NATIONAL BANKSHARES INC
Form 10-K
March 13, 2019

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

[x] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Fiscal Year Ended December 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 of incorporation)	(I.R.S. Employer Identification No.)

101 Hubbard Street

P.O. Box 90002

Blacksburg, VA 24062-9002

(540) 951-6300

(Address and telephone number of principal executive offices)

Securities registered pursuant to Section 12(b) of the Act:	Securities registered Pursuant to Section 12(g) of the Act:
None	Common Stock, Par Value $1.25 per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [x]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [x]

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T(§232.405 of this chapter) during the preceding 12 months (or for such period that the registrant was required to submit files). Yes [x] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

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

Large accelerated filer [ ] Accelerated filer [x] Non-accelerated filer [ ] 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 [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes [ ] No [x]

The aggregate market value of the voting common stock of the registrant held by stockholders (not including voting common stock held by Directors, Executive Officers and Corporate Governance) on June 30, 2018 (the last business day of the most recently completed second fiscal quarter) was approximately $322,849,994. As of March 11, 2019, the registrant had 6,505,574 shares of voting common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the following documents are incorporated herein by reference into the Part of the Form 10-K indicated.

Document	**Part of Form 10-K into which incorporated**
National Bankshares, Inc. 2018 Annual Report to Stockholders	Part II
National Bankshares, Inc. Proxy Statement for the 2019 Annual Meeting of Stockholders	Part III

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NATIONAL BANKSHARES, INC. AND SUBSIDIARIES

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Part I

$ in thousands, except per share data

Item 1. Business

History and Business

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.

The National Bank of Blacksburg

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, mobile and internet banking and it operates twenty-four automated teller machines in its service area.

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 believes its prudent lending policies 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, 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 inventory, accounts receivables or equipment and personal guarantees from the borrowing entity's principal owners. The Bank's policy limits lending up to 60% of the appraised value for inventory, up to 90% of the lower of cost of market value of 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 generally 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, hotels and motels, 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.

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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 on a direct basis. During 2018 and years prior, automobile loans were also originated on an indirect basis through selected dealerships. This program has been discontinued in 2019. 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. 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.

At December 31, 2018, NBB had total assets of $1,253,172 and total deposits of $1,052,082. NBB's net income for 2018 was $16,877, which produced a return on average assets of 1.35% and a return on average equity of 9.14%. Refer to Note 11 of the Notes to Consolidated Financial Statements for NBB's risk-based capital ratios.

National Bankshares Financial Services, Inc.

In 2001, National Bankshares Financial Services, Inc. was formed in Virginia as a wholly-owned subsidiary of NBI. NBFS offers non-deposit investment products and insurance products for sale to the public. NBFS works cooperatively with Infinex Investments, Inc. to provide investments and with Bankers Insurance, LLC for insurance products. NBFS does not significantly contribute to NBI's net income.

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Operating Revenue

The following table displays components that contributed 15% or more of the Company's total operating revenue for the years ended December 31, 2018, 2017 and 2016.

Period	Class of Service	Percentage of Total Revenues	
December 31, 2018	Interest and Fees on Loans	61.49	%
	Interest on Investments	22.02	%
	Noninterest Income	15.17	%
December 31, 2017	Interest and Fees on Loans	61.22	%
	Interest on Investments	21.55	%
	Noninterest Income	15.62	%
December 31, 2016	Interest and Fees on Loans	61.12	%
	Interest on Investments	22.96	%
	Noninterest Income	14.81	%

Market Area

The Company's market area in southwest Virginia is made up of the counties of Montgomery, Roanoke, Giles, Pulaski, Tazewell, Wythe, Smyth and Washington. It includes the independent cities of Roanoke, Radford and Galax, and the portions of Carroll and Grayson Counties that are adjacent to Galax. The Company also serves those portions of Mercer County, Monroe County and McDowell County, West Virginia that are contiguous with Tazewell County, Virginia. Although largely rural, the market area is home to two major universities, Virginia Tech and Radford University, and to three community colleges. Virginia Tech, located in Blacksburg, Virginia, is the area's largest employer and is the Commonwealth's second largest university. A second state supported university, Radford University, is located nearby. In recent years, Virginia Tech's Corporate Research Center has brought a number of technology-related companies to Montgomery County.

In addition to education, the market area has a diverse economic base with manufacturing, agriculture, tourism, healthcare, retail and service industries. Large manufacturing facilities in the region include Celanese Acetate, the largest employer in Giles County, and Volvo Heavy Trucks, the largest company in Pulaski County. Both of these firms have experienced cycles of hiring and layoffs within the past several years. Tazewell County is largely dependent on the coal mining industry and on agriculture for its economic base. Coal production is a cyclical industry that has declined significantly in recent years and suffered from increased regulations. Montgomery County, Bluefield in Tazewell County and Abingdon in Washington County are regional retail centers and have facilities to provide basic health care for the region.

NBI’s market area offers the advantages of a good quality of life, scenic beauty, moderate climate and historical and cultural attractions. The region has had some recent success attracting retirees, particularly from the Northeast and urban northern Virginia.

Because NBI’s market area is economically diverse and includes large public employers, it has historically avoided the most extreme effects of past economic downturns. If the economy wavers or experiences recession, it is likely that unemployment will rise and that other economic indicators will negatively impact the Company's trade area.

Competition

The banking and financial services industry in NBI’s market area is highly competitive. The competitive business environment is a result of changes in regulation, changes in technology and product delivery systems and competition from other financial institutions as well as non-traditional financial services. NBB competes for loans and deposits with other commercial banks, credit unions, securities and brokerage companies, mortgage companies, insurance companies, retailers, automobile companies and other nonbank financial service providers. Many of these competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services than NBB. In order to compete, NBB relies upon a deep knowledge of its markets, a service-based business philosophy, personal relationships with customers, specialized services tailored to meet customers’ needs and the convenience of office locations. In addition, the bank is generally competitive with other financial institutions in its market area with respect to interest rates paid on deposit accounts, interest rates charged on loans and other service charges on loans and deposit accounts.

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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 further cybersecurity breaches, in light of the evolving sophistication of system intruders, the risk 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.

Organization and Employment

NBI, NBB and NBFS are organized in a holding company/subsidiary structure. At December 31, 2018, NBB had 231 full time equivalent employees and NBFS had 4 full time employees. NBB performs services and charges commensurate fees to NBI and NBFS.

Regulation, Supervision and Government Policy

NBI and NBB are subject to state and federal banking laws and regulations that provide for general regulatory oversight of all aspects of their operations. As a result of substantial regulatory burdens on banking, financial institutions like NBI and NBB are at a disadvantage to other competitors who are not as highly regulated, and NBI and NBB's costs of doing business are accordingly higher. Legislative efforts to prevent a repeat of the 2008 financial crisis culminated in the Dodd-Frank Wall Street Reform Act of 2010. This legislation, together with existing and planned regulations, dramatically increased the regulatory burden on commercial banks. The burden falls disproportionately on community banks like NBB, which must devote a higher proportion of their human and other resources to compliance than do their larger competitors. The financial crisis also heightened the examination focus by banking regulators, particularly on Bank Secrecy Act, real estate-related assets and commercial loans. However, with the passage of the Economic Growth, Regulatory Reform and Consumer Protection Act ("EGRRCPA") in 2018, a number of regulatory requirements for smaller financial institutions like the Company were reduced or eliminated (see below). The following is a brief summary of certain laws, rules and regulations that affect NBI and NBB.

NBI is a bank holding company qualified as a financial holding company under the Federal Bank Holding Company Act ("BHCA"), which is administered by the Board of Governors of the Federal Reserve System (the "Federal Reserve"). NBI is required to file an annual report with the Federal Reserve and may be required to furnish additional information pursuant to the BHCA. The Federal Reserve is authorized to examine NBI and its subsidiaries. With some limited exceptions, the BHCA requires a bank holding company to obtain prior approval from the Federal Reserve before acquiring or merging with a bank or before acquiring more than 5% of the voting shares of a bank unless it already controls a majority of shares.

The Bank Holding Company Act. Under the BHCA, a bank holding company is generally prohibited from engaging in nonbanking activities unless the Federal Reserve has found those activities to be incidental to banking. Bank holding companies also may not acquire more than 5% of the voting shares of any company engaged in nonbanking activities. Amendments to the BHCA that were included in the Gramm-Leach-Bliley Act of 1999 (see below) permitted any bank holding company with bank subsidiaries that are well-capitalized, well-managed and which have a satisfactory or better rating under the Community Reinvestment Act (see below) to file an election with the Federal Reserve to become a financial holding company. A financial holding company may engage in any activity that is (i) financial in nature (ii) incidental to a financial activity or (iii) complementary to a financial activity. Financial activities include insurance underwriting, insurance agency activities, securities dealing and underwriting and providing financial, investment or economic advising services. NBI is a financial holding company that currently engages in insurance agency activities and providing financial, investment or economic advising services.

The Virginia Banking Act. The Virginia Banking Act requires all Virginia bank holding companies to register with the Virginia State Corporation Commission (the "Commission"). NBI is required to report to the Commission with respect to its financial condition, operations and management. The Commission may also make examinations of any bank holding company and its subsidiaries and must approve the acquisition of ownership or control of more than 5% of the voting shares of any Virginia bank or bank holding company.

The Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act ("GLBA") permits significant combinations among different sectors of the financial services industry, allows for expansion of financial service activities by bank holding companies and offers financial privacy protections to consumers. GLBA preempts most state laws that prohibit financial holding companies from engaging in insurance activities. GLBA permits affiliations between banks and securities firms in the same holding company structure, and it permits financial holding companies to directly engage in a broad range of securities and merchant banking activities.

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The Sarbanes-Oxley Act. The Sarbanes-Oxley Act ("SOX") protects investors by improving the accuracy and reliability of corporate disclosures. It impacts all companies with securities registered under the Securities Exchange Act of 1934, including NBI. SOX creates increased responsibility for chief executive officers and chief financial officers with respect to the content of filings with the Securities and Exchange Commission. Section 404 of SOX and related Securities and Exchange Commission rules focused increased scrutiny by internal and external auditors on NBI's systems of internal controls over financial reporting, which is designed to ensure that those internal controls are effective in both design and operation. SOX sets out enhanced requirements for audit committees, including independence and expertise, and it includes stronger requirements for auditor independence and limits the types of non-audit services that auditors can provide. Finally, SOX contains additional and increased civil and criminal penalties for violations of securities laws.

Capital and Related Requirements. In August, 2018, the Federal Reserve updated the Small Bank Holding Company Policy Statement ("the Statement"), in compliance with the EGRRCPA. The Statement, among other things, exempts bank holding companies that fall below a certain asset threshold from reporting consolidated regulatory capital ratios and from minimum regulatory capital requirements. The interim final rule expands the exemption to bank holding companies with consolidated total assets of less than $3 billion. Prior to August 2018, the statement exempted bank holding companies with consolidated total assets of less than $1 billion. As a result of the interim final rule, the Company qualifies as of August, 2018 as a small bank holding company and is no longer subject to regulatory capital requirements on a consolidated basis.

The Bank continues to be subject to various capital requirements administered by banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and discretionary actions by regulators that could have a direct material effect on the Company's financial statements. The Bank's capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings and other factors.

The regulations require a minimum ratio of certain capital measures. In addition, the Bank is required to maintain a "capital conservation buffer" in excess of the minimum ratio requirements. The implementation period for the capital conservation buffer began in 2016 and will be fully phased in on January 1, 2019. The following table presents the required minimum ratios and minimum ratios with the capital conservation buffer for 2018, as well as the final minimum ratios with the capital conservation buffer when fully phased in:

Regulatory Capital Ratios	**Minimum Ratio**		**Minimum Ratio With Capital Conservation Buffer as of December 31, 2018**		**Minimum Ratio With Capital Conservation Buffer beginning January 1, 2019**	
Common Equity Tier 1 Capital to Risk Weighted Assets	4.50	%	6.375	%	7.00	%
Tier 1 Capital to Risk Weighted Assets	6.00	%	7.875	%	8.50	%
Total Capital to Risk Weighted Assets	8.00	%	9.875	%	10.50	%
Leverage Ratio	4.00	%	4.00	%	4.00	%

Risk-weighted assets are assets on the balance sheet as well as certain off-balance sheet items, such as standby letters of credit, to which weights between 0% and 1250% are applied, according to the risk of the asset type. Common Equity Tier 1 Capital ("CET1") is capital according to the balance sheet, adjusted for goodwill and intangible assets and other prescribed adjustments. At the Company's election, CET1 is also adjusted to exclude accumulated other comprehensive income. Tier 1 Capital is CET1 adjusted for additional capital deductions. Total Capital is Tier 1 Capital increased for the allowance for loan losses and adjusted for other items. The leverage ratio is the ratio of Tier 1 capital to total average assets, less goodwill and intangibles and certain deferred tax assets. Pursuant to the EGRRCPA the regulators have proposed a single "Community Bank Leverage Ratio" which would eliminate the four required capital ratios disclosed above for qualifying and electing banks and require the disclosure of a single leverage ratio based on the new Community Capital Leverage Ratio.

NBI is expected to be a source of capital strength for its subsidiary bank, and regulators can undertake a number of enforcement actions against NBI if its subsidiary bank becomes undercapitalized. NBI's bank subsidiary is well capitalized and fully in compliance with capital guidelines. Failure to meet statutorily mandated capital guidelines or more restrictive ratios separately established for financial institutions could subject NBB or the Company to a variety of enforcement remedies, including issuance of a capital directive, the termination of deposit insurance by the FDIC, a prohibition on accepting or renewing brokered deposits, limitations on the rates of interest that the institution may pay on its deposits and other restrictions on its business. Failure to maintain excess reserves for the capital conservation buffer would limit the ability to make capital distributions and pay discretionary bonuses to executives. As described above, significant additional restrictions can be imposed on NBB if it would fail to meet applicable capital requirements.

Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act was signed into law on July 21, 2010. Its wide ranging provisions affect all federal financial regulatory agencies and nearly every aspect of the American financial services industry. The Dodd-Frank Act created an independent Consumer Financial Protection Bureau ("CFPB") which has the ability to write rules for consumer protections governing all financial institutions. All consumer protection responsibility formerly handled by other banking regulators was consolidated in the CFPB. It oversees the enforcement of all federal laws intended to ensure fair access to credit. For smaller financial institutions such as NBI and NBB, the CFPB coordinates its examination activities through their primary regulators.

The Dodd-Frank Act contains provisions designed to reform mortgage lending, which includes the requirement of additional disclosures for consumer mortgages, and the CFPB implemented many mortgage lending regulations to carry out its mandate. Additionally, in response to the Dodd-Frank Act, the Federal Reserve issued rules in 2011 which had the effect of limiting the fees charged to merchants by credit card companies for debit card transactions. The Dodd-Frank Act also contains provisions that affect corporate governance and executive compensation.

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The Dodd-Frank Act provisions are extensive and have required the Company and the Bank to deploy resources to comply with them. Several federal agencies, including the Federal Reserve, the CFPB and the Securities and Exchange Commission, have been in the process of issuing final regulations implementing major portions of the legislation, and this process will be affected by the EGRRCPA, which rolls back many provisions of the Dodd-Fran Act (see below).

Source of Strength. Federal Reserve policy has historically required bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. The Dodd-Frank Act codified this policy as a statutory requirement. Under this requirement, the Company is expected to commit resources to support NBB, including at times when the Company may not be in a financial position to provide such resources. Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to depositors and to certain other indebtedness of such subsidiary banks. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment.

The Economic Growth, Regulatory Reform and Consumer Protection Act of 2018. In May 2018 the EGRRCPA amended provisions of the Dodd-Frank Act and other statutes administered by banking regulators. Among these amendments are provisions to tailor applicability of certain of the enhanced prudential standards for Systemically Important Financial Institutions ("SIFI's") and to increase the $50 billion asset threshold in two stages to $250 billion to which these enhanced standards apply. The Act exempts insured depositary institutions (and their parent companies) with less than $10 billion in consolidated assets and that meet certain tests from the Volker Rule (which prohibits banks from conducting certain investment activities with their own accounts). As discussed above, the EGRRCPA requires the regulators to promulgate rules establishing a new Community Bank Leverage Ratio (currently proposed to be 9%) for financial institutions with less than $10 billion in consolidated assets. If the financial institution maintains its tangible equity above the Community Bank Leverage Ratio it will be deemed in compliance with the various regulatory capital requirements currently in effect. The Act increases the asset threshold from $1 billion to $3 billion for financial institutions to qualify for an 18 month on site examination schedule. The EGRRCPA changes numerous other regulatory requirements based on the size and complexity of financial institutions, particularly benefiting smaller institutions like the Company.

The National Bank of Blacksburg

NBB is a national banking association incorporated under the laws of the United States, and the bank is subject to regulation and examination by the Office of the Comptroller of the Currency ("the OCC"). NBB's deposits are insured by the Federal Deposit Insurance Corporation ("the FDIC") up to the limits of applicable law. The OCC, as the primary regulator, and the FDIC regulate and monitor all areas of NBB's operation. These areas include adequacy of capitalization and loss reserves, loans, deposits, business practices related to the charging and payment of interest, investments, borrowings, payment of dividends, security devices and procedures, establishment of branches, corporate reorganizations and maintenance of books and records. NBB is required to maintain certain capital ratios. It must also prepare quarterly reports on its financial condition for the OCC and conduct an annual audit of its financial affairs.

The OCC requires NBB to adopt internal control structures and procedures designed to safeguard assets and monitor and reduce risk exposure. While appropriate for the safety and soundness of banks, these requirements add to overhead expense for NBB and other banks.

The Community Reinvestment Act. NBB is subject to the provisions of the Community Reinvestment Act ("CRA"), which imposes an affirmative obligation on financial institutions to meet the credit needs of the communities they serve, including low and moderate income neighborhoods. The OCC monitors NBB's compliance with the CRA and assigns public ratings based upon the bank's performance in meeting stated assessment goals. Unsatisfactory CRA ratings can result in restrictions on bank operations or expansion. NBB received a "satisfactory" rating in its last CRA examination by the OCC.

The Gramm-Leach-Bliley Act. In addition to other consumer privacy provisions, the Gramm-Leach-Bliley Act ("GLBA") restricts the use by financial institutions of customers' nonpublic personal information. At the inception of the customer relationship and annually thereafter, NBB is required to provide its customers with information regarding its policies and procedures with respect to handling of customers' nonpublic personal information. GLBA generally prohibits a financial institution from providing a customer's nonpublic personal information to unaffiliated third parties without prior notice and approval by the customer.

The USA Patriot Act. The USA Patriot Act ("Patriot Act") facilitates the sharing of information among government entities and financial institutions to combat terrorism and money laundering. The Patriot Act imposes an obligation on NBB to establish and maintain anti-money laundering policies and procedures, including a customer identification program. The Bank must screen all customers against government lists of known or suspected terrorists. The Patriot Act, particularly as it relates to money laundering, is a significant focus of regulators and there is substantial regulatory oversight to insure compliance.

Consumer Laws and Regulations. There are a number of laws and regulations that regulate banks' consumer loan and deposit transactions. Among these are the Truth in Lending Act, the Truth in Savings Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Fair Credit Reporting Act, the Electronic Funds Transfer Act, the Fair Debt Collections Practices Act, the Home Mortgage Disclosure Act, the Service Members Civil Relief Act, laws governing flood insurance, federal and state laws prohibiting unfair and deceptive business practices, foreclosure laws and various regulations that implement some or all of the foregoing. NBB is required to comply with these laws and regulations in its dealings with customers. In addition, the CFPB has adopted and may continue to refine rules regulating consumer mortgage lending pursuant to the Dodd-Frank Act. There are numerous disclosure and other compliance requirements associated with the consumer laws and regulations. The EGRRCPA modified a number of these requirements, including, for qualifying institutions with less than $10 billion in assets, a safe harbor for compliance with the "ability to pay" requirements for consumer mortgage loans.

Deposit Insurance. NBB has deposits that are insured by the FDIC. The FDIC maintains a Deposit Insurance Fund ("DIF") that is funded by risk-based insurance premium assessments on insured depository institutions. Assessments are determined based upon several factors, including the level of regulatory capital and the results of regulatory examinations. The FDIC may adjust assessments if the insured institution's risk profile changes or if the size of the DIF declines in relation to the total amount of insured deposits. Beginning April 1, 2011, an institution's assessment base became consolidated total assets less its average tangible equity as defined by the FDIC. The FDIC has authority to impose (and has imposed during the recent financial crisis) special measures to boost the deposit insurance fund such as prepayments of assessments and additional special assessments.

After giving primary regulators an opportunity to first take action, FDIC may initiate an enforcement action against any depository institution it determines is engaging in unsafe or unsound actions or which is in an unsound condition, and the FDIC may terminate that institution's deposit insurance. NBB has no knowledge of any matter that would threaten its FDIC insurance coverage.

Capital Requirements. The capital requirements discussed above with relation to NBI are applied to NBB by the OCC. The OCC guidelines provide that banks experiencing internal growth or making acquisitions are expected to maintain strong capital positions well above minimum levels, without reliance on intangible assets. In addition, implementation of the BASEL III requirements increase required capital minimums as well as compliance costs due to their complexity unless the Bank qualifies and elects to comply with the new Community Bank Leverage Ratio discussed above.

Limits on Dividend Payments. A significant portion of NBI's income is derived from dividends paid by NBB. As a national bank, NBB may not pay dividends from its capital, and it may not pay dividends if the bank would become undercapitalized, as defined by regulation, after paying the dividend. Without prior OCC approval, NBB's dividend payments in any calendar year are restricted to the bank's retained net income for that year, as that term is defined by the laws and regulations, combined with retained net income from the preceding two years, less any required transfer to surplus.

The OCC and FDIC have authority to limit dividends paid by NBB if the payments are determined to be an unsafe and unsound banking practice. Any payment of dividends that depletes the bank's capital base could be deemed to be an unsafe and unsound banking practice.

Branching. As a national bank, NBB is required to comply with the state branch banking laws of Virginia, the state in which the bank is located. NBB must also have the prior approval of the OCC to establish a branch or acquire an existing banking operation. Under Virginia law, NBB may open branch offices or acquire existing banks or bank branches anywhere in the state. Virginia law also permits banks domiciled in the state to establish a branch or to acquire an existing bank or branch in another state. The Dodd-Frank Act permits the OCC to approve applications by national banks like NBB to establish *de novo* branches in any state in which a bank located in that state is permitted to establish a branch.

Ability-to-Repay and Qualified Mortgage Rule. Pursuant to the Dodd-Frank Act, the CFPB amended Regulation Z as implemented by the Truth in Lending Act, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers' ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the covered transaction; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) the monthly debt-to-income ratio or residual income; and (viii) credit history. Alternatively, the mortgage lender can originate “qualified mortgages,” which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a “qualified mortgage” is a mortgage loan without negative amortization, interest-only payments, balloon payments or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Qualified mortgages that are “higher-priced” (e.g. subprime loans) create a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not “higher-priced” (e.g. prime loans) are given a safe harbor of compliance. The Company is predominantly an originator of compliant qualified mortgages.

Monetary Policy

The monetary and interest rate policies of the Federal Reserve, as well as general economic conditions, affect the business and earnings of NBI. NBB and other banks are particularly sensitive to interest rate fluctuations. The spread between the interest paid on deposits and that which is charged on loans is the most important component of the bank’s earnings. In addition, interest earned on investments held by NBI and NBB has a significant effect on earnings. U.S. fiscal policy, including deficits requiring increased governmental borrowing also can affect interest rates. As conditions change in the national and international economy and in the money markets, the Federal Reserve’s actions, particularly with regard to interest rates, and the effects of fiscal policies can impact loan demand, deposit levels and earnings at NBB. It is not possible to accurately predict the effects on NBI of economic and interest rate changes.

Other Legislative and Regulatory Concerns

Particularly because of uncertain economic conditions and the current political environment, federal and state laws and regulations are regularly proposed that could affect the regulation of financial institutions. New, revised or rescinded regulations could add to the regulatory burden on banks and other financial service providers and increase the costs of compliance, or they could change the products that can be offered and the manner in which financial institutions do business. We cannot foresee how regulation of financial institutions may change in the future and how those changes might affect NBI.

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Company Website

NBI maintains a website at www.nationalbankshares.com. The Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports are made available on its website as soon as is practical after the material is electronically filed with the Securities and Exchange Commission. The Company's proxy materials for the 2019 annual meeting of stockholders are also posted on a separate website at www.nationalbanksharesproxy.com. Access through the Company's websites to the Company's filings is free of charge. The Securities and Exchange Commission maintains an internet site (http://www.sec.gov) that contains reports, proxy, and information statements, and other information the Company files electronically with the SEC.

Item 1A. Risk Factors

If economic trends reverse or recession returns, our credit risk will increase and there could be greater loan losses.

A reversal in economic trends or return to a recession is likely to result in a higher rate of business closures and increased job losses in the region in which we do business. In addition, reduced State funding for the public colleges and universities that are large employers in our market area could have an adverse effect on employment levels and on the area's economy. These factors would increase the likelihood that more of our customers would become delinquent or default on their loans. A higher level of loan defaults could result in higher loan losses, which could adversely affect our performance.

A reversal in economic trends, return to recession, or change in interest rates could increase the risk of losses in our investment portfolio.

The Company holds both corporate and municipal bonds in its investment portfolio. A reversal in economic recovery or return to recession could increase the actual or perceived risk of default by both corporate and government issuers and, in either case, could adversely affect the value of these investments. In addition, the value of these investments could be affected by a change in interest rates and related factors, including the pricing of securities.

The condition of the local real estate market could negatively affect our business.

Substantially all of the Company's real property collateral is located in its market area. If there is a decline in real estate values, especially in the Company's market area, the collateral for loans would deteriorate and provide significantly less security.

Focus on lending to small to mid-sized community-based businesses may increase its credit risk.

Most of the Company's commercial business and commercial real estate loans are made to small business or middle market customers. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities and have a heightened vulnerability to economic conditions. If general economic conditions in the market areas in which the Company operates negatively impact this important customer sector, the Company's results of operations and financial condition may be adversely affected. Moreover, a portion of these loans have been made by the Company in recent years and the borrowers may not have experienced a complete business or economic cycle since becoming borrowers of the Bank. The deterioration of the borrowers' businesses may hinder their ability to repay their loans with the Company, which could have a material adverse effect on the Company's financial condition and results of operations.

Market interest rates are rising. When market interest rates rise further, our net interest income can be negatively affected in the short term.

The direction and speed of interest rate changes affect our net interest margin and net interest income. In the short term, rising interest rates may negatively affect our net interest income if our interest-bearing liabilities (generally deposits) reprice sooner than our interest-earning assets (generally loans).

The allowance for loan losses may not be adequate to cover actual losses.

In accordance with accounting principles generally accepted in the United States, an allowance for loan losses is maintained to provide for loan losses. The allowance for loan losses may not be adequate to cover actual credit losses, and future provisions for credit losses could materially and adversely affect operating results. The allowance for loan losses is based on prior experience, as well as an evaluation of the risks in the current portfolio. The amount of future losses is susceptible to changes in economic, operating, and other outside forces and conditions, including changes in interest rates, all of which are beyond the Company's control; and these losses may exceed current estimates. Federal regulatory agencies, as an integral part of their examination process, review the Company's loans and allowance for loan losses. The Company also outsources an independent loan review. While management believes that the allowance for loan losses is adequate to cover current losses, it cannot make assurances that it will not further increase the allowance for loan losses or that regulators will not require it to increase this allowance. Either of these occurrences could adversely affect earnings.

The allowance for loan losses requires management to make significant estimates that affect the financial statements. Due to the inherent nature of this estimate, management cannot provide assurance that it will not significantly increase the allowance for loan losses, which could materially and adversely affect earnings.

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Nonperforming assets take significant time to resolve and adversely affect the Company's results of operations and financial condition.

The Company's nonperforming assets adversely affect its net income in various ways. The Company expects to continue to incur additional losses relating to volatility in nonperforming loans. The Company does not record interest income on nonaccrual loans, which adversely affects its income and increases credit administration costs. When the Company receives collateral through foreclosures and similar proceedings, it is required to mark the related asset to the then fair market value of the collateral less estimated selling costs, which may, and often does, result in a loss. An increase in the level of nonperforming assets also increases the Company's risk profile and may impact the capital levels regulators believe are appropriate in light of such risks. The Company utilizes various techniques such as workouts and restructurings to manage problem assets. Increases in or negative adjustments in the value of these problem assets, the underlying collateral, or in the borrowers' performance or financial condition, could adversely affect the Company's business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management and staff, which can be detrimental to the performance of their other responsibilities, including generation of new loans. There can be no assurance that the Company will avoid further increases in nonperforming loans in the future.

The Company relies upon independent appraisals to determine the value of the real estate which secures a significant portion of its loans, and the values indicated by such appraisals may not be realizable if the Company is forced to foreclose upon such loans.

A significant portion of the Company's loan portfolio consists of loans secured by real estate. The Company relies upon independent appraisers to estimate the value of such real estate. Appraisals are only estimates of value and the independent appraisers may make mistakes of fact or judgment which adversely affect the reliability of their appraisals. In addition, events occurring after the initial appraisal may cause the value of the real estate to increase or decrease. As a result of any of these factors, the real estate securing some of the Company's loans may be more or less valuable than anticipated at the time the loans were made. If a default occurs on a loan secured by real estate that is less valuable than originally estimated, the Company may not be able to recover the outstanding balance of the loan and will suffer a loss.

If more competitors come into our market area, our business could suffer.

The financial services industry in our market area is highly competitive, with a number of commercial banks, credit unions, insurance companies and stockbrokers seeking to do business with our customers. If there is additional competition from new business or if our existing competitors focus more attention on our market, we could lose customers and our business could suffer.

Additional laws and regulations or revisions and rescission of existing laws and regulations could lead to a significant increase in our regulatory burden.

While the risk appears to have diminished somewhat, both federal and state governments could enact new laws affecting financial institutions that would further increase our regulatory burden and could negatively affect our profits. Likewise, revisions or rescission of existing laws and regulations already implemented may result in additional compliance costs, at least in the short-term or, if done imprudently, could ultimately create economic risks negatively affecting our revenues.

New laws and regulations could limit our sources of noninterest income.

While the risk appears to have diminished somewhat, new laws and regulations could limit our ability to offer certain profitable products and services. This could have a negative effect on the level of noninterest income.

Intense oversight by regulators could result in stricter requirements and higher overhead costs.

Regulators for the Company and the subsidiary bank are tasked with ensuring compliance with applicable laws and regulations. Laws and regulations are subject to a degree of interpretation. The regulatory environment has caused financial industry regulators to take more extreme interpretations, which could impact the Company’s earnings.

Political risks in the U.S. and the rest of the world could negatively affect the financial markets.

Political risks in the U.S. and the rest of the world could affect financial markets and affect fiscal policy which could negatively affect our investment portfolio and earnings.

Our information systems may experience an interruption or security breach.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions of our internet banking, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the possible failure, interruption or security breach of our information systems, there can be no assurance that any such failure, interruption or security breach will not occur or, if they do occur, that they will be adequately addressed.

In the ordinary course of business, the Company collects and stores sensitive data, including proprietary business information and personally identifiable information of its customers and employees, in systems and on networks. The secure processing, maintenance and use of this information is critical to the Company’s operations and business strategy. The Company has invested in accepted technologies, and annually reviews its processes and practices that are designed to protect its networks, computers and data from damage or unauthorized access. Despite these security measures, the Company’s computer systems experienced two cyber-intrusions, one in May 2016 and one in January 2017 in which certain customer information was compromised, but which did not cause interruption to the Company’s normal operations. The Company has implemented additional security measures since the breaches. The Company’s computer systems and infrastructure may in the future be vulnerable to attacks by hackers or breached due to employee error, malfeasance or other disruptions. A breach of any kind could compromise systems and the information stored there could be accessed, damaged or disclosed. The occurrence of any failure, interruption or security breach of our communications and information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny or expose us to civil litigation and possible financial liability.

Cyber-attacks may disarm and/or bypass system safeguards and allow unauthorized access and misappropriation of financial data and assets.

As a financial institution holding company, we are vulnerable to and the target of cyber-attacks that attempt to access our digital technology systems, disarm and/or bypass system safeguards, access customer data and ultimately increase the risk of economic and reputational loss.

The Company experienced two cyber-intrusions, one in May 2016 and one in January 2017 in which certain customer information was compromised. The Company has strengthened its multi-faceted approach to reduce the exposure of our systems to cyber- intrusions, strengthen our defenses against hackers and protect customer accounts and information relevant to customer accounts from unauthorized access. These tools include digital technology safeguards, internal policies and procedures, and employee training.

The Company believes its cybersecurity risk management program reasonably addresses the risk from cybersecurity attacks. However, it is not possible to fully eliminate exposure. We may experience human error or have unknown susceptibilities that allow our systems to become victim to a highly-sophisticated cyber-attack. If hackers gain entry to our systems, they may disable other safeguards that limit loss, including limits on the number, amount, and frequency of ATM withdrawals, as well as other loss-prevention or detection measures.

Cybersecurity attacks are probable and may result in additional costs.

The Company has experienced many attempted cybersecurity attacks, of which two resulted in a breach. The Company estimates that the probability of future attempted cyber-attacks is high. To reduce the risk of loss from cyber-attacks and to remediate vulnerabilities discovered through the breach investigations, the Company has incurred costs related to forensic investigations, legal and advisory expenses, insurance premiums, system monitoring and testing, and installing new technological infrastructure and defenses. The Company has implemented every recommendation from the forensic investigations. If the Company experiences another cyber-breach, these costs will increase as well as potential costs for litigation, reputational harm and regulatory costs.

Insurance may not cover losses from cybersecurity attacks.

The Company has invested in insurance related to cybersecurity. Insurance policies are necessary to protect the Company from major losses but may be written in such a way as to limit the protection from certain risks, including cyber risks for which the availability of insurance coverage is currently limited. If the insurance carrier denies coverage of losses the Company may litigate, resulting in additional legal expense. Because of policy technicalities, litigation may not result in a favorable outcome for the Company.

The Company relies on other companies to provide key components of the Company's business infrastructure.

Third parties provide key components of the Company's business operations such as data processing, recording and monitoring transactions, online banking interfaces and services, internet connections and network access. While the Company has selected these third party vendors carefully, it does not control their actions. Any problem caused by these third parties, including those resulting from disruptions in communication services provided by a vendor, failure of a vendor to handle current or higher volumes, failures of a vendor to provide services for any reason or poor performance of services, could adversely affect the Company's ability to deliver products and services to its customers and otherwise conduct its business. Financial or operational difficulties of a third party vendor could also hurt the Company's operations if those difficulties interface with the vendor's ability to serve the Company. Replacing these third party vendors could also create significant delay and expense and damage the Company's ability to service its customers resulting in a loss of goodwill. Accordingly, use of such third parties creates an unavoidable inherent risk to the Company's business operations.

Consumers may increasingly decide not to use the Bank to complete their financial transactions, which would have a material adverse impact on the Company's financial condition and operations.

Technology and other changes are allowing parties to complete financial transactions through alternative methods that historically have involved banks. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts, mutual funds or general-purpose reloadable prepaid cards. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost of deposits as a source of funds could have a material adverse effect on the Company's financial condition and results of operations.

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Changes in funding for higher education could materially affect our business.

Two major employers in the Company’s market area are Virginia Tech and Radford University, both state-supported institutions. If federal or state support for public colleges and universities wanes, our business may be adversely affected from declines in university programs, capital projects, employment, enrollment and other related factors.

The Company is dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect the Company’s operations and prospects.

The Company currently depends on the services of a number of key management personnel. The loss of key personnel could materially and adversely affect the results of operations and financial condition. The Company’s success also depends in part on the ability to attract and retain additional qualified management personnel. Competition for such personnel is strong and the Company may not be successful in attracting or retaining the personnel it requires.

Changes in accounting standards could impact reported earnings.

The authorities who promulgate accounting standards, including the Financial Accounting Standards Board, SEC, and other regulatory authorities, periodically change the financial accounting and reporting standards that govern the preparation of the Company’s consolidated financial statements. These changes are difficult to predict and can materially impact how the Company records and reports its financial condition and results of operations. In some cases, the Company could be required to apply a new or revised standard retroactively, resulting in the restatement of financial statements for prior periods. Such changes could also require the Company to incur additional personnel or technology costs. Most notably, new guidance on the calculation of credit reserves using current expected credit losses (“CECL”) was finalized in June, 2016. The standard will be effective for the Company beginning January 1, 2020. The Company has formed a management committee to prepare for the new standards. The committee has implemented new data collection and has begun the process to run preliminary CECL models along with the incurred loss model currently in use. To implement the new standard, the Company will incur costs related to data collection and documentation, technology, training and increased audit expenses to validate the model. The Company expects that implementation could significantly impact our required credit reserves. Other impacts to capital levels, profit and loss and various financial metrics will also result.

The Company is subject to claims and litigation pertaining to fiduciary responsibility.

From time to time, customers make claims and take legal action pertaining to the performance of the Company’s fiduciary responsibilities. Whether customer claims and legal action related to the performance of the Company’s fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to the Company, they may result in significant financial liability and/or adversely affect the market perception of the Company and its products and services, as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on the Company’s business, which, in turn, could have a material adverse effect on the Company’s financial condition and results of operations.

The Company’s ability to pay dividends depends upon the results of operations of its subsidiaries.

The Company is a financial holding company and a bank holding company that conducts substantially all of its operations through NBB. As a result, the Company’s ability to make dividend payments on its common stock depends primarily on certain federal regulatory considerations and the receipt of dividends and other distributions from NBB. There are various regulatory restrictions on the ability of NBB to pay dividends or make other payments to the Company. Although the Company has historically paid a cash dividend to the holders of its common stock, holders of the common stock are not entitled to receive dividends, and regulatory or economic factors may cause the Company’s Board of Directors to consider, among other things, the reduction of dividends paid on the Company’s common stock.

While the Company’s common stock is currently traded on the NASDAQ Capital Market, it has less liquidity than stocks for larger companies quoted on a national securities exchange.

The trading volume in the Company’s common stock on the NASDAQ Capital Market has been relatively low when compared with larger companies listed on the NASDAQ Capital Market or other stock exchanges. There is no assurance that a more active and liquid trading market for the common stock will exist in the future. Consequently, stockholders may not be able to sell a substantial number of shares for the same price at which stockholders could sell a smaller number of shares. In addition, the Company cannot predict the effect, if any, that future sales of its common stock in the market, or the availability of shares of common stock for sale in the market, will have on the market price of the common stock. Sales of substantial amounts of common stock in the market, or the potential for large amounts of sales in the market, could cause the price of the Company’s common stock to decline, or reduce the Company’s ability to raise capital through future sales of common stock.

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A change in tax rates applicable to the Company may cause impairment of deferred tax assets.

The Company determines deferred income taxes using the balance sheet method. Under this method, each asset and liability is examined to determine the difference between its book basis and its tax basis. The difference between the book basis and the tax basis of each asset and liability is multiplied by the Company's marginal tax rate to determine the net deferred tax asset or liability. If the applicable tax rate changes, the effect of the change on deferred tax assets is recognized as an increase or decrease to income tax expense.

When changes in tax rates and laws are enacted, the company must recognize the changes in the period in which they are enacted. On December 22, 2017, The Tax Cuts and Jobs Act ("the ACT") was signed into law and became effective January 1, 2018. The Act changed the Company's applicable tax rate from a 35% marginal rate in 2017 and years prior to a flat 21% for 2018. Deferred tax assets were re-valued from 35% to 21% in 2017, with a resulting charge to income tax expense.

Item 1B. Unresolved Staff Comments

There are no unresolved staff comments.

Item 2. Properties

NBB owns and has a branch bank in NBI's headquarters building located at 101 Hubbard Street, Blacksburg, Virginia. NBB's main office is at 100 South Main Street, Blacksburg, Virginia. NBB owns an additional seventeen branch offices and it leases six branch locations and a loan production office. We believe that existing facilities are adequate for current needs and to meet anticipated growth.

Item 3. Legal Proceedings

NBI, NBB, and NBFS are not currently involved in any material pending legal proceedings. There are no legal proceedings against the company related to cybersecurity. As of December 31, 2018, the Company is party to a lawsuit to recover from the insurance carrier damages related to the two cybersecurity incidents. The lawsuit was settled during the first quarter of 2019 subject to a non-disclosure agreement.

Item 4. Mine Safety Disclosures

Not applicable.

Part II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Common Stock Information and Dividends

National Bankshares, Inc.'s common stock is traded on the NASDAQ Capital Market under the symbol "NKSH." As of December 31, 2018, there were 628 record stockholders of NBI common stock.

NBI's primary source of funds for dividend payments is dividends from its bank subsidiary, NBB. Bank dividend payments are restricted by regulators, as more fully disclosed in Note 10 of Notes to Consolidated Financial Statements.

On May 9, 2018, NBI's Board of Directors approved the repurchase of up to 100,000 shares of equity securities and on November 14, 2018 NBI's Board of Directors approved the repurchase of an additional 150,000 shares of equity securities that are registered by the Company pursuant to Section 12 of the Securities Exchange Act of 1934. During 2018, there were no shares repurchased, and 250,000 shares may yet be purchased under the program.

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Stock Performance Graph

The following graph compares the yearly percentage change in the cumulative total of stockholder return on NBI common stock with the cumulative return on the NASDAQ Composite Index, and the NASDAQ Bank Index for the five-year period commencing on December 31, 2013. These comparisons assume the investment of $100 in National Bankshares, Inc. common stock in each of the indices on December 31, 2013, and the reinvestment of dividends.

	2013	2014	2015	2016	2017	2018
NATIONAL BANKSHARES, INC.	100	85	104	131	141	116
NASDAQ COMPOSITE INDEX	100	115	123	134	174	169
NASDAQ BANK INDEX	100	104	112	155	163	138

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Item 6. Selected Financial Data

National Bankshares, Inc. and Subsidiaries

Selected Consolidated Financial Data

$ in thousands, except per share data	Year ended December 31, 2018	2017	2016	2015	2014
Selected Income Statement Data:					
Interest income	**$43,224**	$41,260	$40,930	$42,914	$43,944
Interest expense	**5,047**	4,125	4,166	4,183	4,899
Net interest income	**38,177**	37,135	36,764	38,731	39,045
Provision for (recovery of) loan losses	**(81)**	157	1,650	2,009	1,641
Noninterest income	**7,729**	7,636	7,115	6,764	6,503
Noninterest expense	**27,276**	24,229	23,335	22,913	21,815
Income taxes	**2,560**	6,293	3,952	4,740	5,178
Net income	**16,151**	14,092	14,942	15,833	16,914
Per Share Data:					
Basic net income	**2.32**	2.03	2.15	2.28	2.43
Diluted net income	**2.32**	2.03	2.15	2.28	2.43
Cash dividends declared	**1.21**	1.17	1.16	1.14	1.13
Book value	**27.34**	26.57	25.62	24.74	23.93
Selected Balance Sheet Data at End of Year:					
Loans, net of unearned income and deferred fees and costs, and the allowance for loan losses	**702,409**	660,144	639,452	610,711	597,203
Total securities	**426,230**	459,751	440,409	389,288	385,385
Total assets	**1,256,032**	1,256,757	1,233,942	1,203,519	1,158,798
Total deposits	**1,051,942**	1,059,734	1,043,442	1,018,859	982,428
Stockholders' equity	**190,238**	184,896	178,263	172,114	166,303
Selected Balance Sheet Daily Averages:					
Loans, net of unearned income and deferred fees and costs, and the allowance for loan losses	**675,647**	644,998	613,366	611,554	584,857
Total securities	**455,810**	442,101	420,915	379,805	361,028
Total assets	**1,251,843**	1,235,754	1,206,745	1,155,594	1,120,848
Total deposits	**1,045,798**	1,038,586	1,013,787	976,597	957,684
Stockholders' equity	**186,637**	184,539	180,047	171,732	157,832

Selected Ratios:

Return on average assets	**1.29**	**%**	1.14	%	1.24	%	1.37	%	1.51	%
Return on average equity	**8.65**	**%**	7.64	%	8.30	%	9.22	%	10.72	%
Dividend payout ratio	**52.13**	**%**	57.77	%	54.02	%	50.09	%	46.43	%
Average equity to average assets	**14.91**	**%**	14.93	%	14.92	%	14.86	%	14.08	%
Efficiency ratio[1]	**53.20**	**%**	50.41	%	49.32	%	49.41	%	47.08	%

(1) The efficiency ratio is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational efficiency. Such information is not prepared in accordance with U.S. generally accepted accounting principles (GAAP) and should not be viewed as a substitute for GAAP. See "Non-GAAP Financial Measures" included in Item 7 of this Form 10-K.

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Item 7. 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 results of operations, financial condition, liquidity and capital resources of National Bankshares, Inc. and its subsidiaries (the "Company"). The discussion should be read in conjunction with the material presented in Item 8, "Financial Statements and Supplementary Data," of this Form 10-K.

Subsequent events have been considered through the date on which the Form 10-K was issued.

Cautionary Statement Regarding Forward-Looking Statements

We make forward-looking statements in this Form 10-K 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 this 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.

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Non-GAAP Financial Measures

This report refers to certain financial measures that are computed under a basis other than GAAP ("non-GAAP"), including the efficiency ratio, the net interest margin and the noninterest margin.

The efficiency ratio is computed by dividing noninterest expense, excluding the write-down of insurance receivable, by the sum of net interest income on a tax-equivalent basis and noninterest income. The tax rate used to calculate fully taxable equivalent basis is 21% in 2018 and 35% in 2017 and years prior. This is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational efficiency. Such information is not prepared in accordance with U.S. generally accepted accounting principles (GAAP) and should not be construed as such. Management believes such financial information is meaningful to the reader in understanding operating performance, but cautions that such information not be viewed as a substitute for GAAP. The components of the efficiency ratio calculation are summarized in the following table.

$ in thousands	**Year ended December 31,**		
	2018	**2017**	**2016**
Noninterest expense	**$27,276**	$24,229	$23,335
Less: write-down of insurance receivable	**(2,010)**	---	---
Noninterest expense for ratio calculation	**$25,266**	$24,229	$23,335
Taxable-equivalent net interest income	**$39,764**	$40,432	$40,201
Noninterest income	**7,729**	7,636	7,115
Total income for ratio calculation	**$47,493**	$48,068	$47,316
Efficiency ratio	**53.20 %**	50.41 %	49.32 %

The net interest margin is calculated by dividing taxable equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax equivalent net interest income is considered in the calculation of this ratio. Tax equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for 2018 is 21% and 35% for 2017 and years prior. The reconciliation of tax equivalent net interest income, which is not a measurement under GAAP, to net interest income, is reflected in the table below.

$ in thousands	**Year ended December 31,**		
	2018	**2017**	**2016**
GAAP measures:			
Interest and fees on loans	**$31,333**	$29,932	$29,365
Interest on interest-bearing deposits	**672**	791	532
Interest and dividends on securities - taxable	**6,856**	5,711	5,910
Interest on securities - nontaxable	**4,363**	4,826	5,123

Total interest income	**$43,224**	$41,260	$40,930
Interest on deposits	**$4,883**	$4,125	$4,166
Interest on borrowings	**164**	---	---
Total interest expense	**$5,047**	$4,125	$4,166
Net interest income	**$38,177**	$37,135	$36,764
Non-GAAP measures:			
Tax benefit on nontaxable loan income	**$406**	$661	$628
Tax benefit on nontaxable securities income	**1,181**	2,636	2,809
Total tax benefit on nontaxable interest income	**$1,587**	$3,297	$3,437
Total tax-equivalent net interest income	**$39,764**	$40,432	$40,201

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The noninterest margin is calculated by dividing noninterest expense (excluding the write-down of insurance receivable) less noninterest income (excluding realized securities gain/loss, net) by average year-to-date assets. The reconciliation of adjusted noninterest income and adjusted noninterest expense, which are not measurements under GAAP, is reflected in the table below.

$ in thousands	**Year ended December 31,**		
	2018	**2017**	**2016**
Noninterest expense under GAAP	**$27,276**	$24,229	$23,335
Less: write-down of insurance receivable	**(2,010)**	---	---
Noninterest expense for ratio calculation, non-GAAP	**$25,266**	$24,229	$23,335
Noninterest income under GAAP	**$7,729**	$7,636	$7,115
Less: realized securities gains, net	**(17)**	(14)	(232)
Noninterest income for ratio calculation, non-GAAP	**$7,712**	$7,622	$6,883
Net noninterest expense, non-GAAP	**$17,554**	$16,607	$16,452
Average assets	**$1,251,843**	$1,235,755	$1,206,745
Noninterest margin	**1.40%**	1.34%	1.36%

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 secured by residential 1-4 family properties with outstanding principal balances greater than $250 are based on an appraisal. Appraisals are also used to value impaired loans secured by commercial real estate with outstanding principal balances greater than $500. Collateral-method impaired loans secured by residential 1-4 family property with outstanding principal balances of $250 or less, or secured by commercial real estate with outstanding principal balances of $500 or less, 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 twenty-four 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. Troubled debt restructurings may be removed from TDR status, and therefore from individual evaluation, if the restructuring agreement specifies a contractual interest rate that is a market interest rate at the time of restructuring and the loan is in compliance with its modified terms one year after the restructure was completed.

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 December 31, 2018 considered market and portfolio conditions during 2018 as well as the levels of delinquencies and net charge-offs in the eight quarters prior to the quarter ended December 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 5 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 using data from September 30, 2018. 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 comparables 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). 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. is a financial holding company incorporated under the laws of Virginia. Located in southwest Virginia, NBI has two wholly-owned subsidiaries, the National Bank of Blacksburg and National Bankshares Financial Services, Inc. The National Bank of Blacksburg ("NBB"), which does business as National Bank from twenty-five office locations and one loan production office, is a community bank. NBB is the source of nearly all of the Company's revenue. National Bankshares Financial Services, Inc. ("NBFS") does business as National Bankshares Investment Services and National Bankshares Insurance Services. Income from NBFS is not significant at this time, nor is it expected to be so in the near future.

National Bankshares, Inc. 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 June 29, 2009.

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Performance Summary

The following table presents NBI's key performance ratios for the years ending December 31, 2018 and December 31, 2017:

	Year Ended December 31,	
	2018	**2017**
Return on average assets	**1.29 %**	1.14 %
Return on average equity	**8.65 %**	7.64 %
Basic net earnings per common share	**$2.32**	$2.03
Fully diluted net earnings per common share	**$2.32**	$2.03
Net interest margin [1]	**3.36 %**	3.45 %
Noninterest margin [2]	**1.40 %**	1.34 %

(1) Net Interest Margin – Non-GAAP measure of year-to-date tax equivalent net interest income divided by year-to-date average earning assets. Please see Item 7 for a reconciliation of non-GAAP measures to GAAP.

(2) Noninterest Margin – Non-GAAP measure of noninterest expense (excluding the insurance receivable write-down, provision for bad debts and income taxes) less noninterest income (excluding securities gains and losses) divided by average year-to-date assets. Please see Item 7 for a reconciliation of non-GAAP measures to GAAP.

The return on average assets for the year ended December 31, 2018 was 1.29%, an increase from 1.14% for the year ended December 31, 2017. The return on average equity increased from 7.64% for the year ended December 31, 2017 to 8.65% for the year ended December 31, 2018.

The net interest margin decreased from 3.45% for the year ended December 31, 2017 to 3.36% for the year ended December 31, 2018. The net interest margin benefitted from Federal Reserve interest rate increases but reflected a decline in the taxable-equivalent yield of tax-advantaged loans and securities. The taxable-equivalent yield is based on the Company's statutory tax rate, which fell from 35% in 2017 to 21% in 2018 when the Tax Cuts and Jobs Act became effective.

The noninterest margin increased from 1.34% to 1.40% over the same period, while basic net earnings per common share increased from $2.03 for the year ended December 31, 2017 to $2.32 for the year ended December 31, 2018.

Growth

NBI's key growth indicators are shown in the following table:

$ in thousands	**12/31/2018**	**12/31/2017**
Securities	**$426,230**	$459,751
Loans, net of unearned income and deferred fees and costs, and the allowance for loan losses	**702,409**	660,144
Deposits	**1,051,942**	1,059,734
Total assets	**1,256,032**	1,256,757

Total assets decreased in 2018, as a result of a decrease in customer deposits. Customer deposits decreased $7,792 or 0.74% from December 31, 2017, with decreases mainly from maturing certificates of deposit. The liquidity provided by the maturation of securities supported growth in loans of $42,265 or 6.40%. Securities decreased by $33,521 or 7.29%.

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Asset Quality

Key indicators of NBI's asset quality are presented in the following table:

$ in thousands	12/31/2018	12/31/2017
Nonperforming loans[(1)]	**$ 3,420**	$ 2,769
Loans past due 90 days or more and accruing	**35**	51
Other real estate owned	**2,052**	2,817
Allowance for loan losses to loans[(2)]	**1.04 %**	1.19 %
Net charge-off ratio	**0.07 %**	0.08 %

(1) Nonperforming loans include nonaccrual loans plus restructured loans in nonaccrual status. Accruing restructured loans are not included.
(2) Loans are net of unearned income and deferred fees and costs.

The Company monitors asset quality indicators in managing credit risk and in determining the allowance and provision for loan losses. At December 31, 2018, nonperforming loans were $3,420 or 0.48% of loans net of unearned income and deferred fees and costs. This compares to $2,769 or 0.41% at December 31, 2017. Loans past due 90 days or more and still accruing at year-end 2018 totaled $35, a decrease from $51 at December 31, 2017. The net charge-off ratio decreased from 0.08% for the year ended December 31, 2017 to 0.07% for the year ended December 31, 2018, while other real estate owned decreased $765 for the same period.

The Company's risk analysis determined an allowance for loan losses of $7,390 at December 31, 2018, resulting in a recovery for the year of $81. This compares with an allowance for loan losses of $7,925 as of December 31, 2017, and a provision of $157 for the year ended December 31, 2017. The ratio of the allowance for loan losses to loans decreased to 1.04%, from 1.19% at December 31, 2018. The methodology for determining the allowance for loan losses relies on historical charge-off trends, modified by trends in nonperforming loans and economic indicators. More information about the level and calculation methodology of the allowance for loan losses is provided in "Provision and Allowance for Loan Losses", "Balance Sheet – Loans – Risk Elements," "Balance Sheet – Loans – Troubled Debt Restructurings," as well as Notes 1 and 5 to the financial statements.

Sufficient resources have been dedicated to working out problem assets, and exposure to loss is somewhat mitigated because most of the nonperforming loans are collateralized. More information about nonaccrual and past due loans is provided in "Balance Sheet – Loans – Risk Elements" and Note 5 to the financial statements. The Company continues to monitor risk levels within the loan portfolio and expects that any further increase in the allowance for loan losses would be the result of the refinement of loss estimates and would not dramatically affect net income.

Net Interest Income

Net interest income for the year ended December 31, 2018 was $38,177, an increase of $1,042, or 2.81%, when compared to the prior year. The net interest margin for 2018 was 3.36%, compared to 3.45% for 2017. Total interest income for the period ended December 31, 2018 was $43,224, an increase of $1,964 from the period ended December 31, 2017. Interest expense increased by $922 during the same time frame, from $4,125 for the year ended December 31, 2017 to $5,047 for the year ended December 31, 2018. The increase in interest expense came about in part because of deposit pricing increases required to remain competitive in a rising interest rate environment. The Company also engaged in short-term borrowings during 2018 to meet loan demand while anticipating maturity of securities and an increase in deposits that is typical during the fourth quarter. Please refer to the section titled “Analysis of Changes In Interest Income and Interest Expense” for further information related to rate and volume changes.

The amount of net interest income earned is affected by various factors, including changes in market interest rates due to the Federal Reserve Board’s monetary policy, U.S. fiscal policy, the level and composition of the earning assets and the composition of interest-bearing liabilities. The Company has the ability to respond over time to interest rate movements and reduce volatility in the net interest margin. However, the frequency and/or magnitude of changes in market interest rates are difficult to predict and may have a greater impact on net interest income than adjustments by management.

The Federal Reserve increased its target federal funds rate by 25 basis points in December 2017 and raised rates by 25 basis points again in March, June, September and December, 2018, ending the year at a target of 2.50%. The rate increases positively affected the yield on the Company’s interest-bearing deposits in other banks and taxable securities for 2018. The yield on interest-bearing deposits increased from 1.10% for 2017 to 1.84% for 2018 and the yield on taxable securities increased from 1.82% for 2017 to 2.07% for 2018. The rate increases also positively affected the yield on loans, but was offset by the decline in the Company’s tax rate. The Tax Cuts and Jobs Act became effective January 1, 2018 and decreased the Company’s tax rate from a marginal 35% to a flat 21%. The resulting decrease in the fully taxable equivalent value of income on tax-exempt loans exceeded the benefit of the rate increases.

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The primary source of funds used to support the Company’s interest-earning assets is deposits. Deposits are obtained in the Company’s trade area through traditional marketing techniques. Other funding sources, such as the Federal Home Loan Bank, while available, are only used occasionally. The cost of funds is dependent on interest rate levels and competitive factors. This limits the ability of the Company to react to interest rate movements.

Federal Reserve policies and market forces influence the Company’s net interest margin. Rates may increase or decrease in the future. The Company anticipates any rate increases will have a positive impact on the Company’s future net interest income. Management cannot predict the timing and level of interest rate movements.

Analysis of Net Interest Earnings

The following table shows the major categories of interest-earning assets and interest-bearing liabilities, the interest earned or paid, the average yield or rate on the daily average balance outstanding, net interest income and net yield on average interest-earning assets for the years indicated.

	December 31, 2018			**December 31, 2017**			**December 31, 2016**		
$ in thousands	**Average Balance**	**Interest**	**Average Yield/ Rate**	**Average Balance**	**Interest**	**Average Yield/ Rate**	**Average Balance**	**Interest**	**Average Yield/ Rate**
Interest-earning assets:									
Loans, net of unearned income and deferred fees and costs (1)(2)(3)(4)	**$683,624**	**$31,739**	**4.64 %**	$653,756	$30,593	4.68 %	$622,239	$29,993	4.82 %
Taxable securities(5)	**340,594**	**6,856**	**2.01 %**	313,255	5,711	1.82 %	280,842	5,910	2.10 %
Nontaxable securities (1)(5)	**123,668**	**5,544**	**4.48 %**	131,762	7,462	5.66 %	139,429	7,932	5.69 %
Interest-bearing deposits	**36,562**	**672**	**1.84 %**	71,603	791	1.10 %	102,819	532	0.52 %
Total interest-earning assets	**$1,184,448**	**$44,811**	**3.78 %**	$1,170,376	$44,557	3.81 %	$1,145,329	$44,367	3.87 %
Interest-bearing liabilities:									
Interest-bearing demand deposits	**$606,766**	**$4,121**	**0.68 %**	$598,661	$3,344	0.56 %	$567,971	$3,144	0.55 %
Savings deposits	**140,918**	**236**	**0.17 %**	140,997	244	0.17 %	134,982	315	0.23 %
Time deposits	**105,674**	**526**	**0.50 %**	120,220	537	0.45 %	140,490	707	0.50 %
Borrowings	**7,192**	**164**	**2.28 %**	---	---	---	---	---	---
	$860,550	**$5,047**	**0.59 %**	$859,878	$4,125	0.48 %	$843,443	$4,166	0.49 %

Total interest-bearing liabilities						
Net interest income[1] and interest rate spread	**$39,764**	**3.19 %**	$40,432	3.33 %	$40,201	3.38 %
Net yield on average interest-earning assets		**3.36 %**		3.45 %		3.51 %

(1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 21% in 2018 and 35% in 2017 and 2016.
(2) Loan fees of $115 in 2018, $303 in 2017 and $360 in 2016 are included in total interest income.
(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.

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The following table reconciles net interest income on a fully-taxable equivalent basis to net interest income on a GAAP basis.

$ in thousands	December 31,		
	2018	**2017**	**2016**
Net interest income, GAAP	**$38,177**	$37,135	$36,764
Taxable equivalent adjustment	**1,587**	3,297	3,437
Net interest income, fully taxable equivalent	**$39,764**	$40,432	$40,201

Analysis of Changes in Interest Income and Interest Expense

The Company’s primary source of revenue is net interest income, which is the difference between the interest and fees earned on loans and investments and the interest paid on deposits and other funds. The Company’s net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities and by changes in yields earned on interest-earning assets and rates paid on interest-bearing liabilities. The following table sets forth, for the years indicated, a summary of the changes in interest income and interest expense resulting from changes in average asset and liability balances (volume) and changes in average interest rates (rate).

$ in thousands	2018 Over 2017 Changes Due To			2017 Over 2016 Changes Due To		
	Rates(2)	**Volume(2)**	**Net Dollar Change**	**Rates(2)**	**Volume(2)**	**Net Dollar Change**
Interest income: (1)						
Loans	$(243)	$ 1,389	$1,146	$(891)	$ 1,491	$600
Taxable securities	623	522	1,145	(839)	640	(199)
Nontaxable securities	(1,482)	(436)	(1,918)	(36)	(434)	(470)
Interest-bearing deposits	377	(496)	(119)	460	(201)	259
Increase (decrease) in income on interest-earning assets	$(725)	$ 979	$254	$(1,306)	$ 1,496	$190
Interest expense:						
Interest-bearing demand deposits	$731	$ 46	$777	$29	$ 171	$200
Savings deposits	(8)	---	(8)	(84)	13	(71)
Time deposits	58	(69)	(11)	(74)	(96)	(170)
Short-term borrowings	---	164	164	---	---	---
Increase (decrease) in expense of interest-bearing liabilities	$781	$ 141	$922	$(129)	$ 88	$(41)

Increase (decrease) in net interest income	$(1,506)	$ 838	$(668)	$(1,177)	$ 1,408	$ 231

(1) Taxable equivalent basis using a Federal income tax rate of 21% in 2018 and 35% in 2017 and 2016.
(2) Variances caused by the change in rate times the change in volume have been allocated to rate and volume changes proportional to the relationship of the absolute dollar amounts of the change in each.

Net interest income on a taxable-equivalent basis decreased $668 when 2018 is compared with 2017. Total interest income on a taxable equivalent basis increased $254 while total interest expense increased by $922. A decline in the yield of interest-earning assets and an increase in the yield on interest-bearing liabilities decreased net interest income by $1,506, offset by increases due to volume of $838.

The Federal Reserve increased rates by 25 basis points in December 2017 and four times in 2018. The rate increases had a direct and immediate effect on the Company's interest-bearing deposits. Interest income on interest-bearing deposits increased $377 due to rates, but declined by $496 due to reduced volume, for a net decrease of $119 when 2018 is compared with 2017. Taxable securities also benefitted from the increased interest rate environment, as matured and called securities were invested at higher rates. Interest income on taxable securities increased $1,145 when 2018 is compared with 2017, the result of an increase of $522 due to volume along with an increase of $623 due to rates.

Taxable equivalent interest income on loans increased $1,146 when 2018 and 2017 are compared, due to robust growth in the loan portfolio. The average balance of loans increased from $653,756 in 2017 to $683,624 in 2018, increasing interest income by $1,389. Increase due to volume was offset slightly by a decrease of $243 due to yield. Taxable equivalent yields on tax-advantaged loans were negatively impacted by a decrease in the Company's statutory tax rate from 35% in 2017 to 21% in 2018. If the 35% rate were applicable during 2018, yields would have shown an increase.

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Taxable-equivalent interest on non-taxable securities declined $1,482 due to rates and $436 due to volume. The lower yields available upon reinvestment of called and matured securities negatively impacted income from securities during 2018.

Interest on time deposits declined $11 from 2017 to 2018, with a increase of $58 due to rates offset by a decline of $69 due to decreased volume. See "Net Interest Income" for additional information related to the decline in interest expense.

When 2017 is compared with 2016, taxable-equivalent net interest income increased by $231. Total interest income on a taxable equivalent basis increased $190 while total interest expense declined by $41. Declining yields impacted net interest income by $1,177, offset by increases due to volume of $1,408.

The Federal Reserve increased rates by 25 basis points in December 2016 and three times in 2017. The rate increases had a direct and immediate effect on the Company's interest-bearing deposits. Interest income on interest-bearing deposits increased $460 due to rates, but declined by $201 due to reduced volume, for a net increase of $259 when 2017 is compared with 2016. The Company's securities and loan portfolios did not experience a similar increase in yields due to the longer-term nature of the portfolios, reinvestment opportunities in the bond market and the competitive lending environment of the Company's market area.

Taxable equivalent interest income on loans increased $600 when 2017 and 2016 are compared. The average balance of loans increased from $622,239 in 2016 to $653,756 in 2017, increasing interest income by $1,491. Lower yields reduced interest income by $891.

Interest income on taxable securities decreased $199 when 2017 is compared with 2016, the result of an increase of $640 due to volume offset by a decline of $839 due to rates. Taxable-equivalent interest on non-taxable securities declined $36 due to rates and $434 due to volume. The low interest rate environment in 2016 resulted in a large number of called securities at a time when re-investment opportunities were less attractive than the yields on the original called securities. The lower yields available upon reinvestment of the call securities negatively impacted income from securities during 2017. Because of low yields in the securities markets and a highly competitive loan environment, the Company priced deposits accordingly.

Interest on time deposits declined $170 from 2016 to 2017, with a decline of $74 due to rates and $96 due to decreased volume.

Interest Rate Sensitivity

The Company considers interest rate risk to be a significant risk and has systems in place to measure the exposure of net interest income and fair market values to movement in interest rates. Among the tools available to management is interest rate sensitivity analysis, which provides information related to repricing opportunities. Interest rate shock simulations indicate potential economic loss due to future interest rate changes. Shock analysis is a test that measures the effect of a hypothetical, immediate and parallel shift in interest rates. The following table shows the results of a rate shock and the effects on the return on average assets and the return on average equity projected at December 31, 2018 and 2017. For purposes of this analysis, noninterest income and expenses are assumed to be flat.

Rate Shift (bp)	**Return on Average Assets**		**Return on Average Equity**	
	2018	**2017**	**2018**	**2017**
300	**1.38%**	1.37%	**8.84%**	9.13%
200	**1.39%**	1.40%	**8.92%**	9.28%
100	**1.40%**	1.42%	**8.95%**	9.42%
(-)100	**1.32%**	1.37%	**8.46%**	9.06%
(-)200	**1.16%**	1.23%	**7.47%**	8.17%
(-)300	**1.12%**	1.25%	**7.32%**	8.33%

Simulation analysis is another tool available to the Company to test asset and liability management strategies under rising and falling rate conditions. As a part of the simulation process, certain estimates and assumptions must be made. These include, but are not limited to, asset growth, the mix of assets and liabilities, rate environment and local and national economic conditions. Asset growth and the mix of assets can, to a degree, be influenced by management. Other areas, such as the rate environment and economic factors, cannot be controlled. In addition, competitive pressures can make it difficult to price deposits and loans in a manner that optimally minimizes interest rate risk. Therefore, actual results may vary materially from any particular forecast or shock analysis. This shortcoming is offset somewhat by the periodic reforecasting of the balance sheet to reflect current trends and economic conditions. Shock analysis must also be updated periodically as a part of the asset and liability management process.

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Noninterest Income

$ in thousands	**Year Ended December 31, 2018**	**December 31, 2017**	**December 31, 2016**
Service charges on deposits	**$2,678**	$ 2,776	$ 2,458
Other service charges and fees	**132**	205	212
Credit card fees	**1,431**	1,205	981
Trust fees	**1,565**	1,530	1,346
Bank-owned life insurance income	**901**	758	597
Other income	**1,005**	1,148	1,289
Realized securities gains	**17**	14	232
Total noninterest income	**$7,729**	$ 7,636	$ 7,115

Service charges on deposit accounts totaled $2,678 for the year ended December 31, 2018. This is a decrease of $98, or 3.53%, from $2,776 for the year ended December 31, 2017. Service charges on deposit accounts increased $318, or 12.94%, from 2016 to 2017. This income category is affected by the number of deposit accounts, the level of service charges and the number of checking account overdrafts. The 2018 decrease was driven by a decrease in fees from a lower volume of customer non-sufficient funds and overdraft activity. The 2017 increase resulted primarily from an increase of $325 in non-sufficient funds and overdraft fees due to implementation of a new overdraft privilege program during the second half of 2016.

Other service charges and fees include charges for official checks, income from the sale of checks to customers, safe deposit box rent, fees from letters of credit and income from commissions on the sale of credit life, accident and health insurance. These fees were $132 for the year ended December 31, 2018, a decrease of $73, or 35.61%, from the $205 for 2017. The decline resulted from service charges on letters of credit and check charges. The total for the year ended December 31, 2017 was $7 below the $212 posted for the year ended December 31, 2016.

Credit card fees for the year ended December 31, 2018, were $226 above the $1,205 reported for the year ended December 31, 2017. From 2016 to 2017, credit card fees increased $224, or 22.83%. Credit card fees are presented net of certain processing expenses and are dependent on the volume of transactions.

Trust fees at $1,565 increased by $35 or 2.29% when the years ended December 31, 2018 and 2017 are compared. For the year ended December 31, 2017 trust fees were $1,530, an increase of $184, or 13.67%, from 2016. Trust fees are generated from a number of different types of accounts, including estates, personal trusts, employee benefit trusts, investment management accounts, attorney-in-fact accounts and guardianships. Trust income varies depending on the number and type of accounts under management and financial market conditions. The mix of account types affected the level of trust fees in 2017 and 2018.

Noninterest income from bank-owned life insurance (BOLI) increased, from $758 for the year ended December 31, 2017 to $901 for 2018. The Company purchased an additional $10 million in BOLI in June 2017. BOLI income for the year ended December 31, 2016 was $597. Income from bank-owned life insurance was affected by the performance of the variable rate policies, which has not varied significantly.

Other income is income from smaller balance accounts that cannot be classified in another category. Some examples include gains on mortgage loans sold, net gains from the sale of fixed assets and revenue from investment and insurance sales. Other income for 2018 was $1,005, a decrease of $143, or 12.46%, when compared with $1,148 for the year ended December 31, 2017. In December 2017, the Company realized a gain on the sale of its Marion branch office of $134. When 2017 is compared with 2016, the gain on the sale of fixed assets was offset by a decline of $69 from the sale of mortgage loans due to lower volume, and a decline of $230 due to a one-time vendor signing incentive received in 2016, resulting in a net decrease of $141 from 2016.

During 2018, the $17 realized securities gain stemmed from the call of one security with a gain of $1 and the sale of another security for a gain of $16. During 2017, the Company sold a small investment in community bank stock that resulted in a gain of $4 while all other net realized gains resulted from calls of securities. During 2016, all realized securities gains resulted from calls of securities.

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Noninterest Expense

$ in thousands	Year Ended December 31, 2018	December 31, 2017	December 31, 2016
Salaries and employee benefits	**$14,506**	$ 13,670	$ 12,684
Occupancy, furniture and fixtures	**1,845**	1,820	1,849
Data processing and ATM	**2,784**	2,280	2,151
FDIC assessment	**359**	364	476
Intangibles amortization	**50**	68	257
Net costs of other real estate owned	**553**	205	472
Franchise taxes	**1,278**	1,315	1,296
Write-down of insurance receivable	**2,010**	---	347
Other operating expenses	**3,891**	4,507	3,803
Total noninterest expense	**$27,276**	$ 24,229	$ 23,335

Salary and benefits expense increased $836, or 6.12%, from $13,670 for the year ended December 31, 2017 to $14,506 for 2018. Employee salaries decreased $135 or 1.35%, from $9,968 for 2017 to $9,833 for 2018 due to normal staffing and compensation decisions. Fringe benefits increased $467, or 24.89%, from $1,874 for the year ended December 31, 2017 to $2,341 for 2018. In 2017, fringe benefits expense was reduced by a one-time $175,000 refund, while in 2018 the expense increased $240 for reserve requirements based on claims history. Other salary expenses include expenses for contributions to the employee stock ownership program, pension, salary continuation and incentives. Other salary expense increased $231, or 15.66%, from $1,476 for the year ended December 31, 2017 to $1,707 for 2018 as the result of increased contributions and expenses related to the employee stock ownership plan and the pension plan. Also impacting salary expense was an increase of $170 for deferred costs associated with loan production.

When 2017 is compared with 2016, salary and benefits expense increased $986, or 7.77%, from $12,684 for the year ended December 31, 2016 to $13,670 for 2017. Employee salaries increased $256 or 2.63% which was the result of normal staffing and compensation decisions. Expense associated with the health insurance reserve increased $419. The Company participates in a “self-funded” insurance plan and reserves amounts based on employee health insurance usage and calculated projections. In 2016, the Company benefitted from refunds due to a change in the calculation of the required minimum reserve and from positive claims history. The Company began in 2017, a new incentive compensation program for senior employees, which contributed $280 to the increase. The increases were offset by a $101 decrease in salary expense related to deferred costs associated with loan production.

Occupancy, furniture and fixtures expense was $1,845 for the year ended December 31, 2018, an increase of $25, or 1.37%, from the prior year. When 2017 is compared with 2016, the expense decreased $29 or 1.57% due to higher expenditures on security equipment and building maintenance in 2016.

Data processing and ATM expense was $2,784 in 2018, $2,280 in 2017 and $2,151 in 2016. The increase of $504 or 22.11% from 2017 to 2018 and $129 or 6.00% from 2016 to 2017 was due to increased maintenance expense associated with infrastructure upgrades. The Company is committed to maintaining up-to-date technology in a cost-effective manner.

When the years ended December 31, 2018 and December 31, 2017 are compared, the Federal Deposit Insurance Corporation assessment expense decreased $5 or 1.37%. The total expense for 2018 was $359, which compares with $364 for 2017. The FDIC assessment is accrued based on a method provided by the FDIC. The FDIC's Deposit Insurance Fund reserve ratio reached a target threshold during the second quarter of 2016, resulting in lower FDIC insurance expense for many federally insured institutions. The FDIC assessment expense for the year ended December 31, 2017 decreased $112 from $476 for 2016.

The expense for intangibles amortization is related to acquisitions. There were no acquisitions in the last year, and the expense for 2018 decreased from 2017 by $18 or 26.47%. The expense for intangibles amortization decreased $189 from 2016 to 2017. The decrease in core deposit intangibles amortization from 2016 to 2017 and from 2017 to 2018 is due to certain core deposit intangibles becoming fully amortized. As of December 31, 2018, all core deposits are fully amortized.

Net costs of other real estate owned increased from $205 for the period ended December 31, 2017 to $553 for the year ended December 31, 2018. From 2016 to 2017, net costs of other real estate owned decreased $267 from $472. This expense category varies with the number of foreclosed properties owned by NBB and with the expense associated with each. It includes write-downs on other real estate owned plus other costs associated with carrying these properties, as well as net gains or losses on the sale of other real estate. In 2018, write-downs on other real estate were $476. This compares with $113 in 2017 and $268 in 2016. Other real estate is initially accounted for at fair value less estimated costs to sell using current valuations, which include appraisals, real estate evaluations and realtor market opinions. If new valuation information indicates a decline from the initial basis, the Company records a write-down. Other costs for these properties in 2018 were $64, compared with $80 in 2017 and $118 in 2016. The Company recorded a loss of $13 on the sale of OREO in 2018, a loss of $12 for 2017 and a loss of $86 for 2016. The Company's market area is showing positive economic signs, and the national economy appears to show mixed economic signals. We anticipate that there may be additional foreclosures in the future. The Company currently has loans of $140 in process of foreclosure.

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Franchise taxes are based upon NBB's total equity at the prior year-end, adjusted for real estate taxes and certain other items. Franchise taxes were $1,278 for the period ended December 31, 2018 and $1,315 for 2017, a decrease of $37 or 2.81% due to a refinement in the accrual. Franchise tax expense increased $19 in 2017 from $1,296 in 2016.

The write-down of insurance receivables totaled $2,010 for the year ended December 31, 2018. The Company recognized a previous write-down in 2016 for $347. The write-downs are associated with the two cybersecurity breaches. Please see additional information under the heading Cybersecurity Risks and Incidents.

The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs and charitable donations. For the year ended December 31, 2018, other operating expenses were $3,891. This compares with $4,507 for 2017 and $3,803 for 2016. The $616 decrease from 2017 to 2018 was due to a loss of $189 resulting from a wire fraud in 2017 and a decrease in expenses associated with consulting services related to the cybersecurity breaches and the non-servicing component of pension expense. The $704 increase from 2016 to 2017 was due to the loss of $189 resulting from a wire fraud and an increase in expenses associated with the overdraft program, legal fees, and audit and consulting services.

Cybersecurity Risks and Incidents

The Company treats cybersecurity risk seriously. 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, firewall management, email and web protections, an intrusion prevention system, a cybersecurity insurance policy which covers some but not all losses arising from cybersecurity breaches, as well as ongoing employee training. The costs of these measures were $224 for the twelve months ended December 31, 2018 and $153 for the twelve months ended December 31, 2017. These costs are included in various categories of noninterest expense.

The Company experienced two intrusions to its digital systems, one in May 2016 and one in January 2017. Hackers and related organized criminal groups obtained unauthorized access to certain customer accounts. The attacks disabled certain systems protections, including limits on the number, amount, and frequency of ATM withdrawals. The attacks resulted in the theft of funds disbursed through ATMs. In the May 2016 attack, hackers accessed customer funds and in the January 2017 intrusion, the hackers artificially inflated account balances and did not access customer funds. The Company notified all affected customers, and restored all funds so that no customer experienced a loss.

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 Company adopted and implemented all of the recommendations provided through the investigations.

The financial impact of the attacks include the amount of the theft, as well as costs of investigation and remediation. The theft of funds totaled $570 in the May 2016 attack and $1,838 in the January 2017 attack. The Company recognized an estimated loss of $347 in 2016, and $2,010 in 2018 currently recognizes an insurance receivable in other assets of $50. The insurance carrier offered a settlement of $50 in 2018 and the Company filed suit to recover additional amounts. Litigation procedures were in process as of December 31, 2108. Costs for investigation, remediation, and legal consultation totaled $224 in 2018, $407 in 2017 and $46 in 2016. The Company's litigation against the insurance carrier was settled during the first quarter of 2019, subject to a non-disclosure agreement. As of

December 31, 2018, the Company has appropriately accounted for the breaches. There has been no litigation against the Company to date associated with the breaches.

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 maintains insurance which provides a degree of coverage depending on the nature and circumstances of any cyber penetration but cannot be relied upon to reimburse fully the Company for all losses that may arise. The Company has adopted new protections and invested additional resources to increase its security.

Income Taxes

Income tax expense for 2018 was $2,560 compared to $6,293 in 2017 and $3,952 in 2016. During 2018, the Company's statutory tax rate was 21%; during 2017 and 2016, the Company's marginal tax rate was 35%. The decrease in the tax rate was due to the enactment on December 22, 2017 of the Tax Cuts and Jobs Act, which became effective January 1, 2018.

The Company's effective tax rates for 2018, 2017 and 2016 were 13.68%, 30.87% and 20.92%, respectively. The expected income tax expense based on the Company's statutory tax rate differs from the actual income tax expense due to tax exempt income on municipal securities and loans, and in 2017, the re-valuation of deferred tax assets from 35% to 21%. Generally accepted accounting principles in the United States ("GAAP") require deferred tax assets to be valued at the tax rate at which the Company expects to realize them. As a result of the change in the Company's tax rate, the Company recognized a revaluation adjustment of $1.56 million in 2017, with a corresponding charge to income tax expense. See Note 9 of the Notes to Consolidated Financial Statements for information relating to income taxes.

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Effects of Inflation

The Company's consolidated statements of income generally reflect the effects of inflation. Since interest rates, loan demand and deposit levels are related to inflation, the resulting changes are included in net income. The most significant item which does not reflect the effects of inflation is depreciation expense. Historical dollar values used to determine depreciation expense do not reflect the effects of inflation on the market value of depreciable assets after their acquisition.

Provision and Allowance for Loan Losses

The Company's risk analysis at December 31, 2018 determined an allowance for loan losses of $7,390 or 1.04% 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 $81 for the twelve months ended December 30, 2018, compared with a provision for the twelve month period ended December 31, 2017 of $157. The recovery for the three-month periods ended December 31, 2018 and December 31, 2017 totaled $174 and $567, respectively. 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 $6,820 on a gross basis and as well as net of unearned income and deferred fees and costs, with specific allocations to the allowance for loan losses totaling $139 at December 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 $703,577 on a gross basis and $702,979 net of unearned income and deferred fees and costs, with an allowance of $7,251 or 1.03% at December 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 twelve months ended December 31, 2018 were $454 or 0.07% of average loans, an improvement from $532 or 0.08% for the twelve months ended December 30, 2017. The 8-quarter average historical loss rate applied to the calculation was 0.07% for December 30, 2018 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, which may increase credit risk. However the effect of gradual, measured interest rate changes does not affect credit risk as much as a volatile interest rate environment. 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.

Within the Company's market area, the unemployment, business bankruptcies, the inventory of homes, and the residential vacancy rate improved from December 31, 2017. Personal bankruptcies and the competitive, legal and regulatory environments remained at similar levels to December 31, 2017. Interest rates increased from December 31, 2017. The Federal Reserve's rate increases have been gradual and measured and have not resulted in volatility. The Bank's adjustable rate loans appear to have absorbed the increases without negative impact, as evidenced by improving trends in charge-offs and asset quality since 2016. Because the gradual increases have not resulted in negative impact, no additional allocation was made for the rate increases during the second half of 2018.

The Company considers other factors that impact credit risk, including the risk from changes in the legal and regulatory environments, changes to lending policies and loan review, and changes in management's experience. Each of the factors remained at similar levels to December 31, 2017. Management examined the allocation to the allowance for the risk from changes in the loan review system. The allocation was a legacy from changes made in years prior to 2015. Management deemed that the risk from changes prior to 2015 would now be reflected in the historical loss rates and removed the allocation.

Asset quality indicators affect the level of the allowance for loan losses. Accruing loans past due 30-89 days were 0.23% of total loans, net of unearned income and deferred fees and costs at December 30, 2018, a decrease from 0.34% at December 31, 2017. Accruing loans past due 90 days or more were 0.00% of total loans, net of unearned income and deferred fees and costs at December 30, 2018, a decrease from 0.01% at December 31, 2017. Nonaccrual loans at December 31, 2018 were 0.48% of total loans, net of unearned income and deferred fees and costs, an increase from 0.41% at December 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.

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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 $1,337 or 0.86% from the level at December 31, 2017, resulting in an increased allocation.

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 $1,455 at December 31, 2018 and $3,361 at December 31, 2017. Collectively evaluated loans rated classified were $735 at December 31, 2018 and $1,691 at December 31, 2017. The improvements in levels of criticized assets resulted in lower allocations.

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 December 31, 2018 is 1.04%, 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 1.03%, compared with 1.18% at December 31, 2017. Improvements from December 31, 2017 in the charge-off rate, unemployment, business bankruptcy rate, the inventory of homes, residential vacancy, and criticized loans decreased the required level of the allowance for loan losses, slightly offset by worsening in the level of nonaccrual loans 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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Quarterly Results of Operations

The following is a summary of the unaudited quarterly results of operations for the years ended December 31, 2018, 2017 and 2016:

$ in thousands	2018			
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Income Statement Data:				
Interest income	**$10,484**	**$10,726**	**$10,945**	**$11,069**
Interest expense	**1,081**	**1,145**	**1,245**	**1,576**
Net interest income	**9,403**	**9,581**	**9,700**	**9,493**
Provision for (recovery of) loan losses	**(472)**	**342**	**223**	**(174)**
Noninterest income	**2,023**	**1,868**	**1,914**	**1,924**
Noninterest expense	**8,164**	**6,424**	**6,463**	**6,225**
Income taxes	**438**	**642**	**677**	**803**
Net income	**$3,296**	**$4,041**	**$4,251**	**$4,563**
Per Share Data:				
Basic net income per common share	**$0.47**	**$0.58**	**$0.61**	**$0.66**
Fully diluted net income per common share	**0.47**	**0.58**	**0.61**	**0.66**
Cash dividends per common share	**---**	**0.58**	**---**	**0.63**
Book value per common share	**26.67**	**26.71**	**27.04**	**27.34**

$ in thousands	2017			
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Income Statement Data:				
Interest income	$10,238	$10,295	$10,301	$10,426
Interest expense	1,028	1,048	1,021	1,028
Net interest income	9,210	9,247	9,280	9,398
Provision for (recovery of) loan losses	59	464	201	(567)
Noninterest income	1,850	1,731	1,884	2,171
Noninterest expense	6,283	5,974	6,031	5,941
Income taxes	1,069	970	1,147	3,107
Net income	$3,649	$3,570	$3,785	$3,088
Per Share Data:				
Basic net income per common share	$0.52	$0.51	$0.54	$0.46
Fully diluted net income per common share	0.52	0.51	0.54	0.46
Cash dividends per common share	---	0.56	---	0.61
Book value per common share	26.30	26.49	26.97	26.57

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$ in thousands	2016			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Income Statement Data:				
Interest income	$10,484	$10,292	$10,157	$9,997
Interest expense	1,068	1,063	1,019	1,016
Net interest income	9,416	9,229	9,138	8,981
Provision for loan losses	203	654	291	502
Noninterest income	1,678	1,908	1,769	1,760
Noninterest expense	6,021	5,528	5,908	5,878
Income taxes	1,091	1,090	880	891
Net income	$3,779	$3,865	$3,828	$3,470
Per Share Data:				
Basic net income per common share	$0.54	$0.56	$0.55	$0.51
Fully diluted net income per common share	0.54	0.56	0.55	0.51
Cash dividends per common share	---	0.55	---	0.61
Book value per common share	25.76	25.86	26.47	25.62

Balance Sheet

On December 31, 2018, the Company had total assets of $1,256,032, a decrease of $725 or 0.06%, over total assets of $1,256,757 on December 31, 2017. Total assets at December 31, 2017 were up by $22,815, or 1.85%, over the total at December 31, 2016.

Loans

The Company's loan categorization reflects its approach to loan portfolio management and includes six groups. Real estate construction loans include construction loans for residential and commercial properties, as well as land. Consumer real estate loans include conventional and junior lien mortgages, equity lines and investor-owned residential real estate. Commercial real estate loans are comprised of owner-occupied and leased nonfarm, nonresidential properties, multi-family residence loans and farmland. Commercial non real estate loans include agricultural loans, operating capital lines and loans secured by capital assets. Public sector and IDA loans are extended to municipalities. Consumer non real estate loans include automobile loans, personal loans, credit cards and consumer overdrafts.

A. Types of Loans

$ in thousands	December 31,

	2018	2017	2016	2015	2014
Real estate construction	**$37,845**	$34,694	$36,345	$48,251	$45,562
Consumer real estate	**175,456**	166,965	157,718	143,504	147,039
Commercial real estate	**353,546**	340,414	336,457	309,378	310,762
Commercial non real estate	**46,535**	40,518	39,204	37,571	33,413
Public sector and IDA	**60,777**	51,443	45,474	51,335	41,361
Consumer non real estate	**36,238**	34,648	33,528	29,845	28,182
Total loans	**$710,397**	$668,682	$648,546	$619,884	$606,319
Less unearned income and deferred fees	**(598)**	(613)	(794)	(876)	(853)
Total loans, net of unearned income and deferred fees and costs	**$709,799**	$668,069	$647,752	$619,008	$605,466
Less allowance for loans losses	**(7,390)**	(7,925)	(8,300)	(8,297)	(8,263)
Total loans, net	**$702,409**	$660,144	$639,452	$610,711	$597,203

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B. Maturities and Interest Rate Sensitivities

The following table presents maturities and interest rate sensitivities for commercial non real estate, commercial real estate and real estate construction loans.

$ in thousands	December 31, 2018			
	< 1 Year	**1 – 5 Years**	**After 5 Years**	**Total**
Commercial non real estate	**$33,948**	**$11,964**	**$623**	**$46,535**
Commercial real estate	**74,858**	**225,268**	**53,420**	**353,546**
Real estate construction	**19,111**	**17,612**	**1,122**	**37,845**
Total	**127,917**	**254,844**	**55,165**	**437,926**
Less loans with predetermined interest rates	**(24,993)**	**(25,881)**	**(11,528)**	**(62,402)**
Loans with adjustable rates	**$102,924**	**$228,963**	**$43,637**	**$375,524**

Risk Elements

The following table presents aggregate amounts for nonaccrual loans, restructured loans in nonaccrual, other real estate owned net, and accruing loans which are contractually past due ninety days or more as to interest or principal payments, and accruing restructured loans.

$ in thousands	December 31,				
	2018	**2017**	**2016**	**2015**	**2014**
Nonaccrual loans					
Real estate construction	**$---**	$---	$---	$---	$---
Consumer real estate	**119**	6	256	14	164
Commercial real estate	**192**	---	698	1,146	3,087
Commercial non real estate	**---**	---	217	883	748
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**---**	---	---	---	---
Total nonaccrual loans	**$311**	$6	$1,168	$2,043	$3,999
Restructured loans (TDR Loans) in nonaccrual					
Real estate construction	**$---**	$---	$270	$718	$---
Consumer real estate	**610**	145	---	---	---
Commercial real estate	**2,494**	2,602	4,390	3,921	5,288
Commercial non real estate	**5**	15	24	---	---
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**---**	1	3	---	---
Total restructured loans in nonaccrual	**$3,109**	$2,763	$4,687	$4,639	$5,288
Total nonperforming loans	**$3,420**	$2,769	$5,855	$6,682	$9,287

Other real estate owned, net	**2,052**	2,817	3,156	4,165	4,744
Total nonperforming assets	**$5,472**	$5,586	$9,011	$10,847	$14,031
Accruing loans past due 90 days or more					
Real estate construction	**$---**	$---	$---	$---	$---
Consumer real estate	**---**	11	42	145	82
Commercial real estate	**---**	---	---	---	102
Commercial non real estate	**2**	---	---	---	---
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**33**	40	21	11	23
Total accruing loans past due 90 days or more	**$35**	$51	$63	$156	$207

(continued)

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Accruing restructured loans					
Real estate construction	**$---**	$---	$---	$---	$---
Consumer real estate	**417**	947	877	962	819
Commercial real estate	**1,112**	2,948	2,892	7,645	5,192
Commercial non real estate	**1,010**	1,214	---	207	29
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**13**	25	---	---	---
Total accruing restructured loans	**$2,552**	$5,134	$3,769	$8,814	$6,040

Loan loss and other indicators related to asset quality are presented in the Loan Loss Data table.

Loan Loss Data Table

$ in thousands	**2018**	**2017**	**2016**
Provision for (recovery of) loan losses	**$(81)**	$157	$1,650
Net charge-offs to average net loans	**0.07 %**	0.08 %	0.26 %
Allowance for loan losses to loans, net of unearned income and deferred fees	**1.04 %**	1.19 %	1.28 %
Allowance for loan losses to nonperforming loans	**216.08 %**	286.20%	141.76%
Allowance for loan losses to nonperforming assets	**135.05 %**	141.87%	92.11 %
Nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned	**0.77 %**	0.83 %	1.38 %
Nonaccrual loans	**$311**	$6	$1,168
Restructured loans in nonaccrual status	**3,109**	2,763	4,687
Other real estate owned, net	**2,052**	2,817	3,156
Total nonperforming assets	**$5,472**	$5,586	$9,011
Accruing loans past due 90 days or more	**$35**	$51	$63

Nonperforming loans include nonaccrual loans and restructured loans ("troubled debt restructurings" or "TDR loans") in nonaccrual status, but do not include accruing loans 90 days or more past due or accruing restructured loans. Troubled debt restructurings are discussed in detail under the section titled "D. Modifications and Troubled Debt Restructurings (TDR Loans)" below. Impaired loans, or loans for which management does not expect to collect at the original loan terms, but which may or may not be nonperforming, are presented in Note 5 of Notes to Consolidated Financial Statements.

Total impaired loans at December 31, 2018 were $6,820, of which $3,420 were in nonaccrual status. Impaired loans at December 31, 2017 and 2016 were $11,924 and $9,173, of which $2,763 and $5,404 were in nonaccrual status, respectively.

The ratio of the allowance for loan losses to total nonperforming loans decreased from 286.20% in 2017 to 216.08% in 2018. The Company believes the allowance for loan losses is adequate for the credit risk inherent in the loan portfolio.

D. 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.

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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:

Modifications Made During the 12 Months Ended December 31, 2018

to Borrowers Not Experiencing Financial Difficulty

Modification	**Number of Loans Modified**	**Total Amount Modified**
Rate reductions for competitive purposes	**18**	**$ 8,384**
Payment extensions for less than 3 months	**61**	**646**
Maturity date extensions of more than 3 months and up to 6 months	**134**	**22,663**
Maturity date extensions of more than 6 months and up to 12 months	**308**	**11,777**
Maturity date extensions of more than 12 months	**17**	**2,304**
Advances on non-revolving loans or recapitalization	**8**	**2,076**
Change in amortization term or method	**11**	**1,542**
Change or release of collateral	**43**	**783**
Renewal of expired Home Equity Line of Credit loans to additional 10 years	**20**	**300**
Renewal of single-payment notes	**138**	**2,862**
Total modifications that do not constitute TDRs	**758**	**$ 53,337**

Modifications Made During the 12 Months Ended December 31, 2017

to Borrowers Not Experiencing Financial Difficulty

Modification	**Number of Loans Modified**	**Total Amount Modified**
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 to additional 10 years	19	448
Renewal of single-payment notes	240	5,044
Total modifications that do not constitute TDRs	973	$ 76,857

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Modifications Made During the 12 Months Ended December 31, 2016

to Borrowers Not Experiencing Financial Difficulty