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**FEDERAL DEPOSIT INSURANCE CORPORATION**  
**Washington, D.C. 20429**

**FORM 10-Q**

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

For the quarterly period ended March 31, 2018

**OR**

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: **n/a**

**CARTER BANK & TRUST**

(Name of registrant as specified in its charter)

**Virginia**

(State or other jurisdiction of  
incorporation or organization)

**20-5539935**

(I.R.S. Employer  
Identification No.)

**1300 Kings Mountain Road, Martinsville, Virginia**

(Address of principal executive offices)

**24112**

(Zip Code)

**(276) 656-1776**

(Registrant's telephone number, including area code)

**n/a**

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232-405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  
Yes [ ] No [ X ]

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

Large accelerated filer [ ]

Accelerated filer [X]

Non-accelerated filer [ ] (Do not check if smaller reporting company)

Smaller reporting company [ ]

Emerging growth company [ ]

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes [ ] No [X]

As of May 9, 2018 there were 26,257,761 shares of the registrant's common stock issued and outstanding.

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## **PART I - FINANCIAL INFORMATION**

### **Item 1 - FINANCIAL STATEMENTS CARTER BANK & TRUST CONSOLIDATED BALANCE SHEETS**

(Dollars in Thousands, except Per Share Data)	(Unaudited)	
	March 31,	December 31,
ASSETS	2018	2017*
Cash and Due From Banks	\$ 52,030	\$ 58,533
Interest-Bearing Deposits in Other Financial Institutions	62,880	58,365
Federal Reserve Bank Excess Reserves	97,367	151,715
<b>Total Cash and Cash Equivalents</b>	<b>212,277</b>	<b>268,613</b>
Securities Available-for-Sale, at Fair Value	954,127	947,201
Loans Held-for-Sale	-	517
Portfolio Loans, net of Unearned Income	2,660,898	2,684,445
Allowance for Loan Losses	(36,866)	(35,318)
<b>Portfolio Loans, net</b>	<b>2,624,032</b>	<b>2,649,127</b>
Bank Premises and Equipment, net	79,896	77,273
Other Real Estate Owned, net	63,263	39,793
Goodwill	58,726	59,762
Bank Owned Life Insurance	50,000	-
Other Assets	70,472	70,006
<b>Total Assets</b>	<b>\$ 4,112,793</b>	<b>\$ 4,112,292</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-Bearing Demand	\$ 574,811	\$ 530,242
Interest-Bearing Demand	264,939	260,979
Money Market	107,624	102,686
Savings	690,315	721,459
Certificates of Deposit	2,031,887	2,054,249
<b>Total Deposits</b>	<b>3,669,576</b>	<b>3,669,615</b>
Other Liabilities	10,340	10,551
<b>Total Liabilities</b>	<b>3,679,916</b>	<b>3,680,166</b>
<b>SHAREHOLDERS' EQUITY</b>		
Common Stock, Par Value \$1 Per Share, Authorized 100,000,000		
Shares; 26,257,761 Outstanding in 2018 and 2017	26,258	26,258
Additional Paid-in-Capital	142,178	142,178
Retained Earnings	274,759	265,930
Accumulated Other Comprehensive Loss	(10,318)	(2,240)
<b>Total Shareholders' Equity</b>	<b>432,877</b>	<b>432,126</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 4,112,793</b>	<b>\$ 4,112,292</b>

See accompanying notes to unaudited consolidated financial statements.

\*Derived from audited consolidated financial statements.

**CARTER BANK & TRUST**  
**CONSOLIDATED STATEMENTS OF INCOME**

(Unaudited) (Dollars in Thousands except Per Share Data)	Three Months Ended March 31,	
	2018	2017
<b>INTEREST INCOME</b>		
Loans, including fees		
Taxable	\$ 26,879	\$ 27,456
Non-Taxable	2,636	2,667
Investment Securities		
Taxable	3,755	3,789
Non-Taxable	1,456	1,152
Interest on Bank Deposits	862	1,289
<b>Total Interest Income</b>	<b>35,588</b>	<b>36,353</b>
<b>Interest Expense</b>		
Interest Expense on Deposits	8,151	9,844
<b>Total Interest Expense</b>	<b>8,151</b>	<b>9,844</b>
<b>NET INTEREST INCOME</b>	<b>27,437</b>	<b>26,509</b>
Provision for Loan Losses	1,515	3,880
<b>Net Interest Income After Provision for Loan Losses</b>	<b>25,922</b>	<b>22,629</b>
<b>NONINTEREST INCOME</b>		
Gains on Sales of Securities, net	868	-
Service Charges, Commissions and Fees	1,252	1,008
Debit Card Interchange Fees	1,133	1,205
Insurance Commissions	535	464
Other Real Estate Owned Income	549	109
Other	394	161
<b>Total Noninterest Income</b>	<b>4,731</b>	<b>2,947</b>
<b>NONINTEREST EXPENSE</b>		
Salaries and Employee Benefits	12,260	10,174
Occupancy Expense, net	2,325	2,106
FDIC Insurance Expense	838	1,129
Other Taxes	477	441
Telephone Expense	669	412
Professional and Legal Fees	1,210	278
Data Processing Licensing Fee	268	1,460
Losses (Gains) on Sales and Write-downs of Other Real Estate Owned, net	291	(52)
Loss on Sales and Write-downs of Bank Premises	51	-
Debit Card Expense	652	619
Tax Credits Amortization	1,015	-
Other Real Estate Owned Expense	531	187
Other	1,972	1,050
<b>Total Noninterest Expense</b>	<b>22,559</b>	<b>17,804</b>
<b>Income Before Taxes</b>	<b>8,094</b>	<b>7,772</b>
Income Tax (Benefit) Provision	(735)	1,470
<b>Net Income</b>	<b>\$ 8,829</b>	<b>\$ 6,302</b>
Earnings per Common Share		
<b>Basic and Diluted</b>	<b>\$ 0.34</b>	<b>\$ 0.24</b>

See accompanying notes to unaudited consolidated financial statements.

**CARTER BANK & TRUST**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Dollars in Thousands)

<b>(Unaudited)</b>	<b>Three Months Ended March 31,</b>	
	<b>2018</b>	<b>2017</b>
Net Income	\$ 8,829	\$ 6,302
Other Comprehensive Loss:		
Unrealized (Gains)/Losses on Securities:		
Net Unrealized Loss Arising during the Period	(9,357)	-
Reclassification Adjustment for Gains included in Net Income	(868)	-
Net Unrealized Loss Recognized in Comprehensive Loss	(10,225)	-
Tax Effect	2,147	-
Other Comprehensive Loss	(8,078)	-
<b>Comprehensive Income</b>	<b>\$ 751</b>	<b>\$ 6,302</b>

See accompanying notes to unaudited consolidated financial statements.

**CARTER BANK & TRUST**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in Thousands)

(Unaudited)	Three Months Ended March 31, 2018	Three Months Ended March 31, 2017
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 8,829	\$ 6,302
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities		
Provision for Loan Losses	1,515	3,880
Origination of Loans Held-for-Sale	(2,338)	-
Proceeds From Loans Held-for-Sale	2,855	-
Depreciation of Bank Premises and Equipment	843	802
Benefit for Deferred Taxes	(911)	-
Net Amortization of Securities	1,082	-
Tax Credits Amortization	1,015	-
Securities Gain, net	(868)	-
Write-downs of Other Real Estate Owned	520	42
Gains on Sales of Other Real Estate Owned, Net	(229)	(52)
Loss on Sales of Bank Premises	51	-
Decrease in Other Assets	2,613	6,681
Decrease in Other Liabilities	(211)	(2,009)
<b>Net Cash Provided By Operating Activities</b>	<b>14,766</b>	<b>15,646</b>
<b>INVESTING ACTIVITIES</b>		
Securities Held-to-Maturity:		
Proceeds from Maturities and Redemptions	-	78,022
Purchases	-	(35,517)
Securities Available-for-Sale:		
Proceeds from Sales	45,377	-
Proceeds from Maturities, Redemptions, and Paydowns	96,202	-
Purchases	(158,944)	-
Purchase of Bank Premises and Equipment, Net	(3,517)	(468)
Loan Originations and Payments, Net	(2,087)	1,575
Purchases of Bank Owned Life Insurance	(50,000)	-
Other Real Estate Owned Improvements	(670)	(14)
Proceeds from Sales of Other Real Estate Owned	2,576	1,533
<b>Net Cash (Used In) Provided By Investing Activities</b>	<b>(71,063)</b>	<b>45,131</b>
<b>FINANCING ACTIVITIES</b>		
Net Change in Demand, Money Markets and Savings Accounts	22,323	14,804
Decrease in Time Deposits	(22,362)	(84,622)
<b>Net Cash Used In Financing Activities</b>	<b>(39)</b>	<b>(69,818)</b>
Net Decrease in Cash and Cash Equivalents	(56,336)	(9,041)
Cash and Cash Equivalents at Beginning of Period	268,613	694,777
<b>Cash and Cash Equivalents at End of Period</b>	<b>\$ 212,277</b>	<b>\$ 685,736</b>

See accompanying notes to unaudited consolidated financial statements.

**CARTER BANK & TRUST**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**

(Dollars in Thousands)

<b>(Unaudited)</b>	<b>Three Months Ended March 31, 2018</b>	<b>Three Months Ended March 31, 2017</b>
<b>Supplementary Data:</b>		
Cash Paid for Interest	\$ 8,442	\$ 10,246
Cash Paid for Income Taxes	\$ -	\$ -
Unrealized Losses on Securities Available-for-Sale	\$ (10,225)	\$ -
Transfer from Loans to Other Real Estate Owned	\$ 26,560	\$ 25
Loans Provided for Sales of Other Real Estate Owned	\$ 893	\$ 1,998

See accompanying notes to unaudited consolidated financial statements.

# **CARTER BANK & TRUST**

## **NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

### **NOTE 1 – BASIS OF PRESENTATION**

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

**Basis of Presentation:** The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial reporting and with applicable quarterly reporting regulations of the Securities and Exchange Commission (the “SEC”). They do not include all of the information and notes required by U.S. GAAP for complete financial statements. Therefore, these consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Carter Bank & Trust Annual Report on Form 10-K for the year ended December 31, 2017. In the opinion of management, the accompanying interim financial information reflects all adjustments, consisting only of normal recurring adjustments, necessary to present fairly our financial position and the results of operations for each of the interim periods presented. Results of operations for interim periods are not necessarily indicative to the results of operations that may be expected for a full year or any future period.

**Reclassification:** Certain reclassifications have been made to the prior period financial statements to conform to the current period presentation. Reclassifications had no effect on prior year net income or shareholders’ equity.

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

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

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

service charges and fees, sales of other real estate, insurance commissions and miscellaneous fees. We have performed an analysis of contracts for customer service charges and miscellaneous income. The adoption of ASU 2016-10 did not have a material impact on our consolidated financial statements.

**Recent Accounting Pronouncements:** In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842).” Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Bank does not expect the adoption of ASU 2016-02 to have a material impact on our consolidated financial statements.

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

In January 2017, the FASB issued ASU No. 2017-04, “Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment”. The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit’s goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are not SEC filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2020. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Bank does not expect the adoption of ASU 2017-04 to have a material impact on our consolidated financial statements.

In March 2017, the FASB issued ASU 2017-08, “Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities.” The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption and provide the disclosures required for a change in accounting principle. The Bank is currently assessing the impact that ASU 2017-08 will have on our consolidated financial statements.

In August 2017, the FASB issued ASU 2017-12, “Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.” The amendments in this ASU modify the designation and measurement guidance for hedge accounting as well as provide for increased transparency regarding the presentation of economic results on both the financial statements and related footnotes. Certain aspects of hedge effectiveness assessments will also be simplified upon implementation of this update. The amendments are effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2018. Early adoption is permitted, including adoption in any interim period. The Bank does not expect the adoption of AUS 2017-12 to have a material impact on our consolidated financial statements.

In February 2018, the FASB issued ASU 2018-03, “Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.” The amendments provide targeted improvements to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Specifically, the amendments include clarifications related to: measurement elections, transition requirements, and adjustments associated with equity securities without readily determinable fair values; fair value measurement requirements for forward contracts and purchased options on equity securities; presentation requirements for hybrid financial liabilities for which the fair value option has been elected; and measurement requirements for liabilities denominated in a foreign currency for which the fair value option has been elected. The amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. Early adoption is permitted. The Bank does not expect the adoption of ASU 2018-03 to have a material impact on our consolidated financial statements.

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 2 - INVESTMENT SECURITIES**

The following table sets forth a summary of the available-for-sale investment securities portfolio as of the periods indicated:

	<b>March 31, 2018</b>			
(Dollars in Thousands)	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
U.S. Government Agency Securities	\$ 302,895	\$ -	\$ (5,952)	\$ 296,943
Residential Mortgage-Backed Securities	83,799	14	(1,713)	82,100
Commercial Mortgage-Backed Securities	26,637	-	(725)	25,912
Asset Backed Securities	42,421	24	(93)	42,352
Collateralized Mortgage Obligations	89,913	4	(1,484)	88,433
Small Business Administration	94,275	75	(1,248)	93,102
States and Political Subdivisions	260,309	1,656	(3,492)	258,473
Corporate Notes	66,938	1	(127)	66,812
<b>Total Debt Securities</b>	<b>\$ 967,187</b>	<b>\$ 1,774</b>	<b>\$ (14,834)</b>	<b>\$ 954,127</b>

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

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

The carrying value of securities pledged to for various regulatory and legal requirements was \$294.1 million at March 31, 2018 and \$295.8 million at December 31, 2017.

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Sales of securities were as follows:

(Dollars in Thousands)	Three Months Ended March 31,	
	2018	2017
Gross Realized Gains	\$ 1,065	\$ -
Gross Realized Losses	(197)	-
Net Realized Gains	868	-
<b>Tax Impact</b>	<b>\$ 182</b>	<b>\$ -</b>

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

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

The amortized cost and fair value of the investment securities portfolio by contractual maturity for the periods presented are as follows. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

Dollars in Thousands)	Available-for-Sale	
	Amortized Cost	Fair Value
<b>March 31, 2018</b>		
<b>U.S Government Agencies, Obligations of States and Political Subdivision, Small Business Administration, and Corporate Notes</b>		
Due in One Year or Less	\$ 102,164	\$ 102,097
Due after One Year through Five Years	371,628	366,046
Due after Five Years through Ten Years	63,097	63,230
Due after Ten Years	187,528	183,957
	<b>724,417</b>	<b>715,330</b>
Residential Mortgage-Backed Securities	83,799	82,100
Commercial Mortgage-Backed Securities	26,637	25,912
Collateralized Mortgage Obligations	89,913	88,433
Asset Backed Securities	42,421	42,352
<b>Total Securities</b>	<b>\$ 967,187</b>	<b>\$ 954,127</b>

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

(Dollars in Thousands)	March 31, 2018								
	Less Than 12 Months			12 Months or More			Total		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
U.S. Government Agency Securities	5	\$ 118,879	\$ 1,116	9	\$ 178,064	\$ 4,836	14	\$ 296,943	\$ 5,952
Residential Mortgage-Backed Securities	34	79,059	1,712	1	52	1	35	79,111	1,713
Commercial Mortgage-Backed Securities	9	25,913	725	-	-	-	9	25,913	725
Asset Backed Securities	11	29,621	93	-	-	-	11	29,621	93
Collateralized Mortgage Obligations	29	77,174	1,484	-	-	-	29	77,174	1,484
Small Business Administration	69	73,469	1,248	-	-	-	69	73,469	1,248
States and Political Subdivisions	103	162,299	3,446	11	6,999	46	114	169,298	3,492
Corporate Notes	9	41,062	116	3	11,989	11	12	53,051	127
<b>Total Debt Securities</b>	<b>269</b>	<b>\$ 607,476</b>	<b>\$ 9,940</b>	<b>24</b>	<b>\$ 197,104</b>	<b>\$ 4,894</b>	<b>293</b>	<b>\$ 804,580</b>	<b>\$ 14,834</b>

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

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**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

As of March 31, 2018, no OTTI has been identified for any investment securities in the Bank’s portfolio. The Bank does not believe any individual unrealized loss as of March 31, 2018 represents an other than temporary impairment, or OTTI. At March 31, 2018 there were 293 securities in an unrealized loss position and at December 31, 2017 there were 218 debt securities in an unrealized loss position. The unrealized losses on debt securities were primarily attributable to changes in interest rates and not related to the credit quality of these securities. All debt securities are determined to be investment grade and are paying principal and interest according to the contractual terms of the security. The Bank generally does not intend to sell and it is not more likely than not that the Bank will be required to sell any of the securities in an unrealized loss position before recovery of their amortized cost.

**NOTE 3 – LOANS AND LOANS HELD-FOR-SALE**

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

(Dollars in Thousands)	March 31, 2018 (Unaudited)	December 31, 2017
<b>Commercial</b>		
Commercial Real Estate	\$ 1,359,930	\$ 1,536,957
Commercial and Industrial	913,242	803,833
Commercial Construction	153,236	118,786
<b>Total Commercial Loans</b>	<b>2,426,408</b>	<b>2,459,576</b>
<b>Consumer</b>		
Residential Mortgages	147,710	136,895
Other Consumer	79,080	79,980
Consumer Construction	7,700	7,994
<b>Total Consumer Loans</b>	<b>234,490</b>	<b>224,869</b>
<b>Total Portfolio Loans</b>	<b>2,660,898</b>	<b>2,684,445</b>
Loans Held- for- Sale	-	517
<b>Total Loans</b>	<b>\$ 2,660,898</b>	<b>\$ 2,684,962</b>

The Bank purchases mortgage loans from another financial institution with fully executed contracts with investors. The Bank then holds the loans until funded by the investor. There were no loans held-for-sale as of March 31, 2018. The amount of these loans held-for-sale at December 31, 2017 was \$0.5 million.

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 4 - ALLOWANCE FOR LOAN LOSSES**

The following table presents, by portfolio segment, the changes in the allowance for loan losses and the allocation of the allowance for loan losses for the three month periods ended March 31, 2018 and 2017 and for the year December 31, 2017:

(Dollars in Thousands)	<b>Real Estate</b>	<b>Consumer &amp; Other Loans</b>	<b>Commercial &amp; Industrial</b>	<b>Obligations Of States and Political Sub.</b>	<b>Total</b>
<b>March 31, 2018</b>					
Allowance for Loan Losses:					
Balance: Beginning of Period	\$ 33,367	\$ 288	\$ 1,203	\$ 460	\$ 35,318
Provision Charged to Expense	921	120	485	(11)	1,515
Losses Charged Off	(231)	(218)	-	-	(449)
Recoveries	379	103	-	-	482
<b>Balance, End of Period</b>	<b>\$ 34,436</b>	<b>\$ 293</b>	<b>\$ 1,688</b>	<b>\$ 449</b>	<b>\$ 36,866</b>

(Dollars in Thousands)	<b>Real Estate</b>	<b>Consumer &amp; Other Loans</b>	<b>Commercial &amp; Industrial</b>	<b>Obligations Of States and Political Sub.</b>	<b>Total</b>
<b>March 31, 2017</b>					
Allowance for Loan Losses:					
Balance: Beginning of Period	\$ 32,476	\$ 82	\$ 1,480	\$ 462	\$ 34,500
Provision Charged to Expense	3,894	42	(67)	11	3,880
Losses Charged Off	(347)	(146)	(32)	-	(525)
Recoveries	-	98	-	-	98
<b>Balance, End of Period</b>	<b>\$ 36,023</b>	<b>\$ 76</b>	<b>\$ 1,381</b>	<b>\$ 473</b>	<b>\$ 37,953</b>

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

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

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Dollars in Thousands)	<b>Real Estate</b>	<b>Consumer &amp; Other Loans</b>	<b>Commercial &amp; Industrial</b>	<b>Obligations Of States and Political Sub.</b>	<b>Total</b>
<b>March 31, 2018</b>					
<b>Allowance for Loan Losses:</b>					
Individually Evaluated for Impairment	\$ 544	\$ -	\$ -	\$ -	\$ 544
Collectively Evaluated for Impairment	33,892	293	1,688	449	36,322
<b>Total Loans:</b>					
Individually Evaluated for Impairment	\$ 132,380	\$ -	\$ 266,653	\$ -	\$ 399,033
Collectively Evaluated for Impairment	1,536,196	79,084	189,476	457,113	2,261,869

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

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

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**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Impaired Loans**

The following table includes the recorded investment and unpaid principal balance for impaired loans, excluding purchased impaired loans, with the associated allowance, if applicable at March 31, 2018 and December 31, 2017:

(Dollars in Thousands)	Unpaid Principal Balance	Recorded Balance	Specific Allowance	Average Investment in Impaired Loans	Interest Income Recognized
<b>March 31, 2018</b>					
<b>Loans without a Specific Valuation Allowance</b>					
Real Estate	\$ 127,918	\$ 127,918	\$ -	\$ 125,347	\$ 485
Consumer	-	-	-	-	-
Commercial and Industrial	266,653	266,653	-	292,986	2,986
Obligations of States and Political Subs	-	-	-	-	-
<b>Loans with a specific valuation allowance</b>					
Real Estate	4,462	4,462	544	4,521	5
Consumer	-	-	-	-	-
Commercial and Industrial	-	-	-	-	-
Obligations of States and Political Subs	-	-	-	-	-
<b>Total by Category</b>					
Real Estate	132,380	132,380	544	129,868	490
Consumer	-	-	-	-	-
Commercial and Industrial	266,653	266,653	-	292,986	2,986
Obligations of States and Political Subs	-	-	-	-	-
<b>Total Impaired Loans</b>	<b>\$ 399,033</b>	<b>\$ 399,033</b>	<b>\$ 544</b>	<b>\$ 422,854</b>	<b>\$ 3,476</b>

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Dollars in Thousands)	Unpaid Principal	Recorded	Specific	Average	Interest Income
<b>December 31, 2017</b>	<b>Balance</b>	<b>Balance</b>	<b>Allowance</b>	<b>Investment</b>	<b>Recognized</b>
				<b>in Impaired Loans</b>	
<b>Loans without a Specific Valuation Allowance</b>					
Real Estate	\$ 229,894	\$ 229,894	\$ -	\$ 252,714	\$ 6,660
Consumer	21	21	-	64	-
Commercial and Industrial	215,802	215,802	-	301,649	14,932
Obligations of States and Political Subs	-	-	-	-	-
<b>Loans with a Specific Valuation Allowance</b>					
Real Estate	981	981	32	879	45
Consumer	-	-	-	-	-
Commercial and Industrial	-	-	-	-	-
Obligations of States and Political Subs	-	-	-	-	-
<b>Total by Category</b>					
Real Estate	230,875	230,875	32	253,593	6,705
Consumer	21	21	-	64	-
Commercial and Industrial	215,802	215,802	-	301,649	14,932
Obligations of States and Political Subs	-	-	-	-	-
<b>Total Impaired Loans</b>	<b>\$ 446,698</b>	<b>\$ 446,698</b>	<b>\$ 32</b>	<b>\$ 555,306</b>	<b>\$ 21,637</b>

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

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Troubled Debt Restructurings**

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

(Dollars in Thousands)	March 31, 2018			December 31, 2017		
	Performing TDRs	Nonperforming TDRs	Total TDRs	Performing TDRs	Nonperforming TDRs	Total TDRs
Real Estate	\$ 61,994	\$ 52,295	\$ 114,289	\$ 121,465	\$ 41,804	\$ 163,269
Consumer	-	-	-	-	-	-
Commercial	265,556	-	265,556	133,182	-	133,182
<b>Total TDRs</b>	<b>\$ 327,550</b>	<b>\$ 52,295</b>	<b>\$ 379,845</b>	<b>\$ 254,647</b>	<b>\$ 41,804</b>	<b>\$ 296,451</b>

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

The Bank had four loans modified as TDR’s for the three months ending March 31, 2018 totaling \$130.6 million in post modification balances. Three of the TDR’s totaling \$98.3 million were real estate loans and the fourth TDR totaling \$32.3 million was a commercial and industrial loan. One TDR of \$57.9 million involved modifying the terms of note from contractual principal and interest payments to a single pay loan structure with interest and principal due at maturity. The modification was a result of the borrower experiencing financial difficulties and the single pay structure allows the borrower adequate time to liquidate the collateral and satisfy the Bank’s outstanding loan balance. One TDR of \$32.3 million involved the customer offering additional collateral as part of a forbearance agreement to cure a collateral deficiency in exchange for the Bank renewing the loan and extending the maturity where we would not be enticed to do so without additional collateral. The last two TDR’s totaling \$40.4 million involved the borrower offering additional collateral and entering into a forbearance agreement with the Bank which established a formal liquidation plan for the borrower to market and sell the collateral and satisfy the Bank’s outstanding loan balance.

The Bank had two real estate loans modified as TDRs for the three months ended March 31, 2017 totaling \$19.7 million in post modification balances. The first TDR in the amount of \$16.3 million involved a rate reduction to a level that was not commensurate with a commercial real estate loan. The second TDR in the amount of \$3.4 million involved principal forgiveness in the amount of \$4.3 million. There were no TDR payment defaults during the three months ending March 31, 2018 and 2017. For purposes of this disclosure, a TDR payment default occurs when, within 12 months of the original TDR modification, either a full or partial charge-off occurs or a TDR becomes 90 days or more past due.

The specific reserve portion of the allowance for loan losses on TDRs, if required, is determined by discounting the restructured cash flow at the original effective rate of the loan before modification or is based on the fair value of the collateral less cost to sell, if repayment of the loan is collateral dependent. If the resulting amount is less than the recorded book value, the Bank either establishes a valuation allowance as a component of the allowance for loan losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

consistently for all segments of the portfolio. As of March 31, 2018, there was one specific reserve allocated in the amount of \$0.5 million.

As of March 31, 2018 and December 31, 2017, the Bank had \$270 thousand and \$384 thousand, respectively of residential real estate in the process of foreclosure. The Bank had \$45 thousand at March 31, 2018 and \$315 thousand at December 31, 2017 in residential real estate included in other real estate owned (“OREO”).

**Portfolio Quality Indicators:**

The Bank’s portfolio grading analysis estimates the capability of the borrower to repay the contractual obligations of the loan agreements as scheduled or at all. The Bank’s internal credit risk grading system is based on debt service coverage.

The Bank’s internally assigned grades are as follows:

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

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

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

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

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

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**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

(Dollars in Thousands)		Consumers &	Commercial &	Obligations	
<b>March 31, 2018</b>	<b>Real Estate</b>	<b>Other Loans</b>	<b>Industrial</b>	<b>Of States and</b>	<b>Total</b>
				<b>Political Sub.</b>	
Pass	\$ 1,308,751	\$ 78,992	\$ 37,815	\$ 457,113	\$ 1,882,671
Special Mention	25,914	36	108,670	-	134,620
Substandard	333,911	52	309,644	-	643,607
Doubtful	-	-	-	-	-
Loss	-	-	-	-	-
<b>Total Loans, net of Unearned Income</b>	<b>\$ 1,668,576</b>	<b>\$ 79,080</b>	<b>\$ 456,129</b>	<b>\$ 457,113</b>	<b>\$ 2,660,898</b>
Performing Loans	\$ 1,606,039	\$ 79,080	\$ 456,129	\$ 457,113	\$ 2,598,361
Non-Accrual Loans	62,537	-	-	-	62,537
<b>Total Loans, net of Unearned Income</b>	<b>\$ 1,668,576</b>	<b>\$ 79,080</b>	<b>\$ 456,129</b>	<b>\$ 457,113</b>	<b>\$ 2,660,898</b>

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

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

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

(Dollars in Thousands)	Loans 30-59 Days Past Due	Loans 60-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due	Current Loans	Non-Accrual Loans	Total Loans	Accruing Loans More Than 90 Past Due
<b>March 31, 2018</b>								
Real Estate Loans	\$ 4,545	\$ 1,697	\$ 624	\$ 6,866	\$ 1,599,173	\$ 62,537	\$ 1,668,576	\$ 624
Consumer Loans	365	223	66	654	78,426	-	79,080	66
C & I Loans	34	1	-	35	456,094	-	456,129	-
States and Political Sub.	-	-	-	-	457,113	-	457,113	-
<b>Total</b>	<b>\$ 4,944</b>	<b>\$ 1,921</b>	<b>\$ 690</b>	<b>\$ 7,555</b>	<b>\$ 2,590,806</b>	<b>\$ 62,537</b>	<b>\$ 2,660,898</b>	<b>\$ 690</b>

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

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**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Nonperforming assets consist of nonaccrual loans, nonaccrual TDRs and OREO. The following table summarizes nonperforming assets for the dates presented:

<b>Nonperforming Loans</b>	<b>March 31, 2018</b>	<b>December 31, 2017</b>
Real Estate	\$ 10,242	\$ 51,047
Consumer	-	47
Commercial	-	-
<b>Total Nonperforming Loans</b>	<b>10,242</b>	<b>51,094</b>
<b>Nonperforming Troubled Debt Restructurings</b>		
Real Estate	52,295	41,804
Consumer	-	-
Commercial	-	-
<b>Total Nonperforming Troubled Debt Restructurings</b>	<b>52,295</b>	<b>41,804</b>
<b>Total Nonperforming Loans</b>	<b>62,537</b>	<b>92,898</b>
Other Real Estate Owned	63,263	39,793
<b>Total Nonperforming Assets</b>	<b>\$ 125,800</b>	<b>\$ 132,691</b>
Nonperforming Loans to Total Portfolio Loans	2.35%	3.46%
Nonperforming Assets to Total Portfolio Loans plus OREO	4.62%	4.87%

Nonperforming assets, or NPAs, decreased \$6.9 million to \$125.8 million at March 31, 2018 compared to \$132.7 million at December 31, 2017. The decrease was due to a \$30.4 million decline in nonperforming loans offset by a \$23.5 million increase in OREO. The increase in other real estate owned was primarily due to the transfer of six commercial real estate properties, to one credit relationship totaling \$26.4 million, to OREO during the first quarter of 2018 of which four are currently under contract and expected to close in the second and third quarters of 2018. One additional commercial real estate property in the same credit relationship, which was transferred to OREO during the fourth quarter of 2017 in the amount of \$1.2 million, is also currently under contract. There are no additional losses to be recognized on this credit relationship due to the impending contracts.

The following table summarizes loans past due 30-89 days for the periods presented:

<b>Loans 30 to 89 Days Past Due</b>	<b>March 31, 2018</b>	<b>December 31, 2017</b>
Real Estate	\$ 6,242	\$ 5,443
Consumer	588	392
Commercial	35	161
<b>Total Loans</b>	<b>\$ 6,865</b>	<b>\$ 5,996</b>

The following table summarizes loans past due 90 days or more and still accruing for the periods presented:

<b>Loans 90 Days or More Past Due and Still Accruing</b>	<b>March 31, 2018</b>	<b>December 31, 2017</b>
Real Estate	\$ 624	\$ 493
Consumer	66	59
Commercial	-	4
<b>Total Loans 90 Days or More Past Due</b>	<b>\$ 690</b>	<b>\$ 556</b>

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Loans past due 30 to 89 days increased by \$0.9 million to \$6.9 million at March 31, 2018 compared to \$6.0 million at December 31, 2017. Loans past due 90 days or more and still accruing increased \$134 thousand to \$690 thousand compared to \$556 thousand at December 31, 2017.

**NOTE 5 – FAIR VALUE MEASUREMENTS**

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

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

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

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

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

**Securities:** The fair values of securities available-for-sale are determined by obtaining quoted prices on nationally recognized securities exchanges, if available. This valuation method is classified as Level 1 in the fair value hierarchy. For securities where quoted prices are not available, fair values are calculated on market prices of similar securities, or matrix pricing, which is a mathematical technique, used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Matrix pricing relies on the securities' relationship to similarly traded securities, benchmark curves, and the benchmarking of like securities. Matrix pricing utilizes observable market inputs such as benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, reference data, and industry and economic events. In instances where broker quotes are used, these quotes are obtained from market makers or broker-dealers recognized to be market participants. This valuation method is classified as Level 2 in the fair value hierarchy. For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators.

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

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

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

**Other Real Estate Owned (“OREO”):** OREO is evaluated at the time of acquisition and recorded at fair value as determined by independent appraisal or internal evaluation less costs to sell. Our quarterly evaluations of OREO for impairment are driven by property type. For smaller dollar single family homes, we consult with staff from our special assets group as well as external realtors and appraisers. Based on these consultations, we determine asking prices for OREO properties we are marketing for sale. If the internally evaluated fair value or asking price is below our recorded investment in the property, appropriate write-downs are taken.

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

Description	Quoted Prices In			Significant Unobservable Inputs (Level 3)
	Carrying Value	Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	
<b>Available-for-sale securities</b>				
U.S. Government Agency Securities	\$ 296,943	\$ —	\$ 296,943	\$ —
Residential Mortgage-Backed Securities	82,100	—	82,100	—
Commercial Mortgage-Backed Securities	25,912	—	25,912	—
Asset Backed Securities	42,352	—	42,352	—
Collateralized Mortgage Obligations	88,433	—	88,433	—
Small Business Administration	93,102	—	93,102	—
States and Political Subdivisions	258,473	—	258,473	—
Corporate Notes	66,812	—	66,812	—
<b>Total</b>	<b>\$ 954,127</b>	<b>\$ —</b>	<b>\$ 954,127</b>	<b>\$ —</b>

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

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

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

(Dollars in Thousands)					
<b>March 31, 2018</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Fair Value</b>	
OREO	\$ -	\$ -	\$ 63,263	\$ 63,263	
Impaired Loans	\$ -	\$ -	\$ 3,918	\$ 3,918	
<b>December 31, 2017</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Fair Value</b>	
OREO	\$ -	\$ -	\$ 39,793	\$ 39,793	
Impaired Loans	\$ -	\$ -	\$ 949	\$ 949	

Impaired loans had a carrying amount of \$3.9 million at March 31, 2018 with a valuation allowance of \$0.5 million, resulting in \$0.5 million additional provision for loan losses for the three months ended March 31, 2018. Impaired loans had a carrying amount of \$389 thousand at March 31, 2017 with a valuation allowance of \$2.4 million, resulting in \$2.2 million additional provision for loan losses for the three months ended March 31, 2017. At December 31, 2017, impaired loans had a carrying amount of \$949 thousand, with a valuation allowance of \$32 thousand.

OREO, which is measured at the lower of carrying or fair value less costs to sell, had a net carrying amount of \$63.3 million as of March 31, 2018, compared with \$39.8 million at December 31, 2017. Write-downs of \$0.5 million were recorded on OREO for the three months ended March 31, 2018 compared to \$41 thousand for the three months ended March 31, 2017, respectively.

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

(Dollars in Thousands)

<b>March 31, 2018</b>	<b>Fair Value</b>	<b>Valuation Technique</b>	<b>Unobservable Inputs</b>	<b>Weighted Range</b>	<b>Average</b>
<b>Assets</b>					
Impaired Loans	\$ 3,521	Discounted Cash Flow	Discount Rate	6.5%	6.5%
Impaired Loans	397	Net Present Value	Discount Rate	5.5%	5.5%
<b>Total Impaired Loans</b>	<b>\$ 3,918</b>				
Other Real Estate Owned	\$ 19,863	Discounted Appraisals	Discount & Selling Costs	20.0% - 21.2%	21.0%
Other Real Estate Owned	43,400	Appraisals	Selling Costs	0.0% - 10.0%	5.2%
<b>Total Other Real Estate Owned</b>	<b>\$ 63,263</b>				

(Dollars in Thousands)

<b>December 31, 2017</b>	<b>Fair Value</b>	<b>Valuation Technique</b>	<b>Unobservable Inputs</b>	<b>Weighted Range</b>	<b>Average</b>
<b>Assets</b>					
Impaired Loans	\$ 949	Net Present Value	Discount Rate	5.5 - 6.5%	5.5%
<b>Total Impaired Loans</b>	<b>\$ 949</b>				
Other Real Estate Owned	\$ 20,491	Discounted Appraisals	Discount & Selling Costs	20.0 - 21.2%	21.0%
Other Real Estate Owned	19,302	Appraisals	Selling Costs	0.0% - 10.0%	6.0%
<b>Total Other Real Estate Owned</b>	<b>\$ 39,793</b>				

The carrying values and exit pricing concept fair valued of the Bank's financial statement instruments at March 31, 2018 are as follows:

(Dollars in Thousands)

**Fair Value Measurements at March 31, 2018**

<b>Financial Assets:</b>	<b>Carrying Value</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Cash and Cash Equivalents	\$ 212,277	\$ 52,030	\$ 160,247	\$ -	\$ 212,277
Securities Available-for-Sale	954,127	-	954,127	-	954,127
Loans Held-for-Sale	-	-	-	-	-
Portfolio Loans, net of Unearned Income	2,660,898	-	-	2,544,561	2,544,561
Bank Owned Life Insurance	50,000	-	50,000	-	50,000
Accrued Interest Receivable	16,957	-	4,532	12,425	16,957
<b>Financial Liabilities:</b>					
Deposits	\$3,669,576	\$ 574,811	\$ 3,074,143	\$ -	\$ 3,648,954
Accrued Interest Payable	1,911	-	1,911	-	1,911

The carrying values and estimated fair values of the Bank's financial statement instruments at December 31, 2017 are as follows:

(Dollars in Thousands)

**Fair Value Measurements at December 31, 2017**

<b>Financial Assets:</b>	<b>Carrying Value</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Cash and Cash Equivalents	\$ 268,613	\$ 58,533	\$ 210,080	\$ -	\$ 268,613
Securities Available-for-Sale	947,201	-	947,201	-	947,201
Loans Held-for-Sale	517	-	-	517	517
Portfolio Loans, net of Unearned Income	2,684,445	-	-	2,667,737	2,667,737
Accrued Interest Receivable	21,271	-	6,026	15,245	21,271
<b>Financial Liabilities:</b>					
Deposits	\$ 3,669,615	\$ 530,242	\$ 3,136,640	\$ -	\$ 3,666,882
Accrued Interest Payable	2,202	-	2,202	-	2,202

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

**(a) Cash and Cash Equivalents**

The carrying amounts of cash and short-term instruments approximate fair values and are classified as either Level 1 or Level 2. Non-interest bearing deposits are Level 1 and interest bearing due from bank accounts and FRB excess reserves are Level 2.

**(b) Securities**

Fair values of investment securities are valued using Level 2 techniques similar to as described earlier for available-for-sale securities.

**(c) Loans Held-for-Sale and Portfolio Loans, Net of Unearned Income**

Fair values of loans are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The carrying value of loans held-for-sale approximates the fair value. Loans held-for-sale include purchased mortgage loans from another financial institution with fully executed contracts with an investor. These loans are held until funded by the investor, typically a two-week period.

**(d) Bank Owned Life Insurance**

Bank owned life insurance represents insurance policies on officers of the Bank. The cash value of the policies is an estimate using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

**(d) Deposits**

The fair values disclosed for non-interest bearing deposits are, by definition, equal to the amount payable on demand at the reporting date resulting in a Level 1 classification. The carrying amounts of variable rate interest bearing deposits approximate their fair values at the reporting date resulting in a Level 2 classification. Fair values for fixed rate interest bearing deposits are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

**(e) Accrued Interest Receivable/Payable**

The carrying amounts of accrued interest approximate fair value resulting in a Level 2 or Level 3 classification based on the level of the asset or liability with which the accrual is associated.

**NOTE 6 – REVENUE RECOGNITION**

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

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

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

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

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

**Insurance Commissions:** Commission income is earned based on customer transactions. The commission income is recognized when the transaction is complete. The Bank also receives commission on its investment in VBIC, LLC on an annual basis based on current year's transactions.

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

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

**CARTER BANK & TRUST**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

<u>(Dollars in Thousands)</u>	<u>Point of Revenue Recognition</u>	<u>For the Three Months Ended March 31, 2018</u>
<u>Revenue Streams</u>		
Service Charges on Deposit Accounts	At a point in time	\$ 612
Other Fees and Other Income	At a point in time	660
Debit Card Interchange Fees	At a point in time	1,133
Insurance Commissions		
Customer Commissions	At a point in time	535
Annual Commission on Investment	Over time	-
Other Real Estate Income Owned	At a point in time	549
Gains/Losses on Sales of Other Real Estate Owned	At a point in time	**

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

**NOTE 7 – OFF-BALANCE SHEET ARRANGEMENTS**

Commitments to extend credit, which amounted to \$307.6 million at March 31, 2018 and \$278.7 million at December 31, 2017, respectively, represent agreements to lend to customers with fixed expiration dates or other termination clauses. Since many of the commitments are expected to expire without being funded, the total commitment amounts do not necessarily represent future liquidity requirements. Standby letters of credit are conditional commitments issued by the Bank guaranteeing the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The Bank had outstanding letters of credit in the amount of \$39.9 million at March 31, 2018 and \$38.7 million at December 31, 2017.

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

Our allowance for unfunded commitments is determined using a methodology similar to that used to determine the ALL. Amounts are added to the allowance for unfunded commitments through a charge to current earnings in noninterest expense. The balance in the allowance for unfunded commitments was \$0.5 million at March 31, 2018 and \$0.1 million at December 31, 2017. The allowance for unfunded commitments is included in other liabilities in the Consolidated Balance Sheets and is determined using a similar methodology as our ALL methodology. The reserve is calculated by applying historical loss rates and qualitative adjustments to our unfunded commitments.

## **CARTER BANK & TRUST**

### **ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Management’s Discussion and Analysis of Financial Condition and Results of Operations, or (“MD&A”), represents an overview of our consolidated results of operations and financial condition and highlights material changes in our financial condition and results of operations as of and for the three month periods ended March 31, 2018 and 2017. Our MD&A should be read in conjunction with our Consolidated Financial Statements and notes thereto. The results of operations reported in the accompanying Consolidated Financial Statements are not necessarily indicative of results to be expected in future periods.

#### **Important Note Regarding Forward-Looking Statements**

This quarterly report on Form 10-Q contains or incorporates statements that the Bank believes are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements generally relate to our financial condition, results of operations, plans, objectives, outlook for earnings, revenues, expenses, capital and liquidity levels and ratios, asset levels, asset quality, financial position, and other matters regarding or affecting the Bank and its future business and operations. Forward looking statements are typically identified by words or phrases such as “will likely result,” “expect,” “anticipate,” “estimate,” “forecast,” “project,” “intend,” “believe,” “assume,” “strategy,” “trend,” “plan,” “outlook,” “outcome,” “continue,” “remain,” “potential,” “opportunity,” “believe,” “comfortable,” “current,” “position,” “maintain,” “sustain,” “seek,” “achieve” and variations of such words and similar expressions, or future or conditional verbs such as will, would, should, could or may. Although the Bank believes the assumptions upon which these forward-looking statements are based are reasonable, any of these assumptions could prove to be inaccurate and the forward-looking statements based on these assumptions could be incorrect. The matters discussed in these forward-looking statements are subject to various risks, uncertainties and other factors that could cause actual results and trends to differ materially from those made, projected, or implied in or by the forward-looking statements depending on a variety of uncertainties or other factors including, but not limited to: credit losses; cyber-security concerns; rapid technological developments and changes; sensitivity to the interest rate environment including a prolonged period of low interest rates, a rapid increase in interest rates or a change in the shape of the yield curve; a change in spreads on interest-earning assets and interest-bearing liabilities; regulatory supervision and oversight; legislation affecting the financial services industry as a whole, and the Bank, in particular; the outcome of pending and future litigation and governmental proceedings; increasing price and product/service competition; the ability to continue to introduce competitive new products and services on a timely, cost-effective basis; managing our internal growth and acquisitions; the possibility that the anticipated benefits from acquisitions cannot be fully realized in a timely manner or at all, or that integrating the acquired operations will be more difficult, disruptive or costly than anticipated; containing costs and expenses; reliance on significant customer relationships; general economic or business conditions; deterioration of the housing market and reduced demand for mortgages; deterioration in the overall macroeconomic conditions or the state of the banking industry that could warrant further analysis of the carrying value of goodwill and could result in an adjustment to its carrying value resulting in a non-cash charge to net income; re-emergence of turbulence in significant portions of the global financial and real estate markets that could impact our performance, both directly, by affecting our revenues and the value of our assets and liabilities, and indirectly, by affecting the economy generally and access to capital in the amounts, at the times and on the terms required to support our future businesses. Many of these factors, as well as other factors, are described in our Annual Report on Form 10-K for the year ended December 31, 2017, including Part I, Item 1A, Risk Factors and any of our subsequent filings with the FDIC. Forward-looking statements are based on beliefs and assumptions using information available at the time the statements are made. The Bank cautions you not to unduly rely on forward-looking statements because the

## **CARTER BANK & TRUST**

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

assumptions, beliefs, expectations and projections about future events may, and often do, differ materially from actual results. Any forward-looking statement speaks only as to the date on which it is made, and the Bank undertakes no obligation to update any forward-looking statement to reflect developments occurring after the statement are made.

#### **Critical Accounting Policies and Estimates**

Our critical accounting policies involving significant judgments and assumptions used in the preparation of the Consolidated Financial Statements as of March 31, 2018 have remained unchanged from the disclosures presented in our Annual Report on Form 10-K for the year ended December 31, 2017 under the section "Management's Discussion and Analysis of Financial Condition and Results of Operations."

#### **Overview**

Carter Bank & Trust (the "Bank") is a non-member state Bank headquartered in Martinsville, Virginia with assets of \$4.1 billion at March 31, 2018. The Bank operates branches in Virginia and North Carolina. The Bank provides a full range of financial services with retail, and commercial banking products and insurance. Our common stock trades on the OTCQX Best Market, under the symbol "CARE."

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

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

Our focus continues to be on loan and deposit growth and implementing opportunities to increase fee income while closely monitoring our operating expenses. The Bank is focused on executing our strategy to successfully build our brand and grow our business in our markets. We have benefited from our strategy to deploy our excess cash into higher yielding and diversified investment securities as well as the runoff of higher cost deposits. While the Bank has benefited from recent increases in short-term interest rates, the low interest rate environment still remains a challenge for our net interest income. The Bank has been able to mitigate the impact of lower rates through loan growth offset by pay downs on legacy credits. The Bank expects to benefit from any future increases in interest rates.

#### **Earnings Summary**

Net interest income increased \$0.9 million to \$27.4 million during the first three months of 2018 as compared to the same period of 2017. The increase in net interest income is primarily driven by a \$1.7 million decrease in interest expense during the first three months of 2018 as compared to the same period of 2017 primarily due to the intentional runoff of higher cost certificates of deposit. The net interest margin, on a fully taxable equivalent basis,

## **CARTER BANK & TRUST**

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

increased 30 basis points to 3.04% over the past twelve months, despite the negative impact of a lower taxable equivalent adjustment due to a lower statutory tax rate, offset by our deployment of excess cash into higher yielding and diversified investment securities as well as the aforementioned runoff of higher cost deposits.

The provision for loan losses totaled \$1.5 million for the first three months of 2018 as compared to \$3.9 million for the same period of 2017, a decrease of \$2.4 million or 61.0%. Net charge-offs (recoveries) were \$(33) thousand for the first three months of 2018 as compared to \$427 thousand in the same period of 2017.

Noninterest income increased \$1.0 million, or 31.1%, to \$3.9 million, excluding net securities gains, for the three months ending March 31, 2018 as compared to \$2.9 million in the same period of 2017. The increase in noninterest income included \$0.4 million higher income from other real estate owned due to the acquisition of several properties generating income during the period, increased service charges of \$0.2 million, increased insurance commissions of \$0.1 million and the gain on the sale of our insurance agency during the first quarter of 2018.

Securities gains of \$0.9 million were realized during the first three months of 2018 to take advantage of market opportunities and reduce the credit risk of the securities portfolio.

Noninterest expense increased \$4.8 million, or 26.7%, to \$22.6 million for the three months ended March 31, 2018 as compared to \$17.8 million in the same period of 2017. The increase is primarily due to an increase in salaries and employee benefits expense of \$2.1 million, an increase in professional and legal fees of \$0.9 million, \$1.0 million of tax credit amortization, an increase of \$0.3 in other real estate owned expense and a \$0.3 million increase in the reserve for unfunded loan commitments, included in other expenses. The increase in salaries and benefits was expected and planned as investments were made in the appropriate infrastructure to support the Bank in the future. Other real estate owned expense increased due to the acquisition of several properties during the first quarter of 2018. Offsetting these increases were decreases of \$1.2 million in data processing expenses, due to the write-off of expenses that were previously capitalized that were fully expensed during 2017 and a decrease of \$0.3 million in FDIC insurance expense attributable to lower FDIC assessment rates and a decrease in the assessment base.

The provision for income taxes was a tax benefit of \$0.7 million in the first three months of 2018 as a result of pretax income of \$8.1 million as compared to a tax provision of \$1.5 million in the same period of 2017 and pretax income of \$7.8 million. The tax benefit in the first quarter of 2018 was primarily due to benefits resulting from tax-exempt interest income and a tax credit project.

The effective tax rate was negative 9% for the tax benefit in the first quarter of 2018 and 19% for the tax expense in the comparable period of 2017. The Bank ordinarily generates an annual effective tax rate that is less than the statutory rate for each period (which was 21% for the first quarter of 2018 and 35% for the first quarter of 2017) due primarily to benefits resulting from tax-exempt interest income and a tax credit project.

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

In addition to the results of operations presented in accordance with generally accepted accounting principles, or GAAP, in the United States, management uses, and this quarterly report references, net interest income on a fully taxable equivalent, or ("FTE"), basis, which is a non-GAAP financial measure. Management believes this measure provides information useful to investors in understanding our underlying business, operational performance and

## CARTER BANK & TRUST

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

performance trends as it facilitates comparisons with the performance of other companies in the financial services industry. Although management believes that this non-GAAP financial measure enhance investors' understanding of our business and performance, this non-GAAP financial measure should not be considered an alternative to GAAP or considered to be more important than financial results determined in accordance with GAAP, nor is it necessarily comparable with non-GAAP measures which may be presented by other companies.

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

#### RESULTS OF OPERATIONS

##### Three Months Ended March 31, 2018 Compared to Three Months Ended March 31, 2017

##### Net Interest Income

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

The interest income on interest-earning assets and the net interest margin are presented on an FTE basis. The FTE basis adjusts for the tax benefit of income on certain tax-exempt loans and securities using the federal corporate tax rate for each period (which was 21% for March 31, 2018 and 35% for March 31, 2017) and the dividend-received deduction for equity securities. The Bank believes this to be the preferred industry measurement of net interest income that provides a relevant comparison between taxable and non-taxable sources of interest income.

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

(Dollars in Thousands)	Three Months Ended	
	March 31, 2018	March 31, 2017
Total Interest Income	\$35,588	\$36,353
Total Interest Expense	8,151	9,844
Net Interest Income	27,437	26,509
Adjustment to FTE Basis	1,087	2,057
<b>Net Interest Income (FTE) (non-GAAP)</b>	<b>\$28,524</b>	<b>\$28,566</b>
Net Interest Margin	2.92%	2.54%
Adjustment to FTE Basis	0.12	0.20
<b>Net Interest Income (FTE) (non-GAAP)</b>	<b>3.04%</b>	<b>2.74%</b>

## CARTER BANK & TRUST

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Net interest income, on a fully taxable equivalent basis, was essentially flat even with the negative impact of a lower taxable equivalent adjustment due to a lower corporate tax rate, as compared to the same period in 2017. Interest income, on a fully taxable equivalent basis, declined \$1.7 million and interest expense decreased by \$1.7 million. The decrease in interest expense is primarily driven by the intentional runoff of higher cost certificates of deposit. The net interest margin, on an FTE basis, increased 30 basis points for the three months ended March 31, 2018 as compared to the same period in 2017. The increase was primarily due to the deployment of excess cash into higher yielding and diversified investment securities as well as the runoff of higher cost deposits.

The following table provides information regarding the average balances, interest and rates earned on interest-earning assets and the average balances, interest and rates paid on interest-bearing liabilities for the periods presented:

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

(Dollars in Thousands)	Three Months Ended March 31, 2018			Three Months Ended March 31, 2017		
	Average Balance	Income/Expense	Rate	Average Balance	Income/Expense	Rate
<b>ASSETS</b>						
Interest-Bearing Deposits with Banks	\$ 204,746	\$ 862	1.71%	\$ 640,351	\$ 1,289	0.82%
Tax-Free Investment Securities	169,171	1,842	4.42%	112,868	1,772	6.37%
Taxable Investment Securities	772,468	3,755	1.97%	737,608	3,789	2.08%
Tax-Free Loans	434,428	3,337	3.12%	439,122	4,104	3.79%
Taxable Loans, net of Unearned Income	2,230,068	26,879	4.89%	2,291,207	27,456	4.86%
<b>Total Interest-Earning Assets</b>	<b>\$ 3,810,881</b>	<b>\$ 36,675</b>	<b>3.90%</b>	<b>\$ 4,221,156</b>	<b>\$ 38,410</b>	<b>3.69%</b>
<b>LIABILITIES</b>						
Deposits						
Interest-Bearing Demand	264,680	404	0.62%	255,446	448	0.71%
Money Market	116,845	132	0.46%	174,569	230	0.53%
Savings	710,837	526	0.30%	717,096	885	0.50%
Certificates of Deposit	2,013,030	7,089	1.43%	2,327,314	8,281	1.44%
<b>Total Interest-Bearing Deposits</b>	<b>3,105,392</b>	<b>8,151</b>	<b>1.06%</b>	<b>3,474,425</b>	<b>9,844</b>	<b>1.15%</b>
<b>Total Liabilities</b>	<b>\$ 3,105,392</b>	<b>\$ 8,151</b>	<b>1.06%</b>	<b>\$ 3,474,425</b>	<b>\$ 9,844</b>	<b>1.15%</b>
<b>Net Interest Income (FTE)</b>		<b>\$ 28,524</b>			<b>\$ 28,566</b>	
<b>Net Interest Margin</b>			<b>3.04%</b>			<b>2.74%</b>

Interest income, on a fully taxable equivalent basis, decreased \$1.7 million, or 4.5%, for the three months ended March 31, 2018 as compared to the same period in 2017. The decrease was primarily a result of a decline in average total earning assets of \$410.3 million for the three months ended March 31, 2018 as compared to the same period of 2017. The rates earned on earning assets increased 21 basis points primarily due to diversification of excess cash and the investment portfolio. Average interest-bearing deposits with banks, which are primarily cash at the Federal Reserve Bank, decreased \$435.6 million and the rates increased 89 basis points due to the Federal Funds rate increases since March of 2017. The decline of Federal Reserve Bank balances was utilized to deploy the excess cash into higher yielding and diversified investment securities as well as the aforementioned runoff of higher cost deposits.

## CARTER BANK & TRUST

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Interest expense decreased \$1.7 million, or 17.2 %, for the three months ended March 31, 2018 as compared to the same period in 2017. The decrease was primarily due to decreases in average interest-bearing deposits of \$367.3 million for the three months March 31, 2018 as compared to the same period in 2017, primarily a result of the aforementioned intentional runoff of higher cost certificates of deposits. The cost of interest-bearing deposits decreased 9 basis points for the three months ended March 31, 2018 as compared to the same period in 2017.

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

	Three Months ended March 31, 2018 compared to March 31, 2017		
(Dollars in Thousands)	Net Increase (Decrease)	Increase (Decrease) / Rate	Increase (Decrease) / Volume
<b>ASSETS</b>			
Interest-Bearing Deposits with Banks	\$ (427)	\$ 817	\$ (1,244)
Tax-Free Investment Securities	70	(657)	727
Taxable Investment Securities	(34)	(173)	139
Tax-Free Loans	(767)	(724)	(43)
Taxable Loans, net of Unearned Income	(577)	159	(736)
<b>Total Interest-Earning Assets</b>	<b>\$ (1,735)</b>	<b>\$ (578)</b>	<b>\$ (1,157)</b>
<b>LIABILITIES</b>			
Deposits			
Interest-bearing Demand	(44)	(62)	18
Money Market	(98)	(30)	(68)
Savings	(359)	(351)	(8)
Certificates of Deposit	(1,192)	(86)	(1,106)
<b>Total Interest-Bearing Deposits</b>	<b>(1,693)</b>	<b>(529)</b>	<b>(1,164)</b>
<b>Total Interest-Bearing Liabilities</b>	<b>\$ (1,693)</b>	<b>\$ (529)</b>	<b>\$ (1,164)</b>
<b>Net Interest Income</b>	<b>\$ (42)</b>	<b>\$ (49)</b>	<b>\$ 7</b>

#### Provision for Loan Losses

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

The provision for loan losses decreased \$2.4 million for the three months ended March 31, 2018 compared to the same period in 2017. The decrease in provision expense for the three months ended March 31, 2018 as compared to the same period of 2017 is attributable to a decline in nonperforming loans and resolution of legacy problem credits.

Net charge-offs (recoveries) were \$(33) thousand for the first three months of 2018 as compared to \$427 thousand in the same period of 2017. Annualized net loan charge-offs (recoveries) to loans were (0.01)% for the three months ended March 31, 2018 compared to 0.06% percent for the same period in 2017. Specific reserves increased \$0.5 million to \$0.5 million for the three months ended March 31, 2018 as compared to \$32 thousand at December 31, 2017. The Bank had \$2.4 million of specific reserves at March 31, 2017.

## CARTER BANK & TRUST

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Nonperforming loans decreased at March 31, 2018 by \$30.4 million, to \$62.5 as compared to \$92.9 million at December 31 2017. The allowance for loan losses was 59.0% of nonperforming loans as of March 31, 2018 as compared to 38.0% of nonperforming loans as of December 31, 2017.

The ALL at March 31, 2018 was \$36.9 million compared to \$35.3 million at December 31, 2017. The ALL as a percent of total portfolio loans was 1.39% at March 31, 2018 and 1.32% at December 31, 2017.

#### Noninterest Income

(Dollars in Thousands)	Three Months Ended March 31,			
	2018	2017	\$ Change	% Change
Gains on Sales of Securities, net	\$ 868	\$ -	\$ 868	NM
Service Charges, Commissions and Fees	1,252	1,008	244	24.2%
Debit Card Interchange Fees	1,133	1,205	(72)	(6.0)%
Insurance Commissions	535	464	71	15.3%
Other Real Estate Owned Income	549	109	440	403.7%
Other	394	161	233	144.7%
<b>Total Noninterest Income</b>	<b>\$ 4,731</b>	<b>\$ 2,947</b>	<b>\$ 1,784</b>	<b>60.5%</b>

*NM - percentage not meaningful*

Noninterest income increased \$1.0 million, or 31.1%, to \$3.9 million, excluding net securities gains, for the three months ending March 31, 2018 as compared to \$2.9 million in the same period of 2017. The increase in noninterest income is attributable to \$0.4 million higher income from other real estate owned due to the acquisition of several properties generating income during the period, increased service charges of \$0.2 million, increased insurance fees of \$0.1 million and the gain on the sale of our insurance agency during the first quarter of 2018. Securities gains of \$0.9 million were realized during the first three months of 2018 to take advantage of market opportunities and reduce the credit risk of the securities portfolio.

#### Noninterest Expense

(Dollars in Thousands)	Three Months Ended March 31,			
	2018	2017	\$ Change	% Change
Salaries and Employee Benefits	\$ 12,260	\$ 10,174	\$ 2,086	20.5%
Occupancy Expense, net	2,325	2,106	219	10.4%
FDIC Insurance Expense	838	1,129	(291)	(25.8)%
Other Taxes	477	441	36	8.2%
Telephone Expense	669	412	257	62.4%
Professional and Legal Fees	1,210	278	932	335.3%
Data Processing License Fee	268	1,460	(1,192)	(81.6)%
Debit Card Expense	652	619	33	5.3%
Losses (Gains) on Sales and Write-downs of Other Real Estate Owned, net	291	(52)	343	NM
Losses on Sales and Write-downs of Bank Premises	51	-	51	NM
Tax Credits Amortization	1,015	-	1,015	NM
Other Real Estate Owned Expense	531	187	344	184.0%
Other	1,972	1,050	922	87.8%
<b>Total Noninterest Expense</b>	<b>\$ 22,559</b>	<b>\$ 17,804</b>	<b>\$ 4,755</b>	<b>26.7%</b>

*NM - percentage not meaningful*

## **CARTER BANK & TRUST**

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

Noninterest expense increased \$4.8 million, or 26.7%, to \$22.6 million for the three months ended March 31, 2018 as compared to \$17.8 million in the same period of 2017. The increase is primarily due to an increase in salaries and employee benefits expense of \$2.1 million, an increase in professional and legal fees of \$0.9 million, \$1.0 million of tax credit amortization, an increase of \$0.3 in other real estate owned expense and a \$0.3 million increase in the reserve for unfunded loan commitments, included in other expenses. The increase in salaries and benefits was expected and planned as investments were made in the appropriate infrastructure to support the Bank in the future. Other real estate owned expense increased due to the acquisition of several properties during the first quarter of 2018. Offsetting these increases were decreases of \$1.2 million in data processing expenses, due to the write-off of expenses that were previously capitalized that were fully expensed during 2017 and a decrease of \$0.3 million in FDIC insurance expense attributable to lower FDIC assessment rates and a decrease in the assessment base.

#### **Provision for Income Taxes**

The provision for income taxes was a tax benefit of \$0.7 million in the first three months of 2018 as a result of pretax income of \$8.1 million as compared to a tax provision of \$1.5 million in the same period of 2017 and pretax income of \$7.8 million. The tax benefit in the first quarter of 2018 was primarily due to benefits resulting from tax-exempt interest income and a tax credit project.

The effective tax rate was negative 9% for the tax benefit in the first quarter of 2018 and 19% for the tax expense in the comparable period of 2017. The Bank ordinarily generates an annual effective tax rate that is less than the statutory rate for each period (which was 21% for the first quarter of 2018 and 35% for the first quarter of 2017) due primarily to benefits resulting from tax-exempt interest income and a tax credit project.

#### **Financial Condition March 31, 2018**

Total assets were \$4.1 billion as of March 31, 2018 and December 31, 2017. Total loans were essentially flat at \$2.7 billion as of March 31, 2018 and December 31, 2017 due to the reduction of several large legacy credit relationships, which offset new loan growth. Nonperforming loans decreased \$30.4 million to \$62.5 million as of March 31, 2018 from \$92.9 million at December 31, 2017. The decrease in nonperforming loans is primarily due to nonperforming credits migrating to other real estate owned during the first quarter of 2018. Other real estate owned increased \$23.5 million as of March 31, 2018 as compared to December 31, 2017, primarily due to \$26.4 million in commercial real estate loans that were foreclosed and marketed for sale during the first quarter of 2018. Bank owned life insurance in the amount of \$50.0 million was purchased during the first quarter of 2018.

Federal Reserve Bank excess reserves declined \$54.3 million from December 31, 2017. This excess cash was deployed into higher yielding and diversified securities and also funded the planned decrease in high cost deposits during the past twelve months.

The securities portfolio increased \$6.9 million from December 31, 2017. The increase is a result of more active balance sheet management and as a replacement for loan growth due to the aforementioned reduction of several large legacy credit relationships. As a result, the securities portfolio has been further diversified as to bond types, maturities, and interest rate structures.

## CARTER BANK & TRUST

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Total deposits as of March 31, 2018 and December 31, 2017 were essentially flat at \$3.7 billion. Savings deposits declined with a \$31.1 million or 4.3% decline since year end 2017. Certificates of deposits decreased \$22.4 million, or 1.1%, at March 31, 2018 as compared to year end 2017 due to the intentional reduction in higher cost time deposits. This reduction is strategically aligned with the Bank's plan to improve the net interest margin. Noninterest bearing deposits increased by \$44.6 million, or 8.4%, to \$574.8 million as of March 31, 2018 as compared to \$530.2 million as of December 31, 2017. Noninterest bearing deposits comprised 15.7% and 14.4% of total deposits at March 31, 2018 and December 31, 2017.

The allowance for loan losses was 1.39% of total loans as of March 31, 2018 as compared to 1.32% as of December 31, 2017. The allowance for loan losses was 59.0% of nonperforming loans as of March 31, 2018 as compared to 38.0% of nonperforming loans as of December 31, 2017. In the view of management, the allowance for loan losses is adequate to meet the loss contingency based on experience factors and a review of the loan portfolio.

The Bank remains well capitalized. The Bank's Tier 1 Capital ratio increased to 13.31% as of March 31, 2018 as compared to 12.93% as of December 31, 2017. The Bank's leverage ratio was 9.62% at March 31, 2018 as compared to 9.33% in December 31, 2017. The Bank's Total Risk-Based Capital ratio was 14.56% at March 31, 2018 as compared to 14.15% at December 31, 2017.

#### Securities Activity

The following table sets forth a summary of the available-for-sale investment securities portfolio as of March 31, 2018:

(Dollars in Thousands)	March 31, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government Agency Securities	\$ 302,895	\$ -	\$ (5,952)	\$ 296,943
Residential Mortgage-Backed Securities	83,799	14	(1,713)	82,100
Commercial Mortgage-Backed Securities	26,637	-	(725)	25,912
Asset Backed Securities	42,421	24	(93)	42,352
Collateralized Mortgage Obligations	89,913	4	(1,484)	88,433
Small Business Administration	94,275	75	(1,248)	93,102
States and Political Subdivisions	260,309	1,656	(3,492)	258,473
Corporate Notes	66,938	1	(127)	66,812
<b>Total Debt Securities</b>	<b>\$ 967,187</b>	<b>\$ 1,774</b>	<b>\$ (14,834)</b>	<b>\$ 954,127</b>

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

The securities portfolio increased by \$6.9 million at March 31, 2018 as compared to December 31, 2017. The increase is a result of more active balance sheet management and as a replacement for loan growth due to the

## CARTER BANK & TRUST

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

reduction of several large legacy credit relationships. As a result, the securities portfolio has been further diversified as to bond types, maturities, and interest rate structures. Sales of securities, which resulted in a net realized gain of \$0.9 million, were transacted to take advantage of market opportunities and reduce the credit risk of the securities portfolio.

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

#### Loan Composition

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

(Dollars in Thousands)	March 31, 2018 (Unaudited)	December 31, 2017
<b>Commercial</b>		
Commercial Real Estate	\$ 1,359,930	\$ 1,536,957
Commercial and Industrial	913,242	803,833
Commercial Construction	153,236	118,786
<b>Total Commercial Loans</b>	<b>2,426,408</b>	<b>2,459,576</b>
<b>Consumer</b>		
Residential Mortgages	147,710	136,895
Other Consumer	79,080	79,980
Consumer Construction	7,700	7,994
<b>Total Consumer Loans</b>	<b>234,490</b>	<b>224,869</b>
<b>Total Portfolio Loans</b>	<b>2,660,898</b>	<b>2,684,445</b>
Loans Held- for- Sale	-	517
<b>Total Loans</b>	<b>\$ 2,660,898</b>	<b>\$ 2,684,962</b>

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

Total loans were essentially flat at \$2.7 billion as of March 31, 2018 and December 31, 2017 due to the reduction of several large legacy credit relationships. Commercial loans decreased \$33.2 million, or 1.3%, due to continued legacy loan pay downs. Total consumer loans increased \$9.6 million, or 4.3% due to our newly launched mortgage initiative and a consumer loan purchase program that was implemented during the third quarter of 2017 to diversify the loan portfolio. The Bank purchases mortgage loans from another financial institution with fully executed contracts with investors. The Bank then holds the loans until funded by the investor, typically a two-week period. There were no loans held-for-sale as of March 31, 2018. The amount of these loans held-for-sale at December 31, 2017 was \$0.5 million.

## **CARTER BANK & TRUST**

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

#### **Allowance for Loan Losses**

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

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

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

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

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

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

The ALL was \$36.9 million, or 1.39% of total portfolio loans at March 31, 2018 as compared to \$35.3 million, or 1.32% of total portfolio loans at December 31, 2017.

## **CARTER BANK & TRUST**

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

The increase in the ALL of \$1.5 million was primarily due to a \$0.5 million increase in the specific reserve for impaired loans and a \$1.0 million increase in the reserve for loans collectively evaluated for impairment at March 31, 2018 as compared to December 31, 2017. The \$0.5 million increase in the specific reserve for impaired loans since December 31, 2017 was related to the addition of a new relationship with specific reserves of \$0.5 million. Please reference Note 4 Allowance for Loan Losses for additional information. The \$1.0 million increase since December 31, 2017 in the reserve for collectively evaluated loans is due to the reclassification of several credits from individually evaluated for impairment at December 31, 2017 to collectively evaluated for impairment at March 31, 2018. In addition, several credits were reassigned to different loan pools within the collectively evaluated for impairment segmentation that have varying qualitative adjustments and historical loss rates. The reassignment of credits within the collectively evaluated loan pools was the result of loan restructures and related collateral restructures that took place during the first quarter of 2018.

Impaired loans decreased \$47.7 million, or 10.7%, from December 31, 2017 to \$399.0 million at March 31, 2018. The decrease during the three months ending March 31, 2018 was primarily due to new impaired loans in the amount of \$90.2 million, offset by \$104.1 million in upgrades and \$30.1 million being transferred to other real estate owned. Please refer to Note 4 – Allowance for Loan Losses Impaired Loans for additional information.

Net charge-offs (recoveries) were \$(33) thousand at March 31, 2018. Special mention, substandard and doubtful loans at March 31, 2018 decreased by \$37.9 million to \$778.2 million compared to \$816.1 million at December 31, 2017, with an increase of \$37.6 million in special mention and a decrease of \$75.5 million in substandard.

The Bank individually evaluates all substandard and nonaccrual commercial loans greater than \$0.5 million for impairment. A loan is impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts when due according to the contractual terms of the loan agreement. Our methodology for evaluating whether a loan is impaired includes risk-rating credits on an individual basis and consideration of the borrower's overall financial condition, payment history and available cash resources. In measuring impairment, the Bank primarily utilizes fair market value of the collateral; however, the Bank also uses the discounted cash flow method for loans that are not deemed to be collateral dependent at the time of impairment.

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

An accruing loan that is modified into a TDR can remain in accrual status if, based on a current credit analysis, collection of principal and interest in accordance with the modified terms is reasonably assured, and the borrower has demonstrated sustained historical repayment performance for a reasonable period before the modification. All TDRs are considered to be impaired loans and will be reported as impaired loans for their remaining lives, unless the restructuring agreement specifies an interest rate equal to or greater than the rate that would be accepted at the time

## CARTER BANK & TRUST

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

of the restructuring for a new loan with comparable risk and the Bank fully expects that the remaining principal and interest will be collected according to the restructured agreement. For all TDRs, regardless of size, as well as all other impaired loans, the Bank conducts further analysis to determine the probable loss and assigns a specific reserve to the loan if deemed appropriate. Further, all impaired loans are reported as nonaccrual loans unless the loan is a TDR that has met the requirements to be returned to accruing status. TDRs can be returned to accruing status if the ultimate collectability of all contractual amounts due, according to the restructured agreement, is not in doubt and there is a period of a minimum of six months of satisfactory payment performance by the borrower either immediately before or after the restructuring.

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

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

(Dollars in Thousands)	March 31, 2018			December 31, 2017		
	Performing TDRs	Nonperforming TDRs	Total TDRs	Performing TDRs	Nonperforming TDRs	Total TDRs
Real Estate	\$ 61,994	\$ 52,295	\$ 114,289	\$ 121,465	\$ 41,804	\$ 163,269
Consumer	-	-	-	-	-	-
Commercial	265,556	-	265,556	133,182	-	133,182
<b>Total TDRs</b>	<b>\$ 327,550</b>	<b>\$ 52,295</b>	<b>\$ 379,845</b>	<b>\$ 254,647</b>	<b>\$ 41,804</b>	<b>\$ 296,451</b>

TDRs increased \$83.3 million to \$379.8 million at March 31, 2018 compared to \$296.5 million at December 31, 2017. The increase is primarily due to new performing TDRs totaling \$90.2 million, new nonperforming TDRs totaling \$40.4 million, offset by upgrades in the amount of \$13.9 million and transfers to other real estate owned in the amount of \$29.9 million. The new nonperforming TDRs in the amount of \$40.4 million were previously considered impaired at December 31, 2017. Total TDRs of \$52.3 million and \$41.8 million were on nonaccrual at March 31, 2018 and December 31, 2017, respectively. There were minimal commitments to lend additional funds on one relationship identified as a TDR.

Our charge-off policy for commercial loans requires that loans and other obligations that are not collectible be promptly charged-off when the loss becomes probable, regardless of the delinquency status of the loan. The Bank may elect to recognize a partial charge-off when management has determined that the value of collateral is less than

## CARTER BANK & TRUST

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

the remaining investment in the loan. A loan or obligation does not need to be charged-off, regardless of delinquency status, if (i) management has determined there exists sufficient collateral to protect the remaining loan balance and (ii) there exists a strategy to liquidate the collateral. Management may also consider a number of other factors to determine when a charge-off is appropriate. These factors may include, but are not limited to:

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

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

Our policy is to place loans in all categories in nonaccrual status when collection of interest or principal is doubtful, or generally when interest or principal payments are 90 days or more past due.

Nonperforming assets consist of nonaccrual loans, nonaccrual TDRs and OREO. The following table summarizes nonperforming assets for the dates presented:

<b>Nonperforming Loans</b>	<b>March 31, 2018</b>	<b>December 31, 2017</b>
Real Estate	\$ 10,242	\$ 51,047
Consumer	-	47
Commercial	-	-
<b>Total Nonperforming Loans</b>	<b>10,242</b>	<b>51,094</b>
<b>Nonperforming Troubled Debt Restructurings</b>		
Real Estate	52,295	41,804
Consumer	-	-
Commercial	-	-
<b>Total Nonperforming Troubled Debt Restructurings</b>	<b>52,295</b>	<b>41,804</b>
<b>Total Nonperforming Loans</b>	<b>62,537</b>	<b>92,898</b>
Other Real Estate Owned	63,263	39,793
<b>Total Nonperforming Assets</b>	<b>\$ 125,800</b>	<b>\$ 132,691</b>
Nonperforming Loans to Total Portfolio Loans	2.35%	3.46%
Nonperforming Assets to Total Portfolio Loans plus OREO	4.62%	4.87%

Nonperforming assets, or NPAs, decreased \$6.9 million to \$125.8 million at March 31, 2018 compared to \$132.7 million at December 31, 2017. The decrease was due to a \$30.4 million decline in nonperforming loans offset by a \$23.5 million increase in other real estate owned. The increase in other real estate owned was primarily due to the transfer of six commercial real estate properties, to one credit relationship totaling \$26.4 million, to OREO during the first quarter of 2018 of which four are currently under contract and expected to close in the second and third quarters of 2018. One additional commercial real estate property in the same credit relationship, which was transferred to OREO during the fourth quarter of 2017 in the amount of \$1.2 million, is also currently under contract.

## CARTER BANK & TRUST

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The following table summarizes loans past due 30-89 days for the periods presented:

<b>Loans 30 to 89 Days Past Due</b>	<b>March 31, 2018</b>	<b>December 31, 2017</b>
Real Estate	\$ 6,242	\$ 5,443
Consumer	588	392
Commercial	35	161
<b>Total Loans</b>	<b>\$ 6,865</b>	<b>\$ 5,996</b>

The following table summarizes loans past due 90 days or more and still accruing for the periods presented:

<b>Loans 90 Days or More Past Due and Still Accruing</b>	<b>March 31, 2018</b>	<b>December 31, 2017</b>
Real Estate	\$ 624	\$ 493
Consumer	66	59
Commercial	-	4
<b>Total Loans 90 Days or More Past Due</b>	<b>\$ 690</b>	<b>\$ 556</b>

Loans past due 30 to 89 days increased by \$0.9 million to \$6.9 million at March 31, 2018 compared to \$6.0 million at December 31, 2017. Loans past due 90 days or more and still accruing increased \$134 thousand to \$690 thousand compared to \$556 thousand at December 31, 2017.

#### Deposits

The following tables present the composition of deposits:

<b>(Dollars in Thousands)</b>	<b>March 31, 2018</b>	<b>December 31, 2017</b>	<b>\$ Change</b>
Noninterest-Bearing Demand	\$ 574,811	\$ 530,242	\$ 44,569
Interest-Bearing Demand	264,939	260,979	3,960
Money Market	107,624	102,686	4,938
Savings	690,315	721,459	(31,144)
Certificates of Deposits	2,031,887	2,054,249	(22,362)
<b>Total</b>	<b>\$ 3,669,576</b>	<b>\$ 3,669,615</b>	<b>\$ (39)</b>

Total deposits were essentially flat at \$3.7 billion as of March 31, 2018 and December 31, 2017. Savings deposits represented the largest segment of decline in deposits, with a \$31.1 million or 4.3% decline since year end 2017. Certificates of deposits decreased \$22.4 million, or 1.1%, at March 31, 2018 as compared to year end 2017 due to the intentional reduction in higher cost time deposits. This reduction is strategically aligned with the Bank's plan to improve the net interest margin. Noninterest bearing deposits increased by \$44.6 million, or 8.4%, to \$574.8 million as of March 31, 2018 as compared to \$530.2 million as of December 31, 2017. Noninterest bearing deposits comprised 15.7% and 14.4% of total deposits at March 31, 2018 and December 31, 2017, respectively.

#### Liquidity and Capital Resources

Liquidity is defined as a financial institution's ability to meet its cash and collateral obligations at a reasonable cost. This includes the ability to satisfy the financial needs of depositors who want to withdraw funds or of borrowers

## **CARTER BANK & TRUST**

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)**

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

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

An important component of our ability to effectively respond to potential liquidity stress events is maintaining a cushion of highly liquid assets. Highly liquid assets are those that can be converted to cash quickly, with little or no loss in value, to meet financial obligations. ALCO policy guidelines define a ratio of highly liquid assets to total assets by graduated risk tolerance levels of minimal, moderate and high. At March 31, 2018, the Bank had \$820.3 million in highly liquid assets, which consisted of \$62.9 million in interest-bearing deposits with banks, \$97.4 million in Federal Reserve Bank Excess Reserves, and \$660.0 million in unpledged securities. This resulted in highly liquid assets to total assets ratio of 19.9% at March 31, 2018.

#### **Regulatory Capital Requirements**

Shareholders' equity increased \$0.8 million, or 0.2%, to \$432.9 million at March 31, 2018 as compared to \$432.1 million at December 31, 2017. The increase in shareholders' equity is primarily due to net income of \$8.8 million, offset by a comprehensive loss in the amount of \$8.1 million. Other comprehensive loss of \$8.1 million was primarily due to net unrealized losses on securities available-for-sale driven by an increase in interest rates during the period.

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

We continue to maintain our capital position with a leverage ratio of 9.62% as compared to the regulatory guideline of 5.00% to be well capitalized and a risk-based Common Equity Tier 1 ratio of 13.31% compared to the regulatory guideline of 6.50% to be well capitalized. Our risk-based Tier 1 and Total capital ratios were 13.31% and 14.56%,

## CARTER BANK & TRUST

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

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

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

The Bank intends to maintain a capital position that meets or exceeds the well capitalized requirement as defined by the Federal Reserve Bank and Federal Deposit Insurance Corporation, in addition to the Capital Conservation Buffer. The Bank's average shareholders' equity to average assets ratio was 10.60% at March 31, 2018 compared to 10.27% at December 31, 2017. Formal measurement of the capital ratios for the Bank are performed at each quarter end.

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

The following table summarizes capital amounts and ratios for the Bank for the dates presented:

(Dollars in Thousands)	Adequately Capitalized	Well-Capitalized	March 31, 2018		December 31, 2017	
			Amount	Ratio	Amount	Ratio
Tier 1 Leverage Ratio	4.00%	5.00%	\$ 384,469	9.62%	\$ 374,506	9.33%
Common Equity Tier 1 Capital Ratio	4.50%	6.50%	384,469	13.31%	374,506	12.93%
Tier 1 Capital Ratio	6.00%	8.00%	384,469	13.31%	374,506	12.93%
Total Risk-Based Capital Ratio	8.00%	10.00%	420,604	14.56%	409,972	14.15%

## CARTER BANK & TRUST

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

#### Market Risk

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

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

In order to monitor interest rate risk beyond the 12 month time horizon of rate shocks, we also perform EVE analyses. EVE represents the present value of all asset cash flows minus the present value of all liability cash flows. EVE rate change results are compared to a base case to determine the impact that market rate changes may have on our EVE. As with rate shock analysis, EVE analyses incorporate management assumptions regarding prepayment behavior of fixed rate loans and securities with optionality and the behavior and value of non-maturity deposit products. Our policy guidelines limit the change in EVE given changes in rates of +/- 100, 200 and 300 basis points. We have also temporarily suspended the EVE -200 and -300 basis point scenarios due to the low interest rate environment.

The tables below reflect the rate shock analyses and EVE analyses results for the periods presented. All percentage changes presented are well within prescribed ranges set by management.

March 31, 2018		
Change in Interest Rate (basis points)	% Change in Pretax Net Interest Income	% Change in Economic Value of Equity
300	12.76%	1.59%
200	8.83%	2.29%
100	4.42%	1.96%
(100)	-5.56%	-4.70%

**CARTER BANK & TRUST****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****(Continued)**

<b>December 31, 2017</b>		
Change in Interest Rate (basis points)	% Change in Pretax Net Interest Income	% Change in Economic Value of Equity
300	11.29%	5.50%
200	8.46%	5.30%
100	4.36%	3.69%
(100)	-6.08%	-5.97%

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

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

We use an asset/liability model to measure our interest rate risk. Interest rate risk measures include earnings simulation and gap analysis. Gap analysis is a static measure that does not incorporate assumptions regarding future events. Gap analysis, while a helpful diagnostic tool, displays cash flows for only a single rate environment. Net interest income simulations explicitly measure the exposure to earnings from changes in market rates of interest. Under simulation analysis, our current financial position is combined with assumptions regarding future business to calculate net interest income under various hypothetical rate scenarios. Our net interest income simulations over multiple years under various interest rate scenarios. Reviewing these various measures provides us with a reasonably comprehensive view of our interest rate profile.

The following gap analysis as of March 31, 2018 compares the difference between the amount of interest-earning assets and interest-bearing liabilities subject to repricing over a period of time. The ratio of rate sensitive assets to rate sensitive liabilities repricing within a one year period was 0.58 at March 31, 2018. A ratio of less than one indicates a higher level of repricing liabilities over repricing assets over the next twelve months. The level of the Bank's ratio is largely driven by the modeling of interest-bearing non-maturity deposits, which are included in the analysis as repricing within one year.

**CARTER BANK & TRUST**

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**(Continued)**

(Dollars in Thousands)	Within One Year	One to Five Years	Over Five Years	Total
Uses of Funds				
Investment Securities, Available-for-Sale	\$ 290,641	\$ 359,059	\$ 304,427	\$ 954,127
FRB Excess Reserves	97,367	-	-	97,367
Loans Held-for-Sale	-	-	-	-
Portfolio Loans, net of Non-Accrual	673,774	1,212,390	712,197	2,598,361
<b>Total Earning Assets</b>	<b>\$ 1,061,782</b>	<b>\$ 1,571,449</b>	<b>\$ 1,016,624</b>	<b>\$ 3,649,855</b>
Deposits				
Interest-Bearing Demand	264,939	-	-	264,939
Money Market	107,624	-	-	107,624
Savings	690,315	-	-	690,315
Certificates of Deposit	783,156	1,246,279	2,452	2,031,887
<b>Total Deposits</b>	<b>1,846,034</b>	<b>1,246,279</b>	<b>2,452</b>	<b>3,094,765</b>
<b>Total Interest-Bearing Liabilities</b>	<b>\$ 1,846,034</b>	<b>\$ 1,246,279</b>	<b>\$ 2,452</b>	<b>\$ 3,094,765</b>
Maturity/Rate Sensitivity Gap Per Period	\$ (784,252)	\$ 325,170	\$ 1,014,172	\$ 555,090
Cumulative Maturity/Rate Sensitivity Gap	\$ (784,252)	\$ (459,082)	\$ 555,090	

The following gap analysis as of December 31, 2017 compares the difference between the amount of interest-earning assets and interest-bearing liabilities subject to repricing over a period of time. The ratio of rate sensitive assets to rate sensitive liabilities repricing within a one year period was 0.61 at December 31, 2017. A ratio of less than one indicates a higher level of repricing liabilities over repricing assets over the next twelve months. The level of Carter Bank & Trust's ratio is largely driven by the modeling of interest-bearing non-maturity deposits, which are included in the analysis as repricing within one year.

(Dollars in Thousands)	Within One Year	One to Five Years	Over Five Years	Total
Uses of Funds				
Investment Securities, Available-for-Sale	\$ 292,193	\$ 401,142	\$ 253,866	\$ 947,201
FRB Excess Reserves	151,715	-	-	151,715
Interest Bearing Deposits in Other Financial Institutions	58,365	-	-	58,365
Loans Held-for-Sale	517	-	-	517
Portfolio Loans, net of Non-Accrual	713,067	1,205,607	672,873	2,591,547
<b>Total Earning Assets</b>	<b>\$ 1,215,857</b>	<b>\$ 1,606,749</b>	<b>\$ 926,739</b>	<b>\$ 3,749,345</b>
Deposits				
Interest-Bearing Demand	\$ 260,979	\$ -	\$ -	\$ 260,979
Money Market	102,686	-	-	102,686
Savings	721,459	-	-	721,459
Certificates of Deposit	893,403	1,159,135	1,711	2,054,249
<b>Total Deposits</b>	<b>\$ 1,978,527</b>	<b>\$ 1,159,135</b>	<b>\$ 1,711</b>	<b>\$ 3,139,373</b>
<b>Total Interest-Bearing Liabilities</b>	<b>\$ 1,978,527</b>	<b>\$ 1,159,135</b>	<b>\$ 1,711</b>	<b>\$ 3,139,373</b>
Maturity/Rate Sensitivity Gap Per Period	\$ (762,670)	\$ 447,614	\$ 925,028	\$ 609,972
Cumulative Maturity/Rate Sensitivity Gap	\$ (762,670)	\$ (315,056)	\$ 609,972	

**CARTER BANK & TRUST**  
**ITEM 4 - CONTROLS AND PROCEDURES**

Management is responsible for establishing and maintaining effective disclosure controls and procedures, as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. As of March 31, 2018, an evaluation was performed under the supervision and with the participation of management, including the Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”), of the effectiveness of the design and operation of our disclosure controls and procedures.

Based on and as of the date of such evaluation, our CEO and CFO concluded that the design and operation of our disclosure controls and procedures were effective in all material respects, as of the end of the period covered by this report.

**PART II – OTHER INFORMATION**

**ITEM 1- LEGAL PROCEEDINGS**

On August 2, 2016, the FDIC and the Virginia Bureau of Financial Institutions (the “Bureau”) issued a Consent Order (the “Order”) in connection with compliance by the Bank with the Bank Secrecy Act (the “BSA”) and related regulations and other related anti-money laundering regulations (collectively, the “BSA/AML Requirements”). The Order was issued pursuant to the consent of the Bank, and in consenting to the issuance of the Order the Bank did not admit or deny any unsafe or unsound banking practices or violations of law or regulation related to weaknesses in the Bank’s compliance with the BSA/AML Requirements. The Bank has reviewed, assessed and taken actions to strengthen and enhance compliance programs related to the BSA/AML requirements. The Order, incorporated by reference, to the Bank’s Current Report on Form 8-K filed with the FDIC on August 8, 2016.

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

**ITEM 1A – RISK FACTORS**

As of March 31, 2018, there have been no material changes in the risk factors faced by the Bank from those disclosed in the Bank’s 2017 Annual Report on Form 10-K.

**ITEM 2 – UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

**ITEM 3 - DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4 – MINE SAFETY DISCLOSURES**

None.

**ITEM 5 - OTHER INFORMATION**

None.

**CARTER BANK & TRUST**  
**PART II – OTHER INFORMATION**  
**ITEM 6 - EXHIBITS**

Exhibits:

- 3.1 Articles of Incorporation (incorporated by reference to Exhibit 3.1 to the Bank’s Form 8-A filed with the FDIC February 23, 2007)
- 3.2 Amended and restated Bylaws (as adopted by the Board of Directors on June 21, 2017) (incorporated by reference to Exhibit 3.2 to the Bank’s Form 8-K filed with the FDIC June 26, 2017)
- 10.1\* Qualified Profit Sharing Plan of Carter Bank & Trust (formerly the Qualified Profit Sharing Plan of each of the Merged Banks and MCOV) (incorporated by reference to Exhibit 10.1 to the Bank’s 2006 Form 10K filed with the FDIC July 6, 2007)
- 10.2\* Nonqualified Profit Sharing Plan of Carter Bank & Trust (formerly the Nonqualified Profit Sharing Plan of MCOV) (incorporated by reference to Exhibit 10.2 to the Bank’s 2006 Form 10K filed with the FDIC July 6, 2007)
- 10.3\* Employment Agreement, dated as of June 19, 2017, by and between Carter Bank & Trust and Wendy S. Bell (incorporated by reference to Exhibit 10.3 to the Bank’s Form 8-K filed with the FDIC June 20, 2017)
- 10.4\* Employment Agreement, dated as of September 29, 2017, by and between Carter Bank & Trust and Litz Van Dyke (incorporated by reference to Exhibit 10.4 to the Bank’s Form 8-K filed with the FDIC October 3, 2017)
- 10.5\* Employment Agreement, dated as of September 29, 2017, by and between Carter Bank & Trust and Phyllis Q. Karavatakis (incorporated by reference to Exhibit 10.5 to the Bank’s Form 8-K filed with the FDIC October 3, 2017)
- 10.6\* Employment Agreement, dated as of September 29, 2017, by and between Carter Bank & Trust and Jane Ann Davis (incorporated by reference to Exhibit 10.6 to the Bank’s Form 8-K filed with the FDIC October 3, 2017)
- 10.7\* Employment Agreement, dated as of May 31, 2017, by and between Carter Bank & Trust and Bradford N. Langs (incorporated by reference to Exhibit 10.7 to the Bank’s Form 10-K filed with the FDIC March 15, 2018)
- 10.8\* Employment Agreement, dated as of June 15, 2017, by and between Carter Bank & Trust and Matthew M. Speare (incorporated by reference to Exhibit 10.8 to the Bank’s Form 10-K filed with the FDIC March 15, 2018)
- 31.1 Certification by principal executive officer pursuant to Rule 13a-14(a)
- 31.2 Certification by principal financial officer pursuant to Rule 13a-14(a)
- 32 Certification of principal executive officer and principal financial officer pursuant to 18 U.S.C. § 1350

## SIGNATURES

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

**CARTER BANK& TRUST**  
**(Registrant)**

Date: May 9, 2018

/s/ Litz H. Van Dyke  
Litz H. Van Dyke  
Chief Executive Officer  
(Principal Executive Officer)

Date: May 9, 2018

/s/ Wendy S. Bell  
Wendy S. Bell  
Executive Vice President  
Chief Financial Officer  
(Principal Financial Officer)

**CERTIFICATIONS**

I, Litz H. Van Dyke, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Carter Bank & Trust;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: May 9, 2018

/s/ Litz H. Van Dyke  
Litz H. Van Dyke  
Chief Executive Officer  
(Principal Executive Officer)

I, Wendy Bell, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Carter Bank & Trust;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: May 9, 2018

/s/ Wendy S. Bell  
Wendy S. Bell  
Executive Vice President  
Chief Financial Officer  
(Principal Financial Officer)

**CERTIFICATION OF  
PRINCIPAL EXECUTIVE OFFICER AND PRINCIPAL FINANCIAL OFFICER**

Pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350)

The undersigned, as the principal executive officer and principal financial officer of Carter Bank & Trust, respectively, certify that, to the best of their knowledge and belief, the Quarterly Report on Form 10-Q for the period ended March 31, 2018, which accompanies this certification fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of Carter Bank & Trust at the dates and for the periods indicated. The foregoing certification is made pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350) and shall not be relied upon for any other purpose. The undersigned expressly disclaim any obligation to update the foregoing certification except as required by law.

Date: May 9, 2018

/s/ Litz H. Van Dyke  
Litz H. Van Dyke  
Chief Executive Officer  
(Principal Executive Officer)

Date: May 9, 2018

/s/ Wendy S. Bell  
Wendy S. Bell  
Executive Vice President  
Chief Financial Officer  
(Principal Financial Officer)