

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2019

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  
(State or other jurisdiction of incorporation or organization)

54-1375874  
(I.R.S. Employer Identification No.)

101 Hubbard Street  
P. O. Box 90002  
Blacksburg, VA  
(Address of principal executive offices)

24062-9002  
(Zip Code)

(540) 951-6300  
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Trading Symbol</u>	<u>Name of each exchange on which registered</u>
Common Stock	NKSH	NASDAQ

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  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 shorter period that the registrant was required to submit such files).  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  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.  
 Yes  No

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

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

<u>Class</u>	<u>Par Value</u>	<u>Trading Symbol</u>	<u>Exchange on which Registered</u>	<u>Outstanding shares at November 5, 2019</u>
Common Stock	\$1.25	NKSH	NASDAQ	6,489,574

(This report contains 68 pages)

NATIONAL BANKSHARES, INC. AND SUBSIDIARIES  
Form 10-Q  
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**Part I****Item 1. Financial Statements****Financial Information**  
National Bankshares, Inc. and Subsidiaries  
Consolidated Balance Sheets

<b>(in thousands, except share and per share data)</b>	<b>(Unaudited)</b> <b>September 30,</b> <b>2019</b>	<b>December 31,</b> <b>2018</b>
<b>Assets</b>		
Cash and due from banks	\$ 14,206	\$ 12,882
Interest-bearing deposits	135,490	43,491
Securities available for sale, at fair value	334,150	425,010
Restricted stock, at cost	1,220	1,220
Loans held for sale	2,333	72
Loans:		
Loans, net of unearned income and deferred fees and costs	722,287	709,799
Less allowance for loan losses	(7,262)	(7,390)
Loans, net	715,025	702,409
Premises and equipment, net	8,993	8,646
Operating lease right-of-use asset	2,351	—
Accrued interest receivable	4,233	5,160
Other real estate owned, net	1,470	2,052
Goodwill	5,848	5,848
Bank-owned life insurance	35,338	34,657
Other assets	12,064	14,585
<b>Total assets</b>	<b>\$ 1,272,721</b>	<b>\$ 1,256,032</b>
<b>Liabilities and Stockholders' Equity</b>		
Noninterest-bearing demand deposits	\$ 217,720	\$ 195,441
Interest-bearing demand deposits	580,533	616,527
Savings deposits	145,188	138,175
Time deposits	124,586	101,799
Total deposits	1,068,027	1,051,942
Accrued interest payable	133	89
Operating lease liability	2,358	—
Other liabilities	14,215	13,763
Total liabilities	1,084,733	1,065,794
Commitments and contingencies		

*(continued)*

**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 6,489,574 shares at September 30, 2019 and 6,957,974 shares at December 31, 2018	8,112	8,698
Retained earnings	184,016	193,625
Accumulated other comprehensive loss, net	(4,140)	(12,085)
Total stockholders' equity	187,988	190,238
<b>Total liabilities and stockholders' equity</b>	<b>\$ 1,272,721</b>	<b>\$ 1,256,032</b>

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
Three Months Ended September 30, 2019 and 2018  
(Unaudited)

(in thousands, except share and per share data)	September 30, 2019	September 30, 2018
<b>Interest Income</b>		
Interest and fees on loans	\$ 8,548	\$ 8,005
Interest on interest-bearing deposits	407	111
Interest on securities – taxable	1,565	1,771
Interest on securities – nontaxable	768	1,058
Total interest income	<u>11,288</u>	<u>10,945</u>
<b>Interest Expense</b>		
Interest on time deposits	523	107
Interest on other deposits	1,342	1,034
Interest on borrowed funds	—	104
Total interest expense	<u>1,865</u>	<u>1,245</u>
Net interest income	<u>9,423</u>	<u>9,700</u>
Provision for loan losses	95	223
Net interest income after provision for loan losses	<u>9,328</u>	<u>9,477</u>
<b>Noninterest Income</b>		
Service charges on deposit accounts	643	673
Other service charges and fees	46	20
Credit and debit card fees	350	362
Trust income	440	355
BOLI income	230	222
Other income	227	282
Realized securities gain, net	162	—
Total noninterest income	<u>2,098</u>	<u>1,914</u>
<b>Noninterest Expense</b>		
Salaries and employee benefits	3,823	3,639
Occupancy, furniture and fixtures	468	433
Data processing and ATM	823	684
FDIC assessment	—	88
Intangible assets amortization	—	12
Net costs of other real estate owned	17	274
Franchise taxes	343	314
Other operating expenses	912	1,019
Total noninterest expense	<u>6,386</u>	<u>6,463</u>
Income before income taxes	<u>5,040</u>	<u>4,928</u>
Income tax expense	<u>788</u>	<u>677</u>

*(continued)*

<b>Net Income</b>	<b>\$</b>	<b>4,252</b>	<b>\$</b>	<b>4,251</b>
Basic net income per common share	\$	0.65	\$	0.61
Fully diluted net income per common share	\$	0.65	\$	0.61
Weighted average number of common shares outstanding – basic and diluted		6,499,957		6,957,974
Dividends declared per common share		—		—

See accompanying notes to consolidated financial statements.

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National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Comprehensive Income  
Three Months Ended September 30, 2019 and 2018  
(Unaudited)

<b>(in thousands)</b>	<b>September 30, 2019</b>	<b>September 30, 2018</b>
Net Income	\$ 4,252	\$ 4,251
<b>Other Comprehensive Income (Loss), Net of Tax</b>		
Unrealized holding gain (loss) on available for sale securities net of tax of \$146 and (\$517) for the periods ended September 30, 2019 and 2018, respectively	544	(1,945)
Reclassification adjustment for gain included in net income, net of tax of (\$34) for the period ended September 30, 2019	(128)	--
Other comprehensive income (loss), net of tax	416	(1,945)
<b>Total Comprehensive Income</b>	<b>\$ 4,668</b>	<b>\$ 2,306</b>

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Income  
Nine Months Ended September 30, 2019 and 2018  
(Unaudited)

(in thousands, except share and per share data)	September 30, 2019	September 30, 2018
<b>Interest Income</b>		
Interest and fees on loans	\$ 25,277	\$ 23,159
Interest on interest-bearing deposits	1,048	509
Interest on securities – taxable	4,851	5,125
Interest on securities – nontaxable	2,543	3,362
Total interest income	33,719	32,155
<b>Interest Expense</b>		
Interest on time deposits	1,239	344
Interest on other deposits	4,333	3,023
Interest on borrowed funds	—	104
Total interest expense	5,572	3,471
Net interest income	28,147	28,684
Provision for loan losses	350	93
Net interest income after provision for loan losses	27,797	28,591
<b>Noninterest Income</b>		
Service charges on deposit accounts	1,840	2,037
Other service charges and fees	149	87
Credit and debit card fees	1,015	1,071
Trust income	1,208	1,131
BOLI income	681	678
Other income	1,368	801
Realized securities gain, net	182	—
Total noninterest income	6,443	5,805
<b>Noninterest Expense</b>		
Salaries and employee benefits	11,446	10,878
Occupancy, furniture and fixtures	1,410	1,396
Data processing and ATM	2,363	2,024
FDIC assessment	167	269
Intangible assets amortization	—	37
Net costs of other real estate owned	45	523
Franchise taxes	990	965
Write-down of insurance receivable	—	2,010
Other operating expenses	2,883	2,949
Total noninterest expense	19,304	21,051
Income before income taxes	14,936	13,345
Income tax expense	2,247	1,757

*(continued)*



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<b>Net Income</b>	<b>\$</b>	<b>12,689</b>	<b>\$</b>	<b>11,588</b>
Basic net income per common share	\$	1.92	\$	1.67
Fully diluted net income per common share	\$	1.92	\$	1.67
Weighted average number of common shares outstanding – basic and diluted		<b>6,611,354</b>		6,957,974
Dividends declared per common share	\$	0.67	\$	0.58

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Comprehensive Income  
Nine Months Ended September 30, 2019 and 2018  
(Unaudited)

<b>(in thousands)</b>	<b>September 30, 2019</b>	<b>September 30, 2018</b>
Net Income	\$ 12,689	\$ 11,588
<b>Other Comprehensive Income (Loss), Net of Tax</b>		
Unrealized holding gain (loss) on available for sale securities net of tax of \$2,149 and (\$1,378) for the periods ended September 30, 2019 and 2018, respectively	8,089	(5,182)
Reclassification adjustment for gain included in net income, net of tax of (\$38) for the period ended September 30, 2019	(144)	--
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
Other comprehensive income (loss), net of tax	7,945	(4,291)
<b>Total Comprehensive Income</b>	<b>\$ 20,634</b>	<b>\$ 7,297</b>

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Changes in Stockholders' Equity  
(Unaudited)

Three Months Ended September 30, 2019 and 2018

(in thousands except share data)	Common Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balances at June 30, 2018	\$ 8,698	\$ 189,194	\$ (12,041)	\$ 185,851
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
Balances at June 30, 2019	\$ 8,132	\$ 180,272	\$ (4,556)	\$ 183,848
Net income	---	4,252	---	4,252
Common stock repurchased, 16,000 shares	(20)	(508)	---	(528)
Other comprehensive income, net of tax of \$112	---	---	416	416
<b>Balances at September 30, 2019</b>	<b>\$ 8,112</b>	<b>\$ 184,016</b>	<b>\$ (4,140)</b>	<b>\$ 187,988</b>

See accompanying notes to consolidated financial statements.

Nine Months Ended September 30, 2019 and 2018

(in thousands except share and per share data)	Common Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Total
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
Balances at December 31, 2018	\$ 8,698	\$ 193,625	\$ (12,085)	\$ 190,238
Net income	---	12,689	---	12,689
Common stock repurchased, 468,400 shares	(586)	(17,939)	---	(18,525)
Dividends \$0.67 per share	---	(4,359)	---	(4,359)
Other comprehensive income, net of tax of \$2,111	---	---	7,945	7,945
<b>Balances at September 30, 2019</b>	<b>\$ 8,112</b>	<b>\$ 184,016</b>	<b>\$ (4,140)</b>	<b>\$ 187,988</b>

See accompanying notes to consolidated financial statements.

National Bankshares, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
Nine Months Ended September 30, 2019 and 2018  
(Unaudited)

(in thousands)	September 30, 2019	September 30, 2018
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 12,689	\$ 11,588
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	350	93
Depreciation of bank premises and equipment	552	595
Amortization of intangibles	—	37
Amortization of premiums and accretion of discounts, net	52	43
Gains on disposal of fixed assets	(6)	—
Gain on sales and calls of securities available for sale, net	(182)	—
Loss and write-down on other real estate owned, net	5	464
Gain on sale of repossessed assets, net	4	—
Increase in cash value of bank-owned life insurance	(681)	(678)
Origination of mortgage loans held for sale	(15,191)	(11,032)
Proceeds from sale of mortgage loans held for sale	13,127	10,430
Gain on sale of mortgage loans held for sale	(197)	(165)
Write-down of insurance receivable	—	2,010
Lease expense – Operating	7	—
Net change in:		
Accrued interest receivable	927	(292)
Other assets	409	323
Accrued interest payable	44	103
Other liabilities	452	726
Net cash provided by operating activities	<u>12,361</u>	<u>14,245</u>
<b>Cash Flows from Investing Activities</b>		
Net change in interest-bearing deposits	(91,999)	22,905
Proceeds from calls, principal payments, sales and maturities of securities available for sale	235,900	22,424
Proceeds from calls, principal payments and maturities of securities held to maturity	—	6,430
Purchase of securities available for sale	(134,854)	(24,263)
Net change in restricted stock	—	(1,508)
Purchase of loan participations	(673)	(7,726)
Collection of loan participations	3,219	856
Loan originations and principal collections, net	(15,788)	(27,382)
Proceeds from sale of other real estate owned	592	139
Proceeds from sale of repossessed assets	40	—
Recoveries on loans charged off	218	182
Proceeds from sale and purchases of premises and equipment, net	(893)	(1,101)
Net cash used in investing activities	<u>(4,238)</u>	<u>(9,044)</u>

*(continued)*

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<b>Cash Flows from Financing Activities</b>		
Net change in time deposits	22,787	(18,717)
Net change in other deposits	(6,702)	(18,841)
Common stock repurchased	(18,525)	—
Cash dividends paid	(4,359)	(4,036)
Borrowing advances	—	35,000
Net cash used in financing activities	(6,799)	(6,594)
Net change in cash and due from banks	1,324	(1,393)
Cash and due from banks at beginning of period	12,882	12,926
Cash and due from banks at end of period	\$ 14,206	\$ 11,533
<b>Supplemental Disclosures of Cash Flow Information</b>		
Interest paid on deposits	\$ 5,528	\$ 3,368
Income taxes paid	1,756	1,054
<b>Supplemental Disclosure of Noncash Activities</b>		
Loans charged against the allowance for loan losses	\$ 696	\$ 487
Loans transferred to OREO	15	—
Unrealized net gain (loss) on securities available for sale	10,056	(6,560)
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
Increase in operating lease right-of-use asset upon adoption of ASU 2016-02	968	—
Increase in operating lease liability upon adoption of ASU 2016-02	968	—

See accompanying notes to consolidated financial statements.

**National Bankshares, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**September 30, 2019**  
**(Unaudited)**

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

**Note 1: General**

The consolidated financial statements of National Bankshares, Inc. (“NBI”) and its wholly-owned subsidiaries, The National Bank of Blacksburg (“NBB”) and National Bankshares Financial Services, Inc. (“NBFS”) (collectively, the “Company”), conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The accompanying interim period consolidated financial statements are unaudited; however, in the opinion of management, all adjustments consisting of normal recurring adjustments, which are necessary for a fair presentation of the consolidated financial statements, have been included. The results of operations for the three and nine month periods ended September 30, 2019 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 2018 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](http://www.nationalbankshares.com).

Accounting Standards Adopted in 2019

*ASU No. 2016-02, “Leases (Topic 842)”*

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842).” Among other things, the standard requires lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. For financial reporting purposes, the standard provides for a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach.

Subsequent to the issuance of ASU 2016-02, the FASB issued targeted updates to clarify specific implementation issues including ASU No. 2018-01, “Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842,” ASU No. 2018-10, “Codification Improvements to Topic 842, Leases,” ASU No. 2018-11, “Leases (Topic 842): Targeted Improvements,” ASU No. 2018-20, “Leases (Topic 842): Narrow-Scope Improvements for Lessors,” and ASU No. 2019-01 “Leases (Topic 842): Codification Improvements.” One of the amendments in ASU 2018-11 provides an additional (and optional) transition method to adopt the standard. If elected, an entity initially applies the new leases standard at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Consequently, an entity’s reporting for the comparative periods presented in the financial statements in which it adopts the new leases standard will continue to be in accordance with previous GAAP (Topic 840, Leases).

Upon adoption on January 1, 2019, the Company elected the prospective application approach provided by ASU 2018-11. There was no cumulative effect adjustment at adoption. The Company also elected certain practical expedients within the standard and did not reassess whether any expired or existing contracts are or contain leases, did not reassess the lease classification for any expired or existing leases and did not reassess any initial direct costs for existing leases. The Company evaluated its existing leases as of January 1, 2019 and recognized a right-of-use asset and lease liability for leases with a remaining term greater than 12 months. The Company also recognized a right-of-use asset and lease liability for leases that commenced after January 1, 2019.

*ASU No. 2017-08, “Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities”*

In March 2017, the FASB issued ASU 2017-08, “Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities.” The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Premiums on qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The ASU provided for adoption on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. The Company adopted the ASU on January 1, 2019. Adoption did not have a material impact and no cumulative effect adjustment was recorded.

**Note 2: Loan Portfolio**

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

	September 30, 2019	December 31, 2018
Real estate construction	\$ 42,972	\$ 37,845
Consumer real estate	179,114	175,456
Commercial real estate	360,493	353,546
Commercial non real estate	45,866	46,535
Public sector and IDA	59,731	60,777
Consumer non real estate	34,583	36,238
Gross loans	722,759	710,397
Less unearned income and deferred fees and costs	(472)	(598)
Loans, net of unearned income and deferred fees and costs	\$ 722,287	\$ 709,799

**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 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, usually 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 "special mention." 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 the Company's 2018 Form 10-K, 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	Commercial Non Real Estate
Construction, residential	Commercial and industrial
Construction, other	
	Public Sector and IDA
Consumer Real Estate	Public sector and IDA
Equity lines	
Residential closed-end first liens	Consumer Non Real Estate
Residential closed-end junior liens	Credit cards
Investor-owned residential real estate	Automobile
	Other consumer loans
Commercial Real Estate	
Multifamily real estate	
Commercial real estate, owner-occupied	
Commercial real estate, other	

*Historical Loss Rates*

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

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

*Risk Factors*

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

The analysis of certain factors results in standard allocations to all segments and classes. These factors include the risk from changes in lending policies, loan officers' average years of experience, unemployment levels, bankruptcy rates, interest rate environment, and competition/legal/regulatory environments. Factors analyzed for each class, with resultant allocations based upon the level of risk assessed for each class, include the risk from changes in loan review, levels of past due loans, levels of nonaccrual loans, current class balance as a percentage of total loans, and the percentage of high risk loans within the class. Additionally, factors specific to each segment are analyzed and result in allocations to the segment. Please refer to Note 1: Summary of Significant Accounting Policies 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, 2019								
	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, 2018	\$ 398	\$ 2,049	\$ 2,798	\$ 602	\$ 583	\$ 750	\$ 210	\$ 7,390
Charge-offs	—	(147)	(150)	—	—	(399)	—	(696)
Recoveries	—	—	37	—	—	181	—	218
Provision for (recovery of) loan losses	56	199	14	(75)	(93)	156	93	350
<b>Balance, September 30, 2019</b>	<b>\$ 454</b>	<b>\$ 2,101</b>	<b>\$ 2,699</b>	<b>\$ 527</b>	<b>\$ 490</b>	<b>\$ 688</b>	<b>\$ 303</b>	<b>\$ 7,262</b>

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
<b>Balance, September 30, 2018</b>	<b>\$ 474</b>	<b>\$ 2,178</b>	<b>\$ 3,039</b>	<b>\$ 682</b>	<b>\$ 570</b>	<b>\$ 724</b>	<b>\$ 46</b>	<b>\$ 7,713</b>

Activity in the Allowance for Loan Losses for the Year Ended December 31, 2018								
	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Balance, December 31, 2017	\$ 337	\$ 2,027	\$ 3,044	\$ 1,072	\$ 419	\$ 707	\$ 319	\$ 7,925
Charge-offs	—	(38)	—	(107)	—	(544)	—	(689)
Recoveries	—	3	49	22	—	161	—	235
Provision for (recovery of) loan losses	61	57	(295)	(385)	164	426	(109)	(81)
<b>Balance, December 31, 2018</b>	<b>\$ 398</b>	<b>\$ 2,049</b>	<b>\$ 2,798</b>	<b>\$ 602</b>	<b>\$ 583</b>	<b>\$ 750</b>	<b>\$ 210</b>	<b>\$ 7,390</b>

Allowance for Loan Losses as of September 30, 2019								
	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	\$ —	\$ 3	\$ —	\$ 117	\$ —	\$ —	\$ —	\$ 120
Collectively evaluated for impairment	454	2,098	2,699	410	490	688	303	7,142
<b>Total</b>	<b>\$ 454</b>	<b>\$ 2,101</b>	<b>\$ 2,699</b>	<b>\$ 527</b>	<b>\$ 490</b>	<b>\$ 688</b>	<b>\$ 303</b>	<b>\$ 7,262</b>

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

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Individually evaluated for impairment	\$ ---	\$ 4	\$ ---	\$ 135	\$ ---	\$ ---	\$ ---	\$ 139
Collectively evaluated for impairment	398	2,045	2,798	467	583	750	210	7,251
<b>Total</b>	<b>\$ 398</b>	<b>\$ 2,049</b>	<b>\$ 2,798</b>	<b>\$ 602</b>	<b>\$ 583</b>	<b>\$ 750</b>	<b>\$ 210</b>	<b>\$ 7,390</b>

**Loans as of September 30, 2019**

	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	\$ ---	\$ 1,398	\$ 3,892	\$ 938	\$ ---	\$ 5	\$ ---	\$ 6,233
Collectively evaluated for impairment	42,972	177,716	356,601	44,928	59,731	34,578	---	716,526
<b>Total</b>	<b>\$ 42,972</b>	<b>\$ 179,114</b>	<b>\$ 360,493</b>	<b>\$ 45,866</b>	<b>\$ 59,731</b>	<b>\$ 34,583</b>	<b>\$ ---</b>	<b>\$ 722,759</b>

**Loans as of December 31, 2018**

	Real Estate Construction	Consumer Real Estate	Commercial Real Estate	Commercial Non Real Estate	Public Sector and IDA	Consumer Non Real Estate	Unallocated	Total
Individually evaluated for impairment	\$ ---	\$ 1,452	\$ 4,340	\$ 1,015	\$ ---	\$ 13	\$ ---	\$ 6,820
Collectively evaluated for impairment	37,845	174,004	349,206	45,520	60,777	36,225	---	703,577
<b>Total</b>	<b>\$ 37,845</b>	<b>\$ 175,456</b>	<b>\$ 353,546</b>	<b>\$ 46,535</b>	<b>\$ 60,777</b>	<b>\$ 36,238</b>	<b>\$ ---</b>	<b>\$ 710,397</b>

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

	As of and for the		
	Nine Months Ended September 30, 2019	2018	Year Ended December 31, 2018
Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees and costs	1.01%	1.10%	1.04%
Ratio of net charge-offs to average loans, net of unearned income and deferred fees and costs <sup>(1)</sup>	0.09%	0.06%	0.07%

(1) Net charge-offs are on an annualized basis.

A summary of nonperforming assets follows.

	September 30,		December 31,
	2019	2018	2018
Nonperforming assets:			
Nonaccrual loans	\$ 699	\$ 220	\$ 311
Restructured loans in nonaccrual	3,377	2,856	3,109
Total nonperforming loans	4,076	3,076	3,420
Other real estate owned, net	1,470	2,214	2,052
Total nonperforming assets	\$ 5,546	\$ 5,290	\$ 5,472
Ratio of nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned	0.77%	0.75%	0.77%
Ratio of allowance for loan losses to nonperforming loans <sup>(1)</sup>	178.16%	250.75%	216.08%

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

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

	September 30,		December 31,
	2019	2018	2018
Loans past due 90 days or more and still accruing	\$ 212	\$ 63	\$ 35
Ratio of loans past due 90 days or more and still accruing to loans, net of unearned income and deferred fees and costs	0.03%	0.01%	0.00%
Accruing restructured loans	\$ 1,880	\$ 7,843	\$ 2,552
Impaired loans:			
Impaired loans with no valuation allowance	\$ 5,163	\$ 10,530	\$ 5,667
Impaired loans with a valuation allowance	1,070	1,404	1,153
Total impaired loans	\$ 6,233	\$ 11,934	\$ 6,820
Valuation allowance	(120)	(156)	(139)
Impaired loans, net of allowance	\$ 6,113	\$ 11,778	\$ 6,681
Average recorded investment in impaired loans <sup>(1)</sup>	\$ 6,729	\$ 12,684	\$ 9,788
Interest income recognized on impaired loans, after designation as impaired	\$ 144	\$ 414	\$ 250
Amount of income recognized on a cash basis	\$ —	\$ —	\$ —

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

Nonaccrual loan relationships that meet the Company's balance threshold of \$250 and all TDRs are designated as impaired. The Company also designates as impaired other loan relationships that meet the Company's balance threshold of \$250 and for which the Company does not expect to collect according to the note's contractual terms. No interest income was recognized on nonaccrual loans for the nine months ended September 30, 2019 or September 30, 2018 or for the year ended December 31, 2018.

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

Impaired Loans as of September 30, 2019						
	Principal Balance	Total Recorded Investment <sup>(1)</sup>	Recorded Investment <sup>(1)</sup> for Which There is No Related Allowance	Recorded Investment <sup>(1)</sup> for Which There is a Related Allowance	Related Allowance	
<b>Consumer Real Estate<sup>(2)</sup></b>						
Equity lines	\$ 98	\$ 98	\$ 98	\$ —	\$ —	—
Residential closed-end first liens	749	737	737	—	—	—
Residential closed-end junior liens	132	132	—	132	3	3
Investor-owned residential real estate	441	431	431	—	—	—
<b>Commercial Real Estate<sup>(2)</sup></b>						
Multifamily	281	281	281	—	—	—
Commercial real estate, owner-occupied	1,185	1,160	1,160	—	—	—
Commercial real estate, other	2,867	2,451	2,451	—	—	—
<b>Commercial Non Real Estate<sup>(2)</sup></b>						
Commercial and industrial	938	938	—	938	117	117
<b>Consumer Non Real Estate<sup>(2)</sup></b>						
Automobile	5	5	5	—	—	—
<b>Total</b>	<b>\$ 6,696</b>	<b>\$ 6,233</b>	<b>\$ 5,163</b>	<b>\$ 1,070</b>	<b>\$ 120</b>	

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

(2) Only classes with impaired loans are shown.

Impaired Loans as of December 31, 2018						
	Principal Balance	Total Recorded Investment <sup>(1)</sup>	Recorded Investment <sup>(1)</sup> for Which There is No Related Allowance	Recorded Investment <sup>(1)</sup> for Which There is a Related Allowance	Related Allowance	
<b>Consumer Real Estate<sup>(2)</sup></b>						
Residential closed-end first liens	\$ 728	\$ 719	\$ 719	\$ —	\$ —	—
Residential closed-end junior liens	144	143	—	143	4	4
Investor-owned residential real estate	593	590	590	—	—	—
<b>Commercial Real Estate<sup>(2)</sup></b>						
Multifamily real estate	485	483	483	—	—	—
Commercial real estate, owner occupied	1,363	1,363	1,363	—	—	—
Commercial real estate, other	2,867	2,494	2,494	—	—	—
<b>Commercial Non Real Estate<sup>(2)</sup></b>						
Commercial and industrial	1,018	1,015	5	1,010	135	135
<b>Consumer Non Real Estate<sup>(2)</sup></b>						
Automobile	13	13	13	—	—	—
<b>Total</b>	<b>\$ 7,211</b>	<b>\$ 6,820</b>	<b>\$ 5,667</b>	<b>\$ 1,153</b>	<b>\$ 139</b>	

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

(2) Only classes with impaired loans are shown.

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

	For the Nine Months Ended September 30, 2019	
	Average Recorded Investment <sup>(1)</sup>	Interest Income Recognized
<b>Consumer Real Estate<sup>(2)</sup></b>		
Equity lines	\$ 97	\$ 5
Residential closed-end first liens	990	10
Residential closed-end junior liens	137	6
Investor-owned residential real estate	432	14
<b>Commercial Real Estate<sup>(2)</sup></b>		
Multifamily real estate	463	9
Commercial real estate, owner occupied	1,174	39
Commercial real estate, other	2,451	43
<b>Commercial Non Real Estate<sup>(2)</sup></b>		
Commercial and industrial	976	18
<b>Consumer Non Real Estate<sup>(2)</sup></b>		
Automobile	9	—
<b>Total</b>	<b>\$ 6,729</b>	<b>\$ 144</b>

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

(2) Only classes with impaired loans are shown.

	For the Nine Months Ended September 30, 2018	
	Average Recorded Investment <sup>(1)</sup>	Interest Income Recognized
<b>Real Estate Construction<sup>(2)</sup></b>		
Construction 1-4 family residential	\$ 2,697	\$ 108
<b>Consumer Real Estate<sup>(2)</sup></b>		
Residential closed-end first liens	891	40
Residential closed-end junior liens	162	7
Investor-owned residential real estate	661	18
<b>Commercial Real Estate<sup>(2)</sup></b>		
Multifamily real estate	298	12
Commercial real estate, owner occupied	3,934	145
Commercial real estate, other	2,829	55
<b>Commercial Non Real Estate<sup>(2)</sup></b>		
Commercial and industrial	1,188	28
<b>Consumer Non Real Estate</b>		
Automobile	24	1
<b>Total</b>	<b>\$ 12,684</b>	<b>\$ 414</b>

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

(2) Only classes with impaired loans are shown.

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	For the Year Ended December 31, 2018	
	Average Recorded Investment <sup>(1)</sup>	Interest Income Recognized
<b>Consumer Real Estate<sup>(2)</sup></b>		
Residential closed-end first liens	\$ 1,202	\$ 41
Residential closed-end junior liens	159	9
Investor-owned residential real estate	808	23
<b>Commercial Real Estate<sup>(2)</sup></b>		
Multifamily real estate	491	20
Commercial real estate, owner occupied	3,038	75
Commercial real estate, other	2,744	54
<b>Commercial Non Real Estate<sup>(2)</sup></b>		
Commercial and industrial	1,326	27
<b>Consumer Non Real Estate<sup>(2)</sup></b>		
Automobile	20	1
<b>Total</b>	<b>\$ 9,788</b>	<b>\$ 250</b>

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

(2) Only classes with impaired loans are shown.

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

An analysis of past due and nonaccrual loans follows.

**September 30, 2019**

	30 – 89 Days Past Due and Accruing	90 or More Days Past Due	90 or More Days Past Due and Accruing	Nonaccruals <sup>(2)</sup>
<b>Consumer Real Estate<sup>(1)</sup></b>				
Residential closed-end first liens	\$ 888	\$ 717	\$ 36	\$ 681
Residential closed-end junior liens	22	132	132	—
Investor-owned residential real estate	—	264	—	264
<b>Commercial Real Estate<sup>(1)</sup></b>				
Multifamily real estate	94	—	—	—
Commercial real estate, owner-occupied	243	293	—	531
Commercial real estate, other	—	—	—	2,451
<b>Commercial Non Real Estate<sup>(1)</sup></b>				
Commercial and industrial	211	144	—	144
<b>Consumer Non Real Estate<sup>(1)</sup></b>				
Credit cards	1	1	1	—
Automobile	185	40	40	—
Other consumer loans	91	3	3	5
<b>Total</b>	<b>\$ 1,735</b>	<b>\$ 1,594</b>	<b>\$ 212</b>	<b>\$ 4,076</b>

(1) Only classes with past-due or nonaccrual loans are shown.

(2) Includes current and past due loans in nonaccrual status. Includes impaired loans in nonaccrual status.

**December 31, 2018**

	30 – 89 Days Past Due and Accruing	90 or More Days Past Due	90 or More Days Past Due and Accruing	Nonaccruals <sup>(2)</sup>
<b>Consumer Real Estate<sup>(1)</sup></b>				
Residential closed-end first liens	\$ 647	\$ 119	\$ —	\$ 278
Residential closed-end junior liens	11	—	—	—
Investor-owned residential real estate	—	—	—	451
<b>Commercial Real Estate<sup>(1)</sup></b>				
Multifamily real estate	291	192	—	192
Commercial real estate, owner occupied	325	—	—	—
Commercial real estate, other	—	—	—	2,494
<b>Commercial Non Real Estate<sup>(1)</sup></b>				
Commercial and industrial	10	2	2	5
<b>Consumer Non Real Estate<sup>(1)</sup></b>				
Credit cards	5	—	—	—
Automobile	296	29	29	—
Other consumer loans	50	4	4	—
<b>Total</b>	<b>\$ 1,635</b>	<b>\$ 346</b>	<b>\$ 35</b>	<b>\$ 3,420</b>

(1) Only classes with past-due or nonaccrual loans are shown.

(2) Includes current and past due loans in nonaccrual status. Includes impaired loans in nonaccrual status.

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

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

Determination of risk grades was completed for the portfolio as of September 30, 2019 and December 31, 2018.

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

**September 30, 2019**

	Pass <sup>(1)</sup>	Special Mention <sup>(1)</sup>	Classified <sup>(1)</sup>
<b>Real Estate Construction</b>			
Construction, 1-4 family residential	\$ 7,408	\$ —	\$ —
Construction, other	35,564	—	—
<b>Consumer Real Estate</b>			
Equity lines	15,984	—	—
Closed-end first liens	93,553	—	587
Closed-end junior liens	3,976	—	—
Investor-owned residential real estate	63,593	—	23
<b>Commercial Real Estate</b>			
Multifamily residential real estate	97,522	—	—
Commercial real estate owner-occupied	127,008	—	30
Commercial real estate, other	132,041	—	—
<b>Commercial Non Real Estate</b>			
Commercial and industrial	44,719	62	147
<b>Public Sector and IDA</b>			
States and political subdivisions	59,731	—	—
<b>Consumer Non Real Estate</b>			
Credit cards	5,479	—	—
Automobile	15,648	—	46
Other consumer	13,391	—	14
<b>Total</b>	<b>\$ 715,617</b>	<b>\$ 62</b>	<b>\$ 847</b>

(1) Excludes impaired, if any.



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

December 31, 2018

	Pass <sup>(1)</sup>	Special Mention <sup>(1)</sup>	Classified <sup>(1)</sup>
<b>Real Estate Construction</b>			
Construction, 1-4 family residential	\$ 9,264	\$ ---	\$ ---
Construction, other	28,560	21	---
<b>Consumer Real Estate</b>			
Equity lines	16,026	38	---
Closed-end first liens	92,253	994	582
Closed-end junior liens	3,954	---	---
Investor-owned residential real estate	60,157	---	---
<b>Commercial Real Estate</b>			
Multifamily residential real estate	98,582	---	---
Commercial real estate owner-occupied	123,225	211	32
Commercial real estate, other	127,156	---	---
<b>Commercial Non Real Estate</b>			
Commercial and industrial	45,420	54	46
<b>Public Sector and IDA</b>			
States and political subdivisions	60,777	---	---
<b>Consumer Non Real Estate</b>			
Credit cards	5,724	---	---
Automobile	18,598	133	71
Other consumer	11,691	4	4
<b>Total</b>	<b>\$ 701,387</b>	<b>\$ 1,455</b>	<b>\$ 735</b>

(1) Excludes impaired, if any.

Sales, Purchases and Reclassification of Loans

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

**Troubled Debt Restructurings**

From time to time the Company modifies loans in troubled debt restructurings. Total troubled debt restructurings amounted to \$5,257 at September 30, 2019, \$5,661 at December 31, 2018, and \$10,700 at September 30, 2018.

The Company modified one loan in a troubled debt restructuring during the three and nine month periods ended September 30, 2019.

The following table presents restructuring by class that occurred during the three month period ended September 30, 2019.

	<b>Restructurings That Occurred During the Three Months Ended September 30, 2019</b>		
	<b>Number of Contracts</b>	<b>Pre-Modification Outstanding</b>	<b>Post-Modification Outstanding</b>
		<b>Principal Balance</b>	<b>Principal Balance</b>
<b>Residential Real Estate</b>			
Equity lines	1	\$ 98	\$ 98
<b>Total</b>	<b>1</b>	<b>\$ 98</b>	<b>\$ 98</b>

The restructuring completed during the three-month period ended September 30, 2019 provided relief to the borrower without forgiving principal or interest. The loan covenants require that the balance be paid in full for a period of 30 days each year. The Company allowed the borrower to maintain full funding for the past year, and extended the maturity date. The impairment measurement at September 30, 2019 was based upon the fair value of collateral and did not result in a specific allocation.

The following table presents restructurings by class that occurred during the three month period ended September 30, 2018.

	<b>Restructurings That Occurred During the Three Months Ended September 30, 2018</b>		
	<b>Number of Contracts</b>	<b>Pre-Modification Outstanding</b>	<b>Post-Modification Outstanding</b>
		<b>Principal Balance</b>	<b>Principal Balance</b>
<b>Residential Real Estate</b>			
Investor owned real estate	2	\$ 338	\$ 338
<b>Total</b>	<b>2</b>	<b>\$ 338</b>	<b>\$ 338</b>

The restructurings completed during the three-month period ended September 30, 2018 provided payment relief to the borrowers without forgiving principal or interest. One loan was restructured to provide for a 12-month interest-only period, after which the loan will be re-evaluated. The impairment measurement at September 30, 2018 was based on the fair value of collateral and did not result in a specific allocation. The second restructure consolidated debt at a longer term, provided a rate reduction for certain of the loans consolidated but increased the interest rate on certain other loans consolidated, and capitalized interest. The impairment measurement at September 30, 2018 was based upon the present value of cash flows and did not result in a specific allocation.

The following table presents restructurings by class that occurred during the nine month period ended September 30, 2019.

	<b>Restructurings That Occurred During the Nine Months Ended September 30, 2019</b>		
	<b>Number of Contracts</b>	<b>Pre-Modification Outstanding</b>	<b>Post-Modification Outstanding</b>
		<b>Principal Balance</b>	<b>Principal Balance</b>
<b>Residential Real Estate</b>			
Equity lines	1	\$ 98	\$ 98
<b>Total</b>	<b>1</b>	<b>\$ 98</b>	<b>\$ 98</b>

The restructuring completed during the nine-month period ended September 30, 2019 provided relief to the borrower without forgiving principal or interest. The loan covenants require that the balance be paid in full for a period of 30 days each year. The Company allowed the borrower to maintain full funding for the past year, and extended the maturity date. The impairment measurement at September 30, 2019 was based upon the fair value of collateral and did not result in a specific allocation.

The following table presents restructurings by class that occurred during the nine month period ended September 30, 2018.

	Restructurings That Occurred During the Nine Months Ended September 30, 2018		
	Number of Contracts	Pre-Modification Outstanding Principal Balance	Post-Modification Outstanding Principal Balance
<b>Real Estate Construction</b>			
Construction, other	2	\$ 2,882	\$ 2,882
<b>Residential Real Estate</b>			
Investor owned real estate	2	338	338
<b>Commercial Real Estate</b>			
Commercial real estate owner-occupied	2	715	715
<b>Total</b>	<b>6</b>	<b>\$ 3,935</b>	<b>\$ 3,935</b>

The Company restructured six loans during the nine month period ended September 30, 2018. Each of the construction loans were restructured to extend the maturity and interest only period. Impairment measurements at September 30, 2018 were based on the fair value of the collateral and did not result in a specific allocation.

One of the investor owned real estate loans was restructured to provide for a 12-month interest-only period. The impairment measurement at September 30, 2018 was based on the fair value of collateral and did not result in a specific allocation. The second investor owned residential real estate loan consolidated debt at a longer term, provided a rate reduction for certain of the loans consolidated but increased the interest rate on certain other loans consolidated, and capitalized interest. The impairment measurement at September 30, 2018 was based upon the present value of cash flows and did not result in a specific allocation.

Two commercial real estate loans were restructured to provide a 12-month interest-only period, after which the loans will be re-amortized for a longer term. The impairment measurements at September 30, 2018 were based upon the present value of cash flows and did not result in a specific allocation for either loan.

The Company analyzed its TDR portfolio for loans that defaulted during the three and nine month periods ended September 30, 2019 and September 30, 2018, and that were modified within 12 months prior to default. The Company defines default as one or more payments that occur more than 90 days past the due date, charge-offs, or foreclosure after the date of restructuring.

Of the Company's TDRs at September 30, 2019, seven consumer real estate loans within one relationship totaling \$263 defaulted within 12 months of modification. The impairment measurement is based upon the fair value of collateral, less estimated cost to sell, and resulted in no allocation. All of the defaulted loans are in nonaccrual status and the Company is working with the borrowers to recover its investment. One commercial real estate loan defaulted within 12 months of modification. The impairment measurement is based upon the fair value of collateral, less estimated cost to sell, and resulted in no allocation. Of the restructured loans that defaulted during the nine month period ended September 30, 2018, none were modified within 12 months prior to default.

**Note 4: Securities**

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

<b>September 30, 2019</b>				
	<b>Amortized Costs</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Values</b>
<b>Available for Sale:</b>				
U.S. Government agencies and corporations	\$ 162,855	\$ 2,636	\$ 428	\$ 165,063
States and political subdivisions	82,520	1,550	48	84,022
Mortgage-backed securities	81,141	91	298	80,934
Corporate debt securities	3,996	135	—	4,131
<b>Total securities available for sale</b>	<b>\$ 330,512</b>	<b>\$ 4,412</b>	<b>\$ 774</b>	<b>\$ 334,150</b>

  

<b>December 31, 2018</b>				
	<b>Amortized Costs</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Values</b>
<b>Available for Sale:</b>				
U.S. Government agencies and corporations	\$ 306,264	\$ 449	\$ 6,666	\$ 300,047
States and political subdivisions	118,564	1,218	1,166	118,616
Mortgage-backed securities	586	42	—	628
Corporate debt securities	6,014	—	295	5,719
<b>Total securities available for sale</b>	<b>\$ 431,428</b>	<b>\$ 1,709</b>	<b>\$ 8,127</b>	<b>\$ 425,010</b>

The amortized cost and fair value of single maturity securities available for sale at September 30, 2019, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity.

<b>September 30, 2019</b>			
	<b>Amortized Cost</b>	<b>Fair Value</b>	
<b>Available for Sale:</b>			
Due in one year or less	\$ 61,522	\$	61,525
Due after one year through five years	57,871		58,039
Due after five years through ten years	90,075		90,903
Due after ten years	121,044		123,683
<b>Total securities available for sale</b>	<b>\$ 330,512</b>	<b>\$</b>	<b>334,150</b>

Prior to the second quarter of 2018, the Company designated securities in its portfolio as either available for sale or held to maturity. During the second quarter of 2018, the Company re-designated all of its held to maturity securities to available for sale. The securities were re-designated to provide opportunities to maximize asset utilization. At the time of transfer, the securities had a fair value of \$119,790 and an amortized cost of \$118,662, resulting in an unrealized gain of \$1,128 which was added to accumulated other comprehensive income.

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

	September 30, 2019			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>Temporarily Impaired Securities:</b>				
U.S. Government agencies and corporations	\$ 27,231	\$ 211	\$ 71,778	\$ 217
States and political subdivisions	—	—	591	48
Mortgage-backed securities	49,823	298	—	—
<b>Total</b>	<b>\$ 77,054</b>	<b>\$ 509</b>	<b>\$ 72,369</b>	<b>\$ 265</b>

  

	December 31, 2018			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>Temporarily Impaired Securities:</b>				
U.S. Government agencies and corporations	\$ 17,730	\$ 216	\$ 259,992	\$ 6,450
States and political subdivisions	16,882	352	20,758	814
Corporate debt securities	4,842	194	876	101
<b>Total</b>	<b>\$ 39,454</b>	<b>\$ 762</b>	<b>\$ 281,626</b>	<b>\$ 7,365</b>

The Company had 111 securities with a fair value of \$149,423 that were temporarily impaired at September 30, 2019. The total unrealized loss on these securities was \$774. Of the temporarily impaired total, 73 securities with a fair value of \$72,369 and an unrealized loss of \$265 have been in a continuous loss position for twelve months or more. The Company has determined that these securities are temporarily impaired at September 30, 2019 for the reasons set out below.

U.S. Government agencies. The unrealized loss of \$217 on US Government agency securities stemmed from 72 securities with a fair value of \$71,778. The unrealized losses were caused by interest rate and market fluctuations. The contractual terms of the investments do not permit the issuers to settle the securities at a price less than the cost basis of the investments. The Company is monitoring bond market trends to develop strategies to address unrealized losses. Because the Company does not intend to sell the investments and it is not likely that the Company will be required to sell the investments before recovery of the amortized cost basis, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired.

States and political subdivisions. The unrealized loss of \$48 on state and political subdivision securities stemmed from 1 security with a fair value of \$591. The unrealized loss was caused by interest rate and market fluctuations. The Company is monitoring bond market trends to develop strategies to address unrealized losses. Because the Company does not intend to sell the investment and it is not likely that the Company will be required to sell the investment before recovery of the amortized cost basis, which may be at maturity, the Company does not consider the investment to be other-than-temporarily impaired.

Restricted stock. The Company held restricted stock of \$1,220 as of September 30, 2019 and December 31, 2018. Restricted stock is reported separately from available-for-sale securities. As a member of the Federal Reserve and the Federal Home Loan Bank (“FHLB”) of Atlanta, NBB is required to maintain certain minimum investments in the common stock of those entities. Required levels of investment are based upon NBB’s capital, current borrowings, and a percentage of qualifying assets. The Company purchases stock from or sells stock back to the correspondents based on their calculations. The stock is held by member institutions only and is not actively traded.

Redemption of FHLB stock is subject to certain limitations and conditions. At its discretion, the FHLB may declare dividends on the stock. In addition to dividends, NBB also benefits from its membership with FHLB through eligibility to borrow from the FHLB, using as collateral NBB’s capital stock investment in the FHLB and qualifying NBB real estate mortgage loans totaling \$526,568 at September 30, 2019. Management reviews for impairment based upon the ultimate recoverability of the cost basis of the FHLB stock, and at September 30, 2019, management did not determine any impairment.

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

**Note 5: Recent Accounting Pronouncements**

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. At the FASB’s October 16, 2019 meeting, the Board affirmed its decision to amend the effective date of this ASU for many companies. Public business entities that are SEC filers, excluding those meeting the smaller reporting company definition, will retain the initial required implementation date of fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. All other entities will be required to apply the guidance for fiscal years, and interim periods within those years, beginning after December 15, 2022. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements. The Company has formed a working group to address information requirements, determine methodology, research forecasts and ensure readiness and compliance with the standard. The Company has begun calculating and refining concurrent models using CECL methodology. The Company will continue to fine tune assumptions prior to the effective date.

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

In August 2018, the FASB issued ASU 2018-13, “Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement.” The amendments modify the disclosure requirements in Topic 820 to add disclosures regarding changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements and the narrative description of measurement uncertainty. Certain disclosure requirements in Topic 820 are also removed or modified. The amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Certain of the amendments are to be applied prospectively while others are to be applied retrospectively. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-13 to have a material impact on its consolidated financial statements.

In August 2018, the FASB issued ASU 2018-14, “Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715-20): Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans.” These amendments modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. Certain disclosure requirements have been deleted while the following disclosure requirements have been added: the weighted-average interest crediting rates for cash balance plans and other plans with promised interest crediting rates and an explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period. The amendments also clarify the disclosure requirements in paragraph 715-20-50-3, which state that the following information for defined benefit pension plans should be disclosed: The projected benefit obligation (PBO) and fair value of plan assets for plans with PBOs in excess of plan assets and the accumulated benefit obligation (ABO) and fair value of plan assets for plans with ABOs in excess of plan assets. The amendments are effective for fiscal years ending after December 15, 2020. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-14 to have a material impact on its consolidated financial statements.

In April 2019, the FASB issued ASU 2019-04, “Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments.” This ASU clarifies and improves areas of guidance related to the recently issued standards on credit losses, hedging, and recognition and measurement including improvements resulting from various TRG Meetings. The amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently assessing the impact that ASU 2019-04 will have on its consolidated financial statements.

In May 2019, the FASB issued ASU 2019-05, “Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief.” The amendments in this ASU provide entities that have certain instruments within the scope of Subtopic 326-20 with an option to irrevocably elect the fair value option in Subtopic 825-10, applied on an instrument-by-instrument basis for eligible instruments, upon the adoption of Topic 326. The fair value option election does not apply to held-to-maturity debt securities. An entity that elects the fair value option should subsequently measure those instruments at fair value with changes in fair value flowing through earnings. The amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. The amendments should be applied on a modified-retrospective basis by means of a cumulative-effect adjustment to the opening balance of retained earnings balance in the balance sheet. Early adoption is permitted. The Company is currently assessing the impact that ASU 2019-05 will have on its consolidated financial statements.

**Note 6: Defined Benefit Plan**Components of Net Periodic Benefit Cost

	Pension Benefits	
	Nine Months Ended September 30,	
	2019	2018
Service cost	\$ 600	\$ 651
Interest cost	663	600
Expected return on plan assets	(1,095)	(1,200)
Amortization of prior service cost	(81)	(81)
Recognized net actuarial loss	474	438
Net periodic benefit cost	\$ 561	\$ 408

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

2019 Plan Year Employer Contribution

For the nine months ended September 30, 2019, the Company did not make a contribution to the Plan.

**Note 7: Fair Value Measurements**

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. U.S. GAAP requires that valuation techniques maximize the use of the observable inputs and minimize the use of the unobservable inputs. U.S. GAAP also establishes a fair value hierarchy which prioritizes the valuation inputs into three broad levels. Based on the underlying inputs, each fair value measurement in its entirety is reported in one of the three levels. These levels are:

- Level 1 – Valuation is based on quoted prices in active markets for identical assets and liabilities.
- Level 2 – Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.
- Level 3 – Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Accounting guidance for fair value excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Consequently, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company. The following describes the valuation techniques used by the Company to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the financial statements:

Securities Available for Sale

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). The carrying value of restricted Federal Reserve Bank and Federal Home Loan Bank stock approximates fair value based upon the redemption provisions of each entity and is therefore excluded from the following table.

The following tables present the balances of financial assets measured at fair value on a recurring basis as of September 30, 2019 and December 31, 2018.

Description	Balance as of September 30, 2019	Fair Value Measurements at September 30, 2019 Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Government agencies and corporations	\$ 165,063	\$ —	\$ 165,063	\$ —
States and political subdivisions	84,022	—	84,022	—
Mortgage-backed securities	80,934	—	80,934	—
Corporate debt securities	4,131	—	4,131	—
Total securities available for sale	\$ 334,150	\$ —	\$ 334,150	\$ —

Description	Balance as of December 31, 2018	Fair Value Measurements at December 31, 2018 Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Government agencies and corporations	\$ 300,047	\$ —	\$ 300,047	\$ —
States and political subdivisions	118,616	—	118,616	—
Mortgage-backed securities	628	—	628	—
Corporate debt securities	5,719	—	5,719	—
Total securities available for sale	\$ 425,010	\$ —	\$ 425,010	\$ —

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

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

#### Loans Held for Sale

Loans held for sale are carried at the lower of cost or fair value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale at September 30, 2019 or December 31, 2018.

#### Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due will not be collected according to the contractual terms of the loan agreement. Troubled debt restructurings are impaired loans. Impaired loans are measured at fair value on a nonrecurring basis. If an individually-evaluated impaired loan's balance exceeds fair value, the amount is allocated to the allowance for loan losses. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

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

Loans measured using the fair value of collateral method may be categorized in Level 2 or Level 3. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. Most collateral is real estate. The Company bases collateral method fair valuation upon the "as-is" value of independent appraisals or evaluations. Valuations for impaired loans 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.



The value of real estate collateral is determined by a current (less than 24 months of age) appraisal or internal evaluation utilizing an income or market valuation approach. Appraisals conducted by an independent, licensed appraiser outside of the Company using observable market data is categorized as Level 2. If a current appraisal cannot be obtained prior to a reporting date and an existing appraisal is discounted to obtain an estimated value, or if declines in value are identified after the date of the appraisal, or if an appraisal is discounted for estimated selling costs, the valuation of real estate collateral is categorized as Level 3. Valuations derived from internal evaluations are categorized as Level 3. The value of business equipment is based upon an outside appraisal (Level 2) if deemed significant, or the net book value on the applicable business' financial statements (Level 3) if not considered significant. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3).

The following table summarizes the Company's impaired loans that were measured at fair value on a nonrecurring basis at September 30, 2019 and at December 31, 2018.

Date	Description	Balance	Carrying Value		
			Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Assets:				
September 30, 2019	Impaired loans net of valuation allowance	\$ 950	\$ —	\$ —	\$ 950
December 31, 2018	Impaired loans net of valuation allowance	1,014	---	---	1,014

The following tables present information about Level 3 Fair Value Measurements for September 30, 2019 and December 31, 2018.

Impaired Loans	Valuation Technique	Unobservable Input	Range (Weighted Average)
September 30, 2019	Present value of cash flows	Discount rate	5.50% – 7.25% (5.82%)
December 31, 2018	Present value of cash flows	Discount rate	5.50% – 7.25% (6.05%)

#### Other Real Estate Owned

Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. Valuation of other real estate owned is determined using current appraisals from independent parties, a Level 2 input. If current appraisals cannot be obtained prior to reporting dates, or if declines in value are identified after a recent appraisal is received, appraisal values are discounted, resulting in Level 3 estimates. If the Company markets the property with a realtor, estimated selling costs reduce the fair value, resulting in a valuation based on Level 3 inputs.

The following table summarizes the Company's other real estate owned that was measured at fair value on a nonrecurring basis as of September 30, 2019 and December 31, 2018.

Date	Description	Balance	Carrying Value		
			Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Assets:				
September 30, 2019	Other real estate owned net of valuation allowance	\$ 1,470	\$ —	\$ —	\$ 1,470
December 31, 2018	Other real estate owned net of valuation allowance	2,052	---	---	2,052

The following tables present information about Level 3 Fair Value Measurements for September 30, 2019 and December 31, 2018.

September 30, 2019	Valuation Technique	Unobservable Input	Range (Weighted Average)
Other real estate owned	Discounted appraised value	Selling cost	0.00% <sup>(1)</sup> – 6.00% (0.06%)
Other real estate owned	Discounted appraised value	Discount for lack of marketability and age of appraisal	0.00% – 48.28%(1.05%)

December 31, 2018	Valuation Technique	Unobservable Input	Range (Weighted Average)
Other real estate owned	Discounted appraised value	Selling cost	0.00% <sup>(1)</sup> – 6.00% (0.12%)
Other real estate owned	Discounted appraised value	Discount for lack of marketability and age of appraisal	0.00% – 50.05% (1.45%)

- (1) The Company markets other real estate owned both independently and with local realtors. Properties marketed by realtors are discounted by selling costs. Properties that the Company markets independently are not discounted by selling costs.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company's financial instruments as of September 30, 2019 and December 31, 2018. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For non-marketable equity securities such as Federal Home Loan Bank and Federal Reserve Bank stock, the carrying amount is a reasonable estimate of fair value as these securities can only be redeemed or sold at their par value and only to the respective issuing government-supported institution or to another member institution. For financial liabilities such as noninterest-bearing demand, interest-bearing demand, and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity. Fair values are estimated using the exit price notion.

	September 30, 2019			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
<b>Financial Assets:</b>				
Cash and due from banks	\$ 14,206	\$ 14,206	\$ —	\$ —
Interest-bearing deposits	135,490	135,490	—	—
Securities	334,150	—	334,150	—
Restricted securities	1,220	—	1,220	—
Loans held for sale	2,333	—	2,333	—
Loans, net	715,025	—	—	703,281
Accrued interest receivable	4,233	—	4,233	—
Bank-owned life insurance	35,338	—	35,338	—
<b>Financial Liabilities:</b>				
Deposits	\$ 1,068,027	\$ —	\$ 943,441	\$ 124,567
Accrued interest payable	133	—	133	—

	December 31, 2018			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
<b>Financial Assets:</b>				
Cash and due from banks	\$ 12,882	\$ 12,882	\$ ---	\$ ---
Interest-bearing deposits	43,491	43,491	---	---
Securities	425,010	---	425,010	---
Restricted securities	1,220	---	1,220	---
Loans held for sale	72	---	72	---
Loans, net	702,409	---	---	684,565
Accrued interest receivable	5,160	---	5,160	---
Bank-owned life insurance	34,657	---	34,657	---
<b>Financial Liabilities:</b>				
Deposits	\$ 1,051,942	\$ ---	\$ 950,143	\$ 101,749
Accrued interest payable	89	---	89	---

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

	Net Unrealized Gain (Loss) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Loss
<b>Balance at December 31, 2017</b>	\$ (3,704)	\$ (5,991)	\$ (9,695)
Unrealized holding loss on available for sale securities, net of tax of (\$1,378)	(5,182)	---	(5,182)
Unrealized holding gain on securities transferred from held to maturity to available for sale, net of tax of \$237	891	---	891
<b>Balance at September 30, 2018</b>	\$ (7,995)	\$ (5,991)	\$ (13,986)
<b>Balance at December 31, 2018</b>	\$ (5,072)	\$ (7,013)	\$ (12,085)
Unrealized holding gain on available for sale securities net of tax of \$2,149	8,089	---	8,089
Reclassification adjustment, net of tax of (\$38)	(144)	---	(144)
<b>Balance at September 30, 2019</b>	<b>\$ 2,873</b>	<b>\$ (7,013)</b>	<b>\$ (4,140)</b>

**Note 9: Revenue Recognition**

The Company recognizes revenue from contracts with customers. Noninterest revenue streams such as service charges on deposit accounts, other service charges and fees, credit and debit card fees, trust income, and annuity and insurance commissions is recognized in accordance with ASC Topic 606. Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as financial guarantees, derivatives, and certain credit card fees are outside the scope of the guidance. Noninterest revenue streams within the scope of Topic 606 are discussed below.

*Service Charges on Deposit Accounts*

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

*Other Service Charges and Fees*

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

*Credit and Debit Card Fees*

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

*Trust Income*

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

*Insurance and Investment*

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

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

The following presents noninterest income, segregated by revenue streams in-scope and out-of-scope of Topic 606, for the three and nine months ended September 30, 2019 and 2018.

	<b>Three Months Ended September 30,</b>	
	<b>2019</b>	<b>2018</b>
<b>Noninterest Income</b>		
<i>In-scope of Topic 606:</i>		
Service charges on deposit accounts	\$ 643	\$ 673
Other service charges and fees	46	20
Credit and debit card fees	350	362
Trust income	440	355
Insurance and Investment (included within Other Income on the Consolidated Statements of Income)	97	160
Noninterest Income (in-scope of Topic 606)	\$ 1,576	\$ 1,570
Noninterest Income (out-of-scope of Topic 606)	522	344
Total noninterest income	\$ 2,098	\$ 1,914

	Nine Months Ended September 30,	
	2019	2018
<b>Noninterest Income</b>		
<i>In-scope of Topic 606:</i>		
Service charges on deposit accounts	\$ 1,840	\$ 2,037
Other service charges and fees	149	87
Credit and debit card fees	1,015	1,071
Trust income	1,208	1,131
Insurance and Investment (included within Other Income on the Consolidated Statements of Income)	360	361
Noninterest Income (in-scope of Topic 606)	\$ 4,572	\$ 4,687
Noninterest Income (out-of-scope of Topic 606)	1,871	1,118
Total noninterest income	\$ 6,443	\$ 5,805

**Note 10: Leases**

On January 1, 2019, the Company adopted ASU No. 2016-02 "Leases (Topic 842)" and all subsequent ASUs that modified Topic 842. The Company elected the prospective application approach provided by ASU 2018-11 and did not adjust prior periods for ASC 842. There was no cumulative effect adjustment at adoption. The Company also elected certain practical expedients within the standard and did not reassess whether any expired or existing contracts are or contain leases, did not reassess the lease classification for any expired or existing leases and did not reassess any initial direct costs for existing leases. Prior to adoption, all of the Company's leases were classified as operating leases and remain operating leases at adoption. As stated in to the Company's 2018 Form 10-K, Note 1 Summary of Significant Accounting Policies, the implementation of the new standard resulted in recognition of a right-of-use asset and offsetting lease liability of \$684 for leases existing at the date of adoption.

Contracts that commence subsequent to adoption are evaluated to determine whether they are or contain a lease in accordance with Topic 842. The Company has elected the practical expedient provided by Topic 842 not to allocate consideration in a contract between lease and non-lease components. The Company also elected, as provided by the standard, not to recognize right-of-use assets and lease liabilities for short-term leases, defined by the standard as leases with terms of 12 months or less. Since adoption, the Company entered into new operating leases and recognized right-of-use assets and lease liabilities.

Lease liabilities represent the Company's obligation to make lease payments and are presented at each reporting date as the net present value of the remaining contractual cash flows. Cash flows are discounted at the Company's incremental borrowing rate in effect at the commencement date of the lease. Right-of-use assets represent the Company's right to use the underlying asset for the lease term and are calculated as the sum of the lease liability and if applicable, prepaid rent, initial direct costs and any incentives received from the lessor.

*Lease payments*

Lease payments for short-term leases are recognized as lease expense on a straight-line basis over the lease term, or for variable lease payments, in the period in which the obligation was incurred. Payments for leases with terms longer than twelve months are included in the determination of the lease liability. Payments may be fixed for the term of the lease or variable. If the lease agreement provides a known escalator, such as a specified percentage increase per year or a stated increase at a specified time, the variable payment is included in the cash flows used to determine the lease liability. If the variable payment is based upon an unknown escalator, such as the consumer price index at a future date, the increase is not included in the cash flows used to determine the lease liability. Two of the Company's leases provide known escalators that are included in the determination of the lease liability. The remaining leases do not have variable payments during the term of the lease.

*Options to Extend, Residual Value Guarantees, and Restrictions and Covenants*

Of the Company's five leases, three leases offer the option to extend the lease term. Each of the three leases provides two options of five years each. For one of the leases, the Company is reasonably certain it will exercise one option of five years and has included the additional time and lease payments in the calculation of the lease liability. The lease agreement provides that the lease payment will increase at the exercise date based on the consumer price index-urban ("CPI-U"). Because the CPI-U at the exercise date is unknown, the increase is not included in the cash flows determining the lease liability. None of the Company's leases provide for residual value guarantees and none provide restrictions or covenants that would impact dividends or require incurring additional financial obligations.

The following tables present information about leases:

	September 30, 2019	
Lease liability	\$	2,358
Right-of-use asset	\$	2,351
Weighted average remaining lease term (years)		7.11
Weighted average discount rate		3.02%

	For the Nine Months Ended September 30,			
	2019		2018	
<b>Lease Expense</b>				
Operating lease expense	\$	218	\$	NR
Short-term lease expense		101		NR
Total lease expense	\$	319	\$	223
Cash paid for amounts included in lease liabilities	\$	211	\$	NR
Right-of-use assets obtained in exchange for operating lease liabilities commencing during the period	\$	1,837	\$	NR

The following table presents a maturity schedule of undiscounted cash flows that contribute to the lease liability:

	As of September 30, 2019	
<b>Undiscounted Cash Flow for the</b>		
Three months ending December 31, 2019	\$	89
Twelve months ending December 31, 2020		354
Twelve months ending December 31, 2021		345
Twelve months ending December 31, 2022		349
Twelve months ending December 31, 2023		351
Twelve months ending December 31, 2024		333
Thereafter		848
Total undiscounted cash flows	\$	2,669
Less: discount		(311)
Lease liability	\$	2,358

The contracts in which the Company is lessee are with parties external to the company and not related parties. The Company has a small lease relationship with a director in which the Company is lessor.

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

Dollars in thousands, except per share data

The purpose of this discussion and analysis is to provide information about the financial condition and results of operations of National Bankshares, Inc. and its wholly-owned subsidiaries (the "Company"), which are not otherwise apparent from the consolidated financial statements and other information included in this report. Please refer to the financial statements and other information included in this report as well as the 2018 Annual Report on Form 10-K for an understanding of the following discussion and analysis.

### **Cautionary Statement Regarding Forward-Looking Statements**

We make forward-looking statements in this Form 10-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 financial reform legislation,
- unanticipated increases in the level of unemployment in the Company's trade area,
- the quality or composition of the loan and/or investment portfolios,
- demand for loan products,
- deposit flows,
- competition,
- demand for financial services in the Company's trade area,
- the real estate market in the Company's trade area,
- the Company's technology initiatives, and
- applicable accounting principles, policies and guidelines.

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

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

### **Cybersecurity**

As a financial institution holding company, NBI is subject to cybersecurity risks and has suffered two cybersecurity incidents. To manage and mitigate cybersecurity risk, the Company limits certain transactions and interactions with customers. The Company does not offer online account openings or loan originations, limits the dollar amount of online banking transfers to other banks, does not permit customers to submit address changes or wire requests through online banking, requires a special vetting process for commercial customers who wish to originate ACH transfers, and limits certain functionalities of mobile banking. The Company also requires assurances from key vendors regarding their cybersecurity. While these measures reduce the likelihood and scope of the risk of 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. For information on incidents experienced by the Company, please refer to the section entitled "Cybersecurity Risks and Incidents."

**Non-GAAP Financial Measures**

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

*Net Interest Margin*

The net interest margin is calculated by dividing annualized 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 is 21%. 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	Three Months Ended September 30,	
	2019	2018
GAAP measures:		
Interest and fees on loans	\$ 8,548	\$ 8,005
Interest on interest-bearing deposits	407	111
Interest and dividends on securities - taxable	1,565	1,771
Interest on securities - nontaxable	768	1,058
Total interest income	\$ 11,288	\$ 10,945
Interest on deposits	\$ 1,865	\$ 1,141
Interest on borrowings	—	104
Total interest expense	\$ 1,865	\$ 1,245
Net interest income	\$ 9,423	\$ 9,700
Non-GAAP measures:		
Tax benefit on nontaxable loan income	\$ 116	\$ 110
Tax benefit on nontaxable securities income	209	286
Total tax benefit on nontaxable interest income	\$ 325	\$ 396
Total tax-equivalent net interest income	\$ 9,748	\$ 10,096
Total tax-equivalent net interest income, annualized	\$ 38,674	\$ 40,055
Average interest-earning assets	\$ 1,171,425	\$ 1,186,219
Net interest margin	3.30%	3.38%



\$ in thousands	Nine Months Ended September 30,	
	2019	2018
GAAP measures:		
Interest and fees on loans	\$ 25,277	\$ 23,159
Interest on interest-bearing deposits	1,048	509
Interest and dividends on securities - taxable	4,851	5,125
Interest on securities - nontaxable	2,543	3,362
Total interest income	\$ 33,719	\$ 32,155
Interest on deposits	\$ 5,572	\$ 3,367
Interest on borrowings	—	104
Total interest expense	\$ 5,572	\$ 3,471
Net interest income	\$ 28,147	\$ 28,684
Non-GAAP measures:		
Tax benefit on nontaxable loan income	\$ 348	\$ 293
Tax benefit on nontaxable securities income	691	909
Total tax benefit on nontaxable interest income	\$ 1,039	\$ 1,202
Total tax-equivalent net interest income	\$ 29,186	\$ 29,886
Total tax-equivalent net interest income, annualized	\$ 39,022	\$ 39,957
Average interest-earning assets	\$ 1,177,688	\$ 1,186,623
Net interest margin	3.31%	3.37%

#### Noninterest Margin

The noninterest margin is calculated by dividing noninterest expense (excluding the write-down of insurance receivable) less noninterest income (excluding recovery of insurance receivable and realized securities gain/loss, net), annualized, 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	Three Months Ended September 30,	
	2019	2018
Noninterest expense under GAAP	\$ 6,386	\$ 6,463
Noninterest income under GAAP	\$ 2,098	\$ 1,914
Less: realized securities gains, net	(162)	—
Noninterest income for ratio calculation, non-GAAP	\$ 1,936	\$ 1,914
Net noninterest expense, non-GAAP	\$ 4,450	\$ 4,549
Net noninterest expense, non-GAAP, annualized	17,655	18,048
Average assets	\$ 1,250,473	\$ 1,254,055
Noninterest margin	1.41%	1.44%

\$ in thousands	Nine Months Ended September 30,	
	2019	2018
Noninterest expense under GAAP	\$ 19,304	\$ 21,051
Less: write-down of insurance receivable	—	(2,010)
Noninterest expense for ratio calculation, non-GAAP	\$ 19,304	\$ 19,041
Noninterest income under GAAP	\$ 6,443	\$ 5,805
Less: recovery of insurance receivable	(538)	—
Less: realized securities gains, net	(182)	—
Noninterest income for ratio calculation, non-GAAP	\$ 5,723	\$ 5,805
Net noninterest expense, non-GAAP	\$ 13,581	\$ 13,236
Net noninterest expense, non-GAAP, annualized	18,158	17,696
Average assets	\$ 1,253,245	\$ 1,254,684
Noninterest margin	1.45%	1.41%

#### Annualized Net Income

The return on average assets and return on average equity are calculated by annualizing net income and dividing by average year-to-date assets or equity, respectively. When net income includes larger nonrecurring items, the annualization magnifies their effect. In order to reduce distortion within the ratios, the company adjusts net income for larger non-recurring items prior to annualization, and then nets the items against the annualized net income. The reconciliation of adjusted annualized net income, which is not a measurement under GAAP, is reflected in the table below.

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

	Three Months Ended September 30,	
	2019	2018
Net Income	\$ 4,252	\$ 4,251
Net income, annualized	16,869	16,865

  

	Nine Months Ended September 30,	
	2019	2018
Net Income	\$ 12,689	\$ 11,588
Items deemed non-recurring by management:		
Insurance write-down in 2018, net of tax of \$422	—	1,588
Insurance recovery in 2019, net of tax of \$113	(425)	—
Adjusted net income	12,264	13,176
Adjusted net income, annualized	16,397	17,616
Items deemed non-recurring by management:		
Insurance write-down in 2018, net of tax of \$422	—	(1,588)
Insurance recovery in 2019, net of tax of \$113	425	—
Annualized net income for ratio calculation	\$ 16,822	\$ 16,028

## **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 September 30, 2019 considered market and portfolio conditions during the first nine months of 2019 as well as the levels of delinquencies and net charge-offs in the eight quarters prior to the quarter ended September 30, 2019. If the economy experiences a downturn, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see Note 3 to the consolidated financial statements and “Asset Quality,” and “Provision and Allowance for Loan Losses.”

#### **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. (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. 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.

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

## **Lending**

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

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

*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 was 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.

**Performance Summary**

The following table presents the Company's key performance ratios for the three months ended September 30, 2019 and September 30, 2018. The measures for September 30, 2019 and September 30, 2018 are annualized, except for basic earnings per share and fully diluted earnings per share.

	Three Months Ended September 30,	
	2019	2018
Return on average assets <sup>(1)</sup>	1.35%	1.34%
Return on average equity <sup>(1) (4)</sup>	9.20%	8.97%
Basic earnings per share <sup>(4)</sup>	\$ 0.65	\$ 0.61
Fully diluted earnings per share	\$ 0.65	\$ 0.61
Net interest margin <sup>(2)</sup>	3.30%	3.38%
Noninterest margin <sup>(3)</sup>	1.41%	1.44%

- (1) Return on average assets and return on average equity are non-GAAP measures. Components of GAAP net income that are deemed non-recurring by management are removed prior to annualizing the adjusted net income. The adjusted net income is annualized. Items deemed non-recurring by management are added back to the annualized adjusted net income, and the total is divided by average assets for return on average assets, or divided by average equity for return on average equity. Please refer to the section entitled "Non-GAAP Financial Measures".
- (2) Net interest margin: Period-to-date tax-equivalent net interest income divided by period-to-date average earning assets.
- (3) Noninterest margin: Noninterest expense (excluding non-recurring items, the provision for loan losses and income taxes) less noninterest income (excluding nonrecurring items and securities gains and losses) divided by average period-to-date assets.
- (4) During March 2019, The Company repurchased 452,400 shares under its publicly announced stock repurchase plan. The repurchase reduced shareholders equity by \$17,997. During August 2019, The Company repurchased 16,000 shares under its publicly announced stock repurchase plan. The repurchase reduced shareholders equity by \$528.

The annualized return on average assets increased 1 basis point when the three months ended September 30, 2019 are compared with the three months ended September 30, 2018. The annualized return on average equity increased 23 basis points when the three months ended September 30, 2019 are compared with the three months ended September 30, 2018. The increase in return on average equity was in part due to stock repurchases of 452,400 shares during the first quarter of 2019 and 16,000 shares during the third quarter of 2019. Combined, the repurchases decreased shareholder's equity by \$18,525.

The annualized net interest margin was 3.30% for the three months ended September 30, 2019, down 8 basis points from the 3.38% reported for the three months ended September 30, 2018. The primary factor driving the decrease in the net interest margin was the increase in interest expense for interest-bearing liabilities. Please refer to the discussion under Net Interest Income for further information.

The annualized noninterest margin improved by 3 basis points when the three month period ended September 30, 2019 is compared with the three month period ended September 30, 2018. Please refer to the discussions under noninterest income and noninterest expense for further information.

The following table presents the Company's key performance ratios for the nine months ended September 30, 2019 and September 30, 2018 and the year ended December 31, 2018. The measures for September 30, 2019 and September 30, 2018 are annualized, except for basic earnings per share and fully diluted earnings per share.

	Nine Months Ended September 30, 2019	Nine Months Ended September 30, 2018	Twelve Months Ended December 31, 2018
Return on average assets <sup>(1)</sup>	1.34%	1.28%	1.29%
Return on average equity <sup>(1) (4)</sup>	9.13%	8.61%	8.65%
Basic earnings per share <sup>(4)</sup>	\$ 1.92	\$ 1.67	\$ 2.32
Fully diluted earnings per share	\$ 1.92	\$ 1.67	\$ 2.32
Net interest margin <sup>(2)</sup>	3.31%	3.37%	3.36%
Noninterest margin <sup>(3)</sup>	1.45%	1.41%	1.40%

- (1) Return on average assets and return on average equity are non-GAAP measures. Components of GAAP net income that are deemed non-recurring by management are removed prior to annualizing the adjusted net income. The adjusted net income is annualized. Items deemed non-recurring by management are added back to the annualized adjusted net income, and the total is divided by average assets for return on average assets, or divided by average equity for return on average equity. Please refer to the section entitled "Non-GAAP Financial Measures".
- (2) Net interest margin: Year-to-date tax-equivalent net interest income divided by year-to-date average earning assets.
- (3) Noninterest margin: Noninterest expense (excluding non-recurring items, the provision for loan losses and income taxes) less noninterest income (excluding nonrecurring items and securities gains and losses) divided by average year-to-date assets.
- (4) During March 2019, The Company repurchased 452,400 shares under its publicly announced stock repurchase plan. The repurchase reduced shareholders equity by \$17,997. During August 2019, the Company repurchased 16,000 shares under the same repurchase plan. The repurchase reduced shareholders equity by \$528.

The annualized return on average assets increased 6 basis points for the nine months ended September 30, 2019 compared with the nine months ended September 30, 2018. The annualized return on average equity increased 52 basis points for the nine months ended September 30, 2019 compared with the nine months ended September 30, 2018.

The annualized net interest margin was 3.31% for the nine months ended September 30, 2019, down 6 basis points from the 3.37% reported for the nine months ended September 30, 2018. The primary factor driving the decrease in the net interest margin was the increase in interest expense for interest-bearing liabilities. Please refer to the discussion under Net Interest Income for further information.

The annualized noninterest margin for the nine months ended September 30, 2019 improved by 4 basis points when compared with the nine month period ended September 30, 2018. Please refer to the discussions under noninterest income and noninterest expense for further information.

## **Growth**

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

	September 30, 2019	December 31, 2018	Percent Change
Interest-bearing deposits	\$ 135,490	\$ 43,491	211.54%
Securities and restricted stock	335,370	426,230	(21.32)%
Loans, net	715,025	702,409	1.80%
Deposits	1,068,027	1,051,942	1.53%
Total assets	1,272,721	1,256,032	1.33%



**Asset Quality**

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

	September 30, 2019	September 30, 2018	December 31, 2018
Nonperforming loans	\$ 4,076	\$ 3,076	\$ 3,420
Loans past due 90 days or more, and still accruing	212	63	35
Other real estate owned	1,470	2,214	2,052
Allowance for loan losses to loans	1.01%	1.10%	1.04%
Net charge-off ratio	0.09%	0.06%	0.07%
Ratio of nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned	0.77%	0.75%	0.77%
Ratio of allowance for loan losses to nonperforming loans	178.16%	250.75%	216.08%

The Company's risk analysis at September 30, 2019 determined an allowance for loan losses of \$7,262 or 1.01% of loans net of unearned income and deferred fees and costs, a decrease from \$7,390 or 1.04% at December 31, 2018. The determination of the appropriate level for the allowance for loan losses resulted in a provision of \$350 for the nine months ended September 30, 2019, compared with a provision for the nine month period ended September 30, 2018 of \$93. 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 \$6,233 on a gross basis and \$6,234 net of unearned income and deferred fees and costs, with specific allocations to the allowance for loan losses totaling \$120 at September 30, 2019. Individually evaluated impaired loans at December 31, 2018 were \$6,820 on a gross basis as well as net of unearned income and deferred fees and costs, with specific allocations to the allowance for loan losses of \$139. The specific allocation is determined based on criteria particular to each impaired loan.

Collectively evaluated loans totaled \$716,526 on a gross basis and \$716,053 net of unearned income and deferred fees and costs, with an allowance of \$7,142 or 1.00% at September 30, 2019. At December 31, 2018, 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%.

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 nine months ended September 30, 2019 were \$478 or 0.09% (annualized) of average loans, an increase from \$305 or 0.06% (annualized) for the nine months ended September 30, 2018. Net charge-offs for the year ended December 31, 2018 were \$454 or 0.07% of average loans. The 8-quarter average historical loss rate applied to the calculation was 0.06% for September 30, 2019, 0.07% for December 31, 2018 and 0.10% for September 30, 2018. 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 number of business and personal bankruptcies, the inventory of new and existing homes and the unemployment rate increased from levels at December 31, 2018, indicating increased credit risk and resulting in increased allocation. The competitive, legal and regulatory environments and residential vacancy rates remained at similar levels to December 31, 2018, and the allocation remained at the level at December 31, 2018. Interest rates decreased during the third quarter. The Company assessed this as a positive indicator for credit risk, and reduced the risk allocation for the decrease as well as prior rate increases that have been absorbed in the portfolio.

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. The legal and regulatory environment, lending policies, and management’s experience remained at similar levels to December 31, 2018. Slight changes to the loan review system to align with regulatory guidance resulted in a slight increase in the allocation.

Asset quality indicators affect the level of the allowance for loan losses. Accruing loans past due 30-89 days were 0.24% of total loans, net of unearned income and deferred fees and costs at September 30, 2019, a slight increase from 0.23% at December 31, 2018. Accruing loans past due 90 days or more were 0.03% of total loans, net of unearned income and deferred fees and costs at September 30, 2019, and 0.00% at December 31, 2018. Nonaccrual loans at September 30, 2019 were 0.56% of total loans, net of unearned income and deferred fees and costs, an increase from 0.48% at December 31, 2018. Levels of past due and nonaccrual loans are analyzed on a class-basis. Decreases in past due and nonaccrual loans within a class reduce the required level of the allowance for loan losses, while increases in past due and nonaccrual loans within a class increase the required level of the allowance for loan losses.

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 decreased \$21,908 or 13.94% from the level at December 31, 2018, resulting in a decreased 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 \$62 at September 30, 2019 and \$1,455 at December 31, 2018. The decline in loans rated “special mention” was in large part due to a change in the loan review system to align with regulatory guidance. As a result the “special mention” rating is no longer applied to consumer loans. The risk in the portfolio has not changed, but consumer loans will no longer impact the analysis of special mention loans in the allowance. In order to account for the change in the way that special mention loans impact the allowance calculation, the allocation for changes in loan review was increased. Collectively evaluated loans rated classified were \$847 at September 30, 2019 and \$735 at December 31, 2018.

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 September 30, 2019 is 1.01%, a decrease from 1.04% at December 31, 2018. The ratio of the allowance for collectively-evaluated loan losses to collectively-evaluated loans, net of unearned income and deferred fees and costs was 1.00%, compared with 1.03% at December 31, 2018. Improvements from December 31, 2018 in loans rated special mention, classified, and considered high risk, as well as a reduced allocation for the interest rate environment, decreased the required level of the allowance for loan losses. Other indicators slightly offset the improvements, including a slight worsening in business and personal bankruptcy, housing inventory, loans past due, the unemployment rate, and nonaccrual loans. 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.

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

<b>Other Real Estate Owned<sup>(1)</sup></b>	<b>September 30, 2019</b>	<b>September 30, 2018</b>	<b>December 31, 2018</b>
Real estate construction	\$ 1,443	\$ 2,012	\$ 2,012
Consumer real estate	27	12	13
Commercial real estate	—	190	27
Total other real estate owned	<u>\$ 1,470</u>	<u>\$ 2,214</u>	<u>\$ 2,052</u>
Loans in process of foreclosure	\$ 891	\$ 1,012	\$ 140

(1) Net of valuation allowance.

Other real estate owned decreased \$582 from December 31, 2018 and \$744 from September 30, 2018. As of September 30, 2019, loans secured by residential real estate totaling \$891 are in various stages of foreclosure and may impact other real estate owned in future quarters. It is not possible to accurately predict the future total of other real estate owned because property sold at foreclosure may be acquired by third parties and NBB’s other real estate owned properties are regularly marketed and sold.

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

**Modifications and Troubled Debt Restructurings (“TDRs”)**

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

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

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

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

**Nine Months Ended September 30, 2019**

<b>Modifications To Borrowers Not Experiencing Financial Difficulty</b>	<b>Number of Loans Modified</b>	<b>Amount Modified (in thousands)</b>
Rate reductions for competitive purposes	4	\$ 11,242
Payment extensions for less than 3 months	59	1,124
Maturity date extensions of more than 3 months and up to 6 months	113	15,763
Maturity date extensions of more than 6 months and up to 12 months	218	13,949
Maturity date extensions of more than 12 months	5	5,639
Advances on non-revolving loans or capitalization	4	1,019
Change in amortization term or method	4	346
Change or release of collateral	20	383
Renewal of expired Home Equity Line of Credit loans for additional 10 years	28	1,236
Renewal of single-payment notes	80	2,500
<b>Total modifications that do not constitute TDRs</b>	<b>535</b>	<b>\$ 53,201</b>

**Nine Months Ended September 30, 2018**

<b>Modifications To Borrowers Not Experiencing Financial Difficulty</b>	<b>Number of Loans Modified</b>	<b>Amount Modified (in thousands)</b>
Rate reductions for competitive purposes	8	\$ 2,371
Payment extensions for less than 3 months	39	451
Maturity date extensions of more than 3 months and up to 6 months	98	15,533
Maturity date extensions of more than 6 months and up to 12 months	237	8,618
Maturity date extensions of more than 12 months	12	1,600
Advances on non-revolving loans or capitalization	7	1,845
Change in amortization term or method	7	965
Change or release of collateral	38	568
Renewal of expired Home Equity Line of Credit loans for additional 10 years	10	153
Renewal of single-payment notes	110	2,344
<b>Total modifications that do not constitute TDRs</b>	<b>566</b>	<b>\$ 34,448</b>

**Twelve Months Ended December 31, 2018**

<b>Modifications To Borrowers Not Experiencing Financial Difficulty</b>	<b>Number of Loans Modified</b>	<b>Amount Modified (in thousands)</b>
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 for additional 10 years	20	300
Renewal of single-payment notes	138	2,862
<b>Total modifications that do not constitute TDRs</b>	<b>758</b>	<b>\$ 53,337</b>

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

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

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

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

The Company's TDRs were \$5,257 at September 30, 2019, a decrease from \$5,661 at December 31, 2018. Accruing TDR loans amounted to \$1,880 at September 30, 2019 and \$2,552 at December 31, 2018. TDRs with at least six months of current payment history may accrue interest.

<b>TDR Status as of September 30, 2019</b>					
	<b>Total TDR Loans</b>	<b>Accruing</b>			<b>Nonaccrual</b>
		<b>Current</b>	<b>30-89 Days Past Due</b>	<b>90+ Days Past Due</b>	
Consumer real estate	\$ 945	\$ 418	\$ —	\$ 132	\$ 395
Commercial real estate	3,368	386	—	—	2,982
Commercial non real estate	939	939	—	—	—
Consumer non real estate	5	2	3	—	—
<b>Total TDR Loans</b>	<b>\$ 5,257</b>	<b>\$ 1,745</b>	<b>\$ 3</b>	<b>\$ 132</b>	<b>\$ 3,377</b>

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

	Accruing					
	Total TDR Loans	Current	30-89 Days Past Due	90+ Days Past Due	Nonaccrual	
Consumer real estate	\$ 1,027	\$ 417	\$ ---	\$ ---	\$ 610	
Commercial real estate	3,606	1,112	---	---	2,494	
Commercial non real estate	1,015	1,010	---	---	5	
Consumer non real estate	13	9	4	---	---	
<b>Total TDR Loans</b>	<b>\$ 5,661</b>	<b>\$ 2,548</b>	<b>\$ 4</b>	<b>\$ ---</b>	<b>\$ 3,109</b>	

Restructuring generally results in a loan with either lower payments or a maturity extended beyond that originally required, and is expected to result in a lower risk of loss associated with nonperformance than the pre-modified loan. The Company modified one loan during the nine month period ended September 30, 2019 and modified six loans during the nine month period ended September 30, 2018. Please refer to Note 3 for information on troubled debt restructurings.

**Net Interest Income**

The net interest income analysis for the three months ended September 30, 2019 and 2018 follows:

	Three Months Ended					
	September 30, 2019			September 30, 2018		
	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate
<b>Interest-earning assets:</b>						
Loans, net <sup>(1)(2)(3)(4)</sup>	\$ 721,653	\$ 8,664	4.76%	\$ 694,590	\$ 8,115	4.64%
Taxable securities <sup>(5)(6)</sup>	280,987	1,565	2.21%	348,582	1,771	2.02%
Nontaxable securities <sup>(1)(5)</sup>	93,204	977	4.16%	120,615	1,344	4.42%
Interest-bearing deposits	75,581	407	2.14%	22,432	111	1.96%
<b>Total interest-earning assets</b>	<b>\$ 1,171,425</b>	<b>\$ 11,613</b>	<b>3.93%</b>	<b>\$ 1,186,219</b>	<b>\$ 11,341</b>	<b>3.79%</b>
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$ 583,031	\$ 1,221	0.83%	\$ 598,864	\$ 982	0.65%
Savings deposits	143,430	121	0.33%	140,923	52	0.15%
Time deposits	121,028	523	1.71%	100,534	107	0.42%
Borrowings	1	---	---	15,978	104	2.58%
<b>Total interest-bearing liabilities</b>	<b>\$ 847,490</b>	<b>\$ 1,865</b>	<b>0.87%</b>	<b>\$ 856,299</b>	<b>\$ 1,245</b>	<b>0.58%</b>
<b>Net interest income and interest rate spread</b>		<b>\$ 9,748</b>	<b>3.06%</b>		<b>\$ 10,096</b>	<b>3.21%</b>
<b>Net yield on average interest-earning assets</b>			<b>3.30%</b>			<b>3.38%</b>

(1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 21%.

(2) Included in interest income are loan fees of \$26 and \$30 for the three months ended September 30, 2019 and 2018, respectively.

(3) Nonaccrual loans are included in average balances for yield computations.

(4) Includes loans held for sale.

(5) Daily averages are shown at amortized cost.

(6) Includes restricted stock.

	Nine Months Ended					
	September 30, 2019			September 30, 2018		
	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate
Interest-earning assets:						
Loans, net <sup>(1)(2)(3)(4)</sup>	\$ 717,627	\$ 25,625	4.77%	\$ 677,110	\$ 23,452	4.63%
Taxable securities <sup>(5)(6)</sup>	298,141	4,851	2.18%	343,661	5,125	1.99%
Nontaxable securities <sup>(1)(5)</sup>	100,711	3,234	4.29%	126,486	4,271	4.51%
Interest-bearing deposits	61,209	1,048	2.29%	39,366	509	1.73%
Total interest-earning assets	\$ 1,177,688	\$ 34,758	3.95%	\$ 1,186,623	\$ 33,357	3.76%
Interest-bearing liabilities:						
Interest-bearing demand deposits	\$ 598,915	\$ 4,007	0.89%	\$ 611,741	\$ 2,864	0.63%
Savings deposits	141,913	326	0.31%	141,430	159	0.15%
Time deposits	113,630	1,239	1.46%	107,767	344	0.43%
Borrowings	—	—	—	5,385	104	2.58%
Total interest-bearing liabilities	\$ 854,458	\$ 5,572	0.87%	\$ 866,323	\$ 3,471	0.54%
Net interest income and interest rate spread		\$ 29,186	3.08%		\$ 29,886	3.22%
Net yield on average interest-earning assets			3.31%			3.37%

- (1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 21%.
- (2) Included in interest income are loan fees of \$75 and \$87 for the nine months ended September 30, 2019 and 2018, respectively.
- (3) Nonaccrual loans are included in average balances for yield computations.
- (4) Includes loans held for sale.
- (5) Daily averages are shown at amortized cost.
- (6) Includes restricted stock.

The net interest margin decreased 8 basis points when the three month periods ended September 30, 2019 and September 30, 2018 are compared, and 6 basis points when the nine month periods ended September 30, 2019 and September 30, 2018 are compared. The decrease in interest rate spread resulted from an increase in the cost of interest-bearing liabilities of 29 basis points when the three month periods ended September 30, 2019 and September 30, 2018 are compared and 33 basis points when the nine month periods ended September 30, 2019 and September 30, 2018 are compared. The increase in the cost of deposits was partially offset by an increase in tax-equivalent yield on interest-earning assets of 14 basis points when the three month period ended September 30, 2019 is compared to the period ending September 30, 2018 and an increase of 19 basis points when the nine month period ended September 30, 2019 and September 30, 2018 are compared.

The tax-equivalent yield on loans increased 12 basis points when the three month period ended September 30, 2019 is compared with the same period ended September 30, 2018, and 14 basis points when the nine month periods ended September 30, 2019 and September 30, 2018 are compared. The yield on taxable securities increased 19 basis points when the three month period ended September 30, 2019 is compared with the three month period ended September 30, 2018, and when the nine month period ended September 30, 2019 is compared with the same period ended September 30, 2018. The yield on nontaxable securities decreased 26 basis points when the three month periods ended September 30, 2019 and September 30, 2018 are compared and 22 basis points when the nine month periods ended September 30, 2019 and September 30, 2018 are compared.

The increase in the cost of interest-bearing liabilities came from an increase in deposit offering rates. The cost of interest-bearing demand deposits increased 18 basis points when the three month period ended September 30, 2019 is compared with the same period ended September 30, 2018 and 26 basis points for the nine month period ending September 30, 2019 when compared with the same period ended September 30, 2018. The cost of savings deposits increased 18 basis points when the three month periods ended September 30, 2019 and September 30, 2018 are compared and 16 basis points when the nine month periods ended September 30, 2019 and September 30, 2018 are compared. The cost of time deposits increased 129 basis points when the three month periods ended September 30, 2019 and September 30, 2018 are compared and 103 basis points when the nine month periods ended September 30, 2019 and September 30, 2018 are compared. The Company's yield on earning assets and cost of funds are largely dependent on the interest rate environment.

**Provision and Allowance for Loan Losses**

The calculation of the allowance for loan losses resulted in a provision for loan losses of \$95 for the three months ended September 30, 2019 and \$223 for the three months ended September 30, 2018. The provision for loan losses was \$350 for the nine month period ended September 30, 2019, compared with a provision of \$93 for the same period ended September 30, 2018. The provision for loan losses is the result of a detailed analysis to estimate an adequate allowance for loan losses. The ratio of the allowance for loan losses to total loans at September 30, 2019 was 1.01%, compared with 1.04% at December 31, 2018 and 1.10% at September 30, 2018. The annualized net charge-off ratio was 0.08% for the three months ended September 30, 2019, 0.09% for the nine months ended September 30, 2019, 0.06% for the nine months ended September 30, 2018 and 0.07% for the year ended December 31, 2018. See "Asset Quality" for additional information.

**Noninterest Income**

	Three Months Ended		
	September 30, 2019	September 30, 2018	Percent Change
Service charges on deposits	\$ 643	\$ 673	(4.46)%
Other service charges and fees	46	20	130.00%
Credit and debit card fees	350	362	(3.31)%
Trust fees	440	355	23.94%
BOLI income	230	222	3.60%
Other income	227	282	(19.50)%
Realized securities gain, net	162	---	100.00%

	Nine Months Ended		
	September 30, 2019	September 30, 2018	Percent Change
Service charges on deposits	\$ 1,840	\$ 2,037	(9.67)%
Other service charges and fees	149	87	71.26%
Credit and debit card fees	1,015	1,071	(5.23)%
Trust fees	1,208	1,131	6.81%
BOLI income	681	678	0.44%
Other income	1,368	801	70.79%
Realized securities gain, net	182	---	100.00%

Service charges on deposit accounts decreased 4.46% and 9.67% for the three and nine month periods ended September 30, 2019 when compared with the same periods ended September 30, 2018. Other service charges and fees increased 130.00% and 71.26% for the three and nine month periods ended September 30, 2019 compared with the same periods ended September 30, 2018. Other service charges include charges for official checks, income from the sale of checks to customers, safe deposit box rent, fees for letters of credit and the income earned from commissions on the sale of credit life, accident and health insurance. Increased volume in letters of credit and greater check charge fee income provided most of the increase. Service charges on deposits and other service charges and fees are subject to normal business fluctuation and are not due to changes in fee structure.

Credit and debit card fees are presented net of interchange expense. Credit and debit card fees decreased \$12 and \$56 for the three and nine month periods ended September 30, 2019 when compared with the same periods last year. Credit and debit card fees are based on volume and other factors.

Income from trust fees increased \$85 and \$77 for the three and nine month periods ended September 30, 2019 when compared with the same periods ended September 30, 2018. Trust income varies depending on the total assets held in trust accounts, the type of accounts under management and financial market conditions.

BOLI income increased \$8 when the three month periods ended September 30, 2019 and September 30, 2018 are compared. For the nine month period ended September 30, 2019, BOLI income increased \$3 when compared with the same period ended September 30, 2018.

Other income includes fees on the sale of secondary-market mortgages, net gains from the sale of fixed assets, revenue from investment and insurance sales and other miscellaneous components. These areas fluctuate with market conditions and competitive factors. Other income decreased \$55 for the three month period ended September 30, 2019 when compared with the same period ending September 30, 2018. Other income increased \$567 for the nine month period ended September 30, 2019 when compared with the same period ended September 30, 2018. The Company recognized a recovery of \$538 on a previously recognized insurance loss.

The Company realized a gain on the call and sale of securities of \$162 and \$182 during the three and nine month periods ended September 30, 2019. Most of the gains resulted from sale of securities under a restructuring program intended to provide a measure of security from interest rate risk. No gains on securities were realized during the first nine months of 2018. Net realized securities gains and losses are market driven.

### Noninterest Expense

	Three Months Ended		
	September 30, 2019	September 30, 2018	Percent Change
Salaries and employee benefits	\$ 3,823	\$ 3,639	5.06%
Occupancy, furniture and fixtures	468	433	8.08%
Data processing and ATM	823	684	20.32%
FDIC assessment	—	88	(100.00)%
Intangibles amortization	—	12	(100.00)%
Net costs of other real estate owned	17	274	(93.80)%
Franchise taxes	343	314	9.24%
Other operating expenses	912	1,019	(10.50)%

	Nine Months Ended		
	September 30, 2019	September 30, 2018	Percent Change
Salaries and employee benefits	\$ 11,446	\$ 10,878	5.22%
Occupancy, furniture and fixtures	1,410	1,396	1.00%
Data processing and ATM	2,363	2,024	16.75%
FDIC assessment	167	269	(37.92)%
Intangibles amortization	—	37	(100.00)%
Net costs of other real estate owned	45	523	(91.40)%
Franchise taxes	990	965	(2.59)%
Write-down of insurance receivable	—	2,010	(100.00)%
Other operating expenses	2,883	2,949	(2.24)%

Total noninterest expense decreased \$77 or 1.19% when the three month periods ended September 30, 2019 and September 30, 2018 are compared, and decreased \$1,747 or 8.30% when the nine month period ended September 30, 2019 is compared with the same period of 2018. The decrease when the nine month periods are compared was largely driven by the \$2,010 write-down of the insurance receivable in the first quarter of 2018.

Salaries and employee benefits increased \$184 and \$568 when the three and nine month periods ended September 30, 2019 are compared with the same periods in 2018. This expense category includes employee salaries, payroll taxes, insurance and fringe benefits, ESOP contribution accruals, the service component of net periodic pension cost, and salary continuation expenses.

Occupancy, furniture and fixtures expense increased \$35 and \$14 when the three and nine month periods ended September 30, 2019 are compared with the same periods ended September 30, 2018.

Data processing and ATM expense increased \$139 and \$339 when the three and nine month periods ended September 30, 2019 are compared with the same periods in 2018, due to infrastructure upgrades.

FDIC assessment expense decreased \$88 and \$102 when the three and nine month periods ended September 30, 2019 are compared with the same periods of 2018. The FDIC assessment is accrued based on a method provided by the FDIC. During the third quarter of 2019, the FDIC notified the Bank that it was eligible for small bank assessment credits. The credits were applied to the Bank's September 30, 2019 assessment. If the FDIC's Deposit Insurance Fund Reserve Ratio maintains a certain ratio, the Bank may be able to use additional credits for future assessments.

Core deposit intangibles are the result of prior merger and acquisition activity and are amortized over a period of years. Amortization of the Company's intangible assets was completed in 2018. This accounted for the decline in intangibles amortization expense of \$12 and \$37 for the three and nine month periods ended September 30, 2019 compared with the same periods of 2018.



Net costs of other real estate owned decreased \$257 and \$478 when the three and nine month periods ended September 30, 2019 are compared with the same periods in 2018. The cost of other real estate owned includes maintenance costs as well as valuation write-downs and gains and losses on the sale of properties. The expense varies with the number of properties, the maintenance required and changes in the real estate market. OREO properties are accounted for at fair value less cost to sell upon foreclosure and are thereafter periodically appraised to determine market value. Declines in market value are recognized through valuation expense. There were no write downs on OREO properties during the nine months ended September 30, 2019, compared with \$247 and \$452 for the three and nine months ended September 30, 2018. The Company recognized a loss on the sale of OREO of \$5 for the nine months ended September 30, 2019 and \$12 for the nine months ended September 30, 2018.

Franchise tax expense increased \$29 or 9.24% when the three month periods ended September 30, 2019 and September 30, 2018 are compared. Franchise tax expense increased \$25 or 2.59% when the nine month periods ended September 30, 2019 and September 30, 2018 are compared. Franchise tax is primarily based on capital levels of the subsidiary bank.

The Company recognized an expense of \$2,010 during the nine month period ended September 30, 2018 to reduce and insurance receivable related to a cybersecurity breach. Please see the discussion under the section “Cybersecurity Risks and Incidents” below.

The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs, postage, charitable donations, losses and other expenses. Other operating expense decreased \$107 and \$66 when the three and nine month periods ended September 30, 2019 are compared with the same periods ended September 30, 2018.

### **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 \$92 and \$681 for the three and nine month periods ended September 30, 2019 compared with \$104 and \$251 for the three and nine month periods ended September 30, 2018. These costs are included in various categories of noninterest expense.

As disclosed in the Company’s December 31, 2018 10-K, the Company experienced two intrusions to its digital systems, one in May 2016 and one in January 2017. The Company retained two nationally recognized firms to investigate and remediate the intrusions and has 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, remediation and litigation the Company pursued against the insurance carrier. The Company recognized a write-down of the insurance receivable of \$2,010 during the nine month period ended September 30, 2018. Costs for legal consultation totaled \$12 and \$157 for the three and nine month periods ended September 30, 2019, compared with \$65 and \$85 for the three and nine month periods ended September 30, 2018. The Company’s litigation against the insurance carrier was settled during the first quarter of 2019, subject to a non-disclosure agreement. 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 Tax**

Income tax expense was \$788 and \$2,247 for the three and nine month periods ended September 30, 2019, compared with \$677 and \$1,757 for the three and nine month periods ended September 30, 2018. The Company’s statutory tax rate is 21%. The Company’s effective tax rate was 15.63% and 15.04% for the three and nine month periods ended September 30, 2019, compared with 13.74% and 13.17% for the three and nine month periods ended September 30, 2018. The increase in the effective tax rate resulted from smaller holdings of tax-advantaged municipal securities during 2019 compared with 2018.

**Balance Sheet**

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

<b>Assets</b>	<b>September 30, 2019</b>	<b>December 31, 2018</b>	<b>Percent Change</b>
Interest-bearing deposits	\$ 61,209	\$ 36,562	67.41%
Securities available for sale and restricted stock	398,455	400,694	(0.56)%
Securities held to maturity	—	55,116	(100.00)%
Loans, net	709,766	675,647	5.05%
<b>Total assets</b>	<b>1,253,244</b>	<b>1,251,843</b>	<b>0.11%</b>
<b>Liabilities and stockholders' equity</b>			
Noninterest-bearing demand deposits	\$ 198,397	\$ 192,440	3.10%
Interest-bearing demand deposits	598,915	606,766	(1.29)%
Savings deposits	141,913	140,918	0.71%
Time deposits	113,630	105,674	7.53%
Stockholders' equity	184,286	186,637	(1.26)%

**Securities**

During the third quarter of 2019, the Company implemented a program to restructure the securities portfolio. The program is intended to increase yields and reduce interest rate risk. The restructuring is expected to be completed during the fourth quarter of 2019. During the second quarter of 2018, the Company reclassified all held to maturity securities as available for sale. At the time of transfer, the securities were recorded at fair value of \$119,790 and an unrealized gain of \$891, net of tax was recorded in accumulated other comprehensive income.

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

**Loans**

	<b>September 30, 2019</b>	<b>December 31, 2018</b>	<b>Percent Change</b>
Real estate construction loans	\$ 42,972	\$ 37,845	13.55%
Consumer real estate loans	179,114	175,456	2.08%
Commercial real estate loans	360,493	353,546	1.96%
Commercial non real estate loans	45,866	46,535	(1.44)%
Public sector and IDA	59,731	60,777	(1.72)%
Consumer non real estate	34,583	36,238	(4.57)%
Less: unearned income and deferred fees and costs	(472)	(598)	(21.07)%
<b>Loans, net of unearned income and deferred fees and costs</b>	<b>\$ 722,287</b>	<b>\$ 709,799</b>	<b>1.76%</b>

The Company's loans, net of unearned income and deferred fees and costs increased \$12,488 or 1.76% from \$709,799 at December 31, 2018 to \$722,287 at September 30, 2019. Real estate construction, consumer real estate, and commercial real estate loans increased from December 31, 2018, while commercial non real estate, consumer non real estate, and public sector and IDA loans decreased.

## Deposits

	September 30, 2019	December 31, 2018	Percent Change
Noninterest-bearing demand deposits	\$ 217,720	\$ 195,441	11.40%
Interest-bearing demand deposits	580,533	616,527	(5.84)%
Saving deposits	145,188	138,175	5.08%
Time deposits	124,586	101,799	22.38%
Total deposits	\$ 1,068,027	\$ 1,051,942	1.53%

Total deposits increased \$16,085 or 1.53% from \$1,051,942 at December 31, 2018 to \$1,068,027 at September 30, 2019. Increases in noninterest-bearing demand, savings deposits, and time deposits totaled \$52,079 when September 30, 2019 is compared with December 31, 2018. These increases were offset by a decrease in interest-bearing demand deposits of \$35,994 when September 30, 2019 is compared with December 31, 2018. The Company increased its offering rates during the fourth quarter of 2018. Deposits do not include any brokered deposits.

## Liquidity

Liquidity measures the Company's ability to meet its financial commitments at a reasonable cost. Demands on the Company's liquidity include funding additional loan demand and accepting withdrawals of existing deposits. The Company has diverse liquidity sources, including customer and purchased deposits, customer repayments of loan principal and interest, sales, calls and maturities of securities, Federal Reserve discount window borrowing, short-term borrowing, and Federal Home Loan Bank advances. At September 30, 2019, the bank did not have discount window borrowings, short-term borrowings, or FHLB advances. To assure that short-term borrowing is readily available, the Company tests accessibility annually.

The Company considers its security portfolio for typical liquidity needs, within accounting, legal and strategic parameters. Prior to the second quarter of 2018, the securities portfolio was segregated into available-for-sale and held-to-maturity. During the second quarter of 2018, the Company re-classified all its held-to-maturity securities to available-for-sale. Portions of the securities portfolio are pledged to meet state requirements for public funds deposits. Discount window borrowings also require pledged securities. Increased/decreased liquidity from public funds deposits or discount window borrowings results in increased/decreased liquidity from pledging requirements. The Company monitors public funds pledging requirements and unpledged available-for-sale securities accessible for liquidity needs.

Regulatory capital levels at the subsidiary bank determine the Bank's ability to use purchased deposits and the Federal Reserve discount window. At September 30, 2019, the Bank is considered well capitalized and does not have any restrictions on purchased deposits or borrowing ability at the Federal Reserve discount window.

The Company monitors factors that may increase its liquidity needs. Some of these factors include deposit trends, large depositor activity, maturing deposit promotions, interest rate sensitivity, maturity and repricing timing gaps between assets and liabilities, the level of unfunded loan commitments, loan growth and share repurchase activity within the Company's own stock. At September 30, 2019, the Company's liquidity is sufficient to meet projected trends in these areas.

To monitor and estimate liquidity levels, the Company performs stress testing under varying assumptions on credit sensitive liabilities and the sources and amounts of balance sheet and external liquidity available to replace outflows. The Company's Contingency Funding Plan sets forth avenues for rectifying liquidity shortfalls. At September 30, 2019, the analysis indicated adequate liquidity under the tested scenarios.

The Company utilizes several other strategies to maintain sufficient liquidity. Loan and deposit growth are managed to keep the loan to deposit ratio within the Company's own policy range of 65% to 75%. At September 30, 2019, the loan to deposit ratio was 67.63%. The investment strategy takes into consideration the term of the investment, and securities in the available for sale portfolio are laddered based upon projected funding needs.

## Capital Resources

Total stockholders' equity at September 30, 2019 was \$187,988, a decrease of \$2,250 or 1.18%, from the \$190,238 at December 31, 2018. In May 2018, the Company's Board of Directors authorized a 100,000 share repurchase program and subsequently increased the authorization in February 2019 to a total of one million shares. The program does not require any specific number of share repurchases. The program and 1 million share authorization was renewed in May 2019 and expires May 31, 2020. The Company repurchased 452,400 shares during March 2019 and 16,000 shares during August 2019. The March repurchase reduced shareholders equity by \$17,997 and the August repurchase reduced shareholders equity by \$528.

The Company's subsidiary bank is subject to various capital requirements administered by banking agencies. Risk based capital ratios for the Bank are shown in the following tables.

	NBB	Regulatory Capital Minimum Ratios	Regulatory Capital Minimum Ratios with Capital Conservation Buffer
Common Equity Tier I Capital Ratio	22.48%	4.50%	7.00%
Tier I Capital Ratio	22.48%	6.00%	8.50%
Total Capital Ratio	23.39%	8.00%	10.50%
Leverage Ratio	14.64%	4.00%	4.00%

Risk-based capital ratios are calculated in compliance with FDIC rules based on Basel III capital requirements. Banks are subject to an additional capital conservation buffer in order to make capital distributions or discretionary bonus payments. The Bank's ratios are well above the required minimums and the capital conservation buffer at September 30, 2019.

On September 17, 2019 the Federal Deposit Insurance Corporation finalized a rule that introduces an optional simplified measure of capital adequacy for qualifying community banking organizations (i.e., the community bank leverage ratio (CBLR) framework), as required by the Economic Growth, Regulatory Relief and Consumer Protection Act. The CBLR framework is designed to reduce burden by removing the requirements for calculating and reporting risk-based capital ratios for qualifying community banking organizations that opt into the framework.

In order to qualify for the CBLR framework, a community banking organization must have a tier 1 leverage ratio of greater than 9 percent, less than \$10 billion in total consolidated assets, and limited amounts of off-balance-sheet exposures and trading assets and liabilities. A qualifying community banking organization that opts into the CBLR framework and meets all requirements under the framework will be considered to have met the well-capitalized ratio requirements under the Prompt Corrective Action regulations and will not be required to report or calculate risk-based capital.

The CBLR framework will be available for banks to use in their March 31, 2020, Call Report. The Company is currently evaluating whether to opt into the CBLR framework.

#### **Off-Balance Sheet Arrangements**

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

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

The Company sells mortgages on the secondary market. Our agreement with the purchaser provides for strict underwriting and documentation requirements. Violation of the representations and warranties of the agreement would entitle the purchaser to recourse provisions. The Company has determined that its risk in this area is not significant because of a low volume of secondary market mortgage loans and high underwriting standards. The Company estimates a potential loss reserve for recourse provisions that is not material as of September 30, 2019. To date, no recourse provisions have been invoked. If funds were needed, the Company would access the same sources as noted above for funding lines and letters of credit.

There were no material changes in off-balance sheet arrangements during the nine months ended September 30, 2019, except for normal seasonal fluctuations in the total of mortgage loan commitments.

#### **Contractual Obligations**

The Company had no finance lease or purchase obligations and no long-term debt at September 30, 2019. The Company adopted ASC 842, Leases, as of January 1, 2019. Operating lease right-of-use assets and liabilities, which are for buildings used in the Company's day-to-day operations are recognized on the Consolidated Balance Sheet and have not changed materially from those which were disclosed in the Company's 2018 Form 10-K.

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

The Company considers interest rate risk to be a significant market risk and has systems in place to measure the exposure of net interest income to adverse movement in interest rates. Interest rate shock analyses provide management with an indication of potential economic loss due to future rate changes. There have not been any changes which would significantly alter the results disclosed as of December 31, 2018 in the Company's 2018 Form 10-K.

#### **Item 4. Controls and Procedures**

The Company's management evaluated, with the participation of the Company's principal executive officer and principal financial officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on that evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective as of September 30, 2019 to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified by the Company's management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) during the three months ended September 30, 2019 that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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

**Part II****Other Information****Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

Please refer to the “Risk Factors” previously disclosed in Item 1A of our 2018 Annual Report on Form 10-K and the factors discussed under “Cautionary Statement Regarding Forward-Looking Statements” in Part I, Item 2 of this Form 10-Q.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****Purchases of Equity Securities by the Issuer**

Share repurchase activity during the nine months ended September 30, 2019 was as follows:

<b>Period</b>	<b>Total Number of Shares Purchased<sup>(1)</sup></b>	<b>Average Price Paid Per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Program<sup>(1)</sup></b>	<b>Number of Shares that May Yet Be Purchased Under the Program<sup>(1)</sup></b>
January 1, 2019 – January 31, 2019	---	\$ ---	---	250,000
February 1, 2019 – February 28, 2019	---	---	---	1,000,000
March 1, 2019 – March 31, 2019	452,400	39.78	452,400	547,600
Total during first quarter 2019	452,400	\$ 39.78	452,400	
April 1, 2019 – April 30, 2019	---	---	---	547,600
May 1, 2019 – May 31, 2019	---	---	---	1,000,000
June 1, 2019 – June 30, 2019	---	---	---	1,000,000
Total during second quarter 2019	---		---	
July 1, 2019 – July 31, 2019	---	---	---	1,000,000
August 1, 2019 – August 31, 2019	16,000	33.00	16,000	984,000
September 1, 2019 – September 30, 2019	---	---	---	984,000
Total during third quarter 2019	16,000	\$ 33.00	16,000	
Total year-to-date 2019	468,400	\$ 39.55	468,400	

(1) In May 2018, the Company announced the Board of Directors had authorized a 100,000 share repurchase program. In November 2018, the Company announced that the Board of Directors increased its authorization to repurchase up to 250,000 shares. In February 2019, the Company announced that the Board of Directors increased its authorization to repurchase up to 1,000,000 shares, with an expiration date of May 31, 2019. In May, 2019, the Company renewed authorization to repurchase up to 1,000,000 shares, with an expiration date of May 31, 2020. The Company’s share repurchase program does not obligate it to acquire any specific number of shares.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

**Index of Exhibits**

<b>Exhibit No.</b>	<b>Description</b>	<b>Page No. in Sequential System</b>
3(i)	<a href="#">Amended and Restated Articles of Incorporation of National Bankshares, Inc.</a>	(incorporated herein by reference to Exhibit 3.1 of the Form 8K for filed on March 16, 2006)
3(ii)	<a href="#">Amended By-laws of National Bankshares, Inc.</a>	(incorporated herein by reference to Exhibit 3(ii) of the Form 8K filed on July 9, 2014)
4	Specimen copy of certificate for National Bankshares, Inc. common stock	(incorporated herein by reference to Exhibit 4(a) of the Annual Report on Form 10K for fiscal year ended December 31, 1993)
*10(i)	<a href="#">National Bankshares, Inc. 1999 Stock Option Plan</a>	(incorporated herein by reference to Exhibit 4.3 of the Form S-8, filed as Registration No. 333-79979 with the Commission on June 4, 1999)
*10(ii)	<a href="#">Executive Employment Agreement dated March 11, 2015, between National Bankshares, Inc. and James G. Rakes</a>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 11, 2015)
*10(iii)	<a href="#">Employee Lease Agreement dated August 14, 2002, between National Bankshares, Inc. and The National Bank of Blacksburg</a>	(incorporated herein by reference to Exhibit 10 of Form 10Q for the period ended September 30, 2002)
*10(iv)	<a href="#">Executive Employment Agreement dated March 11, 2015, between National Bankshares, Inc. and F. Brad Denardo</a>	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on March 11, 2015)
*10(v)	<a href="#">Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and James G. Rakes</a>	(incorporated herein by reference to Exhibit 99 of the Form 8K filed on February 8, 2006)
*10(vi)	<a href="#">Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and F. Brad Denardo</a>	(incorporated herein by reference to Exhibit 99 of the Form 8K filed on February 8, 2006)
*10(vii)	<a href="#">Salary Continuation Agreement dated February 8, 2006, between The National Bank of Blacksburg and David K. Skeens</a>	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(viii)	<a href="#">First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes</a>	(incorporated herein by reference to Exhibit 10 of the Form 8K filed on December 19, 2007)
*10(ix)	<a href="#">First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo</a>	(incorporated herein by reference to Exhibit 10 of the Form 8K filed on December 19, 2007)
*10(x)	<a href="#">First Amendment, dated December 19, 2007, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens</a>	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(xi)	<a href="#">Second Amendment, dated June 12, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo</a>	(incorporated herein by reference to Exhibit 10 of the Form 8K filed on June 12, 2008)
*10(xii)	<a href="#">Second Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for James G. Rakes</a>	(incorporated herein by reference to Exhibit 10(iii) of the Annual Report on Form 10K for fiscal year ended December 31, 2008)
*10(xiii)	<a href="#">Second Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens</a>	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(xiv)	<a href="#">Third Amendment, dated December 17, 2008, to The National Bank of Blacksburg Salary Continuation Agreement for F. Brad Denardo</a>	(incorporated herein by reference to Exhibit 10(iii) of the Annual Report on Form 10K for fiscal year ended December 31, 2008)
*10(xv)	<a href="#">Third Amendment, dated January 20 2012, to The National Bank of Blacksburg Salary Continuation Agreement for David K. Skeens</a>	(incorporated herein by reference to Exhibit 10.2 of the Form 8K filed on January 25, 2012)
*10(xvi)	<a href="#">Salary Continuation Agreement dated May 24, 2013 between The National Bank of Blacksburg and Paul A. Mylum</a>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 8, 2018)
*10(xvii)	<a href="#">Second Salary Continuation Agreement dated June 26, 2016 between The National Bank of Blacksburg and F. Brad Denardo</a>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on July 20, 2016)
*10(xviii)	<a href="#">Salary Continuation Agreement dated February 8, 2006 between The National Bankshares, Inc. and Lara E. Ramsey</a>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
*10(xix)	<a href="#">First Amendment, dated December 19, 2007, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey</a>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
*10(xx)	<a href="#">Second Amendment, dated December 17, 2008, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey</a>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)
*10(xxi)	<a href="#">Third Amendment, dated June 22, 2016, to National Bankshares, Inc. Salary Continuation Agreement for Lara E. Ramsey</a>	(incorporated herein by reference to Exhibit 10.1 of the Form 8K filed on March 6, 2017)

+23	<a href="#">Consent of Yount, Hyde &amp; Barbour, P.C. to incorporation by reference of independent auditor's report included in this Form 10-K, into registrant's registration statement on Form S-8</a>	(incorporated herein by reference to Exhibit 23 of the Annual Report on Form 10K for fiscal year ended December 31, 2018)
+31(i)	<a href="#">Section 906 Certification of Chief Executive Officer</a>	(included herewith)
+31(ii)	<a href="#">Section 906 Certification of Chief Financial Officer</a>	(included herewith)
+32(i)	<a href="#">18 U.S.C. Section 1350 Certification of Chief Executive Officer</a>	(included herewith)
+32(ii)	<a href="#">18 U.S.C. Section 1350 Certification of Chief Financial Officer</a>	(included herewith)
+101	The following materials from National Bankshares, Inc.'s Quarterly Report on Form 10-Q for the period ended September 30, 2019 are formatted in XBRL (Extensible Business Reporting Language), furnished herewith: (i) Consolidated Statements of Income for the three and nine month periods ended September 30, 2019 and September 30, 2018; (ii) Consolidated Statements of Comprehensive Income for the three and nine month periods ended September 30, 2019 and September 30, 2018; (iii) Consolidated Balance Sheets at September 30, 2019 and December 31, 2018; (iv) Consolidated Statements of Changes in Stockholders' Equity for the three and nine months ended September 30, 2019 and 2018; (v) Consolidated Statements of Cash Flows for the nine months ended September 30, 2019 and 2018; and (vi) Notes to Consolidated Financial Statements.	(included herewith)

\* Indicates a management contract or compensatory plan.

**Signatures**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NATIONAL BANKSHARES, INC.

Date: November 7, 2019

/s/ F. Brad Denardo

F. Brad Denardo  
Chairman, President and  
Chief Executive Officer  
(Principal Executive Officer)

Date: November 7, 2019

/s/ David K. Skeens

David K. Skeens  
Treasurer and  
Chief Financial Officer  
(Principal Financial Officer)  
(Principal Accounting Officer)