

FIRST UNITED CORP/MD/  
Form 10-Q  
November 07, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-Q**

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

For quarterly period ended September 30, 2016

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

Commission file number 0-14237

First United Corporation

(Exact name of registrant as specified in its charter)

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

19 South Second Street, Oakland, Maryland 21550-0009  
(Address of principal executive offices) (Zip Code)

(800) 470-4356

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 6,269,004 shares of common stock, par value \$.01 per share, as of October 31, 2016.

**INDEX TO QUARTERLY REPORT**

**FIRST UNITED CORPORATION**

**PART I. FINANCIAL INFORMATION**

|          |  |    |
|----------|--|----|
| Item 1.  | <u>Financial Statements (unaudited)</u>  | 3  |
|          | <u>Consolidated Statement of Financial Condition – September 30, 2016 and December 31, 2015</u>  | 3  |
|          | <u>Consolidated Statement of Operations - for the three and nine months ended September 30, 2016 and 2015</u>                                    | 4  |
|          | <u>Consolidated Statement of Comprehensive Income – for the three and nine months ended September 30, 2016 and 2015</u>                          | 6  |
|          | <u>Consolidated Statement of Changes in Shareholders' Equity - for the nine months ended September 30, 2016 and year ended December 31, 2015</u> | 8  |
|          | <u>Consolidated Statement of Cash Flows - for the nine months ended September 30, 2016 and 2015</u>  | 9  |
|          | <u>Notes to Consolidated Financial Statements</u>  | 10 |
| Item 2.  | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>   | 55 |
| Item 3.  | <u>Quantitative and Qualitative Disclosures about Market Risk</u>  | 79 |
| Item 4.  | <u>Controls and Procedures</u>   | 79 |
|          | <b><u>PART II. OTHER INFORMATION</u></b>   | 80 |
| Item 1.  | <u>Legal Proceedings</u>   | 80 |
| Item 1A. | <u>Risk Factors</u>  | 80 |
| Item 2.  | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>   | 80 |
| Item 3.  | <u>Defaults upon Senior Securities</u>   | 80 |
| Item 4.  | <u>Mine Safety Disclosures</u>   | 80 |

|                                  |    |
|----------------------------------|----|
| Item 5. <u>Other Information</u> | 80 |
| Item 6. <u>Exhibits</u>          | 80 |
| <u>SIGNATURES</u>                | 80 |
| <u>EXHIBIT INDEX</u>             | 81 |

**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****FIRST UNITED CORPORATION**

## Consolidated Statement of Financial Condition

(In thousands, except per share and percentage data)

|  | September<br>30,<br>2016<br>(Unaudited) | December 31,<br>2015 |
|--|---|----------------------|
| Assets   |   |                      |
| Cash and due from banks  | \$64,560                                | \$ 50,188            |
| Interest bearing deposits in banks   | 1,524                                   | 1,953                |
| Cash and cash equivalents  | 66,084                                  | 52,141               |
| Investment securities – available-for-sale (at fair value)   | 148,037                                 | 170,232              |
| Investment securities – held to maturity (fair value \$103,286 at September 30, 2016 and \$106,742 at December 31, 2015) | 98,387                                  | 105,560              |
| Restricted investment in bank stock, at cost   | 5,881                                   | 5,904                |
| Loans  | 902,489                                 | 879,023              |
| Allowance for loan losses  | (12,044 )                               | (11,922 )            |
| Net loans  | 890,445                                 | 867,101              |
| Premises and equipment, net  | 27,363                                  | 25,198               |
| Goodwill and other intangible assets, net  | 11,004                                  | 11,004               |
| Bank owned life insurance  | 40,672                                  | 40,150               |
| Deferred tax assets  | 19,278                                  | 19,790               |
| Other real estate owned  | 10,259                                  | 6,883                |
| Accrued interest receivable and other assets   | 20,779                                  | 19,495               |
| Total Assets   | \$1,338,189                             | \$ 1,323,458         |
| Liabilities and Shareholders' Equity   |   |                      |
| Liabilities:   |   |                      |
| Non-interest bearing deposits  | \$221,650                               | \$ 204,569           |
| Interest bearing deposits  | 797,535                                 | 794,225              |
| Total deposits   | 1,019,185                               | 998,794              |
| Short-term borrowings  | 35,785                                  | 35,828               |
| Long-term borrowings   | 146,747                                 | 147,537              |
| Accrued interest payable and other liabilities   | 21,704                                  | 20,528               |
| Total Liabilities  | 1,223,421                               | 1,202,687            |

Shareholders' Equity:

|  |             |              |
|--|-------------|--------------|
| Preferred stock – no par value; Authorized 2,000 shares of which 30 shares of Series A, \$1,000 per share liquidation preference, 9% cumulative, issued and outstanding 20 shares at September 30, 2016 and 30 shares at December 31, 2015 | 20,000      | 30,000       |
| Common Stock – par value \$.01 per share; Authorized 25,000 shares; issued and outstanding 6,269 shares at September 30, 2016 and 6,255 at December 31, 2015   | 63          | 63           |
| Surplus  | 22,130      | 21,986       |
| Retained earnings  | 89,836      | 85,551       |
| Accumulated other comprehensive loss   | (17,261 )   | (16,829 )    |
| Total Shareholders' Equity   | 114,768     | 120,771      |
| Total Liabilities and Shareholders' Equity   | \$1,338,189 | \$ 1,323,458 |

*See accompanying notes to the consolidated financial statements*

**FIRST UNITED CORPORATION**

## Consolidated Statement of Operations

(In thousands, except per share data)

|   | Nine months ended<br>September 30,<br>2016      2015<br>(Unaudited) |           |
|---|---|-----------|
| Interest income                                     |   |           |
| Interest and fees on loans                          | \$ 29,225   | \$ 27,549 |
| Interest on investment securities                   |   |           |
| Taxable   | 4,303   | 5,365     |
| Exempt from federal income tax                      | 635   | 970       |
| Total investment income                             | 4,938   | 6,335     |
| Other   | 295   | 268       |
| Total interest income                               | 34,458  | 34,152    |
| Interest expense                                    |   |           |
| Interest on deposits                                | 2,373   | 3,018     |
| Interest on short-term borrowings                   | 42  | 42        |
| Interest on long-term borrowings                    | 3,761   | 4,213     |
| Total interest expense                              | 6,176   | 7,273     |
| Net interest income                                 | 28,282  | 26,879    |
| Provision for loan losses                           | 2,208   | 626       |
| Net interest income after provision for loan losses | 26,074  | 26,253    |
| Other operating income                              |   |           |
| Net gains   | 525   | 100       |
| Service charges                                     | 2,469   | 2,177     |
| Trust department                                    | 4,369   | 4,225     |
| Debit card income                                   | 1,569   | 1,445     |
| Bank owned life insurance                           | 1,130   | 849       |
| Brokerage commissions                               | 696   | 706       |
| Other   | 463   | 308       |
| Total other income                                  | 10,696  | 9,710     |
| Total other operating income                        | 11,221  | 9,810     |
| Other operating expenses                            |   |           |
| Salaries and employee benefits                      | 15,661  | 15,703    |
| FDIC premiums                                       | 754   | 1,404     |
| Equipment   | 1,815   | 1,905     |
| Occupancy   | 1,867   | 1,867     |
| Data processing                                     | 2,067   | 2,439     |
| Professional Services                               | 843   | 1,145     |
| Other real estate owned                             | 639   | 976       |
| Other   | 5,552   | 4,782     |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|   |          |          |
|---|----------|----------|
| Total other operating expenses                                  | 29,198   | 30,221   |
| Income before income tax expense                                | 8,097    | 5,842    |
| Provision for income tax expense                                | 2,237    | 1,351    |
| Net Income  | 5,860    | 4,491    |
| Accumulated preferred stock dividends                           | (1,575 ) | (2,025 ) |
| Net Income Available to Common Shareholders                     | \$4,285  | \$2,466  |
| Basic and diluted net income per common share                   | \$0.68   | \$0.39   |
| Weighted average number of basic and diluted shares outstanding | 6,263    | 6,247    |

*See accompanying notes to the consolidated financial statements*



**FIRST UNITED CORPORATION**

## Consolidated Statement of Operations

(In thousands, except per share data)

|   | Three Months Ended<br>September 30,<br>2016      2015<br>(Unaudited) |          |
|---|--|----------|
| Interest income                                     |  |          |
| Interest and fees on loans                          | \$ 9,886   | \$ 9,311 |
| Interest on investment securities                   |  |          |
| Taxable   | 1,378  | 1,755    |
| Exempt from federal income tax                      | 199  | 302      |
| Total investment income                             | 1,577  | 2,057    |
| Other   | 100  | 93       |
| Total interest income                               | 11,563   | 11,461   |
| Interest expense                                    |  |          |
| Interest on deposits                                | 784  | 960      |
| Interest on short-term borrowings                   | 14   | 14       |
| Interest on long-term borrowings                    | 1,271  | 1,277    |
| Total interest expense                              | 2,069  | 2,251    |
| Net interest income                                 | 9,494  | 9,210    |
| Provision for loan losses                           | 294  | 500      |
| Net interest income after provision for loan losses | 9,200  | 8,710    |
| Other operating income                              |  |          |
| Net gains   | 245  | 95       |
| Service charges                                     | 856  | 792      |
| Trust department                                    | 1,435  | 1,455    |
| Debit card income                                   | 534  | 530      |
| Bank owned life insurance                           | 295  | 294      |
| Brokerage commissions                               | 189  | 238      |
| Other   | 240  | 90       |
| Total other income                                  | 3,549  | 3,399    |
| Total other operating income                        | 3,794  | 3,494    |
| Other operating expenses                            |  |          |
| Salaries and employee benefits                      | 5,217  | 5,445    |
| FDIC premiums                                       | 80   | 474      |
| Equipment   | 606  | 634      |
| Occupancy   | 621  | 617      |
| Data processing                                     | 721  | 823      |
| Professional Services                               | 254  | 240      |
| Other real estate owned                             | 389  | (71 )    |
| Other   | 1,874  | 1,500    |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|   |          |          |
|---|----------|----------|
| Total other operating expenses                                  | 9,762    | 9,662    |
| Income before income tax expense                                | 3,232    | 2,542    |
| Provision for income tax expense                                | 947      | 594      |
| Net Income  | 2,285    | 1,948    |
| Accumulated preferred stock dividends                           | (450 )   | (675 )   |
| Net Income Available to Common Shareholders                     | \$ 1,835 | \$ 1,273 |
| Basic and diluted net income per common share                   | \$ 0.29  | \$ 0.20  |
| Weighted average number of basic and diluted shares outstanding | 6,269    | 6,255    |

*See accompanying notes to the consolidated financial statements*

**FIRST UNITED CORPORATION**

## Consolidated Statement of Comprehensive Income

(In thousands)

|  | Nine months ended<br>September 30,<br>2016      2015<br>(Unaudited) |          |
|--|---|----------|
| Comprehensive Income (in thousands)                                      |   |          |
| Net Income   | \$ 5,860  | \$ 4,491 |
| Other comprehensive income, net of tax and reclassification adjustments: |   |          |
| Net unrealized gains on investments with OTTI                            | 224   | 3,729    |
| Net unrealized (losses)/gains on all other AFS securities                | (207 )  | 1,394    |
| Net unrealized gains on HTM securities                                   | 547   | 225      |
| Net unrealized (losses)/gains on cash flow hedges                        | (480 )  | 55       |
| Net unrealized losses on pension   | (561 )  | (2,452 ) |
| Net unrealized gains on SERP   | 45  | 31       |
| Other comprehensive (loss)/income, net of tax                            | (432 )  | 2,982    |
| Comprehensive income   | \$ 5,428  | \$ 7,473 |

*See accompanying notes to the consolidated financial statements*

**FIRST UNITED CORPORATION**

## Consolidated Statement of Comprehensive Income

(In thousands)

|  | Three months ended<br>September 30,<br>2016      2015<br>(Unaudited) |          |
|--|--|----------|
| Comprehensive Income (in thousands)                                      |  |          |
| Net Income   | \$ 2,285   | \$ 1,948 |
| Other comprehensive income, net of tax and reclassification adjustments: |  |          |
| Net unrealized gains on investments with OTTI                            | 27   | 913      |
| Net unrealized (losses)/gains on all other AFS securities                | (460 )   | 727      |
| Net unrealized gains on HTM securities                                   | 182  | 64       |
| Net unrealized gains on cash flow hedges                                 | 157  | 20       |
| Net unrealized losses on pension   | (266 )   | (1,616 ) |
| Net unrealized gains on SERP   | 15   | 10       |
| Other comprehensive (loss)/income, net of tax                            | (345 )   | 118      |
| Comprehensive income   | \$ 1,940   | \$ 2,066 |

*See accompanying notes to the consolidated financial statements*

**FIRST UNITED CORPORATION**

## Consolidated Statement of Changes in Shareholders' Equity

(In thousands)

|                                | Preferred<br>Stock | Common<br>Stock | Surplus  | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income/(Loss) | Total<br>Shareholders'<br>Equity |
|--------------------------------|--------------------|-----------------|----------|----------------------|--|----------------------------------|
|                                | (Unaudited)        |                 |          |                      |  |                                  |
| Balance at January 1, 2015     | \$30,000           | \$ 62           | \$21,795 | \$77,375             | \$ (20,233 )   | \$ 108,999                       |
| Net income                     |                    |                 |          | 10,876               |  | 10,876                           |
| Other comprehensive income     |                    |                 |          |                      | 3,404  | 3,404                            |
| Stock based compensation       |                    | 1               | 191      |                      |  | 192                              |
| Preferred stock dividends paid |                    |                 |          | (2,700 )             |  | (2,700 )                         |
| Balance at December 31, 2015   | 30,000             | 63              | 21,986   | 85,551               | (16,829 )  | 120,771                          |
| Net income                     |                    |                 |          | 5,860                |  | 5,860                            |
| Other comprehensive loss       |                    |                 |          |                      | (432 )   | (432 )                           |
| Stock based compensation       |                    |                 | 144      |                      |  | 144                              |
| Preferred stock redemption     | (10,000)           |                 |          |                      |  | (10,000 )                        |
| Preferred stock dividends paid |                    |                 |          | (1,575 )             |  | (1,575 )                         |
| Balance at September 30, 2016  | \$20,000           | \$ 63           | \$22,130 | \$89,836             | \$ (17,261 )   | \$ 114,768                       |

*See accompanying notes to the consolidated financial statements*

**FIRST UNITED CORPORATION**

## Consolidated Statement of Cash Flows

(In thousands)

|   | Nine months ended<br>September 30,<br>2016      2015<br>(Unaudited) |          |
|---|---|----------|
| <b>Operating activities</b>   |   |          |
| Net income  | \$5,860   | \$4,491  |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |          |
| Provision for loan losses   | 2,208   | 626      |
| Depreciation  | 1,246   | 1,307    |
| Stock compensation  | 144   | 144      |
| Gain on sales of other real estate owned  | (140 )  | (718 )   |
| Write-downs of other real estate owned  | 366   | 1,202    |
| Gain on loan sales  | (66 )   | (40 )    |
| Loss on disposal of fixed assets  | 0   | 2        |
| Net amortization of investment securities discounts and premiums- AFS             | 257   | 436      |
| Net amortization of investment securities discounts and premiums- HTM             | 82  | 78       |
| Gains on sales of investment securities – available-for-sale                      | (459 )  | (62 )    |
| Amortization of deferred loan fees  | (368 )  | (408 )   |
| (Increase)/decrease in accrued interest receivable and other assets               | (82 )   | 2,638    |
| Decrease in deferred tax benefit  | 318   | 377      |
| Decrease in accrued interest payable and other liabilities                        | (289 )  | (137 )   |
| Earnings on bank owned life insurance   | (1,130 )  | (849 )   |
| Net cash provided by operating activities   | 7,947   | 9,087    |
| <b>Investing activities</b>   |   |          |
| Proceeds from maturities/calls of investment securities available-for-sale        | 33,227  | 38,713   |
| Proceeds from maturities/calls of investment securities held-to-maturity          | 16,533  | 6,348    |
| Proceeds from sales of investment securities available-for-sale                   | 43,782  | 52,672   |
| Purchases of investment securities available-for-sale                             | (54,587)  | (47,640) |
| Purchases of investment securities held-to-maturity                               | (9,442 )  | (3,709 ) |
| Proceeds from sales of other real estate owned                                    | 2,265   | 5,870    |
| Proceeds from loan sales  | 8,838   | 4,935    |
| Proceeds from disposal of fixed assets  | 260   | 6        |
| Purchase of BOLI policy   | 0   | (5,500 ) |
| Proceeds from BOLI death benefit  | 608   | 0        |
| Net decrease in FHLB stock  | 23  | 1,620    |
| Net increase in loans   | (39,823)  | (8,967 ) |
| Purchases of premises and equipment   | (3,671 )  | (699 )   |
| Net cash (used in)/provided by investing activities                               | (1,987 )  | 43,649   |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|   |          |          |
|---|----------|----------|
| Financing activities                                |          |          |
| Net increase in deposits                            | 20,391   | 15,018   |
| Preferred stock dividends paid                      | (1,575 ) | (2,025 ) |
| Preferred stock redemption                          | (10,000) | 0        |
| Common stock grants                                 | 0        | 1        |
| Net decrease in short-term borrowings               | (43 )    | (1,341 ) |
| Payments on long-term borrowings                    | (790 )   | (35,051) |
| Net cash provided/(used in) by financing activities | 7,983    | (23,398) |
| Increase in cash and cash equivalents               | 13,943   | 29,338   |
| Cash and cash equivalents at beginning of the year  | 52,141   | 35,451   |
| Cash and cash equivalents at end of period          | \$66,084 | \$64,789 |
| Supplemental information                            |          |          |
| Interest paid                                       | \$6,175  | \$7,533  |
| Non-cash investing activities:                      |          |          |
| Transfers from loans to other real estate owned     | \$5,867  | \$899    |

*See accompanying notes to the consolidated financial statements*

## FIRST UNITED CORPORATION

NoteS to Consolidated Financial Statements (UNAUDITED)

### Note 1 – Basis of Presentation

The accompanying unaudited consolidated financial statements of First United Corporation and its consolidated subsidiaries, including First United Bank & Trust (the “Bank”), have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information, as required by the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 270, *Interim Reporting*, and with the instructions to Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all the information and footnotes required for annual financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation, consisting of normal recurring items, have been included. Operating results for the nine- and three-month periods ended September 30, 2016 are not necessarily indicative of the results that may be expected for the full year or for any future interim period. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in First United Corporation’s Annual Report on Form 10-K for the year ended December 31, 2015. For purposes of comparability, certain prior period amounts have been reclassified to conform to the 2016 presentation. Such reclassifications had no impact on net income or equity.

As used in these notes, the term “the Corporation” refers to First United Corporation and, unless the context clearly requires otherwise, its consolidated subsidiaries.

### Note 2 – Earnings Per Common Share

Basic earnings per common share is derived by dividing net income available to common shareholders by the weighted-average number of common shares outstanding during the period and does not include the effect of any potentially dilutive common stock equivalents. Diluted earnings per share is derived by dividing net income available to common shareholders by the weighted-average number of shares outstanding, adjusted for the dilutive effect of outstanding common stock equivalents. There were no common stock equivalents at September 30, 2016 or September 30, 2015.

The following tables set forth the calculation of basic and diluted earnings per common share for the nine- and three-month periods ended September 30, 2016 and 2015:



Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

| (in thousands, except for per share amount) | Nine months ended September 30, |                |                  |         |                |                  |
|---|---------------------------------|----------------|------------------|---------|----------------|------------------|
|   | 2016                            |                |                  | 2015    |                |                  |
|   | Income                          | Average Shares | Per Share Amount | Income  | Average Shares | Per Share Amount |
| Basic and Diluted Earnings Per Share:       |                                 |                |                  |         |                |                  |
| Net income                                  | \$5,860                         |                |                  | \$4,491 |                |                  |
| Preferred stock dividends                   | (1,575)                         |                |                  | (2,025) |                |                  |
| Net income available to common shareholders | \$4,285                         | 6,263          | \$ 0.68          | \$2,466 | 6,247          | \$ 0.39          |

| (in thousands, except for per share amount) | Three months ended September 30, |                |                  |         |                |                  |
|---|----------------------------------|----------------|------------------|---------|----------------|------------------|
|   | 2016                             |                |                  | 2015    |                |                  |
|   | Income                           | Average Shares | Per Share Amount | Income  | Average Shares | Per Share Amount |
| Basic and Diluted Earnings Per Share:       |                                  |                |                  |         |                |                  |
| Net income                                  | \$2,285                          |                |                  | \$1,948 |                |                  |
| Preferred stock dividends                   | (450 )                           |                |                  | (675 )  |                |                  |
| Net income available to common shareholders | \$1,835                          | 6,269          | \$ 0.29          | \$1,273 | 6,255          | \$ 0.20          |

**Note 3 – Net Gains**

The following table summarizes the gain/(loss) activity for the nine- and three-month periods ended September 30, 2016 and 2015:

| (in thousands)                   | Nine months ended     |        | Three months ended    |        |
|----------------------------------|-----------------------|--------|-----------------------|--------|
|                                  | September 30,<br>2016 | 2015   | September 30,<br>2016 | 2015   |
| Net gains/(losses):              |                       |        |                       |        |
| Available-for-sale securities:   |                       |        |                       |        |
| Realized gains                   | \$ 688                | \$ 373 | \$ 273                | \$ 217 |
| Realized losses                  | (229 )                | (311 ) | (41 )                 | (138 ) |
| Gain on sale of consumer loans   | 66                    | 40     | 18                    | 16     |
| Loss on disposal of fixed assets | 0                     | (2 )   | (5 )                  | 0      |
| Net gains                        | \$ 525                | \$ 100 | \$ 245                | \$ 95  |

**Note 4 – Cash and Cash Equivalents**

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

| (in thousands)   | September<br>30,<br>2016 | December<br>31,<br>2015 |
|--|--------------------------|-------------------------|
| Cash and due from banks, weighted average interest rate of 0.24% (at September 30, 2016) | \$ 64,560                | \$ 50,188               |

Interest bearing deposits in banks, which represent funds invested at a correspondent bank, are carried at cost which approximates fair value and, as of September 30, 2016 and December 31, 2015, consisted of daily funds invested at the Federal Home Loan Bank (“FHLB”) of Atlanta, First Tennessee Bank (“FTN”), and Merchants and Traders (“M&T”).

| (in thousands)   | September 30,<br>2016 | December 31,<br>2015 |
|--|-----------------------|----------------------|
| FHLB daily investments, interest rate of 0.31% (at September 30, 2016) | \$ 511                | \$ 742               |
| FTN daily investments, interest rate of 0.00% (at September 30, 2016)  | 0                     | 200                  |

|   |          |          |
|---|----------|----------|
| M&T daily investments, interest rate of 0.15% (at September 30, 2016) | 1,013    | 1,011    |
|   | \$ 1,524 | \$ 1,953 |

**Note 5 – Investments**

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

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

The following table shows a comparison of amortized cost and fair values of investment securities at September 30, 2016 and December 31, 2015:

| (in thousands)                                   | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | OTTI in AOCI |
|--|----------------|------------------------|-------------------------|------------|--------------|
| <b>September 30, 2016</b>                        |                |                        |                         |            |              |
| <b>Available for Sale:</b>                       |                |                        |                         |            |              |
| U.S. government agencies                         | \$ 25,000      | \$ 4                   | 3                       | \$ 25,001  | \$ 0         |
| Commercial mortgage-backed agencies              | 56,191         | 850                    | 31                      | 57,010     | 0            |
| Collateralized mortgage obligations              | 21,014         | 57                     | 63                      | 21,008     | 0            |
| Obligations of states and political subdivisions | 24,403         | 737                    | 49                      | 25,091     | 0            |
| Collateralized debt obligations                  | 24,721         | 0                      | 4,794                   | 19,927     | (427 )       |
| Total available for sale                         | \$ 151,329     | \$ 1,648               | \$ 4,940                | \$ 148,037 | \$ (427 )    |
| <b>Held to Maturity:</b>                         |                |                        |                         |            |              |
| U.S. government agencies                         | \$ 15,704      | \$ 1,135               | \$ 0                    | \$ 16,839  | \$ 0         |
| Residential mortgage-backed agencies             | 52,784         | 1,230                  | 19                      | 53,995     | 0            |
| Commercial mortgage-backed agencies              | 17,657         | 1,073                  | 0                       | 18,730     | 0            |
| Collateralized mortgage obligations              | 5,255          | 25                     | 0                       | 5,280      | 0            |
| Obligations of states and political subdivisions | 6,987          | 1,455                  | 0                       | 8,442      | 0            |
| Total held to maturity                           | \$ 98,387      | \$ 4,918               | \$ 19                   | \$ 103,286 | \$ 0         |
| <b>December 31, 2015</b>                         |                |                        |                         |            |              |
| <b>Available for Sale:</b>                       |                |                        |                         |            |              |
| U.S. government agencies                         | 34,079         | 14                     | 129                     | 33,964     | 0            |
| Residential mortgage-backed agencies             | 14,285         | 105                    | 220                     | 14,170     | 0            |
| Commercial mortgage-backed agencies              | 43,780         | 52                     | 196                     | 43,636     | 0            |
| Collateralized mortgage obligations              | 9,690          | 43                     | 123                     | 9,610      | 0            |
| Obligations of states and political subdivisions | 45,949         | 915                    | 223                     | 46,641     | 0            |
| Collateralized debt obligations                  | 25,766         | 0                      | 3,555                   | 22,211     | (799 )       |
| Total available for sale                         | \$ 173,549     | \$ 1,129               | \$ 4,446                | \$ 170,232 | \$ (799 )    |
| <b>Held to Maturity:</b>                         |                |                        |                         |            |              |
| U.S. government agencies                         | \$ 24,704      | \$ 634                 | \$ 0                    | \$ 25,338  | \$ 0         |
| Residential mortgage-backed agencies             | 53,734         | 276                    | 98                      | 53,912     | 0            |
| Commercial mortgage-backed agencies              | 18,078         | 171                    | 17                      | 18,232     | 0            |
| Collateralized mortgage obligations              | 6,419          | 0                      | 122                     | 6,297      | 0            |
| Obligations of states and political subdivisions | 2,625          | 338                    | 0                       | 2,963      | 0            |
| Total held to maturity                           | \$ 105,560     | \$ 1,419               | \$ 237                  | \$ 106,742 | \$ 0         |

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

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

| (in thousands)  | Nine months ended |          | Three months ended |          |
|-----------------|-------------------|----------|--------------------|----------|
|                 | September 30,     |          | September 30,      |          |
|                 | 2016              | 2015     | 2016               | 2015     |
| Proceeds        | \$43,782          | \$52,672 | \$18,191           | \$28,005 |
| Realized gains  | 688               | 373      | 273                | 217      |
| Realized losses | 229               | 311      | 41                 | 138      |

The following table shows the Corporation's investment securities with gross unrealized losses and fair values at September 30, 2016 and December 31, 2015, aggregated by investment category and the length of time that individual securities have been in a continuous unrealized loss position:

| (in thousands)                                   | Less than 12 months |                   | 12 months or more |                   |
|--|---------------------|-------------------|-------------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses |
| September 30, 2016                               |                     |                   |                   |                   |
| Available for Sale:                              |                     |                   |                   |                   |
| U.S. government agencies                         | \$9,997             | \$ 3              | \$0               | \$ 0              |
| Commercial mortgage-backed agencies              | 12,683              | 31                | 0                 | 0                 |
| Collateralized mortgage obligations              | 15,104              | 63                | 0                 | 0                 |
| Obligations of states and political subdivisions | 267                 | 1                 | 3,231             | 48                |
| Collateralized debt obligations                  | 12,361              | 1,140             | 7,566             | 3,654             |
| Total available for sale                         | \$50,412            | \$ 1,238          | \$10,797          | \$ 3,702          |
| Held to Maturity:                                |                     |                   |                   |                   |
| Residential mortgage-backed agencies             | \$3,858             | \$ 18             | \$448             | \$ 1              |
| Total held to maturity                           | \$3,858             | \$ 18             | \$448             | \$ 1              |
| December 31, 2015                                |                     |                   |                   |                   |
| Available for Sale:                              |                     |                   |                   |                   |
| U.S. government agencies                         | \$23,929            | \$ 129            | \$0               | \$ 0              |
| Residential mortgage-backed agencies             | 0                   | 0                 | 8,051             | 220               |
| Commercial mortgage-backed agencies              | 25,858              | 196               | 0                 | 0                 |
| Collateralized mortgage obligations              | 5,299               | 123               | 0                 | 0                 |
| Obligations of states and political subdivisions | 11,537              | 104               | 4,048             | 119               |
| Collateralized debt obligations                  | 0                   | 0                 | 7,688             | 3,555             |
| Total available for sale                         | \$66,623            | \$ 552            | \$19,787          | \$ 3,894          |
| Held to Maturity:                                |                     |                   |                   |                   |
| Residential mortgage-backed agencies             | \$11,085            | \$ 98             | \$0               | \$ 0              |
| Commercial mortgage-backed agencies              | 9,518               | 17                | 0                 | 0                 |
| Collateralized mortgage obligations              | 6,297               | 122               | 0                 | 0                 |
| Total held to maturity                           | \$26,900            | \$ 237            | \$0               | \$ 0              |

Management systematically evaluates securities for impairment on a quarterly basis. Management assesses whether (a) the Corporation has the intent to sell a security being evaluated and (b) it is more likely than not that the Corporation will be required to sell the security prior to its anticipated recovery. If neither applies, then declines in the fair values of securities below their cost that are considered other-than-temporary declines are split into two components. The first is the loss attributable to declining credit quality. Credit losses are recognized in earnings as realized losses in the period in which the impairment determination is made. The second component consists of all other losses, which are recognized in other comprehensive loss. In estimating other-than-temporary impairment ("OTTI") losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) adverse conditions specifically related to the security, an industry, or a geographic area, (3) the historic and

implied volatility of the fair value of the security, (4) changes in the rating of the security by a rating agency, (5) recoveries or additional declines in fair value subsequent to the balance sheet date, (6) failure of the issuer of the security to make scheduled interest or principal payments, and (7) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future. Management also monitors cash flow projections for securities that are considered beneficial interests under the guidance of ASC Subtopic 325-40, *Investments – Other – Beneficial Interests in Securitized Financial Assets*, (ASC Section 325-40-35). Further discussion about the evaluation of securities for impairment can be found in Item 2 of Part I of this report under the heading “*Investment Securities*”.

Management believes that the valuation of certain securities is a critical accounting policy that requires significant estimates in preparation of the Corporation's consolidated financial statements. Management utilizes an independent third party to prepare both the impairment valuations and fair value determinations for the Corporation's collateralized debt obligation ("CDO") portfolio consisting of pooled trust preferred securities. Based on management's review of the assumptions and results of the third-party review, it believes that the valuations are adequate at September 30, 2016.

U.S. Government Agencies – Available for Sale – There was one U.S. government agency in an unrealized loss position for less than 12 months as of September 30, 2016. The security is of investment grade and the Corporation does not intend to sell it, and it is not more than likely than not that the Corporation will be required to sell it before recovery of its amortized cost basis, which may be at maturity. Accordingly, management does not consider this investment to be other-than-temporarily impaired at September 30, 2016. There were no U.S. government agency investments in an unrealized loss position for more than 12 months as of September 30, 2016.

Commercial Mortgage-Backed Agencies – Available for Sale – There were two commercial mortgage-backed agencies in an unrealized loss position for less than 12 months as of September 30, 2016. The securities are of the highest investment grade and the Corporation has the intent and ability to hold the investments to maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at September 30, 2016. There were no commercial mortgage-backed agencies in an unrealized loss position for more than 12 months as of September 30, 2016.

Collateralized Mortgage Obligations – Available for Sale – There were two collateralized mortgage obligations in an unrealized loss position for less than 12 months as of September 30, 2016. The securities are of the highest investment grade and the Corporation has the intent and ability to hold the investments to maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at September 30, 2016. There were no collateralized mortgage obligations in an unrealized loss position for more than 12 months as of September 30, 2016.

Obligations of State and Political Subdivisions – Available for Sale – There was one obligation of state and political subdivisions that has been in an unrealized loss position for less than 12 months and one security that has been in an unrealized loss position for 12 months or more at September 30, 2016. These investments are of investment grade as determined by the major rating agencies and management reviews the ratings of the underlying issuers and performs an in-depth credit analysis on the securities. Management believes that this portfolio is well-diversified throughout the United States, and all bonds continue to perform according to their contractual terms. The Corporation does not intend to sell these investments and it is not more likely than not that the Corporation will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at September 30, 2016.



Collateralized Debt Obligations – Available for Sale - The \$3.7 million in unrealized losses greater than 12 months at September 30, 2016 relates to four pooled trust preferred securities that are included in the CDO portfolio. There were eight pooled trust preferred securities that have been in an unrealized loss position for less than 12 months at September 30, 2016. The eight investments in an unrealized loss for less than 12 months at September 30, 2016 are being held at First United Corporation. These investments had previously been held at the Bank, but, were transferred to First United Corporation at their fair value during the fourth quarter of 2015. The transfer resulted in a loss of \$3.5 million being recognized through earnings. See Note 9 for a discussion of the methodology used by management to determine the fair values of these securities. Based upon a review of credit quality and the cash flow tests performed by the independent third party, management determined that there were no securities that had credit-related non-cash OTTI charges during the first nine months of 2016. The unrealized losses on the remaining securities in the portfolio are primarily attributable to continued depression in marketability, liquidity and the current economic environment.

U.S. Government Agencies – Held to Maturity – There were no U.S. government agencies in an unrealized loss position as of September 30, 2016.

Residential Mortgage-Backed Agencies – Held to Maturity - Three residential mortgage-backed agencies have been in an unrealized loss position for less than 12 months as of September 30, 2016. There was one residential mortgage-backed agency in an unrealized loss position for 12 months or more. The securities are of the highest investment grade and the Corporation has the intent and ability to hold the investments to maturity. Accordingly, management does not consider these investments to be other-than-temporarily impaired at September 30, 2016.

Commercial Mortgage-Backed Agencies – Held to Maturity - There were no commercial mortgage-backed agencies in the Held to Maturity portfolio as of September 30, 2016 in a loss position.

Collateralized Mortgage Obligations – Held to Maturity – There were no collateralized mortgage obligations in the Held to Maturity portfolio as of September 30, 2016 in a loss position.

Obligations of State and Political Subdivisions – Held to Maturity – There were no obligations of state and political subdivisions in the Held to Maturity portfolio as of September 30, 2016 in a loss position.

The following tables present a cumulative roll-forward of the amount of non-cash OTTI charges related to credit losses which have been recognized in earnings for the trust preferred securities in the CDO portfolio held and not intended to be sold for the nine- and three-month periods ended September 30, 2016 and 2015:

| (in thousands)  | Nine months ended September 30, |           |
|---|---------------------------------|-----------|
|   | 2016                            | 2015      |
| Balance of credit-related OTTI at January 1                             | \$ 3,133                        | \$ 12,583 |
| Decreases for previously recognized credit-related OTTI due to transfer | (3,045 )                        | 0         |
| Additions for decreases in cash flows expected to be collected          | 33                              | 0         |
| Reduction for increases in cash flows expected to be collected          | (7 )                            | (479 )    |
| Balance of credit-related OTTI at September 30                          | \$ 114                          | \$ 12,104 |

| (in thousands)  | Three months ended September 30, |           |
|---|----------------------------------|-----------|
|   | 2016                             | 2015      |
| Balance of credit-related OTTI at July 1                                | \$ 116                           | \$ 12,243 |
| Decreases for previously recognized credit-related OTTI due to transfer | 0                                | 0         |
| Additions for decreases in cash flows expected to be collected          | 0                                | 0         |
| Reduction for increases in cash flows expected to be collected          | (2 )                             | (139 )    |
| Balance of credit-related OTTI at September 30                          | \$ 114                           | \$ 12,104 |



The amortized cost and estimated fair value of securities by contractual maturity at September 30, 2016 are shown in the following table. Actual maturities may differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

| (in thousands)                         | September 30, 2016 |            |
|--|--------------------|------------|
|  | Amortized Cost     | Fair Value |
| <b>Contractual Maturity</b>            |                    |            |
| Available for sale:                    |                    |            |
| Due after one year through five years  | \$10,671           | \$ 10,681  |
| Due after five years through ten years | 19,939             | 20,102     |
| Due after ten years                    | 43,514             | 39,236     |
|  | 74,124             | 70,019     |
| Commercial mortgage-backed agencies    | 56,191             | 57,010     |
| Collateralized mortgage obligations    | 21,014             | 21,008     |
| Total available for sale               | \$151,329          | \$ 148,037 |
| Held to Maturity:                      |                    |            |
| Due after five years through ten years | \$15,704           | \$ 16,839  |
| Due after ten years                    | 6,987              | 8,442      |
|  | 22,691             | 25,281     |
| Residential mortgage-backed agencies   | \$52,784           | \$ 53,995  |
| Commercial mortgage-backed agencies    | 17,657             | 18,730     |
| Collateralized mortgage obligations    | 5,255              | 5,280      |
| Total held to maturity                 | \$98,387           | \$ 103,286 |

#### **Note 6 – Restricted Investment in Bank Stock**

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

Management evaluates the restricted stock for impairment in accordance with ASC Industry Topic 942, *Financial Services – Depository and Lending-* (ASC Section 942-325-35). Management’s evaluation of potential impairment is based on management’s assessment of the ultimate recoverability of the cost of the restricted stock rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability is influenced by criteria such as (a) the significance of the decline in net assets of the issuing bank as compared to the capital stock amount for that bank and the length of time this situation has persisted, (b) commitments by the issuing bank to make payments required by law or regulation and the level of such payments in relation to the operating performance of that bank, and (c) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the issuing bank. Management has evaluated the restricted stock for impairment and believes that

no impairment charge is necessary as of September 30, 2016.

The Corporation recognizes dividends received on its restricted stock investments on a cash basis. For the nine months ended September 30, 2016, dividends of \$203,073 were recognized in earnings. For the comparable period of 2015, dividends of \$234,445 were recognized in earnings. For the three months ended September 30, 2016, dividends of \$65,897 were recognized in earnings. For the comparable period of 2015, dividends of \$78,777 were recognized in earnings.

**Note 7 – Loans and Related Allowance for Loan Losses**

The following table summarizes the primary segments of the loan portfolio at September 30, 2016 and December 31, 2015:

| (in thousands)                        | Commercial Real Estate | Acquisition and Development | Commercial and Industrial | Residential Mortgage | Consumer  | Total      |
|---------------------------------------|------------------------|-----------------------------|---------------------------|----------------------|-----------|------------|
| September 30, 2016                    |                        |                             |                           |                      |           |            |
| Individually evaluated for impairment | \$ 20,568              | \$ 2,541                    | \$ 1,061                  | \$ 5,024             | \$ 0      | \$ 29,194  |
| Collectively evaluated for impairment | \$ 272,019             | \$ 109,050                  | \$ 74,536                 | \$ 393,445           | \$ 24,245 | \$ 873,295 |
| Total loans                           | \$ 292,587             | \$ 111,591                  | \$ 75,597                 | \$ 398,469           | \$ 24,245 | \$ 902,489 |
| December 31, 2015                     |                        |                             |                           |                      |           |            |
| Individually evaluated for impairment | \$ 14,646              | \$ 4,496                    | \$ 1,076                  | \$ 4,590             | \$ 0      | \$ 24,808  |
| Collectively evaluated for impairment | \$ 265,859             | \$ 106,490                  | \$ 72,777                 | \$ 384,149           | \$ 24,940 | \$ 854,215 |
| Total loans                           | \$ 280,505             | \$ 110,986                  | \$ 73,853                 | \$ 388,739           | \$ 24,940 | \$ 879,023 |

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

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

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Bank has a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as bankruptcy, repossession, or death occurs to raise awareness of a possible credit event. The Bank’s Commercial Loan Officers are responsible for the timely and accurate risk rating of the loans in the commercial segments at origination and on an ongoing basis. The Bank’s experienced Credit Quality and Loan Review Department performs an annual review of all commercial relationships of \$500,000 or greater. Confirmation of the appropriate risk grade is included as part of the review process on an ongoing basis. The Credit Quality and Loan Review Department continually reviews and assesses loans within the portfolio. In addition, the Bank engages an external consultant to conduct loan reviews on at least an annual basis. Generally, the external consultant reviews commercial relationships greater than \$1,000,000 and/or criticized non-consumer loans greater than \$500,000. Detailed reviews, including plans for resolution, are performed on loans classified as Substandard on a quarterly basis. Loans in the Special Mention and Substandard categories that are collectively evaluated for impairment are given separate consideration in the determination of the allowance.

The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention and Substandard within the internal risk rating system at September 30, 2016 and December 31, 2015:

| (in thousands)                      | Pass       | Special Mention | Substandard | Total      |
|-------------------------------------|------------|-----------------|-------------|------------|
| September 30, 2016                  |            |                 |             |            |
| Commercial real estate              |            |                 |             |            |
| Non owner-occupied                  | \$ 138,595 | \$ 11,315       | \$ 12,711   | \$ 162,621 |
| All other CRE                       | 108,317    | 9,352           | 12,297      | 129,966    |
| Acquisition and development         |            |                 |             |            |
| 1-4 family residential construction | 18,607     | 0               | 582         | 19,189     |
| All other A&D                       | 88,708     | 67              | 3,627       | 92,402     |
| Commercial and industrial           | 73,630     | 158             | 1,809       | 75,597     |
| Residential mortgage                |            |                 |             |            |
| Residential mortgage - term         | 310,243    | 0               | 10,779      | 321,022    |
| Residential mortgage - home equity  | 76,279     | 0               | 1,168       | 77,447     |
| Consumer                            | 24,137     | 0               | 108         | 24,245     |
| Total                               | \$ 838,516 | \$ 20,892       | \$ 43,081   | \$ 902,489 |
| December 31, 2015                   |            |                 |             |            |
| Commercial real estate              |            |                 |             |            |
| Non owner-occupied                  | \$ 140,378 | \$ 11,574       | \$ 7,378    | \$ 159,330 |
| All other CRE                       | 103,811    | 1,184           | 16,180      | 121,175    |
| Acquisition and development         |            |                 |             |            |
| 1-4 family residential construction | 15,011     | 0               | 700         | 15,711     |
| All other A&D                       | 89,963     | 74              | 5,238       | 95,275     |
| Commercial and industrial           | 69,420     | 1,212           | 3,221       | 73,853     |
| Residential mortgage                |            |                 |             |            |
| Residential mortgage - term         | 300,558    | 167             | 10,744      | 311,469    |
| Residential mortgage - home equity  | 75,491     | 0               | 1,779       | 77,270     |
| Consumer                            | 24,881     | 0               | 59          | 24,940     |
| Total                               | \$ 819,513 | \$ 14,211       | \$ 45,299   | \$ 879,023 |

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





The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and non-accrual loans at September 30, 2016 and December 31, 2015:

| (in thousands)                         | Current    | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90<br>Days+<br>Past Due | Total<br>Past<br>Due and<br>Accruing | Non-Accrual | Total<br>Loans |
|--|------------|---------------------------|---------------------------|-------------------------|--------------------------------------|-------------|----------------|
| September 30, 2016                     |            |                           |                           |                         |                                      |             |                |
| Commercial real estate                 |            |                           |                           |                         |                                      |             |                |
| Non owner-occupied                     | \$ 152,608 | \$ 326                    | \$ 0                      | \$ 0                    | \$ 326                               | \$ 9,687    | \$ 162,621     |
| All other CRE                          | 123,090    | 1,029                     | 0                         | 0                       | 1,029                                | 5,847       | 129,966        |
| Acquisition and development            |            |                           |                           |                         |                                      |             |                |
| 1-4 family residential<br>construction | 19,189     | 0                         | 0                         | 0                       | 0                                    | 0           | 19,189         |
| All other A&D                          | 92,041     | 35                        | 91                        | 189                     | 315                                  | 46          | 92,402         |
| Commercial and industrial              | 75,536     | 47                        | 2                         | 12                      | 61                                   | 0           | 75,597         |
| Residential mortgage                   |            |                           |                           |                         |                                      |             |                |
| Residential mortgage - term            | 315,522    | 359                       | 2,582                     | 233                     | 3,174                                | 2,326       | 321,022        |
| Residential mortgage - home<br>equity  | 76,095     | 882                       | 232                       | 0                       | 1,114                                | 238         | 77,447         |
| Consumer                               | 23,992     | 116                       | 132                       | 5                       | 253                                  | 0           | 24,245         |
| Total                                  | \$ 878,073 | \$ 2,794                  | \$ 3,039                  | \$ 439                  | \$ 6,272                             | \$ 18,144   | \$ 902,489     |
| December 31, 2015                      |            |                           |                           |                         |                                      |             |                |
| Commercial real estate                 |            |                           |                           |                         |                                      |             |                |
| Non owner-occupied                     | \$ 157,217 | \$ 634                    | \$ 171                    | \$ 0                    | \$ 805                               | \$ 1,308    | \$ 159,330     |
| All other CRE                          | 110,022    | 1,179                     | 0                         | 0                       | 1,179                                | 9,974       | 121,175        |
| Acquisition and development            |            |                           |                           |                         |                                      |             |                |
| 1-4 family residential<br>construction | 15,711     | 0                         | 0                         | 0                       | 0                                    | 0           | 15,711         |
| All other A&D                          | 93,284     | 0                         | 174                       | 0                       | 174                                  | 1,817       | 95,275         |
| Commercial and industrial              | 73,619     | 13                        | 36                        | 0                       | 49                                   | 185         | 73,853         |
| Residential mortgage                   |            |                           |                           |                         |                                      |             |                |
| Residential mortgage - term            | 306,248    | 227                       | 2,149                     | 907                     | 3,283                                | 1,938       | 311,469        |
| Residential mortgage - home<br>equity  | 76,195     | 505                       | 203                       | 91                      | 799                                  | 276         | 77,270         |
| Consumer                               | 24,604     | 224                       | 85                        | 27                      | 336                                  | 0           | 24,940         |
| Total                                  | \$ 856,900 | \$ 2,782                  | \$ 2,818                  | \$ 1,025                | \$ 6,625                             | \$ 15,498   | \$ 879,023     |

Non-accrual loans totaled \$18.1 million at September 30, 2016, compared to \$15.5 million at December 31, 2015. The increase in non-accrual balances at September 30, 2016 is primarily due to one large participation loan moved to non-accrual during the third quarter offset by one large relationship moving to other real estate owned ("OREO"). Non-accrual loans which have been subject to a partial charge-off totaled \$5.2 million at September 30, 2016, compared to \$4.1 million at December 31, 2015. Loans secured by 1-4 family residential real estate properties in the

process of foreclosure were \$1.2 million at September 30, 2016 and \$1.8 million at December 31, 2015.

Accruing loans past due 30 days or more decreased to .69% of the loan portfolio at September 30, 2016, compared to .76% at December 31, 2015. The decrease for the first nine months of 2016 was due primarily to improvements in the non-owner occupied commercial real-estate, offset by an increase in the residential home equity portfolio.

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

The Bank's methodology for determining the ALL is based on the requirements of ASC Section 310-10-35, *Receivables-Overall-Subsequent Measurement*, for loans individually evaluated for impairment and ASC Subtopic 450-20, *Contingencies-Loss Contingencies*, for loans collectively evaluated for impairment, as well as the Interagency Policy Statement on the Allowance for Loan and Lease Losses and other bank regulatory guidance. The total of the two components represents the allocated portion of the Bank's ALL. In the second quarter of 2015, management determined that it would be prudent to establish an unallocated portion of the ALL to protect the Bank from other risks associated with the loan portfolio that may not be specifically identifiable.

The following table summarizes the primary segments of the ALL at September 30, 2016 and December 31, 2015, segregated by the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment:

| (in thousands)                        | Commercial Real Estate | Acquisition and Development | Commercial and Industrial | Residential Mortgage | Consumer | Unallocated | Total    |
|---------------------------------------|------------------------|-----------------------------|---------------------------|----------------------|----------|-------------|----------|
| September 30, 2016                    |                        |                             |                           |                      |          |             |          |
| Individually evaluated for impairment | \$ 1,886               | \$ 159                      | \$ 0                      | \$ 143               | \$ 0     | \$ 0        | \$2,188  |
| Collectively evaluated for impairment | \$ 3,638               | \$ 1,107                    | \$ 890                    | \$ 3,522             | \$ 199   | \$ 500      | \$9,856  |
| Total ALL                             | \$ 5,524               | \$ 1,266                    | \$ 890                    | \$ 3,665             | \$ 199   | \$ 500      | \$12,044 |
| December 31, 2015                     |                        |                             |                           |                      |          |             |          |
| Individually evaluated for impairment | \$ 144                 | \$ 867                      | \$ 16                     | \$ 130               | \$ 0     | \$ 0        | \$1,157  |
| Collectively evaluated for impairment | \$ 2,436               | \$ 3,262                    | \$ 706                    | \$ 3,655             | \$ 206   | \$ 500      | \$10,765 |
| Total ALL                             | \$ 2,580               | \$ 4,129                    | \$ 722                    | \$ 3,785             | \$ 206   | \$ 500      | \$11,922 |

Management evaluates individual loans in all of the commercial segments for possible impairment if the loan (a) is greater than \$500,000 or (b) is part of a relationship that is greater than \$750,000 and is either (1) in nonaccrual status or (2) risk-rated Substandard and greater than 60 days past due. Loans are considered to be impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in evaluating impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. The Bank does not separately evaluate individual consumer and residential mortgage loans for impairment, unless such loans are part of a larger relationship that is

impaired; otherwise, loans in these segments are considered impaired when they are classified as non-accrual.

Once the determination has been made that a loan is impaired, the determination of whether a specific allocation of the allowance is necessary is measured by comparing the recorded investment in the loan to the fair value of the loan using one of three methods: (a) the present value of expected future cash flows discounted at the loan's effective interest rate; (b) the loan's observable market price; or (c) the fair value of the collateral less selling costs. The method is selected on a loan-by-loan basis, with management primarily utilizing the fair value of collateral method. If the fair value of the collateral less selling costs method is utilized for collateral securing loans in the commercial segments, then an updated external appraisal is ordered on the collateral supporting the loan if the loan balance is greater than \$500,000 and the existing appraisal is greater than 18 months old. If an updated appraisal has not been received and reviewed in time for the determination of estimated fair value at quarter (or year) end, or if the appraisal is found to be deficient following the Corporation's internal appraisal review process and re-ordered, then the estimated fair value of the collateral is determined by adjusting the existing appraisal by the appropriate percentage from an internally prepared appraisal discount grid. This grid considers the age of a third party appraisal and the geographic region where the collateral is located. The discount rates in the appraisal discount grid are updated periodically to reflect the most current knowledge that management has available, including the results of current appraisals. A specific allocation of the ALL is recorded if there is any deficiency in collateral value determined by comparing the estimated fair value to the recorded investment of the loan. When updated appraisals are received and reviewed, adjustments are made to the specific allocation as needed.

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

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary at September 30, 2016 and December 31, 2015:

| (in thousands)                      | Impaired Loans with Specific Allowance |                    | Impaired Loans with No Specific Allowance | Total Impaired Loans |                          |
|-------------------------------------|--|--------------------|---|----------------------|--------------------------|
|                                     | Recorded Investment                    | Related Allowances | Recorded Investment                       | Recorded Investment  | Unpaid Principal Balance |
| September 30, 2016                  |  |                    |   |                      |                          |
| Commercial real estate              |  |                    |   |                      |                          |
| Non owner-occupied                  | \$ 9,440                               | \$ 1,780           | \$ 635                                    | \$ 10,075            | \$ 10,200                |
| All other CRE                       | 449                                    | 221                | 10,044                                    | 10,493               | 11,106                   |
| Acquisition and development         |  |                    |   |                      |                          |
| 1-4 family residential construction | 582                                    | 117                | 0   | 582                  | 628                      |
| All other A&D                       | 248                                    | 42                 | 1,711                                     | 1,959                | 2,200                    |
| Commercial and industrial           | 0                                      | 0                  | 1,061                                     | 1,061                | 1,870                    |
| Residential mortgage                |  |                    |   |                      |                          |
| Residential mortgage - term         | 408                                    | 28                 | 4,378                                     | 4,786                | 5,135                    |
| Residential mortgage – home equity  | 0                                      | 0                  | 238                                       | 238                  | 277                      |
| Consumer                            | 0                                      | 0                  | 0   | 0                    | 0                        |
| Total impaired loans                | \$ 11,127                              | \$ 2,188           | \$ 18,067                                 | \$ 29,194            | \$ 31,416                |
| December 31, 2015                   |  |                    |   |                      |                          |
| Commercial real estate              |  |                    |   |                      |                          |
| Non owner-occupied                  | \$ 676                                 | \$ 144             | \$ 1,031                                  | \$ 1,707             | \$ 1,842                 |
| All other CRE                       | 0                                      | 0                  | 12,939                                    | 12,939               | 13,302                   |
| Acquisition and development         |  |                    |   |                      |                          |
| 1-4 family residential construction | 700                                    | 178                | 0   | 700                  | 746                      |
| All other A&D                       | 1,979                                  | 689                | 1,817                                     | 3,796                | 8,362                    |
| Commercial and industrial           | 16                                     | 16                 | 1,060                                     | 1,076                | 3,343                    |
| Residential mortgage                |  |                    |   |                      |                          |
| Residential mortgage - term         | 440                                    | 112                | 3,874                                     | 4,314                | 4,808                    |
| Residential mortgage – home equity  | 57                                     | 18                 | 219                                       | 276                  | 297                      |
| Consumer                            | 0                                      | 0                  | 0   | 0                    | 0                        |
| Total impaired loans                | \$ 3,868                               | \$ 1,157           | \$ 20,940                                 | \$ 24,808            | \$ 32,700                |

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

historical loss amounts are modified by other qualitative factors.

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

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

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

Management reviews the loan portfolio on a quarterly basis using a defined, consistently applied process in order to make appropriate and timely adjustments to the ALL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALL. Residential mortgage and consumer loans are charged off after they are 120 days contractually past due. All other loans are charged off based on an evaluation of the facts and circumstances of each individual loan. When the Bank believes that its ability to collect is solely dependent on the liquidation of the collateral, a full or partial charge-off is recorded promptly to bring the recorded investment to an amount that the Bank believes is supported by an ability to collect on the collateral. The circumstances that may impact the Bank’s decision to charge-off all or a portion of a loan include default or non-payment by the borrower, scheduled foreclosure actions, and/or prioritization of the Bank’s claim in bankruptcy. There may be circumstances where, due to pending events, the Bank will place a specific allocation of the ALL on a loan for which a partial charge-off has been previously recognized. This specific allocation may be either charged off or removed depending upon the outcome of the pending event. Full or partial charge-offs are not recovered until full principal and interest on the loan have been collected, even if a subsequent appraisal supports a higher value. Loans with partial charge-offs generally remain in non-accrual status. Both full and partial charge-offs reduce the recorded investment of the loan and the ALL and are considered to be charge-offs for purposes of all credit loss metrics and trends, including the historical rolling charge-off rates used in the determination of the ALL. At September 30, 2016, \$.5 million of the ALL was considered to be unallocated.



The following tables present the activity in the ALL for the nine- and three-month periods ended September 30, 2016 and 2015:

| (in thousands)                    | Commercial Real Estate | Acquisition and Development | Commercial and Industrial | Residential Mortgage | Consumer | Unallocated | Total    |
|-----------------------------------|------------------------|-----------------------------|---------------------------|----------------------|----------|-------------|----------|
| ALL balance at January 1, 2016    | \$ 2,580               | \$ 4,129                    | \$ 722                    | \$ 3,785             | \$ 206   | \$ 500      | \$11,922 |
| Charge-offs                       | (2,632 )               | (78 )                       | (518 )                    | (516 )               | (237 )   | 0           | (3,981 ) |
| Recoveries                        | 85                     | 1,278                       | 45                        | 373                  | 114      | 0           | 1,895    |
| Provision                         | 5,491                  | (4,063 )                    | 641                       | 23                   | 116      | 0           | 2,208    |
| ALL balance at September 30, 2016 | \$ 5,524               | \$ 1,266                    | \$ 890                    | \$ 3,665             | \$ 199   | \$ 500      | \$12,044 |
| ALL balance at January 1, 2015    | \$ 2,424               | \$ 3,912                    | \$ 1,680                  | \$ 3,862             | \$ 187   | \$ 0        | \$12,065 |
| Charge-offs                       | (295 )                 | (256 )                      | 0                         | (200 )               | (247 )   | 0           | (998 )   |
| Recoveries                        | 66                     | 100                         | 24                        | 162                  | 166      | 0           | 518      |
| Provision                         | 386                    | 732                         | (970 )                    | (132 )               | 110      | 500         | 626      |
| ALL balance at September 30, 2015 | \$ 2,581               | \$ 4,488                    | \$ 734                    | \$ 3,692             | \$ 216   | \$ 500      | \$12,211 |
| (in thousands)                    | Commercial Real Estate | Acquisition and Development | Commercial and Industrial | Residential Mortgage | Consumer | Unallocated | Total    |
| ALL balance at July 1, 2016       | \$ 4,405               | \$ 3,118                    | \$ 737                    | \$ 3,723             | \$ 195   | \$ 500      | \$12,678 |
| Charge-offs                       | (623 )                 | 0                           | (259 )                    | (300 )               | (97 )    | 0           | (1,279 ) |
| Recoveries                        | (8 )                   | (4 )                        | 7                         | 319                  | 37       | 0           | 351      |
| Provision                         | 1,750                  | (1,848 )                    | 405                       | (77 )                | 64       | 0           | 294      |
| ALL balance at September 30, 2016 | \$ 5,524               | \$ 1,266                    | \$ 890                    | \$ 3,665             | \$ 199   | \$ 500      | \$12,044 |
| ALL balance at July 1, 2015       | \$ 2,566               | \$ 3,806                    | \$ 1,007                  | \$ 3,707             | \$ 223   | \$ 500      | \$11,809 |
| Charge-offs                       | (8 )                   | 0                           | 0                         | (164 )               | (73 )    | 0           | (245 )   |
| Recoveries                        | 1                      | 59                          | 4                         | 29                   | 54       | 0           | 147      |
| Provision                         | 22                     | 623                         | (277 )                    | 120                  | 12       | 0           | 500      |
| ALL balance at September 30, 2015 | \$ 2,581               | \$ 4,488                    | \$ 734                    | \$ 3,692             | \$ 216   | \$ 500      | \$12,211 |

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



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

| (in thousands)                      | Nine months ended<br>September 30, 2016 |  |  | Nine months ended<br>September 30, 2015 |  |  |
|-------------------------------------|---|--|--|---|--|--|
|                                     | Average<br>investment                   | Interest<br>income<br>recognized on<br>an accrual<br>basis | Interest<br>income<br>recognized<br>on a cash<br>basis | Average<br>investment                   | Interest<br>income<br>recognized<br>on an accrual<br>basis | Interest<br>income<br>recognized<br>on a cash<br>basis |
| Commercial real estate              |   |  |  |   |  |  |
| Non owner-occupied                  | \$5,903                                 | \$ 125   | \$ 0   | \$4,314                                 | \$ 117   | \$ 0   |
| All other CRE                       | 12,142                                  | 135  | 8  | 7,626                                   | 89   | 8  |
| Acquisition and development         |   |  |  |   |  |  |
| 1-4 family residential construction | 641                                     | 21   | 0  | 745                                     | 26   | 0  |
| All other A&D                       | 2,933                                   | 72   | 0  | 5,311                                   | 94   | 0  |
| Commercial and industrial           | 1,095                                   | 32   | 0  | 1,471                                   | 60   | 18   |
| Residential mortgage                |   |  |  |   |  |  |
| Residential mortgage - term         | 4,718                                   | 121  | 4  | 4,245                                   | 124  | 4  |
| Residential mortgage – home equity  | 302                                     | 0  | 0  | 349                                     | 0  | 2  |
| Consumer                            | 0                                       | 0  | 0  | 7                                       | 0  | 0  |
| Total                               | \$27,734                                | \$ 506   | \$ 12  | \$24,068                                | \$ 510   | \$ 32  |

| (in thousands)                      | Three months ended<br>September 30, 2016 |  |  | Three months ended<br>September 30, 2015 |  |  |
|-------------------------------------|--|--|--|--|--|--|
|                                     | Average<br>investment                    | Interest<br>income<br>recognized on<br>an accrual<br>basis | Interest<br>income<br>recognized<br>on a cash<br>basis | Average<br>investment                    | Interest<br>income<br>recognized<br>on an accrual<br>basis | Interest<br>income<br>recognized<br>on a cash<br>basis |
| Commercial real estate              |  |  |  |  |  |  |
| Non owner-occupied                  | \$10,210                                 | \$ 78  | \$ 0   | \$4,607                                  | \$ 39  | \$ 0   |
| All other CRE                       | 11,191                                   | 55   | 4  | 7,935                                    | 34   | 0  |
| Acquisition and development         |  |  |  |  |  |  |
| 1-4 family residential construction | 582                                      | 6  | 0  | 701                                      | 8  | 0  |
| All other A&D                       | 1,997                                    | 24   | 0  | 5,091                                    | 31   | 0  |
| Commercial and industrial           | 1,119                                    | 13   | 0  | 1,253                                    | 13   | 0  |
| Residential mortgage                |  |  |  |  |  |  |
| Residential mortgage - term         | 4,916                                    | 43   | 0  | 4,400                                    | 42   | 2  |
| Residential mortgage – home equity  | 307                                      | 0  | 0  | 321                                      | 0  | 0  |
| Consumer                            | 0  | 0  | 0  | 0  | 0  | 0  |
| Total                               | \$30,322                                 | \$ 219   | \$ 4   | \$24,308                                 | \$ 167   | \$ 2   |

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

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

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

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

The following tables present the volume and recorded investment at the time of modification of TDRs by class and type of modification that occurred during the periods indicated:

| (in thousands)                       | Temporary Rate Modification |                     | Extension of Maturity |                     | Modification of Payment and Other Terms |                     |
|--------------------------------------|-----------------------------|---------------------|-----------------------|---------------------|---|---------------------|
|                                      | Number of Contracts         | Recorded Investment | Number of Contracts   | Recorded Investment | Number of Contracts                     | Recorded Investment |
| Nine months ended September 30, 2016 |                             |                     |                       |                     |   |                     |
| Commercial real estate               |                             |                     |                       |                     |   |                     |
| Non owner-occupied                   | 0                           | \$ 0                | 0                     | \$ 0                | 0                                       | \$ 0                |
| All other CRE                        | 0                           | 0                   | 1                     | 203                 | 0                                       | 0                   |
| Acquisition and development          |                             |                     |                       |                     |   |                     |
| 1-4 family residential construction  | 0                           | 0                   | 1                     | 582                 | 0                                       | 0                   |
| All other A&D                        | 0                           | 0                   | 1                     | 1,664               | 0                                       | 0                   |
| Commercial and industrial            | 0                           | 0                   | 1                     | 482                 | 1                                       | 486                 |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|                                    |   |       |   |          |   |        |
|------------------------------------|---|-------|---|----------|---|--------|
| Residential mortgage               |   |       |   |          |   |        |
| Residential mortgage – term        | 1 | 54    | 1 | 61       | 1 | 72     |
| Residential mortgage – home equity | 0 | 0     | 0 | 0        | 0 | 0      |
| Consumer                           | 0 | 0     | 0 | 0        | 0 | 0      |
| Total                              | 1 | \$ 54 | 5 | \$ 2,992 | 2 | \$ 558 |

25

| (in thousands)                        | Temporary Rate Modification |                     | Extension of Maturity |                     | Modification of Payment and Other Terms |                     |
|---------------------------------------|-----------------------------|---------------------|-----------------------|---------------------|---|---------------------|
|                                       | Number of Contracts         | Recorded Investment | Number of Contracts   | Recorded Investment | Number of Contracts                     | Recorded Investment |
| Three months ended September 30, 2016 |                             |                     |                       |                     |   |                     |
| Commercial real estate                |                             |                     |                       |                     |   |                     |
| Non owner-occupied                    | 0                           | \$ 0                | 0                     | \$ 0                | 0                                       | \$ 0                |
| All other CRE                         | 0                           | 0                   | 0                     | 0                   | 0                                       | 0                   |
| Acquisition and development           |                             |                     |                       |                     |   |                     |
| 1-4 family residential construction   | 0                           | 0                   | 1                     | 582                 | 0                                       | 0                   |
| All other A&D                         | 0                           | 0                   | 1                     | 1,664               | 0                                       | 0                   |
| Commercial and industrial             | 0                           | 0                   | 1                     | 482                 | 0                                       | 0                   |
| Residential mortgage                  |                             |                     |                       |                     |   |                     |
| Residential mortgage – term           | 0                           | 0                   | 1                     | 61                  | 0                                       | 0                   |
| Residential mortgage – home equity    | 0                           | 0                   | 0                     | 0                   | 0                                       | 0                   |
| Consumer                              | 0                           | 0                   | 0                     | 0                   | 0                                       | 0                   |
| Total                                 | 0                           | \$ 0                | 4                     | \$ 2,789            | 0                                       | \$ 0                |

During the nine months ended September 30, 2016, there were four new TDRs. In addition, three existing TDRs which had reached their original modification maturity were re-modified. A \$3,341 reduction of the ALL resulted from a change to the impairment evaluation of four loans, from being evaluated collectively to being evaluated individually. During the nine months ended September 30, 2016, there were no payment defaults.

During the three months ended September 30, 2016, there was one new TDR. A \$468 reduction of the ALL resulted from a change to the impairment evaluation of the loan, from being evaluated collectively to being evaluated individually. During the three months ended September 30, 2016, there were no payment defaults.

| (in thousands)                       | Temporary Rate Modification |                     | Extension of Maturity |                     | Modification of Payment and Other Terms |                     |
|--------------------------------------|-----------------------------|---------------------|-----------------------|---------------------|---|---------------------|
|                                      | Number of Contracts         | Recorded Investment | Number of Contracts   | Recorded Investment | Number of Contracts                     | Recorded Investment |
| Nine Months Ended September 30, 2015 |                             |                     |                       |                     |   |                     |
| Commercial real estate               |                             |                     |                       |                     |   |                     |
| Non owner-occupied                   | 0                           | \$ 0                | 1                     | \$ 3,097            | 1                                       | \$ 136              |
| All other CRE                        | 0                           | 0                   | 1                     | 237                 | 5                                       | 3,847               |
| Acquisition and development          |                             |                     |                       |                     |   |                     |
| 1-4 family residential construction  | 0                           | 0                   | 0                     | 0                   | 0                                       | 700                 |
| All other A&D                        | 0                           | 0                   | 3                     | 372                 | 0                                       | 1,746               |
| Commercial and industrial            | 0                           | 0                   | 1                     | 930                 | 0                                       | 0                   |
| Residential mortgage                 |                             |                     |                       |                     |   |                     |
| Residential mortgage – term          | 1                           | 156                 | 2                     | 599                 | 1                                       | 116                 |
| Residential mortgage – home equity   | 0                           | 0                   | 0                     | 0                   | 0                                       | 0                   |
| Consumer                             | 0                           | 0                   | 0                     | 0                   | 0                                       | 0                   |
| Total                                | 1                           | \$ 156              | 8                     | \$ 5,235            | 7                                       | \$ 6,545            |

| (in thousands)                        | Temporary Rate Modification |                     | Extension of Maturity |                     | Modification of Payment and Other Terms |                     |
|---------------------------------------|-----------------------------|---------------------|-----------------------|---------------------|---|---------------------|
|                                       | Number of Contracts         | Recorded Investment | Number of Contracts   | Recorded Investment | Number of Contracts                     | Recorded Investment |
| Three Months Ended September 30, 2015 |                             |                     |                       |                     |   |                     |
| Commercial real estate                |                             |                     |                       |                     |   |                     |
| Non owner-occupied                    | 0                           | \$ 0                | 0                     | \$ 0                | 0                                       | \$ 0                |
| All other CRE                         | 0                           | 0                   | 0                     | 0                   | 0                                       | 0                   |
| Acquisition and development           |                             |                     |                       |                     |   |                     |
| 1-4 family residential construction   | 0                           | 0                   | 0                     | 0                   | 1                                       | 700                 |
| All other A&D                         | 0                           | 0                   | 0                     | 0                   | 1                                       | 1,746               |
| Commercial and industrial             | 0                           | 0                   | 0                     | 0                   | 0                                       | 0                   |
| Residential mortgage                  |                             |                     |                       |                     |   |                     |
| Residential mortgage – term           | 1                           | 156                 | 0                     | 0                   | 0                                       | 0                   |
| Residential mortgage – home equity    | 0                           | 0                   | 0                     | 0                   | 0                                       | 0                   |
| Consumer                              | 0                           | 0                   | 0                     | 0                   | 0                                       | 0                   |
| Total                                 | 1                           | \$ 156              | 0                     | \$ 0                | 2                                       | \$ 2,446            |

During the nine months ended September 30, 2015, there were eight new TDRs. In addition, 10 existing TDRs which had reached their original modification maturity were re-modified. A \$5,744 reduction of the ALL resulted from a change to the impairment evaluation of two loans from evaluated collectively to being evaluated individually. The remaining six new TDRs were impaired at the time of modification, resulting in no impact to the ALL as a result of the modifications and there was no impact to the recorded investment relating to the transfer of these loans.





During the quarter ended June 30, 2015, one residential mortgage loan totaling \$70,000 that was modified as a TDR within the previous 12 months was transferred to non-accrual, and is considered a payment default. There were no payment defaults in the quarters ended September 30, 2015 or March 31, 2015.

### Note 8 – Other Real Estate Owned

The following table presents the components of OREO at September 30, 2016 and December 31, 2015:

| (in thousands)              | September 30, 2016 | December 31, 2015 |
|-----------------------------|--------------------|-------------------|
| Commercial real estate      | \$ 3,332           | \$ 1,520          |
| Acquisition and development | 6,128              | 4,167             |
| Residential mortgage        | 799                | 1,196             |
| Total OREO                  | \$ 10,259          | \$ 6,883          |

The following table presents the activity in the OREO valuation allowance for the nine- and three-month periods ended September 30, 2016 and 2015:

| (in thousands)              | For the Nine Months Ended<br>September 30, |          | For the Three Months Ended<br>September 30, |          |
|-----------------------------|--|----------|---|----------|
|                             | 2016                                       | 2015     | 2016  | 2015     |
| Balance beginning of period | \$ 4,430                                   | \$ 3,440 | \$ 3,599                                    | \$ 3,843 |
| Fair value write-down       | 366  | 1,202    | 269   | 350      |
| Sales of OREO               | (1,205 )                                   | (831 )   | (277 )                                      | (382 )   |
| Balance at end of period    | \$ 3,591                                   | \$ 3,811 | \$ 3,591                                    | \$ 3,811 |

The following table presents the components of OREO expenses, net, for the nine- and three-month periods ended September 30, 2016 and 2015:

| (in thousands)             | For the Nine Months Ended<br>September 30, |           | For the Three Months Ended<br>September 30, |           |
|----------------------------|--|-----------|---|-----------|
|                            | 2016                                       | 2015      | 2016  | 2015      |
| Gains on real estate, net  | \$ (140 )                                  | \$ (718 ) | \$ (9 )                                     | \$ (640 ) |
| Fair value write-down, net | 366  | 1,202     | 269   | 350       |
| Expenses, net              | 495  | 704       | 152   | 248       |
| Rental and other income    | (82 )                                      | (212 )    | (23 )                                       | (29 )     |

|                         |        |        |        |          |
|-------------------------|--------|--------|--------|----------|
| Total OREO expense, net | \$ 639 | \$ 976 | \$ 389 | \$ (71 ) |
|-------------------------|--------|--------|--------|----------|

### Note 9 – Fair Value of Financial Instruments

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

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

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

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

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

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

The level established within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. Transfers in and out of Level 1, 2 or 3 are recorded at fair value at the beginning of the reporting period.

Management believes that the Corporation's valuation techniques are appropriate and consistent with the techniques used by other market participants. However, the use of different methodologies and assumptions could result in a different estimate of fair values at the reporting date. The valuation techniques used by the Corporation to measure, on a recurring and non-recurring basis, the fair value of assets as of September 30, 2016 are discussed in the paragraphs that follow.

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

The fair value of investments is determined using a market approach. As of September 30, 2016, the U.S. Government agencies, residential and commercial mortgage-backed securities, collateralized mortgage obligations, and state and political subdivisions bonds segments are classified as Level 2 within the valuation hierarchy. Their fair values were determined based upon market-corroborated inputs and valuation matrices, which were obtained through third party data service providers or securities brokers through which the Corporation has historically transacted both purchases and sales of investment securities.

The CDO segment, which consists of pooled trust preferred securities issued by banks, thrifts and insurance companies, is classified as Level 3 within the valuation hierarchy. At September 30, 2016, the Corporation owned 12 pooled trust preferred securities with an amortized cost of \$24.7 million and a fair value of \$19.9 million. The market for these securities at September 30, 2016 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which these securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive, as few CDOs have been issued since 2007. There are currently very few market participants who are willing to effect transactions in these securities. The market values for these securities or any securities other than those issued or guaranteed by the U.S. Department of the Treasury (the "Treasury") are depressed relative to historical levels. Therefore, in the current market, a low market price for a particular bond may only provide evidence of stress in the credit markets in general rather than being an indicator of credit problems with a particular issue. Given the conditions in the current debt markets and the absence of observable transactions in the secondary and new issue markets, management has determined that (a) the few observable transactions and market quotations that are available are not reliable for the purpose of obtaining fair value at September 30, 2016, (b) an income valuation approach technique (i.e. present value) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than a market approach, and (c) the CDO segment is appropriately classified within Level 3 of the valuation hierarchy because management determined that significant adjustments were required to determine fair value at the measurement date.

Management relies on an independent third party to prepare both the evaluations of OTTI as well as the fair value determinations for its CDO portfolio. Management believes that the valuations are adequately reflected at September 30, 2016.

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

***Derivative financial instruments (Cash flow hedge)*** – The Corporation’s open derivative positions are interest rate swap agreements. Those classified as Level 2 open derivative positions are valued using externally developed pricing models based on observable market inputs provided by a third party and validated by management. The Corporation has considered counterparty credit risk in the valuation of its interest rate swap assets.

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

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

For Level 3 assets and liabilities measured at fair value on a recurring and non-recurring basis as of September 30, 2016 and December 31, 2015, the significant unobservable inputs used in the fair value measurements were as follows:

| (in thousands)                             | Fair Value at September 30, 2016 | Valuation Technique          | Significant Unobservable Inputs | Significant Unobservable Input Value                 |
|--|----------------------------------|------------------------------|---------------------------------|--|
| Recurring:                                 |                                  |                              |                                 |  |
| Investment Securities – available for sale | \$ 19,927                        | Discounted Cash Flow         | Discount Rate                   | Range of LIBOR+ 4.50% to 5.50%                       |
| Non-recurring:                             |                                  |                              |                                 |  |
| Impaired Loans                             | \$ 14,430                        | Market Comparable Properties | Marketability Discount          | 10.0% - 15.1% <sup>(1)</sup><br>(weighted avg 12.1%) |
| Other Real Estate Owned                    | \$ 425                           | Market Comparable Properties | Marketability Discount          | 10.0% - 15.0% <sup>(1)</sup><br>(weighted avg 10.0%) |

| (in thousands)                             | Fair Value at December 31, 2015 | Valuation Technique          | Significant Unobservable Inputs  | Significant Unobservable Input Value                 |
|--|---------------------------------|------------------------------|----------------------------------|--|
| Recurring:                                 |                                 |                              |                                  |  |
| Investment Securities – available for sale | \$ 22,211                       | Discounted Cash Flow         | Discount Rate                    | Range of LIBOR+ 4.5% to 5.5%                         |
| Cash Flow Hedge                            | \$ (66)                         | ) Discounted Cash Flow       | Reuters Third Party Market Quote | 99.9% (weighted avg 99.9%)                           |
| Non-recurring:                             |                                 |                              |                                  |  |
| Impaired Loans                             | \$ 6,247                        | Market Comparable Properties | Marketability Discount           | 3.0% - 15.0% <sup>(1)</sup> (weighted avg 11.3%)     |
| Other Real Estate Owned                    | \$ 4,133                        | Market Comparable Properties | Marketability Discount           | 10.0% - 15.0% <sup>(1)</sup><br>(weighted avg 12.5%) |

NOTE:

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



For assets measured at fair value on a recurring and non-recurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2016 and December 31, 2015 are as follows:

| <b>Fair Value Measurements at September 30,</b>  |                    |                  |                     |
|--|--------------------|------------------|---------------------|
| <b>2016 Using</b>                                |                    |                  |                     |
| <b>Quoted</b>                                    |                    |                  |                     |
| <b>Prices</b>                                    |                    |                  |                     |
| <b>Assets</b>                                    | <b>Measured at</b> | <b>in</b>        | <b>Significant</b>  |
|  |                    | <b>Active</b>    | <b>Other</b>        |
| <b>Fair Value</b>                                | <b>9/30/2016</b>   | <b>Markets</b>   | <b>Unobservable</b> |
|  |                    | <b>for</b>       | <b>Inputs</b>       |
|  |                    | <b>Identical</b> | <b>Inputs</b>       |
|  |                    | <b>Assets</b>    | <b>(Level 3)</b>    |
|  |                    | <b>(Level 1)</b> | <b>(Level 2)</b>    |
| <b>(in thousands)</b>                            |                    |                  |                     |
| <b>Recurring:</b>                                |                    |                  |                     |
| <b>Investment securities available-for-sale:</b> |                    |                  |                     |
| U.S. government agencies                         | \$ 25,001          | \$ 25,001        |                     |
| Commercial mortgage-backed agencies              | \$ 57,010          | \$ 57,010        |                     |
| Collateralized mortgage obligations              | \$ 21,008          | \$ 21,008        |                     |
| Obligations of states and political subdivisions | \$ 25,091          | \$ 25,091        |                     |
| Collateralized debt obligations                  | \$ 19,927          |                  | \$ 19,927           |
| Financial Derivatives                            | \$ (865 )          | \$ (865 )        | \$                  |
| <b>Non-recurring:</b>                            |                    |                  |                     |
| Impaired loans                                   | \$ 14,430          |                  | \$ 14,430           |
| Other real estate owned                          | \$ 425             |                  | \$ 425              |

**Fair Value Measurements at December 31,**

| <b>2015 Using</b> |                    |                  |                     |
|-------------------|--------------------|------------------|---------------------|
| <b>Quoted</b>     |                    |                  |                     |
| <b>Prices</b>     |                    |                  |                     |
| <b>Assets</b>     | <b>Measured at</b> | <b>in</b>        | <b>Significant</b>  |
|                   |                    | <b>Active</b>    | <b>Other</b>        |
| <b>Fair Value</b> | <b>for</b>         | <b>Markets</b>   | <b>Unobservable</b> |
|                   |                    | <b>Identical</b> | <b>Inputs</b>       |
|                   |                    | <b>for</b>       | <b>Inputs</b>       |
|                   |                    | <b>Identical</b> | <b>Inputs</b>       |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

| (in thousands)                                   | 12/31/2015 | Assets    |           |           |
|--|------------|-----------|-----------|-----------|
|  |            | (Level 1) | (Level 2) | (Level 3) |
| Recurring:                                       |            |           |           |           |
| Investment securities available-for-sale:        |            |           |           |           |
| U.S. government agencies                         | \$ 33,964  |           | \$ 33,964 |           |
| Residential mortgage-backed agencies             | \$ 14,170  |           | \$ 14,170 |           |
| Commercial mortgage-backed agencies              | \$ 43,636  |           | \$ 43,636 |           |
| Collateralized mortgage obligations              | \$ 9,610   |           | \$ 9,610  |           |
| Obligations of states and political subdivisions | \$ 46,641  |           | \$ 46,641 |           |
| Collateralized debt obligations                  | \$ 22,211  |           |           | \$ 22,211 |
| Financial Derivative                             | \$ (66 )   |           |           | \$ (66 )  |
| Non-recurring:                                   |            |           |           |           |
| Impaired loans                                   | \$ 6,247   |           |           | \$ 6,247  |
| Other real estate owned                          | \$ 4,133   |           |           | \$ 4,133  |

There were no transfers of assets between any of the fair value hierarchy for the nine-month periods ended September 30, 2016 and 2015.

The following tables show a reconciliation of the beginning and ending balances for fair valued assets measured on a recurring basis using Level 3 significant unobservable inputs for the nine- and three-month periods ended September 30, 2016 and 2015:

**Fair Value Measurements Using Significant**

**Unobservable Inputs (Level 3)  
Investment Securities**

| (In thousands)                            | Available for Sale | Cash Flow Hedge |
|---|--------------------|-----------------|
| Beginning balance January 1, 2016         | \$ 22,211          | \$ (66 )        |
| Total (losses)/gains realized/unrealized: |                    |                 |
| Included in other comprehensive loss      | (2,284 )           | 66              |
| Ending balance September 30, 2016         | \$ 19,927          | \$ 0            |

**Fair Value Measurements Using Significant**

**Unobservable Inputs (Level 3)  
Investment Securities**

| (in thousands)                         | Available for Sale | Cash Flow Hedge |
|--|--------------------|-----------------|
| Beginning balance January 1, 2015      | \$ 25,339          | \$ (199 )       |
| Total gains realized/unrealized:       |                    |                 |
| Included in other comprehensive income | 6,589              | 92              |
| Ending balance September 30, 2015      | \$ 31,928          | \$ (107 )       |

**Fair Value Measurement Using Significant**

**Unobservable Inputs (Level 3)  
Investment Securities**

| (in thousands)                       | Available for Sale | Cash Flow Hedge |
|--------------------------------------|--------------------|-----------------|
| Beginning balance July 1, 2016       | \$ 20,230          | \$ 0            |
| Total losses realized/unrealized:    |                    |                 |
| Included in other comprehensive loss | (303 )             | 0               |
| Ending balance September 30, 2016    | \$ 19,927          | \$ 0            |

**Fair Value Measurement Using Significant**

**Unobservable Inputs (Level 3)  
Investment Securities**

| (in thousands) | Cash Flow Hedge |
|----------------|-----------------|
|                |                 |

|  | <b>Available for Sale</b> |           |
|--|---------------------------|-----------|
| Beginning balance July 1, 2015         | \$ 30,046                 | \$ (140 ) |
| Total gains realized/unrealized:       |                           |           |
| Included in other comprehensive income | 1,882                     | 33        |
| Ending balance September 30, 2015      | \$ 31,928                 | \$ (107 ) |

Gains (realized and unrealized) included in earnings for the periods identified above are reported in the Consolidated Statement of Operations in Other Operating Income. There were no gains or losses included in earnings attributable to the change in realized/unrealized gains or losses related to the assets for the nine- and three- month periods ended September 30, 2016 and 2015.

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

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

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

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

***Securities held to maturity:*** Investments in debt securities classified as held to maturity are measured subsequently at amortized cost in the statement of financial position.

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

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

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

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

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

***Off-balance-sheet financial instruments:*** In the normal course of business, the Bank makes commitments to extend credit and issues standby letters of credit. The Bank expects most of these commitments to expire without being drawn upon; therefore, the commitment amounts do not necessarily represent future cash requirements. Due to the uncertainty of cash flows and difficulty in the predicting the timing of such cash flows, fair values were not estimated for these instruments.

The following tables present fair value information about financial instruments, whether or not recognized in the Consolidated Statement of Financial Condition, for which it is practicable to estimate that value. The actual carrying amounts and estimated fair values of the Corporation's financial instruments that are included in the Consolidated Statement of Financial Condition are as follows:

|   | September 30, 2016 |          | Fair Value Measurements   |   |  |
|---|--------------------|----------|---|---|--|
|   | Carrying           | Fair     | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (in thousands)                          | Amount             | Value    |   |   |  |
| <b>Financial Assets:</b>                |                    |          |   |   |  |
| Cash and due from banks                 | \$64,560           | \$64,560 | \$64,560  |   |  |
| Interest bearing deposits in banks      | 1,524              | 1,524    | 1,524   |   |  |
| Investment securities - AFS             | 148,037            | 148,037  |   | \$ 128,110  | \$ 19,927  |
| Investment securities - HTM             | 98,387             | 103,286  |   | 94,844  | 8,442  |
| Restricted bank stock                   | 5,881              | 5,881    |   | 5,881   |  |
| Loans, net                              | 890,445            | 895,433  |   |   | 895,433  |
| Accrued interest receivable             | 3,645              | 3,645    |   | 3,645   |  |
| <b>Financial Liabilities:</b>           |                    |          |   |   |  |
| Deposits – non-maturity                 | 777,294            | 777,294  |   | 777,294   |  |
| Deposits – time deposits                | 241,891            | 246,235  |   | 246,235   |  |
| Short-term borrowed funds               | 35,785             | 35,785   |   | 35,785  |  |
| Long-term borrowed funds                | 146,747            | 148,591  |   | 148,591   |  |
| Accrued interest payable                | 479                | 479      |   | 479   |  |
| Financial derivatives                   | 865                | 865      |   | 865   |  |
| Off balance sheet financial instruments | 0                  | 0        | 0   |   |  |

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

Loans are measured using a discounted cash flow method. The significant unobservable inputs used in the Level 3 fair value measurements of the Corporation's loans included in the tables above are calculated based on the Corporation's internal new volume rate.



**Note 10 – Accumulated Other Comprehensive Loss**

The following table presents the changes in each component of accumulated other comprehensive loss for the 12 months ended December 31, 2015 and the three-month periods ended March 31, 2016, June 30, 2016 and September 30, 2016:

| (in thousands)   | Investment securities- with OTTI AFS | Investment securities- all other AFS | Investment securities- HTM | Cash Flow Hedge | Pension Plan | SERP     | Total       |
|--|--------------------------------------|--------------------------------------|----------------------------|-----------------|--------------|----------|-------------|
| Accumulated OCL, net:  |                                      |                                      |                            |                 |              |          |             |
| Balance - January 1, 2015                                      | \$ (3,679 )                          | \$ (2,555 )                          | \$ (2,255 )                | \$ (119 )       | \$ (11,392)  | \$ (233) | \$ (20,233) |
| Other comprehensive income/(loss) before reclassifications     | 1,154                                | 1,344                                | 0                          | 80              | (1,736 )     | (113)    | 729         |
| Amounts reclassified from accumulated other comprehensive loss | 2,059                                | (174 )                               | 284                        | 0               | 465          | 41       | 2,675       |
| Balance - December 31, 2015                                    | \$ (466 )                            | \$ (1,385 )                          | \$ (1,971 )                | \$ (39 )        | \$ (12,663)  | \$ (305) | \$ (16,829) |
| Other comprehensive income/(loss) before reclassifications     | (899 )                               | 558                                  | 0                          | (331 )          | (343 )       | 0        | (1,015 )    |
| Amounts reclassified from accumulated other comprehensive loss | (22 )                                | (124 )                               | 143                        | 0               | 130          | 15       | 142         |
| Balance – March 31, 2016                                       | \$ (1,387 )                          | \$ (951 )                            | \$ (1,828 )                | \$ (370 )       | \$ (12,876)  | \$ (290) | \$ (17,702) |
| Other comprehensive income/(loss) before reclassifications     | 1,099                                | (169 )                               | 0                          | (306 )          | (210 )       | 0        | 414         |
| Amounts reclassified from accumulated other comprehensive loss | 19                                   | (12 )                                | 222                        | 0               | 128          | 15       | 372         |
| Balance – June 30, 2016  | \$ (269 )                            | \$ (1,132 )                          | \$ (1,606 )                | \$ (676 )       | \$ (12,958)  | \$ (275) | \$ (16,916) |
| Other comprehensive income/(loss) before reclassifications     | 28                                   | (321 )                               | 0                          | 157             | (395 )       | 0        | (531 )      |
| Amounts reclassified from accumulated other comprehensive loss | (1 )                                 | (139 )                               | 182                        | 0               | 129          | 15       | 186         |
| Balance - September 30, 2016                                   | \$ (242 )                            | \$ (1,592 )                          | \$ (1,424 )                | \$ (519 )       | \$ (13,224)  | \$ (260) | \$ (17,261) |

The following tables present the components of comprehensive income for the nine- and three-month periods ended September 30, 2016 and 2015:

| Components of Comprehensive Income (in thousands) | Before Tax Amount | Tax (Expense) Benefit | Net     |
|---|-------------------|-----------------------|---------|
| For the nine months ended September 30, 2016      |                   |                       |         |
| Available for sale (AFS) securities with OTTI:    |                   |                       |         |
| Unrealized holding gains                          | \$ 380            | \$ (152 )             | \$228   |
| Less: accretible yield recognized in income       | 7                 | (3 )                  | 4       |
| Net unrealized gains on investments with OTTI     | 373               | (149 )                | 224     |
| Available for sale securities – all other:        |                   |                       |         |
| Unrealized holding gains                          | 115               | (46 )                 | 69      |
| Less: gains recognized in income                  | 460               | (184 )                | 276     |
| Net unrealized losses on all other AFS securities | (345 )            | 138                   | (207)   |
| Held to maturity securities:                      |                   |                       |         |
| Unrealized holding gains                          | 0                 | 0                     | 0       |
| Less: amortization recognized in income           | (911 )            | 364                   | (547)   |
| Net unrealized gains on HTM securities            | 911               | (364 )                | 547     |
| Cash flow hedges:                                 |                   |                       |         |
| Unrealized holding losses                         | (799 )            | 319                   | (480)   |
| Pension Plan:                                     |                   |                       |         |
| Unrealized net actuarial loss                     | (1,578 )          | 630                   | (948)   |
| Less: amortization of unrecognized loss           | (636 )            | 254                   | (382)   |
| Less: amortization of transition asset            | 0                 | 0                     | 0       |
| Less: amortization of prior service costs         | (9 )              | 4                     | (5 )    |
| Net pension plan liability adjustment             | (933 )            | 372                   | (561)   |
| SERP:   |                   |                       |         |
| Unrealized net actuarial loss                     | 0                 | 0                     | 0       |
| Less: amortization of unrecognized loss           | (59 )             | 24                    | (35 )   |
| Less: amortization of prior service costs         | (15 )             | 5                     | (10 )   |
| Net SERP liability adjustment                     | 74                | (29 )                 | 45      |
| Other comprehensive loss                          | \$ (719 )         | \$ 287                | \$(432) |

| Components of Comprehensive Income (in thousands) | Before Tax<br>Amount | Tax (Expense)<br>Benefit | Net       |
|---|----------------------|--------------------------|-----------|
| For the nine months ended September 30, 2015      |                      |                          |           |
| Available for sale (AFS) securities with OTTI:    |                      |                          |           |
| Unrealized holding gains                          | \$ 6,682             | \$ (2,665                | ) \$4,017 |
| Less: accretable yield recognized in income       | 479                  | (191                     | ) 288     |
| Net unrealized gains on investments with OTTI     | 6,203                | (2,474                   | ) 3,729   |
| Available for sale securities – all other:        |                      |                          |           |
| Unrealized holding gains                          | 2,380                | (949                     | ) 1,431   |
| Less: gains recognized in income                  | 62                   | (25                      | ) 37      |
| Net unrealized gains on all other AFS securities  | 2,318                | (924                     | ) 1,394   |
| Held to maturity securities:                      |                      |                          |           |
| Unrealized holding gains                          | 0                    | 0                        | 0         |
| Less: amortization recognized in income           | (374                 | ) 149                    | (225 )    |
| Net unrealized gains on HTM securities            | 374                  | (149                     | ) 225     |
| Cash flow hedges:                                 |                      |                          |           |
| Unrealized holding gains                          | 92                   | (37                      | ) 55      |
| Pension Plan:                                     |                      |                          |           |
| Unrealized net actuarial loss                     | (4,651               | ) 1,856                  | (2,795)   |
| Less: amortization of unrecognized loss           | (576                 | ) 229                    | (347 )    |
| Less: amortization of transition asset            | 15                   | (6                       | ) 9       |
| Less: amortization of prior service costs         | (9                   | ) 4                      | (5 )      |
| Net pension plan liability adjustment             | (4,081               | ) 1,629                  | (2,452)   |
| SERP:   |                      |                          |           |
| Unrealized net actuarial loss                     | 0                    | 0                        | 0         |
| Less: amortization of unrecognized loss           | (37                  | ) 15                     | (22 )     |
| Less: amortization of prior service costs         | (15                  | ) 6                      | (9 )      |
| Net SERP liability adjustment                     | 52                   | (21                      | ) 31      |
| Other comprehensive income                        | \$ 4,958             | \$ (1,976                | ) \$2,982 |

| Components of Comprehensive Income (in thousands) | Before Tax<br>Amount | Tax (Expense)<br>Benefit | Net     |
|---|----------------------|--------------------------|---------|
| For the three months ended September 30, 2016     |                      |                          |         |
| Available for sale (AFS) securities with OTTI:    |                      |                          |         |
| Unrealized holding gains                          | \$ 47                | \$ (19                   | ) \$28  |
| Less: accretable yield recognized in income       | 2                    | (1                       | ) 1     |
| Net unrealized gains on investments with OTTI     | 45                   | (18                      | ) 27    |
| Available for sale securities – all other:        |                      |                          |         |
| Unrealized holding losses                         | (534                 | ) 213                    | (321)   |
| Less: gains recognized in income                  | 232                  | (93                      | ) 139   |
| Net unrealized losses on all other AFS securities | (766                 | ) 306                    | (460)   |
| Held to maturity securities:                      |                      |                          |         |
| Unrealized holding gains                          | 0                    | 0                        | 0       |
| Less: amortization recognized in income           | (303                 | ) 121                    | (182)   |
| Net unrealized gains on HTM securities            | 303                  | (121                     | ) 182   |
| Cash flow hedges:                                 |                      |                          |         |
| Unrealized holding gains                          | 261                  | (104                     | ) 157   |
| Pension Plan:                                     |                      |                          |         |
| Unrealized net actuarial loss                     | (657                 | ) 262                    | (395)   |
| Less: amortization of unrecognized loss           | (212                 | ) 85                     | (127)   |
| Less: amortization of transition asset            | 0                    | 0                        | 0       |
| Less: amortization of prior service costs         | (3                   | ) 1                      | (2 )    |
| Net pension plan liability adjustment             | (442                 | ) 176                    | (266)   |
| SERP:   |                      |                          |         |
| Unrealized net actuarial loss                     | 0                    | 0                        | 0       |
| Less: amortization of unrecognized loss           | (20                  | ) 7                      | (13 )   |
| Less: amortization of prior service costs         | (5                   | ) 3                      | (2 )    |
| Net SERP liability adjustment                     | 25                   | (10                      | ) 15    |
| Other comprehensive loss                          | \$ (574              | ) \$ 229                 | \$(345) |

| Components of Comprehensive Income (in thousands) | Before Tax<br>Amount | Tax (Expense)<br>Benefit | Net     |
|---|----------------------|--------------------------|---------|
| For the three months ended September 30, 2015     |                      |                          |         |
| Available for sale (AFS) securities with OTTI:    |                      |                          |         |
| Unrealized holding gains                          | \$ 1,658             | \$ (661                  | ) \$997 |
| Less: accretable yield recognized in income       | 139                  | (55                      | ) 84    |
| Net unrealized gains on investments with OTTI     | 1,519                | (606                     | ) 913   |
| Available for sale securities – all other:        |                      |                          |         |
| Unrealized holding gains                          | 1,288                | (515                     | ) 773   |
| Less: gains recognized in income                  | 79                   | (33                      | ) 46    |
| Net unrealized gains on all other AFS securities  | 1,209                | (482                     | ) 727   |
| Held to maturity securities:                      |                      |                          |         |
| Unrealized holding gains                          | 0                    | 0                        | 0       |
| Less: amortization recognized in income           | (106                 | ) 42                     | (64     |
| Net unrealized gains on HTM securities            | 106                  | (42                      | ) 64    |
| Cash flow hedges:                                 |                      |                          |         |
| Unrealized holding gains                          | 33                   | (13                      | ) 20    |
| Pension Plan:                                     |                      |                          |         |
| Unrealized net actuarial loss                     | (2,892               | ) 1,153                  | (1,739) |
| Less: amortization of unrecognized loss           | (204                 | ) 80                     | (124    |
| Less: amortization of transition asset            | 5                    | (2                       | ) 3     |
| Less: amortization of prior service costs         | (3                   | ) 1                      | (2      |
| Net pension plan liability adjustment             | (2,690               | ) 1,074                  | (1,616) |
| SERP:   |                      |                          |         |
| Unrealized net actuarial loss                     | 0                    | 0                        | 0       |
| Less: amortization of unrecognized gain           | (13                  | ) 5                      | (8      |
| Less: amortization of prior service costs         | (5                   | ) 3                      | (2      |
| Net SERP liability adjustment                     | 18                   | (8                       | ) 10    |
| Other comprehensive income                        | \$ 195               | \$ (77                   | ) \$118 |

The following table presents the details of amount reclassified from accumulated other comprehensive loss for the nine- and three-month periods ended September 30, 2016 and 2015:

| Amounts Reclassified from Accumulated Other Comprehensive (Loss (in thousands)) | For the<br>Nine<br>months<br>ended<br>September<br>30,<br>2016 | For the<br>Nine<br>months<br>ended<br>September<br>30,<br>2015 | Affected Line Item in the<br>Statement Where Net Income is<br>Presented |
|---|--|--|---|
| Unrealized gains and losses on investment securities with OTTI:                 |  |  |   |
| Accretable yield  | \$ 7   | \$ 479   | Interest income on taxable investment securities                        |
| Taxes   | (3   | ) (191   | ) Tax expense   |
|   | \$ 4   | \$ 288   | Net of tax  |
| Unrealized gains on available for sale investment securities - all others:      |  |  |   |
| Gains on sales  | \$ 459   | \$ 62  | Net gains   |
| Taxes   | (183   | ) (25  | ) Tax expense   |
|   | \$ 276   | \$ 37  | Net of tax  |
| Unrealized losses on held to maturity securities:                               |  |  |   |
| Amortization  | \$ (911  | ) \$ (374  | ) Interest income on taxable investment securities                      |
| Taxes   | 364  | 149  | Tax benefit   |
|   | \$ (547  | ) \$ (225  | ) Net of tax  |
| Net pension plan liability adjustment:  |  |  |   |
| Amortization of unrecognized loss   | (636   | ) (576   | ) Salaries and employee benefits  |
| Amortization of transition asset  | 0  | 15   | Salaries and employee benefits  |
| Amortization of prior service costs   | (9   | ) (9   | ) Salaries and employee benefits  |
| Taxes   | 258  | 227  | Tax benefit   |
|   | \$ (387  | ) \$ (343  | ) Net of tax  |
| Net SERP liability adjustment:  |  |  |   |
| Amortization of unrecognized loss   | (59  | ) (37  | ) Salaries and employee benefits  |
| Amortization of prior service costs   | (15  | ) (15  | ) Salaries and employee benefits  |
| Taxes   | 29   | 21   | Tax benefit   |
|   | \$ (45   | ) \$ (31   | ) Net of tax  |
| Total reclassifications for the period  | \$ (699  | ) \$ (274  | ) Net of tax  |

| Amounts Reclassified from Accumulated Other<br>Comprehensive Loss (in thousands) | For the   | For the   | Affected Line Item in the Statement<br>Where Net Income is Presented |
|--|-----------|-----------|--|
|  | Three     | Three     |  |
|  | months    | months    |  |
|  | ended     | ended     |  |
|  | September | September |  |
|  | 30,       | 30,       |  |
|  | 2016      | 2015      |  |
| Unrealized gains and losses on investment securities with OTTI:                  |           |           |  |
| Accretable Yield   | \$ 2      | \$ 139    | Interest income on taxable investment securities                     |
| Taxes  | (1 )      | (55 )     | Tax expense  |
|  | \$ 1      | \$ 84     | Net of tax   |
| Unrealized gains on available for sale investment securities - all others:       |           |           |  |
| Gains on sales   | \$ 232    | \$ 79     | Net gains  |
| Taxes  | (93 )     | (33 )     | Tax expense  |
|  | \$ 139    | \$ 46     | Net of tax   |
| Unrealized losses on held to maturity securities:                                |           |           |  |
| Amortization   | \$ (303 ) | \$ (106 ) | Interest income on taxable investment securities                     |
| Taxes  | 121       | 42        | Tax benefit  |
|  | \$ (182 ) | \$ (64 )  | Net of tax   |
| Net pension plan liability adjustment:   |           |           |  |
| Amortization of unrecognized loss  | (212 )    | (204 )    | Salaries and employee benefits                                       |
| Amortization of transition asset   | 0         | 5         | Salaries and employee benefits                                       |
| Amortization of prior service costs  | (3 )      | (3 )      | Salaries and employee benefits                                       |
| Taxes  | 86        | 79        | Tax benefit  |
|  | \$ (129 ) | \$ (123 ) | Net of tax   |
| Net SERP liability adjustment:   |           |           |  |
| Amortization of unrecognized loss  | (20 )     | (13 )     | Salaries and employee benefits                                       |
| Amortization of prior service costs  | (5 )      | (5 )      | Salaries and employee benefits                                       |
| Taxes  | 10        | 8         | Tax benefit  |
|  | \$ (15 )  | \$ (10 )  | Net of tax   |
| Total reclassifications for the period   | \$ (186 ) | \$ (67 )  | Net of tax   |

### Note 11 – Junior Subordinated Debentures and Restrictions on Dividends

First United Corporation is the parent company to three statutory trust subsidiaries - First United Statutory Trust I and First United Statutory Trust II, both of which are Connecticut statutory trusts (“Trust I” and “Trust II”, respectively), and

First United Statutory Trust III, a Delaware statutory trust (“Trust III” and, together with Trust I and Trust II, the “Trusts”). The Trusts were formed for the purposes of selling preferred securities to investors and using the proceeds to purchase junior subordinated debentures from First United Corporation (“TPS Debentures”) that would qualify as regulatory capital.

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



\$20.6 million—floating rate payable quarterly based on three-month LIBOR plus 275 basis points (3.61% at September 30, 2016), maturing in 2034, became redeemable five years after issuance at First United Corporation's option.

\$10.3 million—floating rate payable quarterly based on three-month LIBOR plus 275 basis points (3.61% at September 30, 2016) maturing in 2034, became redeemable five years after issuance at First United Corporation's option.

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

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

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

Until further notice from the Reserve Bank, First United Corporation is required to obtain the Reserve Bank's prior approval before making any future interest payments under the TPS Debentures. In considering a request for approval, the Reserve Bank will consider, among other things, the Corporation's financial condition and its quarterly results of operations. In addition to this pre-approval requirement, First United Corporation's ability to make future quarterly interest payments under the TPS Debentures will depend in large part on its receipt of dividends from the Bank, and the declaration and payment of which are subject to limitations under Maryland corporation and banking law and federal banking law. As a result of these limitations, no assurance can be given that First United Corporation will make the quarterly interest payments due under the TPS Debentures in any future quarter. In the event that First United Corporation does not receive the approvals necessary for it to make future quarterly interest payments, or if the Bank is unable to fund those payments, then First United Corporation will have to again elect to defer interest payments. First United Corporation has received approval for the fourth quarter 2016 payments.



## Note 12 – Preferred Stock

On January 30, 2009, pursuant to the Troubled Asset Repurchase Program Capital Purchase Program adopted by the Treasury, First United Corporation issued to the Treasury 30,000 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A, having no par value, (the “Series A Preferred Stock”), and a Warrant to purchase 326,323 shares of common stock at an exercise price of \$13.79 per share, for an aggregate consideration of \$30 million. The proceeds from this transaction qualify as Tier 1 capital and the Warrant qualified as tangible common equity.

On December 4, 2014, the Treasury sold all of its shares of Series A Preferred Stock to third-party investors. On May 26, 2015, First United Corporation repurchased the warrant from the Treasury for \$120,786, which is included in other expense. The warrant was canceled and as a result of the repurchase, the Treasury has no remaining equity investment in First United Corporation.

On February 14, 2016, First United Corporation redeemed 10,000 shares of the Series A Preferred Stock, having an aggregate liquidation amount of \$10.0 million on a pro rata basis from each of the holders.

The terms of the Series A Preferred Stock call for the payment, if declared by the Corporation’s Board of Directors, of cash dividends on February 15<sup>th</sup>, May 15<sup>th</sup>, August 15<sup>th</sup> and November 15<sup>th</sup> of each year. The holders of the Series A Preferred Stock are entitled to receive, if and when declared by the Board of Directors, out of assets legally available for payment, cumulative cash dividends at a rate per annum of 9% per share of Series A Preferred Stock on a liquidation amount of \$1,000 per share with respect to each dividend period from after February 15, 2014. Under the terms of the Series A Preferred Stock, First United Corporation may, at its option and after consulting with the Reserve Bank, redeem shares of Series A Preferred Stock, in whole or in part, at any time and from time to time, for cash at a per share amount equal to the sum of the liquidation preference per share plus any accrued and unpaid dividends to but excluding the redemption date.

Until further notice from the Reserve Bank, First United Corporation is required to obtain the Reserve Bank’s prior approval before making any future quarterly dividend payment on the Series A Preferred Stock. In considering a request for approval, the Reserve Bank will consider, among other things, the Corporation’s financial condition and its quarterly results of operations. In addition, First United Corporation’s ability to make future quarterly dividend payments on the Series A Preferred Stock will depend in large part on its receipt of dividends from the Bank, the declaration and payment of which, as discussed above, are subject to limitations. If First United Corporation does not obtain the regulatory approvals required for a particular quarterly dividend, or if the Bank is prohibited from paying a dividend to First United Corporation, then First United Corporation would have to again suspend quarterly dividend payments, which would result in a prohibition against paying any dividends or other distributions on the outstanding shares of First United Corporation’s common stock during the suspension period. First United Corporation has received approval for the fourth quarter 2016 payments.



**Note 13 – Borrowed Funds**

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

| (Dollars in thousands)                              | Nine months ended<br>September 30, 2016 | Year ended December<br>31, 2015 |   |   |
|---|---|---------------------------------|---|---|
| Securities sold under agreements to repurchase:     |   |                                 |   |   |
| Outstanding at end of period                        | \$ 35,785                               | \$ 35,828                       |   |   |
| Weighted average interest rate at end of period     | 0.12                                    | 0.16                            | % | % |
| Maximum amount outstanding as of any month end      | \$ 39,456                               | \$ 47,131                       |   |   |
| Average amount outstanding                          | \$ 29,505                               | \$ 35,908                       |   |   |
| Approximate weighted average rate during the period | 0.14                                    | 0.16                            | % | % |

At September 30, 2016, the repurchase agreements were secured by \$54.7 million in investment securities issued by government related agencies. A minimum of 102% of fair value is pledged against account balances.

The following is a summary of long-term borrowings with original maturities exceeding one year:

| (in thousands)   | September<br>30,<br>2016 | December<br>31,<br>2015 |
|--|--------------------------|-------------------------|
| FHLB advances, bearing fixed interest at rates ranging from 1.34% to 3.69% at September 30, 2016 | \$ 105,017               | \$ 105,807              |
| Junior subordinated debt, bearing variable interest rate of 3.61% at September 30, 2016          | 30,929                   | 30,929                  |
| Junior subordinated debt, bearing fixed interest rate of 9.88% at September 30, 2016             | 10,801                   | 10,801                  |
| Total long-term debt   | \$ 146,747               | \$ 147,537              |

At September 30, 2016, the long-term FHLB advances were secured by \$254.3 million in loans.

The contractual maturities of all long-term borrowings are as follows:

September 30, 2016

December 31, 2015

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

| (in thousands)       | Fixed<br>Rate | Floating Rate | Total     | Total      |
|----------------------|---------------|---------------|-----------|------------|
| Due in 2016          | 0             | 0             | 0         | 0          |
| Due in 2017          | 0             | 0             | 0         | 0          |
| Due in 2018          | 20,000        | 0             | 20,000    | 20,000     |
| Due in 2019          | 20,000        | 0             | 20,000    | 0          |
| Due in 2020          | 30,000        | 0             | 30,000    | 30,000     |
| Thereafter           | 45,818        | 30,929        | 76,747    | 97,537     |
| Total long-term debt | \$115,818     | \$ 30,929     | \$146,747 | \$ 147,537 |

**Note 14 – Employee Benefit Plans**

The following tables present the components of the net periodic pension plan cost for First United Corporation's Defined Benefit Pension Plan (the "Pension Plan") and the Bank's Supplemental Executive Retirement Plan ("SERP") for the periods indicated:

| Pension<br><br>(in thousands)                              | For the Nine months ended<br>September 30, |           | For the Three months ended<br>September 30, |          |
|--|--|-----------|---|----------|
|  | 2016                                       | 2015      | 2016  | 2015     |
| Service cost   | \$ 228                                     | \$ 242    | \$ 76                                       | \$ 74    |
| Interest cost  | 1,305                                      | 1,177     | 435   | 403      |
| Expected return on assets                                  | (2,089 )                                   | (2,224 )  | (708 )                                      | (740 )   |
| Amortization of transition asset                           | 0  | (15 )     | 0   | (5 )     |
| Amortization of net actuarial loss                         | 636  | 576       | 212   | 204      |
| Amortization of prior service cost                         | 9  | 9         | 3   | 3        |
| Net pension expense/(credit) included in employee benefits | \$ 89                                      | \$ (235 ) | \$ 18                                       | \$ (61 ) |

| SERP<br><br>(in thousands)                     | For the Nine months ended<br>September 30, |        | For the Three months ended<br>September 30, |        |
|--|--|--------|---|--------|
|  | 2016                                       | 2015   | 2016  | 2015   |
| Service cost                                   | \$ 73                                      | \$ 87  | \$ 24                                       | \$ 29  |
| Interest cost                                  | 187  | 174    | 62  | 58     |
| Amortization of recognized loss                | 59   | 37     | 20  | 13     |
| Amortization of prior service cost             | 15   | 15     | 5   | 5      |
| Net SERP expense included in employee benefits | \$ 334                                     | \$ 313 | \$ 111                                      | \$ 105 |

The Pension Plan is a noncontributory defined benefit pension plan covers our employees who were hired prior to the freeze and others who were grandfathered into the plan. The benefits are based on years of service and the employees' compensation during the last five years of employment.

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

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

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

The Corporation will assess the need for future annual contributions to the pension plan based upon its funded status and an evaluation of the future benefits to be provided thereunder. A contribution of \$3.0 million was made to the pension plan during the second quarter of 2016. The Corporation expects to fund the annual projected benefit payments for the SERP from operations.



On January 9, 2015, the Corporation and members of management who do not participate in the SERP entered into participation agreements under the Deferred Compensation Plan, each styled as a SERP Alternative Participation Agreement (the “Participation Agreement”). Pursuant to each Participation Agreement, the Corporation agreed, for each Plan Year (as defined in the Deferred Compensation Plan) in which it determines that it has been Profitable (as defined in the Participation Agreement), to make a discretionary contribution to the participant’s Employer Account in an amount equal to 15% of the participant’s base salary level for such Plan Year, with the first Plan Year being the year ending December 31, 2015. The Participation Agreement provides that the participant will become 100% vested in the amount maintained in his or her Employer Account upon the earliest to occur of the following events: (a) Normal Retirement (as defined in the Participation Agreement); (b) Separation from Service (as defined in the Participation Agreement) following a Change of Control (as defined in the Deferred Compensation Plan) and subsequent Triggering Event (as defined in the Participation Agreement); (c) Separation from Service due to a Disability (as defined in the Participation Agreement); (d) with respect to a particular award of Employer Contribution Credits, the participant’s completion of two consecutive Years of Service (as defined in the Participation Agreement) immediately following the Plan Year for which such award was made; or (e) death. Notwithstanding the foregoing, however, a participant will lose entitlement to the amount maintained in his or her Employer Account in the event employment is terminated for Cause (as defined in the Participation Agreement). In addition, the Participation Agreement conditions entitlement to the amounts held in the Employer Account on the participant (1) refraining from engaging in Competitive Employment (as defined in the Participation Agreement) for three years following his or her Separation from Service, (2) refraining from injurious disclosure of confidential information concerning the Corporation, and (3) remaining available, at the Corporation’s reasonable request, to provide at least six hours of transition services per month for 12 months following his or her Separation from Service (except in the case of death or Disability), except that only item (2) will apply in the event of a Separation from Service following a Change of Control and subsequent Triggering Event.

In January 2016, the Board of Directors of First United Corporation approved a discretionary contribution in the amount of \$63,500. Expense for the first nine months of 2016 for the Participation Agreement was \$23,828 and expense for the third quarter of 2016 was \$7,943.

#### **Note 15 – Equity Compensation Plan Information**

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

On June 18, 2008, the Board of Directors of First United Corporation adopted a Long-Term Incentive Program (the “LTIP”). This program was adopted as a sub-plan of the Omnibus Plan to reward participants for increasing shareholder value, align executive interests with those of shareholders, and serve as a retention tool for key executives. Under the LTIP, participants are granted shares of restricted common stock of First United Corporation. The amount of an award

is based on a specified percentage of the participant's salary as of the date of grant. These shares will vest if the Corporation meets or exceeds certain performance thresholds.

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

Stock-based awards were made to non-employee directors in May 2016 pursuant to First United Corporation's director compensation policy. Beginning May 2014, each director receives an annual retainer of 1,000 shares of First United Corporation common stock, plus \$10,000, all or some of which may be paid, at the director's election, in cash or additional shares of common stock. A total of 14,384 fully-vested shares of common stock were issued to directors in 2016, which had a fair market value of \$10.34 per share. Director stock compensation expense was \$109,823 for the nine months ended September 30, 2016 and \$111,848 for the nine months ended September 30, 2015. Stock compensation expense for the three months ended September 30, 2016 was \$37,183 and \$35,889 for the three months ended September 30, 2015.

In January 2015, a one-time stock grant was awarded to one executive officer in the amount of 4,845 shares at a fair market value of \$8.63. In February 2015, a one-time stock grant was awarded to one executive officer in the amount of 5,387 shares at a fair market value of \$8.76. These shares do not have any performance restrictions; however, they have a two-year vesting period. Executive stock compensation expense was \$34,145 for the nine months ended September 30, 2016 and \$32,094 for the nine months ended September 30, 2015. Executive stock compensation expense was \$11,382 for the three months ended September 30, 2016 and \$11,382 for the three months ended September 30, 2015.

#### **Note 16 – Letters of Credit and Off Balance Sheet Liabilities**

The Corporation does not issue any guarantees that would require liability recognition or disclosure other than the standby letters of credit issued by the Bank. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Generally, the Bank's letters of credit are issued with expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral and/or personal guarantees supporting these commitments. The Bank had \$1.7 million of outstanding standby letters of credit at September 30, 2016 and \$1.6 million at December 31, 2015. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payment required by the letters of credit. Management does not believe that the amount of the liability associated with guarantees under standby letters of credit outstanding at September 30, 2016 and December 31, 2015 is material.

#### **Note 17 – Derivative Financial Instruments**

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

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

In March 2016, the Corporation entered into four new interest rate swap contracts totaling \$30.0 million notional amount, hedging future cash flows associated with floating rate trust preferred debt. These contracts are a three-year

\$5.0 million contract maturing June 17, 2019, a five-year \$5.0 million contract maturing March 17, 2021, a seven-year \$5.0 million contract maturing March 17, 2023 and a 10-year \$15.0 million contract maturing March 17, 2026.

The fair value of the interest rate swap contracts was (\$.9) million at September 30, 2016 and (\$66) thousand at December 31, 2015 and was reported in Other Liabilities on the Consolidated Statement of Financial Condition. Investment securities in the amount of \$5.2 million were posted as collateral as of September 30, 2016.

For the nine months ended September 30, 2016, the Corporation recorded a decrease in the value of the derivatives of \$.8 million and the related deferred tax benefit of \$319 thousand in net accumulated other comprehensive loss to reflect the effective portion of cash flow hedges. ASC Subtopic 815-30 requires this amount to be reclassified to earnings if the hedge becomes ineffective or is terminated. There was no hedge ineffectiveness recorded for the nine months ending September 30, 2016. The Corporation does not expect any losses relating to these hedges to be reclassified into earnings within the next 12 months.

Interest rate swap agreements are entered into with counterparties that meet established credit standards and the Corporation believes that the credit risk inherent in these contracts is not significant as of September 30, 2016.

The table below discloses the impact of derivative financial instruments on the Corporation's Consolidated Financial Statements for the nine and three- months ended September 30, 2016 and 2015.

Derivative in Cash Flow Hedging Relationships

| (in thousands)           | Amount of gain recognized in OCI on derivative (effective portion) | Amount of gain or (loss) reclassified from accumulated OCI into income (effective portion) <sup>(a)</sup> | Amount of gain or (loss)   |
|--------------------------|--|---|--|
|                          |  |   | recognized in income or derivative (ineffective portion and amount excluded from effectiveness testing) <sup>(b)</sup> |
| Interest rate contracts: |  |   |  |
| Nine months ended:       |  |   |  |
| September 30, 2016       | \$ (480)   | ) \$ 0  | \$ 0   |
| September 30, 2015       | 55   | 0   | 0  |
| Three months ended:      |  |   |  |
| September 30, 2016       | \$ 157   | \$ 0  | \$ 0   |
| September 30, 2015       | 20   | 0   | 0  |

Notes:

(a) Reported as interest expense

(b) Reported as other income

**Note 18 – Variable Interest Entities (VIE)**

As noted in Note 11, First United Corporation created the Trusts for the purposes of raising regulatory capital through the sale of mandatorily redeemable preferred capital securities to third party investors and common equity interests to First United Corporation. The Trusts are considered Variable Interest Entities (“VIEs”), but are not consolidated because First United Corporation is not the primary beneficiary of the Trusts. At September 30, 2016, the Corporation reported all of the \$41.7 million of TPS Debentures issued in connection with these offerings as long-term borrowings and it reported its \$1.3 million equity interest in the Trusts as “Other Assets”.

In November 2009, the Bank became a 99.99% limited partner in Liberty Mews Limited Partnership (“Liberty Mews”), a Maryland limited partnership formed for the purpose of acquiring, developing and operating low-income housing units in Garrett County, Maryland. The Partnership was financed with a total of \$10.6 million of funding, including a \$6.1 million equity contribution from the Bank as the limited partner. Liberty Mews used the proceeds from these sources to purchase the land and construct a 36-unit low income housing rental complex at a total cost of \$10.6 million. The total assets of Liberty Mews were approximately \$8.9 million at September 30, 2016 and \$9.1 million at December 31, 2015.

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

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

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

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

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

The Corporation's tax expense for the nine months ended September 30, 2016 was approximately \$.6 million lower as a result of the impact of the tax credits and the tax losses relating to the partnership.

At September 30, 2016 and December 31, 2015, the Corporation included its total investment in Liberty Mews in "Other Assets" in its Consolidated Statement of Financial Condition. As of September 30, 2016, the Bank's commitment in Liberty Mews was fully funded. The following table presents details of the Bank's involvement with Liberty Mews at the dates indicated:

| (in thousands)                       | September 30,<br>2016 | December 31,<br>2015 |
|--------------------------------------|-----------------------|----------------------|
| Investment in LIHTC Partnership      |                       |                      |
| Carrying amount on Balance Sheet of: |                       |                      |
| Investment (Other Assets)            | \$ 3,382              | \$ 3,844             |
| Maximum exposure to loss             | 3,382                 | 3,844                |

**Note 19 – Assets and Liabilities Subject to Enforceable Master Netting Arrangements**

*Interest Rate Swap Agreements (“Swap Agreements”)*

The Corporation has entered into interest rate swap agreements to modify the re-pricing characteristics of certain interest-bearing liabilities as a part of managing interest rate risk. The swap agreements have been designated as cash flow hedges, and accordingly, the fair value of the interest rate swap contracts is reported in Other Liabilities on the Consolidated Statement of Financial Condition. The swap agreements were entered into with a third party financial institution. The Corporation is party to master netting arrangements with its financial institution counterparty; however, the Corporation does not offset assets and liabilities under these arrangements for financial statement presentation purposes. The master netting arrangements provide for a single net settlement of all swap agreements, as well as collateral, in the event of default on, or termination of, any one contract. Collateral, in the form of cash and investment securities, are pledged by the Corporation as the counterparty with net liability positions in accordance with contract thresholds. See Note 17 to the Consolidated Financial Statements for more information.



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

The Bank enters into agreements under which it sells interests in U.S. securities to certain customers subject to an obligation to repurchase, and on the part of the customers to resell, such interests. Under these arrangements, the Bank may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Bank to repurchase the assets. As a result, these repurchase agreements are accounted for as collateralized financing arrangements (i.e. secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the Consolidated Statement of Condition, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. There is no offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Bank does not enter into reverse repurchase agreements, there is no such offsetting to be done with the repurchase agreements. The right of setoff for a repurchase agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the repurchase agreement should the Bank be in default (i.e. fails to repurchase the U.S. securities on the maturity date of the agreement). The investment security collateral, maintained at 102% of the borrowing, is held by a third party financial institution in the counterparty’s custodial account.

The following table presents the liabilities subject to an enforceable master netting arrangement or repurchase agreements at September 30, 2016 and December 31, 2015.

| (In thousands)                | Gross Amounts of Recognized Liabilities | Gross Amounts Offset in the Statement of Condition | Net Amounts of Liabilities Presented in the Statement of Condition | Gross Amounts Not Offset in the Statement of Condition |                         |            |
|-------------------------------|---|--|--|--|-------------------------|------------|
|                               |   |  |  | Financial Instruments                                  | Cash Collateral Pledged | Net Amount |
| September 30, 2016            |   |  |  |  |                         |            |
| Interest Rate Swap Agreements | \$ 865                                  | \$ 0   | \$ 865   | \$ (865)   | ) \$ 0                  | \$ 0       |
| Repurchase Agreements         | \$ 35,785                               | \$ 0   | \$ 35,785  | \$ (35,785)  | ) \$ 0                  | \$ 0       |
| December 31, 2015             |   |  |  |  |                         |            |
| Interest Rate Swap Agreements | \$ 66                                   | \$ 0   | \$ 66  | \$ (66)  | ) \$ 0                  | \$ 0       |
| Repurchase Agreements         | \$ 35,828                               | \$ 0   | \$ 35,828  | \$ (35,828)  | ) \$ 0                  | \$ 0       |

**Note 20 – Adoption of New Accounting Standards and Effects of New Accounting Pronouncements**

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

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments- Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. ASU 2016-13 introduces an approach based on expected losses to estimate credit losses on certain types of financial instruments. It also modifies the impairment model for available-for-sale (“AFS”) debt securities and provides for a simplified accounting model for purchases financial assets with credit deterioration since their origination. The new model referred to as current expected credit losses (“CECL”) model, will apply to: (a) financial assets subject to credit losses and measured at amortized cost, and (b) certain off-balance sheet credit exposures. This includes loans, held to maturity debt securities, loan commitments, financial guarantees and net investments in leases as well as reinsurance and trade receivables. The estimate of expected credit losses (“ECL”) should consider historical information, current information, and supportable forecasts, including estimates of prepayments. ASU 2016-13 is effective for public business entities for annual periods beginning after December 15, 2019, and interim periods within those annual periods, and for all other entities for annual periods beginning after December 15, 2020 and interim periods within annual periods beginning after December 15, 2018 with early adoption permitted. The Corporation is evaluating the provisions of ASU 2016-13.

In March 2016, the FASB issued ASU 2016-09, *Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*. ASU 2016-09 introduces amendments intended to simplify the accounting for stock compensation. ASU 2016-09 requires all excess tax benefits and tax deficiencies to be recognized as income tax expense or benefit in the income statement. The tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. An entity should also recognize excess tax benefits, and assess the need for a valuation allowance, regardless of whether the benefit reduces taxes payable in the current period. The ASU also requires excess tax benefits be classified along with other income tax cash flows as an operating activity in the statement of cash flows. ASU 2016-09 is effective for public business entities for annual periods beginning after December 15, 2016, and interim periods within those annual periods, and for all other entities for annual periods beginning after December 15, 2017 and interim periods within annual periods beginning after December 15, 2018 with early adoption permitted. The Corporation is evaluating the provisions of ASU 2016-09, but believes that its adoption will not have a material impact on the Corporation’s financial condition or results of operations.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. ASU 2016-02 is intended to improve financial reporting about leasing transactions by requiring organizations that lease assets – referred to as “lessees” – to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases. Under the new guidance, a lessee will be required to recognize assets and liabilities for leases with lease terms of more than 12 months. The amendments will require disclosures to help investors and other financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 applies to all public business entities for annual and interim periods after December 15, 2018, and for all other entities for annual periods beginning after December 15, 2019 and interim periods beginning after December 15, 2020 with early adoption permitted. The Corporation is evaluating the provisions of ASU 2016-02, but believes that its adoption will not have a material impact on the Corporation’s financial condition or results of operations.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10)*. The update requires all equity investments to be measured at fair value with changes in the fair value recognized through net

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

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

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*, which establishes a comprehensive revenue recognition standard for virtually all industries under U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. ASU 2014-09 specifies that an entity shall recognize revenue when, or as, the entity satisfies a performance obligation by transferring a promised good or service (i.e. an asset) to a customer. An asset is transferred when, or as, the customer obtains control of the asset. Entities are required to disclose qualitative and quantitative information on the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. ASU 2014-09 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, with early adoption not permitted. In August 2015, the FASB issued ASU 2015-14 to defer the date of ASU 2014-09 by one year to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application would be permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The Corporation is evaluating the provisions of ASU 2014-09, but believes that its adoption will not have a material impact on the Corporation's financial condition or results of operations.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **INTRODUCTION**

The following discussion and analysis is intended as a review of material changes in and significant factors affecting the financial condition and results of operations of First United Corporation and its consolidated subsidiaries for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and the notes thereto contained in Item 1 of Part I of this report. Unless the context clearly suggests otherwise, references in this report to “us”, “we”, “our”, and “the Corporation” are to First United Corporation and its consolidated subsidiaries.

### **FORWARD-LOOKING STATEMENTS**

This report may contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Readers of this report should be aware of the speculative nature of “forward-looking statements.” Statements that are not historical in nature, including those that include the words “anticipate”, “estimate”, “should”, “expect”, “believe”, “intend”, and similar expressions, are based on current expectations, estimates and projections about, among other things, the industry and the markets in which we operate, and they are not guarantees of future performance. Whether actual results will conform to expectations and predictions is subject to known and unknown risks and uncertainties, including risks and uncertainties discussed in this report; general economic, market, or business conditions; changes in interest rates, deposit flow, the cost of funds, and demand for loan products and financial services; changes in our competitive position or competitive actions by other companies; changes in the quality or composition of our loan and investment portfolios; our ability to manage growth; changes in laws or regulations or policies of federal and state regulators and agencies; and other circumstances beyond our control. Consequently, all of the forward-looking statements made in this report are qualified by these cautionary statements, and there can be no assurance that the actual results anticipated will be realized, or if substantially realized, will have the expected consequences on our business or operations. These and other risks are discussed in detail in the periodic reports that First United Corporation files with the Securities and Exchange Commission (the “SEC”) (see Item 1A of Part II of this report for further information). Except as required by applicable laws, we do not intend to publish updates or revisions of any forward-looking statements we make to reflect new information, future events or otherwise.

### **FIRST UNITED CORPORATION**

First United Corporation is a Maryland corporation chartered in 1985 and a bank holding company registered with the Board of Governors of the Federal Reserve System (the “FRB”) under the Bank Holding Company Act of 1956, as

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

At September 30, 2016, the Corporation had total assets of \$1.3 billion, net loans of \$890.4 million, and deposits of \$1.0 billion. Shareholders’ equity at September 30, 2016 was \$114.8 million.

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

## ESTIMATES AND CRITICAL ACCOUNTING POLICIES

This discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. (See Note 1 of the Notes to Consolidated Financial Statements included in Item 8 of Part II of First United Corporation's Annual Report on Form 10-K for the year ended December 31, 2015). On an on-going basis, management evaluates estimates, including those related to loan losses and intangible assets, other-than-temporary impairment ("OTTI") of investment securities, income taxes, fair value of investments and pension plan assumptions. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Management believes the following critical accounting policies affect our more significant judgments and estimates used in the preparation of the consolidated financial statements.

Management does not believe that any material changes in our critical accounting policies have occurred since December 31, 2015.

### *Allowance for Loan Losses*

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

### *Goodwill and Other Intangible Assets*



Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 350, *Intangibles - Goodwill and Other*, establishes standards for the amortization of acquired intangible assets and impairment assessment of goodwill. The \$11.0 million recorded as goodwill at September 30, 2016 is primarily related to the Bank’s 2003 acquisition of Huntington National Bank branches and is not subject to periodic amortization.

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

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

### *Accounting for Income Taxes*

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

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

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

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

Management systematically evaluates securities for impairment on a quarterly basis. Based upon application of accounting guidance for subsequent measurement in ASC Topic 320, *Investments – Debt and Equity Securities* (Section 320-10-35), management assesses whether (a) the Corporation has the intent to sell a security being evaluated and (b) it is more likely than not that the Corporation will be required to sell the security prior to its anticipated recovery. If neither applies, then declines in the fair values of securities below their cost that are considered other-than-temporary declines are split into two components. The first is the loss attributable to declining credit quality. Credit losses are recognized in earnings as realized losses in the period in which the impairment determination is made. The second component consists of all other losses, which are recognized in other comprehensive loss. In estimating OTTI losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) adverse conditions specifically related to the security, an industry, or a geographic area, (3) the

historic and implied volatility of the fair value of the security, (4) changes in the rating of the security by a rating agency, (5) recoveries or additional declines in fair value subsequent to the balance sheet date, (6) failure of the issuer of the security to make scheduled interest or principal payments, and (7) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future. Management also monitors cash flow projections for securities that are considered beneficial interests under the guidance of ASC Subtopic 325-40, *Investments – Other – Beneficial Interests in Securitized Financial Assets*, (ASC Section 325-40-35). This process is described more fully in the Investment Securities section of the Consolidated Balance Sheet Review.

#### *Fair Value of Investments*

We have determined the fair value of our investment securities in accordance with the requirements of ASC Topic 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements required under other accounting pronouncements. The Corporation measures the fair market values of its investments based on the fair value hierarchy established in Topic 820. The determination of fair value of investments and other assets is discussed further in Note 9 to the consolidated financial statements presented elsewhere in this report.

*Pension Plan Assumptions*

Our pension plan costs are calculated using actuarial concepts, as discussed within the requirements of ASC Topic 715, *Compensation – Retirement Benefits*. Pension expense and the determination of our projected pension liability are based upon two critical assumptions: (a) the discount rate; and (b) the expected return on plan assets. We evaluate each of these critical assumptions annually. Other assumptions impact the determination of pension expense and the projected liability including the primary employee demographics, such as retirement patterns, employee turnover, mortality rates, and estimated employer compensation increases. These factors, along with the critical assumptions, are carefully reviewed by management each year in consultation with our pension plan consultants and actuaries. Further information about our pension plan assumptions, the plan's funded status, and other plan information is included in Note 14 to the consolidated financial statements presented elsewhere in this report.

## SELECTED FINANCIAL DATA

The following table sets forth certain selected financial data for the nine-month periods ended September 30, 2016 and 2015 and is qualified in its entirety by the detailed information and unaudited financial statements, including the notes thereto, included elsewhere in this quarterly report.

|   | As of or for the Nine months ended |   |          |   |
|---|------------------------------------|---|----------|---|
|   | September 30,                      |   | 2015     |   |
|   | 2016                               |   | 2015     |   |
| Per Share Data                                |                                    |   |          |   |
| Basic and diluted net income per common share | \$ 0.68                            |   | \$ 0.39  |   |
| Basic and diluted book value per common share | \$ 15.12                           |   | \$ 13.52 |   |
| Significant Ratios                            |                                    |   |          |   |
| Return on Average Assets <sup>(a)</sup>       | 0.59                               | % | 0.45     | % |
| Return on Average Equity <sup>(a)</sup>       | 6.86                               | % | 5.34     | % |
| Average Equity to Average Assets              | 8.61                               | % | 9.23     | % |

Note: <sup>(a)</sup> Annualized

## RESULTS OF OPERATIONS

*Overview*

Consolidated net income available to common shareholders was \$4.3 million for the first nine months of 2016, compared to \$2.5 million for the same period of 2015. Basic and diluted net income per common share for the first nine months of 2016 were both \$.68, compared to basic and diluted net income per common share of \$.39 for the same period of 2015. The increase in earnings was due to an increase in net interest income of \$1.4 million, offset by an increase of \$1.6 million in provision for loan losses, an increase of \$1.4 million in other operating income, and a decrease of \$1.0 million in other operating expenses offset by an increase of \$.9 million in provision for income taxes. The net interest margin for the first nine months of 2016, the year ended December 31, 2015 and the first nine months of 2015, on a fully tax equivalent (“FTE”) basis, was 3.21%, 3.04% and 3.07%, respectively. The increase in interest income on earning assets and a reduction in interest expense contributed to the increase in the net interest margin for the first nine months of 2016 when compared to the margin recorded for the year ended December 31, 2015.

The provision for loan losses increased to \$2.2 million for the nine months ended September 30, 2016 from the \$.6 million recorded for the nine months ended September 30, 2015. The increase was due primarily to a specific allocation on a large participation loan on a mall in Pennsylvania during the second quarter. Specific allocations have been made for impaired loans where management has determined that the collateral supporting the loans is not adequate to cover the loan balance, and the qualitative factors affecting the ALL have been adjusted based on the current economic environment and the characteristics of the loan portfolio.

Interest expense on our interest-bearing liabilities decreased \$1.1 million during the nine months ended September 30, 2016 when compared to the same period of 2015 due to a 14 basis point reduction in the average rate paid due primarily to reductions in rates on interest-bearing deposits. During 2015 and continuing into 2016, our retail staff has focused on shifting the Bank's deposit mix from higher cost certificates of deposit and towards lower cost core deposit accounts. This strategic focus will continue throughout 2016 as we continue to place an emphasis on the full relationship customer.

Other operating income increased \$1.4 million during the first nine months of 2016 when compared to the same period of 2015. This increase was primarily attributable to net gains on sales of investment securities as well as increases in service charge income related to paper statement fees implemented in late 2015, trust and brokerage income, debit card income and increased BOLI income due to a one-time death benefit received in the second quarter.

Operating expenses decreased \$1.0 million in the first nine months of 2016 when compared to the same period of 2015. This was due primarily to a \$.3 million decrease in other real estate owned ("OREO") expenses primarily due to a reduction in valuation allowances, a \$.7 million decrease in FDIC premiums, a \$.3 million decrease in professional services and a \$.4 million decrease in data processing expenses due to reduced expenses related to our core processor. These decreases were offset by a \$.8 million increase in other miscellaneous expenses due to increased marketing expenses related to our new branding initiative, increased loan fees and other miscellaneous expenses.

Consolidated net income available to common shareholders was \$1.8 million, or \$.29 per common share, for the third quarter of 2016, compared to \$1.3 million, or \$.20 per common share, for the same period of 2015. The increase in earnings for the third quarter of 2016 when compared to the third quarter of 2015 was attributable to an increase in net interest income of \$.3 million, an increase in other operating income of \$.3 million and a decline in provision for loan losses of \$.2 million, partially offset by increases in other operating expenses of approximately \$.1 million and an increase of \$.4 million in provision for income taxes. The net interest margin for the third quarter of 2016, on an FTE basis, was 3.22% compared to 3.13% for the same period of 2015.

Other operating income increased \$.3 million during the third quarter of 2016 when compared to the same period of 2015. This increase was due to a \$.2 million increase on net gains on sales of investment securities as well as increased service charge income related to paper statement fees and account analysis fees.

Operating expenses increased \$.1 million in the third quarter of 2016 when compared to the same period of 2015. This increase was due to an increase of \$.5 million in OREO expense relating to valuation write-downs in the third quarter 2016 compared to gains on sales of OREO properties in the third quarter of 2015, an increase of \$.4 million in miscellaneous expenses due to increased marketing and printed supplies relating to our new branding initiative, and increased contract labor expenses and miscellaneous loan fees, offset by a decrease in FDIC premiums of \$.4 million and a \$.2 million decrease in salaries and employee benefits primarily related to reduced health insurance costs.



*Net Interest Income*

Net interest income is the largest source of operating revenue and is the difference between the interest earned on interest-earning assets and the interest expense incurred on interest-bearing liabilities. For analytical and discussion purposes, net interest income is adjusted to an FTE basis to facilitate performance comparisons between taxable and tax-exempt assets. FTE income is determined by increasing tax-exempt income by an amount equal to the federal income taxes that would have been paid if this income were taxable at the statutorily applicable rate.

The following table sets forth the average balances, net interest income and expense, and average yields and rates of our interest-earning assets and interest-bearing liabilities for the nine-month periods ended September 30, 2016 and 2015:

| (dollars in thousands)                     | Nine months ended September 30,<br>2016 |          |                       | 2015               |          |                       |   |  |
|--|---|----------|-----------------------|--------------------|----------|-----------------------|---|--|
|  | Average<br>Balance                      | Interest | Average<br>Yield/Rate | Average<br>Balance | Interest | Average<br>Yield/Rate |   |  |
| Assets                                     |   |          |                       |                    |          |                       |   |  |
| Loans                                      | \$902,407                               | \$29,251 | 4.33                  | % \$840,458        | \$27,576 | 4.39                  | % |  |
| Investment Securities:                     |   |          |                       |                    |          |                       |   |  |
| Taxable                                    | 229,932                                 | 4,303    | 2.50                  | 285,013            | 5,365    | 2.52                  |   |  |
| Non taxable                                | 21,772                                  | 1,017    | 6.24                  | 35,597             | 1,553    | 5.83                  |   |  |
| Total                                      | 251,704                                 | 5,320    | 2.82                  | 320,610            | 6,918    | 2.88                  |   |  |
| Federal funds sold                         | 33,005                                  | 89       | 0.36                  | 25,219             | 30       | 0.16                  |   |  |
| Interest-bearing deposits with other banks | 1,703                                   | 3        | 0.24                  | 4,622              | 4        | 0.11                  |   |  |
| Other interest earning assets              | 5,889                                   | 203      | 4.60                  | 6,889              | 234      | 4.55                  |   |  |
| Total earning assets                       | 1,194,708                               | 34,866   | 3.90                  | % 1,197,798        | 34,762   | 3.88                  | % |  |
| Allowance for loan losses                  | (12,239 )                               |          |                       | (11,966 )          |          |                       |   |  |
| Non-earning assets                         | 142,023                                 |          |                       | 141,218            |          |                       |   |  |
| Total Assets                               | \$1,324,492                             |          |                       | \$1,327,050        |          |                       |   |  |
| Liabilities and Shareholders' Equity       |   |          |                       |                    |          |                       |   |  |
| Interest-bearing demand deposits           | \$177,934                               | \$109    | 0.08                  | % \$151,646        | \$79     | 0.07                  | % |  |
| Interest-bearing money markets             | 234,861                                 | 250      | 0.14                  | 220,088            | 359      | 0.22                  |   |  |
| Savings deposits                           | 146,693                                 | 125      | 0.11                  | 135,717            | 177      | 0.17                  |   |  |
| Time deposits:                             |   |          |                       |                    |          |                       |   |  |
| Less than \$100k                           | 124,964                                 | 953      | 1.02                  | 144,394            | 1,138    | 1.05                  |   |  |
| \$100k or more                             | 120,183                                 | 936      | 1.04                  | 135,400            | 1,265    | 1.25                  |   |  |
| Short-term borrowings                      | 29,635                                  | 42       | 0.19                  | 35,922             | 42       | 0.16                  |   |  |
| Long-term borrowings                       | 147,102                                 | 3,761    | 3.42                  | 170,472            | 4,213    | 3.30                  |   |  |
| Total interest-bearing liabilities         | 981,372                                 | 6,176    | 0.84                  | % 993,639          | 7,273    | 0.98                  | % |  |



Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|  |             |          |      |             |          |      |   |
|--|-------------|----------|------|-------------|----------|------|---|
| Non-interest-bearing deposits              | 207,563     |          |      | 201,312     |          |      |   |
| Other liabilities                          | 21,570      |          |      | 19,687      |          |      |   |
| Shareholders' Equity                       | 113,987     |          |      | 112,412     |          |      |   |
| Total Liabilities and Shareholders' Equity | \$1,324,492 |          |      | \$1,327,050 |          |      |   |
| Net interest income and spread             |             | \$28,690 | 3.06 | %           | \$27,489 | 2.90 | % |
| Net interest margin                        |             |          | 3.21 | %           |          | 3.07 | % |

Note:

(1) The above table reflects the average rates earned or paid stated on an FTE basis assuming a 35% tax rate. Non-GAAP interest income on a fully taxable equivalent was \$408 and \$610, respectively.

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

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

Net interest income, on an FTE basis, increased \$1.2 million (4.37%) during the first nine months of 2016 over the same period in 2015 due to a \$1.1 million (15.08%) decrease in interest expense; and \$.1 million (.30%) increase in interest income. The net interest margin for the first nine months of 2016 was 3.21%, compared to 3.07% for the first nine months of 2015.

Comparing the first nine months of 2016 to the same period of 2015, the slight increase in interest income was due to an increase of \$1.7 million in interest income on loans. This increase was due primarily to the increase in average loan balances of \$61.9 million. This increase was offset by a decrease in interest income on investments due to a decline in average investments of \$68.9 million.

Interest expense decreased during the first nine months of 2016 when compared to the same period of 2015 due primarily to a decrease of \$12.3 million on our average balance of interest-bearing liabilities. This decrease was primarily due to the continued shift of higher cost certificates of deposit to lower cost core deposits. The effect of this shift was a decrease in average balances in certificates of deposit of \$34.6 million and a decrease of 24 basis points in the average rate paid and an increase of \$52.0 million in average balances in core deposits and a decrease of 13 basis points in the average rate paid. Although the average balance in long-term borrowings decreased \$23.3 million due primarily to the payoff of a \$30 million FHLB advance in July 2015; the effective rate paid on long-term borrowings increased 12 basis points due to the increase in rates paid on off-balance sheet interest rate swaps compared to the prior period. The effect on the average rate paid was a 14 basis point decrease from .98% for the nine months ended September 30, 2015 to .84% for the same period of 2016.

The following table sets forth the average balances, net interest income and expense, and average yields and rates of our interest-earning assets and interest-bearing liabilities for the three-month periods ended September 30, 2016 and 2015:

| (dollars in thousands)                      | Three months ended September 30,<br>2016 |          |                    | 2015            |          |                    |  |  |
|---|--|----------|--------------------|-----------------|----------|--------------------|--|--|
|   | Average Balance                          | Interest | Average Yield/Rate | Average Balance | Interest | Average Yield/Rate |  |  |
| <b>Assets</b>                               |  |          |                    |                 |          |                    |  |  |
| Loans                                       | \$911,069                                | \$9,894  | 4.37 %             | \$842,189       | \$9,320  | 4.39 %             |  |  |
| <b>Investment Securities:</b>               |  |          |                    |                 |          |                    |  |  |
| Taxable                                     | 221,277                                  | 1,378    | 2.50               | 271,411         | 1,755    | 2.57               |  |  |
| Non taxable                                 | 19,242                                   | 319      | 6.67               | 33,689          | 483      | 5.69               |  |  |
| Total                                       | 240,519                                  | 1,697    | 2.84               | 305,100         | 2,238    | 2.91               |  |  |
| Federal funds sold                          | 41,024                                   | 33       | 0.32               | 34,330          | 14       | 0.16               |  |  |
| Interest-bearing deposits with other banks  | 1,911                                    | 1        | 0.21               | 3,692           | 1        | 0.11               |  |  |
| Other interest earning assets               | 5,881                                    | 66       | 4.51               | 6,080           | 78       | 5.12               |  |  |
| Total earning assets                        | 1,200,404                                | 11,691   | 3.92 %             | 1,191,391       | 11,651   | 3.88 %             |  |  |
| Allowance for loan losses                   | (12,570 )                                |          |                    | (11,890 )       |          |                    |  |  |
| Non-earning assets                          | 146,964                                  |          |                    | 141,912         |          |                    |  |  |
| Total Assets                                | \$1,334,798                              |          |                    | \$1,321,413     |          |                    |  |  |
| <b>Liabilities and Shareholders' Equity</b> |  |          |                    |                 |          |                    |  |  |
| Interest-bearing demand deposits            | \$175,482                                | \$28     | 0.06 %             | \$160,616       | \$23     | 0.06 %             |  |  |
| Interest-bearing money markets              | 236,405                                  | 95       | 0.16               | 218,661         | 122      | 0.22               |  |  |
| Savings deposits                            | 149,894                                  | 43       | 0.11               | 138,837         | 56       | 0.16               |  |  |
| <b>Time deposits:</b>                       |  |          |                    |                 |          |                    |  |  |
| Less than \$100k                            | 113,907                                  | 301      | 1.06               | 141,711         | 368      | 1.03               |  |  |
| \$100k or more                              | 127,539                                  | 317      | 1.00               | 130,328         | 391      | 1.19               |  |  |
| Short-term borrowings                       | 31,126                                   | 14       | 0.18               | 39,010          | 14       | 0.14               |  |  |
| Long-term borrowings                        | 146,750                                  | 1,271    | 3.48               | 152,452         | 1,277    | 3.32               |  |  |
| Total interest-bearing liabilities          | 981,103                                  | 2,069    | 0.85 %             | 981,615         | 2,251    | 0.91 %             |  |  |
| Non-interest-bearing deposits               | 217,702                                  |          |                    | 203,971         |          |                    |  |  |
| Other liabilities                           | 21,545                                   |          |                    | 21,433          |          |                    |  |  |
| Shareholders' Equity                        | 114,448                                  |          |                    | 114,394         |          |                    |  |  |
| Total Liabilities and Shareholders' Equity  | \$1,334,798                              |          |                    | \$1,321,413     |          |                    |  |  |
| Equity                                      |  |          |                    |                 |          |                    |  |  |
| Net interest income and spread              |  | \$9,622  | 3.07 %             |                 | \$9,400  | 2.97 %             |  |  |
| Net interest margin                         |  |          | 3.22 %             |                 |          | 3.13 %             |  |  |

Note:

- (1) The above table reflects the average rates earned or paid stated on an FTE basis assuming a 35% tax rate. Non-GAAP interest income on a fully taxable equivalent was \$128 and \$190, respectively.
- (2) Net interest margin is calculated as net interest income divided by average earning assets.
- (3) The average yields on investments are based on amortized cost.

Net interest income, on an FTE basis, increased \$.2 million (2.36%) during the third quarter of 2016 over the same period in 2015 due to a slight increase in interest income as well as a \$.2 million (8.09%) decrease in interest expense. The net interest margin in the third quarter of 2016 was 3.22%, compared to 3.13% for third quarter of 2015.

Comparing the third quarter of 2016 to the same period of 2015, the slight increase in interest income was due to the increase in average loans of \$68.9 million offset by a reduction in average investment balances of \$64.6 million. The overall rate earned on earning assets for the third quarter of 2016 increased 4 basis points compared to the third quarter of 2015.

Interest expense decreased during the third quarter of 2016 when compared to the same period of 2015 due to a decrease on the average rate paid of 6 basis points from .91% for the three months ended September 30, 2015 to .85% for the same period of 2016 due primarily to the shift in balances from higher cost certificates of deposit to lower cost core deposits.

The following table sets forth an analysis of volume and rate changes in interest income and interest expense for our average interest-earning assets and average interest-bearing liabilities for the nine-month periods ended September 30, 2016 and 2015:

| (in thousands and tax equivalent basis) | 2016 Compared to 2015 |           |         |
|---|-----------------------|-----------|---------|
|   | Volume                | Rate      | Net     |
| <b>Interest Income:</b>                 |                       |           |         |
| Loans                                   | \$2,682               | \$(1,007) | \$1,675 |
| Taxable Investments                     | (1,377)               | 315       | (1,062) |
| Non-taxable Investments                 | (862 )                | 326       | (536 )  |
| Federal funds sold                      | 28                    | 31        | 59      |
| Other interest earning assets           | (190 )                | 158       | (32 )   |
| Total interest income                   | 281                   | (177 )    | 104     |
| <b>Interest Expense:</b>                |                       |           |         |
| Interest-bearing demand deposits        | 22                    | 8         | 30      |
| Interest-bearing money markets          | 21                    | (130 )    | (109 )  |
| Savings deposits                        | 12                    | (64 )     | (52 )   |
| Time deposits less than \$100           | (198 )                | 13        | (185 )  |
| Time deposits \$100 or more             | (158 )                | (171 )    | (329 )  |
| Short-term borrowings                   | (12 )                 | 12        | 0       |
| Long-term borrowings                    | (798 )                | 346       | (452 )  |
| Total interest expense                  | (1,111)               | 14        | (1,097) |
| Net interest income                     | \$1,392               | \$(191 )  | \$1,201 |

Note:

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

63

The following table sets forth an analysis of volume and rate changes in interest income and interest expense for our average interest-earning assets and average interest-bearing liabilities for the three-month periods ended September 30, 2016 and 2015:

| (in thousands and tax equivalent basis) | 2016 Compared to 2015 |           |       |
|---|-----------------------|-----------|-------|
|   | Volume                | Rate      | Net   |
| <b>Interest Income:</b>                 |                       |           |       |
| Loans                                   | \$3,009               | \$(2,233) | \$776 |
| Taxable Investments                     | (1,256)               | 885       | (371) |
| Non-taxable Investments                 | (963 )                | 765       | (198) |
| Federal funds sold                      | 22                    | 2         | 24    |
| Other interest earning assets           | (94 )                 | 83        | (11 ) |
| Total interest income                   | 718                   | (498 )    | 220   |
| <b>Interest Expense:</b>                |                       |           |       |
| Interest-bearing demand deposits        | 10                    | (8 )      | 2     |
| Interest-bearing money markets          | 29                    | (57 )     | (28 ) |
| Savings deposits                        | 13                    | (30 )     | (17 ) |
| Time deposits less than \$100           | (295 )                | 219       | (76 ) |
| Time deposits \$100 or more             | (28 )                 | (86 )     | (114) |
| Short-term borrowings                   | (14 )                 | 14        | 0     |
| Long-term borrowings                    | (199 )                | 8         | (191) |
| Total interest expense                  | (484 )                | 60        | (424) |
| Net interest income                     | \$1,202               | \$(558 )  | \$644 |

Note:

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

#### *Provision for Loan Losses*

The provision for loan losses was \$2.2 million for the nine months ended September 30, 2016, compared to \$.6 million for the nine months ended September 30, 2015. A \$1.6 million specific allocation on a participation loan on a mall in Pennsylvania in the second quarter (discussed below in the section entitled “FINANCIAL CONDITION” under the heading “Allowance and Provision for Loan Losses”), was the most significant factor in the increased provision expense. Management strives to ensure that the ALL reflects a level commensurate with the risk inherent in our loan portfolio.





*Other Operating Income*

Other operating income, exclusive of gains, increased \$1.0 million during the first nine months of 2016 when compared to the same period of 2015. This increase was primarily attributable to increases in service charge income relating to the implementation of paper statement fees in late 2015, trust and brokerage income, debit card income, and BOLI income due to a one-time death benefit of \$.2 million received during the second quarter of 2016.

Net gains of \$.5 million were reported in other income in the first nine months of 2016, compared to net gains of \$.1 million during the same period of 2015. The increase resulted from gains on sales of investment securities used for loan funding during the first half of 2016.

Other operating income, exclusive of gains, increased \$.2 million during the third quarter of 2016 when compared to the same period of 2015. This increase was due increased service charge income relating to a paper statement fee implemented in late 2015, and account analysis fees, and an increase in other miscellaneous income.

Net gains of \$.2 million were reported in other income in the third quarter of 2016, compared to \$.1 million in the same period of 2015. This increase was due to gains realized on sales of investment securities.

The following table shows the major components of other operating income for the nine- and three-month periods ended September 30, 2016 and 2015, exclusive of net gains:

|                           | Income as % of Total Other Operating<br>Income<br>For the Nine months ended<br>September 30, |   |      | Income as % of Total Other Operating<br>Income<br>For the Three months ended<br>September 30, |     |      |     |   |
|---------------------------|--|---|------|---|-----|------|-----|---|
|                           | 2016   |   | 2015 | 2016  |     | 2015 |     |   |
| Service charges           | 23   | % | 22   | %   | 24  | %    | 23  | % |
| Trust department          | 41   | % | 43   | %   | 41  | %    | 42  | % |
| Debit card Income         | 15   | % | 16   | %   | 15  | %    | 17  | % |
| Bank owned life insurance | 11   | % | 9    | %   | 8   | %    | 8   | % |
| Brokerage income          | 6  | % | 7    | %   | 5   | %    | 7   | % |
| Other income              | 4  | % | 3    | %   | 7   | %    | 3   | % |
|                           | 100  | % | 100  | %   | 100 | %    | 100 | % |

*Other Operating Expenses*

Operating expenses decreased \$1.0 million in the first nine months of 2016 when compared to the same period of 2015. This was due primarily to a \$.3 million decrease in OREO expenses, a \$.7 million decrease in FDIC premiums, a \$.3 million decrease in professional services and a \$.4 million decrease in data processing expenses due to reduced expenses related to our core processor. These decreases were offset by an increase of \$.8 million in other miscellaneous expenses due to a reserve for a pending loan claim, increased marketing and printed supplies relating to our new branding initiative and increased miscellaneous loan fees.

Operating expenses increased \$.1 million in the third quarter of 2016 when compared to the same period of 2015. This increase was due to an increase of \$.5 million in OREO expenses due to valuation write-downs in the third quarter of 2016 compared to gains on sales of properties in the third quarter of 2015 and a \$.4 million increase in other miscellaneous expenses discussed above, offset by a decrease of \$.4 million in FDIC premiums and a \$.2 million decrease in salaries and employee benefits primarily related to reduced health insurance costs.

The composition of other operating expenses for the nine- and three-month periods ended September 30, 2016 and 2015 is illustrated in the following table.

|  | Expense as % of Total Other Operating Expenses For the Nine months ended September 30, |   |      |   | Expense as % of Total Other Operating Expenses For the Three months ended September 30, |   |      |   |
|--|--|---|------|---|---|---|------|---|
|  | 2016   |   | 2015 |   | 2016  |   | 2015 |   |
| Salaries and employee benefits           | 53   | % | 52   | % | 53  | % | 56   | % |
| FDIC premiums                            | 3  | % | 5    | % | 1   | % | 5    | % |
| Occupancy, equipment and data processing | 20   | % | 20   | % | 20  | % | 22   | % |
| Professional Services                    | 3  | % | 4    | % | 3   | % | 2    | % |
| Other real estate owned                  | 2  | % | 3    | % | 4   | % | 0    | % |
| Other                                    | 19   | % | 16   | % | 19  | % | 15   | % |
|  | 100  | % | 100  | % | 100   | % | 100  | % |

#### *Provision for Income Taxes*

In reporting interim financial information, income tax provisions should be determined under the procedures set forth in ASC Topic 740, *Income Taxes* (Section 740-270-30). This guidance provides that at the end of each interim period, an entity should make its best estimate of the effective tax rate expected to be applicable for the full fiscal year. The rate so determined should be used in providing for income taxes on a current year-to-date basis. The effective tax rate should reflect anticipated investment tax credits, capital gains rates, and other available tax planning alternatives. In arriving at this effective tax rate, however, no effect should be included for the tax related to significant, unusual or extraordinary items that will be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year.

The effective tax rate for the first nine months of 2016 was 27.6%, compared to an effective tax rate of 23.1% for the first nine months of 2015. Our effective income tax rates differed from the 35% federal statutory rate due to the effects of tax-exempt income on loans, securities and bank-owned life insurance, as well as the low income housing tax credits.

#### FINANCIAL CONDITION

##### *Balance Sheet Overview*

When compared to December 31, 2015, total assets at September 30, 2016 remained stable at \$1.3 billion. During the first nine months of 2016, cash and interest-bearing deposits in other banks increased \$13.9 million, the investment portfolio decreased \$29.4 million, and gross loans increased \$23.5 million. Total liabilities increased by \$20.7 million during the first nine months of 2016 due primarily to an increase in deposits of \$20.4 million. Comparing September 30, 2016 to December 31, 2015, shareholders' equity decreased \$6.0 million as a result of First United Corporation's redemption of \$10.0 million of its outstanding shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, in February 2016, offset partially by \$4.3 million in earnings during the first nine months of 2016.

*Loan Portfolio*

The following table presents the composition of our loan portfolio at the dates indicated:

| (dollars in thousands)      | September 30, 2016 |       | December 31, 2015 |       |
|-----------------------------|--------------------|-------|-------------------|-------|
| Commercial real estate      | \$ 292,587         | 33 %  | \$ 280,505        | 32 %  |
| Acquisition and development | 111,591            | 12 %  | 110,986           | 13 %  |
| Commercial and industrial   | 75,597             | 8 %   | 73,853            | 8 %   |
| Residential mortgage        | 398,469            | 44 %  | 388,739           | 44 %  |
| Consumer                    | 24,245             | 3 %   | 24,940            | 3 %   |
| Total Loans                 | \$ 902,489         | 100 % | \$ 879,023        | 100 % |

Comparing September 30, 2016 to December 31, 2015, outstanding loans increased by \$23.5 million (2.67%), commercial real estate (“CRE”) loans increased \$12.0 million due to several new large relationships booked during the first nine months, acquisition and development (“A&D”) loans increased \$.6 million, commercial and industrial (“C&I”) loans increased \$1.7 million, residential mortgages increased by \$9.7 million primarily due to new loans booked in our 5/1 and 7/1 ARM programs, and the consumer portfolio decreased by \$.7 million. Approximately 37% of the commercial loan portfolio was collateralized by real estate at September 30, 2016, compared to 39% at December 31, 2015.

*Risk Elements of Loan Portfolio*

The following table presents the risk elements of our loan portfolio at the dates indicated. Management is not aware of any potential problem loans other than those listed in this table or discussed below.

| (dollars in thousands)  | September 30,<br>2016 | % of Applicable<br>Portfolio | December 31,<br>2015 | % of<br>Applicable<br>Portfolio |   |
|---|-----------------------|------------------------------|----------------------|---------------------------------|---|
| Non-accrual loans:  |                       |                              |                      |                                 |   |
| Commercial real estate  | \$ 15,534             | 5.31                         | % \$ 11,282          | 4.00                            | % |
| Acquisition and development                                   | 46                    | 0.04                         | % 1,817              | 1.60                            | % |
| Commercial and industrial                                     | 0                     | 0.00                         | % 185                | 0.30                            | % |
| Residential mortgage  | 2,564                 | 0.64                         | % 2,214              | 0.60                            | % |
| Consumer  | 0                     | 0.00                         | % 0                  | 0.00                            | % |
| Total non-accrual loans                                       | \$ 18,144             | 2.01                         | % \$ 15,498          | 1.76                            | % |
| Accruing Loans Past Due 90 days or more:                      |                       |                              |                      |                                 |   |
| Commercial real estate  | \$ 0                  |                              | \$ 0                 |                                 |   |
| Acquisition and development                                   | 189                   |                              | 0                    |                                 |   |
| Commercial and industrial                                     | 12                    |                              | 0                    |                                 |   |
| Residential mortgage  | 233                   |                              | 998                  |                                 |   |
| Consumer  | 5                     |                              | 27                   |                                 |   |
| Total loans past due 90 days or more                          | \$ 439                |                              | \$ 1,025             |                                 |   |
| Total non-accrual and accruing loans past due 90 days or more | \$ 18,583             |                              | \$ 16,523            |                                 |   |
| Restructured Loans (TDRs):                                    |                       |                              |                      |                                 |   |
| Performing  | \$ 8,100              |                              | \$ 8,168             |                                 |   |
| Non-accrual (included above)                                  | 1,666                 |                              | 5,851                |                                 |   |
| Total TDRs  | \$ 9,766              |                              | \$ 14,019            |                                 |   |
| Other real estate owned                                       | \$ 10,259             |                              | \$ 6,883             |                                 |   |
| Impaired loans without a valuation allowance                  | \$ 18,067             |                              | \$ 20,940            |                                 |   |
| Impaired loans with a valuation allowance                     | 11,127                |                              | 3,868                |                                 |   |
| Total impaired loans  | \$ 29,194             |                              | \$ 24,808            |                                 |   |
| Valuation allowance related to impaired loans                 | \$ 2,188              |                              | \$ 1,157             |                                 |   |

Performing loans considered to be impaired (including performing troubled debt restructurings, or TDRs), as defined and identified by management, amounted to \$11.0 million at September 30, 2016 and \$9.3 million at December 31,

2015. Loans are identified as impaired when, based on current information and events, management determines that we will be unable to collect all amounts due according to contractual terms. These loans consist primarily of A&D loans and CRE loans. The fair values are generally determined based upon independent third party appraisals of the collateral or discounted cash flows based upon the expected proceeds. Specific allocations have been made where management believes there is insufficient collateral to repay the loan balance if liquidated and there is no secondary source of repayment available.

The level of performing impaired loans (other than performing TDRs) increased \$1.8 million during the nine months ended September 30, 2016, due to the addition three loans totaling \$1.9 million from one relationship with an equipment company.

The following table presents the details of impaired loans that are TDRs by class at September 30, 2016 and December 31, 2015:

| (in thousands)                      | September 30, 2016     |                        | December 31, 2015      |                        |
|-------------------------------------|------------------------|------------------------|------------------------|------------------------|
|                                     | Number of<br>Contracts | Recorded<br>Investment | Number of<br>Contracts | Recorded<br>Investment |
| <b>Performing</b>                   |                        |                        |                        |                        |
| <b>Commercial real estate</b>       |                        |                        |                        |                        |
| Non owner-occupied                  | 3                      | \$ 388                 | 3                      | \$ 399                 |
| All other CRE                       | 3                      | 3,077                  | 2                      | 2,965                  |
| <b>Acquisition and development</b>  |                        |                        |                        |                        |
| 1-4 family residential construction | 1                      | 582                    | 1                      | 700                    |
| All other A&D                       | 2                      | 1,912                  | 2                      | 1,980                  |
| Commercial and industrial           | 2                      | 767                    | 2                      | 890                    |
| <b>Residential mortgage</b>         |                        |                        |                        |                        |
| Residential mortgage – term         | 8                      | 1,374                  | 5                      | 1,234                  |
| Residential mortgage – home equity  | 0                      | 0                      | 0                      | 0                      |
| Consumer                            | 0                      | 0                      | 0                      | 0                      |
| Total performing                    | 19                     | \$ 8,100               | 15                     | \$ 8,168               |
| <b>Non-accrual</b>                  |                        |                        |                        |                        |
| <b>Commercial real estate</b>       |                        |                        |                        |                        |
| Non owner-occupied                  | 0                      | \$ 0                   | 0                      | \$ 0                   |
| All other CRE                       | 3                      | 1,611                  | 5                      | 3,520                  |
| <b>Acquisition and development</b>  |                        |                        |                        |                        |
| 1-4 family residential construction | 0                      | 0                      | 0                      | 0                      |
| All other A&D                       | 0                      | 0                      | 4                      | 1,721                  |
| Commercial and industrial           | 0                      | 0                      | 1                      | 169                    |
| <b>Residential mortgage</b>         |                        |                        |                        |                        |
| Residential mortgage – term         | 1                      | 55                     | 4                      | 441                    |
| Residential mortgage – home equity  | 0                      | 0                      | 0                      | 0                      |
| Consumer                            | 0                      | 0                      | 0                      | 0                      |
| Total non-accrual                   | 4                      | 1,666                  | 14                     | 5,851                  |
| Total TDRs                          | 23                     | \$ 9,766               | 29                     | \$ 14,019              |

The level of TDRs decreased \$4.2 million during the nine months ended September 30, 2016. Four loans totaling \$.4 million were added to performing TDRs, and three loan already in performing TDRs were re-modified. There were 10 non-accrual loans totaling \$3.6 million that were transferred to OREO during the nine months ended September 30, 2016. Additionally, \$1.0 million in net principal payments were received during the same time period.

*Allowance and Provision for Loan Losses*



The ALL is maintained to absorb losses from the loan portfolio. The ALL is based on management's continuing evaluation of the quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated loss experience, and the amount of non-performing loans.

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

The following table presents a summary of the activity in the ALL for the nine months ended September 30:

| (dollars in thousands)  | 2016      | 2015      |
|---|-----------|-----------|
| Balance, January 1  | \$ 11,922 | \$ 12,065 |
| Charge-offs:  |           |           |
| Commercial real estate  | (2,632 )  | (295 )    |
| Acquisition and development   | (78 )     | (256 )    |
| Commercial and industrial   | (518 )    | 0         |
| Residential mortgage  | (516 )    | (200 )    |
| Consumer  | (237 )    | (247 )    |
| Total charge-offs   | (3,981 )  | (998 )    |
| Recoveries:   |           |           |
| Commercial real estate  | 85        | 66        |
| Acquisition and development   | 1,278     | 100       |
| Commercial and industrial   | 45        | 24        |
| Residential mortgage  | 373       | 162       |
| Consumer  | 114       | 166       |
| Total recoveries  | 1,895     | 518       |
| Net credit losses   | (2,086 )  | (480 )    |
| Provision for loan losses   | 2,208     | 626       |
| Balance at end of period  | \$ 12,044 | \$ 12,211 |
| Allowance for loan losses to gross loans outstanding (as %)                       | 1.33 %    | 1.45 %    |
| Net charge-offs to average loans outstanding during the period, annualized (as %) | 0.31 %    | 0.08 %    |

The ALL increased slightly to \$12.0 million at September 30, 2016, from \$11.9 million at December 31, 2015. The provision for loan losses increased to \$2.2 million for the first nine months of 2016, compared to \$.6 million for the same period of 2015. Net charge-offs increased to \$2.1 million for the nine months ended September 30, 2016, compared to \$.5 million for the nine months ended September 30, 2015. The ratio of the ALL to loans outstanding was 1.33% at September 30, 2016, 1.36% at December 31, 2015, and 1.45% at September 30, 2015.

The ratio of net charge-offs to average loans for the nine months ended September 30, 2016 was an annualized .31%, compared to an annualized .08% for the same period in 2015 and .14% for the year ended December 31, 2015. The CRE portfolio had an annualized net charge-off rate as of September 30, 2016 of 1.24%, compared to an annualized net charge-off rate of .05% as of December 31, 2015. This increase in charge-offs is related to a \$1.7 million charge-off on one loan due to reduced appraised value on the property. The A&D loans improved to an annualized net recovery rate as of September 30, 2016 of 1.52%, compared to an annualized net charge-off rate of .79% as of December 31, 2015. This improvement was due primarily to obtaining new appraisals on properties that secure a large loan relationship. The ratio for C&I loans had a net charge-off rate of .75% as of September 30, 2016, compared to no charge-offs as of December 31, 2015. The residential mortgage ratios were a net charge-off rate of .05% as of September 30, 2016 and a net charge-off rate of .02% as of December 31, 2015, and the consumer loan ratios were net charge-off rates of .68% and .40% as of September 30, 2016 and December 31, 2015, respectively.

Management believes that the ALL at September 30, 2016 is adequate to provide for probable losses inherent in our loan portfolio. Amounts that will be recorded for the provision for loan losses in future periods will depend upon trends in the loan balances, including the composition of the loan portfolio, changes in loan quality and loss experience trends, potential recoveries on previously charged-off loans and changes in other qualitative factors. Management also applies interest rate risk, collateral value and debt service sensitivity analyses to the Commercial real estate loan portfolio and obtains new appraisals on specific loans under defined parameters to assist in the determination of the periodic provision for loan losses.

*Investment Securities*

At September 30, 2016, the total amortized cost basis of the available-for-sale investment portfolio was \$151.3 million, compared to a fair value of \$148.0 million. Unrealized gains and losses on securities available-for-sale are reflected in accumulated other comprehensive loss, a component of shareholders' equity. The amortized cost basis of the held to maturity portfolio was \$98.4 million, compared to a fair value of \$103.3 million.

The following table presents the composition of our securities portfolio at amortized cost and fair values at the dates indicated:

| (dollars in thousands)                          | September 30, 2016 |                 |                  | December 31, 2015 |                 |                  |
|---|--------------------|-----------------|------------------|-------------------|-----------------|------------------|
|   | Amortized Cost     | Fair Value (FV) | FV as % of Total | Amortized Cost    | Fair Value (FV) | FV as % of Total |
| <b>Securities Available-for-Sale:</b>           |                    |                 |                  |                   |                 |                  |
| U.S. government agencies                        | \$25,000           | \$25,001        | 17 %             | \$34,079          | \$33,964        | 20 %             |
| Residential mortgage-backed agencies            | 0                  | 0               | 0 %              | 14,285            | 14,170          | 8 %              |
| Commercial mortgage-backed agencies             | 56,191             | 57,010          | 39 %             | 43,780            | 43,636          | 26 %             |
| Collateralized mortgage obligations             | 21,014             | 21,008          | 14 %             | 9,690             | 9,610           | 6 %              |
| Obligations of state and political subdivisions | 24,403             | 25,091          | 17 %             | 45,949            | 46,641          | 27 %             |
| Collateralized debt obligations                 | 24,721             | 19,927          | 13 %             | 25,766            | 22,211          | 13 %             |
| Total available for sale                        | \$151,329          | \$148,037       | 100 %            | \$173,549         | \$170,232       | 100 %            |
| <b>Securities Held to Maturity:</b>             |                    |                 |                  |                   |                 |                  |
| U.S. government agencies                        | \$15,704           | \$16,839        | 17 %             | \$24,704          | \$25,338        | 24 %             |
| Residential mortgage-backed agencies            | 52,784             | 53,995          | 52 %             | 53,734            | 53,912          | 51 %             |
| Commercial mortgage-backed agencies             | 17,657             | 18,730          | 18 %             | 18,078            | 18,232          | 17 %             |
| Collateralized mortgage obligations             | 5,255              | 5,280           | 5 %              | 6,419             | 6,297           | 6 %              |
| Obligations of state and political subdivisions | 6,987              | 8,442           | 8 %              | 2,625             | 2,963           | 2 %              |
| Total held to maturity                          | \$98,387           | \$103,286       | 100 %            | \$105,560         | \$106,742       | 100 %            |

Total investment securities available-for-sale decreased \$22.2 million since December 31, 2015. This decline during the first nine months was due to sales of investments for loan funding as well as calls on investments. At September 30, 2016, the securities classified as available-for-sale included a net unrealized loss of \$3.3 million, which represents the difference between the fair value and amortized cost of securities in the portfolio.

As discussed in Note 9 to the consolidated financial statements presented elsewhere in this report, the Corporation measures fair market values based on the fair value hierarchy established in ASC Topic 820, *Fair Value*

*Measurements and Disclosures.* The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). Level 3 prices or valuation techniques require inputs that are both significant to the valuation assumptions and are not readily observable in the market (i.e. supported with little or no market activity). These Level 3 instruments are valued based on both observable and unobservable inputs derived from the best available data, some of which is internally developed, and considers risk premiums that a market participant would require.

Approximately \$128.1 million of the available-for-sale portfolio was valued using Level 2 pricing and had net unrealized gains of \$1.5 million at September 30, 2016. The remaining \$19.9 million of the securities available-for-sale represents the entire CDO portfolio, which was valued using significant unobservable inputs (Level 3 assets). The \$4.8 million in net unrealized losses associated with this portfolio relates to 12 pooled trust preferred securities that comprise the CDO portfolio. Net unrealized losses of \$1.5 million represent non-credit related OTTI charges on eight of the securities, while \$3.3 million of unrealized losses relates to four securities which have had no credit related OTTI. The increases in unrealized losses on these securities were primarily attributable to continued depression in the marketability and liquidity associated with CDOs.

The following table provides a summary of the trust preferred securities in the CDO portfolio and the credit status of these securities as of September 30, 2016:

### Level 3 Investment Securities Available for Sale

(Dollars in Thousands)

| Investment Description         | First United Level 3 Investments |       |                |                   | Security Credit Status |                      |                     |   |                               |  |                                 |
|--------------------------------|----------------------------------|-------|----------------|-------------------|------------------------|----------------------|---------------------|---|-------------------------------|--|---------------------------------|
|                                | Deal                             | Class | Amortized Cost | Fair Market Value | Unrealized Gain/(Loss) | Lowest Credit Rating | Original Collateral | Deferrals/ Defaults as % of Original Collateral | Performing Collateral Support | Collateral Support as % of Performing Collateral | Number of Issuers/Total Issuers |
| Preferred Term Security XI*    | B-1                              | 1,340 | 913            | (427 )            | C                      | 635,775              | 12.03 %             | 386,075   | (10,197)                      | -2.64 %  | 44 / 53                         |
| Preferred Term Security XVIII* | C                                | 1,344 | 1,239          | (105 )            | C                      | 676,565              | 15.12 %             | 363,656   | (8,998 )                      | -2.47 %  | 45 / 62                         |
| Preferred Term Security XVIII  | C                                | 2,092 | 1,858          | (234 )            | C                      | 676,565              | 15.12 %             | 363,656   | (8,998 )                      | -2.47 %  | 45 / 62                         |
| Preferred Term Security XIX*   | C                                | 1,619 | 1,501          | (118 )            | C                      | 700,535              | 6.14 %              | 515,303   | 10,208                        | 1.98 %   | 54 / 62                         |
| Preferred Term Security XIX*   | C                                | 972   | 901            | (71 )             | C                      | 700,535              | 6.14 %              | 515,303   | 10,208                        | 1.98 %   | 54 / 62                         |
| Preferred Term Security XIX*   | C                                | 2,270 | 2,102          | (168 )            | C                      | 700,535              | 6.14 %              | 515,303   | 10,208                        | 1.98 %   | 54 / 62                         |
| Preferred Term Security XIX*   | C                                | 972   | 901            | (71 )             | C                      | 700,535              | 6.14 %              | 515,303   | 10,208                        | 1.98 %   | 54 / 62                         |

Edgar Filing: FIRST UNITED CORP/MD/ - Form 10-Q

|  |     |        |        |         |      |           |        |         |        |         |          |
|--|-----|--------|--------|---------|------|-----------|--------|---------|--------|---------|----------|
| Preferred<br>Term<br>Security<br>XXII*               | C-1 | 1,210  | 1,103  | (107 )  | C    | 1,386,600 | 15.14% | 923,324 | 12,792 | 1.39 %  | 66 / 83  |
| Preferred<br>Term<br>Security<br>XXII*               | C-1 | 3,023  | 2,757  | (266 )  | C    | 1,386,600 | 15.14% | 923,324 | 12,792 | 1.39 %  | 66 / 83  |
| Preferred<br>Term<br>Security<br>XXIII               | C-1 | 1,879  | 1,057  | (822 )  | C    | 1,467,000 | 16.84% | 853,185 | 45,227 | 5.30 %  | 85 / 102 |
| Preferred<br>Term<br>Security<br>I-P-IV              | B-1 | 3,000  | 2,098  | (902 )  | CCC- | 325,000   | 0.00 % | 154,950 | 38,045 | 24.55 % | 16 / 16  |
| Preferred<br>Term<br>Security<br>I-P-IV              | B-1 | 5,000  | 3,497  | (1,503) | CCC- | 325,000   | 0.00 % | 154,950 | 38,045 | 24.55 % | 16 / 16  |
| Total Level 3<br>Securities<br>Available for<br>Sale |     | 24,721 | 19,927 | (4,794) |      |           |        |         |        |         |          |

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

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

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

quality. Credit losses are recognized in earnings as realized losses in the period in which the impairment determination is made. The second component consists of all other losses. The other losses are recognized in other comprehensive income. In estimating OTTI charges, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) adverse conditions specifically related to the security, an industry, or a geographic area, (3) the historic and implied volatility of the security, (4) changes in the rating of a security by a rating agency, (5) recoveries or additional declines in fair value subsequent to the balance sheet date, (6) failure of the issuer of the security to make scheduled interest payments, and (7) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future. Due to the duration and the significant market value decline in the pooled trust preferred securities held in our portfolio, we performed more extensive testing on these securities for purposes of evaluating whether or not an OTTI has occurred.



The market for these securities as of September 30, 2016 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which these securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive, as no new CDOs have been issued since 2007. There are currently very few market participants who are willing to effect transactions in these securities. The market values for these securities, or any securities other than those issued or guaranteed by the U.S. Department of the Treasury (the “Treasury”), are very depressed relative to historical levels. Therefore, in the current market, a low market price for a particular bond may only provide evidence of stress in the credit markets in general rather than being an indicator of credit problems with a particular issue. Given the conditions in the current debt markets and the absence of observable transactions in the secondary and new issue markets, management has determined that (a) the few observable transactions and market quotations that are available are not reliable for the purpose of obtaining fair value at September 30, 2016, (b) an income valuation approach technique (i.e. present value) that maximizes the use of relevant unobservable inputs and minimizes the use of observable inputs will be equally or more representative of fair value than a market approach, and (c) the CDO segment is appropriately classified within Level 3 of the valuation hierarchy because management determined that significant adjustments were required to determine fair value at the measurement date.

Management relies on an independent third party to prepare both the evaluations of OTTI and the fair value determinations for the CDO portfolio. Management does not believe that there were any material differences in the OTTI evaluations and pricing between December 31, 2015 and September 30, 2016.

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

Based upon a review of credit quality and the cash flow tests performed by the independent third party, management determined that no securities had credit-related OTTI during the first nine months of 2016.

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

other similar interest.”

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

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

Based on its review, management concluded that the two CDOs evidence “typical extensions of credit” and do not exhibit any of these seven characteristics. Accordingly, management concluded that none of these CDOs constitutes an “ownership interest” as defined by the Volcker Rule and that, therefore, as of September 30, 2016, the Corporation has the current intent and ability to hold these CDOs until maturity.

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

### *Deposits*

The following table presents the composition of our deposits at the dates indicated:

| (dollars in thousands)                | September 30, 2016 |        | December 31, 2015 |        |
|---------------------------------------|--------------------|--------|-------------------|--------|
| Non-interest bearing demand deposits: |                    |        |                   |        |
| Retail                                | \$ 221,650         | 21.7 % | \$ 204,569        | 20.5 % |
| Interest-bearing deposits:            |                    |        |                   |        |
| Demand                                | 175,851            | 17.3 % | 176,084           | 17.6 % |
| Money Market:                         |                    |        |                   |        |
| Retail                                | 155,700            | 15.3 % | 160,597           | 16.1 % |
| Brokered/ICS                          | 73,127             | 7.2 %  | 62,197            | 6.2 %  |
| Savings deposits                      | 150,966            | 14.8 % | 140,772           | 14.1 % |
| Time deposits less than \$100,000:    |                    |        |                   |        |
| Retail                                | 119,895            | 11.7 % | 129,324           | 13.0 % |
| Brokered/CDARS                        | 377                | 0.0 %  | 434               | 0.0 %  |
| Time deposits \$100,000 or more:      |                    |        |                   |        |
| Retail                                | 119,054            | 11.7 % | 122,123           | 12.2 % |
| Brokered/CDARS                        | 2,565              | 0.3 %  | 2,694             | 0.3 %  |
| Total Deposits                        | \$ 1,019,185       | 100 %  | \$ 998,794        | 100 %  |

Total deposits increased \$20.4 million during the first nine months of 2016 when compared to deposits at December 31, 2015. With the continued focus of our retail staff to change the mix of the deposit portfolio, we have seen increases in core deposits and reductions in certificates of deposit. Non-interest bearing deposits increased \$17.1 million. Traditional savings accounts increased \$10.2 million due to continued growth in our Prime Saver product. Total demand deposits decreased \$.2 million and total money market accounts increased \$6.0 million due to increased

balances in our ICS money market account due primarily to a shift of trust department balances to the ICS product. Time deposits less than \$100,000 declined \$9.5 million and time deposits greater than \$100,000 decreased \$3.2 million.

*Borrowed Funds*

The following table presents the composition of our borrowings at the dates indicated:

| (in thousands)                                 | September 30,<br>2016 | December 31,<br>2015 |
|--|-----------------------|----------------------|
| Securities sold under agreements to repurchase | \$ 35,785             | \$ 35,828            |
| Total short-term borrowings                    | \$ 35,785             | \$ 35,828            |
| <br>   |                       |                      |
| FHLB advances                                  | \$ 105,017            | \$ 105,807           |
| Junior subordinated debt                       | 41,730                | 41,730               |
| Total long-term borrowings                     | \$ 146,747            | \$ 147,537           |

Total short-term borrowings decreased by \$43 thousand during the first nine months of 2016 due to a slight decrease in our Treasury Management product. Long-term borrowings decreased by \$.8 million during the first nine months of 2016 due to scheduled monthly amortization of long-term advances and the maturity of a small edge advance.

*Liquidity Management*

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

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

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

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

1. Unsecured Fed Funds lines of credit with upstream correspondent banks (M&T Bank, PNC Bank, Atlantic Community Banker's Bank, Community Banker's Bank, SunTrust and Zions National Bank).
2. Secured advances with the FHLB of Atlanta, which are collateralized by eligible one to four family residential mortgage loans, home equity lines of credit, commercial real estate loans, various securities and pledged cash.
3. Secured line of credit with the Fed Discount Window for use in borrowing funds up to 90 days, using municipal securities as collateral.
4. Brokered deposits, including CDs and money market funds, provide a method to generate deposits quickly. These deposits are strictly rate driven but often provide the most cost effective means of funding growth.
5. One Way Buy CDARS/ICS funding – a form of brokered deposits that has become a viable supplement to brokered deposits obtained directly.

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

### *Market Risk and Interest Sensitivity*

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

At September 30, 2016, we were asset sensitive.

Our interest rate risk management goals are:

- Ensure that the Board of Directors and senior management will provide effective oversight and ensure that risks are adequately identified, measured, monitored and controlled;
- Enable dynamic measurement and management of interest rate risk;
- Select strategies that optimize our ability to meet our long-range financial goals while maintaining interest rate risk within policy limits established by the Board of Directors;
- Use both income and market value oriented techniques to select strategies that optimize the relationship between risk and return; and
- Establish interest rate risk exposure limits for fluctuation in net interest income (“NII”), net income and economic value of equity.

In order to manage interest sensitivity risk, management formulates guidelines regarding asset generation and pricing, funding sources and pricing, and off-balance sheet commitments. These guidelines are based on management’s outlook

regarding future interest rate movements, the state of the regional and national economy, and other financial and business risk factors. Management uses computer simulations to measure the effect on net interest income of various interest rate scenarios. Key assumptions used in the computer simulations include cash flows and maturities of interest rate sensitive assets and liabilities, changes in asset volumes and pricing, and management's capital plans. This modeling reflects interest rate changes and the related impact on net interest income over specified periods.

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

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

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



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

### *Capital Resources*

We require capital to fund loans, satisfy our obligations under the Bank's letters of credit, meet the deposit withdrawal demands of the Bank's customers, and satisfy our other monetary obligations. To the extent that deposits are not adequate to fund our capital requirements, we can rely on the funding sources identified above under the heading "Liquidity Management". At September 30, 2016, the Bank had \$70.0 million available through unsecured lines of credit with correspondent banks, \$7.9 million available through a secured line of credit with the Fed Discount Window and approximately \$149.3 million available through the FHLB. Management is not aware of any demands, commitments, events or uncertainties that are likely to materially affect our ability to meet our future capital requirements.

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

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

The Basel III capital rules include new risk-based capital and leverage ratios, which will be phased in from 2015 to 2019, and which refine the definition of what constitutes "capital" for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Corporation under the final rules are: (a) a new common equity Tier 1 capital ratio of 4.5%; (b) a Tier 1 capital ratio of 6% (increased from 4%); (c) a total capital ratio of 8% (unchanged from current rules); and (d) a Tier 1 leverage ratio of 4% for all institutions. The final rules also establish a "capital conservation buffer" above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital. The capital conservation buffer will be phased-in over four years beginning on January 1, 2016, as follows: the maximum buffer will be 0.625% of risk-weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. This will result in the following minimum ratios beginning in 2019: (1) a common equity Tier 1 capital ratio of 7.0%, (2) a Tier 1 capital ratio of 8.5%, and (3) a total capital ratio of 10.5%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum

percentage of eligible retained income that could be utilized for such actions.

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

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

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

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

The following table presents our capital ratios:

|  | September 30,<br>2016 |   | December 31,<br>2015 |   | Required for<br>Capital<br>Adequacy<br>Purposes |   | Required to be<br>Well Capitalized |   |
|--|-----------------------|---|----------------------|---|---|---|------------------------------------|---|
| Total Capital (to risk-weighted assets)                |                       |   |                      |   |   |   |                                    |   |
| Consolidated   | 16.93                 | % | 17.37                | % | 8.00  | % | 10.00                              | % |
| First United Bank & Trust                              | 16.73                 | % | 16.24                | % | 8.00  | % | 10.00                              | % |
| Tier 1 Capital (to risk-weighted assets)               |                       |   |                      |   |   |   |                                    |   |
| Consolidated   | 14.69                 | % | 15.31                | % | 6.00  | % | 8.00                               | % |
| First United Bank & Trust                              | 15.48                 | % | 14.99                | % | 6.00  | % | 8.00                               | % |
| Common Equity Tier 1 Capital (to risk-weighted assets) |                       |   |                      |   |   |   |                                    |   |
| Consolidated   | 10.51                 | % | 9.92                 | % | 4.50  | % | 6.50                               | % |
| First United Bank & Trust                              | 15.48                 | % | 14.99                | % | 4.50  | % | 6.50                               | % |

|                                    |       |   |       |   |      |   |      |   |
|------------------------------------|-------|---|-------|---|------|---|------|---|
| Tier 1 Capital (to average assets) |       |   |       |   |      |   |      |   |
| Consolidated                       | 10.77 | % | 11.51 | % | 4.00 | % | 5.00 | % |
| First United Bank & Trust          | 10.99 | % | 10.52 | % | 4.00 | % | 5.00 | % |

*Contractual Obligations, Commitments and Off-Balance Sheet Arrangements*

Loan commitments are made to accommodate the financial needs of our customers. Letters of credit commit us to make payments on behalf of customers when certain specified future events occur. The credit risks inherent in loan commitments and letters of credit are essentially the same as those involved in extending loans to customers, and these arrangements are subject to our normal credit policies. Loan commitments and letters of credit totaled \$113.1 million and \$1.7 million, respectively, at September 30, 2016, compared to \$129.1 million and \$1.6 million, respectively, at December 31, 2015. We are not a party to any other off-balance sheet arrangements.

See Note 13 to the consolidated financial statements presented elsewhere in this report for further disclosure on Borrowed Funds. There have been no other significant changes to contractual obligations as presented at December 31, 2015.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our primary market risk is interest rate fluctuation and we have procedures in place to evaluate and mitigate this risk. This market risk and our procedures are described above in Item 2 of Part I of this report under the caption “*Market Risk and Interest Sensitivity*”, and in Item 7 of Part II of First United Corporation’s Annual Report on Form 10-K for the year ended December 31, 2015 under the caption “Market Risk and Interest Sensitivity”. Management believes that no material changes in our procedures used to evaluate and mitigate these risks have occurred since December 31, 2015. We believe the investment portfolio restructuring has better positioned the Corporation for a rising interest rate environment.

### Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 with the SEC, such as this Quarterly Report, is recorded, processed, summarized and reported within the periods specified in those rules and forms, and that such information is accumulated and communicated to our management, including First United Corporation’s principal executive officer (“CEO”) and the principal accounting officer (“CFO”), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls as of September 30, 2016 was carried out under the supervision and with the participation of management, including the CEO and the CFO. Based on that evaluation, management, including the CEO and the CFO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the quarter ended September 30, 2016, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2015. Management does not believe that any material changes in our risk factors have occurred since they were last disclosed.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

None.

Item 6. Exhibits

The exhibits filed or furnished with this quarterly report are listed in the Exhibit Index that follows the signatures, which index is incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FIRST UNITED CORPORATION

Date: November 7, 2016 /s/ Carissa L. Rodeheaver  
Carissa L. Rodeheaver, CPA, CFP  
Chairman of the Board, President  
and Chief Executive Officer  
(Principal Executive Officer)

Date November 7, 2016 /s/ Tonya K. Sturm  
Tonya K. Sturm, Senior Vice President,  
Chief Financial Officer  
(Principal Accounting Officer)



EXHIBIT INDEX

Exhibit Description

- 31.1 Certifications of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)
- 31.2 Certifications of the Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)
- 32 Certification of the Principal Executive Officer and the Principal Accounting Office pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith)
- 101.INS XBRL Instance Document (filed herewith)
- 101.SCH XBRL Taxonomy Extension Schema (filed herewith)
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase (filed herewith)
- 101.DEF XBRL Taxonomy Extension Definition Linkbase (filed herewith)
- 101.LAB XBRL Taxonomy Extension Label Linkbase (filed herewith)
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase (filed herewith)