PREPARED. PRESENT. PROACTIVE.

2013 ANNUAL REPORT

PARAGON
COMMERCIAL CORPORATION

"The responsiveness and level of experience at Paragon is what we need from a bank. They're a good fit for us."

Chris Judy, Thomas, Judy & Tucker, P.A. (left), with Mark Bolash, Client Development Officer

CONTENTS

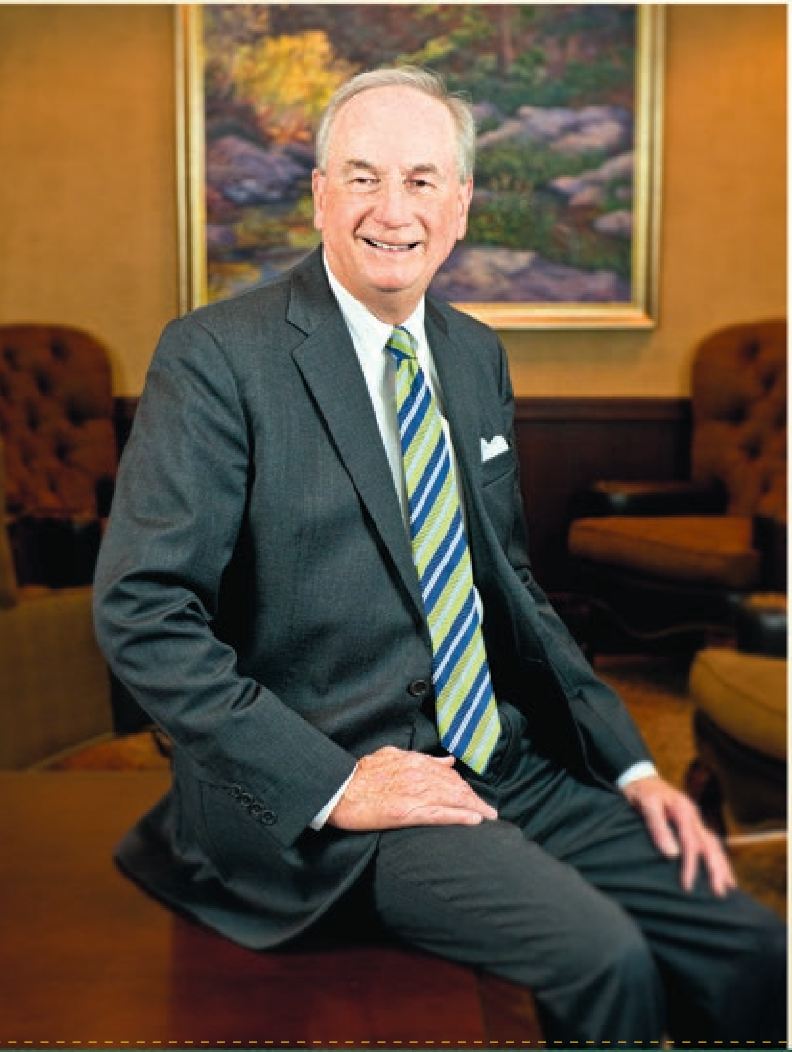
This Annual Report serves as the annual financial disclosure statement furnished pursuant to the Federal Deposit Insurance Corporation's rules and regulations. This statement has not been reviewed or confirmed for accuracy or relevance by the Federal Deposit Insurance Corporation.

TO OUR SHAREHOLDERS

By almost any measure, 2013 was the most successful year in the bank's nearly 15-year history. A heightened emphasis on private banking, supported by the rollout of a refined branding strategy and a continued focus on credit quality, has gained traction in the marketplace. Following are some of the more significant highlights:

Our consolidated net income increased by 55% to $4.9 million, the highest since the beginning of the Great Recession, and resembles our pre-recession earnings performance.

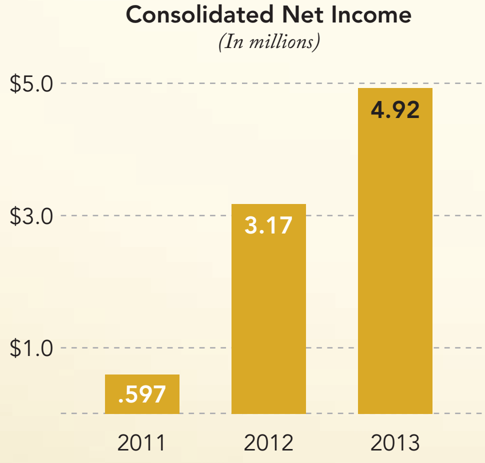
Our assets grew by 8% to just over $1.0 billion. Paragon enjoyed success in lending, with a net loan increase of $48 million (7%). This is remarkable in light of the fact that our credit department reduced classified loans and out of market loans by $83 million.



The bank reduced its level of non-performing loans from $16.1 million (2.23% of assets) to $2.1 million. That represents a reduction to just .28% of loans compared to the state median of 1.74%. Our charge-offs, while still higher than desired, were $3.6 million (.48% of loans)—a significant improvement over previous years.

Under the leadership of Market Presidents, Phil Jurney (Charlotte) and Brian Reid (Raleigh), Paragon achieved outstanding deposit growth in 2013. Charlotte grew local core deposits by $58 million, a 55% increase over 2012. Raleigh grew local core deposits by $103 million, a 38% increase. This is meaningful because it demonstrates Paragon's ability to fund itself with two locations.

In 2008 the bank recognized the need to change its funding strategy. Until then brokered and Internet deposits were used as a source of funding to support loan growth over and above what we could attract from local markets. We recognized that relationship building was about more than extending credit to clients. Paragon needed to promote local deposits in order to strengthen its local market presence. With this funding strategy, we have reduced Internet deposits by $57 million and brokered deposits by $33 million in 2013.



The new funding strategy resulted in the impressive results above. But there was more to our success story than an improved funding strategy. Management reinforced the decision to actively pursue private banking relationships with individuals to complement our standing as a private bank for business. Our Market Presidents stressed the importance of deposit acquisition and internal referrals. We hired more Private Bankers in both markets to attract the owners of our business clients, key executives and entrepreneurs.

We also moved our Charlotte office to a larger, more visible and accessible location in the prestigious South Park area. And there are plans for a new office space in Cary for a dedicated private banking facility.

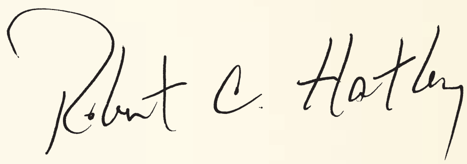
We hired our first Director of Marketing, Scott Williams, to lead our efforts to effectively target local prospects and enhance our brand position as a private bank for individuals and businesses. To better reflect this dual focus we have updated our brand message and identity elements, rebuilt our website and introduced a new symbol for our bank that represents our commitment to providing extraordinary client experiences. You'll find more details on the pages that follow.

We head into 2014 excited about the future potential of Paragon Bank.

We anticipate that earnings and growth will continue to rise. Credit quality will continue to improve, minimizing any material impact on future earnings. Local core deposits will continue to grow, not only to the extent of our annual loan growth, but also to continue reducing current levels of brokered and Internet deposits.

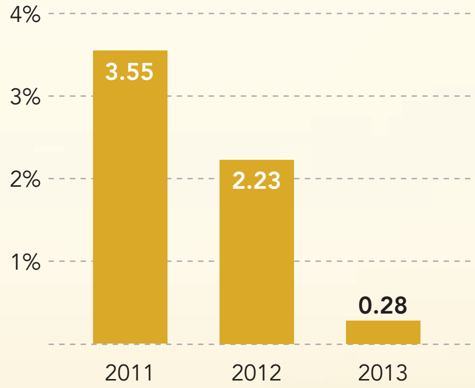
Our new Cary office will be open by mid-2014 and will be the prototype of future private banking offices. Improved visibility and accessibility at the new Charlotte office should enhance our bottom line. Our new marketing initiatives are gaining traction as the bank further distinguishes itself from its competitors.

We are proud of what Paragon has accomplished in our first 15 years. We have enjoyed the successes and worked through the challenges as a team. We have created an exceptional company. Our staff is talented and motivated for the future, and our goal will always be to provide an extraordinary client experience that places Paragon ahead of its competitors.



Robert C. Hatley
President and Chief Executive Officer

Nonperforming Loans
(Percent of total loans)




PARAGON
PARAGON

THE EVOLUTION OF A BANK

A Rebranding Story

A resurgent performance in 2013 has all eyes focused on the future. Net income is up. Loan growth has exceeded all expectations. Core deposit growth is up significantly in Raleigh and Charlotte, dramatically reducing the need for brokered deposits. Meanwhile, nonperforming loans have been significantly reduced.

By all accounts it was a very good year. The numbers say so. But the numbers are in many ways a reflection of the bank's vision. And in 2013, that vision would lead to an expansive branding effort designed to crystallize the bank's positioning in the markets it serves.

By 2013 the bank had evolved from a business bank to a multi-dimensional financial institution offering private banking services for businesses *and* individuals. Now it was time to emphasize that message to the marketplace.

The branding effort began with a messaging strategy based on the bank's key differentiator—the Paragon client experience. This "Extraordinary Client Experience" became the foundation and inspiration for the bank's brand, grounded by its three-pronged commitment to each client:

Prepared. Present. Proactive.

Paragon Commercial Bank, while still the bank's legal name, was shortened to Paragon Bank in the marketplace. A new logo was developed, employing three interlocking arcs to symbolize the prepared, present and proactive aspects of our Extraordinary Client Experience.

Everything about the updated branding was designed to reflect the client experience that separates Paragon from ordinary banks. Now, with a powerful, concerted expression of its vision in place, the differences between Paragon Bank and its competitors will become clearer with the advantages to prospective new clients more vivid.

The three interlocking arcs of the new Paragon logo symbolize the Prepared, Present and Proactive aspects of our Extraordinary Client Experience.

"Paragon's knowledge of my business and family goals and the creativity behind their solutions make them the perfect financial partner."

Steve Rohletter, Stanley Steemer (left),
with Charles Bartz, Client Development Officer

PREPARED:
A people philosophy that benefits every client, not a select few.

The Paragon philosophy holds that every client is preeminently important and thus deserving of an elite level of service. This is why one of our founding principles is a commitment to building and maintaining one of the most prepared teams of banking professionals around.

Many Paragon clients have shared stories about frustrations at other banks in which inexperienced bankers were unable to provide the expertise needed. This is not the case at Paragon.

By investing in highly trained, highly experienced Client Development Officers, Paragon Bank has positioned itself to offer an elite level of services to all of its clients. From large business relationships to individual private banking relationships, every Paragon client receives the very best that the bank has to offer.

"What we do isn't obvious to the casual observer. Paragon invested the time, gaining a deep understanding of how we help restore the environment, and how they could help us. That's why Paragon is our bank."

John Preyer, Restoration Systems LLC

Nerissa Hill, Client Relationship Coordinator, and Warren Miller, Client Development Officer, discuss client relationship strategies.

PRESENT:
A higher level of accessibility keeps clients well connected.

Whether clients prefer to work face-to-face, by phone or online, Paragon will be there—working the way each client prefers, keeping them fully connected to their information and to our expertise. A Paragon Client Development Officer, backed by a team of professionals, is a client's direct connection to all of the financial resources at Paragon Bank. At Paragon there are no impersonal call centers because Paragon support teams are there when clients need them.

Client Development Officers create a service strategy built around the personal or business banking needs and preferences of each client to ensure an extraordinary level of attention as we help them reach their financial goals.

"I trust Paragon. They're responsive, accessible and reliable. That's what I look for in a bank."

Keely Simerville, private banking client (right), and Salley Griffith, Client Development Officer

PROACTIVE:

A goals-based plan of action inspired by each client.

Paragon clients work with one of the most experienced teams of banking professionals in the state. The people who serve our clients have been hand picked for their experience and resourcefulness as well as for their track record in delivering creative, sound solutions to each client.

Just as every success story is unique, so are the needs of each client, which is why every success story at Paragon begins with understanding. By cultivating a deep understanding of a client's personal style, needs and preferences, the Paragon team is able to take an informed initiative while helping clients achieve their financial goals.

Andy Scott, Client Development Officer, and Lauren Schlafer, Treasury Management Support Manager, review strategies to help a client more efficiently manage business funds.

THINK EXTRAORDINARY.

In an industry teeming with me-too banking strategies, Paragon has chosen a different path. Our approach is for the individual and the company that still believe, as we do, in the power of the client relationship. The correlation of this approach and the bank's success is apparent in our financial performance.

We have invested significant resources, in people, facilities and technology, to create an extraordinary client experience for every Paragon client. Prepared, Present and Proactive are the foundational elements of that experience, where every client matters, every client is served, and success is driven by understanding.

Jessica Kerr (left) and Melanie Robinson, both Client Development Officers, leave the Charlotte office to meet with clients.

BOARD OF DIRECTORS

Curtis C. Brewer, III
Owner
Brewer Properties, LLC

Roy L. Harmon, Jr.
Chairman and CEO
Bank of Tennessee

Robert C. Hatley
President and CEO
Paragon Bank

K. Wesley M. Jones
Managing Partner
Five Oaks Capital Partners, LLC

Howard Jung (Chairman)
Vice President
Ace Hardware Stores, Inc.

John N. Miller
President
Triangle Financial Concepts, Inc.

Thomas B. Oxholm
Vice President, Finance
and Administration
Wake Stone Corporation

Alvin G. Ragland
Chief Human Resources Executive
NC Department of Public Safety

Billie J. Redmond
CEO
TradeMark Properties, Inc.

F. Alton Russell
Chairman and Counsel
The Title Company of North
Carolina, Inc.

R. Frank Gray
Bank Counsel
Jordan Price Wall Gray
Jones & Carlton, PLLC

Standing left to right: John N. Miller, F. Alton Russell, K. Wesley Jones, Thomas B. Oxholm, Alvin G. Ragland, Roy L. Harmon, Jr.;
Sitting left to right: Curtis C. Brewer, III, Howard Jung, Robert C. Hatley, Billie J. Redmond, R. Frank Gray (not pictured)

EXECUTIVE OFFICERS

Robert C. Hatley
President and
Chief Executive Officer

Steven E. Crouse
Executive Vice President
Chief Financial Officer

Matthew C. Davis
Executive Vice President
Chief Operating Officer

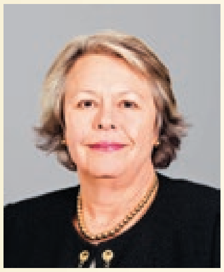
Left to right: Bob Hatley, Steve Crouse, Matt Davis

RALEIGH
Client Development Officers

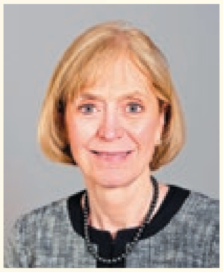
Brian K. Reid
Triangle Market President

Mark Bolash
Senior Vice President

Martin Borden
Senior Vice President



JoAnn Harper
Vice President



Patsy Johnson
Senior Vice President

Preston Mahan
Vice President

Sally A. Neuman
Senior Vice President

Pat Barry O'Quinn
Senior Vice President

Jason Rapuano
Vice President

Andy Scott
Senior Vice President

Michael G. Stellar
Senior Vice President

Jennifer Terry
Senior Vice President

Connie Thames
Senior Vice President

John S. Towles
Senior Vice President

Lisa Valentino
Vice President

Raleigh Advisory Board

James M. Barnes
President
NAI Carolantic Realty

Jeffrey A. Brovet
Audit Partner
Thomas, Judy & Tucker

Linda J. Folger
Partner
Trisure Corporation

Jill Wells Heath
President and CEO
Mulkey Engineers & Consultants

Bobby R. Lewis
Principal
Raleigh Development Company

John McKinney
Vice President of Sales & Marketing
Alfred Williams & Company

Virginia G. Parker
Senior Vice President for Resource Development and Strategic Partnerships
United Way of the Greater Triangle

James R. Vann
Attorney at Law
Vann Attorneys

Tommy West
Chairman
West Brothers Transportation Services

CHARLOTTE

Client Development Officers

Phillip R. Jurney
Charlotte Market President

Charles W. Bartz
Senior Vice President

Ryan Borst
Senior Vice President

Stephanie L. Bryant
Vice President

Salley Griffith
Vice President

Jessica L. Kerr
Vice President

Warren D. Miller
Senior Vice President

Melanie C. Robinson
Senior Vice President

D. Gray Steelman
Senior Vice President

Charlotte Advisory Board

Ralph Breeden
President and CEO
The Woodbury Group

Charles Campbell
Partner
Brackett Flagship Properties, LLC

George H. Edmiston, Jr.
President
Carolinas Investment Consulting, LLC

K. Wesley M. Jones
Managing Partner
Five Oaks Capital Partners, LLC

Peirce Ward
Investment Advisor
New England Financial

Wesley Walls
Senior Vice President of Development
Pavilion Development Company

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

GrantThornton

Board of Directors of
Paragon Commercial Corporation:

We have audited the accompanying consolidated financial statements of Paragon Commercial Corporation (a North Carolina corporation) and subsidiaries, which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

AUDITOR'S RESPONSIBILITY

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

OPINION

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Paragon Commercial Corporation and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

GRANT THORNTON LLP

Charlotte, North Carolina
March 19, 2014

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

At December 31:	2013	2012
ASSETS		
Cash and due from banks:		
Interest-earning	$ 25,238	$ 2,341
Noninterest-earning	19,899	16,037
Investment securities – available-for-sale, at fair value	147,196	147,974
Federal Home Loan Bank stock, at cost	6,323	6,396
Loans – net of unearned income and deferred fees	767,392	722,366
Allowance for loan losses	(6,939)	(10,348)
Net Loans	760,453	712,018
Accrued interest receivable	3,130	2,796
Bank premises and equipment	15,268	13,779
Bank owned life insurance	26,622	25,775
Other real estate owned	18,174	18,756
Deferred tax assets	8,477	8,347
Other assets	4,991	3,451
Total Assets	$ 1,035,771	$ 957,670
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand	$ 83,897	$ 63,922
Interest-bearing checking and money market	277,205	202,793
Time deposits	409,050	433,586
Total Deposits	770,152	700,301
Repurchase agreements and federal funds purchased	28,012	26,303
Federal Home Loan Bank advances	115,000	110,000
Other borrowings	9,616	10,000
Subordinated debentures	30,338	30,338
Accrued interest payable	624	731
Other liabilities	4,426	4,012
Total Liabilities	958,168	881,685
Commitments and contingencies (Notes H and N)		
Stockholders' Equity:		
Common stock-Class A, $1 par value; 10,000,000 shares authorized; 34,608 and 34,464 issued and outstanding as of December 31, 2013 and 2012, respectively	34	34
Common stock-Class B, $1 par value; 10,000,000 shares authorized; 884 issued and outstanding as of December 31, 2013 and 2012	1	1
Additional paid-in-capital	51,963	51,832
Accumulated other comprehensive income (loss)	(562)	2,875
Retained earnings	26,167	21,243
Total Stockholders' Equity	77,603	75,985
Total Liabilities and Stockholders' Equity	$ 1,035,771	$ 957,670

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

Years Ended December 31:	2013	2012
INTEREST INCOME		
Loans and fees on loans	$ 36,811	$ 34,432
Investment securities and FHLB stock	3,735	4,385
Federal funds and other	55	71
Total Interest Income	40,601	38,888
INTEREST EXPENSE		
Interest-bearing checking and money market	1,479	1,336
Time deposits	6,931	8,634
Borrowings and repurchase agreements	2,108	4,444
Total Interest Expense	10,518	14,414
Net Interest Income	30,083	24,474
PROVISION FOR LOAN LOSSES	156	929
Net Interest Income after Provision for Loan Losses	29,927	23,545
NON-INTEREST INCOME		
Service charges and fees	245	220
Net gain on sale of securities	88	359
Impairment on securities	(39)	(350)
Mortgage origination fees and gains on sale of loans	171	134
Net loss on sale or impairment of foreclosed assets	(3,824)	(2,356)
Increase in cash surrender value of bank owned life insurance	847	907
Other fees and income	437	380
Total Non-Interest Income	(2,075)	(706)
NON-INTEREST EXPENSE		
Salaries and employee benefits	9,531	7,705
Problem loan and foreclosure related expenses	1,446	2,444
FDIC and other supervisory assessments	1,637	2,329
Occupancy	1,550	960
Data processing	1,097	1,031
Professional fees	944	525
Other	3,969	2,915
Total Non-Interest Expense	20,174	17,909
Income before Income Taxes	7,678	4,930
INCOME TAX EXPENSE	2,754	1,756
Net Income	$ 4,924	$ 3,174
NET INCOME PER COMMON SHARE		
Basic	$ 138.81	$ 90.02
Diluted	$ 138.81	$ 89.84

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

Years Ended December 31:	2013	2012
Net income	$ 4,924	$ 3,174
Other comprehensive (loss) income items:		
Securities available for sale:		
Unrealized gains (losses)	(7,921)	2,205
Reclassification of gains recognized in net income	(49)	(9)
Other comprehensive (loss) income	(7,970)	2,196
Deferred tax (benefit) expense	(3,150)	870
Other comprehensive income (loss), net of tax	(4,820)	1,326
Cash flow hedges:		
Unrealized gains	2,285	–
Other comprehensive income	2,285	–
Deferred tax expense	902	–
Other comprehensive income, net of tax	1,383	–
Total other comprehensive loss, net of tax	(3,437)	–
Comprehensive income	$ 1,487	$ 4,500

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock				Additional	Accumulated Other		Total
	Class A		Class B		Paid-in	Comprehensive	Retained	Stockholders'
(In thousands, except per share data)	Shares	Amount	Shares	Amount	Capital	Income (Loss)	Earnings	Equity
Balance at December 31, 2011	34,303	$ 34	884	$ 1	$ 51,633	$ 1,549	$ 18,069	$ 71,286
Net income	–	–	–	–	–	–	3,174	3,174
Unrealized gain on securities, net of taxes of $870	–	–	–	–	–	1,326	–	1,326
Stock based compensation	–	–	–	–	90	–	–	90
Exercise of stock options	160	–	–	–	109	–	–	109
Balance at December 31, 2012	34,464	$ 34	884	$ 1	$ 51,832	$ 2,875	$ 21,243	$ 75,985
Net income	–	–	–	–	–	–	4,924	4,924
Unrealized loss on securities, net of taxes of $3,150	–	–	–	–	–	(4,820)	–	(4,820)
Unrealized gain on cash flow hedges, net of taxes of $902	–	–	–	–	–	1,383	–	1,383
Stock based compensation	–	–	–	–	20	–	–	20
Exercise of stock options	144	–	–	–	111	–	–	111
Balance at December 31, 2013	34,608	$ 34	884	$ 1	$ 51,963	$ (562)	$ 26,167	$ 77,603

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

At December 31:	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 4,924	$ 3,174
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	831	600
Provision for loan losses	156	929
Net impairments and loss on sale of foreclosed assets	3,824	2,356
Increase in cash surrender value of life insurance	(847)	(907)
Accretion of premiums/discounts on securities, net	(964)	(1,008)
Net gain on sale of securities	(88)	(359)
Net loss (gain) on disposition of premises and equipment	11	(14)
Impairment on securities	39	350
Deferred tax expense	2,118	2,148
Stock based compensation	20	90
Changes in assets and liabilities:		
Accrued interest receivable and other assets	(931)	2,543
Accrued interest payable and other liabilities	307	696
Net cash provided by operating activities	9,400	10,598
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (purchase) sale of Federal Home Loan Bank stock	73	(2,468)
Purchase of securities available for sale	(47,083)	(53,558)
Proceeds from maturities and paydowns of securities available for sale	23,962	25,069
Proceeds from sales of securities available for sale	18,284	45,158
Net increase in loans	(59,243)	(48,882)
Proceeds from sale of foreclosed real estate	7,536	14,568
Additions to bank premises and equipment	(2,331)	(4,958)
Other investing activites, net	(126)	138
Net cash used in investing activities	(58,928)	(24,933)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in demand and money market deposit accounts	94,387	28,555
Net decrease in time deposits	(24,536)	(72,566)
Net increase in repurchase agreements	1,709	5,534
Net increase in FHLB and other borrowings	4,616	25,000
Exercise of stock options	111	109
Net cash provided by (used in) financing activities	76,287	(13,368)
Net change in cash and cash equivalents	26,759	(27,703)
Cash and cash equivalents at beginning of year	18,378	46,081
Cash and cash equivalents at end of year	$ 45,137	$ 18,378

The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE A – ORGANIZATION AND OPERATIONS

On June 30, 2001, Paragon Commercial Corporation (the "Company") was formed as a holding company for Paragon Commercial Bank (the "Bank"). The Company currently has no operations and conducts no business on its own other than owning the Bank and two Trusts, Paragon Commercial Capital Trust I and II.

The Bank was incorporated on May 4, 1999 and began banking operations on May 10, 1999. The Bank is engaged in general commercial banking in Wake County, NC, operating under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation and the North Carolina Commissioner of Banks. The Bank undergoes periodic examinations by those regulatory authorities.

The Company formed Paragon Commercial Capital Trust I ("Trust I") during 2004 in order to facilitate the issuance of trust preferred securities. The Trust is a statutory business trust formed under the laws of the state of Delaware, of which all common securities are owned by the Company. The Company formed Paragon Commercial Capital Trust II ("Trust II") during 2006 to serve the same purpose. The junior subordinated debentures issued by the Company to the trusts are classified as debt and the Company's equity interest in the trusts are included in other assets.

The trust preferred securities presently qualify as Tier 1 regulatory capital and are reported in Federal Reserve regulatory reports as minority interests in unconsolidated subsidiaries. The junior subordinated debentures do not qualify as Tier 1 regulatory capital.

In addition to its headquarters in Raleigh, NC, the bank has a location in Charlotte, NC.

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements include the accounts and transactions of Paragon Commercial Corporation and Paragon Commercial Bank. All significant intercompany transactions and balances are eliminated in consolidation. Paragon Commercial Capital Trusts I and II are not consolidated subsidiaries of the Company.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, other than temporary impairment on investment securities, fair value of other real estate owned, realization of deferred tax assets and the fair value of financial instruments.

Cash and Cash Equivalents

Cash and cash equivalents include demand and time deposits (with original maturities of 90 days or less) at other institutions, federal funds sold and other short-term investments. Generally, federal funds are purchased and sold for one-day periods. At times, the Company places deposits with high credit quality financial institutions in amounts, which may be in excess of federally insured limits. Depository institutions are required to maintain reserve and clearing balances with the Federal Reserve Bank ("FRB"). Accordingly, the Company has amounts restricted for this purpose of $8.9 million and $196,000 included in cash and due from banks on the consolidated balance sheet as of December 31, 2013 and 2012, respectively.

Investment Securities

Debt securities that the Bank has the positive intent and ability to hold to maturity are classified as "held-to-maturity" securities and reported at amortized cost. Debt and equity securities that are bought and held principally for the purpose of selling in the near term are classified as "trading" securities and reported at fair value with unrealized gains and losses included in earnings. Available-for-sale securities are reported at fair value and consist of debt or equity securities not classified as trading securities nor as held-to-maturity securities. Unrealized holding gains and losses on available-for-sale securities are reported as a net amount in other comprehensive income net of income taxes. Gains and losses on the sale of available-for-sale securities are determined using the specific-identification method. Premiums and discounts are recognized in interest income using the effective interest method over the period to maturity.

At each reporting date, the Company evaluates each investment security in a loss position for other-than-temporary impairment. The review includes an analysis of the facts and circumstances of each individual investment such as (1) the length of time and the extent to which the fair value has been below cost, (2) changes in the earnings performance, credit rating, asset quality, or business prospects of the issuer, (3) the ability of the issuer to make principal and interest payments, (4) changes in the regulatory, economic, or technological environment of the issuer, and (5) changes in the general market condition of either the geographic area or industry in which the issuer operates.

Regardless of these factors, if the Company has developed a plan to sell the security or it is likely that the Company will be forced to sell the security in the near future, then the impairment is considered other-than-temporary and the carrying value of the security is permanently written down to the current fair value with the difference between the new carrying value and the amortized cost charged to earnings. If the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis less any current period credit loss, the other-than-temporary impairment is separated into the following: (1) the amount representing the credit loss and (2) the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings, and the amount of the total other-than-temporary impairment related to other factors is recognized in other comprehensive income, net of applicable taxes.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are reported at their outstanding principal adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed and any subsequent payments received are applied only to the outstanding principal balance.

Allowance for Loan and Lease Losses

The allowance for loan and lease losses ("ALLL") is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. The provision for loan losses is based upon management's best estimate of the amount needed to provide for losses that are inherent in the portfolio. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The Company conducts an analysis of the loan portfolio on a regular basis. This analysis is used in assessing the sufficiency of the allowance for loan losses and in the determination of the necessary provision for loan losses. The review process generally begins with the identification of problem loans to be reviewed on an individual basis for impairment. When a loan has been identified as impaired, a specific reserve may be established based on the Company's calculation of the loss embedded in the individual loan. In addition to specific reserves on impaired loans, the Company has a nine point grading system for each non-homogeneous loan in the portfolio to reflect the risk characteristic of the loan. The loans identified and measured for impairment are segregated from risk-rated loans within the portfolio. Loans are then grouped by loan type and by risk rating. Each loan type is assigned an allowance factor based on historical loss experience, economic conditions and overall portfolio quality including delinquency rates and concentrations. The ALLL is an accounting estimate and as such there is uncertainty associated with the estimate due to the level of subjectivity and judgment inherent in performing the calculation. Management's evaluation of the ALLL also includes considerations of existing general economic and business conditions affecting the key lending areas of the Company, credit quality trends, collateral values, loan volumes and concentrations, seasoning of the loan portfolio, specific industry conditions within portfolio segments, recent loss experience in particular segments of the portfolio, duration of the current business cycle, bank regulatory examination results and findings of the Company's outsourced loan review consultants. The total of specific reserves required for impaired classified loans and the calculated reserves comprise the allowance for loan losses.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining whether a loan is impaired include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Additionally, management's policy is generally to evaluate only those loans greater than $500 thousand for impairment. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. 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. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including the performance of the Company's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

Other Real Estate Owned

Other real estate owned acquired through, or in lieu of, loan foreclosure are initially recorded at fair value less selling costs, establishing a new cost basis. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of cost or net realizable value. Net realizable value is equivalent to fair market value less costs to sell the assets. Revenue and expenses from holding the properties and adjustments to the cost basis are included in earnings.

Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets which are 3 – 10 years for furniture and equipment and 40 years for buildings. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. Repairs and maintenance costs are charged to operations as incurred, and additions and improvements to premises and equipment are capitalized. Upon sale or retirement, the cost and related accumulated depreciation are removed from the accounts and any gains or losses are reflected in current operations.

Federal Home Loan Bank Stock

As a requirement for membership, the Bank invests in stock of the Federal Home Loan Bank of Atlanta ("FHLB"). This investment is carried at cost. Due to the redemption provisions of the FHLB, the Bank estimated that fair value equals cost.

Bank Owned Life Insurance

The Company has purchased life insurance policies on certain key employees. These policies are recorded at their cash surrender value, or the amount that can be realized. Income from these policies and changes in the net cash surrender value are recorded in noninterest income.

Derivative Instruments and Hedging Activities

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives used to hedge the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges.

For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified to earnings when the hedged transaction affects earnings, and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. The Company assesses the effectiveness of each hedging relationship by comparing the changes in cash flows of the derivative hedging instrument with the changes in cash flows of the designated hedged transactions.

The Company's objective in using derivatives is to add stability to interest income and to manage its exposure to adverse changes in interest rates. To accomplish this objective, the Company uses interest rate swaps as part of its cash flow hedging strategy.

To mitigate exposure to variability in expected future cash flows resulting from changes in interest rates, in May 2013 the Company entered into two Forward Swap arrangements whereby the Company will pay fixed rates on two short term borrowings at some point in the future for a determined period of time. For both agreements, the Company will renew advances with the FHLB for 3 month terms as a primary funding source and pay the prevailing 3 month rate. The first swap, a "2-5 Swap", is a $20 million agreement whereby 2 years from the May 2013 execution date, the Company will begin to swap out the 3 month FHLB advance pricing at that date for a fixed rate of 1.964% for a period of 5 years. The second swap, a "3-5 Swap", is similar in terms except that it is a $30 million agreement whereby 3 years from the May 2013 execution date, the Company will begin to swap out the 3 month FHLB advance pricing at that date for a fixed rate of 2.464% for a period of 5 years.

The Company designated the forward-starting interest rate swaps (the hedging instruments) as cash flow hedges of the risk of changes attributable to the benchmark 3 Month LIBOR interest rate risk for the forecasted issuances of FHLB advances arising from a rollover strategy. Specifically, the company references Derivatives Implementation Group Issue G19, "Cash Flow Hedges: Hedging Interest Rate Risk for the Forecasted Issuances of Fixed-Rate Debt Arising from a Rollover Strategy." The company intends to sequentially issue a series of 3 Month fixed rate debt as part of a planned roll-over of short term debt for the next seven to eight years.

The company anticipates little to no ineffectiveness in this hedging relationship as long as the terms are matched at each forecasted debt issuance. The company notes that, consistent with the previously referenced DIG Issue G19, the actual interest cost incurred at each rollover will be a function of market rates at that time. However, consistent with the examples included in that DIG issue, the company is only hedging the benchmark interest rate risk in that rollover.

The Company does not use derivatives for trading or speculative purposes.

Income Taxes

Deferred tax assets and liabilities are recognized for the estimated future tax benefits or consequences attributable to differences between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. Deferred tax assets are also recognized for operating loss carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which the temporary differences are expected to be recovered or settled. Deferred tax assets are reduced by a valuation allowance if it is more likely than not that the tax benefits will not be realized.

At December 31, 2013, the Company had $8.5 million in net deferred tax assets. A valuation allowance is provided when it is more-likely-than-not that some portion of the deferred tax asset will not be realized. All available evidence, both positive and negative, was considered to determine whether, based on the weight of that evidence, impairment should be recognized. Our forecast process includes judgmental and quantitative elements that may be subject to significant change. If our forecast of taxable income within the carryforward periods available under applicable law and prudent tax planning strategies are not sufficient to cover the amount of net deferred tax assets, such assets may be impaired. Based on our analysis of both positive and negative evidence we concluded there was no impairment of the deferred tax assets at December 31, 2013 and 2012.

Stock Compensation Plans

The Company has a stock-based compensation plan covering certain officers and directors. The Company grants stock options under the plan for a fixed number of shares with an exercise price equal to the fair value of the shares on the date of grant.

The Company's pre-tax compensation cost for stock-based employee and director compensation was approximately $19,656 and $90,000 for the years ended December 31, 2013 and 2012, respectively.

Earnings Per Common Share

Basic and diluted net income per common share have been computed by dividing net income for each period by the weighted average number of shares of common stock outstanding during each period. Diluted net income per common share reflects the potential dilution that could occur if outstanding stock options were exercised.

Basic and diluted net income per common share have been computed based upon net income as presented in the accompanying Consolidated Statements of Income divided by the weighted average number of common shares outstanding or assumed to be outstanding as summarized below:

	2013	2012
Shares used in the computation of earnings per share:		
Weighted average number of shares outstanding – basic	35,471	35,256
Incremental shares from assumed exercise of stock options	–	72
Weighted average number of shares outstanding – diluted	35,471	35,328

In 2013, because the exercise price was in excess of the average current trading price, none of the 888 options outstanding were used in the calculation of diluted EPS. In 2012, 204 of the 1,119 options outstanding were used in the calculation of diluted EPS. For loss periods, diluted EPS is the same as basic EPS due to the fact that including common stock equivalents computed as a result of the stock options outstanding in the calculation of diluted EPS would be antidilutive.

Comprehensive Income

The Company reports as comprehensive income all changes in stockholders' equity during the year from sources other than stockholders. Other comprehensive income refers to all components (revenues, expenses, gains, and losses) of comprehensive income that are excluded from net income.

The Company's only two components of other comprehensive income are unrealized gains and losses on investment securities available-for-sale, net of income taxes and unrealized gains and losses on cash flow hedges, net of income taxes. Information concerning the Company's accumulated other comprehensive income at December 31, 2013 and 2012 is as follows:

(In thousands)	2013	2012
Unrealized (losses) gains on securities available-for-sale	$ (3,215)	$ 4,755
Deferred tax benefit (expense)	1,270	(1,880)
Other comprehensive income, net of tax	$ (1,945)	$ 2,875
Unrealized gains on cash flow hedges	$ 2,285	$ –
Deferred tax expense	(902)	–
Other comprehensive income, net of tax	$ 1,383	$ –
Total Other comprehensive (loss) income	$ (562)	$ 2,875

Recent Accounting Pronouncements

In July 2013, the FASB issued ASU 2013-11, Income Taxes (Topic 740), "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists," to clarify the balance sheet presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The ASU requires an unrecognized tax benefit, or a portion of an unrecognized tax benefit, to be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The Company's adoption of ASU 2013-11 on January 1, 2014 did not have a material effect on the Company's consolidated financial statements.

In January 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-04, Receivables—Troubled Debt

Restructurings by Creditors (Topic 310), "Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure," to clarify when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The ASU requires interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2014. Management intends to adopt ASU 2014-04 on January 1, 2015 and does not believe that the adoption will have a material effect on the Company's consolidated financial statements.

Reclassifications

Certain amounts in the 2012 financial statements have been reclassified to conform to the 2013 presentation. The reclassifications had no effect on total assets, net income or stockholders' equity as previously reported.

NOTE C – INVESTMENT SECURITIES

The following is a summary of the securities portfolio by major classification at December 31, 2013 and 2012.

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2013				
Available-for-sale:				
U.S. agency obligations	$ 30,291	$ 39	$ 1,187	$ 29,143
Collateralized mortgage obligations	52,627	354	371	52,610
Mortgage-backed securities	39,820	403	630	39,593
Municipal bonds	25,302	–	2,331	22,971
Other	2,371	908	400	2,879
	$ 150,411	$ 1,704	$ 4,919	$ 147,196
December 31, 2012				
Available-for-sale:				
U.S. agency obligations	$ 30,427	$ 1,177	$ –	$ 31,604
Collateralized mortgage obligations	49,268	1,675	–	50,943
Mortgage-backed securities	61,659	2,393	–	64,052
Municipal bonds	796	–	8	788
Other	1,069	–	482	587
	$ 143,219	$ 5,245	$ 490	$ 147,974

The amortized cost and fair values of securities available-for-sale at December 31, 2013 by contractual maturity are shown below. Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

(In thousands)	Amortized Cost	Fair Value
Due within one year	$ –	$ –
Due after one year through five years	1,000	600
Due after five years through ten years	12,874	12,467
Due after ten years	135,166	131,850
No stated maturity date	1,371	2,279
	$ 150,411	$ 147,196

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following tables show gross unrealized losses and fair values of investment securities, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position at December 31, 2013 and 2012. At December 31, 2013, the unrealized losses related to nine US Agency obligations, eleven collateralized mortgage obligations, eleven mortgage-backed securities, thirty-five municipal bonds and one other security of which one municipal and one other security had continuous unrealized losses for more than 12 months. At December 31, 2012, the unrealized losses related to one municipal bond and two other securities of which the two other securities had continuous unrealized losses for more than 12 months. The unrealized losses primarily relate to debt securities that have incurred fair value reductions due to higher market interest rates since the securities were purchased. The unrealized losses are not likely to reverse unless and until market interest rates decline to the levels that existed when the securities were purchased. Since none of the unrealized losses on the debt securities in 2012 or 2013 relate to the marketability of the securities or the issuer's ability to honor redemption obligations and since management has the intent to hold these securities until maturity and believes it is more likely than not that the Company will not have to sell any such securities before a recovery of cost given the current liquidity position, none of those debt securities are deemed to be other than temporarily impaired. During 2013, the Company charged additional impairment of $39,000 on shares of common stock against earnings and wrote those securities down to their current market value as of January 2013. During 2012, the Company charged off $350,000 against earnings on another financial institutions preferred stock which was deemed worthless and the Company wrote that security off.

	Less than 12 months		**12 months or Greater**		**Total**	
(In thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2013						
Securities available-for-sale:						
U.S. agency obligations	$ 25,796	$ 1,186	$ –	$ –	$ 25,796	$ 1,186
Collateralized mortgage obligations	26,335	371	–	–	26,335	371
Mortgage-backed securities	26,067	630	–	–	26,067	630
Municipal bonds	22,267	2,242	703	90	22,970	2,332
Other	–	–	600	400	600	400
Total temporarily impaired securities	$ 100,465	$ 4,429	$ 1,303	$ 490	$ 101,768	$ 4,919
December 31, 2012						
Securities available-for-sale:						
Municipal bonds	$ 788	$ 8	$ –	$ –	$ 788	$ 8
Other	–	–	587	482	587	482
Total temporarily impaired securities	$ 788	$ 8	$ 587	$ 482	$ 1,375	$ 490

During the years ended December 31, 2013 and 2012, the Company recognized gross gains and (losses) on sales of available-for-sale investment securities of $106,000 and ($18,000), respectively, for 2013 and $376,000 and ($17,000), respectively, for 2012. Proceeds received from these sales totaled $18.3 million and $45.2 million in 2013 and 2012, respectively.

Securities with a fair value of $77.2 million and $82.3 million were pledged as of December 31, 2013 and 2012, respectively, to secure repurchase agreements, lines of credit and other borrowings.

NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES

Following is a summary of loans at December 31, 2013 and 2012:

(In thousands)	2013	2012
Construction and land development	$ 81,316	$ 99,685
Commercial real estate:		
Commercial real estate	373,379	340,911
Farmland	1,123	1,020
Multifamily, nonresidential and junior liens	63,965	62,998
Total commercial real estate	438,467	404,929
Consumer real estate:		
Home equity lines	21,117	13,271
Secured by 1-4 family residential, secured by first deeds of trust	118,686	100,628
Secured by 1-4 family residential, secured by second deeds of trust	5,774	6,294
Total consumer real estate	145,577	120,193
Commercial and industrial loans (except those secured by real estate)	93,841	80,496
Consumer and other	8,505	17,229
Total loans	767,706	722,532
Deferred loan costs	(314)	(166)
Allowance for loan losses	(6,939)	(10,348)
Net loans	$ 760,453	$ 712,018

Loans are primarily made in the Research Triangle and Charlotte areas of North Carolina. Real estate loans can be affected by the condition of the local real estate market. Commercial and installment loans can be affected by the local economic conditions.

Changes in the allowance for loan losses for the years ended December 31, 2013 and 2012 were as follows:

(In thousands)	Construction and Land Development	Commercial Real Estate	Consumer Real Estate	Commercial and Industrial Loans Not Secured By Real Estate	Consumer and Other	Total Loans
December 31, 2013						
Balance at beginning of the year	$ 3,746	$ 2,463	$ 1,466	$ 2,573	$ 100	$ 10,348
Provision for loan losses	400	(910)	778	(56)	(56)	156
Loans charged off	(2,676)	(761)	(738)	(494)	–	(4,669)
Recoveries	551	392	34	127	–	1,104
Net chargeoffs	(2,125)	(369)	(704)	(367)	–	(3,565)
Balance at end of the year	$ 2,021	$ 1,184	$ 1,540	$ 2,150	$ 44	$ 6,939
December 31, 2012						
Balance at beginning of the year	$ 6,476	$ 3,522	$ 1,402	$ 1,775	$ 94	$ 13,269
Provision for loan losses	(796)	39	115	1,468	103	929
Loans charged off	(2,997)	(1,222)	(52)	(743)	(98)	(5,112)
Recoveries	1,063	124	1	73	1	1,262
Net chargeoffs	(1,934)	(1,098)	(51)	(670)	(97)	(3,850)
Balance at end of the year	$ 3,746	$ 2,463	$ 1,466	$ 2,573	$ 100	$ 10,348

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on the impairment method for the years ended December 31, 2013 and 2012 were as follows:

(In thousands)	Construction and Land Development	Commercial Real Estate	Consumer Real Estate	Commercial and Industrial Loans Not Secured By Real Estate	Consumer and Other	Total Loans
December 31, 2013						
Allowance for Loan Losses:						
Individually evaluated for impairment	$ 300	$ –	$ –	$ 491	$ –	$ 791
Collectively evaluated for impairment	1,721	1,184	1,540	1,659	44	6,148
Total ending allowance	$ 2,021	$ 1,184	$ 1,540	$ 2,150	$ 44	$ 6,939
Loans:						
Individually evaluated for impairment	$ 5,938	$ 3,313	$ 1,755	$ 1,402	$ 214	$ 12,622
Collectively evaluated for impairment	75,378	435,154	143,822	92,439	8,291	755,084
Total ending loans	$ 81,316	$ 438,467	$ 145,577	$ 93,841	$ 8,505	$ 767,706
December 31, 2012						
Allowance for Loan Losses:						
Individually evaluated for impairment	$ 2,248	$ 944	$ 695	$ 534	$ –	$ 4,421
Collectively evaluated for impairment	1,498	1,519	771	2,039	100	5,927
Total ending allowance	$ 3,746	$ 2,463	$ 1,466	$ 2,573	$ 100	$ 10,348
Loans:						
Individually evaluated for impairment	$ 21,908	$ 8,004	$ 3,104	$ 1,481	$ 362	$ 34,859
Collectively evaluated for impairment	77,777	396,925	117,089	79,015	16,867	687,673
Total ending allowance	$ 99,685	$ 404,929	$ 120,193	$ 80,496	$ 17,229	$ 722,532

Loans are charged down or off as soon as the Bank determines that the full principal balance due under any loan becomes uncollectible. The amount of the charge is determined as follows:

- If unsecured, the loan must be charged off in full.
- If secured, the outstanding principal balance of the loan should be charged down to the net recoverable value of the collateral.

Loans are considered uncollectible when:

- No regularly scheduled payment has been made within four months unless fully secured and in the process of collection, or
- The collateral value is insufficient to cover the outstanding indebtedness and it is unlikely the borrower will have the ability to pay the debt in a timely manner.
- The loan is unsecured, the borrower files for bankruptcy protection and there is no other (guarantor, etc.) support from an entity outside of the bankruptcy proceedings.

Impaired loans totaled $12.6 million and $34.9 million at December 31, 2013 and 2012, respectively. Included in the $12.6 million at December 31, 2013 is $3.4 million of loans classified as troubled debt restructurings ("TDRs"). Included in the $34.9 million at December 31, 2011 is $7.5 million of loans classified as troubled debt restructurings ("TDRs"). A modification of a loan's terms constitutes a TDR if the creditor grants a concession to the borrower for economic or legal reasons related to the borrower's financial difficulties that it would not otherwise consider. All TDRs are considered impaired.

The following table provides information on performing and nonperforming restructures for the years ended December 31, 2013 and 2012:

(In thousands)	**2013**	**2012**
Performing restructurings:		
Construction and land development	$ 1,173	$ 3,955
Commercial real estate	1,457	–
Consumer real estate	365	349
Total performing restructurings	2,995	4,304
Nonperforming restructurings:		
Construction and land development	155	2,718
Consumer real estate	72	76
Consumer and other	214	362
Total nonperforming restructurings	441	3,156
Total restructurings	$ 3,436	$ 7,460

The following table provides information about TDRs identified during the current period (in thousands, except number of contracts):

	Modifications for the period ended, December 31, 2013		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructuring			
Commercial real estate	1	$ 1,457	$ 1,457
Total Troubled Debt Restructuring	1	$ 1,457	$ 1,457

Troubled Debt Restructurings that subsequently defaulted:

	Number of Contracts	Recorded Investment
Troubled Debt Restructuring		
Construction and land development	2	$ 4,541
Commercial real estate	1	431
Total Troubled Debt Restructuring	3	$ 4,972

Interest is not typically accrued on loans where an impairment exists. For loans classified as TDRs, the Company further evaluates the loans as performing or non-performing. If, at the time of restructure, it is determined that no impairment exists, the loan will be classified as performing. At December 31, 2013 and 2012, $3.0 million and $4.3 million of TDRs were accruing interest as they were classified as performing.

Interest income recognized on performing TDRs was $115,000 and $594,000 for the years ended December 31, 2013 and 2012, respectively.

In order to quantify the value of impairment, the Company evaluates loans individually. The detail of loans evaluated for impairment at December 31, 2013 is presented below:

(In thousands)	Recorded Investment	Unpaid Contractual Principal Balance	Allocated Allowance
December 31, 2013			
Loans without a specific valuation allowance:			
Construction and land development	$ 655	$ 699	$ –
Commercial real estate	3,313	3,332	–
Consumer real estate	1,255	1,273	–
Commercial and industrial loans			
(except those secured by real estate)	152	166	–
Consumer and other	214	614	–
Loans with a specific valuation allowance:			
Construction and land development	5,631	5,631	300
Commercial and industrial loans			
(except those secured by real estate)	1,402	1,403	491
Total	$ 12,622	$ 13,118	$ 791

In 2012, the Company had $34.9 million of impaired loans. The detail of loans evaluated for impairment as of December 31, 2012 is presented below:

(In thousands)	Recorded Investment	Unpaid Contractual Principal Balance	Allocated Allowance
December 31, 2012			
Loans without a specific valuation allowance:			
Construction and land development	$ 12,182	$ 12,730	$ –
Commercial real estate	4,401	4,401	–
Consumer real estate	1,179	1,218	–
Commercial and industrial loans			
(except those secured by real estate)	1,006	1,458	–
Consumer and other	362	762	–
Loans with a specific valuation allowance:			
Construction and land development	9,726	9,776	2,248
Commercial real estate	3,603	3,642	944
Consumer real estate	1,925	1,925	695
Commercial and industrial loans			
(except those secured by real estate)	475	475	534
Consumer and other	–	–	–
Total	$ 34,859	$ 36,387	$ 4,421

The average recorded investment balance of impaired loans during 2013 and 2012 is as follows:

(In thousands)	**2013**	**2012**
Construction and land development	$ 15,002	$ 31,189
Commercial real estate	7,284	14,498
Consumer real estate	1,249	2,850
Commercial and industrial loans (except those secured by real estate)	1,604	5,482
Consumer and other	296	406
Total loans	$ 25,435	$ 54,425

When the Bank cannot reasonably expect full and timely repayment of its loan, the loan is placed on non-accrual. The bank will continue to track the contractual interest for purposes of customer reporting and any potential litigation or later collection of the loan but accrual of interest for the bank's financial statement purposes is to be discontinued. Subsequent payments of interest can be recognized as income on a cash basis provided that full collection of principal is expected. Otherwise, all payments received are to be applied to principal only.

At the time of non-accrual, past due or accrued interest is reversed from income.

Loans over 90 days past due will automatically be placed on non-accrual. Loans that are less delinquent may also be placed on non-accrual if full collection of principal and interest is unlikely.

The following table presents the recorded investment in nonaccrual and loans past due more than 90 days still accruing by portfolio segment as of December 31:

	Nonaccrual		Loans Past Due Over 90 Days Still Accruing	
(In thousands)	**2013**	**2012**	**2013**	**2012**
Construction and land development	$ 307	$ 12,497	$ –	$ –
Commercial real estate	264	2,082	–	–
Consumer real estate	72	830	–	–
Commercial and industrial loans (except those secured by real estate)	732	335	–	–
Consumer and other	214	361	–	–
Total	$ 1,589	$ 16,105	$ –	$ –

If interest had been earned on non-accrual loans, such income would have approximated $591,000 and $1.1 million for the years ended December 31, 2013 and 2012, respectively.

The following table presents the aging of the recorded investment in past due loans as of December 31, 2013 and 2012 by portfolio segment:

(In thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Nonaccrual	Total Past Due	Current	Total Loans
December 31, 2013							
Construction and land development	$ –	$ –	$ –	$ 307	$ 307	$ 81,009	$ 81,316
Commercial real estate	–	–	–	264	264	438,203	438,467
Consumer real estate	–	818	–	72	890	144,687	145,577
Commercial and industrial loans (except those secured by real estate)	–	–	–	732	732	93,109	93,841
Consumer and other	31	–	–	214	245	8,260	8,505
Total	$ 31	$ 818	$ –	$ 1,589	$ 2,438	$765,268	$ 767,706
December 31, 2012							
Construction and land development	$ 6,436	$ –	$ –	$ 12,497	$ 18,993	$ 80,752	$ 99,685
Commercial real estate	–	2,522	–	2,082	4,604	402,847	404,929
Consumer real estate	1,077	483	–	830	2,390	119,363	120,193
Commercial and industrial loans (except those secured by real estate)	–	98	–	335	433	80,161	80,496
Consumer and other	–	1	–	361	362	16,868	17,229
Total	$ 7,513	$ 3,104	$ –	$ 16,105	$ 26,722	$699,991	$722,532

Credit Quality Indicators

The Company utilizes its nine point grading system in order to evaluate the level of inherent risk in the loan portfolio as part of its allowance for loan losses methodology. Loans collectively evaluated for impairment are grouped by loan type and, in the case of commercial and construction loans, by risk rating. Each loan type is assigned an allowance factor based on risk grade, historical loss experience, economic conditions, overall portfolio quality including delinquency rates and commercial real estate loan concentrations (as applicable). As risk grades increase, additional reserves are applied stated in basis points in order to account for the added inherent risk.

The Company categorizes all business and commercial purpose loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by setting the risk grade at the inception of a loan through the approval process. A certain percentage of loan dollars is reviewed each year by a third party loan review company. The risk rating process is inherently subjective and based upon management's evaluation of the specific facts and circumstances for individual borrowers. As such, the assigned risk ratings are subject to change based upon changes in borrower status and changes in the external environment affecting the borrower. The Company uses the following definitions for risk ratings:

Risk Grade 1 – Minimal Credits in this category are virtually risk-free and are well-collateralized by cash-equivalent instruments. The repayment program is well-defined and achievable. Repayment sources are numerous.

Risk Grade 2 – Modest Loans to borrowers of significantly better than average financial strength or loans secured by readily marketable securities. Earnings performance is consistent and primary and secondary sources of repayment are well established. The borrower exhibits excellent asset quality and liquidity with very strong debt servicing capacity and coverage. Company management has depth, is experienced and well regarded in the industry.

Risk Grade 3 – Average Loans in this category are to borrowers of satisfactory financial strength. Earnings performance is consistent. Primary and secondary sources of repayment are well defined and adequate to retire the debt in a timely and orderly fashion. These borrowers would generally exhibit satisfactory asset quality and liquidity. They have moderate leverage and experienced management in key positions.

Risk Grade 4 – Acceptable Loans in this category are to borrowers involving more than average risk which contain certain characteristics that require some supervision and attention by the lender. Asset quality is acceptable, but debt capacity is modest. Little excess liquidity is available. The borrower may be fully leveraged and unable to sustain major setbacks. Covenants are structured to ensure adequate protection. Management may have limited experience and depth. This category includes loans which are highly leveraged transactions due to regulatory constraints and also includes loans involving reasonable exceptions to policy.

Risk Grade 5 – Acceptable with Care A loan in this category is sound and collectible but contains considerable risk. Although asset quality remains acceptable, the borrower has a smaller and/or less diverse asset base, very little liquidity and limited debt capacity. Earnings performance is inconsistent and the borrower is not strong enough to sustain major setbacks. The borrower may be highly leveraged and below average size or a lower-tier competitor. There might be limited management experience and depth. These loans may be to a well-conceived start-up venture but repayment is still dependent upon a successful operation. This category includes loans with significant documentation or policy exceptions, improper loan structure, or inadequate loan servicing procedures and may also include a loan in which strong reliance for a secondary repayment source is placed on a guarantor who exhibits the ability and willingness to repay or loans which are highly leveraged transactions due to the obligor's financial status.

Risk Grade 6 – Special Mention or Critical Loans in this category have potential weaknesses which may, if not checked or corrected, weaken the asset or inadequately protect the Bank's credit position at some future date. These may also include loans of marginal quality and liquidity that if not corrected may jeopardize the liquidation of the debt and the Bank's credit position. These loans require close supervision and must be monitored to ensure there is not a pattern of deterioration in the credit that may lead to further downgrade. These characteristics include but are not limited to:

- Repayment performance has not been demonstrated to prudent standards and;
- Repayment performance is inconsistent and highly sensitive to business and operating cycle swings;
- Fatal documentation errors.
- Performing as agreed without documented capacity or collateral protection.

Risk Grade 7 – Substandard A substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as substandard must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Risk Grade 8 – Doubtful Loans classified Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. Among these events are:

- Injection of capital
- Alternative financing
- Liquidation of assets or the pledging of additional collateral.

The ability of the borrower to service the debt is extremely weak, overdue status is constant, the debt has been placed on non-accrual status and no definite repayment schedule exists. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.

Risk Grade 9 – Loss Loans classified Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be affected in the future. Probable Loss portions of Doubtful assets should be charged against the Reserve for Loan Losses. Loans may reside in this classification for administrative purposes for a period not to exceed the earlier of thirty (30) days or calendar quarter-end. There were no 9 rated loans as of December 31, 2013 or 2012.

As of December 31, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

	Risk Grade								
	1	2	3	4	5	6	7	8	Total
Balance at December 31, 2013									
Construction and land development	$ 67	$ –	$ 4,831	$ 14,637	$ 54,120	$ 1,452	$ 271	$ –	$ 75,378
Commercial real estate	1,006	2,511	126,678	198,182	91,800	14,551	426	–	435,154
Consumer real estate	–	1,190	65,501	49,739	27,170	222	–	–	143,822
Commercial and industrial loans (except those secured by real estate)	3,412	200	13,145	44,706	30,114	862	–	–	92,439
Consumer and other	101	12	2,330	3,675	2,076	97	–	–	8,291
Total	$ 4,586	$ 3,913	$ 212,485	$ 310,939	$ 205,280	$ 17,184	$ 697	$ –	$ 755,084
Balance at December 31, 2012									
Construction and land development	$ 85	$ –	$ 1,315	$ 15,523	$ 60,706	$ 148	$ –	$ –	$ 77,777
Commercial real estate	849	264	70,835	157,705	144,906	21,955	411	–	396,925
Consumer real estate	491	1,117	41,255	44,223	29,411	592	–	–	117,089
Commercial and industrial loans (except those secured by real estate)	4,019	2,710	6,314	33,941	27,039	4,553	439	–	79,015
Consumer and other	107	10	13,225	1,845	1,680	–	–	–	16,867
Total	$ 5,551	$ 4,101	$ 132,944	$253,237	$ 263,742	$ 27,248	$ 850	$ –	$ 687,673

The Bank has granted loans to certain directors and executive officers of the Bank and their related interests. Such loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other borrowers and, in management's opinion, do not involve more than the normal risk of collectability. All loans to directors and executive officers or their interests are submitted to the Board of Directors for approval. A summary of loans to directors, executive officers and their related interests follows:

(In thousands)	
Loans to directors and officers as a group at December 31, 2012	$ 3,648
Disbursements during 2013	862
Amounts collected during 2013	(1,365)
Loans to directors and officers as a group at December 31, 2013	$ 3,145

NOTE E – BANK PREMISES AND EQUIPMENT

Following is a summary of bank premises and equipment at December 31, 2013 and 2012:

(In thousands)	**2013**	**2012**
Building	$ 14,084	$ 13,979
Furniture and equipment	4,040	4,208
Leasehold improvements	177	185
Construction in progress	1,543	42
Less accumulated depreciation and amortization	(4,576)	(4,635)
	$ 15,268	$ 13,779

Depreciation and amortization expense amounting to $831,000 and $600,000 for the years ended December 31, 2013 and 2012 are included in occupancy expense.

NOTE F – DEPOSITS

At December 31, 2013, the scheduled maturities of time deposits are as follows:

(In thousands)	
2014	$ 271,545
2015	96,021
2016	19,291
2017	10,284
2018	11,909
	$ 409,050

At December 31, 2013 and 2012, time deposits in denominations of $100,000 or more were $370.5 million and $343.5 million, respectively. Interest expense on time deposits in denominations of $100,000 or more aggregated to $5.6 million in 2013 and $6.6 million in 2012.

In the normal course of business, certain directors and executive officers of the Company, including their immediate families and companies in which they have an interest, may be deposit customers.

NOTE G – BORROWINGS

Repurchase Agreements and Federal Funds Purchased
Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The Bank may be required to provide additional collateral based on the fair value of the underlying securities.

Following is an analysis of short-term borrowed funds at December 31, 2013 and 2012:

December 31, 2013

(In thousands)	Balance	End of Period Weighted Avg. Rate
Federal funds purchased	$ –	0.00%
Repurchase agreements	28,011	0.18%
	$ 28,011	0.18%

(In thousands)	Balance	Daily Average Balance Interest Rate
Federal funds purchased	$ 242	0.63%
Repurchase agreements	26,132	0.18%
	$ 26,374	0.18%

(In thousands)	Maximum Outstanding at any Month End
Federal funds purchased	$ 2,581
Repurchase agreements	28,011

December 31, 2012

(In thousands)	Balance	End of Period Weighted Avg. Rate
Federal funds purchased	$ –	0.00%
Repurchase agreements	26,303	0.22%
	$ 26,303	0.22%

(In thousands)	Balance	Daily Average Balance Interest Rate
Federal funds purchased	$ 259	0.27%
Repurchase agreements	26,125	0.23%
	$ 26,384	0.23%

(In thousands)	Maximum Outstanding at any Month End
Federal funds purchased	$ 2,680
Repurchase agreements	31,645

Interest expense on securities sold under agreements to repurchase totaled $46,000 in 2013 and $61,000 in 2012.

Interest on federal funds purchased totaled $1,600 in 2013 and $1,700 in 2012.

Repurchase agreements are collateralized by mortgage-backed securities with carrying values of $30.6 million and fair values of $30.7 million at December 31, 2013. The fed funds lines with the bank's correspondent banks are all unsecured.

Federal Home Loan Bank Advances

Advances from the FHLB had a weighted average rate of 0.20% and 0.74% and total outstanding balances averaged $102.9 million and $110.0 million at December 31, 2013 and 2012, respectively. Included in amounts due to the FHLB at December 2013 year end were five term borrowings totaling $115.0 million. The term borrowings were all short term notes all maturing by February 2014 with note rates varying from 0.17% to 0.23%.

The line of credit and all other advances were collateralized by certain 1 – 4 family mortgages, multifamily first mortgage loans and qualifying commercial loans totaling $379.7 million and by mortgage-backed securities with carrying values of $28.8 million at December 31, 2013. The line offers a borrowing capacity of $226.3 million at year end 2013.

At December 31, 2013, the Company had available lines of credit of approximately $77.5 million at various financial institutions for borrowing on a short-term basis and an available credit line at the FHLB of up to 30% of assets contingent upon adequate collateralization. These lines are subject to annual renewal and are at varying interest rates. No amounts were outstanding on the line at December 31, 2013.

Holding Company Line

The Company has a $10.0 million holding company loan with an unaffiliated institution secured by the stock of the Bank with an outstanding balance of $9.6 million and $10.0 million at December 31, 2013 and December 31, 2012, respectively. The balance is included in other borrowings on the Consolidated Balance Sheets. The loan accrues interest at prime plus 0.75% and expires in November 2017. The note called for interest only payments until November 2013 with principal payments starting after that and amortized over the remaining four year term.

Subordinated Debentures

In 2004, the Company issued $10.3 million of junior subordinated debentures to Paragon Commercial Capital Trust I in exchange for the proceeds of trust preferred securities issued by the Trust. The junior subordinated debentures accrue interest quarterly at an annual rate, reset quarterly, equal to LIBOR plus 2.65% however, the interest payments were deferred until October 2013, when the entire deferred interest amount was repaid. The debentures are redeemable in whole or in part, on any October 23, January 23, April 23, or July 23. Redemption is mandatory at July 23, 2034.

In 2006, the Company issued $8.2 million of junior subordinated debentures to Paragon Commercial Capital Trust II in exchange for the proceeds of trust preferred securities issued by the Trust. The junior subordinated debentures accrue interest quarterly at an annual rate, reset quarterly, equal to LIBOR plus 1.70% however, the interest payments were deferred until September 2013, when the entire deferred interest amount was repaid. The debentures are redeemable on June 20, 2011 or afterwards, in whole or in part, on any March 30, June 30, September 30, or December 30. Redemption is mandatory at June 30, 2036.

In October 2008, the Company issued $11.8 million of subordinated debentures at the Bank level. $7.3 million of the debentures pay interest quarterly at a fixed rate of 9.14% and the remaining $4.5 million pay at an annual rate, reset quarterly, equal to LIBOR plus 5.00%. The debentures are redeemable on November 1, 2013 or any time afterwards, in whole or in part. Redemption is mandatory at November 1, 2018. The debentures are included in long-term debt and qualify as Tier 2 regulatory capital at the Bank level. In January 2014, the Company repaid these debentures, reducing total risk based capital by this amount.

The junior subordinated debentures are included in long-term debt and the Company's equity interest in the trust is included in other assets. The Company guarantees the trust preferred securities through the combined operation of the junior subordinated debentures and other related documents. The Company's obligation under the guarantee is unsecured and subordinate to senior and subordinated indebtedness of the Company.

The trust preferred securities presently qualify as Tier 1 regulatory capital and are reported in Federal Reserve regulatory reports as a minority interest in a consolidated subsidiary. The junior subordinated debentures do not qualify as Tier 1 regulatory capital. On March 1, 2005, the Board of Governors of the Federal Reserve issued a final rule stating that trust preferred securities will continue to be included in Tier 1 capital, subject to stricter quantitative and qualitative standards. For Bank Holding Companies, trust preferred securities will continue to be included in Tier 1 capital up to 25% of core capital elements (including trust preferred securities) net of goodwill less any associated deferred tax liability.

NOTE H – LEASES

The Bank has entered into a non-cancelable operating lease for its Charlotte office. The Company purchased a building in Raleigh in 2005 and relocated its headquarters in March 2007. The acquired building resides on land subject to a land lease which renews every five years with the next renewal in 2018. Future minimum lease payments under these leases for the years ending December 31 are as follows:

(In thousands)	
2014	$ 430
2015	390
2016	442
2017	449
2018	455
Thereafter	4,626
Total	$ 6,792

Total rent expense for the years ended December 31, 2013 and 2012 amounted to $849,000 and $466,000 respectively.

NOTE I – RELATED PARTY TRANSACTIONS

In addition to those transactions discussed in Note D and F, the Bank has entered into an agreement for accounting, data processing, and administrative services with a stockholder corporation that owned approximately 18% of the Company's common stock at December 31, 2013 and 2012. Expenses related to this agreement totaled $530,000 and $524,000 during the years ended December 31, 2013 and 2012, respectively.

NOTE J – EMPLOYEE BENEFIT PLANS

401(k) Retirement Plan

The Bank has adopted a 401(k) retirement plan that covers all eligible employees. The Bank's contribution is limited to 6% of each employee's salary. Matching contributions are funded when accrued. The Bank matches the first 3% of employee contributions. Matching expenses totaled $213,000 and $111,000 for the years ended December 31, 2013 and 2012, respectively.

Employee Stock Purchase Plan

2003 Employee Stock Purchase Plan (the "2003 ESPP"). A split adjusted aggregate of 1,600 shares of common stock of the Company has been reserved for issuance by the Company upon exercise of options to be granted from time to time under the 2003 ESPP.

The 2003 ESPP as amended provided employees of the Company the right to purchase, annually, shares of the Company's common stock at 95% of fair market value. The number of shares that could be purchased in any calendar year by any individual was limited to shares with a fair market value of $25,000.

During 2013 and 2012 there were no shares issued under the plan.

Supplemental Retirement Plan

In May 2004, the Company established a non-qualifying supplemental retirement plan for the benefit of certain key executives. Under the Plan, the participants will receive a fixed retirement benefit over a 20 year period following that participant's retirement. The Plan also provides for payment of death or disability benefits in the event a participating officer becomes permanently disabled or dies prior to attainment of retirement age. Benefits vest over a ten year period beginning at Plan inception with the first 20% vesting after six years of service and 20% vesting annually thereafter. The discount rate used to compute the liability for the expected benefits was 6%.

In July 2007, the Company established another non-qualifying supplemental retirement plan for the benefit of certain other key employees. The terms of the plan were the same as those for the 2004 Plan. In addition, at the same time, the Company established a deferred compensation plan for certain key executives. Terms of the deferred compensation plan were the same as those of the other two plans except that in addition to a service requirement, certain financial objectives had to be met.

In 2012, the Company amended the deferred compensation plan to remove the financial objectives for the remaining participants. For the year ended December 31, 2013 and 2012, the Company recognized an expense of $411,000 and $225,000, respectively, related to the Plans. The accrued liability related to these plans was approximately $1.9 million and $1.5 million as of December 31, 2013 and 2012, respectively, and is included in Other liabilities on the consolidated balance sheet.

At December 31, 2013, the Company had $26.6 million in cash surrender value invested in bank-owned life insurance policies ("BOLI"). Income earned on these policies may be used, at the Company's sole discretion, to fund the benefits payable under the Plans.

Stock Option Plans

The Employee Stock Option Plan, as amended, made available options to purchase 1,850 shares of the Bank's common stock.

The 2006 Omnibus Stock Ownership and Long Term Incentive Plan (the "Omnibus Plan"), as amended, approved an aggregate of 2,500 shares of the common stock of the Company, subject to adjustment, were reserved for issuance under the terms of the Omnibus Plan pursuant to the grant of incentive stock options, non-qualified stock options, restricted stock grants, long-term incentive compensation units and stock appreciation rights.

Options granted under both plans become exercisable in accordance with the vesting schedule specified in the stock option agreements. All unexercised options expire ten years after the date of grant.

A summary of the transactions for the Company's option plans as of and for the years ended December 31, 2013 and 2012, including the weighted average exercise price ("WAEP") and reflecting all stock splits paid to date, is as follows:

	2013			2012		
	Available for Future Grants	Shares	WAEP	Available for Future Grants	Shares	WAEP
Outstanding at beginning of year	2,177	1,119	$ 4,578	2,048	1,408	$ 4,043
Granted	–	–	–	–	–	–
Exercised	–	(144)	775	–	(160)	681
Expired and forfeited	87	(87)	775	129	(129)	3,569
Outstanding at end of year	2,264	888	$ 5,409	2,177	1,119	$ 4,578
Options exercisable at year-end		888	$ 5,409		1,086	$ 4,553

A summary of the status of the Company's nonvested shares as of December 31, 2013 and changes during the year ended December 31, 2013 is presented below:

Nonvested shares	Shares	Weighted Average Grant Date Fair Value
Outstanding at beginning of year	33	$ 1,602
Granted	–	–
Vested	(33)	1,602
Forfeited	–	–
Outstanding at end of year	–	$ –

The following table summarizes information about the Company's stock options at December 31, 2013:

Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life in Years	Number Exercisable
$656.25 – $1,500.00	5	0.08	5
$1,500.01 – $3,000.00	80	1.53	80
$3,000.01 – $4,500.00	–	–	–
$4,500.01 – $6,000.00	595	3.47	595
$6,000.01 – $6,500.00	208	2.98	208
	888	3.16	888

There were no options granted during 2013 or 2012.

At December 31, 2013, there was no aggregate intrinsic value of options outstanding and exercisable. The aggregate intrinsic value of options exercised during 2013 and 2012 was $32,000 and $107,000, respectively.

As of December 31, 2013, there was no unrecognized compensation expense related to the Company's stock option plans. Compensation expense recognized for stock options was $20,000 and $90,000 as of December 31, 2013 and 2012, respectively.

NOTE K – INCOME TAXES

Allocation of federal and state income tax benefit between current and deferred portions for the years ended December 31 is as follows:

(In thousands)	**2013**	**2012**
Current		
Federal	$ 636	$ –
State	–	–
Total Current	636	–
Deferred		
Federal	1,560	1,434
State	558	322
Total Deferred	2,118	1,756
	$ 2,754	$ 1,756

A reconciliation of income tax benefit computed at the statutory federal income tax rate to income tax expense included in the Consolidated Statements of Income is as follows:

(In thousands)	**2013**	**2012**
Expense (benefit) computed at statutory rate of 34%	$ 2,611	$ 1,676
Effect of state income taxes	209	106
Tax exempt income	(413)	(308)
Other	347	282
	$ 2,754	$ 1,756

The components of the net deferred tax asset are as follows:

(In thousands)	**2013**	**2012**
Deferred tax assets:		
Allowance for loan losses	$ 2,725	$ 4,086
Recorded impairment of assets	1,643	1,337
Operating loss carryforwards	3,964	4,573
Deferred compensation	995	864
Net unrealized loss on available for sale securities	1,272	–
Other	404	775
Total deferred tax assets	11,003	11,635
Deferred tax liabilities:		
Premises and equipment	(709)	(696)
Deferred loan costs	(763)	(574)
Prepaid expenses	(152)	(138)
Net unrealized gain on available for sale securities	–	(1,880)
Net unrealized gain on cash flow hedges	(902)	–
Other	–	–
Total deferred tax liabilities	(2,526)	(3,288)
Net recorded deferred tax assets	$ 8,477	$ 8,347

No valuation allowances were required relating to deferred tax assets at December 31, 2013 or 2012 as management believes that realization of the net deferred tax asset is more likely than not.

The Company's net operating loss carry-forwards will begin to expire in 2030.

As of December 31, 2013 and 2012, there were no uncertain tax positions. The amount of uncertain tax positions may increase or decrease in the future for various reasons including adding amounts for current tax positions, expiration of open tax returns due to statutes of limitations, changes in management's judgment about the level of uncertainty, status of examinations, litigation and legislative activity and the addition or elimination of uncertain tax positions. The Company's policy is to report interest and penalties, if any, related to uncertain tax positions in income tax expense in the Consolidated Statements of Income. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2009.

NOTE L – OTHER NON-INTEREST EXPENSE

The major components of other non-interest expense for the years ended December 31, 2013 and 2012 are as follows:

(In thousands)	**2013**	**2012**
Equipment and software related expense	$ 903	$ 621
Advertising and public relations	577	281
Director related fees and expenses	399	152
Franchise and other taxes	304	349
Insurance	223	172
Postage printing and office supplies	184	169
Correspondent bank fees	148	112
Travel related expenses	129	99
Telephone	106	101
Other	996	859
Total	$ 3,969	$ 2,915

NOTE M – REGULATORY MATTERS

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

The ability of the Company to pay dividends is subject to statutory and regulatory restrictions on the payment of cash dividends, including the requirement under the North Carolina banking laws that cash dividends be paid only out of undivided profits and only if the bank has surplus of a specified level. The Federal Reserve also imposes limits on the Company's payment of dividends.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2013 and 2012, that the Company and the Bank met all capital adequacy requirements to which they are subject.

The most recent notification from the Federal Deposit Insurance Corporation categorized Paragon Commercial Bank as well capitalized under the published regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since the notification that management believes have changed the Bank's category. The Company's and the Bank's actual capital amounts and ratios as of December 31, 2013 and 2012 are presented in the following table.

	Actual		Minimum Requirements to be: Adequately Capitalized		Minimum Requirements to be: Well Capitalized	
(In thousands)	Amount	Ratio	Amount	Ratio	Amount	Ratio
2013						
Total Capital (to Risk Weighted Assets)						
Consolidated	$ 111,290	13.9%	$ 64,154	8.0%	$ 80,192	10.0%
Bank	119,689	15.0%	64,060	8.0%	80,074	10.0%
Tier I Capital (to Risk Weighted Assets)						
Consolidated	92,167	11.5%	32,077	4.0%	48,115	6.0%
Bank	100,566	12.6%	32,030	4.0%	48,045	6.0%
Tier I Capital (to Average Assets)						
Consolidated	92,167	9.1%	40,401	4.0%	50,502	5.0%
Bank	100,566	9.9%	40,527	4.0%	50,659	5.0%
2012						
Total Capital (to Risk Weighted Assets)						
Consolidated	$ 107,297	14.1%	$ 60,843	8.0%	$ 76,054	10.0%
Bank	116,315	15.3%	60,795	8.0%	75,994	10.0%
Tier I Capital (to Risk Weighted Assets)						
Consolidated	86,000	11.3%	30,422	4.0%	45,633	6.0%
Bank	95,025	12.5%	30,398	4.0%	45,597	6.0%
Tier I Capital (to Average Assets)						
Consolidated	86,000	8.9%	38,554	4.0%	48,193	5.0%
Bank	95,025	9.9%	38,381	4.0%	47,976	5.0%

Effective, March 30, 2010, the Company entered into a memorandum of understanding with the FDIC and the North Carolina Commissioner of Banks. The informal agreement required the Bank take certain actions to enhance its lending functions and requires that the Bank maintain a leverage capital ratio of 8%, a Tier 1 risk based capital ratio of 10% and a total risk based capital ratio of 12%. It also restricted dividends that could be paid without prior approval and required reporting of progress of implementing additional management improvement plans. Effective October 25, 2013, the memorandum of understanding was terminated.

NOTE N – OFF-BALANCE SHEET RISK

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank, upon extension of credit is based on management's credit evaluation of the borrower. Collateral obtained varies but may include real estate, stocks, bonds, and certificates of deposit.

A summary of the contract amounts of the Bank's exposure to off-balance sheet credit risk as of December 31, 2013 and 2012 is as follows:

(In thousands)	**2013**	**2012**
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	$ 21,750	$ 13,885
Undisbursed lines of credit	80,978	72,272
Standby letters of credit	4,058	4,075
Total	$ 106,786	$ 90,232

NOTE O – FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value is a market-based measurement and is defined as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. In general, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, each reporting entity is required to consider factors specific to the transaction and the asset or liability, the principal or most advantageous market for the asset or liability, and market participants with whom the entity would transact in the market.

Outlined below is the application of the fair value hierarchy applied to the Company's financial assets that are carried at fair value.

Level 1 – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets. An active market for the asset or liability is a market in which the transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. As of December 31, 2013, the types of financial assets and liabilities the Company carried at fair value hierarchy Level 1 included marketable equity securities with readily available market values.

Level 2 – Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. As of December 31, 2013, the types of financial assets and liabilities the Company carried at fair value hierarchy Level 2 included agency bonds, collateralized mortgage obligations, mortgage backed securities, municipal bonds and derivatives.

Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement. Unobservable inputs are supported by little or no market activity or by the entity's own assumptions. As of December 31, 2013, the Company did value certain financial assets including one corporate subordinated debenture, measured on both a recurring and a non-recurring basis, at fair value hierarchy Level 3.

The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs.

Fair Value on a Recurring Basis

The Company measures certain assets at fair value on a recurring basis, as described below.

Investment Securities Available-for-Sale

Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Derivative Assets and Liabilities

Derivative instruments held or issued by the Company for risk management purposes are traded in over-the-counter markets where quoted market prices are not readily available. For those derivatives, the Company measures fair value using models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty credit risk. The Company classifies derivatives instruments held or issued for risk management purposes as Level 2. As of December 31, 2013 the Company's derivative instruments consist solely of interest rate forward swaps. There were no such derivatives as of December 31, 2012.

Below is a table that presents information about assets measured at fair value on a recurring basis at December 31, 2013 and 2012:

		Fair Value Measurements Using		
(In thousands)	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2013				
Securities available-for-sale:				
U.S. agency obligations	$ 29,143	$ _	$ 29,143	$ –
Collateralized mortgage obligations	52,610	–	52,610	–
Mortgage-backed securities	39,593	–	39,593	–
Municipal bonds	22,971	–	22,971	–
Other	2,879	2,279	–	600
	147,196	2,279	144,317	600
Interest rate forward swaps	2,285	–	2,285	–
Total assets at fair value	$ 149,481	$ 2,279	$ 146,602	$ 600
December 31, 2012				
Securities available-for-sale:				
U.S. agency obligations	$ 31,604	$ _	$ 31,604	$ –
Collateralized mortgage obligations	50,943	–	50,943	–
Mortgage-backed securities	64,052	–	64,052	–
Municipal bonds	788	–	788	–
Other	587	27	–	560
Total assets at fair value	$ 147,974	$ 27	$ 147,387	$ 560

The table below presents a reconciliation and income statement classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2013:

(In thousands)	Level 3 Investment Securities
Balance at December 31, 2012	$ 560
Total unrealized gains included in:	
Other comprehensive income	40
Balance at December 31, 2013	$ 600

Fair Value on a Nonrecurring Basis

The Company measures certain assets at fair value on a nonrecurring basis, as described below.

Impaired Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures the impairment. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At December 31, 2013, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. Impaired loans require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as nonrecurring Level 2. When current appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3. Impaired loans totaled $12.6 million and $34.9 million at December 31, 2013 and 2012, respectively.

Other Real Estate Owned

Other real estate, which includes foreclosed assets, is adjusted to fair value upon transfer of loans and premises to other real estate. Subsequently, other real estate is carried at the lower of carrying value or fair value.

At the date of transfer, losses are charged to the allowance for credit losses. Subsequent write-downs are charged to expense in the period they are incurred.

Below is a table that presents information about assets measured at fair value on a nonrecurring basis at December 31, 2013 and 2012:

		Fair Value Measurements Using		
(In thousands)	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2013				
Impaired loans	$ 11,831	$ _	$ –	$ 11,831
Other real estate owned	18,174	–	–	18,174
Total	$ 30,005	$ –	$ –	$ 30,005
December 31, 2012				
Impaired loans	$ 30,438	$ _	$ –	$ 30,438
Other real estate owned	18,756	–	–	18,756
Total	$ 49,194	$ –	$ –	$ 49,194

The Bank provides certain disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows.

In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Accordingly, certain financial instruments and all nonfinancial instruments are excluded from disclosure. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Bank.

The following methods and assumptions were used by the Bank in estimating its fair value disclosures for financial instruments:

Cash and Due from Banks
The carrying amounts for cash and due from banks approximate fair value because of the short maturities of those instruments.

Federal Home Loan Bank Stock
The carrying value of Federal Home Loan Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

Bank-owned life insurance
The carrying value of bank-owned life insurance approximates fair value because this investment is carried at cash surrender value, as determined by the insurer.

Loans
The fair value of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Deposits
The fair value of demand deposits is the amount payable on demand at the reporting date. The fair value of time deposits is estimated by discounting expected cash flows using the rates currently offered for instruments of similar remaining maturities.

Accrued Interest
The carrying amount is a reasonable estimate of fair value.

Short-Term Borrowings and Long-Term Debt
The fair values are based on discounting expected cash flows using the current interest rates for debt with the same or similar remaining maturities and collateral requirements.

Financial Instruments with Off-Balance Sheet Risk
With regard to financial instruments with off-balance sheet risk discussed in Note N, it is not practicable to estimate the fair value of future financing commitments.

The following table presents the estimated fair values and carrying amounts of the Bank's financial instruments, none of which are held for trading purposes, at December 31:

	2013		2012	
(In thousands)	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial Assets:				
Cash and due from banks	$ 45,137	$ 45,137	$ 18,378	$ 18,378
Investment securities available-for-sale	147,196	147,196	147,974	147,974
Loans, net	760,453	757,575	712,018	695,202
Accrued interest receivable	3,130	3,130	2,796	2,796
Federal Home Loan Bank stock	6,323	6,323	6,396	6,396
Bank-owned life insurance	26,622	26,622	25,775	25,775
Financial Liabilities:				
Non-maturing deposits	$ 361,102	$ 361,102	$ 266,715	$ 266,715
Time deposits	409,050	410,283	433,586	437,217
Accrued interest payable	624	624	731	731
Repurchase agreements and federal funds purchased	28,012	28,012	26,303	26,303
FHLB advances and other borrowings	124,616	124,402	120,000	120,067
Subordinated debt	30,338	23,253	30,338	30,102

NOTE P – PARENT COMPANY FINANCIAL DATA

Following are the condensed financial statements of Paragon Financial Corporation as of and for the years ended December 31, 2013 and 2012:

Condensed Balance Sheets

(In thousands)

At December 31:	2013	2012
Assets		
Cash and due from banks:	$ 710	$ 1,493
Investment in Paragon Commercial Bank	104,002	102,997
Investment in unconsolidated subsidiaries	558	558
Other assets	617	592
Total Assets	$ 105,887	$ 105,640
Liabilities and Stockholders' Equity		
Subordinated debentures	$ 18,558	$ 18,558
Other borrowings	9,616	10,000
Accrued interest payable and other liabilities	110	1,097
Total Liabilities	28,284	29,655
Stockholders' Equity:		
Common stock	35	35
Additional paid-in capital	51,963	51,832
Accumulated other comprehensive (loss) income	(562)	2,875
Retained earnings	26,167	21,243
Total Stockholders' Equity	77,603	75,985
Total Liabilities and Stockholders' Equity	$ 105,887	$ 105,640

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Condensed Statements of Income

(In thousands)

At December 31:	2013	2012
Equity in earnings of subsidiary	$ 5,707	$ 3,936
Interest expense	(909)	(912)
Other operating income	22	18
Other operating expenses	(320)	(261)
Income tax benefit	424	393
Net Income	$ 4,924	$ 3,174

Condensed Statements of Cash Flows

(In thousands)

at December 31:	2013	2012
Cash Flows from Operating Activities		
Net income	$ 4,924	$ 3,174
Adjustments to reconcile net income to net cash used in operating activities:		
Equity in earnings of subsidiary	(4,457)	(3,936)
Impairment on securities	39	–
Stock based compensation	20	90
Changes in assets and liabilities:		
Increase in other assets	(30)	402
Increase in other liabilities	(986)	504
Net cash (used in) provided by operating activities	(490)	234
Cash Flows from Investing Activities		
Investment in subsidiaries and trusts	(20)	(89)
Purchase of securities available for sale	–	(68)
Net cash used in investing activities	(20)	(157)
Cash Flows from Financing Activities		
Repayment of long term debt	(384)	–
Proceeds from exercise of stock options	111	110
Net cash (used in) provided by financing activities	(273)	110
Net (decrease) increase in cash and cash equivalents	(783)	187
Cash and cash equivalents, beginning of year	1,493	1,306
Cash and cash equivalents, end of year	$ 710	$ 1,493

NOTE Q – SUPPLEMENTAL CASH FLOW DISCLOSURE

(In thousands)

At December 31:	2013	2012
Supplemental Disclosures of Cash Flow Information		
Interest paid	$ 10,625	$ 15,044
Income taxes paid	$ 636	$ 100
Supplemental Schedule of Noncash Investing and Financing Activities		
Change in fair value of securities available-for-sale, net of taxes	$ (4,820)	$ 2,196
Change in fair value of cash flow hedges, net of taxes	$ 1,383	$ –
Transfer from loans to foreclosed real estate	$ 10,652	$ 9,643
Transfer of SBIC investment from other assets to investments	$ 1,342	$ –

NOTE R – SUBSEQUENT EVENTS

In January, 2014 the Company repaid its October 2008 issued subordinated debentures of $11.8 million which are disclosed in Note G. The Company has evaluated subsequent events through March 19, 2014 the date these consolidated financial statements were available to be issued and has determined that there are no other subsequent events that would require recognition or disclosure in the Company's consolidated financial statements.

MANAGEMENT'S REPORT ON THE FINANCIAL STATEMENTS AND THE INTERNAL CONTROL OVER FINANCIAL REPORTING

March 19, 2014

FINANCIAL STATEMENTS

Management of Paragon Commercial Corporation is responsible for the preparation, integrity and fair presentation of the consolidated financial statements as of December 31, 2013, and the year then ended. The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and, as such, include amounts, some of which are based on judgments and estimates of management.

INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

Management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) which includes the preparation of the Consolidated Financial Statements of Bank Holding Companies (Form Y-9C) in accordance with the relevant instructions of the Board of Governors of the Federal Reserve System (Federal Reserve instructions) to comply with the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act.

Robert C. Hatley
President and Chief Executive Officer
Paragon Commercial Corporation

Steven E. Crouse
Executive Vice President and Chief Financial Officer
Paragon Commercial Corporation

MANAGEMENT'S ASSESSMENT OF PARAGON COMMERCIAL BANK'S COMPLIANCE WITH LAWS AND REGULATIONS

March 19, 2014

COMPLIANCE WITH LAWS AND REGULATIONS

Management of Paragon Commercial Corporation is responsible for compliance with the federal and state laws and regulations concerning dividend restrictions and federal laws and regulations concerning loans to insiders designated by the FDIC as safety and soundness laws and regulations (the "Designated Laws").

Management assessed its compliance with the Designated Laws and based on this assessment, management concludes that Paragon Commercial Corporation complied with the designated laws and regulations relating to safety and soundness during the year ended December 31, 2013.

Robert C. Hatley

Robert C. Hatley
President and Chief Executive Officer
Paragon Commercial Corporation

Steven E. Crouse

Steven E. Crouse
Executive Vice President and Chief Financial Officer
Paragon Commercial Corporation

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