borrower. Collateral for these types of loans often do not have sufficient value in a distressed or liquidation scenario to satisfy the outstanding debt.

Consumer loans are made to individuals and may be secured by assets other than 1-4 family residences, as well as unsecured loans. This segment includes auto loans and unsecured loans and lines. The primary source of repayment for these loans is the income and assets of the borrower. The condition of the local economy, in particular the unemployment rate, is an important indicator of risk for this segment. The value of the collateral, if there is any, is less likely to be a source of repayment due to less certain collateral values.

Obligations of States and Political Subdivision loans are made to local and state municipalities for various purposes including refinancing existing obligations, infrastructure up-fit and expansion, or to purchase new equipment. This segment of loans may be secured by general obligations from the municipal authority or revenues generated by infrastructure and equipment financed by the Bank. The primary repayment source for these loans include the tax basis of the municipality, specific revenue streams related to the infrastructure financed, and other business operations of the municipal authority. The health and stability of state and local economies directly impacts each municipality's tax basis and are important indicators of risk for this segment. The ability of each municipality to increase taxes and fees to offset debt service requirements give this type of loan a very low risk profile in the continuum of the Bank's loan portfolio.

The following is the ALL balance by segment as of December 31 for the years presented below:

| | 2018 | | 2017 | | 2016 | | 2015 | | 2014 | |
|---|---|---|---|---|---|---|---|---|---|---|
| **(Dollars in Thousands)** | **Amount** | **% of Loans in each Category to Total Loans** | **Amount** | **% of Loans in each Category to Total Loans** | **Amount** | **% of Loans in each Category to Total Loans** | **Amount** | **% of Loans in each Category to Total Loans** | **Amount** | **% of Loans in each Category to Total Loans** |
| Real Estate | $35,422 | 73% | $33,367 | 67% | $32,476 | 69% | $16,584 | 67% | $15,244 | 73% |
| Consumer & Other Loans | 2,728 | 3% | 288 | 3% | 82 | 1% | 6,098 | 1% | 5,230 | 2% |
| Commercial & Industrial | 617 | 8% | 1,203 | 12% | 1,480 | 13% | 4,308 | 17% | 3,668 | 11% |
| Obligations of States and Political Sub. | 432 | 16% | 460 | 18% | 462 | 17% | — | 15% | — | 14% |
| **Balance End of Year** | **$39,199** | **100%** | **$35,318** | **100%** | **$34,500** | **100%** | **$26,990** | **100%** | **$24,142** | **100%** |

Significant to our ALL is a higher concentration of commercial loans. The ability of borrowers to repay commercial loans is dependent upon the success of their business and general economic conditions. Due to the greater potential for loss within our commercial portfolio, we monitor the commercial loan portfolio through an internal risk rating system. Loan risk ratings are assigned based upon the creditworthiness of the borrower and are reviewed on an ongoing basis according to our internal policies. Loans rated special mention or substandard have potential or well-defined weaknesses not generally found in high quality, performing loans, and require attention from management to limit loss.

The following table summarizes the ALL balance as of December 31 for the years presented below:

| **(Dollars in Thousands)** | **2018** | **2017** | **2016** | **2015** | **2014** |
|---|---|---|---|---|---|
| Collectively Evaluated for Impairment | $34,000 | $35,286 | $34,256 | $26,440 | $24,142 |
| Individually Evaluated for Impairment | 5,199 | 32 | 244 | 550 | — |
| **Total Allowance for Loan Losses** | **$39,199** | **$35,318** | **$34,500** | **$26,990** | **$24,142** |

The ALL was $39.2 million, or 1.45% of total portfolio loans at December 31, 2018 compared to $35.3 million, or 1.32% of total portfolio loans at December 31, 2017.

The increase in the ALL of $3.9 million was primarily due to a $5.2 million increase in the specific reserve for impaired loans, offset by a $1.3 million decrease for loans collectively evaluated for impairment at December 31, 2018 compared to December 31, 2017. Please reference Note 5-Allowance for Loan Losses for additional information. The $1.3 million decrease since December 31, 2017 in the reserve for collectively evaluated loans is related to an increase in recent historical loan losses offset by reduced qualitative factors as a result of management enhancing internal policies and procedures, loan review systems, reduction in loan concentrations, positive changes in experience, depth, and ability of lending management, and overall strengthening of business and economic conditions in regions and industries where the loan portfolio has exposure.

### Deposits

The following tables present the composition of deposits at December 31:

| (Dollars in Thousands) | 2018 | 2017 | $ Change | % Change |
|---|---|---|---|---|
| Noninterest-Bearing Demand | $ 524,614 | $ 530,242 | $ (5,628) | (1.1)% |
| Interest-Bearing Demand | 277,174 | 260,979 | 16,195 | 6.2% |
| Money Market | 80,835 | 102,686 | (21,851) | (21.3)% |
| Savings | 610,757 | 721,459 | (110,702) | (15.3)% |
| Certificates of Deposits | 2,097,801 | 2,054,249 | 43,552 | 2.1% |
| **Total Deposits** | **$3,591,181** | **$3,669,615** | **$ (78,434)** | **(2.1)%** |

| | For the Year Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | Average Balance | | | Average Cost Rate | | |
| (Dollars in Thousands) | 2018 | 2017 | 2016 | 2018 | 2017 | 2016 |
| Noninterest-Bearing Demand | $ 551,124 | $ 550,496 | $ 534,170 | — | — | — |
| Interest-Bearing Demand | 246,592 | 243,815 | 243,355 | 0.79% | 0.65% | 0.61% |
| Money Market | 96,068 | 141,438 | 219,775 | 0.72% | 0.56% | 0.75% |
| Savings | 663,801 | 727,182 | 710,493 | 0.31% | 0.49% | 0.51% |
| Certificates of Deposit | 2,090,103 | 2,199,263 | 2,633,535 | 1.60% | 1.42% | 1.50% |
| Total Interest-Bearing Deposits | 3,096,564 | 3,311,698 | 3,807,158 | 1.23% | 1.12% | 1.22% |
| **Total Deposits** | **$3,647,688** | **$3,862,194** | **$4,341,328** | **1.23%** | **1.12%** | **1.22%** |

Deposits are our primary source of funds. The Bank believes that our deposit base is stable and that the Bank has the ability to attract new deposits. Total deposits at December 31, 2018 decreased $78.4 million, or 2.1%, from December 31, 2017. Noninterest-bearing deposits decreased slightly by $5.6 million, or 1.1%, to $524.6 million as of December 31, 2018 as compared to $530.2 million at December 31, 2017. Money market and savings accounts collectively declined $132.6 million, or 16.1%, at year-end 2018 as compared to year-end 2017. Interest-bearing demand deposits increased $16.2 million, or 6.2%, to $277.2 million at December 31, 2018 as compared to $261.0 million at December 31, 2017. Certificates of deposit increased $43.6 million in the year-over-year comparison, or 2.1%, due to recent special rate promotions during 2018. Noninterest-bearing deposits comprised 14.6% and 14.4% of total deposits at December 31, 2018 and December 31, 2017, respectively.

The following table summarizes the maturities of our certificates of deposits:

| (Dollars in Thousands) | 2018 |
|---|---|
| 2019 | $ 751,242 |
| 2020 | 672,528 |
| 2021 | 231,714 |
| 2022 | 164,269 |
| 2023 | 275,951 |
| Thereafter | 2,097 |
| **TOTAL** | **$2,097,801** |

Maturities of CDs of $250,000 or more outstanding at December 31, 2018 are summarized as follows:

| (Dollars in Thousands) | Amount | Percent |
|---|---|---|
| Three Months or Less | $ 25,382 | 12.47% |
| Over Three Months Through Twelve Months | 57,581 | 28.30% |
| Over Twelve Months Through Three Years | 83,290 | 40.93% |
| Over Three Years | 37,251 | 18.30% |
| **Total** | **$203,504** | **100%** |

**Capital Resources**

| Risk-based capital ratios | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Common Equity Tier 1 | 13.97% | 12.93% | 12.22% | 11.36% | N/A |
| Tier 1 Ratio | 13.97% | 12.93% | 12.22% | 11.36% | 11.26% |
| Total Risk-Based Capital Ratio | 15.22% | 14.15% | 13.35% | 12.03% | 12.07% |
| Leverage Ratio | 9.69% | 9.33% | 8.10% | 7.61% | 7.32% |

Shareholders' equity increased $4.1 million, or 0.9%, to $436.2 million at December 31, 2018 compared to $432.1 million at December 31, 2017. The increase in shareholders' equity is primarily due to net income of $11.9 million in 2018, offset by other comprehensive loss of $7.8 million. The other comprehensive loss of $7.8 million was primarily due to net unrealized gains on securities available-for-sale driven by the increase in interest rates at the end of the year.

The Bank is subject to capital regulations in accordance with Basel III, as administered by banking regulators. Regulatory agencies measure capital adequacy within a framework that makes capital requirements, in part, dependent on the individual risk profiles of financial institutions. 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 Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's 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.

We continue to maintain our capital position with a leverage ratio of 9.69% as compared to the regulatory guideline of 5.00% to be well capitalized and a risk-based Common Equity Tier 1 ratio of 13.97% compared to the regulatory guideline of 6.50% to be well capitalized. Our risk-based Tier 1 and

Total capital ratios were 13.97% and 15.22%, respectively at December 31, 2018, which places us above the federal bank regulatory agencies' "well capitalized" guidelines of 8.00% and 10.00% for Tier 1 and Total capital, respectively. We believe that we have the ability to raise additional capital, if necessary.

In July 2013 the federal banking agencies issued a final rule to implement Basel III (which were agreements reached in July 2010 by the international oversight body of the Basel Committee on Banking Supervision to require more and higher-quality capital) and the minimum leverage and risk-based capital requirements of the Dodd-Frank Act. The final rule established a comprehensive capital framework, and went into effect on January 1, 2015, for smaller banking organizations such as Carter Bank & Trust. The rule also requires a banking organization to maintain a capital conservation buffer composed of common equity Tier 1 capital in an amount greater than 2.50% of total risk-weighted assets beginning in 2019. The capital conservation buffer is scheduled to phase in over several years, of which 2016 was the first year. The capital conservation was 25% in 2016 and will increase to 50% in 2017, 75% in 2018 and 100% in 2019 and beyond. As a result, starting in 2019, a banking organization must maintain a common equity Tier 1 risk-based capital ratio greater than 7.00%, a Tier I risked based capital ratio greater than 8.5%, and a Total risk based capital ratio greater than 10.5%; otherwise it will be subject to restrictions on capital distributions and discretionary bonus payments. By 2019, when the new rule is fully phased in, the minimum capital requirements plus the capital conservation buffer will exceed the regulatory capital ratios required for an insured depository institution to be well-capitalized under the FDIC's prompt correction action framework.

The Bank intends to maintain a capital position that meets or exceeds the well-capitalized requirement as defined by the Federal Reserve Bank and Federal Deposit Insurance Corporation, in addition to the capital conservation buffer. The Banks average shareholders' equity to average assets ratio was 10.70% at December 31, 2018, as compared to 10.42% at December 31, 2017. Formal measurement of the capital ratios for the Bank is performed at each quarter end.

Federal regulators periodically propose amendments to the regulatory capital rules and the related regulatory framework and consider changes to the capital standards that could significantly increase the amount of capital needed to meet applicable standards. The timing of adoption, ultimate form and effect of any such proposed amendments cannot be predicted.

Management believes that, as of December 31, 2018, the Bank meets all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if such requirements were in effect as of that date.

**Contractual Obligations**

Contractual obligations represent future cash commitments and liabilities under agreements with third parties and exclude contingent contractual liabilities for which we cannot reasonably predict future payments. We have various financial obligations, including contractual obligations and commitments that may require future cash payments. The following table presents as of December 31, 2018, significant fixed and determinable contractual obligations to third parties by payment date:

| | Payments Due In | | | | |
|---|---|---|---|---|---|
| **(Dollars in Thousands)** | **2019** | **2020 – 2021** | **2022 – 2023** | **Later Years** | **Total** |
| Deposits without a Stated Maturity[(1)] | $1,493,380 | $ — | $ — | $ — | $1,493,380 |
| Certificates of Deposits[(1)] | 751,242 | 904,242 | 440,220 | 2,097 | 2,097,801 |
| Operating and Capital Leases | 188 | 268 | 200 | 981 | 1,637 |
| Purchase Obligations | 4,581 | 9,093 | 7,291 | 13,386 | 34,351 |
| **Total** | **$2,249,391** | **$913,603** | **$447,711** | **$16,464** | **$3,627,169** |

Operating lease obligations represent short and long-term lease arrangements as described in Note 7, Premises and Equipment, to the Consolidated Financial Statements included in Part II, Item 8 of this Report. Purchase obligations primarily represent obligations under agreement with a third party data processing vendor and communications charges.

**Off-Balance Sheet Arrangements**

In the normal course of business, we offer off-balance sheet credit arrangements to enable our customers to meet their financing objectives. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the financial statements. Our exposure to credit loss, in the event the customer does not satisfy the terms of the agreement, equals the contractual amount of the obligation less the value of any collateral. We apply the same credit policies in making commitments and standby letters of credit that are used for the underwriting of loans to customers. Commitments generally have fixed expiration dates, annual renewals or other termination clauses and may require payment of a fee. Because many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The following table sets forth the commitments and letters of credit as of December 31:

| (Dollars in Thousands) | 2018 | 2017 |
|---|---|---|
| Commitments to Extend Credit | $387,695 | $278,718 |
| Standby Letters of Credit | 34,354 | 38,664 |
| **Total** | **$422,049** | **$317,382** |

Estimates of the fair value of these off-balance sheet items were not made because of the short-term nature of these arrangements and the credit standing of the counterparties.

Our allowance for unfunded commitments is determined using a methodology similar to that used to determine the ALL. Amounts are added to the allowance for unfunded commitments through a charge to current earnings in noninterest expense. The balance in the allowance for unfunded commitments was $0.3 million at December 31, 2018.

**Liquidity**

Liquidity is defined as a financial institution's ability to meet its cash and collateral obligations at a reasonable cost. This includes the ability to satisfy the financial needs of depositors who want to withdraw funds or of borrowers needing to access funds to meet their credit needs. In order to manage liquidity risk our Board of Directors has delegated authority to the Asset Liability Committee ("ALCO") for formulation, implementation and oversight of liquidity risk management for the Bank. The ALCO's goal is to maintain adequate levels of liquidity at a reasonable cost to meet funding needs in both a normal operating environment and for potential liquidity stress events. The ALCO monitors and manages liquidity through various ratios, reviewing cash flow projections, performing stress tests and by having a detailed contingency funding plan. The ALCO policy guidelines define graduated risk tolerance levels. If our liquidity position moves to a level that has been defined as high risk, specific actions are required, such as increased monitoring or the development of an action plan to reduce the risk position.

Our primary funding and liquidity source is a stable customer deposit base. We believe we have the ability to retain existing deposits and attract new deposits, mitigating any funding dependency on other more volatile sources. Although deposits are the primary source of funds, the Bank has identified various other funding sources that can be used as part of our normal funding program when either a structure or cost efficiency has been identified. Additional funding sources accessible to the Bank include Fed Funds lines with six other financial institutions in the amount of $100.0 million.

An important component of our ability to effectively respond to potential liquidity stress events is maintaining a cushion of highly liquid assets. Highly liquid assets are those that can be converted to cash quickly, with little or no loss in value, to meet financial obligations. ALCO policy guidelines define a ratio of highly liquid assets to total assets by graduated risk tolerance levels of minimal, moderate and high. At December 31, 2018, the Bank had $782.1 million in highly liquid assets, which consisted of $61.4 million in interest-bearing deposits in other financial institutions, $184.8 million in Federal Reserve Bank Excess Reserves, $533.3 million in unpledged securities and $2.6 million in loans held-for-sale. This resulted in highly liquid assets to total assets ratio of 19.4% at December 31, 2018.

### Inflation

Management is aware of the significant effect inflation has on interest rates and can have on financial performance. Our ability to cope with this is best determined by analyzing our capability to respond to changing interest rates and our ability to manage noninterest income and expense. We monitor the mix of interest-rate sensitive assets and liabilities through ALCO in order to reduce the impact of inflation on net interest income. We also control the effects of inflation by reviewing the prices of our products and services, by introducing new products and services and by controlling overhead expenses.

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

### Market Risk

Market risk is defined as the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or capital. For financial institutions, market risk primarily reflects exposures to changes in interest rates. Interest rate fluctuations affect earnings by changing net interest income and other interest-sensitive income and expense levels. Interest rate changes affect capital by changing the net present value of a bank's future cash flows, and the cash flows themselves, as rates change. Accepting this risk is a normal part of banking and can be an important source of profitability and enhancing shareholder value. However, excessive interest rate risk can threaten a bank's earnings, capital, liquidity and solvency. Our sensitivity to changes in interest rate movements is continually monitored by the ALCO.

The ALCO utilizes an asset liability model ("ALM") to monitor and manage market risk through net interest income simulation for various rate shock scenarios and economic value of equity ("EVE"), simulation for various rate shock scenarios. The rate shock scenarios used in the ALM span over multiple time horizons and yield curve shapes and include parallel and non-parallel shifts to ensure the ALCO can mitigate future earnings and market value fluctuations due to changes in market interest rates.

Within the context of the ALM, net interest income rate shock simulations explicitly measure the exposure to earnings from changes in market rates of interest over a defined time horizon. These robust simulations include assumptions of how the balance sheet will react in different rate environments including loan pre-payment speeds, average life of non-maturing deposits, and how sensitive each interest-earning asset and interest-bearing liability is to changes in market rates (betas). Under simulation analysis, our current financial position is combined with assumptions regarding future business to calculate net interest income under various hypothetical rate scenarios. Reviewing these various measures provides us with a more comprehensive view of our interest rate risk profile.

Net interest income rate shock simulation results are compared to a base case to provide an estimate of the impact that market rate changes may have on 12 months and 24 months of pretax net interest income. The base case and rate shock analyses are performed on a static and growth balance sheet. A static balance sheet is a no growth balance sheet in which all maturing and/or repricing cash flows are reinvested in the same product at the existing product spread. Rate shock analyses assume an immediate parallel shift in market interest rates and also include management assumptions regarding the impact of interest rate changes on non-maturity deposit products (noninterest-bearing demand, interest-bearing demand, money market and savings) and changes in the prepayment behavior of loans and securities with optionality. Our policy guidelines limit the change in pretax net interest income over a 12 month horizon using rate shocks of +/- 100, 200, 300 and 400 basis points. We have temporarily suspended the -200, -300 and -400 basis point rate shock analyses. Due to the low interest rate environment, we believe the impact to net interest income when evaluating the -200, -300 and -400 basis point rate shock scenarios does not provide meaningful insight into our interest rate risk position.

In order to monitor interest rate risk beyond the 24 month time horizon of rate shocks, we also perform EVE analyses. EVE represents the present value of all asset cash flows minus the present value of all liability cash flows. EVE analysis results are compared to a base case to determine the impact of market rate changes. As with rate shock analysis, EVE analyses incorporate management assumptions regarding prepayment behavior of fixed rate loans and securities with optionality and the behavior and value of non-maturity deposit products. Our policy guidelines limit the change in EVE given changes in rates of +/- 100, 200, 300 and 400 basis points. We have also temporarily suspended the EVE -200, -300 and -400 basis point scenarios due to the low interest rate environment.

The tables below reflect the net interest income rate shock analyses and EVE analyses results for the periods presented utilizing a static balance sheet. All percentage changes presented are within prescribed ranges set by management.

**December 31, 2018**

| Change in Interest Rate (basis points) | % Change in Pretax Net Interest Income | % Change in Economic Value of Equity |
|---|---|---|
| 400 | 26.47% | 3.94% |
| 300 | 20.28% | 3.93% |
| 200 | 13.98% | 3.64% |
| 100 | 7.08% | 2.51% |
| (100) | -7.29% | -4.98% |

**December 31, 2017**

| Change in Interest Rate (basis points) | % Change in Pretax Net Interest Income | % Change in Economic Value of Equity |
|---|---|---|
| 400 | 13.94% | 5.73% |
| 300 | 11.29% | 5.50% |
| 200 | 8.46% | 5.30% |
| 100 | 4.36% | 3.69% |
| (100) | -6.08% | -5.97% |

The results from the net interest income rate shock analysis are consistent with having an asset sensitive balance sheet, when adjusted for repricing correlations (betas). The above table indicates that in a rising interest rate environment, the Bank is positioned to have increased pretax net interest income for the same asset base due to the balance sheet composition, related maturity structures and repricing correlations to market interest rates for assets and liabilities. Conversely, in a declining interest rate environment the Bank is positioned to have decreased pretax net interest income for the same reasons discussed above.

In addition to rate shocks and EVE analyses, sensitivity analyses are performed to help us identify which model assumptions are critical and cause the greatest impact on pretax net interest income. Sensitivity analyses include changing prepayment behavior of loans and securities with optionality, repricing correlations, and the impact of interest rate changes on non-maturity deposit products (decay rates).

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

**Consolidated Financial Statements**

## CARTER BANK & TRUST

## CONSOLIDATED BALANCE SHEETS

| (Dollars in Thousands Except Per Share Data) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| ASSETS | | |
| Cash and Due From Banks | $ 47,413 | $ 58,533 |
| Interest-Bearing Deposits in Other Financial Institutions | 61,352 | 58,365 |
| Federal Reserve Bank Excess Reserves | 184,798 | 151,715 |
| **Total Cash and Cash Equivalents** | **293,563** | **268,613** |
| Securities Available-for-Sale, at Fair Value | 782,758 | 947,201 |
| Loans Held-for-Sale | 2,559 | 517 |
| Portfolio Loans, net of Unearned Income | 2,703,792 | 2,684,445 |
| Allowance for Loan Losses | (39,199) | (35,318) |
| **Portfolio Loans, net** | **2,664,593** | **2,649,127** |
| Bank Premises and Equipment, net | 85,841 | 77,273 |
| Other Real Estate Owned, net | 33,681 | 39,793 |
| Goodwill | 58,726 | 59,762 |
| Bank Owned Life Insurance | 51,161 | — |
| Other Assets | 66,717 | 70,006 |
| **Total Assets** | **$4,039,599** | **$4,112,292** |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-Bearing Demand | $ 524,614 | $ 530,242 |
| Interest-Bearing Demand | 277,174 | 260,979 |
| Money Market | 80,835 | 102,686 |
| Savings | 610,757 | 721,459 |
| Certificates of Deposit | 2,097,801 | 2,054,249 |
| **Total Deposits** | **3,591,181** | **3,669,615** |
| Other Liabilities | 12,204 | 10,551 |
| **Total Liabilities** | **3,603,385** | **3,680,166** |
| SHAREHOLDERS' EQUITY | | |
| Common Stock, Par Value $1 Per Share, Authorized 100,000,000 Shares; 26,270,174 Outstanding in 2018 and 26,257,761 in 2017 | 26,270 | 26,258 |
| Additional Paid-in-Capital | 142,175 | 142,178 |
| Retained Earnings | 277,835 | 265,930 |
| Accumulated Other Comprehensive Loss | (10,066) | (2,240) |
| **Total Shareholders' Equity** | **436,214** | **432,126** |
| **Total Liabilities and Shareholders' Equity** | **$4,039,599** | **$4,112,292** |

See accompanying notes to audited consolidated financial statements.

**CARTER BANK & TRUST**

**CONSOLIDATED STATEMENTS OF INCOME**

| (Dollars in Thousands except Per Share Data) | Years Ended December 31, 2018 | 2017 | 2016 |
|---|---|---|---|
| **INTEREST INCOME** | | | |
| Loans, including fees | | | |
| Taxable | $119,563 | $108,193 | $107,472 |
| Non-Taxable | 10,107 | 10,901 | 9,772 |
| Investment Securities | | | |
| Taxable | 15,421 | 14,911 | 21,347 |
| Non-Taxable | 4,246 | 4,895 | 4,972 |
| FRB Excess Reserves | 2,476 | 5,112 | 4,085 |
| Interest on Bank Deposits | 206 | 72 | — |
| **Total Interest Income** | **152,019** | **144,084** | **147,648** |
| **Interest Expense** | | | |
| Interest Expense on Deposits | 38,094 | 37,111 | 46,382 |
| Interest Expense on Federal Funds Purchased | 20 | — | — |
| **Total Interest Expense** | **38,114** | **37,111** | **46,382** |
| **NET INTEREST INCOME** | **113,905** | **106,973** | **101,266** |
| Provision for Loan Losses | 16,870 | 43,197 | 17,717 |
| **Net Interest Income After Provision for Loan Losses** | **97,035** | **63,776** | **83,549** |
| **NONINTEREST INCOME** | | | |
| Gain on Sales of Securities, net | 1,271 | 1,186 | — |
| Service Charges, Commissions and Fees | 4,228 | 2,920 | 3,139 |
| Debit Card Interchange Fees | 4,750 | 4,854 | 4,718 |
| Insurance | 1,855 | 2,582 | 2,933 |
| Bank Owned Life Insurance Income | 1,161 | — | — |
| Other Real Estate Owned Income | 2,692 | 448 | 1,261 |
| Other | 1,029 | 601 | 443 |
| **Total Noninterest Income** | **16,986** | **12,591** | **12,494** |
| **NONINTEREST EXPENSE** | | | |
| Salaries and Employee Benefits | 49,958 | 42,711 | 37,527 |
| Occupancy Expense, net | 10,312 | 9,780 | 8,577 |
| FDIC Insurance Expense | 2,985 | 3,890 | 4,914 |
| Other Taxes | 2,571 | 1,907 | 1,760 |
| Telephone Expense | 2,466 | 1,699 | 1,615 |
| Professional and Legal Fees | 5,288 | 6,856 | 1,109 |
| Data Processing Licensing Fee | 1,242 | 5,604 | 3,456 |
| Losses on Sales and Write-downs of Other Real Estate Owned, net | 8,201 | 9,909 | 10,746 |
| Loss on Sales and Write-downs of Bank Premises | 186 | 714 | 10 |
| Debit Card Expense | 2,785 | 2,436 | 2,735 |
| Tax Credit Amortization | 4,060 | — | — |
| Tax Credit Impairment | — | 3,259 | — |
| Other Real Estate Owned Expense | 2,139 | 791 | 1,446 |
| Other | 7,520 | 5,023 | 4,524 |
| **Total Noninterest Expense** | **99,713** | **94,579** | **78,419** |
| **Income (Loss) Before Taxes** | **14,308** | **(18,212)** | **17,624** |
| Income Tax Provision (Benefit) | 2,403 | (17,531) | 1,645 |
| **Net Income (Loss)** | **$ 11,905** | **$ (681)** | **$ 15,979** |
| **Earnings (Loss) per Common Share:** | | | |
| **Basic and Diluted** | **$ 0.45** | **$ (0.03)** | **$ 0.61** |

See accompanying notes to audited consolidated financial statements.

**CARTER BANK & TRUST**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

| (Dollars in Thousands) | Years Ended December 31, 2018 | 2017 | 2016 |
|---|---|---|---|
| Net Income (Loss) | $11,905 | $ (681) | $15,979 |
| Other Comprehensive Loss: | | | |
| Unrealized (Gains)/Losses on Securities: | | | |
| Net Unrealized Losses Arising during the Period | (8,636) | (7,249) | — |
| Transfer of Held-to-Maturity Securities to Available-for-Sale Securities | — | 5,600 | — |
| Reclassification Adjustment for Gains included in Net Income (Loss) | (1,271) | (1,186) | — |
| Net Unrealized Loss Recognized in Comprehensive Loss | (9,907) | (2,835) | — |
| Tax Effect | 2,081 | 992 | — |
| Other Comprehensive Loss | (7,826) | (1,843) | — |
| **Comprehensive Income (Loss)** | **$ 4,079** | **$(2,524)** | **$15,979** |

See accompanying notes to audited consolidated financial statements.

## CARTER BANK & TRUST

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| (Dollars in Thousands) | Common Stock | Additional Paid-in-Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Total Shareholders' Equity |
| **Balance December 31, 2015** | **$26,258** | **$142,178** | **$258,113** | **$ —** | **$426,549** |
| Net Income | — | — | 15,979 | — | 15,979 |
| Cash Dividends Declared and Paid | — | — | (7,878) | — | (7,878) |
| **Balance December 31, 2016** | **$26,258** | **$142,178** | **$266,214** | **$ —** | **$434,650** |
| Net Loss | — | — | (681) | — | (681) |
| Cash Dividends Declared and Paid | — | — | — | — | — |
| Other Comprehensive Loss | — | — | — | (1,843) | (1,843) |
| Reclassification of Certain Tax Effects from Change in Tax Rate | — | — | 397 | (397) | — |
| **Balance December 31, 2017** | **$26,258** | **$142,178** | **$265,930** | **$ (2,240)** | **$432,126** |
| Net Income | — | — | 11,905 | — | 11,905 |
| Cash Dividends Declared and Paid | — | — | — | — | — |
| Issuance of Restricted Stock (12,413 shares) | 12 | (12) | — | — | — |
| Stock compensation expense | — | 9 | — | — | 9 |
| Other Comprehensive Loss | — | — | — | (7,826) | (7,826) |
| **Balance December 31, 2018** | **$26,270** | **$142,175** | **$277,835** | **$(10,066)** | **$436,214** |

See accompanying notes to audited consolidated financial statements.

Form 10-K

## CARTER BANK & TRUST

## CONSOLIDATED STATEMENTS OF CASH FLOWS

| (Dollars in Thousands) | Years Ended December 31, 2018 | 2017 | 2016 |
|---|---|---|---|
| **OPERATING ACTIVITIES** | | | |
| Net Income (Loss) | $ 11,905 | $ (681) | $ 15,979 |
| Adjustments to Reconcile Net Income (Loss) to Net Cash Provided by Operating Activities | | | |
| Provision for Loan Losses | 16,870 | 43,197 | 17,717 |
| Origination of Loans Held-for-Sale | (29,307) | (45,900) | — |
| Proceeds From Loans Held-for-Sale | 27,265 | 45,383 | — |
| Depreciation/Amortization of Bank Premises and Equipment | 3,682 | 3,150 | 3,285 |
| Provision (Benefit) for Deferred Taxes | 4,850 | (10,371) | (5,832) |
| Net Amortization of Securities | 4,704 | 1,332 | — |
| Tax Credit Impairment | — | 3,259 | |
| Tax Credit Amortization | 4,060 | — | — |
| Gains on Sales of Securities, net | (1,271) | (1,186) | — |
| Write-downs of Other Real Estate Owned | 8,714 | 9,967 | 8,411 |
| (Gains) Losses on Sales of Other Real Estate Owned, Net | (513) | (58) | 2,336 |
| Losses on Sales and Write-downs of Bank Premises | 186 | 714 | — |
| Increase in the Value of Life Insurance Contracts | (1,161) | — | — |
| Stock Compensation Expense | 9 | — | — |
| Increase in Other Assets | (2,504) | (8,053) | (9,254) |
| Increase in Other Liabilities | 1,653 | 3,511 | 14 |
| **Net Cash Provided By Operating Activities** | **49,142** | **44,264** | **32,656** |
| **INVESTING ACTIVITIES** | | | |
| Securities Held-to-Maturity: | | | |
| Proceeds from Maturities and Redemptions | — | 57,330 | 667,407 |
| Purchases | — | (41,436) | (125,000) |
| Securities Available-for-Sale: | | | |
| Proceeds from Sales | 133,120 | 123,920 | — |
| Proceeds from Maturities, Redemptions, and Pay downs | 219,223 | 183,197 | — |
| Purchases | (201,240) | (393,499) | — |
| Purchase of Bank Premises and Equipment, Net | (14,613) | (3,540) | (844) |
| Loan Originations and Payments, net | (59,655) | (5,606) | (95,977) |
| Purchases of Bank Owned Life Insurance | (50,000) | — | — |
| Other Real Estate Owned Improvements | (1,272) | (372) | (168) |
| Proceeds from Sales of Other Real Estate Owned | 28,679 | 3,802 | 2,124 |
| **Net Cash Provided by (Used In) Investing Activities** | **54,242** | **(76,204)** | **447,542** |
| **FINANCING ACTIVITIES** | | | |
| Net Change in Demand, Money Markets and Savings Accounts | (121,986) | (66,225) | (45,681) |
| Increase (Decrease) in Time Deposits | 43,552 | (327,999) | (345,041) |
| Cash Dividends | — | — | (7,878) |
| **Net Cash Used In Financing Activities** | **(78,434)** | **(394,224)** | **(398,600)** |
| Net Increase (Decrease) in Cash and Cash Equivalents | 24,950 | (426,164) | 81,598 |
| Cash and Cash Equivalents at Beginning of Period | 268,613 | 694,777 | 613,179 |
| **Cash and Cash Equivalents at End of Period** | **$ 293,563** | **$ 268,613** | **$ 694,777** |

See accompanying notes to audited consolidated financial statements.

## CARTER BANK & TRUST

## CONSOLIDATED STATEMENTS OF CASH FLOWS – (continued)

| (Dollars in Thousands) | Years Ended December 31, 2018 | 2017 | 2016 |
|---|---|---|---|
| **SUPPLEMENTARY DATA** | | | |
| Cash Interest Paid | $37,918 | $ 37,824 | $46,848 |
| Cash Paid for Income Taxes | 175 | 1,675 | 10,801 |
| Transfer of Securities from Held-to-Maturity to Available-for-Sale | — | 863,800 | — |
| Unrealized Gain on Transfer of Securities from Held-to-Maturity to Available-for-Sale | — | 5,600 | — |
| Net Unrealized Losses on Securities Available-for-Sale | (9,907) | (8,435) | — |
| Transfer from Loans to Other Real Estate Owned | 28,212 | 17,912 | 610 |
| Loans Provided for Sales of Other Real Estate Owned | 893 | 7,347 | 7,771 |
| Transfer from Fixed Assets to Other Real Estate Owned | 2,177 | 19,009 | — |

See accompanying notes to audited consolidated financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands in Charts Except for Per Share Data)

## NOTE 1 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Nature of Operations:** Carter Bank & Trust (the "Bank") is a banking institution, incorporated under Virginia law, with headquarters located in Martinsville, Virginia. The Bank is a non-member state bank, regulated by the FDIC and State Bureau of Financial Institutions. The Bank has one wholly owned subsidiary, Mortgage Company of Virginia which owns 100% of Bank Services of Virginia and Bank Services Insurance, Inc. Mortgage Company of Virginia was terminated and dissolved on December 11, 2018. Bank Services of Virginia was terminated and dissolved on July 10, 2018. Bank Services Insurance, Inc. was sold in January of 2018.

**Accounting Policies:** Our financial statements have been prepared in accordance with U.S. generally accepted accounting principles, or GAAP. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the dates of the balance sheets and revenues and expenses for the periods then ended. Actual results could differ from those estimates. Our significant accounting policies are described below.

**Principles of Consolidation:** The Consolidated Financial Statements include the accounts of Carter Bank & Trust and its wholly owned subsidiary. All significant intercompany transactions have been eliminated in consolidation.

**Reclassification:** Amounts in prior years' period financial statements and footnotes are reclassified whenever necessary to conform to the current year's presentation. Reclassifications had no material effect on prior year net income or shareholders' equity.

**Subsequent Event:** The Bank has evaluated subsequent events for recognition and disclosure through March 14, 2019 which is the date the financial statements were available to be issued.

**Use of Estimates:** To prepare financial statements in conformity with accounting principles generally accepted in the U.S., management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and actual results could differ.

**Operating Segments:** While the chief decision-makers monitor the revenue streams of the various products and services, operations are managed and financial performance is evaluated on a Bank-wide basis, and operating segments are aggregated into one as operating results for all segments are similar. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable operating segment.

**Cash and Cash Equivalents:** The Bank considers all cash on hand, amounts due from banks, federal funds sold, and Federal Reserve Bank ("FRB") excess reserves as cash equivalents for the purposes of the consolidated statements of cash flows with all items having maturities fewer than 90 days. Federal funds are customarily sold for one-day periods. The FRB pays the target fed funds rate on the FRB excess reserves.

**Restrictions on Cash:** Cash on hand or on deposit with the FRB was required to meet regulatory reserve and clearing requirements.

**Loan Commitments and Related Financial Instruments:** Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

**Comprehensive Income:** Comprehensive income consists of net income (loss) and other comprehensive loss. Other comprehensive loss includes unrealized gains and losses on securities available-for-sale, net of tax.

**Securities:** The Bank classifies securities into either the held-to-maturity or available-for-sale categories at the time of purchase. All securities are classified as available-for-sale at December 31, 2018 and December 31, 2017. During 2017, management determined to transfer all investment securities previously classified as held-to-maturity to available-for-sale. See further information on this transfer within Note 3. Held-to-maturity securities are those which the Bank has the positive intent and ability to hold until maturity and are reported at amortized cost. Securities classified as available-for-sale include securities, which can be sold for liquidity, investment management, or similar reasons even if there is not a present intention of such a sale. Available-for-sale securities are reported at fair value, with unrealized gains or losses included in other comprehensive loss, net of tax.

Premium amortization is deducted from, and discount accretion is added to, interest income on securities using the level yield method without anticipating prepayments, except for mortgage-backed securities where prepayments are anticipated. Gains and losses are recognized upon the sale of specific identified securities on the completed trade date.

**Other-Than-Temporary Impairments of Securities:** In determining an other-than-temporary impairment ("OTTI"), management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Bank has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an OTTI decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When an OTTI occurs, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss. If an entity intends to sell or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be and is recognized in earnings. The amount of the total OTTI related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment.

**Loans and Allowance for Loan Losses:** Loans are recorded at the amount of the loan disbursed to borrowers plus the applicable amount, if any, of unearned income and other charges, less payments received. Income earned on loans is recognized by methods which generally result in level rates of return on principal amounts outstanding. The net amount of nonrefundable loan origination fees approximates the direct costs associated with the lending process.

The allowance for loan losses is an estimate of probable losses inherent in the loan portfolio as determined by management taking into consideration historical loan loss experience, diversification of the loan portfolio, amounts of secured and unsecured loans, banking industry standards and averages, and general economic conditions. Ultimate losses may vary from current estimates. These estimates are reviewed periodically and as adjustments become necessary, they are reported in earnings in the periods in which they become reasonably estimable.

A loan is considered impaired when it is probable that the Bank will be unable to collect all principal and interest amounts when due according to the contractual terms of the loan agreement. A performing loan may be considered impaired. The allowance for loan losses related to loans identified as impaired is primarily based on the excess of the loan's current outstanding principal balance over the estimated fair value of the related collateral, less cost to sell. For a loan that is not collateral-dependent, the allowance is recorded at the amount by which the outstanding principal balance exceeds the current estimate of the future cash flows on the loan discounted at the loan's original effective interest rate. Interest on impaired loans is recognized when cash is received.

Loans, including impaired loans, are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days based on contractual terms, unless such loans are well-secured and in the process of collection. If a loan or a portion of a loan is classified as doubtful or is partially charged off, the loan is generally classified as nonaccrual. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccrual, if repayment in full of principal and/or interest is unlikely.

While a loan is classified as nonaccrual and the probability of collecting the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to principal outstanding. When the probability of collecting the recorded loan balance is expected, interest income may be recognized on a cash basis.

In the case where a nonaccrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate. Cash interest receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance by the borrower in accordance with the contractual terms of interest and principal.

During the quarterly evaluation of the allowance for loan losses, particular characteristics associated with a segment of the loan portfolio are also considered. These characteristics are detailed below:

Commercial loans not secured by real estate carry risks associated with the successful operation of a business, and the repayments of these loans depend on the profitability and cash flows of the business. Additional risk relates to the value of collateral upon which depreciation occurs and the valuation is less precise.

Loans secured by commercial real estate also carry risks associated with the success of the business and the ability to generate a positive cash flow sufficient to service debts. Real estate security diminishes risks only to the extent that a market exists for the subject collateral.

Residential real estate loans carry risks associated with the continued credit-worthiness of the borrower and changes in the value of the collateral. In instances where construction is in process, these loans carry risks that a project will not be completed as scheduled and budgeted and that the value of the collateral may, at any point be less than the principal amount of the loan. Additional risks may occur if the general contractor, who may not be a loan customer, is unable to finish the project as planned due to financial pressures unrelated to the project.

Consumer loans carry risks associated with the continued credit-worthiness of the borrower and the value of the collateral, such as automobiles, which may depreciate more rapidly than other assets. In addition, these loans may be unsecured. Consumer loans are more likely than real estate loans to be immediately affected in an adverse manner by job loss, divorce, illness, or personal bankruptcy. Consumer loans are further segmented into automobile and recreational vehicle loans and other consumer loans.

Loans to tax-exempt state and political subdivisions carry risks associated with changes in budget constraints or revenue bases of the particular municipality or entity. These loans are dependent on the cash flow from the tax-exempt entity and often times have col lateral upon which depreciation occurs and valuation is less than precise.

**Troubled Debt Restructurings:** In situations where, for economic or legal reasons related to a borrower's financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring ("TDR"). Management strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before their loan reaches nonaccrual status. These modified terms have historically included interest only periods, extended amortization periods beyond what management would typically offer for a similar loan or a below market interest rate when compared to management's underwriting standards for a similar loan type. These concessions are intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of interest, management measures any impairment on the restructuring as noted above for impaired loans.

**Concentration of Credit Risk:** The majority of the Bank's loans, commitments and lines of credit have been granted to customers in the Bank's market area. The concentrations of credit by loan classification are set forth in Note 4.

**Advertising Costs:** We expense all marketing-related costs, including advertising costs, as incurred. Advertising expense was $876 thousand, $191 thousand, and $180 thousand for the years ended 2018, 2017, and 2016, respectively.

**Bank Owned Life Insurance:** We have purchased life insurance policies on certain executive officers and employees. We receive the cash surrender value of each policy upon its termination or benefits are payable to us upon the death of the insured. Changes in net cash surrender value are recognized in noninterest income in the Consolidated Statements of Income.

**Bank Premises and Equipment:** Bank premises and equipment acquired are stated at cost, less accumulated depreciation. Depreciation is charged to operating expenses over the estimated useful life of the assets by the straight-line method. Land is carried at cost. Costs of maintenance or repairs are charged to expense as incurred and improvements are capitalized. Upon retirement or disposal of an asset, the asset and related allowance account are eliminated. Any gain or loss on such transactions is included in current operations. Depreciation has been included under occupancy expense in the Consolidated Statements of Income totaling $3.7 million in 2018, $3.2 million in 2017, and $3.3 million in 2016. The estimated useful life for bank premises ranges from 5 to 40 years and equipment depreciates over a 3 to 10 year period.

**Earnings Per Share:** Basic earnings per share represent income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive common shares had been issued, as well as any adjustment to income resulting from the assumed issuance. The Bank had no dilutive common stock equivalents as of December 31, 2018, 2017 and 2016; therefore, basic and diluted earnings per share are equal for the Bank for the years ended December 2018, 2017, and 2016. The number of weighted average shares used to compute earnings per share was 26,259,223 for the year ended December 31, 2018 and 26,257,761 for the years ended December 31, 2017 and 2016. Non-vested shares of restricted stock are included in the computation of basic and diluted earnings per share because the holder has voting rights and shares in non-forfeitable dividends during the vesting period.

**Other Real Estate Owned:** Real estate properties acquired through or in lieu of loan foreclosure are initially recorded at fair value less estimated selling cost at the date of foreclosure. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, these assets are carried at the lower of their new cost basis or fair value less cost to sell. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Valuations are periodically performed by management, and any write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its carrying value or fair value less cost to sell.

**Income Taxes:** Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences, operating losses, and tax credit carryforwards. Deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest and penalties associated with unrecognized tax benefits are classified as additional income taxes in the consolidated statements of income.

**Transfer of Financial Assets:** Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity, or the ability to unilaterally cause the transferee to return specific assets.

**Retirement Benefits:** The Bank has established an employee benefit plan as described in Note 11. The Bank does not provide any other post-retirement benefits.

**Loans Or Debt Securities Acquired In A Transfer:** Loans acquired through the completion of a transfer, including loans acquired in a business combination that have evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the Bank will be unable to collect all contractually required payments receivable, are initially recorded at fair value (as determined by the present value of the expected future cash flows) with no valuation allowance. Loans are evaluated individually to determine if there is evidence of deterioration of credit quality since origination. Loans with evidence of deterioration of credit quality since origination may be aggregated and accounted for as a pool of loans if the loans being aggregated have common risk characteristics. The difference between the undiscounted cash flows expected at the acquisition and the investment in the loan, or the "accretable yield," is recognized as interest income on a level-yield method over the life of the loan. Contractually required payments for interest and principal that exceed the undiscounted cash flows expected at acquisition, or the "nonaccretable difference," are not recognized as a yield adjustment, as a loss accrual, or a valuation allowance. Increases in expected cash flows subsequent to the initial investment are recognized prospectively through adjustment of the yield on the loan over its remaining life. Decreases in expected cash flows are recognized immediately as impairment. If the Bank does not have the information necessary to reasonably estimate the cash flows to be expected, it may use the cost recovery method or cash basis method of income recognition.

**Goodwill and Intangible Assets:** Goodwill resulting from business combinations prior to January 1, 2009 represents the excess of the purchase price over the fair value of the net assets of businesses acquired. Goodwill resulting from business combinations after January 1, 2009, is generally determined as the excess of the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually or more frequently if events and circumstances exist that indicate that a goodwill impairment test should be performed. The Bank has selected October 1st as the date as of which to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on our balance sheet.

**Fair Value of Financial Instruments:** Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 6. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

**Derivative Instruments and Hedging Activities:** The Bank uses derivative instruments such as interest rate swaps for commercial loans with our customers. Upon entering into swaps with the borrower, The Bank entered into offsetting positions with counterparties to minimize risk to the Bank. The back-to-back swaps qualify as derivatives, but are not designated as hedging instruments. Interest rate swap contracts involve the risk of dealing with borrower and counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument contract is positive, this generally indicates that the counterparty or customer owes the Bank, and results in credit risk to the Bank. When the fair value of a derivative instrument contract is negative, the Bank owes the customer or counterparty, and, therefore, has no risk.

The Bank also enters into commitments to originate mortgage loans whereby the interest rate on the loan is determined prior to funding (rate lock commitments). Rate lock commitments on mortgage loans to be held for sale are considered to be derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 15 to 90 days. The Bank protects itself from changes in interest rates through the use of best efforts forward delivery commitments, whereby the Bank commits to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed interest rate risk on rate lock commitments dues to changes in interest rates.

**Newly Adopted Pronouncements:** During the first quarter of 2018, the Bank adopted ASU 2016-01, “Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities”. The amendments in ASU 2016-01, among other things: (1) requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (2) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (3) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables); and (4) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The adoption of ASU No. 2016-01 on January 1, 2018 did not have a material impact on our consolidated financial statements. In accordance with (2) above, the Bank measured the fair value of its loan and deposit portfolios as of December 31, 2018 using an exit price notion (see Note 5 *Fair Value Measurements*).

During the first quarter of 2018, the Bank adopted ASU 2016-10, “Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing”. This standard is on the recognition of revenue from contracts with customers with the core principle being for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The new standard also results in enhanced disclosures about revenue, provides guidance for transactions that were not previously addressed comprehensively and improves guidance for multiple-element arrangements. Our revenue is comprised of net interest income on financial assets and liabilities, which is explicitly excluded from the scope of the new guidance, and noninterest income. The contracts that are in scope of the guidance are primarily related to service charges on deposit accounts, debit card interchange fees, other service charges and fees, sales of other real estate, insurance commissions and return on investment, and miscellaneous fees. We have performed an analysis of contracts for customer service charges and miscellaneous income. The adoption of ASU 2016-10 did not have a material impact on our consolidated financial statements.

**Recent Accounting Pronouncements:** In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)". Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term.

Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The FASB made subsequent amendments to Topic 842 in July 2018 through ASU 2018-10 ("Codification Improvements to Topic 842, Leases.") and ASU 2018-11 ("Leases (Topic 842): Targeted Improvements.") Among these amendments is the provision in ASU 2018-11 that provides entities with an additional (and optional) transition method to adopt the new leases standard. Under this new transition method, an entity initially applies the new leases standard at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Consequently, an entity's reporting for the comparative periods presented in the financial statements in which it adopts the new leases standard will continue to be in accordance with current GAAP (Topic 840, Leases). The adoption of this standard on January 1, 2019 did not have a material effect on the Bank's consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments". The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. For public companies that are not SEC filers, the amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. We are currently gathering loan level data and assessing our data and system needs. The impact of the current expected credit losses model implementation is being evaluated, but it is expected that a one-time cumulative-effect adjustment to the allowance for loan losses will be recognized in retained earnings on the Consolidated Balance Sheet as of the beginning of the first reporting period in which the new standard is effective, as is consistent with regulatory expectations set forth in interagency guidance. The magnitude of any adjustment or the overall impact of the new standard on financial condition or results of operation cannot yet be determined.

In January 2017, the FASB issued ASU No. 2017-04, "Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment". The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are not SEC filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2020. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Bank does not expect the adoption of ASU 2017-04 to have a material impact on our consolidated financial statements.

In March 2017, the FASB issued ASU 2017-08, "Receivables — Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities". The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption and provide the disclosures required for a change in accounting principle. The Bank does not expect the adoption of ASU 2017-08 to have a material impact on our consolidated financial statements. The Bank is currently assessing the impact that ASU 2017-08 will have on our consolidated financial statements.

In August 2017, the FASB issued ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities". The amendments in this ASU modify the designation and measurement guidance for hedge accounting as well as provide for increased transparency regarding the presentation of economic results on both the financial statements and related footnotes. Certain aspects of hedge effectiveness assessments will also be simplified upon implementation of this update. The amendments are effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2018. Early adoption is permitted, including adoption in any interim period. This ASU was further amended in October 2018 by ASU 2018-16, which adds the Overnight Index Swap rate as a U.S. benchmark interest rate. These amendments will be effective concurrently with ASU 2017-12. The Bank is currently assessing the impact that ASU 2017-12 will have on our consolidated financial statements. The Bank does not expect the adoption of ASU 2017-12 to have a material impact on our consolidated financial statements.

In June 2018, the FASB issued ASU 2018-07, "Compensation- Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting". The amendments expand the scope of Topic 718 to include share-based payments issued to non-employees for goods or services, which were previously excluded. The amendments will align the accounting for share-based payments to nonemployees and employees more similarly. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The Bank does not expect the adoption of ASU 2018-07 to have a material impact on our consolidated financial statements.

In August 2018, the FASB issued ASU 2018-13, "Fair Value Measurement (Topic 820): Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement". The amendments modify the disclosure requirements in Topic 820 to add disclosures regarding changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements and the narrative description of measurement uncertainty. Certain disclosure requirements in Topic 820 are also removed or modified. The amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Certain of the amendments are to be applied prospectively while others are to be applied retrospectively. Early adoption is permitted. The Bank does not expect the adoption of ASU 2018-13 to have a material impact on our consolidated financial statements.

## NOTE 2 — RESTRICTIONS ON CASH AND DUE FROM BANK ACCOUNTS

The Board of Governors of the Federal Reserve System, or the Federal Reserve, imposes certain reserve requirements on all depository institutions. These reserves are maintained in the form of vault cash or as an interest-bearing balance with the Federal Reserve. The required reserves averaged $42.4 million for 2018, $40.4 million for 2017 and $39.6 million for 2016.

## NOTE 3 — INVESTMENT SECURITIES

The following tables present the amortized cost and fair value of available-for-sale securities as of the dates presented:

| | December 31, 2018 | | | |
|---|---|---|---|---|
| **(Dollars in Thousands)** | **Amortized Cost** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Value** |
| U.S. Government Agency Securities | $274,998 | $ — | $ (4,610) | $270,388 |
| Residential Mortgage-Backed Securities | 72,295 | 4 | (1,428) | 70,871 |
| Commercial Mortgage-Backed Securities | 22,322 | — | (530) | 21,792 |
| Asset Backed Securities | 59,368 | 62 | (569) | 58,861 |
| Collateralized Mortgage Obligations | 78,107 | 10 | (1,298) | 76,819 |
| Small Business Administration | 90,673 | 50 | (1,485) | 89,238 |
| States and Political Subdivisions | 170,229 | 329 | (3,084) | 167,474 |
| Corporate Notes | 27,508 | — | (193) | 27,315 |
| **Total Debt Securities** | **$795,500** | **$455** | **$(13,197)** | **$782,758** |

| | December 31, 2017 | | | |
|---|---|---|---|---|
| **(Dollars in Thousands)** | **Amortized Cost** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Value** |
| U.S. Government Agency Securities | $302,894 | $ — | $(4,229) | $298,665 |
| Residential Mortgage-Backed Securities | 60,890 | 35 | (545) | 60,380 |
| Commercial Mortgage-Backed Securities | 25,170 | — | (262) | 24,908 |
| Asset Backed Securities | 16,877 | 3 | (13) | 16,867 |
| Collateralized Mortgage Obligations | 62,351 | 2 | (759) | 61,594 |
| Small Business Administration | 69,232 | 57 | (1,029) | 68,260 |
| States and Political Subdivisions | 302,991 | 4,363 | (391) | 306,963 |
| Corporate Notes | 109,631 | — | (67) | 109,564 |
| **Total Debt Securities** | **$950,036** | **$4,460** | **$(7,295)** | **$947,201** |

On July 26, 2017, the Bank reclassified its entire held-to-maturity portfolio to the available-for-sale portfolio. At the time of reclassification, the investments had an amortized cost of $863.8 million and a net unrealized gain of $5.6 million.

The transfer of securities from the held-to-maturity portfolio to the available-for-sale portfolio resulted from the implementation of a strategy to liquidate selected obligations of the states and political subdivisions portfolio and corporate notes in order to mitigate credit risk and more proactively manage the securities portfolio.

The Bank did not have securities classified as held-to-maturity at December 31, 2018 or December 31, 2017.

The following table shows the composition of gross and net realized gains and losses for the periods presented:

| | Years ended December 31, | | |
|---|---|---|---|
| **(Dollars in Thousands)** | **2018** | **2017** | **2016** |
| Gross Realized Gains | $1,899 | $1,253 | $— |
| Gross Realized Losses | (628) | (67) | — |
| **Net Realized Gains** | **$1,271** | **$1,186** | **$—** |
| **Tax Impact** | **$ 267** | **$ 415** | **$—** |

Gains or losses are recognized in earnings on the trade date using the amortized cost of the specific security sold.

The net realized gains above reflect reclassification adjustments in the calculation of other comprehensive loss. The net realized gains are included in noninterest income as gains on sales of securities, net in the Consolidated Statements of Income. The tax impact is included in income tax provision (benefit) in the Consolidated Statements of Income.

The amortized cost and fair value of securities available-for-sale by contractual maturity at December 31, 2018 and 2017 are included in the tables below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single date are shown separately.

| **(Dollars in Thousands)<br>December 31, 2018** | **Amortized Cost** | **Fair Value** |
|---|---|---|
| **U.S Government Agencies, Obligations of States and Political Subdivisions, Small Business Administration, and Corporate Notes** | | |
| Due in One Year or Less | $139,169 | $138,056 |
| Due after One Year through Five Years | 195,808 | 191,962 |
| Due after Five Years through Ten Years | 47,320 | 46,846 |
| Due after Ten Years | 181,111 | 177,551 |
| | **563,408** | **554,415** |
| Residential Mortgage-Backed Securities | 72,295 | 70,871 |
| Commercial Mortgage-Backed Securities | 22,322 | 21,792 |
| Collateralized Mortgage Obligations | 78,107 | 76,819 |
| Asset Backed Securities | 59,368 | 58,861 |
| **Total Securities** | **$795,500** | **$782,758** |

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| (Dollars in Thousands) December 31, 2017 | Amortized Cost | Fair Value |
|---|---|---|
| **U.S Government Agencies, Obligations of States and Political Subdivisions, Small Business Administration, and Corporate Notes** | | |
| Due in One Year or Less | $174,074 | $174,031 |
| Due after One Year through Five Years | 375,770 | 372,723 |
| Due after Five Years through Ten Years | 57,407 | 58,696 |
| Due after Ten Years | 177,497 | 178,002 |
| | **784,748** | **783,452** |
| Residential Mortgage-Backed Securities | 60,890 | 60,380 |
| Commercial Mortgage-Backed Securities | 25,170 | 24,908 |
| Collateralized Mortgage Obligations | 62,351 | 61,594 |
| Asset Backed Securities | 16,877 | 16,867 |
| **Total Securities** | **$950,036** | **$947,201** |

At December 31, 2018 and December 31, 2017, there were no holdings of securities of any one issuer, other than the U.S. Government and its Agencies, in an amount greater than 10% of stockholders' equity.

The carrying value of securities pledged for various regulatory and legal requirements was $249.4 million at December 31, 2018 and $295.8 million at December 31, 2017.

Securities with unrealized losses at December 31, 2018 and 2017, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows:

**Available-For-Sale Securities**

| | December 31, 2018 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Less Than 12 Months | | | 12 Months or More | | | Total | | |
| (Dollars in Thousands) | Number of Securities | Fair Value | Unrealized Losses | Number of Securities | Fair Value | Unrealized Losses | Number of Securities | Fair Value | Unrealized Losses |
| U.S. Government Agency Securities | — | $ — | $ — | 12 | $270,388 | $ 4,610 | 12 | $270,388 | $ 4,610 |
| Residential Mortgage-Backed Securities | 1 | 3,220 | 71 | 30 | 62,112 | 1,357 | 31 | 65,332 | 1,428 |
| Commercial Mortgage-Backed Securities | — | — | — | 8 | 21,792 | 530 | 8 | 21,792 | 530 |
| Asset Backed Securities | 16 | 40,812 | 560 | 1 | 2,242 | 9 | 17 | 43,054 | 569 |
| Collateralized Mortgage Obligations | 8 | 20,073 | 111 | 21 | 52,073 | 1,187 | 29 | 72,146 | 1,298 |
| Small Business Administration | 25 | 39,766 | 291 | 54 | 41,830 | 1,194 | 79 | 81,596 | 1,485 |
| States and Political Subdivisions | 4 | 10,674 | 129 | 77 | 130,371 | 2,955 | 81 | 141,045 | 3,084 |
| Corporate Notes | 8 | 20,368 | 136 | 1 | 1,947 | 57 | 9 | 22,315 | 193 |
| **Total Debt Securities** | **62** | **$134,913** | **$1,298** | **204** | **$582,755** | **$11,899** | **266** | **$717,668** | **$13,197** |

| | December 31, 2017 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Less Than 12 Months | | | 12 Months or More | | | Total | | |
| (Dollars in Thousands) | Number of Securities | Fair Value | Unrealized Losses | Number of Securities | Fair Value | Unrealized Losses | Number of Securities | Fair Value | Unrealized Losses |
| U.S. Government Agency Securities | 5 | $119,209 | $ 785 | 9 | $179,456 | $3,444 | 14 | $298,665 | $4,229 |
| Residential Mortgage-Backed Securities | 24 | 51,984 | 545 | — | — | — | 24 | 51,984 | 545 |
| Commercial Mortgage-Backed Securities | 8 | 24,908 | 262 | — | — | — | 8 | 24,908 | 262 |
| Asset Backed Securities | 6 | 13,960 | 13 | — | — | — | 6 | 13,960 | 13 |
| Collateralized Mortgage Obligations | 21 | 59,677 | 759 | — | — | — | 21 | 59,677 | 759 |
| Small Business Administration | 55 | 58,770 | 1,029 | — | — | — | 55 | 58,770 | 1,029 |
| States and Political Subdivisions | 61 | 79,833 | 356 | 10 | 6,766 | 35 | 71 | 86,599 | 391 |
| Corporate Notes | 15 | 76,283 | 46 | 4 | 18,478 | 21 | 19 | 94,761 | 67 |
| **Total Debt Securities** | **195** | **$484,624** | **$3,795** | **23** | **$204,700** | **$3,500** | **218** | **$689,324** | **$7,295** |

Securities are evaluated for other-than-temporary impairment ("OTTI") quarterly and more frequently if economic or market concerns warrant. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, the credit quality of the issuer, and whether the Bank intends to sell the security or may be required to sell the security prior to maturity. The Bank has reviewed all securities for other-than-temporary impairment.

As of December 31 2018, no OTTI has been identified for any investment securities in the Bank's portfolio. The Bank does not believe any individual unrealized loss as of December 31, 2018 represents other-than-temporary impairment, or OTTI. At December 31, 2018 there were 266 securities in an unrealized loss position and at December 31, 2017 there were 218 debt securities in an unrealized loss position. The unrealized losses on debt securities were primarily attributable to changes in interest rates and not related to the credit quality of these securities. All debt securities are determined to be investment grade and are paying principal and interest according to the contractual terms of the security. The Bank generally does not intend to sell and it is not more likely than not that the Bank will be required to sell any of the securities in an unrealized loss position before recovery of their amortized cost.

## NOTE 4 — LOANS AND LOANS HELD-FOR-SALE

The composition of the loan portfolio, net of unearned income, by dollar amount is shown in the table below:

| | December 31, | |
|---|---|---|
| **(Dollars in Thousands)** | **2018** | **2017** |
| **Commercial** | | |
| Commercial Real Estate | $1,381,231 | $1,536,957 |
| Commercial and Industrial | 660,872 | 803,833 |
| Commercial Construction | 238,016 | 118,786 |
| **Total Commercial Loans** | **2,280,119** | **2,459,576** |
| **Consumer** | | |
| Residential Mortgages | 339,307 | 136,895 |
| Other Consumer | 73,058 | 79,980 |
| Consumer Construction | 11,308 | 7,994 |
| **Total Consumer Loans** | **423,673** | **224,869** |
| **Total Portfolio Loans** | **2,703,792** | **2,684,445** |
| Loans Held-for-Sale | 2,559 | 517 |
| **Total Loans** | **$2,706,351** | **$2,684,962** |

We attempt to limit our exposure to credit risk by diversifying our loan portfolio by segment, geography, collateral and industry and actively managing concentrations. When concentrations exist in certain segments, we mitigate this risk by reviewing the relevant economic indicators and internal risk rating trends and through stress testing of the loans in these segments. Total commercial loans represented 84% of total portfolio loans at December 31, 2018 and 92% of total portfolio loans at December 31, 2017. Within our commercial portfolio, the CRE and Commercial Construction portfolios combined comprised $1.6 billion or 71% of total commercial loans and 60% of total portfolio loans at December 31, 2018 and comprised $1.7 billion or 67% of total commercial loans and 62% of total portfolio loans at December 31, 2017.

Loans held-for-sale were $2.6 million and $0.5 million as of December 31, 2018 and December 31, 2017, respectively. These loans are purchased mortgage loans from another financial institution with fully executed contracts with investors. The Bank holds the loans until funded by the investor, typically a two-week period.

### Troubled Debt Restructurings

The following table summarizes the restructured loans as of the dates presented:

| | December 31, 2018 | | | December 31, 2017 | | |
|---|---|---|---|---|---|---|
| **(Dollars in Thousands)** | **Performing TDRs** | **Nonperforming TDRs** | **Total TDRs** | **Performing TDRs** | **Nonperforming TDRs** | **Total TDRs** |
| Real Estate | $114,806 | $46,771 | $161,577 | $121,465 | $41,804 | $163,269 |
| Consumer | — | — | — | — | — | — |
| Commercial | — | — | — | 133,182 | — | 133,182 |
| **Total TDRs** | **$114,806** | **$46,771** | **$161,577** | **$254,647** | **$41,804** | **$296,451** |

In order to maximize the collection of loan balances, the Bank evaluates troubled loan accounts on a case-by-case basis to determine if a loan modification would be appropriate. Loan modifications may be utilized when there is a reasonable chance that an appropriate modification would allow our client to continue servicing the debt. A loan is a troubled debt restructuring ("TDR") if both of the following exist: 1.) the debtor is experiencing financial difficulties, and 2.) a creditor has granted a concession to the debtor that it would not normally grant. Nonaccrual loans that are modified can be placed back on accrual status when both principal and interest are current and it is probable that the Bank will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

The Bank had seven loans modified as TDR's for the twelve months ending December 31, 2018 totaling $137.9 million in post-modified recorded balances. Three TDRs in the amount of $98.3 were real estate loans and one TDR in the amount of $32.3 was a commercial and industrial loan. One TDR in the amount of $57.9 million involved modifying the terms of the note from contractual principal and interest payments to a single pay loan structure with interest and principal due at maturity. The modification was a result of the borrower experiencing financial difficulties and the single pay structure allows the borrower adequate timed to liquidate the collateral and satisfy the Bank's outstanding loan balance. One TDR in the amount of $32.3 million involved the customer offering additional collateral as part of a forbearance agreement to cure a collateral deficiency in exchange for the Bank renewing the loan and extending the maturity, a transaction we would not be enticed to do without additional collateral. Two TDRs totaling $40.4 million involved the borrower offering additional collateral and entering into a forbearance agreement with the Bank which established a formal liquidation plan for the borrower to market and sell the collateral and satisfy the Bank's outstanding loan balance. There were three additional TDRs in the amount of $7.3 million modified during the year ended 2018. Two of the three TDRs were related to one relationship and totaled $7.0 million in post modification balances. The concessions under this first TDR relationship included the installation of a forbearance agreement in which the Bank agreed to lend additional funds on a previously delinquent project, a reduction in the current contractual interest rate and the potential for partial debt forgiveness should the borrowers be able to perform all additional obligations under the restructured loan agreement including a timely liquidation of collateral and principal curtailment. In return, the borrowers granted the Bank a cross-collateralization agreement with other performing loans at the Bank to ensure that an adequate collateral margin is maintained going forward. The modification was a result of the borrower experiencing financial difficulties due to project cost overruns and the newly modified loan terms allow the borrower adequate time to liquidate the underlying collateral. The remaining $0.3 million TDR was related to one existing relationship that was reworked as a TDR in previous quarters. There were no TDR payment defaults during the year ended December 31, 2018 for TDRs with outstanding principal balances at year end 2018. For purposes of this disclosure, a TDR payment default occurs when, within 12 months of the original TDR modification, either a full or partial charge-off occurs or a TDR becomes 90 days or more past due.

The Bank had loans modified as TDR's for the twelve months ending December 31, 2017 totaling $256.7 million in post-modified recorded balances. One TDR of $16.3 million involved a rate reduction to a level that was not commensurate with a market rate on a commercial real estate loan. A portion of the first TDR of $16.3 million that was previously modified in the first three months of 2017 was subsequently moved to other real estate via a deed in lieu of foreclosure, during the second quarter 2017. The balance of the first TDR ($0.9 million) was paid off by the borrower with sales proceeds from the collateral securing the loan during the fourth quarter 2017. Another TDR of $3.4 million involved principal forgiveness in the amount of $4.3 million. The balance of the TDR's that occurred for the twelve months ending December 31, 2017 ($237.0 million) involved the modification of loan terms to allow previously amortized loans to begin making interest only payments due to the borrowers' financial difficulties. There was no principal forgiveness associated with this subset of TDR's.

The remaining loan balances associated with these TDR's that were restructured during the twelve months ended December 31, 2017 was $240.4 million at December 31, 2017. There were no TDR payment defaults during the year ended December 31, 2017 for TDRs with outstanding principal balances at year end 2017. For purposes of this disclosure, a TDR payment default occurs when, within 12 months of the original TDR modification, either a full or partial charge-off occurs or a TDR becomes 90 days or more past due.

At December 31, 2018 and December 31, 2017 the Bank had $46.8 million and $41.8 million in loans, respectively, modified as TDR's in previous years which had experienced a payment default subsequent to the rework date and were classified as nonperforming. During the first quarter of 2018 the Bank foreclosed on $29.9 million in loans that were classified as nonperforming TDR's at December 31, 2017.

The specific reserve portion of the allowance for loan losses on TDRs, if required, is determined by discounting the restructured cash flow at the original effective rate of the loan before modification or is based on the fair value of the collateral less cost to sell, if repayment of the loan is collateral dependent. If the resulting amount is less than the recorded book value, the Bank either establishes a valuation allowance as a component of the allowance for loan losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio. As of December 31, 2018, there were two specific reserves allocated in the amount of $5.2 million. As of December 31, 2017, there were two specific reserves allocated in the amount of $32 thousand.

The following is a summary of nonperforming assets as of the dates presented:

| | December 31, | |
|---|---|---|
| **(Dollars in Thousands)** | **2018** | **2017** |
| **Nonperforming Loans** | | |
| Real Estate | $ 3,289 | $ 51,047 |
| Consumer | 65 | 47 |
| Commercial | 606 | — |
| **Total Nonperforming Loans** | **3,960** | **51,094** |
| **Nonperforming Troubled Debt Restructurings** | | |
| Real Estate | 46,771 | 41,804 |
| Consumer | — | — |
| Commercial | — | — |
| **Total Nonperforming Troubled Debt Restructurings** | **46,771** | **41,804** |
| **Total Nonperforming Loans and Troubled Debt Restructurings** | **50,731** | **92,898** |
| Other Real Estate Owned | 33,681 | 39,793 |
| **Total Nonperforming Assets** | **$84,412** | **$132,691** |
| **Nonperforming Loans to Total Portfolio Loans** | **1.88%** | **3.46%** |
| **Nonperforming Assets to Total Portfolio Loans plus OREO** | **3.08%** | **4.87%** |

Nonperforming assets ("NPAs"), decreased $48.3 million to $84.4 million at December 31, 2018 compared to $132.7 million at December 31, 2017. The decrease was due to a $42.2 million decline in nonperforming loans and a $6.1 million decrease in Other Real Estate Owned ("OREO"). The decrease in nonperforming loans is primarily due to the charge-off of a legacy credit in the amount of $10.1 million in the third quarter of 2018 and nonperforming loans migrating to OREO during the first quarter of 2018. The decrease in OREO is primarily due to the migration of nonperforming loans during the first quarter of 2018, offset by write-downs in the amount of $8.7 million during 2018 and sales of properties with a book value of $28.2 million during 2018. Write-downs include $3.5 million on retail bank offices marketed for sale with a remaining book value of $6.8 million. In addition, retail branch offices marketed for sale were transferred to OREO during 2018 in the amount of $2.2 million.

In the ordinary course of business, directors and their related interests were customers of, and had transactions with the Bank. Loan transactions with directors and officers, principal security holders and associates were made on substantially the same terms as those prevailing at the time for comparable loans to other persons and did not involve more than normal risk of collectability or present other unfavorable features. A summary of these transactions is presented below:

| (Dollars in Thousands) | 2018 | 2017 |
|---|---|---|
| Beginning Balance | $16,990 | $17,459 |
| New Loans | 14,240 | 2,775 |
| Repayments | (8,086) | (3,244) |
| **Balance at End of Year** | **$23,144** | **$16,990** |

Total deposit dollars from executive officers, directors, and their related interests at December 31, 2018 and 2017, respectively, were $3.7 million and $3.5 million.

## NOTE 5 — ALLOWANCE FOR LOAN LOSSES

We maintain an allowance for loan losses ("ALL") at a level determined to be adequate to absorb estimated probable credit losses inherent in the loan portfolio as of the balance sheet date. We develop and document a systematic ALL methodology based on the following portfolio segments: 1). Commercial Real Estate ("CRE"), 2). Commercial & Industrial ("C&I"), 3). Consumer 4). Obligations of States and Political Subdivisions. The following is a discussion of the key risks by portfolio segment that management assesses in preparing the ALL.

CRE loans are secured by commercial purpose real estate, including both owner occupied properties and investment properties, for various purposes such as hotels, strip malls and apartments. Operations of the individual projects as well as global cash flows of the debtors are the primary sources of repayment for these loans. The condition of the local economy is an important indicator of risk, but there are also more specific risks depending on the collateral type as well as the business.

C&I loans are made to operating companies or manufacturers for the purpose of production, operating capacity, accounts receivable, inventory or equipment financing. Cash flow from the operations of the borrower is the primary source of repayment for these loans. The condition of the local economy is an important indicator of risk, but there are also more specific risks depending on the industry of the borrower. Collateral for these types of loans often do not have sufficient value in a distressed or liquidation scenario to satisfy the outstanding debt.

Consumer loans are made to individuals and may be either secured by assets other than 1-4 family residences or unsecured. This segment includes auto loans and unsecured loans and lines. The primary source of repayment for these loans is the income and assets of the borrower. The condition of the local economy, in particular the unemployment rate, is an important indicator of risk for this segment. The value of the collateral, if there is any, is less likely to be a source of repayment due to less certain collateral values.

Obligations of States and Political Subdivision loans are made to local and state municipalities for various purposes including refinancing existing obligations, infrastructure upfit and expansion, or to purchase new equipment. This segment of loans may be secured by general obligations from the municipal authority or revenues generated by infrastructure and equipment financed by the Bank. The primary repayment source for these loans include the tax base of the municipality, specific revenue streams related to the infrastructure financed, and other business operations of the municipal authority. The health and stability of state and local economies directly impacts each municipality's tax basis and are important indicators of risk for this segment. The ability of each municipality to increase taxes and fees to offset debt service requirements give this type of loan a very low risk profile in the continuum of the Bank's loan portfolio.

The following table presents, by portfolio segment, the changes in the allowance for loan losses and the allocation of the allowance for loan losses for the years ended December 31, 2018, 2017, and 2016:

| **(Dollars in Thousands) December 31, 2018** | **Real Estate** | **Consumer & Other Loans** | **Commercial & Industrial** | **Obligations Of States and Political Sub.** | **Total** |
|---|---|---|---|---|---|
| Allowance for Loan Losses: | | | | | |
| Balance: Beginning of Year | $ 33,367 | $ 288 | $1,203 | $460 | $ 35,318 |
| Provision Charged to Expense | 12,564 | 4,900 | (566) | (28) | 16,870 |
| Losses Charged Off | (11,924) | (2,710) | (20) | — | (14,654) |
| Recoveries | 1,415 | 250 | — | — | 1,665 |
| **Balance, End of Year** | **$ 35,422** | **$ 2,728** | **$ 617** | **$432** | **$ 39,199** |

| **(Dollars in Thousands) December 31, 2017** | **Real Estate** | **Consumer & Other Loans** | **Commercial & Industrial** | **Obligations Of States and Political Sub.** | **Total** |
|---|---|---|---|---|---|
| Allowance for Loan Losses: | | | | | |
| Balance: Beginning of Year | $ 32,476 | $ 82 | $1,480 | $462 | $ 34,500 |
| Provision Charged to Expense | 42,984 | 461 | (246) | (2) | 43,197 |
| Losses Charged Off | (42,813) | (465) | (31) | — | (43,309) |
| Recoveries | 720 | 210 | — | — | 930 |
| **Balance, End of Year** | **$ 33,367** | **$ 288** | **$1,203** | **$460** | **$ 35,318** |

| **(Dollars in Thousands) December 31, 2016** | **Real Estate** | **Consumer & Other Loans** | **Commercial & Industrial** | **Obligations Of States and Political Sub.** | **Total** |
|---|---|---|---|---|---|
| Allowance for Loan Losses: | | | | | |
| Balance: Beginning of Year | $16,584 | $ 6,098 | $ 4,308 | $ — | $ 26,990 |
| Provision Charged to Expense | 25,448 | (5,616) | (2,577) | 462 | 17,717 |
| Losses Charged Off | (9,687) | (510) | (257) | — | (10,454) |
| Recoveries | 131 | 110 | 6 | — | 247 |
| **Balance, End of Year** | **$32,476** | **$ 82** | **$ 1,480** | **$462** | **$ 34,500** |

We continually monitor the commercial loan portfolio through an internal risk rating system. Loan risk ratings are assigned based upon the creditworthiness of the borrower and are reviewed on an ongoing basis according to our internal policies. Loans within the pass rating generally have a lower risk of loss than loans risk rated as special mention and substandard.

Our risk ratings are consistent with regulatory guidance and are as follows:

**Pass** — The loan is currently performing and is of high quality.

**Special Mention** — Assets with potential weaknesses that warrant management's close attention and if left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institutions credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

**Substandard** — Assets that are inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Assets so classified have a well-defined weakness, or weaknesses that jeopardize the liquidation of the debt. Such assets are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful** — Assets with all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions, and values, highly questionable and improbable.

**Loss** — Assets considered of such little value that its continuance on the books is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

The following tables represent credit exposures by internally assigned grades as of December 31, 2018 and 2017:

| (Dollars in Thousands) December 31, 2018 | Real Estate | Consumers & Other Loans | Commercial & Industrial | Obligations Of States and Political Sub. | Total |
|---|---|---|---|---|---|
| Pass | $1,593,909 | $72,909 | $133,004 | $432,402 | $2,232,224 |
| Special Mention | 10,765 | 45 | 70 | — | 10,880 |
| Substandard | 365,188 | 104 | 95,396 | — | 460,688 |
| Doubtful | — | — | — | — | — |
| Loss | — | — | — | — | — |
| **Total Loans** | **$1,969,862** | **$73,058** | **$228,470** | **$432,402** | **$2,703,792** |
| Performing Loans | $1,919,802 | $72,993 | $227,864 | $432,402 | $2,653,061 |
| Non-Accrual Loans | 50,060 | 65 | 606 | — | 50,731 |
| **Total Loans** | **$1,969,862** | **$73,058** | **$228,470** | **$432,402** | **$2,703,792** |

| (Dollars in Thousands) December 31, 2017 | Real Estate | Consumers & Other Loans | Commercial & Industrial | Obligations Of States and Political Sub. | Total |
|---|---|---|---|---|---|
| Pass | $1,299,705 | $73,921 | $ 24,180 | $470,569 | $1,868,375 |
| Special Mention | 29,989 | 6,000 | 61,019 | — | 97,008 |
| Substandard | 470,938 | 59 | 248,065 | — | 719,062 |
| Doubtful | — | — | — | — | — |
| Loss | — | — | — | — | — |
| **Total Loans** | **$1,800,632** | **$79,980** | **$333,264** | **$470,569** | **$2,684,445** |
| Performing Loans | $1,707,736 | $79,978 | $333,264 | $470,569 | $2,591,547 |
| Non-Accrual Loans | 92,896 | 2 | — | — | 92,898 |
| **Total Loans** | **$1,800,632** | **$79,980** | **$333,264** | **$470,569** | **$2,684,445** |

The Bank individually evaluates all substandard and nonaccrual commercial loans greater than $0.5 million for impairment. A loan is impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Our methodology for evaluating whether a loan is impaired includes risk-rating credits on an individual basis and consideration of the borrower's overall financial condition, payment history and available cash resources. In measuring impairment, the Bank primarily utilizes fair market value of the collateral; however, the Bank also uses the discounted cash flow method for loans that are not deemed to be collateral dependent at the time of impairment. Troubled debt restructurings, or ("TDRs"), whether on accrual or nonaccrual status, are also classified as impaired loans. TDRs are loans where the Bank, for economic or legal reasons related to a borrower's financial difficulties, grant a concession to the borrower that the Bank would not otherwise grant. The Bank strives to identify borrowers in financial difficulty early and work with them to modify the terms before their loan reaches nonaccrual status. These modified terms generally include extensions of maturity dates at a stated interest rate lower than the current market rate for a new loan with similar risk characteristics, reductions in contractual interest rates or principal deferment. While unusual, there may be instances of principal forgiveness. These modifications are generally for longer term periods that would not be considered insignificant.

The following table presents the balances in the ALL and the recorded investment in the loan balances based on impairment method as of December 31, 2018 and 2017.

| (Dollars in Thousands) December 31, 2018 | Real Estate | Consumer & Other Loans | Commercial & Industrial | Obligations Of States and Political Sub. | Total |
|---|---|---|---|---|---|
| **Allowance for Loan Losses:** | | | | | |
| Individually Evaluated for Impairment | $ 5,199 | $ — | $ — | $ — | $ 5,199 |
| Collectively Evaluated for Impairment | 30,223 | 2,728 | 617 | 432 | 34,000 |
| **Total Loans:** | | | | | |
| Individually Evaluated for Impairment | $ 161,577 | $ — | $ — | $ — | $ 161,577 |
| Collectively Evaluated for Impairment | 1,808,285 | 73,058 | 228,470 | 432,402 | 2,542,215 |

| (Dollars in Thousands) December 31, 2017 | Real Estate | Consumer & Other Loans | Commercial & Industrial | Obligations Of States and Political Sub. | Total |
|---|---|---|---|---|---|
| **Allowance for Loan Losses:** | | | | | |
| Individually Evaluated for Impairment | $ 32 | $ — | $ — | $ — | $ 32 |
| Collectively Evaluated for Impairment | 33,335 | 288 | 1,203 | 460 | 35,286 |
| **Total Loans:** | | | | | |
| Individually Evaluated for Impairment | $ 230,875 | $ 21 | $215,802 | $ — | $ 446,698 |
| Collectively Evaluated for Impairment | 1,569,757 | 79,978 | 117,462 | 470,569 | 2,237,766 |

The recorded investment in loans excludes accrued interest receivable and loan origination fees.

The following table includes the recorded investment and unpaid principal balance for impaired loans at December 31, 2018 and 2017:

| (Dollars in Thousands) December 31, 2018 | Unpaid Principal Balance | Recorded Balance | Specific Allowance |
|---|---|---|---|
| **Loans without a Specific Valuation Allowance** | | | |
| Real Estate | $131,198 | $131,198 | $ — |
| Consumer | — | — | — |
| Commercial and Industrial | — | — | — |
| Obligations of States and Political Subs | — | — | — |
| **Loans with a specific valuation allowance** | | | |
| Real Estate | 30,379 | 30,379 | 5,199 |
| Consumer | — | — | — |
| Commercial and Industrial | — | — | — |
| Obligations of States and Political Subs | — | — | — |
| **Total by Category** | | | |
| Real Estate | 161,577 | 161,577 | 5,199 |
| Consumer | — | — | — |
| Commercial and Industrial | — | — | — |
| Obligations of States and Political Subs | — | — | — |
| **Total Impaired Loans** | **$161,577** | **$161,577** | **$5,199** |

| (Dollars in Thousands) December 31, 2017 | Unpaid Principal Balance | Recorded Balance | Specific Allowance |
|---|---|---|---|
| **Loans without a Specific Valuation Allowance** | | | |
| Real Estate | $229,894 | $229,894 | $— |
| Consumer | 21 | 21 | — |
| Commercial and Industrial | 215,802 | 215,802 | — |
| Obligations of States and Political Subs | — | — | — |
| **Loans with a specific valuation allowance** | | | |
| Real Estate | 981 | 981 | 32 |
| Consumer | — | — | — |
| Commercial and Industrial | — | — | — |
| Obligations of States and Political Subs | — | — | — |
| **Total by Category** | | | |
| Real Estate | 230,875 | 230,875 | 32 |
| Consumer | 21 | 21 | — |
| Commercial and Industrial | 215,802 | 215,802 | — |
| Obligations of States and Political Subs | — | — | — |
| **Total Impaired Loans** | **$446,698** | **$446,698** | **$32** |

The following table summarizes investments in loans considered to be impaired and related information on those impaired loans for the year presented:

| **(Dollars in Thousands) December 31, 2018** | **Average Investment in Impaired Loans** | **Estimated Interest Income Recognized** |
|---|---|---|
| **Loans without a Specific Valuation Allowance** | | |
| Real Estate | $128,694 | $3,946 |
| Consumer | — | — |
| Commercial and Industrial | 187,978 | — |
| Obligations of States and Political Subs | — | — |
| **Loans with a specific valuation allowance** | | |
| Real Estate | 23,126 | 20 |
| Consumer | — | — |
| Commercial and Industrial | — | — |
| Obligations of States and Political Subs | — | — |
| **Total by Category** | | |
| Real Estate | 151,820 | 3,966 |
| Consumer | — | — |
| Commercial and Industrial | 187,978 | — |
| Obligations of States and Political Subs | — | — |
| **Total Impaired Loans** | **$339,798** | **$3,966** |

| **(Dollars in Thousands) December 31, 2017** | **Average Investment in Impaired Loans** | **Estimated Interest Income Recognized** |
|---|---|---|
| **Loans without a Specific Valuation Allowance** | | |
| Real Estate | $252,714 | $ 6,660 |
| Consumer | 64 | — |
| Commercial and Industrial | 301,649 | 14,932 |
| Obligations of States and Political Subs | — | — |
| **Loans with a specific valuation allowance** | | |
| Real Estate | 879 | 45 |
| Consumer | — | — |
| Commercial and Industrial | — | — |
| Obligations of States and Political Subs | — | — |
| **Total by Category** | | |
| Real Estate | 253,593 | 6,705 |
| Consumer | 64 | — |
| Commercial and Industrial | 301,649 | 14,932 |
| Obligations of States and Political Subs | — | — |
| **Total Impaired Loans** | **$555,306** | **$21,637** |

Cash basis interest income recognized materially agrees with interest income recognized for the years ended December 31, 2018, 2017, and 2016.

### Age Analysis of Past-Due Loans by Class

The following table includes an aging analysis of the recorded investment of past-due loans as of December 31, 2018 and 2017. Also included are loans that are 90 days or more past due as to interest and principal and still accruing because they are 1) well-secured and in the process of collection, or 2) real estate loans or loans exempt under regulatory rules from being classified as non-accrual.

| (Dollars in Thousands) December 31, 2018 | Loans 30 – 59 Days Past Due | Loans 60 – 89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due | Current Loans | Non-Accrual Loans | Total Loans | Accruing Loans More Than 90 Days Past Due |
|---|---|---|---|---|---|---|---|---|
| Real Estate Loans | $ 678 | $5,368 | $— | $6,046 | $1,913,756 | $50,060 | $1,969,862 | $— |
| Consumer Loans | 1,053 | 457 | — | 1,510 | 71,483 | 65 | 73,058 | — |
| C & I Loans | 39 | 23 | — | 62 | 227,802 | 606 | 228,470 | — |
| States and Political Sub. | — | — | — | — | 432,402 | — | 432,402 | — |
| **Total** | **$1,770** | **$5,848** | **$—** | **$7,618** | **$2,645,443** | **$50,731** | **$2,703,792** | **$—** |

| (Dollars in Thousands) December 31, 2017 | Loans 30 – 59 Days Past Due | Loans 60 – 89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due | Current Loans | Non-Accrual Loans | Total Loans | Accruing Loans More Than 90 Days Past Due |
|---|---|---|---|---|---|---|---|---|
| Real Estate Loans | $5,288 | $155 | $493 | $5,936 | $1,701,800 | $92,896 | $1,800,632 | $493 |
| Consumer Loans | 315 | 77 | 59 | 451 | 79,527 | 2 | 79,980 | 59 |
| C & I Loans | 155 | 6 | 4 | 165 | 333,099 | — | 333,264 | 4 |
| States and Political Sub. | — | — | — | — | 470,569 | — | 470,569 | — |
| **Total** | **$5,758** | **$238** | **$556** | **$6,552** | **$2,584,995** | **$92,898** | **$2,684,445** | **$556** |

As of December 31, 2018 or 2017, there were no nonaccrual or past due loans related to loans held-for-sale.

## NOTE 6 — FAIR VALUE MEASUREMENTS

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. We use various valuation techniques to determine fair value, including market, income and cost approaches. There are three levels of inputs that may be used to measure fair values:

**Level 1:** Quoted prices (unadjusted) for identical assets or liabilities in active markets that an entity has the ability to access as of the measurement date, or observable inputs.

**Level 2:** Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

**Level 3:** Significant unobservable inputs that reflect an entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. When that occurs, we classify the fair value hierarchy on the lowest level of input that is significant to the fair value measurement. We used the following methods and significant assumptions to estimate fair value:

**Securities:** The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges, if available. This valuation method is classified as Level 1 in the fair value hierarchy. For securities where quoted prices are not available, fair values are calculated on market prices of similar securities, or 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. Matrix pricing relies on the securities' relationship to similarly traded securities, benchmark curves, and the benchmarking of like securities. Matrix pricing utilizes observable market inputs such as benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, reference data, and industry and economic events. In instances where broker quotes are used, these quotes are obtained from market makers or broker-dealers recognized to be market participants. This valuation method is classified as Level 2 in the fair value hierarchy. For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators.

**Impaired Loans:** An impaired loan is evaluated at the time the loan is identified as impaired and is recorded at fair value less costs to sell. Fair value is measured based on the value of the collateral securing the loan and is classified as Level 3 in the fair value hierarchy. Fair value is determined using several methods. Generally, the fair value of real estate is determined based on appraisals by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach.

Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. These routine adjustments are made to adjust the value of a specific property relative to comparable properties for variations in qualities such as location, size, and income production capacity relative to the subject property of the appraisal. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

Impaired loans are evaluated quarterly for additional impairment. We obtain updated appraisals on properties securing our loans when circumstances are warranted such as at the time of renewal or when market conditions have significantly changed. This determination is made on a property-by-property basis in light of circumstances in the broader economic climate and our assessment of deterioration of real estate values in the market in which the property is located. The first stage of our assessment involves management's inspection of the property in question. Management also engages in conversations with local real estate professionals and market participants to determine the likely marketing time and value range for the property. The second stage involves an assessment of current trends in the regional market. After thorough consideration of these factors, management will either internally evaluate fair value or order a new appraisal.

**Other Real Estate Owned ("OREO"):** OREO assets are evaluated at the time of acquisition, and are recorded at fair value as determined by an appraisal or evaluation, less costs to sell. After acquisition, most OREO assets are revalued every twelve months, or more frequently when deemed necessary by management based upon changes in market, or collateral, conditions. For smaller OREO assets with existing carrying values less than $0.5 million, management may elect to revalue the assets, at minimum, once every twenty-four months based on the size of the exposure. At December 31, 2018 Carter Bank's OREO assets were in compliance with the Bank's OREO policy as set forth above, and substantially all of the assets were listed for sale with credible third party real estate brokers.

Financial assets measured at fair value on a recurring basis at December 31, 2018 are summarized below:

**Available-for-Sale Securities**

| | Fair Value at December 31, 2018 | | | |
|---|---|---|---|---|
| (Dollars in Thousands) | Carrying Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| U.S. Government Agency Securities | $270,388 | $— | $270,388 | $— |
| Residential Mortgage-Backed Securities | 70,871 | — | 70,871 | — |
| Commercial Mortgage-Backed Securities | 21,792 | — | 21,792 | — |
| Asset Backed Securities | 58,861 | — | 58,861 | — |
| Collateralized Mortgage Obligations | 76,819 | — | 76,819 | — |
| Small Business Administration | 89,238 | — | 89,238 | — |
| States and Political Subdivisions | 167,474 | — | 167,474 | — |
| Corporate Notes | 27,315 | — | 27,315 | — |
| **Total** | **$782,758** | **$—** | **$782,758** | **$—** |

Financial assets measured at fair value on a recurring basis at December 31, 2017 are summarized below:

**Available-for-Sale Securities**

| | Fair Value at December 31, 2017 | | | |
|---|---|---|---|---|
| (Dollars in Thousands) | Carrying Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| U.S. Government Agency Securities | $298,665 | $— | $298,665 | $— |
| Residential Mortgage-Backed Securities | 60,380 | — | 60,380 | — |
| Commercial Mortgage-Backed Securities | 24,908 | — | 24,908 | — |
| Asset Backed Securities | 16,867 | — | 16,867 | — |
| Collateralized Mortgage Obligations | 61,594 | — | 61,594 | — |
| Small Business Administration | 68,260 | — | 68,260 | — |
| States and Political Subdivisions | 306,963 | — | 306,963 | — |
| Corporate Notes | 109,564 | — | 109,564 | — |
| **Total** | **$947,201** | **$—** | **$947,201** | **$—** |

There were no transfers between Level 1 and Level 2 during 2018 or 2017.

Financial assets measured at fair value on a non-recurring basis are summarized below:

| (Dollars in Thousands) December 31, 2018 | Level 1 | Level 2 | Level 3 | Fair Value |
|---|---|---|---|---|
| OREO | $— | $— | $33,681 | $33,681 |
| Impaired Loans | $— | $— | $25,180 | $25,180 |
| **December 31, 2017** | **Level 1** | | | |
| OREO | $— | $— | $39,793 | $39,793 |
| Impaired Loans | $— | $— | $ 949 | $ 949 |

Impaired loans had a carrying amount of $25.2 million at December 31, 2018 with a valuation allowance of $5.2 million, resulting in a $5.2 million increase in provision for loan losses for the year ended December 31, 2018. Impaired loans had a carrying amount of $949 thousand at December 31, 2017 with a valuation allowance of $32 thousand, resulting in a $0.2 million reduction in provision for loan losses for the year ended December 31, 2017.

OREO, which is measured at the lower of carrying or fair value less costs to sell, had a net carrying amount of $33.7 million as of December 31, 2018, compared with $39.8 million at December 31, 2017, respectively. Write-downs of $8.7 million were recorded on OREO for the year ended December 31, 2018 compared to $10.0 million for the year ended December 31, 2017, respectively.

The following table summarizes the Bank's assets that were measured at fair value on a nonrecurring basis as of December 31, 2018 and 2017:

| (Dollars in Thousands) December 31, 2018 Assets | Fair Value | Valuation Technique | Unobservable Inputs | Weighted Range | Average |
|---|---|---|---|---|---|
| Impaired Loans | $24,801 | Discounted Appraisals | Management's Disc. & Selling Costs | 0.0 – 100.0% | 25.5% |
| Impaired Loans | $ 379 | Net Present Value | Discount Rate | 5.5% | 5.5% |
| **Total Impaired Loans** | **$25,180** | | | | |
| Other Real Estate Owned | $24,644 | Appraisals | Selling Costs | 3.0 – 10.0% | 6.2% |
| Other Real Estate Owned | 2,282 | Discounted Cash Flow | Discount Rate | 6.3% | 6.3% |
| Other Real Estate Owned | 1,796 | Internal Valuations | Selling Costs | 5.0% | 5.0% |
| Other Real Estate Owned | 4,959 | Discounted Internal Valuations | Management's Disc. & Selling Costs | 16.9 – 62.1% | 44.4% |
| **Total Other Real Estate Owned** | **$33,681** | | | | |

| (Dollars in Thousands) December 31, 2017 Assets | Fair Value | Valuation Technique | Unobservable Inputs | Weighted Range | Average |
|---|---|---|---|---|---|
| Impaired Loans | $ 949 | Net Present Value | Discount Rate | 5.5 – 6.5% | 5.5% |
| **Total Impaired Loans** | **$ 949** | | | | |
| Other Real Estate Owned | $20,491 | Discounted Appraisals | Discount & Selling Costs | 20.0 – 21.2% | 21.0% |
| Other Real Estate Owned | $19,302 | Appraisals | Selling Costs | 0.0 – 10.0% | 6.0% |
| **Total Other Real Estate Owned** | **$39,793** | | | | |

The carrying values and estimated fair values of the Bank's financial instruments at December 31, 2018 and December 31, 2017 are presented in the following tables. Fair values for December 31, 2018 are estimated under the exit price notion in accordance with the prospective adoption of ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities." Fair values for December 31, 2017 are estimated under the guidance in effect for that period which did not require use of the exit price notion.

Carrying amount and estimated fair values of financial instruments were as follows for the periods indicated:

| (Dollars in Thousands) | Fair Value Measurements at December 31, 2018 | | | | |
|---|---|---|---|---|---|
| | Carrying Value | Level 1 | Level 2 | Level 3 | Total |
| **Financial Assets:** | | | | | |
| Cash and Cash Equivalents | $ 293,563 | $ 47,413 | $ 246,150 | $ — | $ 293,563 |
| Securities Available-for-Sale | 782,758 | — | 782,758 | — | 782,758 |
| Loans Held-for-Sale | 2,559 | — | — | 2,559 | 2,559 |
| Portfolio Loans | 2,703,792 | — | — | 2,585,579 | 2,585,579 |
| Bank Owned Life Insurance | 51,161 | — | 51,161 | — | 51,161 |
| Accrued Interest Receivable | 18,740 | — | 4,623 | 14,117 | 18,740 |
| **Financial Liabilities:** | | | | | |
| Deposits | $3,591,181 | $524,614 | $3,045,276 | $ — | $3,569,890 |
| Accrued Interest Payable | 2,398 | — | 2,398 | — | 2,398 |

| (Dollars in Thousands) | Fair Value Measurements at December 31, 2017 | | | | |
|---|---|---|---|---|---|
| | Carrying Value | Level 1 | Level 2 | Level 3 | Total |
| **Financial Assets:** | | | | | |
| Cash and Cash Equivalents | $ 268,613 | $ 58,533 | $ 210,080 | $ — | $ 268,613 |
| Securities Available-for-Sale | 947,201 | — | 947,201 | — | 947,201 |
| Loans Held-for-Sale | 517 | — | — | 517 | 517 |
| Portfolio Loans | 2,684,445 | — | — | 2,667,737 | 2,667,737 |
| Accrued Interest Receivable | 21,271 | — | 6,026 | 15,245 | 21,271 |
| **Financial Liabilities:** | | | | | |
| Deposits | $3,669,615 | $530,242 | $3,136,640 | $ — | $3,666,882 |
| Accrued Interest Payable | 2,202 | — | 2,202 | — | 2,202 |

## NOTE 7 — PREMISES AND EQUIPMENT

Premises and equipment are stated at cost less accumulated depreciation as follows:

| (Dollars in Thousands) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Bank Premises (including land of $29,729 on December 31, 2018 and $29,960 on December 31, 2017) | $ 87,458 | $ 86,196 |
| Furniture and Equipment | 25,934 | 15,915 |
| Leasehold Improvements | 586 | 658 |
| | **113,978** | **102,769** |
| Accumulated Depreciation | (28,137) | (25,496) |
| **Total** | **$ 85,841** | **$ 77,273** |

The Bank marketed for sale 38 retail branch locations during the fourth quarter of 2017. The real estate was valued based on recent comparative market values received from a real estate broker at that time and was subsequently revalued during the fourth quarter of 2018. Write-downs in the amount of $3.5 million and $5.3 million were recognized during the fourth quarters of 2018 and 2017, respectively. The net remaining carrying value of $6.8 million is classified as held-for-sale in other real estate owned in the consolidated balance sheet as of December 31, 2018. The disposition of the properties is expected to be completed during 2019.

The Bank leases offices from non-related parties under various terms. Rental expense for these leases was $211 thousand in 2018, $142 thousand in 2017, and $141 thousand for 2016.

The Bank currently leases 4 offices under operating leases. The lease for our Lexington office has already been extended into its last renewal period and expires November 1, 2020. The lease for our Amherst office expired September 30, 2018, but was renewed effective October 1, 2018 for a period of two years which ends on September 30, 2020. The Bank also leases its Waynesboro office, whose original term expired July 31, 2007. The lease provides an option to extend for three additional six-year terms. The lease is currently in its second renewal period. In addition, the Bank also leases a loan production office in Roanoke, whose initial three year term commenced on November 1, 2018. At the end of the initial term on October 31, 2021, the Bank has the option to extend for three additional five-year terms. The Bank formerly leased its Weyers Cave office, whose original term expired August 31, 2018. The Bank chose not to renew its lease and closed its location.

Future minimum rental payments under these leases are as follows:

Years Ended December 31:

| **(Dollars in Thousands)** | |
|---|---|
| 2019 | $ 188 |
| 2020 | 171 |
| 2021 | 97 |
| 2022 | 99 |
| 2023 | 101 |
| Thereafter | 981 |
| **Total Minimum Lease Payments** | **$1,637** |

## NOTE 8 — OTHER REAL ESTATE OWNED

The following table presents the other real estate owned activity as of the dates presented:

| (Dollars in Thousands) | Year Ended December 31, 2018 | 2017 | 2016 |
|---|---|---|---|
| Beginning Balance | $ 39,793 | $23,558 | $43,422 |
| Loans Transferred to Other Real Estate Owned | 28,212 | 17,912 | 610 |
| Loans to Finance the Sale of Other Real Estate Owned | (893) | (7,347) | (7,771) |
| Transfer of Closed Retail Offices to Other Real Estate Owned | 2,177 | 19,009 | — |
| Capitalized Expenditures | 1,272 | 372 | 168 |
| Direct Write-Downs | (8,714) | (9,967) | (8,411) |
| Sales of Other Real Estate Owned | (28,166) | (3,744) | (4,460) |
| **End of Year** | **$ 33,681** | **$39,793** | **$23,558** |

At December 31, 2018, and 2017, the balance of real estate owned includes $26.9 million and $26.1 million, respectively of foreclosed properties recorded as a result of obtaining physical possession of the asset. At December 31, 2018 and 2017, the recorded investment of foreclosed residential real estate was $267 thousand and $315 thousand, respectively. At December 31, 2018 and 2017, the recorded investment of consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceeds are in process is $296 thousand and $384 thousand, respectively.

Income and expenses applicable to foreclosed assets include the following:

| (Dollars in Thousands) | Year Ended December 31, 2018 | 2017 | 2016 |
|---|---|---|---|
| Provision for Losses | $8,714 | $ 9,967 | $ 8,411 |
| Operating Expenses, net of rental income | (553) | 343 | 184 |
| Net (Gain) Loss on Sales | (513) | (58) | 2,336 |
| **Other Real Estate Owned Expense** | **$7,648** | **$10,252** | **$10,931** |

## NOTE 9 — GOODWILL AND OTHER INTANGIBLES

In the fourth quarter of 2018, the Bank's reporting unit had positive equity and the Bank elected to perform a qualitative assessment to determine if it was more likely than not that the fair value of the reporting unit exceeded its carrying value, including goodwill. The qualitative assessment indicated that it was more likely than not that the carrying value of the reporting unit exceeded its fair value. Therefore, the Bank proceeded to complete the two-step impairment test.

Step 1 includes the determination of the carrying value of the reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, we are required to perform a second step to the impairment test.

Our annual impairment analysis as of October 1, 2018, indicated that the Step 2 analysis was necessary. Step 2 of the goodwill impairment test is performed to measure the impairment loss. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess. After performing Step 2 it was determined that the implied value of goodwill was greater than the carrying amount and therefore no impairment was recorded.

Core deposit intangibles resulting from the acquisitions were $61.8 million and were fully amortized in 2015.

The following table presents goodwill as of the dates presented:

| (Dollars in Thousands) | 2018 | 2017 |
|---|---|---|
| Balance as of January 1 | $59,762 | $59,762 |
| Change due to Sale of Subsidiary | (1,036) | — |
| Impairment Losses | — | — |
| **Balance as of December 31** | **$58,726** | **$59,762** |

The following table presents other intangibles as of the dates presented:

| (Dollars in Thousands) | 2018 | 2017 |
|---|---|---|
| Balance as of January 1 | $ 122 | $ 33 |
| Change due to Sale of Subsidiary | (122) | 89 |
| Impairment losses | — | — |
| **Balance as of December 31** | **$ —** | **$122** |

## NOTE 10 — DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The following table indicated the amounts representing the value of derivative assets and derivative liabilities at December 31:

| | Fair Values of Derivative Instruments Asset Derivatives (Included in Other Assets) | | | |
|---|---|---|---|---|
| (Dollars in Thousands) | | | 2018 | 2017 |
| | Number of Transactions | Notional Amount | Fair Value | Fair Value |
| **Derivatives not Designated as Hedging Instruments** | | | | |
| Interest Rate Lock Commitments – Mortgage Loans | 5 | $ 383 | $ 1 | $— |
| Interest Rate Swap Contracts – Commercial Loans | 2 | 20,180 | 281 | — |
| **Total Derivatives not Designated as Hedging Instruments** | | | **$282** | **$—** |

| | Fair Values of Derivative Instruments Liability Derivatives (Included in Other Liabilities) | | | |
|---|---|---|---|---|
| (Dollars in Thousands) | | | 2018 | 2017 |
| | Number of Transactions | Notional Amount | Fair Value | Fair Value |
| **Derivatives not Designated as Hedging Instruments** | | | | |
| Forward Sale Contracts – Mortgage Loans | 5 | $ 383 | $ 1 | $— |
| Interest Rate Swap Contracts – Commercial Loans | 2 | 20,180 | 308 | — |
| **Total Derivatives not Designated as Hedging Instruments** | | | **$309** | **$—** |

The following table indicates the gain or loss recognized in income on derivatives for the years ended December 31:

| (Dollars in Thousands) | 2018 | 2017 |
|---|---|---|
| **Derivatives not Designated as Hedging Instruments** | | |
| Interest Rate Lock Commitments – Mortgage Loans | $ 1 | $— |
| Forward Sale Contracts — Mortgage Loans | (1) | — |
| Interest Rate Swap Contracts — Commercial Loans | (27) | — |
| **Total Derivative Loss** | **$(27)** | **$—** |

Presenting offsetting derivatives that are subject to legally enforceable netting arrangements with the same party is permitted. For example, we may have a derivative asset and a derivative liability with the same counterparty to a swap transaction and are permitted to offset the asset position and the liability position resulting in a net presentation.

The following table indicates the gross amounts of commercial loan swap derivative assets and derivative liabilities, the amounts offset and the carrying values in the Consolidated Balance Sheets at December 31:

| | Asset Derivatives (Included in Other Assets) | | Liability Derivatives (Included in Other Liabilities) | |
|---|---|---|---|---|
| (Dollars in Thousands) | 2018 | 2017 | 2018 | 2017 |
| **Derivatives not Designated as Hedging Instruments** | | | | |
| Gross Amounts Recognized | $281 | $— | $ 308 | $— |
| Gross Amounts Offset | — | — | — | — |
| Net Amounts Presented in the Consolidated Balance Sheets | 281 | — | 308 | — |
| Gross Amounts Not Offset (1) | — | — | (260) | — |
| **Net Amount** | **$281** | **$—** | **$ 48** | **$—** |

*(1) Amounts represent collateral posted for the periods presented.*

## NOTE 11 — DEPOSITS

The following table presents the composition of deposits at December 31:

| (Dollars in Thousands) | 2018 | 2017 | $ Change | % Change |
|---|---|---|---|---|
| Noninterest-Bearing Demand | $ 524,614 | $ 530,242 | $ (5,628) | (1.1)% |
| Interest-Bearing Demand | 277,174 | 260,979 | 16,195 | 6.2% |
| Money Market | 80,835 | 102,686 | (21,851) | (21.3)% |
| Savings | 610,757 | 721,459 | (110,702) | (15.3)% |
| Certificates of Deposits | 2,097,801 | 2,054,249 | 43,552 | 2.1% |
| **Total** | **$3,591,181** | **$3,669,615** | **$ (78,434)** | **(2.1)%** |

All deposit accounts are insured by the FDIC up to the maximum amount allowed by law. The Dodd-Frank Act, signed into law on July 21, 2010, makes permanent the $250,000 limit for federal deposit insurance and the coverage limit applies per depositor, per insured depository institution for each account ownership. Time deposits that meet or exceed the FDIC Insurance limit of $250,000 at year-end 2018 and 2017 were $203.5 million and $188.2 million, respectively.

Certificates of Deposit maturing as of December 31:

| (Dollars in Thousands) | 2018 |
|---|---|
| 2019 | $ 751,242 |
| 2020 | 672,528 |
| 2021 | 231,714 |
| 2022 | 164,269 |
| 2023 | 275,951 |
| Thereafter | 2,097 |
| **TOTAL** | **$2,097,801** |

Overdrafts reclassified to loans at December 31, 2018 and 2017 were $0.2 million and $2.1 million, respectively.

## NOTE 12 — EMPLOYEE BENEFIT PLANS

The Bank has adopted an integrated profit sharing plan. Employees participate in the profit sharing plan following completion of six (6) months of service and upon reaching the age of twenty years and six months as of January 1. Vesting is based on years of service to the Bank, with a year being any year an employee works a minimum of 1,000 hours. The following table details the vesting schedule based on years of service for participants:

| | |
|---|---|
| 1 Year of Service | 0% Vested |
| 2 Years of Service | 20% Vested |
| 3 Years of Service | 40% Vested |
| 4 Years of Service | 60% Vested |
| 5 Years of Service | 100% Vested |

Any participant who has reached the age of 62 is fully vested regardless of length of service. Each participant in the plan (who has not reached age 62) becomes 100% vested after five (5) years of service. The contribution to the plan is determined each year by the Board of Directors and thus may fluctuate in amount from year to year. The contribution by the Bank, which includes contributions to the non-qualified plan discussed below, was $1.7 million in 2018, zero in 2017, and $2.4 million in 2016. These amounts are included in salaries and employee benefits in the Consolidated Statements of Income.

The Bank's former Chairman and Chief Executive Officer has participated in the qualified profit sharing plan of the Bank beginning January 1, 2007 until April 7, 2017. He also participated in the non-qualified plan for highly paid executives whose contribution to the qualified plan is limited due to IRS regulations. The contribution to the nonqualified plan is the difference between the amount that would have been allocated to him, in the qualified plan, if there were no IRS limitation, and the actual amount allocated in the plan after applying the IRS limitation. The contributions to these plans on the Bank's former Chairman and Chief Executive Officer's behalf were zero in 2018 and 2017, and $81 thousand for 2016.

Carter Bank & Trust (the "Bank") entered into a Non-Qualified Profit Sharing Plan originally on December 30, 1996, which was subsequently amended and restated effective December 20, 2007. The purpose of the Plan was to provide additional benefits to be paid to the Executive upon the occurrence of a Distributable Event, which is either termination or death. The Board of the Bank approved the amended plan on December 20, 2007. Since inception of the Plan, the Bank's former Chairman and Chief Executive Officer was the only Executive who participated in the Plan. In April 2017, a distributable event occurred, in which distributions will occur over 45 quarterly payments. The value of the plan was $1.2 million as of December 31, 2018, and was solely comprised of cash. The quarterly distributions began on January 1, 2018 and will continue to be paid out in equal quarterly installments approximating $30 thousand.

## NOTE 13 — INCENTIVE AND RESTRICTED STOCK PLAN

The Board of Directors of Bank adopted the Carter Bank & Trust 2018 Omnibus Equity Incentive Plan (the "Plan") on March 29, 2018 based on the recommendation of the Governance and Compensation Committee (the "Committee"). The Plan became effective on June 27, 2018 and reserves 2,000,000 shares of common stock for issuance. The Plan provides for the grant to key employees and non-employee directors of awards that may include one or more of the following: stock options, restricted stock, restricted stock units, stock appreciation rights, stock awards, performance units and performance cash awards (collectively, the "awards"). Subject to accelerated vesting under certain circumstances, the Plan requires a minimum vesting period of one year for awards subject to time-based conditions and a minimum performance period of one year for awards subject to achievement or satisfaction of performance goals. These minimums are applicable to awards other than those granted as part of a retainer for the service of non-employee directors. The Committee will set the vesting period on the awards. No awards may be granted under the Plan more than ten years from the effective date of the Plan.

### Restricted Stock

The Bank periodically issues restricted stock to non-employee directors, executive officers and employees pursuant to our Plan. As of December 31, 2018, 12,413 restricted shares have been granted under the Plan.

During 2018, we granted 12,413 restricted shares of common stock to key personnel under the Plan. These grants were approved by the Committee as compensation for substantial contributions during our recent core systems conversion. These shares fully vest three years after the grant date. The closing price of our stock is used to determine the fair value on the date of the grant.

During 2018, there were no restricted shares of common stock issued to non-employee directors under the Plan.

If any award granted under this Plan terminates, expires, or lapses for any reason other than by virtue of exercise or settlement of the award, or if shares issued pursuant to awards are forfeited, any stock subject to such award again shall be available for future awards under the Plan.

Compensation expense for restricted shares of stock is recognized ratably over the period of service, generally the entire vesting period, based on fair value on the grant date. Compensation expense for performance-based restricted stock is recognized ratably over the remaining vesting period once the likelihood of meeting the performance measure is probable. During 2018, the Bank recognized compensation expense of $9 thousand.

As of December 31, 2018, there was $213 thousand of total unrecognized compensation cost related to restricted stock that will be recognized as compensation expense over a weighted average period of 2.88 years.

The following table provides information about restricted stock granted under the Plan for the years ended December 31:

| | Restricted Shares | Weighted Average Grant Date Fair Value |
|---|---|---|
| **Non-vested at December 31, 2016** | — | $ — |
| Granted | — | — |
| Vested | — | — |
| Forfeited | — | — |
| **Non-vested at December 31, 2017** | — | — |
| Granted | 12,413 | 17.86 |
| Vested | — | — |
| Forfeited | — | — |
| **Non-vested at December 31, 2018** | **12,413** | **$17.86** |

## NOTE 14 — FEDERAL AND STATE INCOME TAXES

The components of the provision (benefit) for income tax expense were as follows:

| (Dollars in Thousands) | 2018 | 2017 | 2016 |
|---|---|---|---|
| Current | $(2,447) | $ (7,160) | $ 7,477 |
| Deferred | 4,850 | (10,371) | (5,832) |
| **Income Tax Provision (Benefit)** | **$ 2,403** | **$(17,531)** | **$ 1,645** |

The following is a reconciliation of the differences between the provision (benefit) for income taxes and the amount computed by applying the statutory federal income tax rate (21% for the year ended December 31, 2018 and 35% for the years ended December 31, 2017 and 2016) to income before taxes:

| | 2018 | | 2017 | | 2016 | |
|---|---|---|---|---|---|---|
| **(Dollars in Thousands)** | **Amount** | **Percent** | **Amount** | **Percent** | **Amount** | **Percent** |
| Federal Income Tax at Statutory Rate | $ 3,006 | 21.0% | $ (6,374) | 35.0% | $ 6,168 | 35.0% |
| State Income Tax, net of Federal Benefit | 190 | 1.3% | — | 0.0% | — | 0.0% |
| Tax-Exempt Interest, net of Disallowance | (2,629) | (18.4)% | (5,173) | 28.4% | (4,812) | (27.3)% |
| Federal Tax Credits, net of Basis Reduction | (1,375) | (9.6)% | (5,868) | 32.2% | (1,907) | (10.8)% |
| Change in Valuation Allowance (excluding the effect of the Act) | (384) | (2.7)% | 3,010 | (16.5)% | (361) | (2.0)% |
| Income from Bank Owned Life Insurance | (244) | (1.7)% | — | 0.0% | — | 0.0% |
| Enactment of Federal Tax Reform | — | 0.0% | 2,798 | (15.4)% | — | 0.0% |
| True-up of Book and Tax Basis Differences | 3,742 | 26.1% | (5,206) | 28.6% | — | 0.0% |
| Other | 97 | 0.8% | (718) | 4.0% | 2,557 | 14.4% |
| **Income Tax Provision (Benefit) and Effective Income Tax Rate** | **$ 2,403** | **16.8%** | **$(17,531)** | **96.3%** | **$ 1,645** | **9.3%** |

On December 22, 2017, H.R.1, commonly known as the Tax Cuts and Jobs Act (the "Act"), was signed into law. The Act includes many provisions that will affect our income tax expense, including reducing our federal tax rate from 35% to 21% effective January 1, 2018. As a result of the rate reduction, we are required to re-measure, through income tax expense in the period of enactment, our deferred tax assets and liabilities using the enacted rate at which we expect them to be recovered or settled. The re-measurement of our net deferred tax asset resulted in additional income tax expense of $2.8 million in 2017.

Also on December 22, 2017, the U.S. Securities and Exchange Commission ("SEC") released Staff Accounting Bulletin No. 118 ("SAB 118") to address any uncertainty or diversity of views in practice in accounting for the income tax effects of the Act in situations where a registrant does not have the necessary information available, prepared, or analyzed in reasonable detail to complete this accounting in the reporting period that includes the enactment date. SAB 118 allowed for a measurement period not to extend beyond one year from the Act's enactment date to complete the necessary accounting.

We recorded provisional amounts of deferred income taxes using reasonable estimates in one area where information necessary to complete the accounting was not available, prepared, or analyzed. Our deferred tax asset for temporary differences associated with equity investments in partnerships was awaiting receipt of Schedules K-1 from outside preparers, which was necessary to determine our 2017 tax impact from these investments.

We completed and recorded the income tax effects of these provisional items during the third quarter of 2018 when the information became available.

Realization of deferred tax assets is dependent upon the generation of future taxable income. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax assets will not be realized. In assessing the need for a valuation allowance, management considers the scheduled reversal of the deferred tax liabilities and the projected future taxable income over the periods in which the temporary differences comprising the deferred tax assets will be deductible. Based on its assessment, management recorded a valuation allowance on deferred tax assets related to its equity investments in partnerships that will generate capital losses upon exiting the investments. The Bank has not identified prudent and feasible strategies to generate future capital gains to offset the capital losses. Management has determined that it is more likely than not that all other deferred tax assets will be realized in future periods so no additional valuation allowance is necessary at December 31, 2018 and 2017.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amount used for income tax purposes. Significant components of the Bank's deferred tax assets and liabilities are as follows:

| **(Dollars in Thousands)**<br>**Deferred Tax Assets** | **2018** | **2017** |
|---|---|---|
| Allowance for Loan Losses | $ 8,389 | $ 7,465 |
| Net Unrealized Loss on Available-for-Sale Securities | 2,676 | 599 |
| Acquisition-Related Fair Value Adjustments | — | 1,154 |
| Valuation Adjustments on Other Real Estate Owned | 1,225 | 1,281 |
| Tax Credit Carryforwards | 3,004 | 7,070 |
| Equity Investment in Partnerships | 1,187 | 2,019 |
| Other | 1,351 | 505 |
| Gross Deferred Tax Assets | 17,832 | 20,093 |
| Less: Valuation Allowance | (1,636) | (2,021) |
| **Total Deferred Tax Assets** | **$16,196** | **$18,072** |

| **Deferred Tax Liabilities** | **2018** | **2017** |
|---|---|---|
| Fixed Asset Depreciation | $(2,616) | $ (6,482) |
| Acquisition-Related Fair Value Adjustments | (5,018) | — |
| Other | — | (255) |
| **Total Deferred Tax Liabilities** | **(7,634)** | **(6,737)** |
| **Net Deferred Tax Assets** | **$ 8,562** | **$11,335** |

At December 31, 2018 and 2017, the Bank had no ASC 740-10 unrecognized tax benefits or accrued interest and penalties recorded. The Bank does not expect the total amount of unrecognized tax benefits to significantly increase within the next twelve months. The Bank recognizes interest and penalties on unrecognized tax benefits in income tax expense.

The Bank is subject to U.S. federal income tax as well as various other state and local jurisdictions. The Bank is generally no longer subject to examination by federal, state and local taxing authorities for years prior to December 31, 2015.

## NOTE 15 — OFF BALANCE SHEET ACTIVITIES AND COMMITMENTS

Commitments to extend credit, which amounted to $387.7 million at December 31, 2018 and $278.7 million at December 31, 2017, represent agreements to lend to customers with fixed expiration dates or other termination clauses. Since many of the commitments are expected to expire without being funded, the total commitment amounts do not necessarily represent future liquidity requirements. Standby letters of credit are conditional commitments issued by the Bank guaranteeing the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The Bank had outstanding letters of credit totaling $34.3 million in 2018 and $38.7 million in 2017.

Our 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 is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and unconditional obligations as it does for on balance sheet instruments. Unless noted otherwise, collateral or other security is required to support financial instruments with credit risk.

Our allowance for unfunded commitments is determined using a methodology similar to that used to determine the ALL. Amounts are added to the allowance for unfunded commitments through a charge to current earnings in noninterest expense. The balance in the allowance for unfunded commitments was $0.3 million and $0.1 million at December 31, 2018 and 2017, respectively.

## NOTE 16 — REVENUE RECOGNITION

On January 1, 2018, the Bank adopted ASU No. 2016-10 “Revenue from Contracts with Customers” (Topic 606) and all subsequent ASUs that modified Topic 606. As stated in Note 1, Summary of Significant Accounting Policies, the implementation of the new standard did not have a material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts were not adjusted and continue to be reported in accordance with our historic accounting under Topic 605.

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as fees associated with mortgage servicing rights, financial guarantees, derivatives, and certain credit card fees are also not in scope of the new guidance. Topic 606 is applicable to noninterest revenue streams such as trust and asset management income, deposit related fees, interchange fees, merchant income, and annuity and insurance commissions and return on investment. However, the recognition of these revenue streams did not change significantly upon adoption of Topic 606. Substantially all of the Bank’s revenue is generated from contracts with customers. Noninterest revenue streams in-scope of Topic 606 are discussed below.

**Service Charges on Deposit Accounts:** Service charges on deposit accounts consist of overdraft fees, service charges on returned checks, stop payment fees, check chargeback fees, minimum balance fees, and other deposit account related fees. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on returned checks are recognized at the point in time that a check is returned. Transaction-based fees, which include services such as stop payment fees, check chargeback fees, and other deposit account related fees are recognized at the point in time the Bank fulfills the customer’s request. Minimum balance fees are system-assessed at the point in time that a customer’s balance is below the required minimum for the product. Service charges on deposits are withdrawn from the customer’s account balance.

**Other Fees and Other Income:** Other fees and other income consists of safe deposit rents, money order fees, check cashing and cashiers’ check fees, wire transfer fees, letter of credit fees, check order income, and other miscellaneous fees. These fees are largely transaction-based; therefore, the Bank’s performance obligation is satisfied and the resultant revenue is recognized at the point in time the service is rendered. Payments for transaction-based fees are generally received immediately or in the following month by a direct charge to a customer's account.

**Debit Card Interchange Fees:** The Bank earns interchange fees from debit cardholder transactions conducted through a card payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder.

**Insurance:** Commission income is earned based on customer transactions. The commission income is recognized when the transaction is complete. The Bank also receives a return on its investment in Bankers Insurance, LLC on an annual basis based on the income of the insurance company and percentage of ownership.

**Other Real Estate Owned Income:** The Bank owns properties acquired through foreclosure that are included in other real estate owned, net on the Consolidated Balance Sheet. If the Bank rents any of those properties, the resultant income is recognized at the point of receipt since the performance obligation has been satisfied. The rents are generally received monthly.

**Gains/Losses on Sales of Other Real Estate Owned:** The Bank records a gain or loss from the sale of other real estate owned when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Bank finances the sale of other real estate owned to the buyer, the Bank assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the other real estate owned asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Bank adjusts the transaction price and related gain (loss) on sale if a significant financing component is present.

The following table summarizes the point of revenue recognition and the income recognized for each of the revenue streams for the year ended December 31, 2018:

| (Dollars in Thousands) | Point of Revenue Recognition | For the Year Ended December 31, 2018 |
|---|---|---|
| **Revenue Streams** | | |
| Service Charges on Deposit Accounts | At a point in time | $3,127 |
| Other Fees and Other Income | At a point in time | 1,756 |
| Debit Card Interchange Fees | At a point in time | 4,750 |
| Insurance | | |
| Customer Commissions | At a point in time | 625 |
| Annual Commission on Investment | Over time | 1,230 |
| Other Real Estate Owned Income | At a point in time | 2,692 |
| Gains/Losses on Sales of Other Real Estate Owned | At a point in time | *** |

*** Reported net with Write-downs on Other Real Estate Owned in Noninterest Expense

## NOTE 17 — CAPITAL ADEQUACY

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgements by regulators. Failure to meet capital requirements can initiate regulatory action. The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. As part of the new requirements, the common equity tier 1 Capital ratio is calculated and utilized in the assessment of capital for all institutions. Under the Basel III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in beginning January 1, 2016, at 0.625%, increasing each year until reaching 2.50% on January 1, 2019. The net unrealized gain or loss on available-for-sale securities is not included in computing regulatory capital. Management believes as of December 31, 2018, the Bank met all capital adequacy requirements to which they are subject.

Prompt corrective action regulations provide five classifications, well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At year-end 2018 and 2017, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the institutions category.

| | Actual | | Minimum Capital Required Basel III Phase-In Schedule | | Minimum Capital Required Basel III Fully Phased-In | | To Be Well Capitalized Under Prompt Corrective Action Regulations | |
|---|---|---|---|---|---|---|---|---|
| **December, 31 2018** | **Amount** | **Ratio** | **Amount** | **Ratio** | **Amount** | **Ratio** | **Amount** | **Ratio** |
| Leverage Ratio | $387,554 | 9.69% | $159,950 | 4.00% | $159,950 | 4.00% | $199,937 | 5.00% |
| Common Equity Tier 1 (to Risk-Weighted Assets) | $387,554 | 13.97% | $176,892 | 6.38% | $194,235 | 7.00% | $180,361 | 6.50% |
| Tier 1 Capital (to Risk-Weighted Assets) | $387,554 | 13.97% | $218,514 | 7.88% | $235,857 | 8.50% | $221,983 | 8.00% |
| Total Capital (to Risk-Weighted Assets) | $422,298 | 15.22% | $274,010 | 9.88% | $291,352 | 10.50% | $277,478 | 10.00% |
| **December, 31 2017** | | | | | | | | |
| Leverage Ratio | $374,506 | 9.33% | $160,590 | 4.00% | $160,590 | 4.00% | $200,738 | 5.00% |
| Common Equity Tier 1 (to Risk-Weighted Assets) | $374,506 | 12.93% | $166,566 | 5.75% | $202,776 | 7.00% | $188,292 | 6.50% |
| Tier 1 Capital (to Risk-Weighted Assets) | $374,506 | 12.93% | $210,018 | 7.25% | $246,228 | 8.50% | $231,744 | 8.00% |
| Total Capital (to Risk-Weighted Assets) | $409,972 | 14.15% | $267,954 | 9.25% | $304,164 | 10.50% | $289,680 | 10.00% |

## NOTE 18 — QUARTERLY FINANCIAL DATA (Unaudited)

The following summarizes the quarterly results of operations for the years ended December 31:

| (Dollars in Thousands) 2018 | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|---|---|---|---|---|
| Total Interest Income | $35,588 | $38,362 | $38,207 | $39,862 |
| Total Interest Expense | 8,151 | 9,111 | 10,079 | 10,773 |
| **Net Interest Income** | **27,437** | **29,251** | **28,128** | **29,089** |
| Provision for Loan Losses | 1,515 | 1,730 | 13,743 | (118) |
| **Net Interest Income after Provision for Loan Losses** | **25,922** | **27,521** | **14,385** | **29,207** |
| Total Non-Interest Income | 4,731 | 4,741 | 4,610 | 3,832 |
| Total Non-Interest Expense | 22,559 | 23,022 | 25,360 | 29,700 |
| **Income Before Income Taxes** | **8,094** | **9,240** | **(6,365)** | **3,339** |
| Income Tax (Benefit) Expense | (735) | 2,041 | 1,164 | (67) |
| **Net Income (Loss)** | **$ 8,829** | **$ 7,199** | **$ (7,529)** | **$ 3,406** |
| **Earnings (Loss) Per Share** | **$ 0.34** | **$ 0.27** | **$ (0.29)** | **$ 0.13** |

| (Dollars in Thousands) 2017 | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|---|---|---|---|---|
| Total Interest Income | $36,353 | $36,084 | $35,050 | $ 36,597 |
| Total Interest Expense | 9,844 | 9,476 | 9,122 | 8,669 |
| **Net Interest Income** | **26,509** | **26,608** | **25,928** | **27,928** |
| Provision for Loan Losses | 3,880 | 12,742 | 13,890 | 12,685 |
| **Net Interest Income after Provision for Loan Losses** | **22,629** | **13,866** | **12,038** | **15,243** |
| Total Non-Interest Income | 2,947 | 2,521 | 3,930 | 3,436 |
| Total Non-Interest Expense | 17,804 | 20,605 | 20,963 | 35,450 |
| **Income Before Income Taxes** | **7,772** | **(4,218)** | **(4,995)** | **(16,771)** |
| Income Tax Expense (Benefit) | 1,470 | (2,735) | (4,566) | (11,700) |
| **Net Income (Loss)** | **$ 6,302** | **$ (1,483)** | **$ (429)** | **$ (5,071)** |
| **Earnings (Loss) Per Share** | **$ 0.24** | **$ (0.06)** | **$ (0.02)** | **$ (0.19)** |

| (Dollars in Thousands) 2016 | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|---|---|---|---|---|
| Total Interest Income | $37,870 | $37,229 | $36,938 | $35,611 |
| Total Interest Expense | 12,043 | 12,031 | 11,579 | 10,729 |
| **Net Interest Income** | **25,827** | **25,198** | **25,359** | **24,882** |
| Provision for Loan Losses | 975 | 975 | 3,214 | 12,553 |
| **Net Interest Income after Provision for Loan Losses** | **24,852** | **24,223** | **22,145** | **12,329** |
| Total Non-Interest Income | 3,373 | 2,595 | 2,842 | 3,684 |
| Total Non-Interest Expense | 16,895 | 18,926 | 18,780 | 23,818 |
| **Income Before Income Taxes** | **11,330** | **7,892** | **6,207** | **(7,805)** |
| Income Tax Expense (Benefit) | 3,000 | 1,610 | 975 | (3,940) |
| **Net Income (Loss)** | **$ 8,330** | **$ 6,282** | **$ 5,232** | **$ (3,865)** |
| **Earnings (Loss) Per Share** | **$ 0.32** | **$ 0.24** | **$ 0.20** | **$ (0.15)** |

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
Carter Bank & Trust
Martinsville, Virginia

**Opinion on the Financial Statements**

We have audited the accompanying consolidated balance sheets of Carter Bank & Trust and subsidiaries' (the "Bank") as of December 31, 2018 and 2017, the related consolidated statements of income (loss), comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2018, and the related notes to the consolidated financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Bank as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2018, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Bank's internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 14, 2019 expressed an unqualified opinion on the effectiveness of the Bank's internal control over financial reporting.

**Basis for Opinion**

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

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ YOUNT, HYDE & BARBOUR, P.C.

We have served as the Bank's auditor since 2012.

Roanoke, Virginia
March 14, 2019

YHB CPAs & Consultants

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders
Carter Bank & Trust
Martinsville, Virginia

**Opinion on the Internal Control over Financial Reporting**

We have audited Carter Bank & Trust and subsidiaries' (the "Bank") internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. In our opinion, the Bank maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets as of December 31, 2018 and 2017, the related consolidated statements of income, comprehensive income(loss), changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2018, and the related notes to the consolidated financial statements of the Bank and our report dated March 14, 2019 expressed an unqualified opinion.

**Basis for Opinion**

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

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

**Definition and Limitations of Internal Control over Financial Reporting**

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

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

/s/ YOUNT, HYDE & BARBOUR, P.C.

Roanoke, Virginia
March 14, 2019

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

None

## ITEM 9A. CONTROLS AND PROCEDURES

### Disclosure Controls and Procedures

The Bank maintains disclosure controls and procedures that are designed to provide assurance that information required to be disclosed by the Bank in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods required by the Securities and Exchange Commission and that such information is accumulated and communicated to the Bank's management including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. An evaluation of the effectiveness of the design and operation of the Bank's disclosure controls and procedures as of the end of the period covered by this report was carried out under the supervision and with the participation of management, including the Bank's Chief Executive Officer and Chief Financial Officer. Based on the evaluation, the aforementioned officers concluded that the Bank's disclosure controls and procedures were effective as of the end of such period.

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

Management of the Bank is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. The Bank's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of the Bank's financial reporting and the preparation of published financial statements in accordance with generally accepted accounting principles.

Management assessed the effectiveness of the Bank's internal control over financial reporting as of December 31, 2018. In making this assessment, management used the 2013 criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control — Integrated Framework*. Based on management's assessment, management believes that as of December 31, 2018, the Company's internal control over financial reporting was effective based on criteria set forth by COSO in its 2013 *Internal Control — Integrated Framework*.

Our independent registered public accounting firm, Yount, Hyde & Barbour, P.C., has issued an attestation report on the effectiveness of our internal controls over financial reporting which appears in Item 8.

### Changes in Internal Control Over Financial Reporting

There have been no changes in the Bank's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the period ended December 31, 2018 that have materially affected, or are reasonably like to materially affect, the Bank's internal control over financial reporting.

## ITEM 9B. OTHER INFORMATION

Not applicable

## PART III

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

The information required by Part III, Item 10 of Form 10-K is incorporated herein from the sections entitled “Section 16(a) Beneficial Ownership Reporting Compliance”, “Election of Directors”, “Executive Officers of the Registrant” and “Nominating, Governance and Compensation Committee Report” in our proxy statement relating to our June 26, 2019 annual meeting of shareholders.

The Bank has adopted a Code of Ethics (the “Code”) that applies to its directors, executive officers and employees and is available on the Bank’s website at www.carterbankandtrust.com under “Investor Relations.” The Bank intends to provide any required disclosure of any amendment to or waiver of the Code that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, on www.carterbankandtrust.com under “Investor Relations” promptly following the amendment or waiver. The Bank may elect to disclose any such amendment or waiver in a report on Form 8-K filed with the FDIC either in addition to or in lieu of the website disclosure. The information contained on or connected to the Bank’s website is not incorporated by reference in this report and should not be considered part of this or any other report that we file or furnish to the FDIC.

### ITEM 11. EXECUTIVE COMPENSATION

The information required by Part III, Item 11 of Form 10-K is incorporated herein from the sections entitled “Compensation Discussion and Analysis;” “Executive Compensation;” “Director Compensation;” “Nominating, Governance and Compensation Committee Interlocks and Insider Participation”; and “Nominating, Governance and Compensation Committee Report” in our proxy statement relating to our June 26, 2019 annual meeting of shareholders.

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

Except as set forth below, the information required by Part III, Item 12 of Form 10-K is incorporated herein from the sections entitled “Principal Beneficial Owners of Carter Bank & Trust Common Stock” and “Beneficial Ownership of Carter Bank & Trust Common Stock by Directors and Officers” in our proxy statement relating to our June 26, 2019 annual meeting of shareholders.

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

The information required by Part III, Item 13 of Form 10-K is incorporated herein from the sections entitled “Related Person Transactions” and “Director Independence” in our proxy statement relating to our June 26, 2019 annual meeting of shareholders.

### ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by Part III, Item 14 of Form 10-K is incorporated herein from the section entitled “Independent Registered Public Accounting Firm” in our proxy statement relating to our June 26, 2019 annual meeting of shareholders.

## PART IV

### ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

**(a) The following documents are filed as part of this Report**.

**Consolidated Financial Statements:** The following consolidated financial statements are included in Part II, Item 8 of this Report. No financial statement schedules are being filed because the required information is inapplicable or is presented in the Consolidated Financial Statements or related notes.



**(b) Exhibits**

| | |
|---|---|
| 3.1 | Articles of Incorporation (incorporated by reference to Exhibit 3.1 to the Bank's Form 8-A filed with the FDIC February 23, 2007) |
| 3.2 | Amended and Restated Bylaws (as adopted by the Board of Directors on December 19, 2018) (incorporated by reference to Exhibit 3.2 to the Bank's Form 8-K filed with the FDIC December 19, 2018) |
| 10.1* | Qualified Profit Sharing Plan of Carter Bank & Trust (formerly the Qualified Profit Sharing Plan of each of the Merged Banks and MCOV) (incorporated by reference to Exhibit 10.1 to the Bank's 2006 Form 10-K filed with the FDIC July 6, 2007) |
| 10.2* | Nonqualified Profit Sharing Plan of Carter Bank & Trust (formerly the Nonqualified Profit Sharing Plan of MCOV) (incorporated by reference to Exhibit 10.2 to the Bank's 2006 Form 10-K filed with the FDIC July 6, 2007) |
| 10.3* | Employment Agreement, dated as of June 19, 2017, by and between Carter Bank & Trust and Wendy S. Bell (incorporated by reference to Exhibit 10.3 to the Bank's Form 8-K filed with the FDIC June 20, 2017) |
| 10.4* | Employment Agreement, dated as of September 29, 2017, by and between Carter Bank & Trust and Litz Van Dyke (incorporated by reference to Exhibit 10.4 to the Bank's Form 8-K filed with the FDIC October 3, 2017) |
| 10.5* | Employment Agreement, dated as of September 29, 2017, by and between Carter Bank & Trust and Phyllis Q. Karavatakis (incorporated by reference to Exhibit 10.5 to the Bank's Form 8-K filed with the FDIC October 3, 2017) |
| 10.6* | Employment Agreement, dated as of September 29, 2017, by and between Carter Bank & Trust and Jane Ann Davis (incorporated by reference to Exhibit 10.6 to the Bank's Form 8-K filed with the FDIC October 3, 2017) |
| 10.7* | Employment Agreement, dated as of May 31, 2017, by and between Carter Bank & Trust and Bradford N. Langs (incorporated by reference to Exhibit 10.7 to the Bank's 2017 Form 10-K filed with the FDIC March 15, 2018) |

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES (continued)**

| | |
|---|---|
| 10.8* | Employment Agreement, dated as of June 15, 2017, by and between Carter Bank & Trust and Matthew M. Speare (incorporated by reference to Exhibit 10.8 to the Bank's Form 10-K filed with the FDIC March 15, 2018) |
| 10.9* | Carter Bank & Trust 2018 Omnibus Equity Incentive Plan (incorporated by reference to the Bank's Proxy Statement filed with the FDIC April 30, 2018) |
| 10.9.1* | Form of Time-Based Restricted Stock Agreement (for employee) for use under the Carter Bank & Trust 2018 Omnibus Equity Incentive Plan (incorporated by reference to Exhibit 10.9.1 to the Bank's Form 8-K filed with the FDIC October 26, 2018) |
| 10.9.2* | Form of Time-Based Restricted Stock Agreement (for non-employee director) for use under the Carter Bank & Trust 2018 Omnibus Equity Incentive Plan (incorporated by reference to Exhibit 10.9.2 to the Bank's Form 10-K filed with the FDIC March 14, 2019) |
| 31.1 | Certification by principal executive officer pursuant to Rule 13a-14(a) |
| 31.2 | Certification by principal financial officer pursuant to Rule 13a-14(a) |
| 32.1 | Certification by principal executive officer pursuant to 18 U.S.C. §1350 |
| 32.2 | Certification by principal financial officer pursuant to 18 U.S.C. §1350 |

* Denotes management contract.

**ITEM 16. FORM 10-K SUMMARY**

Not applicable

## SIGNATURES

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

**CARTER BANK & TRUST**
**(Registrant)**

By: /s/ Litz H. Van Dyke
Name: Litz H. Van Dyke
Title: Chief Executive Officer
Date: March 14, 2019

By: /s/ Wendy S. Bell
Name: Wendy S. Bell
Title: Executive VP & Chief Financial Officer
Date: March 14, 2019

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

By: /s/ James W. Haskins
Name: James W. Haskins
Title: Chairman of the Board
Date: March 14, 2019

By: /s/ Litz H. Van Dyke
Name: Litz H. Van Dyke
Title: Director and Chief Executive Officer
Date: March 14, 2019

By: /s/ Phyllis Q. Karavatakis
Name: Phyllis Q. Karavatakis
Title: Vice Chairman and President and Chief Banking Officer
Date: March 14, 2019

By: /s/ Michael R. Bird
Name: Michael R. Bird
Title: Director
Date: March 14, 2019

By:
Name: Robert W. Conner
Title: Director
Date: March 14, 2019

By:
Name: Gregory W. Feldmann
Title: Director
Date: March 14, 2019

By: /s/ Chester A. Gallimore
Name: Chester A. Gallimore
Title: Director
Date: March 14, 2019

By: /s/ Charles E. Hall
Name: Charles E. Hall
Title: Director
Date: March 14, 2019

By: /s/ Lanny A. Kyle, O.D.
Name: Lanny A. Kyle, O.D.
Title: Director
Date: March 14, 2019

By:
Name: George W. Lester, II
Title: Director
Date: March 14, 2019

By: /s/ E. Warren Matthews
Name: E. Warren Matthews
Title: Director
Date: March 14, 2019

By: /s/ Catherine L. Midkiff
Name: Catherine L. Midkiff
Title: Director
Date: March 14, 2019

By: /s/ Joseph E. Pigg
Name: Joseph E. Pigg
Title: Director
Date: March 14, 2019

**Exhibit 31.1**

## CERTIFICATIONS

I, Litz H. Van Dyke, certify that:

1. I have reviewed this annual report on Form 10-K of Carter Bank & Trust;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 14, 2019

/s/ Litz H. Van Dyke

Litz H. Van Dyke
Chief Executive Officer

**Exhibit 31.2**

## CERTIFICATIONS

I, Wendy S. Bell, certify that:

1. I have reviewed this annual report on Form 10-K of Carter Bank & Trust;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 14, 2019

/s/ Wendy S. Bell

Wendy S. Bell Executive Vice President Chief Financial Officer

**Exhibit 32.1**

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER**
**PURSUANT TO §906 OF THE SARBANES-OXLEY ACT OF 2002 (18 U.S.C. §1350)**

Pursuant to §906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350) I, Litz H. Van Dyke, as Chief Executive Officer of Carter Bank & Trust, certify that, to the best of my knowledge and belief, the Annual Report on Form 10-K for the period ended December 31, 2018, which accompanies this certification fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended, and the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of Carter Bank & Trust at the dates and for the periods indicated. The foregoing certification is made pursuant to §906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350) and shall not be relied upon for any other purpose. The undersigned expressly disclaims any obligation to update the foregoing certification except as required by law.

Date: March 14, 2019

/s/ Litz H. Van Dyke
Litz H. Van Dyke
Chief Executive Officer
(Principal Executive Officer)

**Exhibit 32.2**

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER**
**PURSUANT TO §906 OF THE SARBANES-OXLEY ACT OF 2002 (18 U.S.C. §1350)**

Pursuant to §906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350) I, Wendy S. Bell, as Executive Vice President and Chief Financial Officer of Carter Bank & Trust, certify that, to the best of my knowledge and belief, the Annual Report on Form 10-K for the period ended December 31, 2018, which accompanies this certification fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended, and the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of Carter Bank & Trust at the dates and for the periods indicated. The foregoing certification is made pursuant to §906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350) and shall not be relied upon for any other purpose. The undersigned expressly disclaims any obligation to update the foregoing certification except as required by law.

Date: March 14, 2019

/s/ Wendy S. Bell
Wendy S. Bell
Executive Vice President Chief Financial Officer
(Principal Financial Officer)

Carter Bank & Trust

1300 Kings Mountain Road
Martinsville, Virginia 24112
276.656.1776

CarterBankandTrust.com

Carter Bank & Trust

VOTE

Using a black ink pen, mark your votes with an X as shown in this example. X
Please do not write outside the designated areas.

# Annual Meeting Proxy Card

IF VOTING BY MAIL, SIGN, DETACH AND RETURN THE BOTTOM PORTION IN THE ENCLOSED ENVELOPE.

## A Proposals — The Board of Directors recommends a vote FOR all the nominees listed and FOR Proposal 2.

1. To elect the 13 persons listed below to serve as Directors of the Bank until the 2020 Annual Meeting of Shareholders:

| | For | Withhold | | For | Withhold | | For | Withhold |
|---|---|---|---|---|---|---|---|---|
| 01 - Michael R. Bird | ☐ | ☐ | 02 - Robert W. Conner | ☐ | ☐ | 03 - Gregory W. Feldmann | ☐ | ☐ |
| 04 - Chester A. Gallimore | ☐ | ☐ | 05 - Charles E. Hall | ☐ | ☐ | 06 - James W. Haskins | ☐ | ☐ |
| 07 - Phyllis Q. Karavatakis | ☐ | ☐ | 08 - Lanny A. Kyle, O.D. | ☐ | ☐ | 09 - George W. Lester, II | ☐ | ☐ |
| 10 - E. Warren Matthews | ☐ | ☐ | 11 - Catharine L. Midkiff | ☐ | ☐ | 12 - Joseph E. Pigg | ☐ | ☐ |
| 13 - Litz H. Van Dyke | ☐ | ☐ | | | | | | |

| | For | Against | Abstain |
|---|---|---|---|
| 2. Ratification of the appointment of the independent registered public accounting firm of Crowe LLP as the independent auditors of the Bank for the fiscal year ending December 31, 2019. | ☐ | ☐ | ☐ |

3. To transact such other business as may be properly brought before the meeting or any adjournment thereof. The Board of Directors at present knows of no other business to be presented at the Annual Meeting.

## B Authorized Signatures — This section must be completed for your vote to be counted. — Date and Sign Below

All joint owners must sign. When signing as attorney, executor, administrator, trustee or guardian, please give full title. If more than one trustee, all should sign and provide full title as such.

| Date (mm/dd/yyyy) — Please print date below. | Signature 1 — Please keep signature within the box. | Signature 2 — Please keep signature within the box. |
|---|---|---|
| / / | | |

IF VOTING BY MAIL, SIGN, DETACH AND RETURN THE BOTTOM PORTION IN THE ENCLOSED ENVELOPE.

## Proxy — Carter Bank & Trust

### ANNUAL MEETING OF SHAREHOLDERS OF CARTER BANK & TRUST

Proxy Solicited by Board of Directors for Annual Meeting — June 26, 2019

KNOW ALL MEN BY THESE PRESENT THAT I, the undersigned Shareholder of CARTER BANK & TRUST, MARTINSVILLE, VIRGINIA (the "Bank"), do hereby nominate and appoint Michael R. Bird, Robert W. Conner, and Gregory W. Feldmann, or _____________, or any of them (with full power to act alone), my true and lawful attorney(s) with full power of substitution for me, and in my name, place and stead to vote all of the Common Stock of the Bank, standing in my name on its stock transfer books on April 30, 2019, at the Annual Meeting of its Shareholders to be held at the Frith Center at Patrick Henry Community College, 645 Patriot Ave, Martinsville, Virginia 24112, June 26, 2019 at Ten O'clock A.M., or at any adjournment thereof with all the powers the undersigned would possess if personally present.

The undersigned hereby acknowledges receipt of the Bank's Proxy Statement dated May 24, 2019 and hereby revokes all proxies previously given. THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS AND MAY BE REVOKED PRIOR TO ITS EXERCISE. The Board of Directors recommends a vote "FOR" all director nominees in Proposal I and "FOR" Proposal 2. The Proxy when properly executed will be voted in the manner directed herein by the undersigned shareholder. If no direction is made, this Proxy will be voted "FOR" all director nominees in Proposal 1, "FOR" Proposal 2, and according to the recommendations of the Board of Directors on any other matters that may properly come before the meeting or any adjournment thereof.

In their discretion, the Proxies are authorized to vote upon such other business as may properly come before the meeting.
(Items to be voted appear on reverse side.)

**C** Non-Voting Items

Change of Address — Please print new address below.

Comments — Please print your comments below.

Meeting Attendance
Mark box to the right if you plan to attend the Annual Meeting.