NATIONAL BANKSHARES INC
Form 10-Q
November 07, 2018

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ________ to ________

Commission File Number 0-15204

NATIONAL BANKSHARES, INC.

(Exact name of registrant as specified in its charter)

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

101 Hubbard Street

P. O. Box 90002

Blacksburg, VA 24062-9002
(Address of principal executive offices) (Zip Code)
(540) 951-6300

(Registrant's telephone number, including area code)

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

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

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

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

Smaller reporting company [ ] Emerging growth company [ ]

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

[ ] Yes [x] No

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

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

[ ] Yes [x] No

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

Class	Outstanding at November 6, 2018
Common Stock, $1.25 Par Value	6,957,974

(This report contains 64 pages)

Table of Contents

NATIONAL BANKSHARES, INC. AND SUBSIDIARIES

Form 10-Q

Index

Table of Contents

Part I

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

Consolidated Balance Sheets

(in thousands, except share and per share data)	**(Unaudited) September 30, 2018**	**December 31, 2017**
Assets		
Cash and due from banks	**$ 11,533**	$ 12,926
Interest-bearing deposits	**28,328**	51,233
Securities available for sale, at fair value	**448,485**	331,387
Securities held to maturity (fair value of $130,113 at December 31, 2017)	**---**	127,164
Restricted stock, at cost	**2,708**	1,200
Loans held for sale	**1,027**	260
Loans:		
Loans, net of unearned income and deferred fees and costs	**701,834**	668,069
Less allowance for loan losses	**(7,713)**	(7,925)
Loans, net	**694,121**	660,144
Premises and equipment, net	**8,727**	8,221
Accrued interest receivable	**5,589**	5,297
Other real estate owned, net	**2,214**	2,817
Intangible assets and goodwill	**5,861**	5,898
Bank-owned life insurance	**34,434**	33,756
Other assets	**15,262**	16,454
Total assets	**$ 1,258,289**	$ 1,256,757
Liabilities and Stockholders' Equity		
Noninterest-bearing demand deposits	**$ 199,953**	$ 182,511
Interest-bearing demand deposits	**584,305**	622,189
Savings deposits	**141,751**	140,150
Time deposits	**96,167**	114,884
Total deposits	**1,022,176**	1,059,734
Other borrowed funds	**35,000**	**---**
Accrued interest payable	**165**	62
Other liabilities	**12,791**	12,065
Total liabilities	**1,070,132**	1,071,861
Commitments and contingencies		
Stockholders' Equity		
Preferred stock, no par value, 5,000,000 shares authorized; none issued and outstanding	**---**	---
Common stock of $1.25 par value. Authorized 10,000,000 shares; issued and outstanding 6,957,974 shares at September 30, 2018 and at December 31, 2017	**8,698**	8,698

Retained earnings	**193,445**	185,893
Accumulated other comprehensive loss, net	**(13,986)**	(9,695)
Total stockholders' equity	**188,157**	184,896
Total liabilities and stockholders' equity	**$ 1,258,289**	$ 1,256,757

See accompanying notes to consolidated financial statements.

3

Table of Contents

National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Income

Three Months Ended September 30, 2018 and 2017

(Unaudited)

(in thousands, except share and per share data)	**September 30, 2018**	**September 30, 2017**
Interest Income		
Interest and fees on loans	**$ 8,005**	$ 7,473
Interest on interest-bearing deposits	**111**	224
Interest on securities – taxable	**1,771**	1,426
Interest on securities – nontaxable	**1,058**	1,178
Total interest income	**10,945**	10,301
Interest Expense		
Interest on time deposits	**107**	130
Interest on other deposits	**1,034**	891
Interest on borrowed funds	**104**	---
Total interest expense	**1,245**	1,021
Net interest income	**9,700**	9,280
Provision for loan losses	**223**	201
Net interest income after provision for loan losses	**9,477**	9,079
Noninterest Income		
Service charges on deposit accounts	**673**	710
Other service charges and fees	**20**	42
Credit and debit card fees	**362**	315
Trust income	**355**	365
BOLI income	**222**	233
Other income	**282**	215
Realized securities gain, net	**---**	4
Total noninterest income	**1,914**	1,884
Noninterest Expense		
Salaries and employee benefits	**3,639**	3,478
Occupancy and furniture and fixtures	**433**	459
Data processing and ATM	**684**	565
FDIC assessment	**88**	93
Intangible assets amortization	**12**	13
Net costs of other real estate owned	**274**	58
Franchise taxes	**314**	332

Other operating expenses	**1,019**	1,033
Total noninterest expense	**6,463**	6,031
Income before income taxes	**4,928**	4,932
Income tax expense	**677**	1,147

(continued)

Table of Contents

Net Income	**$4,251**	$3,785
Basic net income per common share	**$0.61**	$0.54
Fully diluted net income per common share	**$0.61**	$0.54
Weighted average number of common shares outstanding – basic and diluted	**6,957,974**	6,957,974
Dividends declared per common share	**---**	---

See accompanying notes to consolidated financial statements.

Table of Contents

National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

Three Months Ended September 30, 2018 and 2017

(Unaudited)

(in thousands)	**September 30, 2018**	**September 30, 2017**
Net Income	**$ 4,251**	$ 3,785
Other Comprehensive Loss, Net of Tax		
Unrealized holding loss on available for sale securities net of tax of ($517) and ($219) for the periods ended September 30, 2018 and 2017, respectively	**(1,945)**	(407)
Reclassification adjustment for gain included in net income, net of tax of ($1) for the period ended September 30, 2017	**---**	(3)
Other comprehensive loss, net of tax	**(1,945)**	(410)
Total Comprehensive Income	**$ 2,306**	$ 3,375

See accompanying notes to consolidated financial statements.

Table of Contents

National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Income

Nine Months Ended September 30, 2018 and 2017

(Unaudited)

(in thousands, except share and per share data)	**September 30, 2018**	**September 30, 2017**
Interest Income		
Interest and fees on loans	**$ 23,159**	$ 22,379
Interest on interest-bearing deposits	**509**	603
Interest on securities – taxable	**5,125**	4,225
Interest on securities – nontaxable	**3,362**	3,627
Total interest income	**32,155**	30,834
Interest Expense		
Interest on time deposits	**344**	410
Interest on other deposits	**3,023**	2,687
Interest on borrowed funds	**104**	---
Total interest expense	**3,471**	3,097
Net interest income	**28,684**	27,737
Provision for loan losses	**93**	724
Net interest income after provision for loan losses	**28,591**	27,013
Noninterest Income		
Service charges on deposit accounts	**2,037**	2,067
Other service charges and fees	**87**	152
Credit and debit card fees	**1,071**	854
Trust income	**1,131**	1,127
BOLI income	**678**	522
Other income	**801**	735
Realized securities gain, net	**---**	8
Total noninterest income	**5,805**	5,465
Noninterest Expense		
Salaries and employee benefits	**10,878**	10,420
Occupancy and furniture and fixtures	**1,396**	1,366
Data processing and ATM	**2,024**	1,673
FDIC assessment	**269**	279
Intangible assets amortization	**37**	56
Net costs of other real estate owned	**523**	142
Franchise taxes	**965**	983

Write-down of insurance receivable	**2,010**	---
Other operating expenses	**2,949**	3,369
Total noninterest expense	**21,051**	18,288
Income before income taxes	**13,345**	14,190
Income tax expense	**1,757**	3,186

(continued)

Table of Contents

Net Income	**$11,588**	$11,004
Basic net income per common share	**$1.67**	$1.58
Fully diluted net income per common share	**$1.67**	$1.58
Weighted average number of common shares outstanding – basic and diluted	**6,957,974**	6,957,974
Dividends declared per common share	**$0.58**	$0.56

See accompanying notes to consolidated financial statements.

Table of Contents

National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

Nine Months Ended September 30, 2018 and 2017

(Unaudited)

(in thousands)	September 30, 2018	September 30, 2017
Net Income	**$ 11,588**	$ 11,004
Other Comprehensive Income (Loss), Net of Tax		
Unrealized holding gain (loss) on available for sale securities net of tax of ($1,378) and $1,235 for the periods ended September 30, 2018 and 2017, respectively	**(5,182)**	2,294
Unrealized holding gain on securities transferred from held to maturity to available for sale, net of tax of $237 for the period ended September 30, 2018	**891**	---
Reclassification adjustment for gain included in net income, net of tax of ($1) for the period ended September 30, 2017.	**---**	(3)
Other comprehensive income (loss), net of tax	**(4,291)**	2,291
Total Comprehensive Income	**$ 7,297**	$ 13,295

See accompanying notes to consolidated financial statements.

Table of Contents

National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity

(Unaudited)

Three Months Ended September 30, 2018 and 2017

(in thousands)	Common Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balances at June 30, 2017	$ 8,698	$181,546	$ (5,958)	$184,286
Net income	---	3,785	---	3,785
Other comprehensive loss, net of tax of ($220)	---	---	(410)	(410)
Balances at September 30, 2017	$ 8,698	185,331	(6,368)	187,661
Balances at June 30, 2018	$ 8,698	$189,194	$ (12,041)	$184,851
Net income	---	4,251	---	4,251
Other comprehensive loss, net of tax of ($517)	---	---	(1,945)	(1,945)
Balances at September 30, 2018	**$ 8,698**	**$193,445**	**$ (13,986)**	**$188,157**

See accompanying notes to consolidated financial statements.

Nine Months Ended September 30, 2018 and 2017

(in thousands)	Common Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balances at December 31, 2016	$ 8,698	$178,224	$ (8,659)	$178,263
Net income	---	11,004	---	11,004
Dividends $0.56 per share	---	(3,897)	---	(3,897)
Other comprehensive income, net of tax of $1,234	---	---	2,291	2,291

Balances at September 30, 2017	$ 8,698	185,331	(6,368)	187,661
Balances at December 31, 2017	$ 8,698	$185,893	$ (9,695)	$184,896
Net income	---	11,588	---	11,588
Dividends $0.58 per share	---	(4,036)	---	(4,036)
Other comprehensive loss, net of tax of ($1,141)	---	---	(4,291)	(4,291)
Balances at September 30, 2018	**$ 8,698**	**$193,445**	**$ (13,986)**	**$188,157**

See accompanying notes to consolidated financial statements.

Table of Contents

National Bankshares, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

Nine Months Ended September 30, 2018 and 2017

(Unaudited)

(in thousands)	**September 30, 2018**	September 30, 2017
Cash Flows from Operating Activities		
Net income	**$ 11,588**	$ 11,004
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	**93**	724
Depreciation of bank premises and equipment	**595**	601
Amortization of intangibles	**37**	56
Amortization of premiums and accretion of discounts, net	**43**	44
Gain on sales and calls of securities available for sale, net	**---**	(4)
Gain on calls of securities held to maturity, net	**---**	(4)
Loss and write-down on other real estate owned, net	**464**	79
Increase in cash value of bank-owned life insurance	**(678)**	(522)
Origination of mortgage loans held for sale	**(11,032)**	(9,666)
Proceeds from sale of mortgage loans held for sale	**10,430**	9,777
Gain on sale of mortgage loans held for sale	**(165)**	(138)
Write-down of insurance receivable	**2,010**	---
Net change in:		
Accrued interest receivable	**(292)**	137
Other assets	**323**	(1,661)
Accrued interest payable	**103**	(4)
Other liabilities	**726**	616
Net cash provided by operating activities	**14,245**	11,039
Cash Flows from Investing Activities		
Net change in interest-bearing deposits	**22,905**	22,008
Proceeds from calls, principal payments, sales and maturities of securities available for sale	**22,424**	10,589
Proceeds from calls, principal payments and maturities of securities held to maturity	**6,430**	6,466
Purchase of securities available for sale	**(24,263)**	(12,081)
Purchases of securities held to maturity	**---**	(1,319)
Net change in restricted stock	**(1,508)**	(30)
Purchase of BOLI	**---**	(10,000)
Purchase of loan participations	**(7,726)**	(1,296)
Collection of loan participations	**856**	751
Loan originations and principal collections, net	**(27,382)**	(12,851)
Proceeds from sale of other real estate owned	**139**	251

Recoveries on loans charged off	**182**	138
Proceeds from sale and purchases of premises and equipment, net	**(1,101)**	(207)
Net cash used in investing activities	**(9,044)**	2,419

(continued)

Table of Contents

Cash Flows from Financing Activities		
Net change in time deposits	**(18,717)**	(11,895)
Net change in other deposits	**(18,841)**	426
Cash dividends paid	**(4,036)**	(3,897)
Borrowing advances	**35,000**	---
Net cash used in financing activities	**(6,594)**	(15,366)
Net change in cash and due from banks	**(1,393)**	(1,908)
Cash and due from banks at beginning of period	**12,926**	13,974
Cash and due from banks at end of period	**$11,533**	$12,066
Supplemental Disclosures of Cash Flow Information		
Interest paid on deposits and borrowed funds	**$3,368**	$3,101
Income taxes paid	**1,054**	2,872
Supplemental Disclosure of Noncash Activities		
Loans charged against the allowance for loan losses	**$487**	$689
Loans transferred to other real estate owned	**---**	97
Unrealized net gain (loss) on securities available for sale	**(6,560)**	3,525
Unrealized net gain on securities transferred from held to maturity to available for sale	**1,128**	---
Fair value of securities transferred from held to maturity to available for sale	**119,790**	---

See accompanying notes to consolidated financial statements.

Table of Contents

National Bankshares, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

September 30, 2018

(Unaudited)

$ in thousands, except per share data

Note 1: General

The consolidated financial statements of National Bankshares, Inc. ("NBI") and its wholly-owned subsidiaries, The National Bank of Blacksburg ("NBB") and National Bankshares Financial Services, Inc. ("NBFS") (collectively, the "Company"), conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The accompanying interim period consolidated financial statements are unaudited; however, in the opinion of management, all adjustments consisting of normal recurring adjustments, which are necessary for a fair presentation of the consolidated financial statements, have been included. The results of operations for the nine month period ended September 30, 2018 are not necessarily indicative of results of operations for the full year or any other interim period. The interim period consolidated financial statements and financial information included in this Form 10-Q should be read in conjunction with the notes to consolidated financial statements included in the Company's 2017 Form 10-K. The Company posts all reports required to be filed under the Securities and Exchange Act of 1934 on its web site at www.nationalbankshares.com.

Accounting Standards Adopted in 2018

ASU No. 2014-09, "Revenue from Contracts with Customers"

In May 2014, the FASB issued ASU No. 2014-09, *"Revenue from Contracts with Customers."* The standard's core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies generally will be required to use more judgment and make more estimates than under current guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. Subsequent to the issuance of ASU 2014-09, the FASB issued targeted updates to clarify specific implementation issues including ASU No. 2016-08, *"Principal versus Agent Considerations (Reporting Revenue Gross versus Net),"* ASU No. 2016-10, *"Identifying Performance Obligations and Licensing,"* ASU No.

2016-12, *"Narrow-Scope Improvements and Practical Expedients,"* and ASU No. 2016-20 *"Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers."* For financial reporting purposes, the standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application.

Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income and expense. The Company completed its overall assessment of revenue streams and review of related contracts potentially affected by the ASU, including trust and asset management fees, deposit related fees, interchange fees, merchant income, bank-financed sales of other real estate owned and annuity and insurance commissions. Based on this assessment, the Company concluded that ASU 2014-09 did not materially change the method in which the Company currently recognizes revenue for these revenue streams. The Company also completed its evaluation of certain costs related to these revenue streams to determine whether such costs should be presented as expenses or contra-revenue (i.e., gross vs. net). Based on its evaluation, the Company determined that the classification of certain debit and credit card related costs should change (i.e., cost previously recorded as expense is now recorded as contra-revenue). The Company identified $2,093 previously presented as credit card processing expense for the nine months ended September 30, 2017 and $715 for the three months ended September 30, 2017, and reclassified it to net against credit card fee income. The Company adopted ASU 2014-09 and its related amendments on its required effective date of January 1, 2018 utilizing the full retrospective approach. There was no impact to net income. Consistent with the full retrospective approach, the Company adjusted prior period amounts for the debit and credit card costs reclassifications noted above.

Table of Contents

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

In January 2016, the FASB issued ASU No. 2016-01, *"Recognition and Measurement of Financial Assets and Financial Liabilities."* This ASU addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments by making targeted improvements to GAAP. The provisions of the ASU that apply to the Company are as follows: (1) require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer; (2) simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value; (3) eliminate the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (4) require use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (5) require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (6) clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The adoption of ASU No. 2016-01 on January 1, 2018 did not have a material impact on the Company's Consolidated Financial Statements. In accordance with (4) above, the Company measured the fair value of its loan portfolio and time deposit portfolio as of September 30, 2018 using an exit price notion (see Note 14 *Fair Value of Assets and Liabilities*).

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

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

Note 2: Loan Portfolio

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

	September 30, 2018	**December 31, 2017**
Real estate construction	**$ 42,548**	$ 34,694
Consumer real estate	**171,679**	166,965
Commercial real estate	**346,756**	340,414
Commercial non real estate	**44,497**	40,518
Public sector and IDA	**59,369**	51,443
Consumer non real estate	**37,587**	34,648
Gross loans	**702,436**	668,682
Less unearned income and deferred fees and costs	**(602)**	(613)
Loans, net of unearned income and deferred fees and costs	**$ 701,834**	$ 668,069

Table of Contents

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

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

Impaired Loans

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

Troubled debt restructurings impact the estimation of the appropriate level of the allowance for loan losses. If the restructuring included forgiveness of a portion of principal or accrued interest, the charge-off is included in the historical charge-off rates applied to the collective evaluation methodology. Restructured loans are individually evaluated for impairment, and the amount of a restructured loan's book value in excess of its fair value is accrued as a specific allocation in the allowance for loan losses. If a TDR loan payment exceeds 90 days past due, it is examined to determine whether the late payment indicates collateral dependency or cash flows below those that were used in the fair value measurement. TDRs, as well as all impaired loans, that are determined to be collateral dependent are charged down to fair value. Deficiencies indicated by impairment measurements for TDRs that are not collateral dependent may be accrued in the allowance for loan losses or charged off if deemed uncollectible.

Collectively-Evaluated Loans

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

Portfolio Segments and Classes

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

Real Estate Construction	
Construction, residential	
Construction, other	Commercial Non Real Estate
	Commercial and industrial
Consumer Real Estate	
Equity lines	Public Sector and IDA
Residential closed-end first liens	Public sector and IDA
Residential closed-end junior liens	
Investor-owned residential real estate	Consumer Non Real Estate
	Credit cards
Commercial Real Estate	Automobile
Multifamily real estate	Other consumer loans
Commercial real estate, owner-occupied	
Commercial real estate, other	

Historical Loss Rates

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

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

15

Table of Contents

Risk Factors

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

The analysis of certain factors results in standard allocations to all segments and classes. These factors include the risk from changes in lending policies, loan officers' average years of experience, unemployment levels, bankruptcy rates, interest rate environment, and competition/legal/regulatory environments. Factors analyzed for each class, with resultant allocations based upon the level of risk assessed for each class, include the risk from changes in loan review, levels of past due loans, levels of nonaccrual loans, current class balance as a percentage of total loans, and the percentage of high risk loans within the class. Additionally, factors specific to each segment are analyzed and result in allocations to the segment. Please refer to Note 1: Summary of Significant Accounting Policies of Form 10-K for a discussion of risk factors pertinent to each class.

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

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

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

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

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

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

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

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

Activity in the Allowance for Loan Losses for the Nine Months Ended September 30, 2018

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Balance, December 31, 2017	**$337**	**$ 2,027**	**$ 3,044**	**$ 1,072**	**$ 419**	**$ 707**	**$ 319**	**$7,925**
Charge-offs	**---**	**(36)**	**---**	**(107)**	**---**	**(344)**	**---**	**(487)**
Recoveries	**---**	**2**	**37**	**22**	**---**	**121**	**---**	**182**
Provision for (recovery of) loan losses	**137**	**185**	**(42)**	**(305)**	**151**	**240**	**(273)**	**93**
Balance, September 30, 2018	**$474**	**$ 2,178**	**$ 3,039**	**$ 682**	**$ 570**	**$ 724**	**$ 46**	**$7,713**

16

Table of Contents

Activity in the Allowance for Loan Losses for the Nine Months Ended September 30, 2017

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Balance, December 31, 2016	$438	$ 1,830	$ 3,738	$ 1,063	$ 330	$ 644	$ 257	$8,300
Charge-offs	---	(146)	(122)	(73)	---	(348)	---	(689)
Recoveries	---	1	44	14	---	79	---	138
Provision for (recovery of) loan losses	(140)	337	33	111	55	357	(29)	724
Balance, September 30, 2017	$298	$ 2,022	$ 3,693	$ 1,115	$ 385	$ 732	$ 228	$8,473

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

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

Allowance for Loan Losses as of September 30, 2018

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Individually evaluated for impairment	**$---**	**$ 14**	**$ ---**	**$ 142**	**$ ---**	**$ ---**	**$ ---**	**$156**
Collectively evaluated for impairment	**474**	**2,164**	**3,039**	**540**	**570**	**724**	**46**	**7,557**
Total	**$474**	**$ 2,178**	**$ 3,039**	**$ 682**	**$ 570**	**$ 724**	**$ 46**	**$7,713**

Allowance for Loan Losses as of December 31, 2017

Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public	Consumer Non Real	Unallocated	Total

					Sector and IDA	Estate		
Individually evaluated for impairment	$---	$ 16	$ ---	$ 160	$ ---	$ 1	$ ---	$177
Collectively evaluated for impairment	337	2,011	3,044	912	419	706	319	7,748
Total	$337	$ 2,027	$ 3,044	$ 1,072	$ 419	$ 707	$ 319	$7,925

Table of Contents

	Loans as of September 30, 2018							
	Real Estate Construction	**Consumer Real Estate**	**Commercial Real Estate**	**Commercial Non Real Estate**	**Public Sector and IDA**	**Consumer Non Real Estate**	**Unallocated**	**Total**
Individually evaluated for impairment	**$2,470**	**$**						