NATIONAL BANKSHARES INC
Form 10-Q
May 09, 2018

Table of Contents

**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)

Table of Contents

**NATIONAL BANKSHARES, INC. AND SUBSIDIARIES**

Form 10-Q

Index

Table of Contents

**Part I**

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

Consolidated Balance Sheets

| | (Unaudited) | |
|---|---|---|
| | **March 31,** | **December 31,** |
| **(in thousands, except share and per share data)** | **2018** | **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.

3

Table of Contents

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)*

Table of Contents

| | | |
|---|---|---|
| **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.

Table of Contents

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.

Table of Contents

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.

Table of Contents

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)*

8

Table of Contents

| | | |
|---|---|---|
| **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.

**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.

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 | Commercial Non Real Estate |
| Construction, residential | Commercial and industrial |
| Construction, other | |
| | Public Sector and IDA |
| Consumer Real Estate | Public sector and IDA |
| Equity lines | |
| Residential closed-end *first* liens | Consumer Non Real Estate |
| Residential closed-end junior liens | Credit cards |
| Investor-owned residential real estate | 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.

11

Table of Contents

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* |

Table of Contents

| | 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* |

Table of Contents

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

| | As of and for the Three Months Ended March 31, 2018 | As of and for the Three Months Ended March 31, 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 | March 31, 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.

14

Table of Contents

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.

Table of Contents

| | 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.

Table of Contents

| | 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.

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*** | ***---*** | ***---*** | |