NATIONAL BANKSHARES INC
Form 10-Q
May 09, 2018

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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, 2018
**[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ________ to ________

Commission File Number 0-15204

**NATIONAL BANKSHARES, INC.**

(Exact name of registrant as specified in its charter)

| Virginia | 54-1375874 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

101 Hubbard Street

P. O. Box 90002

| Blacksburg, VA | 24062-9002 |
|---|---|
| (Address of principal executive offices) | (Zip Code) |

(540) 951-6300

(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, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b–2 of the Exchange Act.

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

Emerging growth company [ ]

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

[ ] Yes [ ] No

Note: the text of Form 10-Q does not, and this amendment will not, appear in the Code of Federal Regulations.

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.

| Class | Outstanding at May 8, 2018 |
|---|---|

Common Stock, $1.25 Par Value 6,957,974

(This report contains 56 pages)

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**NATIONAL BANKSHARES, INC. AND SUBSIDIARIES**

Form 10-Q

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**Part I**

**Item 1. Financial Statements Financial Information**
National Bankshares, Inc. and Subsidiaries

Consolidated Balance Sheets

| (in thousands, except share and per share data) | (Unaudited) March 31, 2018 | December 31, 2017 |
|---|---|---|
| **Assets** | | |
| Cash and due from banks | **$ 10,598** | $ 12,926 |
| Interest-bearing deposits | **76,571** | 51,233 |
| Securities available for sale, at fair value | **337,211** | 331,387 |
| Securities held to maturity (fair value of $124,549 at March 31, 2018 and $130,113 at December 31, 2017) | **122,905** | 127,164 |
| Restricted stock, at cost | **1,221** | 1,200 |
| Loans held for sale | **---** | 260 |
| Loans: | | |
| Loans, net of unearned income and deferred fees and costs | **658,663** | 668,069 |
| Less allowance for loan losses | **(7,391)** | (7,925) |
| Loans, net | **651,272** | 660,144 |
| Premises and equipment, net | **8,120** | 8,221 |
| Accrued interest receivable | **5,360** | 5,297 |
| Other real estate owned, net | **2,741** | 2,817 |
| Intangible assets and goodwill | **5,886** | 5,898 |
| Bank-owned life insurance | **33,984** | 33,756 |
| Other assets | **14,659** | 16,454 |
| **Total assets** | **$ 1,270,528** | $ 1,256,757 |
| | | |
| **Liabilities and Stockholders' Equity** | | |
| Noninterest-bearing demand deposits | **$ 190,746** | $ 182,511 |
| Interest-bearing demand deposits | **628,540** | 622,189 |
| Savings deposits | **142,019** | 140,150 |
| Time deposits | **111,635** | 114,884 |
| Total deposits | **1,072,940** | 1,059,734 |
| Accrued interest payable | **55** | 62 |
| Other liabilities | **11,996** | 12,065 |
| Total liabilities | **1,084,991** | 1,071,861 |
| Commitments and contingencies | | |

| | | |
|---|---|---|
| **Stockholders' Equity** | | |
| Preferred stock, no par value, 5,000,000 shares authorized; none issued and outstanding | ***---*** | *---* |
| Common stock of $1.25 par value. Authorized 10,000,000 shares; issued and outstanding 6,957,974 shares at March 31, 2018 and at December 31, 2017 | ***8,698*** | *8,698* |
| Retained earnings | ***189,189*** | *185,893* |
| Accumulated other comprehensive loss, net | ***(12,350)*** | *(9,695)* |
| Total stockholders' equity | ***185,537*** | *184,896* |
| **Total liabilities and stockholders' equity** | **$** ***1,270,528*** | $ *1,256,757* |

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Income

Three Months Ended March 31, 2018 and 2017

(Unaudited)

| (in thousands, except share and per share data) | March 31, 2018 | March 31, 2017 |
|---|---|---|
| **Interest Income** | | |
| Interest and fees on loans | $7,532 | $7,453 |
| Interest on interest-bearing deposits | 172 | 148 |
| Interest on securities – taxable | 1,608 | 1,402 |
| Interest on securities – nontaxable | 1,172 | 1,235 |
| Total interest income | 10,484 | 10,238 |
| **Interest Expense** | | |
| Interest on time deposits | 121 | 145 |
| Interest on other deposits | 960 | 883 |
| Total interest expense | 1,081 | 1,028 |
| Net interest income | 9,403 | 9,210 |
| Provision for (recovery of) loan losses | (472) | 59 |
| Net interest income after provision for (recovery of) loan losses | 9,875 | 9,151 |
| **Noninterest Income** | | |
| Service charges on deposit accounts | 670 | 665 |
| Other service charges and fees | 33 | 69 |
| Credit and debit card fees | 344 | 244 |
| Trust income | 402 | 401 |
| BOLI income | 228 | 143 |
| Other income | 346 | 328 |
| Total noninterest income | 2,023 | 1,850 |
| **Noninterest Expense** | | |
| Salaries and employee benefits | 3,694 | 3,523 |
| Occupancy and furniture and fixtures | 472 | 438 |
| Data processing and ATM | 733 | 566 |
| FDIC assessment | 91 | 95 |
| Intangible assets amortization | 12 | 31 |

| | | |
|---|---|---|
| Net costs of other real estate owned | ***85*** | *29* |
| Franchise taxes | ***331*** | *322* |
| Write-down of insurance receivable | ***1,724*** | --- |
| Other operating expenses | ***1,022*** | *1,279* |
| Total noninterest expense | ***8,164*** | *6,283* |
| Income before income taxes | ***3,734*** | *4,718* |
| Income tax expense | ***438*** | *1,069* |

(*continued)*

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| | | |
|---|---|---|
| **Net Income** | **$*3,296*** | $*3,649* |
| Basic net income per common share | **$*0.47*** | $*0.52* |
| Fully diluted net income per common share | **$*0.47*** | $*0.52* |
| Weighted average number of common shares outstanding – basic and diluted | ***6,957,974*** | *6,957,974* |
| Dividends declared per common share | **$---** | $--- |

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

Three Months Ended March 31, 2018 and 2017

(Unaudited)

| **(in thousands)** | **March 31, 2018** | **March 31, 2017** |
|---|---|---|
| Net Income | **$*3,296*** | $*3,649* |
| **Other Comprehensive Income (Loss), Net of Tax** | | |
| Unrealized holding gain (loss) on available for sale securities net of tax of ($706) and $580 for the periods ended March 31, 2018 and 2017, respectively | ***(2,655*)** | *1,075* |
| Other comprehensive income (loss), net of tax | ***(2,655*)** | *1,075* |
| **Total Comprehensive Income** | **$*641*** | $*4,724* |

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity

Three Months Ended March 31, 2018 and 2017

(Unaudited)

| **(in thousands)** | **Common Stock** | **Retained Earnings** | **Accumulated Other Comprehensive Loss** | **Total** |
|---|---|---|---|---|
| Balances at December 31, 2016 | $ *8,698* | $*178,224* | $ *(8,659* ) | $*178,263* |
| Net income | --- | *3,649* | --- | *3,649* |
| Other comprehensive income, net of tax of $580 | --- | --- | *1,075* | *1,075* |
| Balances at March 31, 2017 | $ *8,698* | *181,873* | *(7,584* ) | *182,987* |
| | | | | |
| Balances at December 31, 2017 | $ *8,698* | $*185,893* | $ *(9,695* ) | $*184,896* |
| Net income | --- | *3,296* | --- | *3,296* |
| Other comprehensive loss, net of tax of ($706) | --- | --- | *(2,655* ) | *(2,655* ) |
| **Balances at March 31, 2018** | **$ *8,698*** | **$*189,189*** | **$ *(12,350* )** | **$*185,537*** |

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

Three Months Ended March 31, 2018 and 2017

(Unaudited)

| (in thousands) | March 31, 2018 | March 31, 2017 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Net income | $3,296 | $3,649 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for (recovery of) loan losses | (472) | 59 |
| Depreciation of bank premises and equipment | 203 | 204 |
| Amortization of intangibles | 12 | 31 |
| Amortization of premiums and accretion of discounts, net | 15 | 17 |
| Loss and write-down on other real estate owned, net | 76 | 8 |
| Increase in cash value of bank-owned life insurance | (228) | (143) |
| Originations of mortgage loans held for sale | (2,486) | (2,771) |
| Proceeds from sale of mortgage loans held for sale | 2,788 | 2,676 |
| Gain on sale of mortgage loans held for sale | (42) | (35) |
| Write-down of insurance receivable | 1,724 | --- |
| Net change in: | | |
| Accrued interest receivable | (63) | (7) |
| Other assets | 777 | (1,570) |
| Accrued interest payable | (7) | (10) |
| Other liabilities | (69) | 1,432 |
| Net cash provided by operating activities | 5,524 | 3,540 |
| | | |
| **Cash Flows from Investing Activities** | | |
| Net change in interest-bearing deposits | (25,338) | (5,284) |
| Proceeds from calls, principal payments, sales and maturities of securities available for sale | 1,794 | 1,567 |
| Proceeds from calls, principal payments and maturities of securities held to maturity | 4,238 | 1,338 |
| Purchases of securities available for sale | (10,973) | --- |
| Net change in restricted stock | (21) | (30) |
| Purchases of loan participations | (1,521) | (487) |
| Collections of loan participations | 16 | 14 |
| Loan originations and principal collections, net | 10,772 | (4,231) |
| Proceeds from sales of other real estate owned | --- | 196 |

| | | |
|---|---|---|
| Recoveries on loans charged off | ***77*** | *45* |
| Proceeds from sale and purchases of premises and equipment, net | ***(102)*** | *(26)* |
| Net cash used in investing activities | ***(21,058)*** | *(6,898)* |

*(continued)*

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| | | |
|---|---|---|
| **Cash Flows from Financing Activities** | | |
| Net change in time deposits | ***(3,249 )*** | *(5,760 )* |
| Net change in other deposits | ***16,455*** | *8,798* |
| Net cash provided by (used in) financing activities | ***13,206*** | *3,038* |
| Net change in cash and due from banks | ***(2,328 )*** | *(320 )* |
| Cash and due from banks at beginning of period | ***12,926*** | *13,974* |
| Cash and due from banks at end of period | **$*10,598*** | $*13,654* |
| | | |
| **Supplemental Disclosures of Cash Flow Information** | | |
| Interest paid on deposits and borrowed funds | **$*1,088*** | $*1,038* |
| Income taxes paid | **---** | --- |
| | | |
| **Supplemental Disclosure of Noncash Activities** | | |
| Loans charged against the allowance for loan losses | **$*139*** | $*143* |
| Loans transferred to other real estate owned | **---** | --- |
| Unrealized net gain (loss) on securities available for sale | ***(3,361 )*** | *1,655* |

See accompanying notes to consolidated financial statements.

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**National Bankshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**March 31, 2018**

**(Unaudited)**

**$ in thousands, except per share data**

**Note *1*: General**

The consolidated financial statements of National Bankshares, Inc. (“NBI”) and its wholly-owned subsidiaries, The National Bank of Blacksburg (“NBB”) and National Bankshares Financial Services, Inc. (“NBFS”) (collectively, the “Company”), conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The accompanying interim period consolidated financial statements are unaudited; however, in the opinion of management, all adjustments consisting of normal recurring adjustments, which are necessary for a fair presentation of the consolidated financial statements, have been included. The results of operations for the *three* month period ended *March 31, 2018* are *not* necessarily indicative of results of operations for the full year or any other interim period. The interim period consolidated financial statements and financial information included in this Form *10*-Q should be read in conjunction with the notes to consolidated financial statements included in the Company’s *2017* Form *10*-K. The Company posts all reports required to be filed under the Securities and Exchange Act of *1934* on its web site at www.nationalbankshares.com.

Accounting Standards Adopted in *2018*

*ASU No. 2014-09, “Revenue from Contracts with Customers”*

In *May 2014,* the FASB issued ASU *No. 2014-09, “Revenue from Contracts with Customers.”* The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies generally will be required to use more judgment and make more estimates than under current guidance. These *may* include identifying performance obligations in the contract,

estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. Subsequent to the issuance of ASU *2014-09,* the FASB issued targeted updates to clarify specific implementation issues including ASU *No. 2016-08, "Principal versus Agent Considerations (Reporting Revenue Gross versus Net),"* ASU *No. 2016-10, "Identifying Performance Obligations and Licensing,"* ASU *No. 2016-12, "Narrow-Scope Improvements and Practical Expedients,"* and ASU *No. 2016-20 "Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers."* For financial reporting purposes, the standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application.

Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income and expense. The Company completed its overall assessment of revenue streams and review of related contracts potentially affected by the ASU, including trust and asset management fees, deposit related fees, interchange fees, merchant income, bank-financed sales of other real estate owned and annuity and insurance commissions. Based on this assessment, the Company concluded that ASU 2014-09 did not materially change the method in which the Company currently recognizes revenue for these revenue streams. The Company also completed its evaluation of certain costs related to these revenue streams to determine whether such costs should be presented as expenses or contra-revenue (i.e., gross vs. net). Based on its evaluation, the Company determined that the classification of certain debit and credit card related costs should change (i.e., costs previously recorded as expense is now recorded as contra-revenue). The Company identified $654 previously presented as credit card processing expense at March 31, 2017 and reclassified it to net against credit card fee income. The Company adopted ASU 2014-09 and its related amendments on its required effective date of January 1, 2018 utilizing the full retrospective approach. There was no impact to net income. Consistent with the full retrospective approach, the Company adjusted prior period amounts for the debit and credit card costs reclassifications noted above.

*ASU No. 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities"*

In *January 2016,* the FASB issued ASU *No. 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities."* This ASU addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments by making targeted improvements to GAAP. The provisions of the ASU that apply to the Company are as follows: (*1*) require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. However, an entity *may* choose to measure equity investments that do *not* have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer; (*2*) simplify the impairment

assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value; (*3*) eliminate the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (*4*) require use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (*5*) require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (*6*) clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The adoption of ASU *No. 2016-01* on *January 1, 2018* did *not* have a material impact on the Company's

Consolidated Financial Statements. In accordance with (*4*) above, the Company measured the fair value of its loan portfolio and time deposit portfolio as of *March 31, 2018* using an exit price notion (see Note *14 Fair Value of Assets and Liabilities*).

*ASU No. 2017-07, "Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost"*

In *March 2017,* the FASB issued ASU *No. 2017-07, "Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost."* Under the new guidance, employers are required to present the service cost component of the net periodic benefit cost in the same income statement line item (e.g., Salaries and Employee Benefits) as other employee compensation costs arising from services rendered during the period. In addition, only the service cost component will be eligible for capitalization in assets. Employers will present the other components of net periodic benefit cost separately (e.g., Other Noninterest Expense) from the line item that includes the service cost. ASU *No. 2017-07* is effective for interim and annual reporting periods beginning after *December 15, 2017.* Employers will apply the guidance on the presentation of the components of net periodic benefit cost in the income statement retrospectively. The guidance limiting the capitalization of net periodic benefit cost in assets to the service cost component will be applied prospectively. The Company adopted ASU *No. 2017-07* on *January 1, 2018* and utilized the ASU's practical expedient allowing entities to estimate amounts for comparative periods using the information previously disclosed in their pension and other postretirement benefit plan footnote and re-classified non-servicing components of net periodic pension cost from compensation expense to other noninterest expense. ASU *No. 2017-07* did *not* have a material impact on the Company's Consolidated Financial Statements.

Reclassifications

In addition to reclassifications resulting from adoption of new accounting guidance, certain reclassifications have been made to prior period balances to conform to the current year presentations. Prior to *June 2017,* the Company reported certain IRA accounts in interest-bearing demand deposit accounts and in time deposits. During *2017,* the Company re-classified the accounts as savings accounts. In order to provide comparability to prior periods, deposits have been adjusted to reflect the reclassification in each year reported.

**Note *2*: Loan Portfolio**

The loan portfolio, excluding loans held for sale, was comprised of the following.

| | **March 31, 2018** | **December 31, 2017** |
|---|---|---|
| Real estate construction | **$*32,081*** | $ *34,694* |
| Consumer real estate | ***167,428*** | *166,965* |

| | | |
|---|---|---|
| Commercial real estate | ***333,365*** | *340,414* |
| Commercial non real estate | ***42,076*** | *40,518* |
| Public sector and IDA | ***51,091*** | *51,443* |
| Consumer non real estate | ***33,211*** | *34,648* |
| Gross loans | ***659,252*** | *668,682* |
| Less unearned income and deferred fees and costs | ***(589 )*** | *(613 )* |
| Loans, net of unearned income and deferred fees and costs | **$*658,663*** | $ *668,069* |

**Note *3*: Allowance for Loan Losses, Nonperforming Assets and Impaired Loans**

The allowance for loan losses methodology incorporates individual evaluation of impaired loans and collective evaluation of groups of non-impaired loans. The Company performs ongoing analysis of the loan portfolio to determine credit quality and to identify impaired loans. Credit quality is rated based on the loan's payment history, the borrower's current financial situation and value of the underlying collateral.

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 will *not* be collected when due according to the contractual terms of the loan agreement. Impaired loans are those loans that have been modified in a troubled debt restructure ("TDR" or "restructure") and larger, non-homogeneous loans that are in nonaccrual or exhibit payment history or financial status that indicate that collection probably will *not* occur when due according to the loan's terms. Generally, impaired loans are given risk ratings that indicate higher risk, such as "classified" or "other assets especially mentioned." Impaired loans are individually evaluated to determine appropriate reserves and are measured at the lower of the invested amount or the fair value. Impaired loans that are *not* troubled debt restructures and for which fair value measurement indicates an impairment loss are designated nonaccrual. A restructured loan that maintains current status for at least *six* months *may* be in accrual status. Please refer to Note *1:* Summary of Significant Accounting Policies for additional information on evaluation of impaired loans and associated specific reserves, and policies regarding nonaccruals, past due status and charge-offs.

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Troubled debt restructurings impact the estimation of the appropriate level of the allowance for loan losses. If the restructuring included forgiveness of a portion of principal or accrued interest, the charge-off is included in the historical charge-off rates applied to the collective evaluation methodology. Restructured loans are individually evaluated for impairment, and the amount of a restructured loan's book value in excess of its fair value is accrued as a specific allocation in the allowance for loan losses. TDRs that experience a payment default are examined to determine whether the default indicates collateral dependency or cash flows below those that were used in the fair value measurement. TDRs, as well as all impaired loans, that are determined to be collateral dependent are charged down to fair value. Deficiencies indicated by impairment measurements for TDRs that are *not* collateral dependent *may* be accrued in the allowance for loan losses or charged off if deemed uncollectible.

Collectively-Evaluated Loans

The Company evaluated characteristics in the loan portfolio and determined major segments and smaller classes within each segment. These characteristics include collateral type, repayment sources, and (if applicable) the borrower's business model. The methodology for calculating reserves for collectively-evaluated loans is applied at the class level.

*Portfolio Segments and Classes*

The segments and classes used in determining the allowance for loan losses are as follows.

Real Estate Construction

Construction, residential

Construction, other

Consumer Real Estate

Equity lines

Residential closed-end *first* liens

Residential closed-end junior liens

Investor-owned residential real estate

Commercial Non Real Estate

Commercial and industrial

Public Sector and IDA

Public sector and IDA

Consumer Non Real Estate

Credit cards

Automobile

Other consumer loans

Commercial Real Estate

Multifamily real estate

Commercial real estate, owner-occupied

Commercial real estate, other

*Historical Loss Rates*

The Company's allowance methodology for collectively-evaluated loans applies historical loss rates by class to current class balances as part of the process of determining required reserves. Class loss rates are calculated as the net charge-offs for the class as a percentage of average class balance. The Company averages loss rates for the most recent *8* quarters to determine the historical loss rate for each class.

Two loss rates for each class are calculated: total net charge-offs for the class as a percentage of average class loan balance ("class loss rate"), and total net charge-offs for the class as a percentage of average classified loans in the class ("classified loss rate"). Classified loans are those with risk ratings of "substandard" or lower. Net charge-offs in both calculations include charge-offs and recoveries of classified and non-classified loans as well as those associated with impaired loans. Class historical loss rates are applied to non-classified loan balances at the reporting date, and classified historical loss rates are applied to classified balances at the reporting date.

*Risk Factors*

In addition to historical loss rates, risk factors pertinent to credit risk for each class are analyzed to estimate reserves for collectively-evaluated loans. Factors include changes in national and local economic and business conditions, the nature and volume of classes within the portfolio, loan quality, loan officers' experience, lending policies and the Company's loan review system.

The analysis of certain factors results in standard allocations to all segments and classes. These factors include the risk from changes in lending policies, loan officers' average years of experience, unemployment levels, bankruptcy rates, interest rate environment, and competition/legal/regulatory environments. Factors analyzed for each class, with resultant allocations based upon the level of risk assessed for each class, include the risk from changes in loan review, levels of past due loans, levels of nonaccrual loans, current class balance as a percentage of total loans, and the percentage of high risk loans within the class. Additionally, factors specific to each segment are analyzed and result in allocations to the segment. Please refer to Note *1:* Summary of Significant Accounting Policies for a discussion of risk factors pertinent to each class.

Real estate construction loans are subject to general risks from changing commercial building and housing market trends and economic conditions that *may* impact demand for completed properties and the costs of completion. These risks are measured by market-area unemployment rates, bankruptcy rates, building market trends, and interest rates.

The credit quality of consumer real estate is subject to risks associated with the borrower's repayment ability and collateral value, measured generally by analyzing local unemployment and bankruptcy trends, local housing market trends, and interest rates.

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The commercial real estate segment includes loans secured by multifamily residential real estate, commercial real estate occupied by the owner/borrower, and commercial real estate leased to non-owners. Loans in the commercial real estate segment are impacted by economic risks from changing commercial real estate markets, rental markets for multi-family housing and commercial buildings, business bankruptcy rates, local unemployment and interest rate trends that would impact the businesses housed by the commercial real estate.

Commercial non real estate loans are secured by collateral other than real estate, or are unsecured. Credit risk for commercial non real estate loans is subject to economic conditions, generally monitored by local business bankruptcy trends, and interest rates.

Public sector and IDA loans are extended to municipalities and related entities. Credit risk is based upon the entity's ability to repay and interest rate trends.

Consumer non real estate includes credit cards, automobile and other consumer loans. Credit cards and certain other consumer loans are unsecured, while collateral is obtained for automobile loans and other consumer loans. Credit risk stems primarily from the borrower's ability to repay, measured by average unemployment, average personal bankruptcy rates and interest rates.

Factor allocations applied to each class are increased for loans rated special mention and increased to a greater extent for loans rated classified. The Company allocates additional reserves for "high risk" loans. High risk loans include junior liens, interest only and high loan to value loans.

A detailed analysis showing the allowance roll-forward by portfolio segment and related loan balance by segment follows.

**Activity in the Allowance for Loan Losses for the Three Months Ended March 31, 2018**

| | **Real Estate Construction** | **Consumer Real Estate** | **Commercial Real Estate** | **Commercial Non Real Estate** | **Public Sector and IDA** | **Consumer Non Real Estate** | **Unallocated** | **Total** |
|---|---|---|---|---|---|---|---|---|
| Balance, December 31, 2017 | $337 | $ 2,027 | $ 3,044 | $ 1,072 | $ 419 | $ 707 | $ 319 | $7,925 |
| Charge-offs | --- | --- | --- | --- | --- | (139) | --- | (139) |
| Recoveries | --- | --- | 12 | 7 | --- | 58 | --- | 77 |
| Provision for (recovery of) loan losses | (42) | (98) | (266) | (163) | 13 | 54 | 30 | (472) |
| **Balance, March 31, 2018** | $295 | $ 1,929 | $ 2,790 | $ 916 | $ 432 | $ 680 | $ 349 | $7,391 |

**Activity in the Allowance for Loan Losses for the Three Months Ended March 31, 2017**

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non Real Estate | Public Sector and IDA | Consumer Non Real Estate | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Balance, December 31, 2016 | $438 | $ 1,830 | $ 3,738 | $ 1,063 | $ 330 | $ 644 | $ 257 | $8,300 |
| Charge-offs | --- | --- | (30) | --- | --- | (113) | --- | (143) |
| Recoveries | --- | --- | 12 | 4 | --- | 29 | --- | 45 |
| Provision for (recovery of) loan losses | (61) | (84) | (103) | 75 | 87 | 56 | 89 | 59 |
| **Balance, March 31, 2017** | $377 | $ 1,746 | $ 3,617 | $ 1,142 | $ 417 | $ 616 | $ 346 | $8,261 |

**Activity in the Allowance for Loan Losses for the Year Ended December 31, 2017**

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non Real Estate | Public Sector and IDA | Consumer Non Real Estate | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Balance, December 31, 2016 | $438 | $ 1,830 | $ 3,738 | $ 1,063 | $ 330 | $ 644 | $ 257 | $8,300 |
| Charge-offs | --- | (146) | (139) | (82) | --- | (452) | --- | (819) |
| Recoveries | --- | 1 | 131 | 23 | --- | 132 | --- | 287 |
| Provision for (recovery of) loan losses | (101) | 342 | (686) | 68 | 89 | 383 | 62 | 157 |
| **Balance, December 31, 2017** | $337 | $ 2,027 | $ 3,044 | $ 1,072 | $ 419 | $ 707 | $ 319 | $7,925 |

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**Allowance for Loan Losses as of March 31, 2018**

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non Real Estate | Public Sector and IDA | Consumer Non Real Estate | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Individually evaluated for impairment | $--- | $ 15 | $ --- | $ 153 | $ --- | $ 1 | $ --- | $169 |
| Collectively evaluated for impairment | 295 | 1,914 | 2,790 | 763 | 432 | 679 | 349 | 7,222 |
| **Total** | $295 | $ 1,929 | $ 2,790 | $ 916 | $ 432 | $ 680 | $ 349 | $7,391 |

**Allowance for Loan Losses as of December 31, 2017**

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non Real Estate | Public Sector and IDA | Consumer Non Real Estate | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Individually evaluated for impairment | $--- | $ 16 | $ --- | $ 160 | $ --- | $ 1 | $ --- | $177 |
| Collectively evaluated for impairment | 337 | 2,011 | 3,044 | 912 | 419 | 706 | 319 | 7,748 |
| **Total** | $337 | $ 2,027 | $ 3,044 | $ 1,072 | $ 419 | $ 707 | $ 319 | $7,925 |

**Loans as of March 31, 2018**

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non Real Estate | Public Sector and IDA | Consumer Non Real Estate | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Individually evaluated for impairment | $2,817 | $1,155 | $ 6,479 | $ 1,203 | $--- | $ 27 | $ --- | $11,681 |
| Collectively evaluated for impairment | 29,264 | 166,273 | 326,886 | 40,873 | 51,091 | 33,184 | --- | 647,571 |
| **Total** | $32,081 | $167,428 | $ 333,365 | $ 42,076 | $51,091 | $ 33,211 | $ --- | $659,252 |

**Loans as of December 31, 2017**

| | Unallocated | Total |
|---|---|---|

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non Real Estate | Public Sector and IDA | Consumer Non Real Estate | | |
|---|---|---|---|---|---|---|---|---|
| Individually evaluated for impairment | $ *2,882* | $ *1,267* | $ *6,516* | $ *1,229* | $--- | $ *30* | $ --- | $ *11,924* |
| Collectively evaluated for impairment | *31,812* | *165,698* | *333,898* | *39,289* | *51,443* | *34,618* | --- | *656,758* |
| **Total** | $ *34,694* | $ *166,965* | $ *340,414* | $ *40,518* | $ *51,443* | $ *34,648* | $ --- | $ *668,682* |

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A summary of ratios for the allowance for loan losses follows.

| | As of and for the Three Months Ended March 31, 2018 | 2017 | Year Ended December 31, 2017 |
|---|---|---|---|
| Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees and costs | ***1.12*** **%** | *1.27*% | *1.19* % |
| Ratio of net charge-offs to average loans, net of unearned income and deferred fees and costs[1] | ***0.04*** **%** | *0.06*% | *0.08* % |

[1] Net charge-offs are on an annualized basis.

A summary of nonperforming assets follows.

| | March 31, 2018 | 2017 | December 31, 2017 |
|---|---|---|---|
| Nonperforming assets: | | | |
| Nonaccrual loans | **$*6*** | $*1,040* | $ *6* |
| Restructured loans in nonaccrual | ***2,758*** | *4,640* | *2,763* |
| Total nonperforming loans | ***2,764*** | *5,680* | *2,769* |
| Other real estate owned, net | ***2,741*** | *2,952* | *2,817* |
| Total nonperforming assets | **$*5,505*** | $*8,632* | $ *5,586* |
| Ratio of nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned | ***0.83*** **%** | *1.32* % | *0.83* % |
| Ratio of allowance for loan losses to nonperforming loans[1] | ***267.40*** **%** | *145.44*% | *286.20* % |

[1] The Company defines nonperforming loans as nonaccrual loans and restructured loans that are nonaccrual. Nonperforming loans do *not* include loans *90* days past due and still accruing or accruing restructured loans.

A summary of loans past due *90* days or more and impaired loans follows.

| | March 31, | | December 31, |
|---|---|---|---|
| | **2018** | **2017** | **2017** |
| Loans past due 90 days or more and still accruing | **$*52*** | $*63* | $ *51* |
| Ratio of loans past due 90 days or more and still accruing to loans, net of unearned income and deferred fees and costs | ***0.01* %** | *0.01* % | *0.01* % |
| Accruing restructured loans | **$*7,890*** | $*3,747* | $ *5,134* |
| Impaired loans: | | | |
| Impaired loans with no valuation allowance | **$*10,233*** | $*8,172* | $ *10,444* |
| Impaired loans with a valuation allowance | ***1,448*** | *894* | *1,480* |
| Total impaired loans | **$*11,681*** | $*9,066* | $ *11,924* |
| Valuation allowance | ***(169*** ) | *(25* ) | *(177* ) |
| Impaired loans, net of allowance | **$*11,512*** | $*9,041* | $ *11,747* |
| Average recorded investment in impaired loans[1] | **$*11,754*** | $*9,123* | $ *13,344* |
| Interest income recognized on impaired loans, after designation as impaired | **$*120*** | $*67* | $ *528* |
| Amount of income recognized on a cash basis | **$---** | $--- | $ --- |

(*1*) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.

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Nonaccrual loan relationships that meet the Company's balance threshold of *$250* and all TDRs are designated as impaired. The Company also designates as impaired other loan relationships that meet the Company's balance threshold of *$250* and for which the Company does *not* expect to collect according to the note's contractual terms. *No* interest income was recognized on nonaccrual loans for the *three* months ended *March 31, 2018* or *March 31, 2017* or for the year ended *December 31, 2017.*

A detailed analysis of investment in impaired loans, associated reserves and interest income recognized, segregated by loan class follows.

| | **Impaired Loans as of March 31, 2018** | | | | |
|---|---|---|---|---|---|
| | **Principal Balance** | **Total Recorded Investment[1]** | **Recorded Investment[1] for Which There is No Related Allowance** | **Recorded Investment[1] for Which There is a Related Allowance** | **Related Allowance** |
| **Real Estate Construction[2]** | | | | | |
| Construction, other | $*2,817* | $ *2,817* | $ *2,817* | $ --- | $ --- |
| **Consumer Real Estate[2]** | | | | | |
| Residential closed-end first liens | *706* | *664* | *487* | *177* | *10* |
| Residential closed-end junior liens | *168* | *168* | --- | *168* | *5* |
| Investor-owned residential real estate | *344* | *323* | *323* | --- | --- |
| **Commercial Real Estate[2]** | | | | | |
| Multifamily | *300* | *300* | *300* | --- | --- |
| Commercial real estate, owner-occupied | *3,586* | *3,577* | *3,577* | --- | --- |
| Commercial real estate, other | *2,921* | *2,602* | *2,602* | --- | --- |
| **Commercial Non Real Estate[2]** | | | | | |
| Commercial and industrial | *1,211* | *1,203* | *123* | *1,080* | *153* |
| **Consumer Non Real Estate[2]** | | | | | |
| Automobile | *27* | *27* | *4* | *23* | *1* |
| **Total** | $*12,080* | $ *11,681* | $ *10,233* | $ *1,448* | $ *169* |

(*1*) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.
(*2*) Only classes with impaired loans are shown.

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| | Impaired Loans as of December 31, 2017 | | | | |
|---|---|---|---|---|---|
| | Principal Balance | Total Recorded Investment[1] | Recorded Investment[1] for Which There is No Related Allowance | Recorded Investment[1] for Which There is a Related Allowance | Related Allowance |
| **Real Estate Construction[2]** | | | | | |
| Construction 1-4 family residential | $ *2,882* | $ *2,882* | $ *2,882* | $ --- | $ --- |
| **Consumer Real Estate[2]** | | | | | |
| Residential closed-end first liens | *807* | *768* | *590* | *178* | *10* |
| Residential closed-end junior liens | *174* | *174* | --- | *174* | *6* |
| Investor-owned residential real estate | *347* | *325* | *325* | --- | --- |
| **Commercial Real Estate[2]** | | | | | |
| Multifamily real estate | *303* | *303* | *303* | --- | --- |
| Commercial real estate, owner occupied | *3,619* | *3,611* | *3,611* | --- | --- |
| Commercial real estate, other | *2,921* | *2,602* | *2,602* | --- | --- |
| **Commercial Non Real Estate[2]** | | | | | |
| Commercial and industrial | *1,236* | *1,229* | *126* | *1,103* | *160* |
| **Consumer Non Real Estate[2]** | | | | | |
| Automobile | *30* | *30* | *5* | *25* | *1* |
| **Total** | $ *12,319* | $ *11,924* | $ *10,444* | $ *1,480* | $ *177* |

[1] Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.
[2] Only classes with impaired loans are shown.

The following tables show the average recorded investment and interest income recognized for impaired loans.

| | For the Three Months Ended March 31, 2018 | |
|---|---|---|
| | Average Recorded Investment[1] | Interest Income Recognized |
| **Real Estate Construction[2]** | | |
| Construction 1-4 family residential | **$** ***839*** | **$** ***38*** |

| | | |
|---|---|---|
| **Consumer Real Estate**[2] | | |
| Residential closed-end first liens | ***3,387*** | ***10*** |
| Residential closed-end junior liens | ***253*** | ***3*** |
| Investor-owned residential real estate | ***323*** | ***4*** |
| **Commercial Real Estate**[2] | | |
| Multifamily real estate | ***372*** | ***4*** |
| Commercial real estate, owner occupied | ***2,648*** | ***50*** |
| Commercial real estate, other | ***2,384*** | ***---*** |
| **Commercial Non Real Estate**[2] | | |
| Commercial and industrial | ***939*** | ***11*** |
| **Consumer Non Real Estate**[2] | | |
| Automobile | ***609*** | ***---*** |
| **Total** | **$*11,754*** | **$ *120*** |

(1) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.
(2) Only classes with impaired loans are shown.

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| | For the Three Months Ended March 31, 2017 | |
|---|---|---|
| | Average Recorded Investment[1] | Interest Income Recognized |
| **Real Estate Construction**[2] | | |
| Construction 1-4 family residential | $ *267* | $ *3* |
| **Consumer Real Estate**[2] | | |
| Residential closed-end first liens | *606* | *9* |
| Residential closed-end junior liens | *193* | *3* |
| Investor-owned residential real estate | *73* | *1* |
| **Commercial Real Estate**[2] | | |
| Multifamily real estate | *1,091* | --- |
| Commercial real estate, owner occupied | *3,945* | *32* |
| Commercial real estate, other | *2,708* | *17* |
| **Commercial Non Real Estate**[2] | | |
| Commercial and industrial | *237* | *2* |
| **Consumer Non Real Estate** | | |
| Automobile | *3* | --- |
| **Total** | $ *9,123* | $ *67* |

(1) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.
(2) Only classes with impaired loans are shown.

| | For the Year Ended December 31, 2017 | |
|---|---|---|
| | Average Recorded Investment[1] | Interest Income Recognized |
| **Real Estate Construction**[2] | | |
| Construction 1-4 family residential | $ *3,298* | $ *177* |
| **Consumer Real Estate**[2] | | |
| Residential closed-end first liens | *781* | *57* |
| Residential closed-end junior liens | *185* | *11* |
| Investor-owned residential real estate | *329* | *1* |
| **Commercial Real Estate**[2] | | |

| | | |
|---|---|---|
| Multifamily real estate | *748* | *16* |
| Commercial real estate, owner occupied | *4,047* | *200* |
| Commercial real estate, other | *2,638* | --- |
| **Commercial Non Real Estate[(2)]** | | |
| Commercial and industrial | *1,282* | *64* |
| **Consumer Non Real Estate[(2)]** | | |
| Automobile | *36* | *2* |
| **Total** | $ *13,344* | $ *528* |

(1) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.
(2) Only classes with impaired loans are shown.

The Company reviews nonaccrual loans on an individual loan basis to determine whether future payments are reasonably assured. To satisfy this criteria, the Company's evaluation must determine that the underlying cause of the original delinquency or weakness that indicated nonaccrual status has been resolved, such as receipt of new guarantees, increased cash flows that cover the debt service or other resolution. Nonaccrual loans that demonstrate reasonable assurance of future payments and that have made at least *six* consecutive payments in accordance with repayment terms and timeframes *may* be returned to accrual status.

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An analysis of past due and nonaccrual loans follows.

**March 31, 2018**

| | **30 – 89 Days Past Due and Accruing** | **90 or More Days Past Due** | **90 or More Days Past Due and Accruing** | **Nonaccruals[2]** |
|---|---|---|---|---|
| **Consumer Real Estate[1]** | | | | |
| Residential closed-end first liens | *780* | --- | --- | *142* |
| Residential closed-end junior liens | *168* | --- | --- | --- |
| Investor-owned residential real estate | --- | *5* | --- | *6* |
| **Commercial Real Estate[1]** | | | | |
| Multifamily real estate | *498* | --- | --- | --- |
| Commercial real estate, owner-occupied | *394* | --- | --- | --- |
| Commercial real estate, other | --- | *2,602* | --- | *2,602* |
| **Commercial Non Real Estate[1]** | | | | |
| Commercial and industrial | *260* | *20* | *20* | *13* |
| **Consumer Non Real Estate[1]** | | | | |
| Credit cards | *7* | *11* | *11* | --- |
| Automobile | *322* | *1* | *1* | *1* |
| Other consumer loans | *73* | *20* | *20* | --- |
| **Total** | $ *2,502* | $*2,659* | $ *52* | $ *2,764* |

(1) Only classes with past-due or nonaccrual loans are shown.
(2) Includes current and past due loans in nonaccrual status. Includes impaired loans in nonaccrual status.

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**December 31, 2017**

| | 30 – 89 Days Past Due and Accruing | 90 or More Days Past Due | 90 or More Days Past Due and Accruing | Nonaccruals[2] |
|---|---|---|---|---|
| **Consumer Real Estate[1]** | | | | |
| Residential closed-end first liens | *637* | *16* | *11* | *145* |
| Residential closed-end junior liens | *188* | --- | --- | --- |
| Investor-owned residential real estate | *66* | --- | --- | *6* |
| **Commercial Real Estate[1]** | | | | |
| Multifamily real estate | *303* | --- | --- | --- |
| Commercial real estate, owner occupied | *402* | --- | --- | --- |
| Commercial real estate, other | --- | *2,602* | --- | *2,602* |
| **Commercial Non Real Estate[1]** | | | | |
| Commercial and industrial | *131* | --- | --- | *15* |
| **Consumer Non Real Estate[1]** | | | | |
| Credit cards | *7* | *12* | *12* | --- |
| Automobile | *375* | *22* | *22* | *1* |
| Other consumer loans | *154* | *6* | *6* | --- |
| **Total** | $ *2,263* | $*2,658* | $ *51* | $ *2,769* |

(1) Only classes with past-due or nonaccrual loans are shown.
(2) Includes current and past due loans in nonaccrual status. Includes impaired loans in nonaccrual status.

The estimate of credit risk for non-impaired loans is obtained by applying allocations for internal and external factors. The allocations are increased for loans that exhibit greater credit quality risk.

Credit quality indicators, which the Company terms risk grades, are assigned through the Company's credit review function for larger loans and selective review of loans that fall below credit review thresholds. Loans that do *not* indicate heightened risk are graded as "pass." Loans that appear to have elevated credit risk because of frequent or persistent past due status, which is less than *75* days, or that show weakness in the borrower's financial condition are risk graded "special mention." Loans with frequent or persistent delinquency exceeding *75* days or that have a higher level of weakness in the borrower's financial condition are graded "classified." Classified loans have regulatory risk ratings of "substandard" and "doubtful." Allocations are increased by *50%* and by *100%* for loans with grades of "special mention" and "classified," respectively.

Determination of risk grades was completed for the portfolio as of *March 31, 2018* and *December 31, 2017*.

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The following displays collectively-evaluated loans by credit quality indicator.

**March 31, 2018**

| | **Pass** | **Special Mention**[1] | **Classified**[1] |
|---|---|---|---|
| **Real Estate Construction** | | | |
| Construction, 1-4 family residential | $ *9,367* | $ --- | $ --- |
| Construction, other | *19,897* | --- | --- |
| **Consumer Real Estate** | | | |
| Equity lines | *16,560* | *39* | --- |
| Closed-end first liens | *84,519* | *2,379* | *866* |
| Closed-end junior liens | *4,455* | *27* | *10* |
| Investor-owned residential real estate | *56,957* | *275* | *186* |
| **Commercial Real Estate** | | | |
| Multifamily residential real estate | *87,412* | *126* | *198* |
| Commercial real estate owner-occupied | *131,800* | *245* | *752* |
| Commercial real estate, other | *106,353* | --- | --- |
| **Commercial Non Real Estate** | | | |
| Commercial and industrial | *40,447* | *257* | *169* |
| **Public Sector and IDA** | | | |
| States and political subdivisions | *51,091* | --- | --- |
| **Consumer Non Real Estate** | | | |
| Credit cards | *5,328* | --- | --- |
| Automobile | *15,590* | *242* | *175* |
| Other consumer | *11,772* | *50* | *27* |
| **Total** | $ *641,548* | $ *3,640* | $ *2,383* |

(1) Excludes impaired, if any.

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The following displays collectively-evaluated loans by credit quality indicator.

**December 31, 2017**

| | Pass | Special Mention[1] | Classified[1] |
|---|---|---|---|
| **Real Estate Construction** | | | |
| Construction, 1-4 family residential | $*10,396* | $ --- | **$ ---** |
| Construction, other | *21,416* | --- | **---** |
| **Consumer Real Estate** | | | |
| Equity lines | *16,673* | *39* | --- |
| Closed-end first liens | *85,975* | *2,400* | *355* |
| Closed-end junior liens | *4,483* | *29* | *12* |
| Investor-owned residential real estate | *55,410* | *66* | *256* |
| **Commercial Real Estate** | | | |
| Multifamily residential real estate | *95,894* | *127* | --- |
| Commercial real estate owner-occupied | *130,256* | *246* | *763* |
| Commercial real estate, other | *106,612* | --- | --- |
| **Commercial Non Real Estate** | | | |
| Commercial and industrial | *38,904* | *220* | *165* |
| **Public Sector and IDA** | | | |
| States and political subdivisions | *51,443* | --- | --- |
| **Consumer Non Real Estate** | | | |
| Credit cards | *5,493* | --- | --- |
| Automobile | *16,059* | *218* | *116* |
| Other consumer | *12,692* | *16* | *24* |
| **Total** | $*651,706* | $ *3,361* | $ *1,691* |

(*1*) Excludes impaired, if any.

Sales, Purchases and Reclassification of Loans

The Company finances mortgages under “best efforts” contracts with mortgage purchasers. The mortgages are designated as held for sale upon initiation. There have been *no* major reclassifications from portfolio loans to held for sale. Occasionally, the Company purchases or sells participations in loans. All participation loans purchased met the Company’s normal underwriting standards at the time the participation was entered. Participation loans are included in the appropriate portfolio balances to which the allowance methodology is applied.

**Troubled Debt Restructurings**

From time to time the Company modifies loans in troubled debt restructurings. Total troubled debt restructurings amounted to *$10,648* at *March 31, 2018, $7,897* at *December 31, 2017,* and *$8,387* at *March 31, 2017*.

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The following table present restructurings by class that occurred during the *three* month period ended *March 31, 2018.*

| | Restructurings That Occurred During the Three Months Ended March 31, 2018 | | |
|---|---|---|---|
| | Number of Contracts | Pre-Modification Outstanding Principal Balance | Post-Modification Outstanding Principal Balance |
| **Real Estate Construction** | | | |
| Construction, other | *2* | $ *2,882* | $ *2,882* |
| **Total** | *2* | $ *2,882* | $ *2,882* |

Each of the restructurings completed during the *three*-month period ended *March 31, 2018* provided payment relief to the borrowers without forgiving principal or interest. The *two* real estate construction loans were restructured to provide debt relief by extending the maturity and interest-only period for each loan. Impairment measurement, based on the fair value of the collateral, did *not* indicate a specific reserve for each of the real estate construction loans.

The Company did *not* modify any loans in troubled debt restructures during the *three* month period ended *March 31, 2017.*

The Company analyzed its TDR portfolio for loans that defaulted during the *three* month periods ended *March 31, 2018* and *March 31, 2017,* and that were modified within *12* months prior to default. The Company defines default as *one* or more payments that occur more than *90* days past the due date, charge-offs, or foreclosure after the date of restructuring. Of the restructured loans that defaulted during the *three* month periods ended *March 31, 2018* and *March 31, 2017, none* were modified within *12* months prior to default.

**Note *4*: Securities**

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities available for sale by major security type are as follows.

| | **March 31, 2018** | | | |
|---|---|---|---|---|
| | **Amortized Costs** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Values** |
| **Available for Sale:** | | | | |
| U.S. Government agencies and corporations | $322,585 | $ 393 | $ 8,089 | $314,889 |
| States and political subdivisions | 16,101 | 69 | 392 | 15,778 |
| Mortgage-backed securities | 558 | 50 | --- | 608 |
| Corporate debt securities | 6,016 | 42 | 122 | 5,936 |
| **Total securities available for sale** | $345,260 | $ 554 | $ 8,603 | $337,211 |

| | **December 31, 2017** | | | |
|---|---|---|---|---|
| | **Amortized Costs** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Values** |
| **Available for Sale:** | | | | |
| U.S. Government agencies and corporations | $312,604 | $ 609 | $ 5,494 | $307,719 |
| States and political subdivisions | 16,853 | 100 | 119 | 16,834 |
| Mortgage-backed securities | 602 | 57 | --- | 659 |
| Corporate debt securities | 6,016 | 188 | 29 | 6,175 |
| **Total securities available for sale** | $336,075 | $ 954 | $ 5,642 | $331,387 |

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The amortized cost and fair value of single maturity securities available for sale at *March 31, 2018,* by contractual maturity, are shown below. Expected maturities *may* differ from contractual maturities because borrowers *may* have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity.

| | **March 31, 2018** | |
|---|---|---|
| | **Amortized Cost** | **Fair Value** |
| **Available for Sale:** | | |
| Due in one year or less | **$*47,263*** | **$*46,985*** |
| Due after one year through five years | ***181,571*** | ***176,935*** |
| Due after give years through ten years | ***78,203*** | ***75,727*** |
| Due after ten years | ***38,223*** | ***37,564*** |
| **Total securities available for sale** | **$*345,260*** | **$*337,211*** |

The amortized costs, gross unrealized gains, gross unrealized losses and fair values for securities held to maturity by major security type are as follows.

| | **March 31, 2018** | | | |
|---|---|---|---|---|
| | **Amortized Costs** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Values** |
| **Held to Maturity:** | | | | |
| U.S. Government agencies and corporations | **$*3,934*** | **$ *99*** | **$ *1*** | **$*4,032*** |
| States and political subdivisions | ***117,791*** | ***2,184*** | ***649*** | ***119,326*** |
| Mortgage-backed securities | ***196*** | ***18*** | ***---*** | ***214*** |
| Corporate debt securities | ***984*** | ***---*** | ***7*** | ***977*** |
| **Total securities held to maturity** | **$*122,905*** | **$ *2,301*** | **$ *657*** | **$*124,549*** |

| | **December 31, 2017** | | | |
|---|---|---|---|---|
| | **Amortized Costs** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Values** |
| **Held to Maturity:** | | | | |

| | | | | |
|---|---|---|---|---|
| U.S. Government agencies and corporations | $*3,934* | $ *167* | $ --- | $*4,101* |
| States and political subdivisions | *122,039* | *2,929* | *173* | *124,795* |
| Mortgage-backed securities | *209* | *21* | --- | *230* |
| Corporate debt securities | *982* | *5* | --- | *987* |
| **Total securities held to maturity** | $*127,164* | $ *3,122* | $ *173* | $*130,113* |

The amortized cost and fair value of single maturity securities held to maturity at *March 31, 2018,* by contractual maturity, are shown below. Expected maturities *may* differ from contractual maturities because borrowers *may* have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity.

| | **March 31, 2018** | |
|---|---|---|
| | **Amortized Cost** | **Fair Value** |
| **Held to maturity:** | | |
| Due in one year or less | **$*12,536*** | **$*12,714*** |
| Due after one year through five years | ***21,962*** | ***22,712*** |
| Due after give years through ten years | ***27,323*** | ***27,869*** |
| Due after ten years | ***61,084*** | ***61,254*** |
| **Total securities held to maturity** | **$*122,905*** | **$*124,549*** |

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Information pertaining to securities with gross unrealized losses aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows.

| | **March 31, 2018** | | | |
|---|---|---|---|---|
| | **Less Than 12 Months** | | **12 Months or More** | |
| | **Fair Value** | **Unrealized Loss** | **Fair Value** | **Unrealized Loss** |
| **Temporarily Impaired Securities:** | | | | |
| U.S. Government agencies and corporations | ***$76,276*** | ***$ 1,987*** | ***$226,261*** | ***$ 6,103*** |
| States and political subdivisions | ***29,753*** | ***843*** | ***2,889*** | ***198*** |
| Corporate debt securities | ***4,970*** | ***61*** | ***909*** | ***68*** |
| **Total** | ***$110,999*** | ***$ 2,891*** | ***$230,059*** | ***$ 6,369*** |

| | **December 31, 2017** | | | |
|---|---|---|---|---|
| | **Less Than 12 Months** | | **12 Months or More** | |
| | **Fair Value** | **Unrealized Loss** | **Fair Value** | **Unrealized Loss** |
| **Temporarily Impaired Securities:** | | | | |
| U.S. Government agencies and corporations | $*68,380* | $ *871* | $*225,738* | $ *4,623* |
| States and political subdivisions | *18,688* | *194* | *2,989* | *98* |
| Corporate debt securities | --- | --- | *948* | *29* |
| **Total** | $*87,068* | $ *1,065* | $*229,675* | $ *4,750* |

The Company had *377* securities with a fair value of *$341,058* that were temporarily impaired at *March 31, 2018.* The total unrealized loss on these securities was *$9,260.* Of the temporarily impaired total, *238* securities with a fair value of *$230,059* and an unrealized loss of *$6,369* have been in a continuous loss position for *twelve* months or more. The Company has determined that these securities are temporarily impaired at *March 31, 2018* for the reasons set out below.

U.S. Government agencies. The unrealized losses of *$6,103* on US Government agency securities stemmed from *233* securities with a fair value of *$226,261.* The unrealized losses were caused by interest rate and market fluctuations. The contractual term of the investment does *not* permit the issuer to settle the security at a price less than the cost basis of the investment. The Company is monitoring bond market trends to develop strategies to address unrealized losses. Because the Company does *not* intend to sell the investment and it is *not* likely that the Company will be required to sell the investment before recovery of its amortized cost basis, which *may* be at maturity, the Company

does *not* consider this investment to be other-than-temporarily impaired.

States and political subdivisions. This category's unrealized loss of *$198* on *4* securities with a fair value of *$2,889* is primarily the result of interest rate and market fluctuations. The Company reviewed financial statements and cash flows for the each of the securities in continuous loss position for more than *12* months. The Company's analysis determined that the unrealized losses are primarily the result of interest rate and market fluctuations and *not* associated with impaired financial status. The contractual terms of the investments do *not* permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does *not* intend to sell any of the investments and it is *not* likely that the Company will be required to sell any of the investments before recovery of its amortized cost basis, which *may* be at maturity, the Company does *not* consider these investments to be other-than-temporarily impaired.

Corporate debt securities. The unrealized loss of *$68* on *one* corporate debt security with a fair value of *$909* was caused by market and interest rate fluctuations and is *not* associated with impaired financial status. The contractual terms of the investments do *not* permit the issuer to settle the securities at a price less than the cost basis of each investment. Because the Company does *not* intend to sell the investment and it is *not* likely that the Company will be required to sell the investment before recovery of its amortized cost basis, which *may* be at maturity, the Company does *not* consider the investment to be other-than-temporarily impaired.

Restricted stock. The Company held restricted stock of *$1,221* as of *March 31, 2018* and *$1,200* as of *December 31, 2017.* Restricted stock is reported separately from available-for-sale securities and held-to-maturity securities. As a member of the Federal Reserve and the Federal Home Loan Bank ("FHLB") of Atlanta, NBB is required to maintain certain minimum investments in the common stock of those entities. Required levels of investment are based upon NBB's capital and a percentage of qualifying assets. The Company purchases stock from or sells stock back to the correspondents based on their calculations. The stock is held by member institutions only and is *not* actively traded.

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Redemption of FHLB stock is subject to certain limitations and conditions. At its discretion, the FHLB *may* declare dividends on the stock. In addition to dividends, NBB also benefits from its membership with FHLB through eligibility to borrow from the FHLB, using as collateral NBB's capital stock investment in the FHLB and qualifying NBB real estate mortgage loans totaling *$488,193* at *March 31, 2018.* Management reviews for impairment based upon the ultimate recoverability of the cost basis of the FHLB stock, and at *March 31, 2018,* management did *not* determine any impairment.

Management regularly monitors the credit quality of the investment portfolio. Changes in ratings are noted and follow-up research on the issuer is undertaken when warranted. Management intends to carefully monitor any changes in bond quality.

**Note 5: Recent Accounting Pronouncements**

In *February 2016,* the FASB issued ASU *No. 2016-02,* "Leases (Topic *842*)." Among other things, in the amendments in ASU *2016-02,* lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (*1*) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (*2*) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic *606,* Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after *December 15, 2018,* including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would *not* require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors *may not* apply a full retrospective transition approach. The Company is currently assessing the impact that ASU *2016-02* will have on its consolidated financial statements. The Company is the lessee of *six* banking locations and *one* ATM location, the majority of which meet the standard's definition of a financing lease. At the effective date, the Company will recognize a lease liability and a right-of-use asset. Pro-forma analysis based on current lease contracts indicates that the lease liability and the right-of-use asset are similar in amount, with only nominal difference. The Company is the lessor of *three* properties, which will be treated as short-term operating leases.

In *June 2016,* the FASB issued ASU *No. 2016-13,* "Financial Instruments – Credit Losses (Topic *326*): Measurement of Credit Losses on Financial Instruments." The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of

expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after *December 15, 2019.* The Company is currently assessing the impact that ASU *2016-13* will have on its consolidated financial statements. The Company has formed a working group to address information requirements, determine methodology, research forecasts and ensure readiness and compliance with the standard. The Company's existing model provider has released a CECL model and the Company will run multiple concurrent models prior to the effective date.

In *January 2017,* the FASB issued ASU *No. 2017-04,* "Intangibles – Goodwill and Other (Topic *350*): Simplifying the Test for Goodwill Impairment". The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step *2* from the goodwill impairment test. Step *2* measures a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are U.S. Securities and Exchange Commission (SEC) filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after *December 15, 2019.* Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after *January 1, 2017.* The Company does *not* expect the adoption of ASU *2017-04* to have a material impact on its consolidated financial statements.

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

In *August 2017,* the FASB issued ASU *2017-12,* "Derivatives and Hedging (Topic *815*): Targeted Improvements to Accounting for Hedging Activities." The amendments in this ASU modify the designation and measurement guidance for hedge accounting as well as provide for increased transparency regarding the presentation of economic results on both the financial statements and related footnotes. Certain aspects of hedge effectiveness assessments will also be simplified upon implementation of this update. The amendments are effective for annual periods, including interim periods within those annual periods, beginning after *December 15, 2018.* Early adoption is permitted, including adoption in any interim period. The Company is currently assessing the impact that ASU *2017 12* will have on its consolidated financial statements.

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

**Note *6*: Defined Benefit Plan**

Components of Net Periodic Benefit Cost

| | **Pension Benefits Three Months Ended March 31,** | |
|---|---|---|
| | **2018** | **2017** |
| Service cost | **$*217*** | $*173* |
| Interest cost | ***200*** | *186* |
| Expected return on plan assets | ***(400*)** | *(274*) |
| Amortization of prior service cost | ***(27*)** | *(27*) |
| Recognized net actuarial loss | ***146*** | *135* |
| Net periodic benefit cost | **$*136*** | $*193* |

The service cost component of net periodic benefit cost is included in salaries and employee benefits expense. All other components are included in other noninterest expense.

*2018* Plan Year Employer Contribution

For the *three* months ended *March 31, 2018,* the Company did *not* make a contribution to the Plan.

**Note *7*: Fair Value Measurements**

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are *no* quoted market prices for the Company's various financial instruments. In cases where quoted market prices are *not* available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates *may not* be realized in an immediate settlement of the instrument. Accounting guidance for fair value excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented *may not* necessarily represent the underlying fair value of the Company.

The Company records fair value adjustments to certain assets and liabilities and determines fair value disclosures utilizing a definition of fair value of assets and liabilities that states that fair value 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. Additional considerations are involved to determine the fair value of financial assets in markets that are *not* active.

The Company uses 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. |

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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*). The carrying value of restricted Federal Reserve Bank and Federal Home Loan Bank stock approximates fair value based upon the redemption provisions of each entity and is therefore excluded from the following table.

The following tables present the balances of financial assets measured at fair value on a recurring basis as of *March 31, 2018* and *December 31, 2017.*

| | | **Fair Value Measurements at March 31, 2018 Using** | | |
|---|---|---|---|---|
| **Description** | **Balance as of March 31, 2018** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| U.S. Government agencies and corporations | $*314,889* | $--- | $ *314,889* | $ --- |
| States and political subdivisions | *15,778* | --- | *15,778* | --- |
| Mortgage-backed securities | *608* | --- | *608* | --- |
| Corporate debt securities | *5,936* | --- | *5,936* | --- |
| Total securities available for sale | $*337,211* | $--- | $ *337,211* | $ --- |

| Description | Balance as of December 31, 2017 | Fair Value Measurements at December 31, 2017 Using Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| U.S. Government agencies and corporations | $ *307,719* | $--- | $ *307,719* | $ --- |
| States and political subdivisions | *16,834* | --- | *16,834* | --- |
| Mortgage-backed securities | *659* | --- | *659* | --- |
| Corporate debt securities | *6,175* | --- | *6,175* | --- |
| Total securities available for sale | $ *331,387* | $--- | $ *331,387* | $ --- |

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.

Loans Held for Sale

Loans held for sale are carried at the lower of cost or market value. These loans currently consist of *one*-to-*four* family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is *not* materially different than cost due to the short duration between origination and sale (Level *2*). As such, the Company records any fair value adjustments on a nonrecurring basis. *No* nonrecurring fair value adjustments were recorded on loans held for sale at *March 31, 2018* or *December 31, 2017.*

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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 will *not* be collected according to the contractual terms of the loan agreement. Troubled debt restructurings are impaired loans. Impaired loans are measured at fair value on a nonrecurring basis. If an individually-evaluated impaired loan’s balance exceeds fair value, the amount is allocated to the allowance for loan losses. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

The fair value of an impaired loan and measurement of associated loss is based on *one* of *three* methods: the observable market price of the loan, the present value of projected cash flows, or the fair value of the collateral. The observable market price of a loan is categorized as a Level *1* input. The present value of projected cash flows method results in a Level *3* categorization because the calculation relies on the Company’s judgment to determine projected cash flows, which are then discounted at the current rate of the loan, or the rate prior to modification if the loan is a troubled debt restructure.

Loans measured using the fair value of collateral method *may* be categorized in Level *2* or Level *3.* Collateral *may* be in the form of real estate or business assets including equipment, inventory, and accounts receivable. Most collateral is real estate. The Company bases collateral method fair valuation upon the “as-is” value of independent appraisals or evaluations. Valuations for impaired loans with outstanding principal balances of *$250* or more are based on a current appraisal. Appraisals are also used to value impaired loans with principal balances of *$100* or greater and secured by *one* piece of collateral. Collateral-method impaired loans with principal balances below *$100,* or if secured by multiple pieces of collateral, below *$250,* are valued using an evaluation.

The value of real estate collateral is determined by a current (less than *12* months of age) appraisal or internal evaluation utilizing an income or market valuation approach. Appraisals conducted by an independent, licensed appraiser outside of the Company using observable market data is categorized as Level *2.* If a current appraisal cannot be obtained prior to a reporting date and an existing appraisal is discounted to obtain an estimated value, or if declines in value are identified after the date of the appraisal, or if an appraisal is discounted for estimated selling costs, the valuation of real estate collateral is categorized as Level *3.* Valuations derived from internal evaluations are categorized as Level *3.* The value of business equipment is based upon an outside appraisal (Level *2*) if deemed significant, or the net book value on the applicable business’ financial statements (Level *3*) if *not* considered significant. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level *3*).

The following table summarizes the Company’s impaired loans that were measured at fair value on a nonrecurring basis at *March 31, 2018* and at *December 31, 2017.*

| **Date** | **Description** | **Balance** | **Carrying Value** |
| --- | --- | --- | --- |

| | | | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
|---|---|---|---|---|---|
| | Assets: | | | | |
| March 31, 2018 | Impaired loans net of valuation allowance | $ ***1,279*** | **$---** | **$ ---** | **$ *1,279*** |
| December 31, 2017 | Impaired loans net of valuation allowance | *1,303* | --- | --- | *1,303* |

The following tables present information about Level *3* Fair Value Measurements for *March 31, 2018* and *December 31, 2017.*

| **Impaired Loans** | **Valuation Technique** | **Unobservable Input** | **Range (Weighted Average)** |
|---|---|---|---|
| March 31, 2018 | Present value of cash flows | Discount rate | *5.50%-13.25% (5.92%)* |
| December 31, 2017 | Present value of cash flows | Discount rate | *5.50%-13.25% (5.92%)* |

Other Real Estate Owned

Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. Valuation of other real estate owned is determined using current appraisals from independent parties, a level *two* input. If current appraisals cannot be obtained prior to reporting dates, or if declines in value are identified after a recent appraisal is received, appraisal values are discounted, resulting in Level *3* estimates. If the Company markets the property with a realtor, estimated selling costs reduce the fair value, resulting in a valuation based on Level *3* inputs.

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The following table summarizes the Company's other real estate owned that was measured at fair value on a nonrecurring basis.

| Date | Description | Balance | Carrying Value Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|---|
| | Assets: | | | | |
| March 31, 2018 | Other real estate owned net of valuation allowance | $ ***2,741*** | | | $ ***2,741*** |
| December 31, 2017 | Other real estate owned net of valuation allowance | *2,817* | --- | --- | *2,817* |

The following tables present information about Level *3* Fair Value Measurements for *March 31, 2018* and *December 31, 2017.*

| March 31, 2018 | Valuation Technique | Unobservable Input | Range (Weighted Average) |
|---|---|---|---|
| Other real estate owned | Discounted appraised value | Selling cost | *5.00%-6.01% (5.14%)* |
| Other real estate owned | Discounted appraised value | Discount for lack of marketability and age of appraisal | *1.68%-86.03%(13.35%)* |

| December 31, 2017 | Valuation Technique | Unobservable Input | Range (Weighted Average) |
|---|---|---|---|
| Other real estate owned | Discounted appraised value | Selling cost | *2.00%-6.01% (4.72%)* |
| Other real estate owned | Discounted appraised value | Discount for lack of marketability and age of appraisal | *1.68%-68.33%(11.07%)* |

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company's financial instruments as of *March 31, 2018* and *December 31, 2017.* For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For non-marketable equity securities such as Federal Home Loan Bank and Federal Reserve Bank stock, the carrying amount is a reasonable estimate of fair value as these securities can only be redeemed or sold at their par value and only to the respective issuing government-supported institution or to another member institution. For financial liabilities such as noninterest-bearing demand, interest-bearing demand, and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having *no* stated maturity. Fair values for *March 31, 2018* are estimated under the exit price notion in accordance with the prospective adoption of ASU *2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities."* Fair values for *December 31, 2017* are estimated under the guidance in effect for that period, which did *not* require use of the exit price notion.

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| | March 31, 2018 | | | |
|---|---|---|---|---|
| | **Carrying Amount** | **Quoted Prices in Active Markets for Identical Assets**<br><br>**Level 1** | **Significant Other Observable Inputs**<br><br>**Level 2** | **Significant Unobservable Inputs**<br><br>**Level 3** |
| Financial Assets: | | | | |
| Cash and due from banks | $*10,598* | $ *10,598* | $ --- | $ --- |
| Interest-bearing deposits | *76,571* | *76,571* | --- | --- |
| Securities | *460,116* | --- | *461,760* | --- |
| Restricted securities | *1,221* | --- | *1,221* | --- |
| Loans, net | *651,272* | --- | --- | *648,273* |
| Accrued interest receivable | *5,360* | --- | *5,360* | --- |
| Bank-owned life insurance | *33,984* | --- | *33,984* | --- |
| Financial Liabilities: | | | | |
| Deposits | $*1,072,940* | $ --- | $ *961,305* | $ *111,627* |
| Accrued interest payable | *55* | --- | *55* | --- |

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The following table presents the Company's financial instruments as of *December 31, 2017.*

| | December 31, 2017 | | | |
|---|---|---|---|---|
| | Carrying Amount | Quoted Prices in Active Markets for Identical Assets<br><br>Level 1 | Significant Other Observable Inputs<br><br>Level 2 | Significant Unobservable Inputs<br><br>Level 3 |
| Financial Assets: | | | | |
| Cash and due from banks | $ *12,926* | $ *12,926* | $ --- | $ --- |
| Interest-bearing deposits | *51,233* | *51,233* | --- | --- |
| Securities | *458,551* | --- | *461,500* | --- |
| Restricted securities | *1,200* | --- | *1,200* | --- |
| Loans held for sale | *260* | --- | *260* | --- |
| Loans, net | *660,144* | --- | --- | *656,399* |
| Accrued interest receivable | *5,297* | --- | *5,297* | --- |
| Bank-owned life insurance | *33,756* | --- | *33,756* | --- |
| Financial Liabilities: | | | | |
| Deposits | $ *1,059,734* | $ --- | $ *944,850* | $ *113,053* |
| Accrued interest payable | *62* | --- | *62* | --- |

**Note *8*: Components of Accumulated Other Comprehensive Loss**

| | Net Unrealized<br><br>Gain (Loss) on<br><br>Securities | Adjustments Related<br><br>to Pension Benefits | Accumulated Other<br><br>Comprehensive<br><br>Loss |
|---|---|---|---|
| **Balance at December 31, 2016** | $ *(3,588* ) | $ *(5,071* ) | $ *(8,659* ) |
| Unrealized holding gain on available for sale securities, net of tax of $580 | *1,075* | --- | *1,075* |
| **Balance at March 31, 2017** | $ *(2,513* ) | $ *(5,071* ) | $ *(7,584* ) |

| | | | |
|---|---|---|---|
| **Balance at December 31, 2017** | $ *(3,704* ) | $ *(5,991* ) | $ *(9,695* ) |
| Unrealized holding gain on available for sale securities net of tax of ($706) | *(2,655* ) | --- | *(2,655* ) |
| **Balance at March 31, 2018** | **$ *(6,359* )** | **$ *(5,991* )** | **$ *(12,350* )** |

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**Note *9:* Revenue Recognition**

On *January 1, 2018,* the Company adopted ASU *No. 2014-09* “Revenue from Contracts with Customers” (Topic *606*) and all subsequent ASUs that modified Topic *606.* As stated in Note *1* Summary of Significant Accounting Policies, the implementation of the new standard did *not* have a material impact on the measurement or recognition of revenue. Results for reporting periods beginning after *January 1, 2018* and comparative periods are presented under Topic *606.*

Topic *606* does *not* apply to revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as financial guarantees, derivatives, and certain credit card fees are also *not* in scope of the new guidance. Topic *606* is applicable to noninterest revenue streams such as service charges on deposit accounts, other service charges and fees, credit and debit card fees, trust income, and annuity and insurance commissions. However, the recognition of these revenue streams did *not* change significantly upon adoption of Topic *606.* Substantially all of the Company’s revenue is generated from contracts with customers. Noninterest revenue streams in-scope of Topic *606* are discussed below.

*Service Charges on Deposit Accounts*

Service charges on deposit accounts consist of monthly service fees, overdraft and nonsufficient funds fees, ATM fees, wire transfer fees, and other deposit account related fees. The Company’s performance obligation for monthly service fees is generally satisfied, and the related revenue recognized, over the period in which the service is provided. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers’ accounts. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. Wire transfer fees, overdraft and nonsufficient funds fees and other deposit account related fees are transactional based, and therefore, the Company’s performance obligation is satisfied, and related revenue recognized, at a point in time.

*Other Service Charges*

Other service charges include safety deposit box rental fees, check ordering charges, and other service charges. Safe deposit box rental fees are charged to the customer on an annual basis and recognized upon receipt of payment. The Company determined that since rentals and renewals occur fairly consistently over time, revenue is recognized on a basis consistent with the duration of the performance obligation. Check ordering charges are transactional based, and therefore, the Company’s performance obligation is satisfied, and related revenue recognized, at a point in time.

*Credit and Debit Card Fees*

Credit and debit card fees are primarily comprised of interchange fee income and merchant services income. Interchange fees are earned whenever the Company's debit and credit cards are processed through card payment networks such as Visa. Merchant services income mainly represents fees charged to merchants to process their debit and credit card transactions, in addition to account management fees. The Company's performance obligation for interchange fee income and merchant services income are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month. In compliance with Topic *606,* credit and debit card fee income is presented net of associated expense.

*Trust Income*

Trust income is primarily comprised of fees earned from the management and administration of trusts and other customer assets. The Company's performance obligation is generally satisfied over time and the resulting fees are recognized monthly, based upon the month-end market value of the assets under management and the applicable fee rate. Payment is generally received a few days after month end through a direct charge to customers' accounts. The Company does *not* earn performance-based incentives. Estate management fees are based upon the size of the estate. A partial fee is recognized half-way through the estate administration and the remainder of the fee is recognized when remaining assets are distributed and the estate is closed.

*Insurance and Investment*

Insurance income primarily consists of commissions received on insurance product sales. The Company acts as an intermediary between the Company's customer and the insurance carrier. The Company's performance obligation is generally satisfied upon the issuance of the insurance policy. Shortly after the insurance policy is issued, the carrier remits the commission payment to the Company, and the Company recognizes the revenue.

Investment income consists of recurring revenue streams such as commissions from sales of mutual funds and other investments. Commissions from the sale of mutual funds and other investments are recognized on trade date, which is when the Company has satisfied its performance obligation. The Company also receives periodic service fees (i.e., trailers) from mutual fund companies typically based on a percentage of net asset value. Trailer revenue is recorded over time, usually monthly or quarterly, as net asset value is determined.

The following presents noninterest income, segregated by revenue streams in-scope and out-of-scope of Topic *606,* for the *three* months ended *March 31, 2018* and *2017.*

| | **March 31, 2018** | **March 31, 2017** |
|---|---|---|
| **Noninterest Income** | | |
| *In-scope of Topic 606:* | | |
| Service charges on deposit accounts | **$*670*** | $*665* |
| Other service charges and fees | ***33*** | *69* |
| Credit and debit card fees | ***344*** | *244* |
| Trust income | ***402*** | *401* |

| | | |
|---|---|---|
| Insurance and Investment (included within Other Income on the Consolidated Statements of Income) | ***91*** | *80* |
| Noninterest Income (in-scope of Topic 606) | **$*1,540*** | $*1,459* |
| Noninterest Income (out-of-scope of Topic 606) | ***483*** | *391* |
| Total noninterest income | **$*2,023*** | $*1,850* |

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

$ in thousands, except per share data

The purpose of this discussion and analysis is to provide information about the financial condition and results of operations of National Bankshares, Inc. and its wholly-owned subsidiaries (the “Company”), which are not otherwise apparent from the consolidated financial statements and other information included in this report. Please refer to the financial statements and other information included in this report as well as the 2017 Annual Report on Form 10-K for an understanding of the following discussion and analysis.

**Cautionary Statement Regarding Forward-Looking Statements**

We make forward-looking statements in this Form 10-Q that are subject to significant risks and uncertainties. These forward-looking statements include statements regarding our profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk, growth strategy, and financial and other goals, and are based upon our management’s views and assumptions as of the date of this report. The words “believes,” “expects,” “may,” “will,” “should,” “projects,” “contemplates,” “anticipates,” “forecasts,” “intends,” or other similar words or terms are intended to identify forward-looking statements.

These forward-looking statements are based upon or are affected by factors that could cause our actual results to differ materially from historical results or from any results expressed or implied by such forward-looking statements. These factors 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, the Office of the Comptroller of the Currency, the Federal Reserve Board, the Consumer Financial Protection Bureau and the Federal Deposit Insurance Corporation, and the impact of any policies or programs implemented pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) and other financial reform legislation,
- unanticipated increases in the level of unemployment in the Company’s trade area,
- the quality or composition of the loan and/or investment portfolios,
- demand for loan products,
- deposit flows,
- competition,
- demand for financial services in the Company’s trade area,
- the real estate market in the Company’s trade area,
- the Company’s technology initiatives, and
- applicable accounting principles, policies and guidelines.

These risks and uncertainties should be considered in evaluating the forward-looking statements contained in this report. We caution readers not to place undue reliance on those statements, which speak only as of the date of this report. This discussion and analysis should be read in conjunction with the description of our "Risk Factors" in Item 1A. of the most recently filed Form 10-K.

If the national economy or the Company's market area experience a downturn, it is likely that unemployment will rise and that other economic indicators will negatively impact the Company's trade area. Because of the importance to the Company's markets of state-funded universities, cutbacks in the funding provided by the Commonwealth could also negatively impact employment. This could lead to a higher rate of delinquent loans and a greater number of real estate foreclosures. Higher unemployment and the fear of layoffs causes reduced consumer demand for goods and services, which negatively impacts the Company's business and professional customers. An economic downturn could have an adverse effect on all financial institutions, including the Company.

**Cybersecurity**

As a financial institution holding company, NBI is subject to cybersecurity risks and has suffered two cybersecurity incidents. To manage and mitigate cybersecurity risk, the Company limits certain transactions and interactions with customers. The Company does not offer online account openings or loan originations, limits the dollar amount of online banking transfers to other banks, does not permit customers to submit address changes or wire requests through online banking, requires a special vetting process for commercial customers who wish to originate ACH transfers, and limits certain functionalities of mobile banking. The Company also requires assurances from key vendors regarding their cybersecurity. While these measures reduce the likelihood and scope of the risk of cybersecurity breaches, in light of the evolving sophistication of system intruders, the risk to us of such breaches continues to exist. We maintain insurance for these risks but insurance policies are subject to exceptions, exclusions and terms whose applications have not been widely interpreted in litigation. Accordingly, insurance can provide less than complete protection against the losses that result from cybersecurity breaches and pursuing recovery from insurers can result in significant expense. In addition, some risks such as reputational damage and loss of customer goodwill, which can result from cybersecurity breaches cannot be insured against.

## Critical Accounting Policies

### General

The Company’s financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The financial information contained within our statements is, to a significant extent, financial information based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value obtained when earning income, recognizing an expense, recovering an asset or relieving a liability. Although the economics of the Company’s transactions may not change, the timing of events that would impact the transactions could change.

### Allowance for Loan Losses

The allowance for loan losses is an estimate of probable losses inherent in our loan portfolio. The allowance is funded by the provision for loan losses, reduced by charge-offs of loans and increased by recoveries of previously charged-off loans. The determination of the allowance is based on two accounting principles, Accounting Standards Codification (“ASC”) Topic 450-20 (Contingencies) which requires that losses be accrued when occurrence is probable and the amount of the loss is reasonably estimable, and ASC Topic 310-10 (Receivables) which requires accrual of losses on impaired loans if the recorded investment exceeds fair value.

Probable losses are accrued through two calculations, individual evaluation of impaired loans and collective evaluation of the remainder of the portfolio. Impaired loans are larger non-homogeneous loans for which there is a probability that collection will not occur according to the loan terms, as well as loans whose terms have been modified in a troubled debt restructuring. Impaired loans that are not TDR’s with an estimated impairment loss are placed on nonaccrual status. TDR’s with an impairment loss may accrue interest if they have demonstrated six months of timely payment performance.

*Impaired loans*

Impaired loans are identified through the Company’s credit risk rating process. Estimated loss for an impaired loan is the amount of recorded investment that exceeds the loan’s fair value. Fair value of an impaired loan is measured by one of three methods: the fair value of collateral (“collateral method”), the present value of future cash flows (“cash flow method”), or observable market price. The Company applies the collateral method to collateral-dependent loans, loans for which foreclosure is imminent and to loans for which the fair value of collateral is a more reliable estimate of fair

value. The cash flow method is applied to loans that are not collateral dependent and for which cash flows may be estimated.

The Company bases collateral method fair valuation upon the “as-is” value of independent appraisals or evaluations. Valuations for impaired loans with outstanding principal balances of $250 or more are based on a current appraisal. Appraisals are also used to value impaired loans with principal balances of $100 or greater and secured by one piece of collateral. Collateral-method impaired loans with principal balances below $100, or if secured by multiple pieces of collateral, below $250, are valued using an internal evaluation.

Appraisals and internal valuations provide an estimate of market value. Appraisals must conform to the Uniform Standards of Professional Appraisal Practice (“USPAP”) and are prepared by an independent third-party appraiser who is certified and licensed and who is approved by the Company. Appraisals may incorporate market analysis, comparable sales analysis, cash flow analysis and market data pertinent to the property to determine market value.

Internal evaluations are prepared by third party providers and reviewed by employees of the Company who are independent of the loan origination, operation, management and collection functions. Evaluations provide a property’s market value based on the property’s current physical condition and characteristics and the economic market conditions that affect the collateral’s market value. Evaluations incorporate multiple sources of data to arrive at a property’s market value, including physical inspection, independent third-party automated tools, comparable sales analysis and local market information.

Updated appraisals or evaluations are ordered when the loan becomes impaired if the appraisal or evaluation on file is more than twelve months old. Appraisals and evaluations are reviewed for propriety and reasonableness and may be discounted if the Company determines that the value exceeds reasonable levels. If an updated appraisal or evaluation has been ordered but has not been received by a reporting date, the fair value may be based on the most recent available appraisal or evaluation, discounted for age.

The appraisal or evaluation value for a collateral-dependent loan for which recovery is expected solely from the sale of collateral is reduced by estimated selling costs. Estimated losses on collateral-dependent loans, as well as any other impairment loss considered uncollectible, are charged against the allowance for loan losses. Impairment losses that are not considered uncollectible or for loans that are not collateral dependent are accrued in the allowance. Impaired loans with partial charge-offs are maintained as impaired until the remaining balance is satisfied. Smaller homogeneous impaired loans that are not troubled debt restructurings and are not part of a larger impaired relationship are collectively evaluated.

Troubled debt restructurings are impaired loans and are measured for impairment under the same valuation methods as other impaired loans. Troubled debt restructurings are maintained in nonaccrual status until the loan has demonstrated reasonable assurance of repayment with at least six months of consecutive timely payment performance.

*Collectively-evaluated loans*

Non-impaired loans and smaller homogeneous impaired loans that are not troubled debt restructurings and not part of a larger impaired relationship are grouped by portfolio segments. Portfolio segments are further divided into smaller loan classes. Loans within a segment or class have similar risk characteristics.

Probable loss is determined by applying historical net charge-off rates as well as additional percentages for trends and current levels of quantitative and qualitative factors. Loss rates are calculated for and applied to individual classes by averaging loss rates over the most recent 8 quarters. The look-back period of 8 quarters is applied consistently among all classes.

Two loss rates for each class are calculated: total net charge-offs for the class as a percentage of average class loan balance (“class loss rate”), and total net charge-offs for the class as a percentage of average classified loans in the class (“classified loss rate”). Classified loans are those with risk ratings that indicate credit quality is “substandard”, “doubtful” or “loss”. Net charge-offs in both calculations include charge-offs and recoveries of classified and non-classified loans as well as those associated with impaired loans. Class historical loss rates are applied to collectively-evaluated non-classified loan balances, and classified historical loss rates are applied to collectively-evaluated classified loan balances.

Qualitative factors are evaluated and allocations are applied to each class. Qualitative factors include delinquency rates, loan quality and concentrations, loan officers’ experience, changes in lending policies and changes in the loan review process. Economic factors such as unemployment rates, bankruptcy rates and others are evaluated, with standard allocations applied consistently to relevant classes.

The Company accrues additional allocations for criticized loans within each class and for loans designated high risk. Criticized loans include classified loans as well as loans rated “special mention”. Loans rated special mention indicate weakened credit quality but to a lesser degree than classified loans. High risk loans are defined as junior lien mortgages, loans with high loan-to-value ratios and loans with terms that require interest only payments. Both criticized loans and high risk loans are included in the base risk analysis for each class and are allocated additional reserves.

*Estimation of the allowance for loan losses*

The estimation of the allowance involves analysis of internal and external variables, methodologies, assumptions and our judgment and experience. Key judgments used in determining the allowance for loan losses include internal risk rating determinations, market and collateral values, discount rates, loss rates, and our view of current economic conditions. These judgments are inherently subjective and our actual losses could be greater or less than the estimate. Future estimates of the allowance could increase or decrease based on changes in the financial condition of individual borrowers, concentrations of various types of loans, economic conditions or the markets in which collateral may be sold. The estimate of the allowance accrual determines the amount of provision expense and directly affects our financial results.

The estimate of the allowance for March 31, 2018 considered market and portfolio conditions during the first three months of 2018 as well as the levels of delinquencies and net charge-offs in the eight quarters prior to the quarter ended March 31, 2018. If the economy experiences a downturn, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see Note 3 to the consolidated financial statements and “Asset Quality,” and “Provision and Allowance for Loan Losses.”

**Goodwill**

Goodwill is subject to at least an annual assessment for impairment by applying a fair value based test. The Company performs impairment testing in the fourth quarter of each year. The Company’s most recent impairment test was performed in the fourth quarter of 2017. Accounting guidance provides the option of performing preliminary assessment of qualitative factors before performing more substantial testing for impairment. The Company opted not to perform the preliminary assessment. The Company’s goodwill impairment analysis considered three valuation techniques appropriate to the measurement. The first technique uses the Company’s market capitalization as an estimate of fair value; the second technique estimates fair value using current market pricing multiples for companies comparable to the Company; while the third technique uses current market pricing multiples for change-of-control transactions involving companies comparable to the Company. Each measure indicated that the Company’s fair value exceeded its book value, validating that goodwill is not impaired.

Certain key judgments were used in the valuation measurement. Goodwill is held by the Company’s bank subsidiary. The bank subsidiary is 100% owned by the Company, and no market capitalization is available. Because most of the Company’s assets are comprised of the subsidiary bank’s equity, the Company’s market capitalization was used to estimate the Bank’s market capitalization. Other judgments include the assumption that the companies and transactions used as comparable properties for the second and third technique were appropriate to the estimate of the Company’s fair value, and that the comparable multiples are appropriate indicators of fair value, and compliant with accounting guidance.

**Other Real Estate Owned (“OREO”)**

Real estate acquired through, or in lieu of, foreclosure is held for sale and is stated at fair value of the property, less estimated disposal costs, if any. Any excess of cost over the fair value less costs to sell at the time of acquisition is charged to the allowance for loan losses. The fair value is reviewed periodically by management and any write-downs are charged against current earnings. Accounting policy and treatment is consistent with accounting for impaired loans described above.

**Pension Plan**

The Company’s actuary determines plan obligations and annual pension expense using a number of key assumptions. Key assumptions may include the discount rate, the estimated return on plan assets and the anticipated rate of compensation increases. Changes in these assumptions in the future, if any, or in the method under which benefits are calculated may impact pension assets, liabilities or expense.

**Other Than Temporary Impairment of Securities (“OTTI”)**

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (i) the Company intends to sell the security or (ii) it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis. If, however, the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery, the Company must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost basis of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit

loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income (loss). For equity securities, impairment is considered to be other-than-temporary based on the Company's ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in net income. The Company regularly reviews each investment security for other-than-temporary impairment based on criteria that include the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the Company's best estimate of the present value of cash flows expected to be collected from debt securities, the Company's intention with regard to holding the security to maturity and the likelihood that the Company would be required to sell the security before recovery.

**Overview**

National Bankshares, Inc. (the "Company" or "NBI") is a financial holding company that was organized in 1986 under the laws of Virginia and is registered under the Bank Holding Company Act of 1956. It conducts most of its operations through its wholly-owned community bank subsidiary, the National Bank of Blacksburg ("NBB"). It also owns National Bankshares Financial Services, Inc. ("NBFS"), which does business as National Bankshares Insurance Services and National Bankshares Investment Services.

NBI common stock is listed on the NASDAQ Capital Market and is traded under the symbol "NKSH." National Bankshares, Inc. has been included in the Russell Investments Russell 3000 and Russell 2000 Indexes since September 29, 2009.

**Lending**

The National Bank of Blacksburg, which does business as National Bank, was originally chartered in 1891 as the Bank of Blacksburg. Its state charter was converted to a national charter in 1922 and it became the National Bank of Blacksburg. In 2004, NBB purchased Community National Bank of Pulaski, Virginia. In May, 2006, Bank of Tazewell County, a Virginia bank which since 1996 was a wholly-owned subsidiary of NBI, was merged with and into NBB.

NBB is community-oriented and offers a full range of retail and commercial banking services to individuals, businesses, non-profits and local governments from its headquarters in Blacksburg, Virginia and its twenty-four branch offices throughout southwest Virginia and one loan production office in Roanoke Virginia. NBB has telephone and internet banking and it operates twenty-four automated teller machines in its service area.

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The Bank's primary source of revenue stems from lending activities. The Bank focuses lending on small and mid-sized businesses and individuals. Loan types include commercial and agricultural, commercial real estate, construction for commercial and residential properties, residential real estate, home equity and various consumer loan products. The Bank has prudent lending policies to align its underwriting and portfolio management with its risk tolerance and income strategies. Underwriting and documentation requirements are tailored to the unique characteristics and inherent risks of each loan category.

The Bank's loan policy is updated and approved by the Board of Directors annually, and disseminated to lending and loan portfolio management personnel to ensure consistent lending practices. The policy communicates the Company's risk tolerance by prescribing underwriting guidelines and procedures, including approval limits and hierarchy, documentation standards, requirements for collateral and loan-to-value limits, debt coverage and overall credit-worthiness, and guarantor support.

Of primary consideration is the repayment ability of the borrowers and (if secured) the collateral value in relation to the principal balance. Collateral lowers risk and may be used as a secondary source of repayment. The credit decision must be supported by documentation appropriate to the type of loan, including current financial information, income verification or cash flow analysis, tax returns, credit reports, collateral information, guarantor verification, title reports, appraisals (where appropriate), and other documents. A discussion of underwriting policies and procedures specific to the major loan products follows.

*Commercial Loans*. Commercial and agricultural loans primarily finance equipment acquisition, expansion, working capital, and other general business purposes. Because these loans have a higher degree of risk, the Bank generally obtains collateral such as inventories, accounts receivables or equipment, and personal guarantees from the borrowing entity's principal owners. The Bank's policy limits lending to 60% of the appraised value for inventory and equipment and up to 70% for accounts receivables less than 90 days old. Credit decisions are based upon an assessment of the financial capacity of the applicant, including the primary borrower's ability to repay within proposed terms, a risk assessment, financial strength of guarantors and adequacy of collateral. Credit agency reports of individual owners' credit history supplement the analysis.

*Commercial Real Estate Loans.* Commercial mortgages and construction loans are offered to investors, developers and builders primarily within the Bank's market area in southwest Virginia. These loans are secured by first mortgages on real estate. The loan amount is generally limited to 80% of the collateral value and is individually determined based on the property type, quality, location and financial strength of any guarantors. Commercial properties financed include retail centers, office space, apartments and industrial properties.

Underwriting decisions are based upon an analysis of the economic viability of the collateral and creditworthiness of the borrower. The Bank obtains appraisals from qualified certified independent appraisers to establish the value of collateral properties. The property's projected net cash flows compared to the debt service requirement (the "debt service coverage ratio" or "DSCR" ) is required to be 115% or greater and is computed after deduction for a vacancy factor and property expenses, as appropriate. Borrower cash flow may be supplemented by a personal guarantee from the principal(s) of the borrower and guarantees from other parties. The Bank requires title insurance, fire, extended coverage casualty insurance and flood insurance, if appropriate, in order to protect the security interest in the underlying property. In addition, the Bank may employ stress testing techniques on higher balance loans to determine repayment ability in a changing rate environment before granting loan approval.

*Public Sector and Industrial Development Loans.* The Company provides both long and short term loans to municipalities and other governmental entities within its geographical footprint. Borrowers include general taxing authorities such as a city or county, industrial/economic development authorities or utility authorities. Repayment sources are derived from taxation, such as property taxes and sales taxes, or revenue from the project financed with the loan. The Company's underwriting considers local economic and population trends, reserves and liabilities, including pension liabilities.

*Construction Loans.* Construction loans are underwritten against projected cash flows from rental income, business and/or personal income from an owner-occupant or the sale of the property to an end-user. Associated risks may be mitigated by requiring fixed-price construction contracts, performance and payment bonding, controlled disbursements and pre-sale contracts or pre-lease agreements.

*Consumer Real Estate Loans*. The Bank offers a variety of first mortgage and junior lien loans secured by primary residences to individuals within our markets. Credit decisions are primarily based on loan-to-value ("LTV") ratios, debt-to-income ("DTI") ratios, liquidity and net worth. Income and financial information is obtained from personal tax returns, personal financial statements and employment documentation. A maximum LTV ratio of 80% is generally required, although higher levels are permitted. The DTI ratio is limited to 43% of gross income.

Consumer real estate mortgages may have fixed interest rates for the entire term of the loan or variable interest rates subject to change after the first, third, or fifth year. Variable rates are based on the weekly average yield of United States Treasury Securities and are underwritten at fully-indexed rates. We do not offer certain high risk loan products such as interest-only consumer mortgage loans, hybrid loans, payment option ARMs, reverse mortgage loans, loans with initial teaser rates or any product with negative amortization. Hybrid loans are loans that start out as a fixed rate mortgage, but after a set number of years they automatically adjust to an adjustable rate mortgage. Payment option ARMs usually have adjustable rates, for which borrowers choose their monthly payment of either a full payment, interest only, or a minimum payment which may be lower than the payment required to reduce the balance of the loan in accordance with the originally underwritten amortization.

Home equity loans are secured primarily by second mortgages on residential property. The underwriting policy for home equity loans generally permits aggregate (the total of all liens secured by the collateral property) borrowing availability up to 80% of the appraised value of the collateral. We offer both fixed rate and variable rate home equity loans, with variable rate loans underwritten at fully-indexed rates. Decisions are primarily based on LTV ratios, DTI ratios, liquidity and credit history. We do not offer home equity loan products with reduced documentation.

*Consumer Loans*. Consumer loans include loans secured by automobiles, loans to consumers secured by other non-real estate collateral and loans to consumers that are unsecured. Automobile loans include loans secured by new or used automobiles. We originate automobile loans either on a direct basis or on an indirect basis through selected dealerships. We require borrowers to maintain collision insurance on automobiles securing consumer loans. Our procedures for underwriting consumer loans include an assessment of an applicant's overall financial capacity, including credit history and the ability to meet existing obligations and payments on the proposed loan. An applicant's creditworthiness is the primary consideration, and if the loan is secured by an automobile or other collateral, the underwriting process also includes a comparison of the value of the collateral security to the proposed loan amount.

*Other Products and Services*. Deposit products offered by the Bank include interest-bearing and non-interest bearing demand deposit accounts, money market deposit accounts, savings accounts, certificates of deposit, health savings accounts and individual retirement accounts. Deposit accounts are offered to both individuals and commercial businesses. Merchant credit card services and business and consumer debit and credit cards are available. NBB offers other miscellaneous services normally provided by commercial banks, such as letters of credit, night depository, safe deposit boxes, utility payment services and automatic funds transfer. NBB conducts a general trust business that has wealth management, trust and estate services for individual and business customers.

**Performance Summary**

The following table presents the Company's key performance ratios for the three months ended March 31, 2018 and March 31, 2017 and the year ended December 31, 2017. The measures for March 31, 2018 and March 31, 2017 are annualized, except for basic earnings per share and fully diluted earnings per share.

| | **Three Months Ended March 31, 2018** | | **Three Months Ended March 31, 2017** | | **Twelve Months Ended December 31, 2017** | |
|---|---|---|---|---|---|---|
| Return on average assets [1] | **1.32** | **%** | 1.21 | % | 1.14 | % |
| Return on average equity [1] | **8.85** | **%** | 8.20 | % | 7.64 | % |
| Basic earnings per share | **$ 0.47** | | $ 0.52 | | $ 2.03 | |
| Fully diluted earnings per share | **$ 0.47** | | $ 0.52 | | $ 2.03 | |
| Net interest margin [2] | **3.38** | **%** | 3.49 | % | 3.45 | % |
| Noninterest margin [3] | **1.44** | **%** | 1.47 | % | 1.34 | % |

(1) The return on average assets and return on average equity are calculated by annualizing net income to date. For 2018, the annualization factor was not applied to the recovery of loan losses or the insurance write-off.
(2) Net interest margin: Year-to-date tax-equivalent net interest income divided by year-to-date average earning assets.
(3) Noninterest margin: Noninterest expense (excluding non-recurring items, the provision for bad debts and income taxes) less noninterest income (excluding securities gains and losses) divided by average year-to-date assets.

The following table details the calculation of annualized net income for the return on average assets and the return on average equity:

| | **Three Months Ended March 31, 2018** | **Three Months Ended March 31, 2017** |
|---|---|---|
| Net Income | **$3,296** | $3,649 |
| Items deemed non-recurring by management: | | |
| Insurance write-down, net of tax of $361 | **1,362** | --- |
| Recovery of loan losses, net of tax of ($99) | **(373)** | --- |
| Adjusted net income | **4,285** | 3,649 |
| Adjusted net income, annualized | **17,378** | 14,799 |
| Items deemed non-recurring by management: | | |
| Insurance write-down, net of tax of ($361) | **(1,362)** | --- |
| Recovery of loan losses, net of tax of $99 | **373** | --- |
| Annualized net income for ratio calculation | **$16,389** | $14,799 |

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The annualized return on average assets increased 11 basis points for the three months ended March 31, 2018 compared with the three months ended March 31, 2017 and increased 18 basis points compared with the twelve months ended December 31, 2017.

The annualized return on average equity was 8.85% for the three months ended March 31, 2018, an increase from 8.20% for the three month period ended March 31, 2017 and 7.64% for the twelve month period ended December 31, 2017.

The annualized net interest margin was 3.38% for the three months ended March 31, 2018, down 11 basis points from the 3.49% reported for the three months ended March 31, 2017 and down 7 basis points from the 3.45% reported for the twelve months ended December 31, 2017. The primary factor driving the decrease in the net interest margin was the decrease in income from nontaxable securities. Please refer to the discussion under Net Interest Income for further information.

The annualized noninterest margin improved by 3 basis points when compared with the three month period ended March 31, 2017 and increased by 10 basis points from the twelve months ended December 31, 2017. Please refer to the discussions under noninterest income and noninterest expense for further information

**Growth**

NBI’s key growth indicators are shown in the following table.

| | **March 31, 2018** | **December 31, 2017** | **Percent Change** | |
|---|---|---|---|---|
| Interest-bearing deposits | **$76,571** | $51,233 | 49.46 | % |
| Securities | **461,337** | 459,751 | 0.34 | % |
| Loans, net | **651,272** | 660,144 | (1.34 | )% |
| Deposits | **1,072,940** | 1,059,734 | 1.25 | % |
| Total assets | **1,270,528** | 1,256,757 | 1.10 | % |

**Asset Quality**

Key indicators of the Company’s asset quality are presented in the following table.

| | March 31, 2018 | March 31, 2017 | December 31, 2017 |
|---|---|---|---|
| Nonperforming loans | **$2,764** | $5,680 | $ 2,769 |
| Loans past due 90 days or more, and still accruing | **52** | 63 | 51 |
| Other real estate owned | **2,741** | 2,952 | 2,817 |
| Allowance for loan losses to loans | **1.12 %** | 1.27 % | 1.19 % |
| Net charge-off ratio | **0.04 %** | 0.06 % | 0.08 % |
| Ratio of nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned | **0.83 %** | 1.32 % | 0.83 % |
| Ratio of allowance for loan losses to nonperforming loans | **267.40 %** | 145.44 % | 286.20 % |

The Company's risk analysis at March 31, 2018 determined an allowance for loan losses of $7,391 or 1.12% of loans net of unearned income and deferred fees and costs, a decrease from $7,925 or 1.19% at December 31, 2017. The determination of the appropriate level for the allowance for loan losses resulted in a recovery of provision for loan losses of $472 for the three months ended March 31, 2018, compared with a provision of $59 for the three months ended March 31, 2017 and a provision for the twelve month period ended December 31, 2017 of $157. To determine the appropriate level of the allowance for loan losses, the Company considers credit risk for certain loans designated as impaired and for non-impaired ("collectively evaluated") loans.

Individually evaluated impaired loans totaled $11,681 on a gross basis and $11,666 net of unearned income and deferred fees and costs, with specific allocations to the allowance for loan losses of $169 at March 31, 2018. Individually evaluated impaired loans at December 31, 2017 were $11,924 on a gross basis and $11,919 net of unearned income and deferred fees and costs, with specific allocations to the allowance for loan losses of $177. The specific allocation is determined based on criteria particular to each impaired loan.

Collectively evaluated loans totaled $647,571 on a gross basis and $646,997 net of unearned income and deferred fees and costs, with an allowance of $7,222 or 1.12% at March 31, 2018. At December 31, 2017, collectively evaluated loans totaled $656,758 on a gross basis and $656,150 net of unearned income and deferred fees and costs, with an allowance of $7,748 or 1.18%.

For collectively evaluated loans, the Company applies to each loan class a historical net charge-off rate, adjusted for qualitative factors that influence credit risk. Qualitative factors evaluated for impact to credit risk include economic measures, asset quality indicators, loan characteristics, and internal Bank policies and management.

Net charge-off rates for each class are averaged over 8 quarters (2 years) to determine the historical net charge off rate applied to each class of collectively evaluated loans. Net charge-offs for the three months ended March 31, 2018 were $62 or 0.04% (annualized) of average loans, an improvement from $98 or 0.06% (annualized) for the three months ended March 31, 2017. Net charge-offs for the twelve months ended December 31, 2017 were $532 or 0.08% of loans. The 8-quarter average historical loss rate applied to the calculation was 0.14% for March 31, 2018, 0.28% for March 31, 2017 and 0.17% for December 31, 2017. Increases in the net charge-off rate increase the required allowance for collectively-evaluated loans, while decreases in the net charge-off rate decrease the required allowance for collectively-evaluated loans.

Economic factors influence credit risk and impact the allowance for loan loss. The Company considers economic indicators within its market area, including: unemployment, personal bankruptcy filings, business bankruptcy filings, the interest rate environment, residential vacancy rates, housing inventory for sale, and the competitive environment. Lower unemployment lowers credit risk and the allowance for loan losses, while higher unemployment increases credit risk. Higher bankruptcy filings indicate heightened credit risk and increase the allowance for loan losses, while lower bankruptcy filings have a beneficial impact on credit risk. The interest rate environment impacts variable rate loans. As interest rates increase, the payment on variable rate loans increases, increasing credit risk. Residential vacancy rates and housing inventory for sale impact the Company’s residential construction customers and the consumer real estate market. Higher levels increase credit risk. Higher competition for loans increases credit risk, while lower competition decreases credit risk.

Economic indicators that improved from December 31, 2017 were lower personal and business bankruptcies, residential residency rates, and housing inventory for sale in the Company’s market area. Improved economic indicators result in a lower requirement for the allowance for loan losses. Economic indicators that negatively impacted credit risk included elevated unemployment rate and increases in the interest rate environment, when data at March 31, 2018 are compared with data at December 31, 2017. The competitive environment remained at a similar level to that at December 31, 2017.

The Company considers other factors that impact credit risk, including the legal and regulatory environments, changes to lending policies and loan review, and management’s experience. Each of the factors remained at similar levels to December 31, 2017.

Asset quality indicators affect the level of the allowance for loan losses. Accruing loans past due 30-89 days were 0.38% of total loans, net of unearned income and deferred fees and costs at March 31, 2018, an increase from 0.34% at December 31, 2017 and 0.33% at March 31, 2017. Accruing loans past due 90 days or more were 0.01% of total loans, net of unearned income and deferred fees and costs at March 31, 2018, the same level as December 31, 2017 and March 31, 2017. Nonaccrual loans at March 31, 2018 were 0.42% of total loans, net of unearned income and deferred fees and costs, 0.41% at December 31, 2017 and 0.87% at March 31, 2017. Decreases in past due and nonaccrual loans reduce the required level of the allowance for loan losses, while increases in past due and nonaccrual loans increase the required level of the allowance for loan losses.

Loans rated "special mention" and "classified" (together, "criticized assets") indicate heightened credit risk. Higher levels of criticized assets increase the required level of the allowance for collectively-evaluated loans, while lower levels of criticized assets reduce the required level of the allowance for collectively-evaluated loans. Loans rated special mention receive a 50% greater allocation for qualitative risk factors, and loans rated classified receive a 100% greater allocation for qualitative risk factors. A classified loss rate is also applied to classified loans, calculated as net charge offs divided by classified loans.

Collectively evaluated loans rated "special mention" were $3,640 at March 31, 2018, $3,361 at December 31, 2017 and $11,380 at March 31, 2017. Collectively evaluated loans rated classified were $2,383 at March 31, 2018, $1,691 at December 31, 2017 and $3,205 at March 31, 2017.

Levels of high risk loans are considered in the determination of the level of the allowance for loan loss. High risk loans are defined by the Company as loans secured by junior liens, interest-only loans and loans with a high loan-to-value ratio. A decrease in the level of high risk loans within a class decreases the required allocation for the loan class, and an increase in the level of high risk loans within a class increases the required allocation for the loan class. Total high risk loans rose $4,243 or 2.72% from the level at December 31, 2017, resulting in an increased allocation.

The calculation of the appropriate level for the allowance for loan losses incorporates analysis of multiple factors and requires management's prudent and informed judgment. The ratio of the allowance for loan losses to total loans, net of unearned income and deferred fees and costs at March 31, 2018 is 1.12%, a decrease from 1.19% at December 31, 2017. The ratio of the allowance for collectively-evaluated loan losses to collectively-evaluated loans, net of unearned income and deferred fees and costs was 1.12%, compared with 1.18% at December 31, 2017. Improvements from December 31, 2017 in the charge-off rate, business and personal bankruptcies, residential vacancy, and housing inventory decreased the required level of the allowance for loan losses, slightly offset by worsening in nonaccrual loans, criticized loans, unemployment, and the impact of the interest rate environment. Based on analysis of historical indicators, asset quality and economic factors, management believes the level of allowance for loan losses is reasonable for the credit risk in the loan portfolio.

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The following table discloses the other real estate owned in physical possession and in process at each reporting date:

| **Other Real Estate Owned[1]** | **March 31, 2018** | **March 31, 2017** | **December 31, 2017** |
|---|---|---|---|
| Real estate construction | **$2,425** | $2,466 | $ 2,425 |
| Consumer real estate | **42** | --- | 42 |
| Commercial real estate | **274** | 486 | 350 |
| Total other real estate owned | **$2,741** | $2,952 | $ 2,817 |
| Other real estate owned in process | **$46** | $1,376 | $ 11 |

(1) Net of valuation allowance.

Other real estate owned decreased $76 from December 31, 2017 and $211 from March 31, 2017. As of March 31, 2018, loans secured by residential real estate totaling $46 are in various stages of foreclosure and may impact other real estate owned in future quarters. It is not possible to accurately predict the future total of other real estate owned because property sold at foreclosure may be acquired by third parties and NBB's other real estate owned properties are regularly marketed and sold.

The Company continues to monitor risk levels within the loan portfolio. Please refer to Note 3: Allowance for Loan Losses, Nonperforming Assets and Impaired Loans for further information on collectively-evaluated loans, individually-evaluated impaired loans and the unallocated portion of the allowance for loan losses.

**Modifications and Troubled Debt Restructurings ("TDRs")**

In the ordinary course of business the Company modifies loan terms on a case-by-case basis, including both consumer and commercial loans, for a variety of reasons. Modifications to consumer loans generally involve short-term deferrals to accommodate specific, temporary circumstances. The Company may grant extensions to borrowers who have demonstrated a willingness and ability to repay their loan but who are experiencing consequences of a specific unforeseen temporary hardship.

An extension defers monthly payments and requires a balloon payment at the original contractual maturity. If the temporary event is not expected to impact a borrower's ability to repay the debt, and if the Company expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay at contractual maturity, the modification is not designated a TDR.

Modifications to commercial loans may include, but are not limited to, changes in interest rate, maturity, amortization and financial covenants. In the original underwriting, loan terms are established that represent the then-current and projected financial condition of the borrower. If the modified terms are consistent with competitive market conditions and representative of terms the borrower could otherwise obtain in the open market, the modified loan is not categorized as a TDR.

The Company codes modifications to assist in identifying troubled debt restructurings. The majority of modifications were granted for competitive reasons and did not constitute troubled debt restructurings. A description of modifications that did not result in troubled debt restructurings follows:

**Three Months Ended March 31, 2018**

| **Modifications To Borrowers Not Experiencing Financial Difficulty** | **Number of Loans Modified** | **Total Amount Modified (in thousands)** |
|---|---|---|
| Rate reductions for competitive purposes | **---** | **$ ---** |
| Payment extensions for less than 3 months | **9** | **75** |
| Maturity date extensions of more than 3 months and up to 6 months | **30** | **3,931** |
| Maturity date extensions of more than 6 months and up to 12 months | **69** | **3,965** |
| Maturity date extensions of more than 12 months | **6** | **1,253** |
| Advances on non-revolving loans or capitalization | **3** | **685** |
| Change in amortization term or method | **4** | **786** |
| Change or release of collateral | **24** | **419** |
| Renewal of expired Home Equity Line of Credit loans for additional 10 years | **3** | **14** |
| Renewal of single-payment notes | **42** | **689** |
| Total modifications that do not constitute TDRs | **190** | **$ 11,817** |

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**Three Months Ended March 31, 2017**

| Modifications To Borrowers Not Experiencing Financial Difficulty | Number of Loans Modified | Total Amount Modified (in thousands) |
|---|---|---|
| Rate reductions for competitive purposes | 10 | $ 4,145 |
| Payment extensions for less than 3 months | 37 | 906 |
| Maturity date extensions of more than 3 months and up to 6 months | 63 | 11,378 |
| Maturity date extensions of more than 6 months and up to 12 months | 78 | 3,302 |
| Maturity date extensions of more than 12 months | 1 | 3 |
| Advances on non-revolving loans or capitalization | 8 | 1,104 |
| Change in amortization term or method | 7 | 969 |
| Renewal of expired Home Equity Line of Credit loans for additional 10 years | 5 | 213 |
| Renewal of single-payment notes | 70 | 1,466 |
| Total modifications that do not constitute TDRs | 279 | $ 23,486 |

**Twelve Months Ended December 31, 2017**

| Modifications To Borrowers Not Experiencing Financial Difficulty | Number of Loans Modified | Total Amount Modified (in thousands) |
|---|---|---|
| Rate reductions for competitive purposes | 29 | $ 11,783 |
| Payment extensions for less than 3 months | 126 | 2,693 |
| Maturity date extensions of more than 3 months and up to 6 months | 182 | 29,253 |
| Maturity date extensions of more than 6 months and up to 12 months | 316 | 14,675 |
| Maturity date extensions of more than 12 months | 7 | 3,474 |
| Advances on non-revolving loans or recapitalization | 12 | 4,603 |
| Change in amortization term or method | 42 | 4,884 |
| Renewal of expired Home Equity Line of Credit loans for additional 10 years | 19 | 448 |
| Renewal of single-payment notes | 240 | 5,044 |
| Total modifications that do not constitute TDRs | 973 | $ 76,857 |

Modifications in which the borrower is experiencing financial difficulty and for which the Company makes a concession to the original contractual loan terms are designated troubled debt restructurings.

Modifications of loan terms to borrowers experiencing financial difficulty are made in an attempt to protect as much of the Company’s investment in the loan as possible. The determination of whether a modification should be accounted for as a TDR requires significant judgment after consideration of all facts and circumstances surrounding the

transaction.

Assuming all other TDR criteria are met, the Company considers one or a combination of the following concessions to the loan terms to indicate TDR status: a reduction of the stated interest rate, an extension of the maturity date at an interest rate lower than the current market rate for a new loan with a similar term and similar risk, or forgiveness of principal or accrued interest.

The Company has restructured loan terms for certain qualified financially distressed borrowers who have agreed to work in good faith and have demonstrated the ability to make the restructured payments in order to avoid a foreclosure. All TDR loans are individually evaluated for impairment for purposes of determining the allowance for loan losses. TDR loans with an impairment loss or that do not demonstrate current payments for at least six months are maintained on nonaccrual until the borrower demonstrates sustained repayment history under the restructured terms and continued repayment is not in doubt. Otherwise, interest income is recognized using a cost recovery method.

The Company's TDRs were $10,648 at March 31, 2018, an increase from $7,897 at December 31, 2017. Accruing TDR loans amounted to $7,890 at March 31, 2018 and $5,134 at December 31, 2017. TDRs with at least six months of current payment history may accrue interest.

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**TDR Status as of March 31, 2018**

| | **Total TDR Loans** | **Accruing Current** | **30-89 Days Past Due** | **90+ Days Past Due** | **Nonaccrual** |
|---|---|---|---|---|---|
| Real estate construction | **$2,817** | **2,817** | **$ ---** | **$ ---** | **$ ---** |
| Consumer real estate | **1,077** | **767** | **168** | **---** | **142** |
| Commercial real estate | **5,527** | **2,925** | **---** | **---** | **2,602** |
| Commercial non real estate | **1,203** | **1,190** | **---** | **---** | **13** |
| Consumer non real estate | **24** | **19** | **4** | **---** | **1** |
| Total TDR Loans | **$10,648** | **$7,718** | **$172** | **$ ---** | **$ 2,758** |

**TDR Status as of December 31, 2017**

| | **Total TDR Loans** | **Accruing Current** | **30-89 Days Past Due** | **90+ Days Past Due** | **Nonaccrual** |
|---|---|---|---|---|---|
| Real estate construction | $--- | $--- | $--- | $ --- | $ --- |
| Consumer real estate | 1,092 | 773 | 174 | --- | 145 |
| Commercial real estate | 5,550 | 2,948 | --- | --- | 2,602 |
| Commercial non real estate | 1,229 | 1,214 | --- | --- | 15 |
| Consumer non real estate | 26 | 25 | --- | --- | 1 |
| Total TDR Loans | $7,897 | $4,960 | $174 | $ --- | $ 2,763 |

Restructuring generally results in a loan with either lower payments or a maturity extended beyond that originally required, and is expected to result in a lower risk of loss associated with nonperformance than the pre-modified loan. The Company modified two loans during the three month period ended March 31, 2018 and did not modified any loans during the three month period ended March 31, 2017. Please refer to Note 3 for information on troubled debt restructurings.

**Net Interest Income**

The net interest income analysis for the three months ended March 31, 2018 and 2017 follows:

| | Three Months Ended March 31, 2018 | | | March 31, 2017 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest | Average Yield/ Rate | Average Balance | Interest | Average Yield/ Rate |
| Interest-earning assets: | | | | | | |
| Loans, net [1][2][3][4] | **$665,089** | **$7,620** | **4.65** % | $649,907 | $7,616 | 4.75 % |
| Taxable securities [5][6] | **334,849** | **1,608** | **1.95** % | 310,370 | 1,402 | 1.83 % |
| Nontaxable securities [1][5] | **131,331** | **1,489** | **4.60** % | 134,454 | 1,910 | 5.76 % |
| Interest-bearing deposits | **45,740** | **172** | **1.53** % | 72,322 | 148 | 0.83 % |
| Total interest-earning assets | **$1,177,009** | **$10,889** | **3.75** % | $1,167,053 | $11,076 | 3.85 % |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | **$612,831** | **$905** | **0.60** % | $595,138 | $819 | 0.56 % |
| Savings deposits | **141,171** | **55** | **0.16** % | 137,415 | 64 | 0.19 % |
| Time deposits | **114,116** | **121** | **0.43** % | 128,375 | 145 | 0.46 % |
| Total interest-bearing liabilities | **$868,118** | **$1,081** | **0.51** % | $860,928 | $1,028 | 0.48 % |
| Net interest income and interest rate spread | | **$9,808** | **3.24** % | | $10,048 | 3.37 % |
| Net yield on average interest-earning assets | | | **3.38** % | | | 3.49 % |

(1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 21% for the three month period ended March 31, 2018 and 35% for the three month period ended March 31, 2017.
(2) Included in interest income are loan fees of $42 and $116 for the three months ended March 31, 2018 and 2017, respectively.
(3) Nonaccrual loans are included in average balances for yield computations.
(4) Includes loans held for sale.
(5) Daily averages are shown at amortized cost.
(6) Includes restricted stock.

The following tables reconcile net interest income on a fully-taxable equivalent basis to net interest income on a GAAP basis.

| | Three Months Ended March, | |
|---|---|---|
| | **2018** | **2017** |
| Net interest income, fully taxable equivalent basis | **$9,808** | $10,048 |
| Less: taxable equivalent adjustment | **(405 )** | (838 ) |
| Net interest income | **$9,403** | $9,210 |

The net interest margin decreased 11 basis points for the three month period ended March 31, 2018 when compared with the three month period ended March 31, 2017. The decrease in interest rate spread resulted from a decline in the yield on earning assets of 10 basis points and an increase in the cost of interest-bearing liabilities of 3 basis points when the three-month periods ended March 31, 2018 and 2017 are compared.

The yield on loans declined 10 basis points when the three month period ended March 31, 2018 is compared with the same period ended March 31, 2017. The decline stemmed from contractual repricing terms and the renegotiation of loan interest rates in response to competition. The decrease in the Company's tax rate from a marginal rate of 35% in 2017 to 21% in 2018 also reduced the fully taxable-equivalent yield on nontaxable loans when the three month periods ended March 31, 2018 and 2017 are compared.

The yield on taxable securities increased 12 basis points when the three month period ended March 31, 2018 is compared with the same period ended March 31, 2017. The yield on nontaxable securities decreased 116 basis points when the three month periods ended March 31, 2018 and March 31, 2017 are compared. As with nontaxable loans, the fully taxable-equivalent yield on nontaxable securities was negatively impacted by the reduction in tax rate.

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The increase in the cost of interest-bearing liabilities came from an increase in the cost of interest-bearing demand deposits. The cost of interest-bearing demand deposits increased 4 basis points for the three month period ending March 31, 2018, when compared with the same period ended March 31, 2017. The Company's yield on earning assets and cost of funds are largely dependent on the interest rate environment.

**Provision and Allowance for Loan Losses**

The calculation of the allowance for loan losses resulted in a recovery of loan losses for the three month period ended March 31, 2018 was $472, compared with a provision for loan losses of $59 for the same period ended March 31, 2017. The provision for loan losses is the result of a detailed analysis to estimate an adequate allowance for loan losses. The ratio of the allowance for loan losses to total loans at March 31, 2018 was 1.12%, which compares to 1.19% at December 31, 2017 and 1.27% at March 31, 2018. The net charge-off ratio was 0.04% for the three months ended March 31, 2018, 0.06% for the three months ended March 31, 2017 and 0.08% for the year ended December 31, 2017. See "Asset Quality" for additional information.

**Noninterest Income**

| | Three Months Ended | | |
|---|---|---|---|
| | **March 31, 2018** | **March 31, 2017** | **Percent Change** |
| Service charges on deposits | **$670** | $ 665 | **0.75** % |
| Other service charges and fees | **33** | 69 | **(52.17** )% |
| Credit and debit card fees | **344** | 244 | **40.98** % |
| Trust fees | **402** | 401 | **0.25** % |
| BOLI income | **228** | 143 | **59.44** % |
| Other income | **346** | 328 | **5.49** % |

Service charges on deposit accounts increased slightly for the three month period ended March 31, 2018 when compared with the same period ended March 31, 2017. Other service charges and fees decreased when the three period ended March 31, 2018 are compared with the same period ended March 31, 2017. Other service charges include charges for official checks, income from the sale of checks to customers, safe deposit box rent, fees for letters of credit and the income earned from commissions on the sale of credit life, accident and health insurance. Service

charges on deposits and other service charges and fees are subject to normal business fluctuation and are not due to changes in fee structure.

Credit and debit card fees are presented net of interchange expense. Credit and debit card fees increased $100 for the three month period ended March 31, 2018, when compared with the same period last year. During the latter half of 2017, the Company sold its merchant processing business, which resulted in a decline in associated merchant interchange expense when the three month periods ended March 31, 2018 and March 21, 2017 are compared. Credit and debit card fees are based on volume and other factors.

Income from trust fees was similar for the three months ended March 31, 2018 and the three month period ended March 31, 2017. Trust income varies depending on the total assets held in trust accounts, the type of accounts under management and financial market conditions.

BOLI income increased $85 for the three month period ended March 31, 2018 compared with the three month period ended March 31, 2017. The Company purchased $10 million in additional BOLI investments on June 30, 2017.

Other income includes fees on the sale of secondary-market mortgages, net gains from the sale of fixed assets, revenue from investment and insurance sales and other smaller miscellaneous components. These areas fluctuate with market conditions and because of competitive factors. Other income increased $18 or 5.49% for the three month period ended March 31, 2018, when compared with the same period ended March 31, 2017. Most of the increase was due to increases in commissions on securities sales and income recognized on investments in partnerships.

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**Noninterest Expense**

| | Three Months Ended | | |
|---|---|---|---|
| | March 31, 2018 | March 31, 2017 | Percent Change |
| Salaries and employee benefits | **$3,694** | $3,523 | **4.85** % |
| Occupancy, furniture and fixtures | **472** | 438 | **7.76** % |
| Data processing and ATM | **733** | 566 | **29.51** % |
| FDIC assessment | **91** | 95 | **(4.21** )% |
| Intangibles amortization | **12** | 31 | **(61.29** )% |
| Net costs of other real estate owned | **85** | 29 | **193.10** % |
| Franchise taxes | **331** | 322 | **2.80** % |
| Write-down of insurance receivable | **1,724** | --- | NR |
| Other operating expenses | **1,022** | 1,279 | **(20.09** )% |

Total noninterest expense increased $1,881 or 29.94% for the three month period ended March 31, 2018 when compared with the same period of 2017. The increase stemmed primarily from increases in data processing and ATM, net costs of other real estate owned and other operating expenses.

Salaries and employee benefits increased $171 or 4.85% for the three month period ended March 31, 2018 when compared with the same period in 2017. This expense category includes employee salaries, payroll taxes, insurance and fringe benefits, ESOP contribution accruals, the service component of net periodic pension cost, and salary continuation expenses. A decrease in salary expense of $71 was offset by increases in payroll taxes of $39, fringe benefits of $74, and pension servicing cost of $120. Please refer to Note 1: General for information on adoption of pension accounting guidance effective January 1, 2018.

Occupancy, furniture and fixtures expense increased $34 when the three month periods ended March 31, 2018 and March 31, 2017 are compared.

Data processing and ATM expense increased $167 when the three month period ended March 31, 2018 is compared with the same period in 2017, due to infrastructure upgrades.

FDIC assessment expense decreased $4 for the three month period ended March 31, 2018 when compared with the same periods of 2017. The FDIC assessment is accrued based on a method provided by the FDIC. The calculation is based on average assets divided by average tangible equity and incorporates risk-based factors to determine the amount of the assessment.

Core deposit intangibles are the result of prior merger and acquisition activity and are amortized over a period of years. Certain of the Company’s intangible assets became fully amortized during 2017. This accounted for the decline

in intangibles amortization expense of $19 for the three month period ended March 31, 2018, compared with the same period of 2017.

Net costs of other real estate owned increased $56 for the three month period ended March 31, 2018, compared with the same periods in 2017. The cost of other real estate owned includes maintenance costs as well as valuation write-downs and gains and losses on the sale of properties. The expense varies with the number of properties, the maintenance required and changes in the real estate market. OREO properties are accounted for at fair value less cost to sell upon foreclosure and are thereafter periodically appraised to determine market value. Declines in market value are recognized through valuation expense. Write downs on OREO properties were $76 for the three months ended March 31, 2018, compared with $12 for the three months ended March 31, 2017. Carrying expenses totaled $9 for the three months ended March 31, 2018, compared with $21 for the three months ended March 31, 2017.

Franchise tax expense for the three month period ended March 31, 2018 was at a similar level to the same period ended March 31, 2017. Franchise tax is based on capital levels of the subsidiary bank

The Company recognized an expense of $1,724 during the first quarter of 2018 to reduce its insurance receivable related to a cybersecurity breach. Please see the discussion under the section "Cybersecurity Risks and Incidents" below.

The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs, postage, charitable donations, losses and other expenses. Other operating expense decreased $257 or 20.09% for the three month period ended March 31, 2018, compared with the same periods of 2017. The decrease is related to consulting and advisory services for the cybersecurity breach and non-service components of net periodic pension cost. During the first quarter of 2017, the Company incurred $135 in consulting and advisory expenses related to the cybersecurity breach (discussed in further detail below). Expense for non-service components of net periodic pension cost decreased $132 when the three month periods ended March 31, 2018 and March 31, 2017 are compared.

**Cybersecurity Risks and Incidents**

As disclosed in previous reports, the Company's computer system experienced two cyber intrusions, one in May of 2016 and one in January of 2017. The theft of funds totaled $2,408. The Company notified all affected customers, and restored all funds so that no customer experienced a loss. The Company filed a claim with its insurance carrier on or about August 1, 2017.

The Company retained a nationally recognized firm to investigate and remediate the May 2016 intrusion and a separate nationally recognized firm to investigate and remediate the January 2017 intrusion. The firms provided the Company with recommendations concerning its systems and procedures. The Company adopted and implemented all of the recommendations resulting from the investigation of the May 2016 intrusion and has implemented most of the recommendations from the investigation of the January 2017 intrusion, with targeted completion for all such recommendations in 2018.

The Company filed an insurance claim in 2017 for both of the breaches and is awaiting a formal response from the insurance company. On April 4, 2018, legal counsel informed the Company's management of recent correspondence with the insurance carrier. The correspondence suggests the insurance carrier may apply coverage in such a way as to limit insurance liability for the losses to a maximum of $500. In this case, the insurance carrier likely would reimburse the Company for $337. If this occurs, the Company will vigorously pursue litigation to recover the full amount, less the applicable deductible. We believe that litigation will ultimately resolve the case favorably. However, in light of the recent information from the carrier and to comply with accounting guidance surrounding contingencies, the Company reduced the amount of the insurance receivable to the worst-case scenario of $337, resulting in a write-down of $1,724, effective for the first quarter of 2018. If the Company recovers amounts in excess of the receivable, it will recognize a gain in the period of recovery.

The Company has a program to identify, mitigate and manage its cybersecurity risks. The program includes penetration testing and vulnerability assessment, technological defenses such as antivirus software, patch management, and firewall management, ongoing employee training, email and web protections, an intrusion prevention system and an additional targeted cybersecurity insurance policy. Cybersecurity costs other than the insurance receivable write-down include legal fees, system monitoring and protection and insurance and totaled $41 for the three months ended March 31, 2018. Cybersecurity costs for the three months ended March 31, 2017 included breach investigation, system monitoring and protection and totaled $142. These costs are included in various categories of noninterest expense.

We have deployed a multi-faceted approach to limit the risk and impact of unauthorized access to customer accounts and to information relevant to customer accounts. We use digital technology safeguards, internal policies and procedures, and employee training to reduce the exposure of our systems to cyber-intrusions. However, it is not possible to fully eliminate exposure. The potential for financial and reputational losses due to cyber-breaches is increased by the possibility of human error, unknown system susceptibilities, and the rising sophistication of cyber-criminals to attack systems, disable safeguards and gain access to accounts and related information. The company has adopted protections and invested resources to increase its security, and continues to monitor security threats and opportunities to increase security.

**Income Tax**

The Tax Cuts and Jobs Act ("the Act") was enacted December 22, 2017 and took effect January 1, 2018. The Act reduced the Company's statutory tax rate from a marginal rate of 35% to a flat 21%. The Company's effective tax rate for the three month period ended March 31, 2018 was 11.73%, compared with 22.66% for the three month period ended March 31, 2017.

**Balance Sheet**

Year-to-date daily averages for the major balance sheet categories are as follows:

| **Assets** | **March 31, 2018** | **December 31, 2017** | **Percent Change** |
|---|---|---|---|
| Interest-bearing deposits | **$45,740** | $71,603 | **(36.12** )% |
| Securities available for sale and restricted stock | **334,364** | 310,499 | **7.69** % |
| Securities held to maturity | **125,045** | 131,602 | **(4.98** )% |
| Loans, net | **656,930** | 644,998 | **1.85** % |
| Total assets | **1,246,071** | 1,235,755 | **0.83** % |
| | | | |
| **Liabilities and stockholders' equity** | | | |
| Noninterest-bearing demand deposits | **$180,811** | $178,708 | **1.18** % |
| Interest-bearing demand deposits | **612,831** | 598,661 | **2.37** % |
| Savings deposits | **141,171** | 140,997 | **0.12** % |
| Time deposits | **114,116** | 120,220 | **(5.08** )% |
| Stockholders' equity | **185,147** | 184,540 | **0.33** % |

**Securities**

Management regularly monitors the quality of the securities portfolio, and management closely follows the uncertainty in the economy and the volatility of financial markets. The value of individual securities will be written down if the decline in fair value is considered to be other than temporary based upon the totality of circumstances. See Note 4: Securities for additional information.

**Loans**

| | March 31, 2018 | December 31, 2017 | Percent Change |
|---|---|---|---|
| Real estate construction loans | **$32,081** | $34,694 | **(7.53)**% |
| Consumer real estate loans | **167,428** | 166,965 | **0.28** % |
| Commercial real estate loans | **333,365** | 340,414 | **(2.07)**% |
| Commercial non real estate loans | **42,076** | 40,518 | **3.85** % |
| Public sector and IDA | **51,091** | 51,443 | **(0.68)**% |
| Consumer non real estate | **33,211** | 34,648 | **(4.15)**% |
| Less: unearned income and deferred fees and costs | **(589)** | (613) | **3.92** % |
| Loans, net of unearned income and deferred fees and costs | **$658,663** | $668,069 | **(1.41)**% |

The Company's loans, net of unearned income and deferred fees and costs decreased $9,406 or 1.41% from $668,069 at December 31, 2017 to $658,663 at March 31, 2018. The decrease stemmed primarily from a decrease in commercial real estate loans of $7,049 or 2.07% and real estate construction loans of $2,613 or 7.53%.

**Deposits**

| | March 31, 2018 | December 31, 2017 | Percent Change |
|---|---|---|---|
| Noninterest-bearing demand deposits | **$190,746** | $182,511 | **4.51** % |
| Interest-bearing demand deposits | **628,540** | 622,189 | **1.02** % |
| Saving deposits | **142,019** | 140,150 | **1.33** % |
| Time deposits | **111,635** | 114,884 | **(2.83)**% |
| Total deposits | **$1,072,940** | $1,059,734 | **1.25** % |

Total deposits increased $13,206 or 1.25% from $1,059,734 at December 31, 2017 to $1,072,940 at March 31, 2018. Increases in noninterest-bearing demand, interest-bearing demand and savings deposits totaled $16,445 when March 31, 2018 is compared with December 31, 2017. These increases were offset by a decrease in time deposits of $3,249 when March 31, 2018 is compared with December 31, 2017. Historically low rates have caused a migration from time deposits to other types of deposits. As longer-term certificates of deposit mature, customers appear unwilling to commit their funds for extended periods at low interest rates. Time deposits do not include any brokered deposits.

**Liquidity**

Liquidity measures the Company's ability to meet its financial commitments at a reasonable cost. Demands on the Company's liquidity include funding additional loan demand and accepting withdrawals of existing deposits. The Company has diverse liquidity sources, including customer and purchased deposits, customer repayments of loan principal and interest, sales, calls and maturities of securities, Federal Reserve discount window borrowing, short-term borrowing, and Federal Home Loan Bank advances. At March 31, 2018, the bank did not have discount window borrowings, short-term borrowings, or FHLB advances. To assure that short-term borrowing is readily available, the Company tests accessibility annually.

Liquidity from securities is restricted by accounting and business considerations. The securities portfolio is segregated into available-for-sale and held-to-maturity. The Company considers only securities designated available-for-sale for typical liquidity needs. Further, portions of the securities portfolio are pledged to meet state requirements for public funds deposits. Discount window borrowings also require pledged securities. Increased/decreased liquidity from public funds deposits or discount window borrowings results in increased/decreased liquidity from pledging requirements. The Company monitors public funds pledging requirements and unpledged available-for-sale securities accessible for liquidity needs.

Regulatory capital levels determine the Company's ability to use purchased deposits and the Federal Reserve discount window. At March 31, 2018, the Company is considered well capitalized and does not have any restrictions on purchased deposits or borrowing ability at the Federal Reserve discount window.

The Company monitors factors that may increase its liquidity needs. Some of these factors include deposit trends, large depositor activity, maturing deposit promotions, interest rate sensitivity, maturity and repricing timing gaps between assets and liabilities, the level of unfunded loan commitments and loan growth. At March 31, 2018, the Company's liquidity is sufficient to meet projected trends in these areas.

To monitor and estimate liquidity levels, the Company performs stress testing under varying assumptions on credit sensitive liabilities and the sources and amounts of balance sheet and external liquidity available to replace outflows. The Company's Contingency Funding Plan sets forth avenues for rectifying liquidity shortfalls. At March 31, 2018, the analysis indicated adequate liquidity under the tested scenarios.

The Company utilizes several other strategies to maintain sufficient liquidity. Loan and deposit growth are managed to keep the loan to deposit ratio within the Company's own policy range of 65% to 75%. At March 31, 2018, the loan to deposit ratio was 61.39%, slightly below policy levels. The investment strategy takes into consideration the term of the investment, and securities in the available for sale portfolio are laddered based upon projected funding needs.

**Capital Resources**

Total stockholders' equity at March 31, 2018 was $185,537, an increase of $641 or 0.35%, from the $184,896 at December 31, 2017.

Risk based capital ratios are shown in the following table.

| | **Ratios at March 31, 2018** | **Regulatory Capital Minimum Ratios** | **Regulatory Capital Minimum Ratios with Capital Conservative Buffer** |
|---|---|---|---|
| Common Equity Tier I Capital Ratio | **23.97 %** | 4.50 % | 6.375 % |
| Tier I Capital Ratio | **23.97 %** | 6.00 % | 7.875 % |
| Total Capital Ratio | **24.88 %** | 8.00 % | 9.875 % |
| Leverage Ratio | **15.58 %** | 4.00 % | 5.875 % |

Risk-based capital ratios are calculated in compliance with Federal Reserve rules based on Basel III capital requirements. The Company's ratios are well above the required minimums at March 31, 2018.

Banks and bank holding companies are subject to an additional capital conservation buffer in order to make capital distributions or discretionary bonus payments. The implementation period for the capital conservation buffer began in 2016 and will be fully phased in January 1, 2019, with .625% added each year and a final buffer of 2.5% in excess of regulatory capital minimum ratios.

**Off-Balance Sheet Arrangements**

In the normal course of business, NBB extends lines of credit and letters of credit to its customers. Depending on their needs, customers may draw upon lines of credit at any time in any amount up to a pre-approved limit. Standby letters of credit are issued for two purposes. Financial letters of credit guarantee payments to facilitate customer purchases. Performance letters of credit guarantee payment if the customer fails to complete a specific obligation.

Historically, the full approved amount of letters and lines of credit has not been drawn at any one time. The Company has developed plans to meet a sudden and substantial funding demand. These plans include accessing a line of credit with a correspondent bank, borrowing from the FHLB, selling available for sale investments or loans and raising additional deposits.

The Company sells mortgages on the secondary market for which there are recourse agreements should the borrower default. Mortgages must meet strict underwriting and documentation requirements for the sale to be completed. The Company has determined that its risk in this area is not significant because of a low volume of secondary market mortgage loans and high underwriting standards. The Company estimates a potential loss reserve for recourse provisions that is not material as of March 31, 2018. To date, no recourse provisions have been invoked. If funds were needed, the Company would access the same sources as noted above for funding lines and letters of credit.

There were no material changes in off-balance sheet arrangements during the three months ended March 31, 2018, except for normal seasonal fluctuations in the total of mortgage loan commitments.

**Contractual Obligations**

The Company had no capital lease or purchase obligations and no long-term debt at March 31, 2018. Operating lease obligations, which are for buildings used in the Company's day-to-day operations, were not material as of March 31, 2018 and have not changed materially from those which were disclosed in the Company's 2017 Form 10-K.

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

The Company considers interest rate risk to be a significant market risk and has systems in place to measure the exposure of net interest income to adverse movement in interest rates. Interest rate shock analyses provide management with an indication of potential economic loss due to future rate changes. There have not been any changes which would significantly alter the results disclosed as of December 31, 2017 in the Company's 2017 Form 10-K.

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**Item 4. Controls and Procedures**

The Company’s management evaluated, with the participation of the Company’s principal executive officer and principal financial officer, the effectiveness of the Company’s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of the end of the period covered by this report. Based on that evaluation, the Company’s principal executive officer and principal financial officer concluded that the Company’s disclosure controls and procedures are effective as of March 31, 2018 to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified by the Company's management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the Company’s internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) during the three months ended March 31, 2018 that have materially affected, or are reasonably likely to materially affect, the Corporation’s internal control over financial reporting.

Because of the inherent limitations in all control systems, the Company believes that no system of controls, no matter how well designed and operated, can provide absolute assurance that all control issues have been detected.

**Part II**

**Other Information**

**Item 1. Legal Proceedings**

There are no pending or threatened legal proceedings to which the Company or any of its subsidiaries is a party or to which the property of the Company or any of its subsidiaries is subject that, in the opinion of management, may materially impact the financial condition of the Company.

**Item 1A. Risk Factors**

Please refer to the “Risk Factors” previously disclosed in Item 1A of our 2017 Annual Report on Form 10-K and the factors discussed under “Cautionary Statement Regarding Forward-Looking Statements” in Part I. Item 2 of this Form 10-Q.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

See Index of Exhibits.

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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.

NATIONAL BANKSHARES, INC.

| | |
|---|---|
| Date: May 9, 2018 | /s/ F. Brad Denardo<br>F. Brad Denardo<br>President and<br>Chief Executive Officer<br>(Principal Executive Officer) |
| Date: May 9, 2018 | /s/ David K. Skeens<br>David K. Skeens<br>Treasurer and<br>Chief Financial Officer<br>(Principal Financial Officer)<br>(Principal Accounting Officer) |

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**Index of Exhibits**

| Exhibit No. | Description | Page No. in Sequential System |
|---|---|---|
| 3(i) | Amended and Restated Articles of Incorporation of National Bankshares, Inc. | (incorporated herein by reference to Exhibit 3.1 of the Form 8K for filed on March 16, 2006) |
| 3(ii) | Amended By-laws of National Bankshares, Inc. | (incorporated herein by reference to Exhibit 3(ii) of the Form 8K filed on July 9, 2014) |
| 4 | Specimen copy of certificate for National Bankshares, Inc. common stock | (incorporated herein by reference to Exhibit 4(a) of the Annual Report on Form 10K for fiscal year ended December 31, 1993) |
| *10(i) | National Bankshares, Inc. 1999 Stock Option Plan | (incorporated herein by reference to Exhibit 4.3 of the Form S-8, filed as Registration No. 333-79979 with the Commission on June 4, 1999) |
| *10(ii) | Executive Employment Agreement dated March 11, 2015, between National Bankshares, Inc. and James G. Rakes | (incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 11, 2015) |
| *10(iii) | Employee Lease Agreement dated August 14, 2002, between National Bankshares, Inc. and The National Bank of Blacksburg | (incorporated herein by reference to Exhibit 10 of Form 10Q for the period ended September 30, 2002) |
| *10(iv) | Executive Employment Agreement dated March 11, 2015, between National Bankshares, Inc. and F. Brad Denardo | (incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on March 11, 2015) |
| *10(v) | Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and James G. Rakes | (incorporated herein by reference to Exhibit 99 of the Form 8K filed on February 8, 2006) |
| *10(vi) | Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and F. Brad Denardo | (incorporated herein by reference to Exhibit 99 of the Form 8K filed on February 8, 2006) |
| *10(vii) | Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and David K. Skeens | (incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012) |
| *10(viii) | First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes | (incorporated herein by reference to Exhibit 10 of the Form 8K filed on December 19, 2007) |
| *10(ix) | First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo | (incorporated herein by reference to Exhibit 10 of the Form 8K filed on December 19, 2007) |
| *10(x) | First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens | (incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012) |

| | | |
|---|---|---|
| *10(xi) | Second Amendment, dated June 12, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo | (incorporated herein by reference to Exhibit 10 of the Form 8K filed on June 12, 2008) |
| *10(xii) | Second Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes | (incorporated herein by reference to Exhibit 10(iii) of the Annual Report on Form 10K for fiscal year ended December 31, 2008) |
| *10(xiii) | Second Amendment, dated September 12, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens | (incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012) |
| *10(xiv) | Third Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo | (incorporated herein by reference to Exhibit 10(iii) of the Annual Report on Form 10K for fiscal year ended December 31, 2008) |

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|---|---|---|
| *10(xv) | Third Amendment, dated January 20 2012, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens | (incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012) |
| *10(xvi) | Salary Continuation Agreement dated May 24, 2013 between The National Bank of Blacksburg and Paul A. Mylum | (incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 8, 2018) |
| *10(xvii) | Second Salary Continuation Agreement dated July 1, 2016 between The National Bank of Blacksburg and F. Brad Denardo | (incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on July 20, 2016) |
| *10(xviii) | Salary Continuation Agreement dated February 6, 2006 between The National Bankshares, Inc. and Lara E. Ramsey | (incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017) |
| *10(xix) | First Amendment, dated December 19, 2007, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey | (incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017) |
| *10(xx) | Second Amendment, dated September 12, 2008, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey | (incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017) |
| *10(xxi) | Third Amendment, dated September 22, 2016, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey | (incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017) |
| +23 | Consent of Yount, Hyde & Barbour, P.C. to incorporation by reference of independent auditor's report included in this Form 10-K, into registrant's registration statement on Form S-8 | (incorporated herein by reference to Exhibit 23 of the Annual Report on Form 10K for fiscal year ended December 31, 2017) |
| +31(i) | Section 906 Certification of Chief Executive Officer | (included herewith) |
| +31(ii) | Section 906 Certification of Chief Financial Officer | (included herewith) |
| +32(i) | 18 U.S.C. Section 1350 Certification of Chief Executive Officer | (included herewith) |
| +32(ii) | 18 U.S.C. Section 1350 Certification of Chief Financial Officer | (included herewith) |

| | | |
|---|---|---|
| +101 | The following materials from National Bankshares, Inc.'s Quarterly Report on Form 10-Q for the period ended March 31, 2018 are formatted in XBRL (Extensible Business Reporting Language), furnished herewith: (i) Consolidated Statements of Income for the three month period ended March 31, 2018 and 2017; (ii) Consolidated Statements of Comprehensive Income for the three month period ended March 31, 2018 and 2017; (iii)Consolidated Balance Sheets at March 31, 2018 and December 31, 2017; (iv) Consolidated Statements of Changes in Stockholders' Equity for the three months ended March 31, 2018 and 2017; (v) Consolidated Statements of Cash Flows for the three months ended March 31, 2018 and 2017; and (vi) Notes to Consolidated Financial Statements. | (included herewith) |

* Indicates a management contract or compensatory plan.