BAY BANKS OF VIRGINIA INC
Form 10-Q
May 13, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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, 2014

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

COMMISSION FILE NUMBER: 0-22955

BAY BANKS OF VIRGINIA, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

VIRGINIA	**54-1838100**
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	**(I.R.S. EMPLOYER IDENTIFICATION NO.)**
100 SOUTH MAIN STREET, KILMARNOCK, VA	**22482**
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)	**(ZIP CODE)**

(804) 435-1171

(REGISTRANT S TELEPHONE NUMBER, INCLUDING AREA CODE)

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

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

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

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨	Smaller reporting company x

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date:

4,818,733 shares of common stock on May 7, 2014

FORM 10-Q

For the interim period ending March 31, 2014.

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

BAY BANKS OF VIRGINIA, INC.

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)	March 31, 2014 (unaudited)	December 31, 2013 [(1)]
ASSETS		
Cash and due from banks	$ 6,253	$ 6,789
Interest-bearing deposits	6,922	8,900
Federal funds sold	333	120
Securities available for sale, at fair value	37,711	38,522
Restricted securities	1,530	1,638
Loans receivable, net of allowance for loan losses of $2,950 and $2,925	250,649	247,912
Loans held for sale		196
Premises and equipment, net	10,622	10,620
Accrued interest receivable	1,026	1,124
Other real estate owned, net	3,538	3,897
Bank owned life insurance	5,176	5,129
Goodwill	2,808	2,808
Mortgage servicing rights	601	579
Other assets	2,928	2,901
Total assets	$ 330,097	$ 331,135
LIABILITIES		
Noninterest-bearing deposits	$ 56,975	$ 57,805
Savings and interest-bearing demand deposits	113,833	114,056
Time deposits	96,098	96,486
Total deposits	266,906	268,347
Securities sold under repurchase agreements	8,438	9,118
Federal Home Loan Bank advances	15,000	15,000
Other liabilities	1,814	1,534
Total liabilities	292,158	293,999
SHAREHOLDERS EQUITY		
Common stock ($5 par value; authorized - 10,000,000 shares; outstanding - 4,818,733 and 4,817,856 shares, respectively)	24,094	24,089

Additional paid-in capital		2,772		2,757
Retained earnings		11,923		11,463
Accumulated other comprehensive loss, net		(850)		(1,173)
Total shareholders equity		37,939		37,136
Total liabilities and shareholders equity	$	330,097	$	331,135

(1) Derived from the audited consolidated financial statements.

See Notes to Consolidated Financial Statements.

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BAY BANKS OF VIRGINIA, INC.

CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

(Dollars in thousands, except per share amounts)	For the three months ended March 31, 2014	2013
INTEREST INCOME		
Loans, including fees	$ 3,161	$ 3,154
Securities:		
Taxable	94	124
Tax-exempt	98	57
Federal funds sold		
Interest-bearing deposit accounts	4	18
Total interest income	3,357	3,353
INTEREST EXPENSE		
Deposits	458	631
Federal funds purchased		
Securities sold under repurchase agreements	2	4
FHLB advances	100	139
Total interest expense	560	774
Net interest income	2,797	2,579
Provision for loan losses	165	83
Net interest income after provision for loan losses	2,632	2,496
NON-INTEREST INCOME		
Income from fiduciary activities	212	165
Service charges and fees on deposit accounts	243	275
VISA-related fees	89	180
Other service charges and fees	240	233
Secondary market lending fees	111	132
Bank owned life insurance income	47	
Net (losses) gains on sale of securities available for sale	(1)	3
Other real estate gains (losses)	30	(14)

Net gains on sale of former branch	138	
Other income	4	12
Total non-interest income	1,113	986
NON-INTEREST EXPENSES		
Salaries and employee benefits	1,587	1,730
Occupancy expense	358	341
Software maintenance	138	130
Bank franchise tax	47	44
VISA expense	70	155
Telephone expense	56	49
FDIC assessments	66	103
Foreclosure property expense	31	23
Consulting expense	99	23
Other expense	656	671
Total non-interest expenses	3,108	3,269
Net income before income taxes	637	213
Income tax expense	177	73
Net income	$ 460	$ 140
Basic Earnings Per Share		
Average basic shares outstanding	4,817,885	4,813,812
Earnings per share, basic	$ 0.10	$ 0.03
Diluted Earnings Per Share		
Average diluted shares outstanding	4,827,921	4,816,490
Earnings per share, diluted	$ 0.10	$ 0.03

See Notes to Consolidated Financial Statements.

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BAY BANKS OF VIRGINIA, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

	For the three months ended	
(Dollars in thousands)	March 31, 2014	March 31, 2013
Net income	$ 460	$ 140
Other comprehensive income (loss):		
Unrealized gains (losses) on securities:		
Unrealized holding gains (losses) arising during the period	490	(74)
Deferred tax (expense) benefit	(168)	25
Reclassification of net securities (gains) losses and impairments recognized in net income	1	(3)
Deferred tax benefit		1
Unrealized gains (losses) adjustment, net of tax	323	(51)
Defined benefit pension plan:		
Net periodic pension (benefit) cost	(6)	20
Net pension gain (loss)	6	(20)
Deferred tax benefit		
Defined benefit pension plan adjustment, net of tax		
Post retirement benefit plan:		
Net periodic cost	11	15
Net loss	(11)	(15)
Deferred tax benefit		
Post retirement benefit plan adjustment, net of tax		
Total other comprehensive income (loss)	323	(51)
Comprehensive income	$ 783	$ 89

See Notes to Consolidated Financial Statements.

BAY BANKS OF VIRGINIA, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(unaudited)

(Dollars in thousands, except share data or amounts)	Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders Equity
Three Months ended March 31, 2014						
Balance at beginning of period	4,817,856	$ 24,089	$ 2,757	$ 11,463	$ (1,173)	$ 37,136
Net income				460		460
Other comprehensive income					323	323
Stock-based compensation	877	5	15			20
Balance at end of period	4,818,733	$ 24,094	$ 2,772	$ 11,923	$ (850)	$ 37,939

See Notes to Consolidated Financial Statements.

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BAY BANKS OF VIRGINIA, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(Dollars in thousands)	For the Three Months Ended March 31, 2014	2013
Cash Flows From Operating Activities		
Net income	$ 460	$ 140
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	187	187
Net amortization and accretion of securities	105	101
Provision for loan losses	165	83
Stock compensation expense	20	119
Deferred income taxes		(4)
Loss (gain) on securities available-for-sale	1	(3)
Increase in OREO valuation allowance		16
Gain on sale of other real estate	(30)	(2)
Gain on disposal of former branch	(138)	
Mortgage servicing rights	(22)	
Increase in bank owned life insurance	(47)	
Gain on loans sold to FNMA	(50)	(105)
Loan originations for sale to FNMA	(2,086)	(8,004)
Loan sales to FNMA	2,332	7,183
(Increase) decrease in accrued income and other assets	(143)	148
Increase (decrease) in other liabilities	107	(142)
Net cash provided by (used in) operating activities	861	(283)
Cash Flows From Investing Activities		
Proceeds from maturities and principal paydowns of available-for-sale securities	664	616
Proceeds from sales and calls of available-for-sale securities	1,292	1,095
Purchases of available-for-sale securities	(761)	(3,492)
Sales of restricted securities	108	67
Increase in federal funds sold	(213)	(821)
Loan (originations) and principal collections, net	(2,865)	4,621
Proceeds from sale of other real estate	352	2
Purchases of premises and equipment	(142)	(112)
Proceeds from the sale of premises and equipment	311	
Net cash (used in) provided by investing activities	(1,254)	1,976
Cash Flows From Financing Activities		
Decrease in demand, savings, and other interest-bearing deposits	(1,053)	(4,799)

Net decrease in time deposits	(388)	(2,680)
Net (decrease) increase in securities sold under repurchase agreements	(680)	1,777
Net cash used in financing activities	(2,121)	(5,702)
Net decrease in cash and due from banks	(2,514)	(4,009)
Cash and due from banks at beginning of period	15,689	39,924
Cash and due from banks at end of period	$ 13,175	$ 35,915
Supplemental Schedule of Cash Flow Information		
Cash paid for:		
Interest	$ 570	$ 778
Income taxes	$ 134	$ 53
Non-cash investing and financing:		
Unrealized gain (loss) on investment securities	$ 491	$ (77)
Loans transferred to other real estate owned	$ 197	$ 526
Loans originated to facilitate the sale of OREO	$ 234	$

See Notes to Consolidated Financial Statements.

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Notes to Consolidated Financial Statements (Unaudited)

Note 1: General

Bay Banks of Virginia, Inc. (the Company) owns 100% of the Bank of Lancaster (the Bank), 100% of Bay Trust Company, Inc. (the Trust Company) and 100% of Steptoes Holdings, LLC (Steptoes Holdings). The consolidated financial statements include the accounts of the Bank, the Trust Company, Steptoes Holdings and Bay Banks of Virginia, Inc.

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (GAAP) and to the general practices within the banking industry. In management s opinion, all adjustments, consisting only of normal recurring adjustments necessary for a fair presentation of the consolidated financial statements, have been included. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full year or for any other interim periods. These consolidated financial statements should be read in conjunction with the financial statements and notes to financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2013.

Certain amounts in the consolidated financial statements of prior periods have been reclassified to conform to current year presentations. The reclassifications had no effect on net income, net income per share or shareholders equity as previously reported.

Note 2: Significant Accounting Policies

Loans

The Company grants mortgage loans on real estate; commercial and industrial loans; and consumer and other loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans on real estate. The ability of the Company s debtors to honor their contracts is dependent upon the real estate and general economic conditions in the Company s market areas.

Loans are reported at their recorded investment, which is the outstanding principal balance net of any unearned income, such as deferred fees and costs, and charge-offs. Interest on loans is recognized over the term of the loan and is calculated using the interest method on principal amounts outstanding. Loan origination fees and certain direct origination costs are deferred and recognized as an adjustment of the related loan yield via straight line amortization over the contractual term of the loan, adjusted for early pay-offs.

The accrual of interest is generally discontinued at the time a loan is 90 days or more past due, or earlier, if collection is uncertain based on an evaluation of the net realizable value of the collateral and the financial strength of the borrower. Payments received for loans no longer accruing interest are applied to the unpaid principal balance. Loans greater than 90 days past due may remain on accrual status if the credit is well secured and in process of collection. Credit card loans and other personal loans are typically charged off no later than 180 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are charged off at an earlier date if collection of principal or interest is considered doubtful. Nonaccrual and past due policies are materially the same for all types of loans.

All interest accrued but not collected for loans that are placed on non-accrual or charged off is reversed against interest income. Any interest received on these loans is accounted for on the cash basis or cost recovery method until qualifying for return to accrual. Generally, a loan is returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured, or it becomes well secured and in the process of collection.

Allowance for loan losses (ALL)

The ALL reflects management s judgment of probable loan losses inherent in the portfolio at the balance sheet date. Management uses a disciplined process and methodology to establish the ALL each quarter. To determine the total ALL, the Company estimates the reserves needed for each segment of the portfolio, including loans analyzed individually and pools of loans analyzed on a segmented basis. Considerations include historical experience, the nature and volume of the loan portfolio, adverse situations that may affect a borrower s ability to repay, estimated value of any underlying collateral, prevailing local and national economic conditions, and internal policies and procedures including credit risk management and underwriting. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as additional information becomes available.

During the third quarter of 2012, management enhanced the ALL calculation methodology by changing the historical loss factor period from six quarters to the length of a business cycle. This increased the historical loss period to 16 quarters, and assumed the business cycle to have begun in the fourth quarter of 2008. As the length of that business cycle extended, so did the length of the historical loss factor period. During the third quarter of 2013, management determined that the business cycle had ended given noticeable national economic improvement and local real estate market stabilization and ceased this approach. The then current 19 quarters of historical losses will be used henceforth. This change in methodology produced an immaterial change in the ALL calculation.

Management employs a risk rating system to evaluate and consistently categorize loan portfolio credit risk. Loans assigned risk rating grades include all commercial loans not secured by real estate, commercial mortgages, residential mortgages greater than $1 million, smaller residential mortgages which are impaired, loans to real estate developers and contractors, consumer loans greater than $250 thousand with chronic delinquency, and troubled debt restructures. The grading analysis estimates the capability of the borrower to repay the contractual obligations of the loan agreements as scheduled. Risk grades are evaluated as new information becomes available for each borrowing relationship or at least quarterly. All other loans not specifically assigned a risk rating grade are monitored as a discrete pool of loans generally based on delinquency status. Risk rating categories are as follows:

<u>Pass</u> Borrower is strong or sound and collateral securing the loan, if any, is adequate.

Watch Borrower exhibits some signs of financial stress but is generally believed to be a satisfactory customer and collateral, if any, may be in excess of 90% of the loan balance.

Special Mention Adverse trends in the borrower s financial position are evident and warrant management s close attention and any collateral may not be fully adequate to secure loan balance.

Substandard A loan in this category has a well-defined weakness in the primary repayment source that jeopardizes the timely collection of the debt. There is a distinct possibility that a loss may result if the weakness is not corrected.

Doubtful Default has already occurred and it is likely that foreclosure or repossession procedures have begun or will begin in the near future. Weaknesses make collection or liquidation in full, based on currently existing information, highly questionable and improbable.

Loss Uncollectible and of such little value that continuance as a bankable asset is not warranted.

The ALL consists of specific, general, and unallocated components. The specific component is determined by identifying impaired loans (as described below) then evaluating each one to calculate the amount of impairment. Impaired loans measured for impairment generally include: (1) non-accruing Special mention, Substandard and Doubtful loans in excess of $250,000; (2) Substandard and Doubtful loans in excess of $500,000; (3) Special Mention loans in excess of $500,000 if any of the loans in the relationship are more than 30 days past due or if the borrower has filed for bankruptcy; and (4) all troubled debt restructurings (TDRs). A specific allowance arises when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component collectively evaluates smaller commercial loans, residential mortgages and consumer loans, grouped into segments and classes. Historical loss experience is calculated and applied to each segment or class, then adjusted for qualitative factors. Qualitative factors include changes in the local and national economic outlook, including unemployment, interest rates, inflation rates and real estate trends; the level and trend of past due and nonaccrual loans; strength of policies and procedures; and oversight of credit risk and quality of underwriting. These qualitative adjustments reflect management s judgment of risks inherent in the segments. An unallocated component is maintained if needed to cover uncertainties that could affect management s estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. Changes in the allowance for loan losses and the related provision expense can materially affect net income.

The specific component of the ALL calculation accounts for the loan loss reserve necessary on impaired loans. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not considered impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower s prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Accrual of interest may or may not be discontinued for any given impaired loan. Impairment is measured by either the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Because large groups of smaller balance homogeneous loans are collectively evaluated for impairment, the Company does not generally separately identify smaller balance individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a troubled debt restructuring agreement.

The general component of the ALL calculation collectively evaluates groups of loans in segments or classes, as noted above. The segments are: (1) Mortgage loans on real estate; (2) Commercial and industrial loans; and (3) Consumer and other loans. The segment for Mortgage loans on real estate is disaggregated into the following classes: (1) Construction, land and land development; (2) Farmland; (3) Residential first mortgages; (4) Residential revolving and junior mortgages; (5) Commercial mortgages (non-owner-occupied); and (6) Commercial mortgages (owner-occupied). Every loan is assigned to a segment or a class. Loans in segment 1 are secured by real estate. Loans in segments 2 and 3 are secured by other types of collateral or are unsecured. A given segment or class may not reflect the purpose of a loan. For example, a business owner may provide his residence as collateral for a loan to his company, in which case the loan would be grouped in a residential mortgage class. Historical loss factors are calculated for the prior 19 quarters by segment and class, and then applied to the current balances in each segment and class. Finally, qualitative factors are applied to each segment and class.

Construction and development loans carry risks that the project will not be finished according to schedule or according to budget and the value of the collateral, at any point in time, may be less than the principal amount of the loan. These loans also bear the risk that the general contractor may face financial pressure unrelated to the project. Loans secured by land, farmland and residential mortgages carry the risk of continued credit-worthiness of the borrower and changes in value of the underlying real estate collateral. Commercial mortgages and commercial and industrial loans carry risks associated with the profitable operation of a business and its related cash flows. Additionally, commercial and industrial loans carry risks associated with the value of collateral other than real estate which may depreciate over time. Consumer loans carry risks associated with the continuing credit-worthiness of the borrower and are more likely than real estate loans to be adversely affected by divorce, unemployment, personal illness or bankruptcy of an individual. Consumer loans secured by automobiles carry risks associated with rapidly depreciating collateral. Consumer loans include credit cards.

The summation of the specific, general and unallocated components results in the total estimated ALL. Management may also include an unallocated component to cover uncertainties in the level of probable losses. This estimate is inherently subjective and actual losses could be greater or less than the estimates.

Additions to the ALL are made by charges to earnings through the provision for loan losses. Charge-offs result from credit exposures deemed to be uncollectible and the ALL is reduced by these. Recoveries of previously charged off amounts are credited back to the ALL. Charge-off policies are materially the same for all types of loans.

Mortgage servicing rights (MSRs)

MSRs are included on the consolidated balance sheet and recorded at fair value on an ongoing basis. Changes in the fair value of the MSRs are recorded in the results of operations. A fair value analysis of MSRs is performed on a quarterly basis.

Note 3: Amendments to the Accounting Standards Codification

In January 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-04, Receivables Troubled Debt Restructurings by Creditors (Subtopic 310-4): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The amendment clarifies that an in-substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, either upon (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amendment also requires interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. Companies should apply this amendment for fiscal years and interim periods beginning after December 15, 2014. The Company adopted the new guidance during the first quarter of 2014. The adoption did not have a material impact on the Company s consolidated financial statements. Disclosures are included in Note 6.

In March 2014, the FASB issued ASU 2014-06, Technical Corrections and Improvements Related to Glossary Terms. These amendments relate to glossary terms and cover a wide range of topics in Accounting Standards Codification. These amendments are presented in four sections which include deletion of master glossary terms, addition to master glossary terms links, duplicate master glossary terms and other technical corrections related to glossary terms. The amendments were not expected to result in substantive changes to the application of existing guidance. The amendments were effective upon issuance and did not have a material impact on the Company s consolidated financial statements.

Note 4: Securities

The aggregate amortized costs and fair values of the available-for-sale securities portfolio are as follows:

(Dollars in thousands)				
Available-for-sale securities		Gross	Gross	
	Amortized	Unrealized	Unrealized	Fair
March 31, 2014 (unaudited)	Cost	Gains	(Losses)	Value

U.S. Government agencies	$ 9,199	$ 7	$ (80)	$ 9,126
State and municipal obligations	27,485	136	(783)	26,838
Certificates of deposits	1,736	11		1,747
	$ 38,420	$ 154	$ (863)	$ 37,711

Available-for-sale securities December 31, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U.S. Government agencies	$ 9,383	$ 11	$ (86)	$ 9,308
State and municipal obligations	27,690	109	(1,242)	26,557
Certificates of deposits	1,736	9		1,745
Auction rate security	912			912
	$ 39,721	$ 129	$ (1,328)	$ 38,522

Gross realized gains and gross realized losses on sales and calls of securities were as follows:

	For the Three months ended March 31,			
(Dollars in thousands)	2014		2013	
Gross realized gains	$		$	5
Gross realized losses		(1)		(2)
Net realized (losses) gains	$	(1)	$	3
Aggregate proceeds	$	1,292	$	1,095

Average yields on securities were 2.36% and 2.17% for the three months ended March 31, 2014 and 2013, respectively.

Securities with a market value of $11.2 million and $12.9 million were pledged as collateral for repurchase agreements and for other purposes as required by law as of March 31, 2014 and December 31, 2013, respectively.

Securities in an unrealized loss position at March 31, 2014 and December 31, 2013, by duration of the unrealized loss, are shown below. With the exception of the auction rate security which was sold in the first quarter of 2014, the unrealized loss positions were directly related to interest rate movements as there is minimal credit risk exposure in these investments. All agency securities, states and municipal securities and certificates of deposit are investment grade or better and their losses are considered temporary. Management does not intend to sell the securities and does not expect to be required to sell the securities. Furthermore, all amortized cost bases are expected to be recovered. Bonds with unrealized loss positions at March 31, 2014 included 16 U.S. treasuries, one federal agency and 46 municipals. Bonds with unrealized loss positions at December 31, 2013 included 50 municipals, 14 U.S. treasuries and agencies and one federal agency. The tables are shown below.

	Less than 12 months		12 months or more		Total	
(Dollars in thousands)	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
March 31, 2014	Value	Loss	Value	Loss	Value	Loss
U.S. Government agencies	$ 5,716	$ 58	$ 1,405	$ 22	$ 7,121	$ 80
States and municipal obligations	12,589	687	2,470	96	15,059	783
Total temporarily impaired securities	$ 18,305	$ 745	$ 3,875	$ 118	$ 22,180	$ 863

	Less than 12 months		12 months or more		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
December 31, 2013	Value	Loss	Value	Loss	Value	Loss
U.S. Government agencies	$ 4,808	$ 66	$ 1,462	$ 20	$ 6,270	$ 86
States and municipal obligations	14,255	1,120	2,306	122	16,561	1,242
Total temporarily impaired securities	$ 19,063	$ 1,186	$ 3,768	$ 142	$ 22,831	$ 1,328

The Company held one South Carolina Student Loan Corporation auction rate security with a face amount of $1.2 million and a carrying amount of $912 thousand as of December 31, 2013. In the first quarter of 2014, the Company sold this auction rate security for $912 thousand.

The Company s investment in Federal Home Loan Bank of Atlanta (FHLB) stock totaled $971,400 and $1,079,800 at March 31, 2014 and December 31, 2013, respectively. The investment in FHLB stock is a required investment related to the Company s membership with the FHLB. This investment is carried at cost since there is no ready market and redemptions have historically has been made at par. The Company does not consider this investment to be other-than-temporarily impaired at March 31, 2014 and no impairment has been recognized. FHLB stock is shown in the restricted securities line item on the consolidated balance sheets and is not a part of the available-for-sale securities portfolio.

The Company also had an investment in Federal Reserve Bank of Richmond (FRB) stock which totaled $382 thousand at both March 31, 2014 and December 31, 2013, respectively. The investment in FRB stock is a required investment and is carried at cost since there is no ready market. The Company does not consider this investment to be other-than-temporarily impaired at March 31, 2014 and no impairment has been recognized. FRB stock is shown in the restricted securities line item on the consolidated balance sheets and is not part of the available-for-sale securities portfolio.

Note 5: Loans

The following is a summary of the balances of loans:

(Dollars in thousands)	March 31, 2014	December 31, 2013
Mortgage loans on real estate:		
Construction, Land and Land Development	$ 32,882	$ 31,839
Farmland	1,240	1,262
Commercial Mortgages (Non-Owner Occupied)	14,789	14,626
Commercial Mortgages (Owner Occupied)	34,384	34,177
Residential First Mortgages	114,631	114,458
Residential Revolving and Junior Mortgages	25,077	24,045
Commercial and Industrial loans	24,610	23,938
Consumer Loans	5,514	5,986
Total loans	253,127	250,331
Net unamortized deferred loans costs	472	506
Allowance for loan losses	(2,950)	(2,925)
Loans, net	$ 250,649	$ 247,912

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The recorded investment in past due and non-accruing loans is shown in the following table. A loan past due by more than 90 days is generally placed on nonaccrual unless it is both well secured and in the process of collection.

(Dollars in thousands)

Loans Past Due and Nonaccruals

March 31, 2014	30-89 Days Past Due	90 Days or More Past Due and Still Accruing	Nonaccruals	Total Past Due and Nonaccruals	Current	Total Loans
Mortgage Loans on Real Estate:						
Construction, Land and Land Development	$ 64	$	$ 850	$ 914	$ 31,968	$ 32,882
Farmland					1,240	1,240
Commercial Mortgages (Non-Owner Occupied)	264			264	14,525	14,789
Commercial Mortgages (Owner Occupied)			421	421	33,963	34,384
Residential First Mortgages	1,079		743	1,822	112,809	114,631
Residential Revolving and Junior Mortgages	7		79	86	24,991	25,077
Commercial and Industrial			228	228	24,382	24,610
Consumer Loans	111	8	3	122	5,392	5,514
Total	$ 1,525	$ 8	$ 2,324	$ 3,857	$ 249,270	$ 253,127

Loans Past Due and Nonaccruals

December 31, 2013	30-89 Days Past Due	90 Days or More Past Due and Still Accruing	Nonaccruals	Total Past Due and Nonaccruals	Current	Total Loans
Mortgage Loans on Real Estate:						
Construction, Land and Land Development	$ 65	$	$ 854	$ 919	$ 30,920	$ 31,839
Farmland					1,262	1,262
Commercial Mortgages (Non-Owner Occupied)					14,626	14,626
Commercial Mortgages (Owner Occupied)			427	427	33,750	34,177
Residential First Mortgages	668		1,083	1,751	112,707	114,458
Residential Revolving and Junior Mortgages	108		76	184	23,861	24,045
Commercial and Industrial	16		311	327	23,611	23,938
Consumer Loans	60	19	3	82	5,904	5,986
Total	$ 917	$ 19	$ 2,754	$ 3,690	$ 246,641	$ 250,331

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Note 6: Allowance for Loan Losses

Allowance for Loan Losses

A disaggregation of and an analysis of the change in the allowance for loan losses by segment is shown below.

(Dollars in thousands)	Mortgage Loans on Real Estate	Commercial and Industrial	Consumer Loans	Total
For the Three Months Ended				
March 31, 2014				
ALLOWANCE FOR LOAN LOSSES:				
Beginning Balance	$ 2,465	$ 256	$ 204	$ 2,925
(Charge-offs)	(139)		(9)	(148)
Recoveries	6		2	8
Provision	165	(8)	8	165
Ending Balance	$ 2,497	$ 248	$ 205	$ 2,950
Individually evaluated for impairment	$ 620	$	$ 32	$ 652
Collectively evaluated for impairment	1,877	248	173	2,298

	Mortgage Loans on Real Estate	Commercial and Industrial	Consumer Loans	Total
For the Three Months Ended				
March 31, 2013				
ALLOWANCE FOR LOAN LOSSES:				
Beginning Balance	$ 2,571	$ 262	$ 260	$ 3,093
(Charge-offs)	(167)		(28)	(195)
Recoveries	51		2	53
Provision	42	44	(3)	83
Ending Balance	$ 2,497	$ 306	$ 231	$ 3,034
Individually evaluated for impairment	$ 814	$	$ 74	$ 888
Collectively evaluated for impairment	1,683	306	157	2,146

Loan receivables evaluated for impairment individually and collectively by segment as of March 31, 2014 and December 31, 2013 are as follows:

(Dollars in thousands)	Total

As of March 31, 2014	Mortgage Loans on Real Estate	Commercial and Industrial	Consumer Loans	
Individually evaluated for impairment	$ 7,866	$	$ 38	$ 7,904
Collectively evaluated for impairment	215,137	24,610	5,476	245,223
Total Gross Loans	$ 223,003	$ 24,610	$ 5,514	$ 253,127
As of December 31, 2013				
Individually evaluated for impairment	$ 6,306	$ 311	$ 39	$ 6,656
Collectively evaluated for impairment	214,101	23,627	5,947	243,675
Total Gross Loans	$ 220,407	$ 23,938	$ 5,986	$ 250,331

Internal Risk Rating Grades

Internal risk rating grades are generally assigned to commercial loans not secured by real estate, commercial mortgages, residential mortgages greater than $1 million, smaller residential mortgages which are impaired, loans to real estate developers and contractors, consumer loans greater than $250,000 with chronic delinquency, and TDRs, as shown in the following table. The grading analysis estimates the capability of the borrower to repay the contractual obligations of the loan agreements as scheduled. Risk grades (refer to Note 2) are evaluated as new information becomes available for each borrowing relationship or at least quarterly.

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(Dollars in thousands) As of March 31, 2014 INTERNAL RISK RATING GRADES	Construction, Land and Land Development	Farmland	Commercial Mortgages (Non-Owner Occupied)	Commercial Mortgages (Owner Occupied)	Commercial and Industrial	Total
Grade:						
Pass	$ 26,677	$ 1,240	$ 9,725	$ 24,556	$ 21,110	$ 83,308
Watch	3,479		4,725	5,576	2,522	16,302
Special mention	1,416			2,501	663	4,580
Substandard	1,310		339	1,751	315	3,715
Doubtful						
Total	$ 32,882	$ 1,240	$ 14,789	$ 34,384	$ 24,610	$ 107,905

As of December 31, 2013 INTERNAL RISK RATING GRADES	Construction, Land and Land Development	Farmland	Commercial Mortgages (Non-Owner Occupied)	Commercial Mortgages (Owner Occupied)	Commercial and Industrial	Total
Grade:						
Pass	$ 25,616	$ 1,262	$ 9,083	$ 23,984	$ 20,310	$ 80,255
Watch	3,493		5,204	7,429	2,743	18,869
Special mention	1,416			1,001	487	2,904
Substandard	1,314		339	1,763	399	3,815
Doubtful						
Total	$ 31,839	$ 1,262	$ 14,626	$ 34,177	$ 23,939	$ 105,843

Loans not assigned internal risk rating grades are comprised of smaller residential mortgages and smaller consumer loans. Payment activity of these loans is reviewed monthly by management. However, some of these loans are graded when the borrower s total exposure to the Bank exceeds the limits noted above. Loans are considered to be nonperforming when they are delinquent by 90 days or more or non-accruing and credit risk is primarily evaluated by delinquency status, as shown in the table below.

(Dollars in thousands) As of March 31, 2014 PAYMENT ACTIVITY STATUS	Residential First Mortgages (1)	Residential Revolving and Junior Mortgages (2)	Consumer Loans (3)	Total
Performing	$ 113,888	$ 24,998	$ 5,503	$ 144,389
Nonperforming	743	79	11	833
Total	$ 114,631	$ 25,077	$ 5,514	$ 145,222

As of December 31, 2013 PAYMENT ACTIVITY STATUS	Residential First Mortgages (4)	Residential Revolving and Junior Mortgages (5)	Consumer Loans (6)	Total
Performing	$ 113,375	$ 23,969	$ 5,964	$ 143,308
Nonperforming	1,083	76	22	1,181
Total	$ 114,458	$ 24,045	$ 5,986	$ 144,489

(1) Residential First Mortgages which have been assigned a risk rating grade of Substandard totaled $2.3 million as of March 31, 2014.
(2) Residential Revolving and Junior Mortgages which have been assigned a risk rating grade of Substandard totaled $218 thousand as of March 31, 2014.
(3) Consumer Loans which have been assigned a risk rating grade of Substandard totaled $8 thousand as of March 31, 2014.
(4) Residential First Mortgages which have been assigned a risk rating grade of Substandard totaled $2.6 million as of December 31, 2013.
(5) Residential Revolving and Junior Mortgages which have been assigned a risk rating grade of Substandard totaled $216 thousand as of December 31, 2013.
(6) Consumer Loans which have been assigned a risk rating grade of Substandard totaled $9 thousand as of December 31, 2013.

Impaired Loans

The following tables show the Company s recorded investment and the customers unpaid principal balances for impaired loans, with the associated allowance amount, if applicable as of March 31, 2014 and December 31, 2013 along with the average recorded investment and interest income recognized for the three months ended March 31, 2014 and 2013.

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(Dollars in thousands) IMPAIRED LOANS	As of March 31, 2014 (unaudited)			As of December 31, 2013		
With no related allowance:	Recorded Investment	Customers Unpaid Principal Balance	Related Allowance	Recorded Investment	Customers Unpaid Principal Balance	Related Allowance
Mortgage loans on real estate:						
Construction, land & land development	$ 453	$ 453	$	$ 453	$ 453	$
Residential First Mortgages	1,917	1,925		1,053	1,057	
Residential Revolving and Junior Mortgages (1)	98	98				
Commercial Mortgages (Non-owner occupied)	264	264		264	264	
Commercial Mortgages (Owner occupied)	2,457	2,471		1,831	1,840	
Commercial and Industrial				311	311	
Consumer (2)						
	$ 5,189	$ 5,211	$	$ 3,912	$ 3,925	$
With an allowance recorded:						
Mortgage loans on real estate:						
Construction, land & land development	$ 148	$ 156	$ 63	$ 151	$ 156	$ 51
Residential First Mortgages	2,187	2,193	397	2,198	2,198	409
Residential Revolving and Junior Mortgages (1)	237	289	159	251	879	173
Commercial Mortgages (Non-owner occupied)						
Commercial Mortgages (Owner occupied)	105	105	1	105	105	1
Commercial and Industrial						
Consumer (2)	38	38	32	39	39	33
	$ 2,715	$ 2,781	$ 652	$ 2,744	$ 3,377	$ 667
Total Impaired Loans:						
Mortgage loans on real estate:						
Construction, land & land development	$ 601	$ 609	$ 63	$ 604	$ 609	$ 51
Residential First Mortgages	4,104	4,118	397	3,251	3,255	409
Residential Revolving and Junior Mortgages (1)	335	387	159	251	879	173
Commercial Mortgages (Non-owner occupied)	264	264		264	264	
Commercial Mortgages (Owner occupied)	2,562	2,576	1	1,936	1,945	1
Commercial and Industrial				311	311	
Consumer (2)	38	38	32	39	39	33
	$ 7,904	$ 7,992	$ 652	$ 6,656	$ 7,302	$ 667

(1) Junior mortgages include equity lines.
(2) Includes credit cards.

(Dollars in thousands) IMPAIRED LOANS	For the Three Months Ended March 31, 2014 Average Recorded Investment	Interest Income Recognized	For the Three Months Ended March 31, 2013 Average Recorded Investment	Interest Income Recognized
With no related allowance:				
Mortgage Loans on Real Estate:				
Construction, Land and Land Development	$ 452	$ 1	$ 14	$
Residential First Mortgages	1,485	22	1,143	3
Residential Revolving and Junior Mortgages (1)	49	1	97	
Commercial Mortgages (Non-owner occupied)	264	4		
Commercial Mortgages (Owner occupied)	2,144	29	755	7
Consumer (2)				
	4,394	57	2,009	10
With an allowance recorded:				
Mortgage Loans on Real Estate:				
Construction, Land and Land Development	150		200	
Residential First Mortgages	2,193	21	2,855	26
Residential Revolving and Junior Mortgages (1)	244	2	1,042	1
Commercial Mortgages (Non-owner occupied)				
Commercial Mortgages (Owner occupied)	105	2	535	
Consumer (2)	39	1	74	2
	2,731	26	4,706	29
Total				
Mortgage Loans on Real Estate:				
Construction, Land and Land Development	602	1	214	
Residential First Mortgages	3,678	43	3,998	29
Residential Revolving and Junior Mortgages (1)	293	3	1,139	1
Commercial Mortgages (Non-owner occupied)	264	4		
Commercial Mortgages (Owner occupied)	2,249	31	1,290	7
Consumer (2)	39	1	74	2
	$ 7,125	$ 83	$ 6,715	$ 39

(1) Junior mortgages include equity lines.
(2) Includes credit cards.

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Smaller non-accruing loans and non-accruing loans that are not graded because they are included in homogenous pools generally do not meet the criteria for impairment testing, and are therefore excluded from impaired loan disclosures. At March 31, 2014 and December 31, 2013, non-accruing loans excluded from impaired loan disclosure totaled $404 thousand and $724 thousand, respectively. If interest on these non-accruing loans had been accrued, such income would have approximated $4 thousand and $11 thousand during the three months ended March 31, 2014 and 2013, respectively.

Loan Modifications

Loans modified as TDRs are considered impaired and are individually evaluated for the amount of impairment in the ALL. The following table presents, by segments of loans, information related to loans modified as TDRs during the three months ended March 31, 2014 and 2013.

(Dollars in thousands)	For the three months ended March 31, 2014			For the three months ended March 31, 2013		
TROUBLED DEBT RESTRUCTURINGS	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Residential first mortgages (1)				2	$ 315	$ 315

(1) Modifications were capitalization of the interest .

During the three months ended March 31, 2014 and 2013, no defaults occurred on loans modified in the preceding 12 months.

Foreclosures

As of March 31, 2014 and December 31, 2013, 11 residential properties with a fair value of $2.1 million and 11 residential properties with a fair value of $2.4 million, respectively, were included in other real estate owned (OREO). There were no collateralized consumer residential mortgage loans in the process of foreclosure as of March 31, 2014.

The balance of OREO as of March 31, 2014 consisted of 13 lots, two former convenience stores, one former restaurant, one commercial business property and a seafood house. The balance of OREO as of December 31, 2013 consisted of 14 lots, two former convenience stores, on former nursery property, one former restaurant, one commercial business property and a seafood house.

Note 7: Earnings per share

The following table shows the weighted average number of shares used in computing earnings per share and the effect on the weighted average number of shares of dilutive potential common stock.

For the Three Months Ended

	March 31, 2014		March 31, 2013	
(Unaudited)	Average Shares	Per share Amount	Average Shares	Per share Amount
Basic earnings per share	4,817,885	$ 0.10	4,813,812	$ 0.03
Effect of dilutive securities:				
Stock options	10,036		2,678	
Diluted earnings per share	4,827,921	$ 0.10	4,816,490	$ 0.03

For the three months ended March 31, 2014 and 2013, options on 76,067 and 185,467 shares, respectively, were not included in computing diluted earnings per share because their effects were anti-dilutive.

Note 8: Stock-Based Compensation

On June 28, 2013, the Company registered a new stock-based compensation plan, which superseded all other plans. There are 377,123 shares available for grant under this plan at March 31, 2014.

Stock-based compensation expense related to stock awards during the three month periods ended March 31, 2014 and 2013 was $19 thousand and $93 thousand, respectively. Compensation expense for stock options is the estimated fair value of options granted using the Black-Scholes Model amortized on a straight-line basis over the vesting period of the award. There was no unrecognized compensation expense related to stock options as of March 31, 2014.

Options for a total of 7,000 shares were granted and vested during the three months ended March 31, 2014. The fair value of options granted during the three months ended March 31, 2014 was $2.75. The variables used in these calculations include the historical dividend yield of 0.0%, expected life of the options of five years, expected stock price volatility of 51.4%, and a risk-free interest rate of 2.7%, which is assumed to be the rate on 5-year U.S. Treasury bonds.

Options for a total of 89,500 shares were granted and vested during the three months ended March 31, 2013. The fair value of options granted during the three months ended March 31, 2013 was $1.03 and $1.08. The variables used in these calculations include the historical dividend yield of 3.6%, expected life of the options of five years, expected stock price volatility of 33.8%, and a risk-free interest rate of 0.86%, which is assumed to be the rate on 5-year U.S. Treasury bonds.

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Stock option plan activity for the three months ended March 31, 2014 (unaudited) is summarized below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (1)
Options outstanding, January 1, 2014	191,002	$ 7.35	6.8	
Granted	7,000	5.99		
Forfeited				
Exercised				
Expired				
Options outstanding, March 31, 2014	198,002	$ 7.30	6.7	$ 127,814

(1) The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on March 31, 2014. This amount changes based on changes in the market value of the Company s common stock.

In the first quarter of 2014, 877 shares of restricted stock was granted to an executive which will vest over 12 months, with $5 thousand to be recorded as compensation expense over this period.

Note 9: Employee Benefit Plans

The Company has a non-contributory, defined benefit pension plan for full-time employees who were over 21 years of age and vested in the plan as of December 31, 2012, when the plan was frozen. Each participant s account balance grows based on monthly interest credits. The Company funds pension costs in accordance with the funding provisions of the Employee Retirement Income Security Act.

The Company sponsors a postretirement benefit plan covering current and future retirees who acquire age 55 and 10 years of service or age 65 and 5 years of service. The post-retirement benefit plan provides coverage toward a retiree s eligible medical and life insurance benefits expenses. The plan is unfunded and funded as benefits are due.

Components of Net Periodic Benefit Cost

(Unaudited)

(Dollars in thousands)	Pension Benefits		Post-Retirement Benefits	
Three months ended March 31,	2014	2013	2014	2013
Service cost	$	$	$ 4	$ 6

Interest cost	36	36	7	7
Expected return on plan assets	(51)	(54)		
Amortization of unrecognized net loss	9	23		1
Amortization of transition obligation				1
Net periodic (benefit) cost	$ (6)	$ 5	$ 11	$ 15

The Company expects to make no contribution to its pension plan and $11 thousand to its post-retirement benefit plan in 2014. The Company has contributed $3 thousand toward the post-retirement plan during the first three months of 2014.

Note 10: Long Term Debt

On March 31, 2014, the Bank had FHLB debt consisting of two advances (see table below). The $10 million advance was restructured during the second quarter of 2013 to extend the maturity and reduce the interest rate from 4.23% to a three month LIBOR-based floating rate advance.

Advances on the FHLB lines are secured by a blanket lien on qualified 1 to 4 family residential real estate loans with a lendable collateral value of $56.6 million. Immediate available credit, as of March 31, 2014, was $39.6 million. With additional collateral, the total line of credit is $65.9 million, with $48.9 million available.

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The two advances are shown in the following table.

Description	Balance	Originated	Current Interest Rate	Maturity Date
Adjustable Rate Hybrid	$ 10,000,000	4/12/2013	2.38%	4/13/2020
Fixed Rate Hybrid	5,000,000	5/20/2011	2.69%	5/20/2014
	$ 15,000,000			

Note 11: Fair Value Measurements
The Company uses fair value to record certain assets and liabilities and to determine fair value disclosures. Authoritative accounting guidance clarifies that fair value of certain assets and liabilities is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

Authoritative accounting guidance specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company s market assumptions. The three levels of the fair value hierarchy based on these two types of inputs are as follows:

Level 1 Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by the Company to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the financial statements:

Securities available-for-sale: Securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy.

Defined benefit plan assets: Defined benefit plan assets are recorded at fair value on an annual basis at year end.

Mortgage servicing rights: MSRs are recorded at fair value on a recurring basis, with changes in fair value recorded in the result of operations. A valuation model, which utilizes a discounted cash flow analysis using interest rates and prepayment assumptions currently quoted for comparable instruments and a discount rate, is used to determine fair value. MSRs are classified as Level 3.

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The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2014 and December 31, 2013:

(Dollars in thousands)	Fair Value Measurements at March 31, 2014 Using			
	Balance	Level 1	Level 2	Level 3
Securities available for sale:				
U. S. Government agencies	$ 9,126	$	$ 9,126	$
State and municipal obligations	26,838		26,838	
Certificates of deposit	1,747		1,747	
Total securities available for sale:	$ 37,711	$	$ 37,711	$
Mortgage servicing rights	$ 601	$	$	$ 601
Defined benefit plan assets:				
Cash and cash equivalents	$ 3	$ 3	$	$
Mutual funds - fixed income	1,070	1,070		
Mutual funds - equity	1,747	1,747		
Total defined benefit plan assets	$ 2,820	$ 2,820	$	$

	Fair Value Measurements at December 31, 2013 Using			
	Balance	Level 1	Level 2	Level 3
Securities available for sale:				
U. S. Government agencies	$ 9,308	$	$ 9,308	$
State and municipal obligations	26,557		26,557	
Certificates of deposit	1,745		1,745	
Auction rate security	912			912
Total securities available for sale:	$ 38,522	$	$ 37,610	$ 912
Mortgage servicing rights	$ 579	$	$	$ 579
Defined benefit plan assets:				
Cash and cash equivalents	$ 3	$ 3	$	$
Mutual funds - fixed income	1,070	1,070		
Mutual funds - equity	1,747	1,747		
Total defined benefit plan assets	$ 2,820	$ 2,820	$	$

The reconciliation of items using Level 3 inputs is as follows:

(Dollars in thousands)	Auction Rate Security	MSRs
Balance, January 1, 2014	$ 912	$ 579
Impairments		
Fair value adjustments		22
Redemptions and sales	(912)	
Balance, March 31, 2014	$	$ 601

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Company to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements:

Impaired Loans: Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. Any given loan may have multiple types of collateral. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral value is significantly adjusted due to differences in the comparable properties, or is discounted by the Company because of marketability, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business financial statements if not considered significant. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

Other Real Estate Owned: OREO is measured at fair value less estimated costs to sell, based on an appraisal conducted by an independent, licensed appraiser outside of the Company. If the collateral value is significantly adjusted due to differences in the comparable properties, or is discounted by the Company because of marketability, then the fair value is considered Level 3. OREO is measured at fair value on a nonrecurring basis. The initial fair value of OREO is based on an appraisal done at the time of foreclosure. Subsequent fair value adjustments are recorded in the period incurred and included in other noninterest income on the Consolidated Statements of Income.

The following table summarizes the Company s assets that were measured at fair value on a nonrecurring basis at the end of the respective period.

		Fair Value Measurements at March 31, 2014 Using		
(Dollars in thousands) Description	Balance as of March 31, 2014	Level 1	Level 2	Level 3
Impaired Loans, net	$ 2,063	$	$	$ 2,063
Other real estate owned, net	3,538			3,538

		Fair Value Measurements at December 31, 2013 Using		
Description	Balance as of December 31, 2013	Level 1	Level 2	Level 3
Impaired Loans, net	$ 2,077	$	$	$ 2,077
Other real estate owned, net	3,897			3,897

The following table displays quantitative information about Level 3 Fair Value Measurements as of March 31, 2014 and December 31, 2013:

(Dollars in thousands)	Balance as of March 31, 2014	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired Loans, net	$ 2,063	Discounted appraised value	Selling Cost	10% - 20% (10%)
			Lack of Marketability	25% - 100% (54%)
Other real estate owned, net	3,538	Discounted appraised value	Selling Cost	3% - 13% (6%)
			Lack of Marketability	7% - 20% (15%)

	Balance as of December 31, 2013	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired Loans, net	$ 2,077	Discounted appraised value	Selling Cost	10% - 20% (10%)
			Lack of Marketability	25% - 100% (54%)
Other real estate owned, net	3,897	Discounted appraised value	Selling Cost	3% - 13% (6%)
			Lack of Marketability	7% - 30% (15%)

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The estimated fair values of financial instruments are shown in the following table. The carrying amounts in the table are included in the balance sheet under the applicable captions.

		Fair Value Measurements at March 31, 2014 Using		
(Dollars in thousands) Description	Balance as of March 31, 2014	Level 1	Level 2	Level 3
Financial Assets:				
Cash and due from banks	$ 6,253	$ 6,253	$	$
Interest-bearing deposits	6,922	6,922		
Federal funds sold	333	333		
Securities available-for-sale	37,711		37,711	
Restricted securities	1,530			1,530
Loans, net	250,649			255,852
Loans held for sale				
Accrued interest receivable	1,026		1,026	
Mortgage servicing rights	601			601
Financial Liabilities:				
Non-interest-bearing liabilities	$ 56,975	$ 56,975	$	$
Savings and other interest-bearing deposits	113,833		113,833	
Time deposits	96,098			97,405
Securities sold under repurchase agreements	8,438		8,438	
FHLB advances	15,000		15,944	
Accrued interest payable	157		157	

		Fair Value Measurements at December 31, 2013 Using		
Description	Balance as of December 31, 2013	Level 1	Level 2	Level 3
Financial Assets:				
Cash and due from banks	$ 6,789	$ 6,789	$	$
Interest-bearing deposits	8,900	8,900		
Federal funds sold	120	120		
Securities available-for-sale	38,522		37,610	912
Restricted securities	1,638			1,638
Loans, net	247,912			253,139
Loans held for sale	196			196
Accrued interest receivable	1,124		1,124	
Mortgage servicing rights	579			579
Financial Liabilities:				
Non-interest-bearing liabilities	$ 57,805	$ 57,805	$	$
Savings and other interest-bearing deposits	114,056		114,056	

Time deposits	96,486		98,049
Securities sold under repurchase agreements	9,118	9,118	
FHLB advances	15,000	15,923	
Accrued interest payable	167	167	

The carrying amounts of cash and due from banks, interest-bearing deposits, federal funds sold or purchased, accrued interest and non-interest-bearing deposits, are payable on demand, or are of such short duration that carrying value approximates market value.

Securities available-for-sale are carried at the fair values measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Therefore carrying value equals market value. The carrying value of restricted securities approximates fair value based on the redemption provisions of the issuer.

The fair value of performing loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar remaining maturities. This calculation ignores loan fees and certain factors affecting the interest rates charged on various loans such as the borrower s creditworthiness and compensating balances and dissimilar types of real estate held as collateral. The fair value of impaired loans is measured as described within the Impaired Loans section of this note. The fair value of loans does not consider the lack of liquidity and uncertainty in the market that would affect the valuation.

Time deposits are presented at estimated fair value using interest rates offered for deposits of similar remaining maturities.

The fair value of the FHLB advances is estimated by discounting the future cash flows using the current interest rate offered for similar advances.

The fair value of commitments to extend credit is estimated using the fees currently charged to enter similar agreements, taking into account the remaining terms of the agreements and the present credit worthiness of the counter parties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of standby letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counter parties at the reporting date. At March 31, 2014 and December 31, 2012, the fair value of loan commitments and standby letters of credit was immaterial and therefore, they are not included in the table above.

The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair value of the Company s financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Company s overall interest rate risk.

Note 12: Changes in Accumulated Other Comprehensive Income (Loss)

The balances in accumulated other comprehensive income (loss) are shown in the following table (dollars in thousands):

(Dollars in thousands)	Net Unrealized Gains (Losses) on Securities	Pension and Post-retirement Benefit Plans	Accumulated Other Comprehensive Income (Loss)
Balance January 1, 2014	$ (791)	$ (382)	$ (1,173)
Change in net unrealized holding gains on securities, before reclassification, net of tax expense of $168	322		322
Reclassification for previously unrealized net losses recognized in income, net of tax benefit of $0	1		1
Balance March 31, 2014	$ (468)	$ (382)	$ (850)

Net Unrealized Gains	Pension and	Accumulated Other Comprehensive

	(Losses) on Securities	Post-retirement Benefit Plans	Income (Loss)
Balance January 1, 2013	$ 279	$ (660)	$ (381)
Change in net unrealized holding losses on securities, before reclassification, net of tax expense of $25	(49)		(49)
Reclassification for previously unrealized net gains recognized in income, net of tax benefit of $1	(1)		(1)
Balance March 31, 2013	$ 229	$ (660)	$ (431)

Reclassification for previously unrealized (losses) gains and impairments on securities are reported in the Consolidated Statements of Income as follows. No unrealized gains (losses) on pension and post-employment related costs were reclassified to the Consolidated Statements of Income in the first quarter of 2014 and 2013.

Accumulated Other Comprehensive Income (Loss)
Reclassification for the Three Months Ended
Holding Gains (Losses) on Securities

(In thousands)	March 31, 2014	March 31, 2013
Net (losses) gains on sale of securities available-for-securities	$ (1)	$ 1
Tax (expense) benefit		(1)
Impact on net income	$ (1)	$

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

The following discussion is intended to assist in understanding the results of operations and the financial condition of Bay Banks of Virginia, Inc. (the Company). This discussion should be read in conjunction with the above consolidated financial statements and the notes thereto.

STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This report contains statements concerning the Company s expectations, plans, objectives, future financial performance and other statements that are not historical facts. These statements may constitute forward-looking statements as defined by federal securities laws. These statements may address issues that involve estimates and assumptions made by management, risks and uncertainties, and actual results could differ materially from historical results or those anticipated by such statements. Factors that could have a material adverse effect on the operations and future prospects of the Company include, but are not limited to, changes in interest rates, general economic conditions, the legislative/regulatory climate, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Board of Governors of the Federal Reserve System, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, expansion activities, demand for financial services in the Company s market area and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating the forward-looking statements contained herein, and readers are cautioned not to place undue reliance on such statements, which speak only as of the date they are made.

EXECUTIVE SUMMARY

Earnings increased 228.6% for the first quarter of 2014 compared to the first quarter of 2013. The first quarter results are highlighted by loan growth, improved margins and lower expenses. The capital position remains solid. During the first quarter, the Company opened a loan production and wealth management office in Richmond, Virginia. The operations of this office are expected to be neutral to earnings within 15 months and had little impact on earnings in the first quarter of 2014. Core earnings and growth remain as priorities for the Company. Asset quality improved, with nonperforming assets down to 1.77% of total assets as of March 31, 2014.

The portfolio of loans serviced for Fannie Mae grew by $1.1 million since December 31, 2013 to $60.0 million as of March 31, 2014. This growth helped drive $22 thousand of gains in the value of the related MSRs during the first quarter of 2014. The in-house loan portfolio grew by $2.8 million, or 1.1%, during the first quarter of 2014.

Asset quality improved. OREO balances are down to $3.5 million as of March 31, 2014 compared to $3.9 million as of December 31, 2013. During the first quarter of 2014, three OREO properties were sold and three were added through foreclosures. Non-accruing loan balances are down to $2.3 million as of March 31, 2014 as compared to $2.8 million at December 31, 2013.

Annualized net loan charge-offs against the ALL are down to 0.22% of total loans during the first three months of 2014 compared to 0.24% during the first three months of 2013.

The net interest margin increased to 3.81% for the first quarter of 2014 compared to 3.40% for the same period in 2013. As this historic low-rate climate continues, loan and investment yields continue to decline, but increased loan balances have mitigated reductions in interest income. From March 31, 2013 to March 31, 2014, loan balances grew by $18.9 million. The refinance of a FHLB advance in April, 2013, and scheduled maturities of time deposits in 2013, have reduced both costs of funds and interest expense. The Bank s other FHLB advance will mature in May, 2014, and provide opportunity for further reductions. Maturities of time deposits are typically renewed at lower rates, leave the Bank or transfer to a lower-cost checking or savings account.

During the first quarter of 2014, the Company sold a troubled investment for which an impairment loss was recognized in 2013 (refer to Note 4). In addition, during the first quarter of 2014, the Company sold its former Heathsville, Virginia, branch office recognizing a gain of approximately $138 thousand.

Finally, the Company s core capital levels and regulatory ratios remain well above what is considered well capitalized by the Company s regulators. The Company took no Troubled Asset Relief Program or Small Business Lending Fund investments from the U.S. Treasury.

For more information, visit the Company s website at www.baybanks.com. Information contained on the Company s website is not a part of this report.

EARNINGS SUMMATION

For the three months ended March 31, 2014 and 2013, net income was $460 thousand and $140 thousand, respectively, an increase of $320 thousand or 228.6% from 2013 to 2014. Diluted earnings per average share for the three months ended March 31, 2014 and 2013 were $0.10 and $0.03, respectively. Return on average assets was 0.56% for the three months ended March 31, 2014 compared to 0.17% for the three months ended March 31, 2013. The annualized return on average equity was 4.90% and 1.53% for the three months ended March 31, 2014 and 2013, respectively.

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RESULTS OF OPERATIONS

The principal source of earnings for the Company is net interest income. Net interest income is the amount by which interest income exceeds interest expense. The net interest margin is net interest income expressed as a percentage of interest-earning assets. Changes in the volume and mix of interest-earning assets and interest-bearing liabilities, the associated yields and rates, and the volume of non-performing assets have an effect on net interest income, the net interest margin, and net income.

FOR THE THREE MONTHS ENDED MARCH 31, 2014 COMPARED TO THE THREE MONTHS ENDED MARCH 31, 2013

NET INTEREST INCOME

Net Interest Income Analysis (unaudited)

(Fully taxable equivalent basis)	Average Balances, Income and Expense, Yields and Rates					
(Dollars in Thousands)	Three months ended 3/31/2014			Three months ended 3/31/2013		
	Average Balance	Income/ Expense	Yield/ Cost	Average Balance	Income/ Expense	Yield/ Cost
INTEREST-EARNING ASSETS:						
Taxable Investments	$ 21,794	$ 94	1.73%	$ 26,734	$ 124	1.86%
Tax-Exempt Investments (1)	19,316	148	3.07%	11,775	85	2.88%
Total Investments	41,110	242	2.36%	38,509	209	2.17%
Gross Loans (2)	251,676	3,161	5.04%	235,022	3,154	5.38%
Interest-bearing Deposits	5,930	4	0.29%	32,658	18	0.23%
Federal Funds Sold	147		0.07%	204		0.07%
Total Interest Earning Assets	$ 298,863	$ 3,407	4.56%	$ 306,393	$ 3,381	4.41%
INTEREST-BEARING LIABILITIES:						
Savings Deposits	$ 44,387	$ 17	0.16%	$ 46,031	$ 30	0.26%
NOW Deposits	41,817	15	0.15%	40,997	23	0.23%
Time Deposits => $100,000	44,049	201	1.85%	47,239	260	2.23%
Time Deposits < $100,000	50,887	198	1.58%	58,149	277	1.93%
Money Market Deposit Accounts	27,237	27	0.40%	27,879	41	0.60%
Total Deposits	208,377	458	0.89%	220,295	631	1.16%
Federal Funds Purchased	137		0.00%			0.00%
Securities Sold Under Repurchase Agreements	7,380	2	0.11%	6,908	4	0.23%
FHLB Advances	15,000	100	2.70%	15,000	139	3.76%
Total Interest-Bearing Liabilities	$ 230,894	$ 560	0.98%	$ 242,203	$ 774	1.30%
Net interest income and net interest margin		$ 2,847	3.81%		$ 2,607	3.40%

Non interest-bearing deposits	$ 57,192	0.00%	$ 49,129	0.00%
Total Cost of funds		0.78%		1.06%
Net interest spread		3.78%		3.35%

Notes:

(1) Income and yield assumes a federal tax rate of 34%.
(2) Includes Visa program and nonaccrual loans.

Interest income for the three months ended March 31, 2014, on a tax-equivalent basis, was $3.4 million, an increase of $26 thousand from the first quarter of 2013. Interest expense for the three months ended March 31, 2014, was $560 thousand, a decrease of $214 thousand from the first quarter of 2013, due mainly to reductions in both balances and costs of time deposits, but also from the reduced cost of an FHLB advance. Net interest income for the three months ended March 31, 2014, on a tax-equivalent basis, was $2.8 million, an increase of $240 thousand from the first quarter of 2013. The annualized net interest margin was 3.81% and 3.40% for the three months ended March 31, 2014 and 2013, respectively. The deposit mix continues to improve as lower cost balances in checking accounts have increased while higher cost time deposit balances have declined. Further reductions in the cost of funds are anticipated as time deposits mature and are replaced at lower rates. As long as market rates remain low, this positive trend is expected to continue.

The net interest spread, which is the difference between the annualized yield on earning assets and the total cost of funds, increased to 3.78% for the three months ended March 31, 2014, compared to 3.35% for the three months ended March 31, 2013.

NON-INTEREST INCOME

Non-interest income for the three months ended March 31, 2014 increased $127 thousand, or 12.9%, compared to the three months ended March 31, 2013. This increase was primarily due a gain of $138 thousand recognized on the sale of the former branch office in Heathsville, Virginia. VISA-related fees declined by $91 thousand due to assignment of merchant agreements to a third party, but were offset by increases of $47 thousand from bank-owned life insurance and $44 thousand from gains on sale of OREO.

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NON-INTEREST EXPENSE

For the three months ended March 31, 2014, non-interest expenses totaled $3.1 million, a decrease of $161 thousand, or 4.9%, compared to the same period in 2013. This decrease is primarily the result of a reduction in salary and benefits of $143 due to lower stock compensation costs and lending commissions. Consulting expense increased by $76 thousand due to accounting services and VISA expense declined by $85 thousand due to the aforementioned assignment of merchant agreements to a third party.

AVERAGE INTEREST-EARNINGS ASSETS AND AVERAGE INTEREST-BEARING LIABILITIES

Average interest-earning assets decreased 2.5% to $298.9 million for the three months ended March 31, 2014, as compared to $306.4 million for the three months ended March 31, 2013, as interest-bearing deposits were redeployed into higher yielding loans and bank-owned life insurance. Average interest-earning assets as a percent of total average assets was 91.3% for the three months ended March 31, 2014 as compared to 93.0% for the same period in 2013. The loan portfolio, with $251.7 million in average balances as of March 31, 2014, is the largest category of interest-earning assets.

Average interest-bearing liabilities decreased 4.7% to $230.9 million for the three months ended March 31, 2014, as compared to $242.2 million for the three months ended March 31, 2013. The largest category of interest-bearing liabilities is time deposits, with combined average balances of $94.9 million for the three months ended March 31, 2014, down from $105.4 million for the similar period in 2013.

ASSET QUALITY

In the first three months of 2014, asset quality improved. Non-performing assets, which include OREO and non-performing loans, declined $0.8 million to $5.9 million, or 1.8% of assets. This level also represents 2.3% of loans plus OREO.

Non-Performing Assets

(Dollars in Thousands)	March 31, 2014	December 31, 2013
Loans past due 90 days or more and still accruing	$ 8	$ 18
Non-accruing loans	2,324	2,754
Total non-performing loans	2,332	2,772
Other real estate owned	3,538	3,897
Total non-performing assets	$ 5,870	$ 6,669
Allowance for loan losses	$ 2,950	$ 2,925
Allowance to non-performing loans	126.5%	105.5%
Non-performing assets to total assets	1.77%	2.01%

Non-performing loans, which include loans past due 90 days or more and still accruing, plus non-accruing loans, as a percentage of total loans, decreased to 0.9% as of March 31, 2014 compared to 1.1% as of December 31, 2013. Non-accruing loans totaled $2.3 million as of March 31, 2014, down from $2.8 million at year-end 2013.

Loans charged off during the first three months of 2014, net of recoveries, totaled $140 thousand compared to $142 thousand for the first three months of 2013. This represents a decline in the annualized net charge-off ratio to 0.22% for the first three months of 2014 compared to 0.24% for the first three months of 2013, reflecting an improvement in asset quality. The majority of the charge-offs were anticipated and specific reserves had been provided for them in the ALL. Management is maintaining an adequate level of the ALL at 1.16% and 1.17% of total loans for March 31, 2014 and December 31, 2013, respectively.

Classified assets, which include loans with risk rating grades of substandard, doubtful and loss, plus OREO, decreased by $1.7 million during the first three months of 2014 to $9.8 million, or 24.55% of Tier 1 capital plus the allowance for loan losses. Risk rating grades are assigned conservatively, causing some homogenous loans, such as residential mortgages, to fall into the pool of adversely risk rated loans and thereby evaluated for impairment, even though they may be performing as agreed and therefore not impaired.

As of March 31, 2014, loans valued at $7.9 million were considered impaired, whereas $6.7 million were considered impaired as of December 31, 2013. Between December 31, 2013 and March 31, 2014, five loans were identified as impaired and none were dispensed through foreclosures and charge-offs. Management has reviewed the impaired credits and the underlying collateral and expects no additional losses above those which are specifically reserved in ALL.

FINANCIAL CONDITION

Total assets remained relatively flat at $330.1 million as of March 31, 2014 compared to $331.1 million at December 31, 2013. Cash and due from banks, which produces no income, decreased to $6.3 million on March 31, 2014 from $6.8 million at year-end 2013, a result of normal daily fluctuation in deposit transactions. Interest-bearing deposits at other banks, which is mainly the Bank s cash on deposit at the Federal Reserve Bank of Richmond, has declined by $2.0 million since year end 2013.

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During the three months ended March 31, 2014, gross loans increased by $2.8 million or 1.1%, to $253.1 million from $250.3 million at year-end 2013. The largest components of this increase were $1.0 million related to construction and land development, $1.0 million related to residential revolving and junior mortgages and $0.7 million related to commercial and industrial.

The Bank had $3.5 million of OREO at March 31, 2014 and $3.9 million at December 31, 2013. As of March 31, 2014, OREO consists of 11 residences, 13 lots, two former convenience stores, one former restaurant, one commercial business property and a seafood house. During the first three months of 2014, three properties with a total book value of $197 thousand from two borrowers were added through foreclosures, and three properties with a total book value of $556 thousand were sold. There were no write-downs of OREO properties during the first three months of 2014, compared to $16 thousand for the same period in 2013. All properties maintained as OREO are valued at the lesser of carrying value or fair value less estimated costs to sell and are actively marketed.

In March 2014, the Company sold a former branch in Heathsville, Virginia for $311 thousand and recognized a gain of $138 thousand on the sale. The branch was included in other assets as of December 31, 2013.

As of March 31, 2014, securities available-for-sale at fair value totaled $37.7 million as compared to $38.5 million on December 31, 2013. This represents a net decrease of $811 thousand or 2.1% for the three months. The decrease in securities available-for-sale is primarily the result of the sale of a troubled asset with a fair value of $912 thousand. An impairment loss was recognized on this asset in 2013 and therefore, no gain or loss was recognized on the sale of the asset as its carrying value equaled its fair value at the time of sale. As of March 31, 2014, available-for-sale securities represented 11.4% of total assets and 12.6% of earning assets. All securities in the Company s investment portfolio are classified as available-for-sale and marked to market on a monthly basis. These gains or losses, net of tax, are booked as an adjustment to shareholders equity, and are not realized as an adjustment to earnings until the securities are actually sold or an other than temporary impairment occurs.

In the second quarter of 2013, the Company purchased $5.0 million of bank owned life insurance in order to offset the cost of employee benefits. The bank owned life insurance s fair market value as of March 31, 2014 was $5.2 million.

As of March 31, 2014, total deposits were $266.9 million compared to $268.3 million at year-end 2013. This represents a decrease in balances of $1.4 million or 0.5% during the three months. The decline consisted of $388 thousand of reductions in time deposit balances, $223 thousand in savings and interest-bearing demand deposits, and $830 thousand in non-interest bearing deposits.

As of March 31, 2014, securities sold under repurchase agreements decreased $680 thousand to $8.4 million from $9.1 million at December 31, 2013. This decrease was the result of normal seasonality for these customers.

LIQUIDITY

Liquidity represents an institution s ability to meet present and future financial obligations (such as commitments to fund loans) through either the sale or maturity of existing assets or the acquisition of additional funds through liability management. Liquid assets include cash, interest-bearing deposits with other banks, federal funds sold and investments and loans maturing within one year. The Company s ability to obtain deposits and purchase funds at favorable rates are major factors for liquidity. Management believes that the Company maintains overall liquidity that is sufficient to satisfy its depositors requirements and to meet its customers credit needs.

At March 31, 2014, cash totaled $6.3 million, federal funds sold totaled $333 thousand, interest-bearing deposits totaled $6.9 million, and securities and loans maturing in one year or less totaled $26.0 million. This results in a liquidity ratio as of March 31, 2014 of 12.0% as compared to 12.9% as of December 31, 2013. The Company determines this ratio by dividing the sum of cash and cash equivalents, investment securities maturing in one year or less, loans maturing in one year or less and federal funds sold, by total assets. The Bank has a formal liquidity management policy and contingency plan, which includes periodic evaluation of cash flow projections.

In addition, the Company has a line of credit with the FHLB of $65.9 million, plus federal funds lines of credit with correspondent banks totaling $20.3 million.

CAPITAL RESOURCES

Capital resources represent funds, earned or obtained, over which a financial institution can exercise greater long-term control in comparison with deposits and borrowed funds. The adequacy of the Company s capital is reviewed by management on an ongoing basis with reference to size, composition, and quality of the Company s resources and consistency with regulatory requirements and industry standards. Management seeks to maintain a capital structure that will assure an adequate level of capital to support anticipated asset growth and to absorb potential losses, yet allows management to effectively leverage its capital to maximize return to shareholders. The Company s capital, also known as shareholders equity, is comprised mainly of outstanding common stock and retained earnings. Capital can be increased with securities offerings or through earnings.

Several factors impact shareholders equity, including net income and regulatory capital requirements. The Company s capital resources are also impacted by net unrealized gains or losses on securities. The available-for-sale securities portfolio is marked to market monthly and unrealized gains or losses, net of taxes, are recognized as accumulated other comprehensive income (loss) on the balance sheets and statement of changes in shareholders equity. Another factor affecting accumulated other comprehensive income (loss) is changes in the market value of the Company s pension and post-retirement benefit plans. The Company s shareholders equity before accumulated other comprehensive loss was $38.8 million on March 31, 2014 compared to $38.3 million on December 31, 2013. Accumulated other comprehensive loss decreased $323 thousand between December 31, 2013 and March 31, 2014, primarily as a result of decreases in unrealized net losses in the investment portfolio.

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Book value per share, before accumulated other comprehensive loss, on March 31, 2014, compared to December 31, 2013, increased to $8.05 from $7.96. Book value per share, including accumulated other comprehensive loss, increased to $7.87 on March 31, 2014 from $7.71 on December 31, 2013. No cash dividends were paid for the three-month period ended March 31, 2014, nor for the comparable period ended March 31, 2013.

The Bank is subject to minimum regulatory capital ratios as defined by Federal Financial Institutions Examination Council guidelines. These ratios continue to be well in excess of regulatory minimums. As of March 31, 2014, the Bank maintained Tier 1 capital of $30.9 million, net risk weighted assets of $239.3 million, and Tier 2 capital of $2.9 million. On March 31, 2014, the Tier 1 leverage ratio was 9.57%, the Tier 1 capital to risk weighted assets ratio was 12.92%, and the total capital ratio to risk weighted assets ratio was 14.16%.

OFF BALANCE SHEET COMMITMENTS

In the normal course of business, the Company offers various financial products to its customers to meet their credit and liquidity needs. These instruments may involve elements of liquidity, credit and interest rate risk in excess of the amount recognized in the Consolidated Balance Sheets. The Company s exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby-letters of credit is represented by the contractual amount of these instruments. Subject to its normal credit standards and risk monitoring procedures, the Company makes contractual commitments to extend credit. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments may expire without being completely drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Conditional commitments are issued by the Company in the form of performance stand-by letters of credit, which guarantee the performance of a customer to a third-party. The credit risk of issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

Off Balance Sheet Arrangements

(unaudited)	March 31, 2014	December 31, 2013
(Dollars in thousands)		
Total Loan Commitments Outstanding	$ 36,789	$ 37,279
Standby-by Letters of Credit	331	329

The Company maintains liquidity and credit facilities with non-affiliated banks in excess of the total loan commitments and stand-by letters of credit. As these commitments are earning assets only upon takedown of the instrument by the customer, thereby increasing loan balances, management expects the revenue of the Company to be enhanced as these credit facilities are utilized.

There have been no material changes to the off balance sheet items disclosed in Management s Discussion and Analysis of Financial Condition and Results of Operation in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

CONTRACTUAL OBLIGATIONS

There have been no material changes outside the ordinary course of business to the contractual obligations disclosed in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

RECENT ACCOUNTING PRONOUNCEMENTS

Refer to Note 3, Amendments to the Accounting Standards Codification, for information related to the adoption of new amendments to the Accounting Standards Codification.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not required.

ITEM 4. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

As of the end of the period to which this report relates, the Company has carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures pursuant to Rule 13a-14 of the Securities Exchange Act of 1934. In designing and evaluating its disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that objectives of the disclosure controls and procedures are met. The design of any disclosure controls and procedures is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential conditions. Based upon their evaluation, the Company s Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company s periodic Securities and Exchange Commission filings as of March 31, 2014.

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CHANGES IN INTERNAL CONTROLS OVER FINANCIAL REPORTING

There was no change to the Company s internal control over financial reporting during the three months ended March 31, 2014 that materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In the ordinary course of its operations, the Company is a party to various legal proceedings. Based upon information currently available, management believes that such legal proceedings, in the aggregate, will not have a material adverse effect on the business, financial condition, or results of operations of the Company.

ITEM 1A. RISK FACTORS

Not required.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None to report.

ITEM 3. DEFAULT UPON SENIOR SECURITIES

None to report.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None to report.

ITEM 6. EXHIBITS

3.2 Bylaws of Bay Banks of Virginia, Inc., as amended March 28, 2014 (incorporated by reference by previously filed 8-K on March 28, 2014)

31.1	Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification Pursuant to 18 U.S.C Section 1350 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following materials from the Company s Quarterly Report on Form 10-Q for the quarter ended March 31, 2014, formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets as of March 31, 2014 and December 31, 2013, (ii) Consolidated Statements of Income for the three months ended March 31, 2014 and 2013, (iii) Consolidated Statements of Comprehensive Income for the three months ended March 31, 2014 and 2013, (iv) Consolidated Statements of Changes in Shareholders Equity for the three months ended March 31, 2014, (v) Consolidated Statements of Cash Flows for the three months ended March 31, 2014 and 2013, and (vi) Notes to Consolidated Financial Statements.

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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.

	Bay Banks of Virginia, Inc. (Registrant)	
May 13, 2014	By:	/s/ Randal R. Greene Randal R. Greene President and Chief Executive Officer (Principal Executive Officer)
	By:	/s/ Deborah M. Evans Deborah M. Evans Treasurer and Chief Financial Officer (Principal Financial and Accounting Officer)

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