NATIONAL BANKSHARES INC
Form 10-K
March 14, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

[x] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Fiscal Year Ended December 31, 2017

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from ________ to ________.

Commission File Number: 0-15204

NATIONAL BANKSHARES, INC.

(Exact name of registrant as specified in its charter)

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

101 Hubbard Street

P.O. Box 90002

Blacksburg, VA 24062-9002

(540) 951-6300

(Address and telephone number of principal executive offices)

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

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

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

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

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

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

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

Large accelerated filer [ ] Accelerated filer [x] Non-accelerated filer [ ] Smaller reporting company [ ] Emerging growth company [ ]

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

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

The aggregate market value of the voting common stock of the registrant held by stockholders (not including voting common stock held by Directors, Executive Officers and Corporate Governance) on June 30, 2017 (the last business day of the most recently completed second fiscal quarter) was approximately $283,885,339. As of March 12, 2018, the registrant had 6,957,974 shares of voting common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

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

Document	**Part of Form 10-K into which incorporated**
National Bankshares, Inc. 2017 Annual Report to Stockholders	Part II
National Bankshares, Inc. Proxy Statement for the 2018 Annual Meeting of Stockholders	Part III

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NATIONAL BANKSHARES, INC. AND SUBSIDIARIES

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Part I

$ in thousands, except per share data

Item 1. Business

History and Business

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

The National Bank of Blacksburg

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

At December 31, 2017, NBB had total assets of $1,253,722 and total deposits of $1,059,806. NBB's net income for 2017 was $14,575, which produced a return on average assets of 1.18% and a return on average equity of 7.99%. Refer to Note 12 of the Notes to Consolidated Financial Statements for NBB's risk-based capital ratios.

National Bankshares Financial Services, Inc.

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

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Operating Revenue

The following table displays components that contributed 15% or more of the Company's total operating revenue for the years ended December 31, 2017, 2016 and 2015.

Period	**Class of Service**	**Percentage of Total Revenues**	
December 31, 2017	Interest and Fees on Loans	57.96	%
	Interest on Investments	20.41	%
	Noninterest Income	20.10	%
December 31, 2016	Interest and Fees on Loans	57.73	%
	Interest on Investments	21.69	%
	Noninterest Income	19.53	%
December 31, 2015	Interest and Fees on Loans	58.10	%
	Interest on Investments	23.31	%
	Noninterest Income	18.10	%

Market Area

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

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

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

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

Competition

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

Cybersecurity

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

Organization and Employment

NBI, NBB and NBFS are organized in a holding company/subsidiary structure. Functions that serve both subsidiaries, including audit, compliance, loan review and human resources, are at the holding company level, and fees are charged to the respective subsidiary for those services. In 2018, NBI employees will be transferred to NBB and fees will be charged to NBI for services performed by NBB.

At December 31, 2017, NBI employed 17 full time employees, NBB had 211 full time equivalent employees and NBFS had 4 full time employees.

Regulation, Supervision and Government Policy

NBI and NBB are subject to state and federal banking laws and regulations that provide for general regulatory oversight of all aspects of their operations. As a result of substantial regulatory burdens on banking, financial institutions like NBI and NBB are at a disadvantage to other competitors who are not as highly regulated, and NBI and NBB's costs of doing business are accordingly higher. Legislative efforts to prevent a repeat of the 2008 financial crisis culminated in the Dodd-Frank Wall Street Reform Act of 2010. This legislation, together with existing and planned regulations, dramatically increased the regulatory burden on commercial banks. The burden falls disproportionately on community banks like NBB, which must devote a higher proportion of their human and other resources to compliance than do their larger competitors. The financial crisis has also heightened the examination focus by banking regulators, particularly on real estate-related assets and commercial loans. While the potential for additional laws and regulations that will impact the Company is reduced in the current environment, heightened examination standards with regard to asset quality remain a risk. The following is a brief summary of certain laws, rules and regulations that affect NBI and NBB.

National Bankshares, Inc.

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

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

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

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

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

Capital and Related Requirements. NBI is subject to risk-based capital regulations of the Federal Reserve. The regulations require a minimum ratio of certain capital measures. In addition, the Company is required to maintain a "capital conservation buffer" in excess of the minimum ratio requirements. The implementation period for the capital conservation buffer began in 2016 and will be fully phased in on January 1, 2019. The following table presents the required minimum ratios and minimum ratios with the capital conservation buffer for 2017, as well as the final minimum ratios with the capital conservation buffer when fully phased in:

Regulatory Capital Ratios	**Minimum Ratio**		**Minimum Ratio With Capital Conservation Buffer as of December 31, 2017**		**Minimum Ratio With Capital Conservation Buffer beginning January 1, 2019**	
Common Equity Tier 1 Capital to Risk Weighted Assets	4.50	%	5.75	%	7.00	%
Tier 1 Capital to Risk Weighted Assets	6.00	%	7.25	%	8.50	%
Total Capital to Risk Weighted Assets	8.00	%	9.25	%	10.50	%
Leverage Ratio	4.00	%	4.00	%	4.00	%

Risk-weighted assets are assets on the balance sheet as well as certain off-balance sheet items, such as standby letters of credit, to which weights between 0% and 1250% are applied, according to the risk of the asset type. Common Equity Tier 1 Capital ("CET1") is capital according to the balance sheet, adjusted for goodwill and intangible assets and other prescribed adjustments, as well as accumulated other comprehensive income if the Company elects to exclude. Tier 1 Capital is CET1 adjusted for additional capital deductions. Total Capital is Tier 1 Capital increased for the allowance for loan losses and adjusted for other items. The leverage ratio is the ratio of Tier 1 capital to total average assets, less goodwill and intangibles and certain deferred tax assets.

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

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

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

Although the Dodd-Frank Act provisions themselves are extensive and have required the Company and the Bank to deploy resources to comply with them, the ultimate impact on the Company of this massive legislation remains unknown. Several federal agencies, including the Federal Reserve, the CFPB and the Securities and Exchange Commission, have yet to issue final regulations implementing major portions of the legislation, and this process is ongoing. In addition, the new Administration in Washington, D.C. may reform or rescind various provisions of the Dodd-Frank Act.

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

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The National Bank of Blacksburg

NBB is a national banking association incorporated under the laws of the United States, and the bank is subject to regulation and examination by the Office of the Comptroller of the Currency (“the OCC”). NBB’s deposits are insured by the Federal Deposit Insurance Corporation (“the FDIC”) up to the limits of applicable law. The OCC, as the primary regulator, and the FDIC regulate and monitor all areas of NBB’s operation. These areas include adequacy of capitalization and loss reserves, loans, deposits, business practices related to the charging and payment of interest, investments, borrowings, payment of dividends, security devices and procedures, establishment of branches, corporate reorganizations and maintenance of books and records. NBB is required to maintain certain capital ratios. It must also prepare quarterly reports on its financial condition for the OCC and conduct an annual audit of its financial affairs. The OCC requires NBB to adopt internal control structures and procedures designed to safeguard assets and monitor and reduce risk exposure. While appropriate for the safety and soundness of banks, these requirements add to overhead expense for NBB and other banks.

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

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

The USA Patriot Act. The USA Patriot Act (“Patriot Act”) facilitates the sharing of information among government entities and financial institutions to combat terrorism and money laundering. The Patriot Act imposes an obligation on NBB to establish and maintain anti-money laundering policies and procedures, including a customer identification program. The Bank must screen all customers against government lists of known or suspected terrorists. There is additional regulatory oversight to insure compliance with the Patriot Act.

Consumer Laws and Regulations. There are a number of laws and regulations that regulate banks’ consumer loan and deposit transactions. Among these are the Truth in Lending Act, the Truth in Savings Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Fair Credit Reporting Act, the Electronic Funds Transfer Act, the Fair Debt Collections Practices Act, the Home Mortgage Disclosure Act, the

Service Members Civil Relief Act, laws governing flood insurance, federal and state laws prohibiting unfair and deceptive business practices, foreclosure laws and various regulations that implement some or all of the foregoing. NBB is required to comply with these laws and regulations in its dealings with customers. In addition, the CFPB has adopted and may continue to refine rules regulating consumer mortgage lending pursuant to the Dodd-Frank Act. There are numerous disclosure and other compliance requirements associated with the consumer laws and regulations.

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

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

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

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

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

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

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

Monetary Policy

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

Other Legislative and Regulatory Concerns

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

Company Website

NBI maintains a website at www.nationalbankshares.com. The Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports are made available on its website as soon as is practical after the material is electronically filed with the Securities and Exchange Commission. The Company's proxy materials for the 2018 annual meeting of stockholders are also posted on a separate website at www.nationalbanksharesproxy.com.

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Item 1A. Risk Factors

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Dodd-Frank Act and its implementing regulations have resulted in greater compliance costs and reduced the profitability of some of our products and services. Implementation of the proposed Basel III rules for capital could increase our compliance costs because of the complexity in the risk assessment rules. While the risk appears to have diminished somewhat, both federal and state governments could enact new laws affecting financial institutions that would further increase our regulatory burden and could negatively affect our profits. Likewise, revisions or rescission of existing laws and regulations already implemented may result in additional compliance costs, at least in the short-term or, if done imprudently, could ultimately create economic risks negatively affecting our revenues.

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

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

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

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

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

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

Our information systems may experience an interruption or security breach.

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

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

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

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

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

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

Cybersecurity attacks are probable and may result in additional costs.

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

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

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

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

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

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

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

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

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

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Changes in accounting standards could impact reported earnings.

The authorities who promulgate accounting standards, including the Financial Accounting Standards Board, SEC, and other regulatory authorities, periodically change the financial accounting and reporting standards that govern the preparation of the Company's consolidated financial statements. These changes are difficult to predict and can materially impact how the Company records and reports its financial condition and results of operations. In some cases, the Company could be required to apply a new or revised standard retroactively, resulting in the restatement of financial statements for prior periods. Such changes could also require the Company to incur additional personnel or technology costs. Most notably, new guidance on the calculation of credit reserves using current expected credit losses was finalized in June, 2016. The standard will be effective for the Company beginning January 1, 2021. The Company has formed a management committee to prepare for the new standards. The committee has implemented new data collection and has begun the process to run preliminary CECL models along with the incurred loss model currently in use. To implement the new standard, the Company will incur costs related to data collection and documentation, technology and training. The Company expects that implementation could significantly impact our required credit reserves. Other impacts to capital levels, profit and loss and various financial metrics will also result.

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

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

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

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

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

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

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

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

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

<u>Item 1B. Unresolved Staff Comments</u>

There are no unresolved staff comments.

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Item 2. Properties

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

Item 3. Legal Proceedings

NBI, NBB, and NBFS are not currently involved in any material pending legal proceedings. There are no legal proceedings related to cybersecurity.

Item 4. Mine Safety Disclosures

Not applicable.

Part II

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

Common Stock Information and Dividends

National Bankshares, Inc.'s common stock is traded on the NASDAQ Capital Market under the symbol "NKSH." As of December 31, 2017, there were 660 record stockholders of NBI common stock. The following is a summary of the market price per share and cash dividend per share of the common stock of National Bankshares, Inc. for 2017 and 2016.

Common Stock Market Prices

	2017		**2016**		**Dividends per share**	
	High	**Low**	**High**	**Low**	**2017**	**2016**
First Quarter	**$ 44.40**	**$36.05**	$ 35.10	$31.75	**$---**	$ ---
Second Quarter	**44.75**	**37.60**	37.10	32.32	**0.56**	0.55
Third Quarter	**46.25**	**36.75**	37.49	33.18	**---**	---
Fourth Quarter	**47.70**	**42.00**	45.35	34.00	**0.61**	0.61

NBI’s primary source of funds for dividend payments is dividends from its bank subsidiary, NBB. Bank dividend payments are restricted by regulators, as more fully disclosed in Note 11 of Notes to Consolidated Financial Statements.

On May 10, 2017, NBI’s Board of Directors approved the repurchase of up to 100,000 shares of equity securities that are registered by the Company pursuant to Section 12 of the Securities Exchange Act of 1934. During 2017, there were no shares repurchased, and 100,000 shares may yet be purchased under the program.

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Stock Performance Graph

The following graph compares the yearly percentage change in the cumulative total of stockholder return on NBI common stock with the cumulative return on the NASDAQ Composite Index, and the NASDAQ Bank Index for the five-year period commencing on December 31, 2012. These comparisons assume the investment of $100 in National Bankshares, Inc. common stock in each of the indices on December 31, 2012, and the reinvestment of dividends.

	2012	**2013**	**2014**	**2015**	**2016**	**2017**
NATIONAL BANKSHARES, INC.	100	117	100	122	154	165
NASDAQ COMPOSITE INDEX	100	140	161	172	188	244
NASDAQ BANK INDEX	100	144	149	161	223	235

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Item 6. Selected Financial Data

National Bankshares, Inc. and Subsidiaries

Selected Consolidated Financial Data

$ in thousands, except per share data	**Year ended December 31,**				
	2017	**2016**	**2015**	**2014**	**2013**
Selected Income Statement Data:					
Interest income	**$41,260**	$40,930	$42,914	$43,944	$45,670
Interest expense	**4,125**	4,166	4,183	4,899	5,955
Net interest income	**37,135**	36,764	38,731	39,045	39,715
Provision for loan losses	**157**	1,650	2,009	1,641	1,531
Noninterest income	**10,379**	9,932	9,486	9,120	9,222
Noninterest expense	**26,972**	26,152	25,635	24,432	24,299
Income taxes	**6,293**	3,952	4,740	5,178	5,317
Net income	**14,092**	14,942	15,833	16,914	17,790
Per Share Data:					
Basic net income	**2.03**	2.15	2.28	2.43	2.56
Diluted net income	**2.03**	2.15	2.28	2.43	2.55
Cash dividends declared	**1.17**	1.16	1.14	1.13	1.12
Book value	**26.57**	25.62	24.74	23.93	21.00
Selected Balance Sheet Data at End of Year:					
Loans, net of unearned income and deferred fees and costs, and the allowance for loan losses	**660,144**	639,452	610,711	597,203	587,463
Total securities	**459,751**	440,409	389,288	385,385	347,109
Total assets	**1,256,757**	1,233,942	1,203,519	1,158,798	1,114,561
Total deposits	**1,059,734**	1,043,442	1,018,859	982,428	960,036
Stockholders' equity	**184,896**	178,263	172,114	166,303	145,892
Selected Balance Sheet Daily Averages:					
Loans, net of unearned income and deferred fees and costs, and the allowance for loan losses	**644,998**	613,366	611,554	584,857	577,746
Total securities	**442,101**	420,915	379,805	361,028	362,334
Total assets	**1,235,754**	1,206,745	1,155,594	1,120,848	1,090,703
Total deposits	**1,038,586**	1,013,787	976,597	957,684	933,482
Stockholders' equity	**184,539**	180,047	171,732	157,832	149,491
Selected Ratios:					

Return on average assets	**1.14**	**%**	1.24	%	1.37	%	1.51	%	1.63	%
Return on average equity	**7.64**	**%**	8.30	%	9.22	%	10.72	%	11.90	%
Dividend payout ratio	**57.77**	**%**	54.02	%	50.09	%	46.43	%	43.74	%
Average equity to average assets	**14.93**	**%**	14.92	%	14.86	%	14.08	%	13.71	%
Efficiency ratio(1)	**53.08**	**%**	52.17	%	49.41	%	47.08	%	45.99	%

(1) The efficiency ratio is calculated by dividing noninterest expense by noninterest income and net interest income on a fully taxable equivalent basis. The tax rate used to calculate fully taxable equivalent basis is 35%.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

$ in thousands, except per share data

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

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

Cautionary Statement Regarding Forward-Looking Statements

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

These forward-looking statements are based upon or are affected by factors that could cause our actual results to differ materially from historical results or from any results expressed or implied by such forward-looking statements. These factors include, but are not limited to, changes in:

- interest rates,
- general economic conditions,
- the legislative/regulatory climate,
- monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury, the Office of the Comptroller of the Currency, the Federal Reserve Board, the Consumer Financial Protection Bureau and the Federal Deposit Insurance Corporation, and the impact of any policies or programs implemented pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") and other financial reform legislation,
- unanticipated increases in the level of unemployment in the Company's trade area,
- the quality or composition of the loan and/or investment portfolios,
- demand for loan products,
- deposit flows,
- competition,
- demand for financial services in the Company's trade area,
- the real estate market in the Company's trade area,
- the Company's technology initiatives, and
- applicable accounting principles, policies and guidelines.

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

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

Critical Accounting Policies

General

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

Allowance for Loan Losses

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

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

Impaired loans

Impaired loans are identified through the Company’s credit risk rating process. Estimated loss for an impaired loan is the amount of recorded investment that exceeds the loan’s fair value. Fair value of an impaired loan is measured by one of three methods: the fair value of collateral (“collateral method”), the present value of future cash flows (“cash flow method”), or observable market price. The Company applies the collateral method to collateral-dependent loans, loans for which foreclosure is imminent and to loans for which the fair value of collateral is a more reliable estimate of fair value. The cash flow method is applied to loans that are not collateral dependent and for which cash flows may be estimated.

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

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

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

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

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

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

Collectively-evaluated loans

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

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

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

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

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

Estimation of the allowance for loan losses

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

The estimate of the allowance for December 31, 2017 considered market and portfolio conditions during 2017 as well as the levels of delinquencies and net charge-offs in the eight quarters prior to the quarter ended December 31, 2017. If the economy experiences a downturn, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see Note 5 to the consolidated financial statements and “Asset Quality,” and “Provision and Allowance for Loan Losses.”

Goodwill

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

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

Other Real Estate Owned (“OREO”)

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

Pension Plan

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

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Other Than Temporary Impairment of Securities (“OTTI”)

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (i) the Company intends to sell the security or (ii) it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis. If, however, the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery, the Company must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost basis of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income (loss). For equity securities, impairment is considered to be other-than-temporary based on the Company’s ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in net income. The Company regularly reviews each investment security for other-than-temporary impairment based on criteria that include the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the Company’s best estimate of the present value of cash flows expected to be collected from debt securities, the Company’s intention with regard to holding the security to maturity and the likelihood that the Company would be required to sell the security before recovery.

Overview

National Bankshares, Inc. is a financial holding company incorporated under the laws of Virginia. Located in southwest Virginia, NBI has two wholly-owned subsidiaries, the National Bank of Blacksburg and National Bankshares Financial Services, Inc. The National Bank of Blacksburg (“NBB”), which does business as National Bank from twenty-five office locations and one loan production office, is a community bank. NBB is the source of nearly all of the Company’s revenue. National Bankshares Financial Services, Inc. (“NBFS”) does business as National Bankshares Investment Services and National Bankshares Insurance Services. Income from NBFS is not significant at this time, nor is it expected to be so in the near future.

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

Performance Summary

The following table presents NBI’s key performance ratios for the years ending December 31, 2017 and December 31, 2016:

	12/31/17	12/31/16
Return on average assets	**1.14 %**	1.24 %
Return on average equity	**7.64 %**	8.30 %
Basic net earnings per common share	**$ 2.03**	$ 2.15
Fully diluted net earnings per common share	**$ 2.03**	$ 2.15
Net interest margin (1)	**3.45 %**	3.51 %
Noninterest margin (2)	**1.34 %**	1.36 %

(1) Net Interest Margin – Year-to-date tax equivalent net interest income divided by year-to-date average earning assets.

(2) Noninterest Margin – Noninterest expense (excluding the provision for bad debts and income taxes) less noninterest income (excluding securities gains and losses) divided by average year-to-date assets.

The return on average assets for the year ended December 31, 2017 was 1.14%, a decrease from 1.24% for the year ended December 31, 2016. The return on average equity decreased from 8.30% for the year ended December 31, 2016 to 7.64% for the year ended December 31, 2017.

The net interest margin decreased from 3.51% at year-end 2016 to 3.45% at December 31, 2017. The net interest margin benefitted from Federal Reserve interest rate increases, but reflected downward repricing of loans for competitive purposes, as well as the Company’s asset liability management practices.

The noninterest margin decreased from 1.36% to 1.34% over the same period, while basic net earnings per common share decreased from $2.15 for the year ended December 31, 2016 to $2.03 for the year ended December 31, 2017.

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Growth

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

	12/31/17	12/31/16
Securities	**$459,751**	$440,409
Loans, net of unearned income and deferred fees and costs, and the allowance for loan losses	**660,144**	639,452
Deposits	**1,059,734**	1,043,442
Total assets	**1,256,757**	1,233,942

Total assets experienced growth in 2017, funded by increases in customer deposits. Customer deposits grew $16,292 or 1.56% from December 31, 2016, with increases mainly from municipal deposits and individuals seeking to safeguard principal by avoiding more volatile investments in financial markets. The liquidity provided by customer deposits supported growth in loans of $20,692 or 3.24%. Securities increased by $19,342 or 4.39%.

In both 2017 and 2016, the Company's growth was internally generated and was not the result of acquisitions or other borrowings.

Asset Quality

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

	12/31/17	12/31/16
Nonperforming loans(1)	**$ 2,769**	$ 5,855
Loans past due 90 days or more and accruing	**51**	63
Other real estate owned	**2,817**	3,156
Allowance for loan losses to loans(2)	**1.19 %**	1.28 %
Net charge-off ratio	**0.08 %**	0.26 %

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

The Company monitors asset quality indicators in managing credit risk and in determining the allowance and provision for loan losses. At December 31, 2017, nonperforming loans were $2,769 or 0.41% of loans net of unearned income and deferred fees and costs. This compares to $5,855 or 0.90% at December 31, 2016. Loans past due 90 days or more and still accruing at year-end 2017 totaled $51, a decrease of $12 or 19.05%, from $63 at December 31, 2016. The net charge-off ratio decreased from 0.26% for the year ended December 31, 2016 to 0.08% for the year ended December 31, 2017, while other real estate owned decreased $339 for the same period.

The Company's risk analysis determined an allowance for loan losses of $7,925 at December 31, 2017, resulting in a provision for the year of $157. This compares with an allowance for loan losses of $8,300 as of December 31, 2016, and a provision of $1,650 for the year ended December 31, 2016. The ratio of the allowance for loan losses to loans decreased to 1.19%, from 1.28% at December 31, 2016. The methodology for determining the allowance for loan losses relies on historical charge-off trends, modified by trends in nonperforming loans and economic indicators. More information about the level and calculation methodology of the allowance for loan losses is provided in "Provision and Allowance for Loan Losses", "Balance Sheet – Loans – Risk Elements," "Balance Sheet – Loans – Troubled Debt Restructurings," as well as Notes 1 and 5 to the financial statements.

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

Net Interest Income

Net interest income for the year ended December 31, 2017 was $37,135, an increase of $371, or 1.01%, when compared to the prior year. The net interest margin for 2017 was 3.45%, compared to 3.51% for 2016. Total interest income for the period ended December 31, 2017 was $41,260, an increase of $330 from the period ended December 31, 2016. Interest expense declined by $41 during the same time frame, from $4,166 for the year ended December 31, 2016 to $4,125 for the year ended December 31, 2017. The decline in interest expense came about in part because higher priced certificates of deposit renewed at lower interest rates and because of the continued migration of time deposits to lower-cost non-time deposits. In addition, low-rate interest-bearing deposits volume increased substantially. Please refer to the section titled "Analysis of Changes In Interest Income and Interest Expense" for further information related to rate and volume changes.

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

The Federal Reserve increased its target federal funds rate by 25 basis points in December 2016 and raised rates by 25 basis points again in March, June and December, 2017, ending the year at a target of 1.50%. The rate increases positively affected the yield on the Company’s interest-bearing deposits in other banks for 2017. The yield on interest-bearing deposits increased from 0.52% for 2016 to 1.10% for 2017. However, the interest rate environment during 2017 is still considered to be relatively low by historical standards.

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

Federal Reserve policies and market forces influence the Company’s net interest margin. Because interest rates continue at relatively low levels, the Company expects that interest rates will likely increase in the future. The Company anticipates any rate increases will have a positive impact on the Company’s future net interest income. Management cannot predict the timing and level of interest rate movements.

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Analysis of Net Interest Earnings

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

	December 31, 2017			December 31, 2016			December 31, 2015		
	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate
Interest-earning assets:									
Loans, net of unearned income and deferred fees and costs (1)(2)(3)(4)	**$653,756**	**$30,593**	**4.68 %**	$622,239	$29,993	4.82 %	$620,547	$31,122	5.02 %
Taxable securities(5)	**313,255**	**5,711**	**1.82 %**	280,842	5,910	2.10 %	234,398	6,776	2.89 %
Nontaxable securities (1)(5)	**131,762**	**7,462**	**5.66 %**	139,429	7,932	5.69 %	147,895	8,425	5.70 %
Interest-bearing deposits	**71,603**	**791**	**1.10 %**	102,819	532	0.52 %	96,677	254	0.26 %
Total interest-earning assets	**$1,170,376**	**$44,557**	**3.81 %**	$1,145,329	$44,367	3.87 %	$1,099,517	$46,577	4.24 %
Interest-bearing liabilities:									
Interest-bearing demand deposits	**$598,661**	**$3,344**	**0.56 %**	$567,971	$3,144	0.55 %	$525,864	$2,916	0.55 %
Savings deposits	**140,997**	**244**	**0.17 %**	134,982	315	0.23 %	127,534	408	0.32 %
Time deposits	**120,220**	**537**	**0.45 %**	140,490	707	0.50 %	163,370	859	0.53 %
Total interest-bearing liabilities	**$859,878**	**$4,125**	**0.48 %**	$843,443	$4,166	0.49 %	$816,768	$4,183	0.51 %
Net interest income(1) and interest rate spread		**$40,432**	**3.33 %**		$40,201	3.38 %		$42,394	3.73 %
Net yield on average interest-earning assets			**3.45 %**			3.51 %			3.86 %

(1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 35% in the three years presented.
(2) Loan fees of $303 in 2017, $360 in 2016 and $448 in 2015 are included in total interest income.
(3) Nonaccrual loans are included in average balances for yield computations.
(4) Includes loans held for sale.
(5) Daily averages are shown at amortized cost.

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

	December 31,		
	2017	**2016**	**2015**
Net interest income, fully taxable equivalent basis	**$40,432**	$40,201	$42,394
Less: taxable equivalent adjustment	**(3,297)**	(3,437)	(3,663)
Net interest income	**$37,135**	$36,764	$38,731

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Analysis of Changes in Interest Income and Interest Expense

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

	2017 Over 2016 Changes Due To			2016 Over 2015 Changes Due To		
	Rates(2)	Volume(2)	Net Dollar Change	Rates(2)	Volume(2)	Net Dollar Change
Interest income: (1)						
Loans	$(891)	$ 1,491	$ 600	$(1,214)	$ 85	$(1,129)
Taxable securities	(839)	640	(199)	(2,055)	1,189	(866)
Nontaxable securities	(36)	(434)	(470)	(11)	(482)	(493)
Interest-bearing deposits	460	(201)	259	261	17	278
Increase (decrease) in income on interest-earning assets	$(1,306)	$ 1,496	$ 190	$(3,019)	$ 809	$(2,210)
Interest expense:						
Interest-bearing demand deposits	$29	$ 171	$ 200	$(5)	$ 233	$228
Savings deposits	(84)	13	(71)	(116)	23	(93)
Time deposits	(74)	(96)	(170)	(36)	(116)	(152)
Increase (decrease) in expense of interest-bearing liabilities	$(129)	$ 88	$ (41)	$(157)	$ 140	$(17)
Increase (decrease) in net interest income	$(1,177)	$ 1,408	$ 231	$(2,862)	$ 669	$(2,193)

(1) Taxable equivalent basis using a Federal income tax rate of 35% in 2017, 2016 and 2015.
(2) Variances caused by the change in rate times the change in volume have been allocated to rate and volume changes proportional to the relationship of the absolute dollar amounts of the change in each.

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

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

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

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

Interest on time deposits declined $170 from 2016 to 2017, with a decline of $74 due to rates and $96 due to decreased volume. See "Net Interest Income" for additional information related to the decline in interest expense.

When 2016 is compared with 2015, taxable-equivalent net interest income declined by $2,193. Total interest expense declined by $17, while interest income on a taxable-equivalent basis decreased $2,210. Declining yields impacted net interest income by $2,862, offset by increases due to favorable changes in volume of $669.

Lower interest rates led to a decline of $1,214 in interest income from loans. The average balance of loans increased from $620,547 in 2015 to $622,239 in 2016, causing an increase in interest income of $85.

Interest income on taxable securities decreased $2,055 due to rates, offset by an increase of $1,189 due to average volume, for a net decrease of $866 compared to 2015. Interest on non-taxable securities on a fully-taxable equivalent basis declined $11 due to rates and $482 due to volume. Because of low yields in the securities markets and a highly competitive loan environment, the Company priced deposits accordingly. Interest on time deposits declined $152 from 2015 to 2016, with a decline of $36 due to rates and $116 due to decreased volume.

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Interest Rate Sensitivity

The Company considers interest rate risk to be a significant risk and has systems in place to measure the exposure of net interest income and fair market values to movement in interest rates. Among the tools available to management is interest rate sensitivity analysis, which provides information related to repricing opportunities. Interest rate shock simulations indicate potential economic loss due to future interest rate changes. Shock analysis is a test that measures the effect of a hypothetical, immediate and parallel shift in interest rates. The following table shows the results of a rate shock and the effects on the return on average assets and the return on average equity projected at December 31, 2017 and 2016. For purposes of this analysis, noninterest income and expenses are assumed to be flat.

Rate Shift (bp)	Return on Average Assets		Return on Average Equity	
	2017	**2016**	**2017**	**2016**
300	**1.37 %**	1.23 %	**9.13 %**	8.37 %
200	**1.40 %**	1.24 %	**9.28 %**	8.42 %
100	**1.42 %**	1.24 %	**9.42 %**	8.45 %
(-)100	**1.37 %**	1.13 %	**9.06 %**	7.70 %
(-)200	**1.23 %**	1.05 %	**8.17 %**	7.20 %
(-)300	**1.25 %**	1.12 %	**8.33 %**	7.57 %

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

Noninterest Income

	Year Ended		
	December 31, 2017	**December 31, 2016**	**December 31, 2015**
Service charges on deposits	**$2,776**	$ 2,458	$ 2,250
Other service charges and fees	**205**	212	215
Credit card fees	**3,948**	3,798	3,861
Trust fees	**1,530**	1,346	1,229

Bank-owned life insurance income	**758**	597	603
Other income	**1,148**	1,289	1,295
Realized securities gains	**14**	232	33
Total noninterest income	**$10,379**	$ 9,932	$ 9,486

Service charges on deposit accounts totaled $2,776 for the year ended December 31, 2017. This is an increase of $318, or 12.94%, from $2,458 for the year ended December 31, 2016. Service charges on deposit accounts increased $208, or 9.24%, from 2015 to 2016. This income category is affected by the number of deposit accounts, the level of service charges and the number of checking account overdrafts. The 2017 increase resulted primarily from an increase of $325 in non-sufficient funds and overdraft fees due to implementation of a new overdraft privilege program during the second half of 2016. The 2016 increase resulted primarily from an increase of $224 in non-sufficient funds and overdraft fees due to implementation of the overdraft privilege program.

Other service charges and fees include charges for official checks, income from the sale of checks to customers, safe deposit box rent, fees from letters of credit and income from commissions on the sale of credit life, accident and health insurance. These fees were $205 for the year ended December 31, 2017, a decrease of $7, or 3.30%, from the $212 for 2016. The total for the year ended December 31, 2016 was $3 below the $215 posted for the year ended December 31, 2015.

Credit card fees for the year ended December 31, 2017, were $150 above the $3,798 reported for the year ended December 31, 2016. From 2015 to 2016, credit card fees decreased $63, or 1.63%. Credit card fees are dependent on the volume of transactions.

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Trust fees at $1,530 increased by $184 or 13.67% when the years ended December 31, 2017 and 2016 are compared. For the year ended December 31, 2016 trust fees were $1,346, an increase of $117, or 9.52%, from 2015. Trust fees are generated from a number of different types of accounts, including estates, personal trusts, employee benefit trusts, investment management accounts, attorney-in-fact accounts and guardianships. Trust income varies depending on the number and type of accounts under management and financial market conditions. The mix of account types also affected the level of trust fees in 2016 and 2017.

Noninterest income from bank-owned life insurance (BOLI) increased, from $597 for the year ended December 31, 2016 to $758 for 2017. The Company purchased an additional $10 million in BOLI in June 2017. BOLI income for the year ended December 31, 2015 was $603. Income from bank-owned life insurance was affected by the performance of the variable rate policies, which has not varied significantly.

Other income is income from smaller balance accounts that cannot be classified in another category. Some examples include gains on mortgage loans sold, net gains from the sale of fixed assets and revenue from investment and insurance sales. Other income for 2017 was $1,148, a decrease of $141, or 10.94%, when compared with $1,289 for the year ended December 31, 2016. In December 2017, the Company sold its Marion branch office and realized a gain on the sale of fixed assets of $134. This was offset by a decline of $69 in the gain on the sale of mortgage loans due to lower volume, and a decline of $230 due to a one-time vendor signing incentive received in 2016. Other income decreased slightly from 2015 to 2016.

During 2017, the Company sold a small investment in community bank stock that resulted in a gain of $4. All other realized gains and losses on securities during 2017, 2016 and 2015 resulted from calls of securities. The Company did not sell any securities in 2016 or 2015.

Noninterest Expense

	Year Ended December 31, 2017	**December 31, 2016**	**December 31, 2015**
Salaries and employee benefits	**$13,746**	$ 12,792	$ 12,522
Occupancy, furniture and fixtures	**1,820**	1,849	1,743
Data processing and ATM	**2,275**	2,186	1,657
FDIC assessment	**364**	476	546
Credit card processing	**2,748**	2,782	2,692
Intangibles amortization	**68**	257	999
Net costs of other real estate owned	**205**	472	608
Franchise taxes	**1,315**	1,296	1,288
Other operating expenses	**4,431**	4,042	3,580
Total noninterest expense	**$26,972**	$ 26,152	$ 25,635

Salary and benefits expense increased $954, or 7.46%, from $12,792 for the year ended December 31, 2016 to $13,746 for 2017. Employee salaries increased $256 or 2.63% which was the result of normal staffing and compensation decisions. Expense associated with the health insurance reserve increased $419. The Company participates in a "self-funded" insurance plan and reserves amounts based on employee health insurance usage and calculated projections. In 2016, the Company benefitted from refunds due to a change in the calculation of the required minimum reserve and from positive claims history. The Company began in 2017, a new incentive compensation program for senior employees, which contributed $280 to the increase. The increases were offset by a $101 decrease in salary expense related to deferred costs associated with loan production. Salary and benefits expense increased $270, or 2.16%, from $12,522 for the year ended December 31, 2015 to $12,792 for 2016. From 2015 to 2016, employee salaries increased $695 or 7.70%, which were the result of normal staffing and compensation decisions. This was offset by a $680 reduction in fringe benefits and a reduction of $171 in BOLI and salary continuation expenses.

Occupancy, furniture and fixtures expense was $1,820 for the year ended December 31, 2017, a decrease of $29, or 1.57%, from the prior year. The decrease stemmed from higher expenditures on security equipment and building maintenance in the previous year. The 2016 total was $1,849, an increase of $106, or 6.08%, from the $1,743 reported at year-end 2015.

Data processing and ATM expense was $2,275 in 2017, $2,186 in 2016 and $1,657 in 2015. The increase of $89 or 4.07% from 2016 to 2017 was due to increased maintenance expense associated with infrastructure upgrades. The Company is committed to maintaining up-to-date technology in a cost-effective manner.

When the years ended December 31, 2017 and December 31, 2016 are compared, the Federal Deposit Insurance Corporation assessment expense decreased $112 or 23.53%. The total expense for 2017 was $364, which compares with $476 for 2016. The FDIC assessment is accrued based on a method provided by the FDIC. The FDIC's Deposit Insurance Fund reserve ratio reached a target threshold during the second quarter of 2016, resulting in lower FDIC insurance expense for many federally insured institutions. The FDIC assessment expense for the year ended December 31, 2016 decreased $70 from $546 for 2015.

Credit card processing expense was $2,748 for the period ended December 31, 2017, a decrease of $34, or 1.22% from 2016's total of $2,782. Credit card processing expense in 2016 increased $90, or 3.34% from 2015. This expense is driven by the volume of credit card, debit card and merchant account transactions and by the level of merchant discount fees. It is subject to a degree of variability.

The expense for intangibles amortization is related to acquisitions. There were no acquisitions in the last year, and the expense for 2017 decreased from 2016 by $189 or 73.54%. The decrease in core deposit intangibles amortization is due to certain core deposit intangibles becoming fully amortized in late 2015, the first half of 2016, and the first quarter of 2017. The expense for intangibles amortization decreased $742 from 2015 to 2016.

Net costs of other real estate owned decreased from $472 for the period ended December 31, 2016 to $205 for the year ended December 31, 2017. From 2015 to 2016, net costs of other real estate owned decreased $136 from $608. This expense category varies with the number of foreclosed properties owned by NBB and with the expense associated with each. It includes write-downs on other real estate owned plus other costs associated with carrying these properties, as well as net gains or losses on the sale of other real estate. In 2017, write-downs on other real estate were $113. This compares with $268 in 2016 and $440 in 2015. Other real estate is initially accounted for at fair value less estimated costs to sell using current valuations, which include appraisals, real estate evaluations and realtor market opinions. If new valuation information indicates a decline from the initial basis, the Company records a write-down. Other costs for these properties in 2017 were $80, compared with $118 in 2016. The Company recorded a loss of $12 on the sale of OREO in 2017 and a loss of $86 for 2016. The Company’s market area is showing mixed economic signs, with some favorable indicators and some unfavorable indicators, and we anticipate that there may be additional foreclosures in the future. The Company currently does not have any loans in process of foreclosure.

Franchise taxes were $1,315 for the period ended December 31, 2017 and $1,296 for 2016, an increase of $19 or 1.47%. Franchise tax expense increased $8 in 2016 from $1,288 in 2015. State bank franchise taxes are based upon NBB’s total equity, which increased in both 2016 and 2017.

The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs and charitable donations. For the year ended December 31, 2017, other operating expenses were $4,431. This compares with $4,042 for 2016 and $3,580 for 2015. The $389 increase from 2016 to 2017 was due to a loss of $189 resulting from a wire fraud and an increase in expenses associated with the overdraft program, legal fees, and audit and consulting services. The $462 increase from 2015 to 2016 was primarily the result of the recognition of $347 in bankcard losses.

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, and firewall management, as well as ongoing employee training. In 2017, the Company also implemented additional email and web protections, an intrusion prevention system and an additional targeted cybersecurity insurance policy. The costs of these measures were $134 for the twelve months ended December 31, 2017 and $66 for the twelve months ended December 31, 2016. These costs are included in various categories of noninterest expense.

The Company experienced two intrusions to its digital systems, one in May 2016 and one in January 2017. Hackers and related organized criminal groups obtained unauthorized access to certain customer accounts. The attacks disabled certain systems protections, including limits on the number, amount, and frequency of ATM withdrawals. The attacks resulted in the theft of funds disbursed through ATMs. In the May 2016 attack, hackers accessed customer funds and in the January 2017 intrusion, the hackers artificially inflated account balances and did not access customer funds. The

Company notified all affected customers, and restored all funds so that no customer experienced a loss.

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

The financial impact of the attacks include the amount of the theft, as well as costs of investigation and remediation. The theft of funds totaled $570 in the May 2016 attack and $1,838 in the January 2017 attack. The Company recognized an estimated loss of $347 in 2016 within other operating expenses, and currently recognizes an insurance receivable in other assets of $2,061. The Company filed an insurance claim in 2017 for both of the breaches and is awaiting a response from the insurance company. The Company has had no adverse communication from the insurance company. Costs for investigation, remediation, and legal consultation totaled $407 in 2017 and $46 in 2016. As of December 31, 2017, the Company has appropriately accounted for the breaches. There has been no litigation 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 has adopted new protections and invested additional resources to increase its security.

Income Taxes

Income tax expense for 2017 was $6,293 compared to $3,952 in 2016 and $4,740 in 2015. During the three years reported, the Company's marginal tax rate was 35%. The Company's effective tax rates for 2017, 2016 and 2015 were 30.87%, 20.92% and 23.04%, respectively. The expected income tax expense based on the Company's marginal tax rate differs from the actual income tax expense due to tax exempt income on municipal securities and loans as well as the re-valuation of deferred tax assets. On December 22, 2017, the Tax Cuts and Jobs Act ("the Act") was enacted and is effective January 1, 2018. The Act will reduce the Company's tax rate to 21%. As a result of the change in the Company's future tax rate, generally accepted accounting principles in the United States ("GAAP") require revaluation in 2017 of deferred tax assets to the rate at which they will be realized. During the fourth quarter, the Company recognized a revaluation adjustment of $1.56 million, with a corresponding charge to income tax expense. See Note 10 of the Notes to Consolidated Financial Statements for addition information relating to income taxes.

Effects of Inflation

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

Provision and Allowance for Loan Losses

The Company's risk analysis at December 31, 2017 determined an allowance for loan losses of $7,925 or 1.19% of loans net of unearned income and deferred fees and costs, a decrease from $8,300 or 1.28% at December 31, 2016. The determination of the appropriate level for the allowance for loan losses resulted in a provision for loan losses of $157 for the twelve months ended December 31, 2017, compared with $1,650 for the twelve months ended December 31, 2016. To determine the appropriate level of the allowance for loan losses, the Company considers credit risk for certain loans designated as impaired and for non-impaired ("collectively evaluated") loans.

Individually evaluated impaired loans totaled $11,924 on a gross basis and $11,919 net of unearned income and deferred fees and costs, with specific allocations to the allowance for loan losses of $177 at December 31, 2017. Individually evaluated impaired loans at December 31, 2016 were $9,173 on a gross basis and $9,168 net of unearned income and deferred fees and costs, with specific allocations to the allowance for loan losses of $26. The specific allocation is determined based on criteria particular to each impaired loan.

Collectively evaluated loans totaled $656,758 on a gross basis and $656,150 net of unearned income and deferred fees and costs, with an allowance of $7,748 or 1.18% at December 31, 2017. At December 31, 2016, collectively evaluated loans totaled $639,373 on a gross basis and $638,584 net of unearned income and deferred fees and costs, with an allowance of $8,274 or 1.30%.

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

Net charge-off rates for each class are averaged over 8 quarters (2 years) to determine the historical net charge off rate applied to each class of collectively evaluated loans. Net charge-offs for the twelve months ended December 31, 2017 were $532 or 0.08% of average loans, an improvement from $1,647 or 0.26% for the twelve months ended December 31, 2016. Net charge-offs for the twelve months ended December 31, 2015 were $1,975 or 0.32% of loans. 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 that impact its markets, 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 necessary allowance for loan losses, while higher unemployment increases credit risk. Higher bankruptcy filings indicate heightened credit risk and increase the allowance for loan losses, while lower bankruptcy filings have a beneficial impact on credit risk. The interest rate environment impacts variable rate loans. As interest rates increase, the payment on variable rate loans increases, increasing credit risk. Residential vacancy rates and housing inventory for sale impact the Company’s residential construction customers and the consumer real estate market. Higher levels increase credit risk. Higher competition for loans increases credit risk, while lower competition decreases credit risk.

Economic indicators that improved from December 31, 2016 were lower unemployment, lower personal bankruptcies and lower housing inventory for sale in the Company’s market area. Improved economic indicators result in a lower requirement for the allowance for loan losses. Economic indicators that negatively impacted credit risk included elevated business bankruptcies and increases in the interest rate environment, when data at December 31, 2017 are compared with data at December 31, 2016. Residential vacancy rates resulted in a slightly larger allowance, and the competitive environment remained at a similar level to that at December 31, 2016.

The Company considers other factors that impact credit risk, including the legal and regulatory environments, changes to lending policies and loan review, and management’s experience. Each of the factors remained at similar levels to December 31, 2016.

Asset quality indicators affect the level of the allowance for loan losses. Accruing loans past due 30-89 days were 0.34% of total loans, net of unearned income and deferred fees and costs at December 30, 2017, a decrease from 0.39% at December 31, 2016. Accruing loans past due 90 days or more were 0.01% of total loans, net of unearned income and deferred fees and costs at December 30, 2017, the same level as December 31, 2016. Nonaccrual loans decreased to 0.41% of total loans, net of unearned income and deferred fees and costs at December 30, 2017, from 0.90% at December 31, 2016. Decreases in past due and nonaccrual loans reduce the required level of the allowance for loan losses, while increases in past due and nonaccrual loans increase the required level of the allowance for loan losses.

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

Collectively evaluated loans rated "special mention" were $3,361 at December 31, 2017, down from $13,519 at December 31, 2016. Collectively evaluated loans rated classified were $1,691 at December 31, 2017, down from $3,052 at December 31, 2016.

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 fell by $6,081 or 3.76% from the level at December 31, 2016, resulting in a decreased allocation.

The calculation of the appropriate level for the allowance for loan losses incorporates analysis of multiple factors and requires management's prudent and informed judgment. The ratio of the allowance for loan losses to total loans, net of unearned income and deferred fees and costs at December 30, 2017 is 1.19%, a decrease from 1.28% at December 31, 2016. The ratio of the allowance for collectively-evaluated loan losses to collectively-evaluated loans, net of unearned income and deferred fees and costs was 1.18%, compared with 1.30% at December 31, 2016. Improvements from December 31, 2016 in the charge-off rate, nonaccrual loans, criticized loans, unemployment, personal bankruptcies and housing inventory decreased the required level of the allowance for loan losses, slightly offset by worsening in business bankruptcies, residential vacancy and the impact of the interest rate environment. Based on analysis of historical indicators, asset quality and economic factors, management believes the level of allowance for loan losses is reasonable for the credit risk in the loan portfolio.

Quarterly Results of Operations

The following is a summary of the unaudited quarterly results of operations for the years ended December 31, 2017, 2016 and 2015:

	2017			
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Income Statement Data:				
Interest income	**$ 10,238**	**$ 10,295**	**$ 10,301**	**$ 10,426**
Interest expense	**1,028**	**1,048**	**1,021**	**1,028**
Net interest income	**9,210**	**9,247**	**9,280**	**9,398**
Provision for loan losses	**59**	**464**	**201**	**(567)**

Noninterest income	**2,504**	**2,455**	**2,598**	**2,822**
Noninterest expense	**6,937**	**6,698**	**6,745**	**6,592**
Income taxes	**1,069**	**970**	**1,147**	**3,107**
Net income	**$3,649**	**$3,570**	**$3,785**	**$3,088**
Per Share Data:				
Basic net income per common share	**$0.52**	**$0.51**	**$0.54**	**$0.46**
Fully diluted net income per common share	**0.52**	**0.51**	**0.54**	**0.46**
Cash dividends per common share	**---**	**0.56**	**---**	**0.61**
Book value per common share	**26.30**	**26.49**	**26.97**	**26.57**

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	2016 First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Income Statement Data:				
Interest income	$10,484	$10,292	$10,157	$9,997
Interest expense	1,068	1,063	1,019	1,016
Net interest income	9,416	9,229	9,138	8,981
Provision for loan losses	203	654	291	502
Noninterest income	2,341	2,618	2,481	2,492
Noninterest expense	6,684	6,238	6,620	6,610
Income taxes	1,091	1,090	880	891
Net income	$3,779	$3,865	$3,828	$3,470
Per Share Data:				
Basic net income per common share	$0.54	$0.56	$0.55	$0.51
Fully diluted net income per common share	0.54	0.56	0.55	0.51
Cash dividends per common share	---	0.55	---	0.61
Book value per common share	25.76	25.86	26.47	25.62

	2015 First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Income Statement Data:				
Interest income	$10,794	$10,724	$10,760	$10,636
Interest expense	1,087	1,051	1,009	1,036
Net interest income	9,707	9,673	9,751	9,600
Provision for loan losses	201	355	178	1,275
Noninterest income	2,258	2,471	2,289	2,468
Noninterest expense	6,687	6,369	6,322	6,257
Income taxes	1,111	1,310	1,341	978
Net income	$3,966	$4,110	$4,199	$3,558
Per Share Data:				
Basic net income per common share	$0.57	$0.59	$0.60	$0.52
Fully diluted net income per common share	0.57	0.59	0.60	0.52
Cash dividends per common share	---	0.53	---	0.61
Book value per common share	24.85	24.10	25.07	25.62

Balance Sheet

On December 31, 2017, the Company had total assets of $1,256,757, an increase of $22,815 or 1.85%, over the total of $1,233,942 on December 31, 2016. For 2017, the growth in assets was entirely internally generated and was not the result of acquisitions. Total assets at December 31, 2016 were up by $30,423, or 2.53%, over the total at December 31, 2015.

Loans

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

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A. Types of Loans

	December 31,				
	2017	**2016**	**2015**	**2014**	**2013**
Real estate construction	**$34,694**	$36,345	$48,251	$45,562	$45,925
Consumer real estate	**166,965**	157,718	143,504	147,039	145,499
Commercial real estate	**340,414**	336,457	309,378	310,762	311,266
Commercial non real estate	**40,518**	39,024	37,571	33,413	31,262
Public sector and IDA	**51,443**	45,474	51,335	41,361	34,220
Consumer non real estate	**34,648**	33,528	29,845	28,182	28,423
Total loans	**$668,682**	$648,546	$619,884	$606,319	$596,595
Less unearned income and deferred fees	**(613)**	(794)	(876)	(853)	(905)
Total loans, net of unearned income and deferred fees and costs	**$668,069**	$647,752	$619,008	$605,466	$595,690
Less allowance for loans losses	**(7,925)**	(8,300)	(8,297)	(8,263)	(8,227)
Total loans, net	**$660,144**	$639,452	$610,711	$597,203	$587,463

B. Maturities and Interest Rate Sensitivities

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

	December 31, 2017			
	< 1 Year	**1 – 5 Years**	**After 5 Years**	**Total**
Commercial non real estate	**$26,301**	**$14,058**	**$159**	**$40,518**
Commercial real estate	**75,047**	**209,177**	**56,190**	**340,414**
Real estate construction	**24,629**	**9,880**	**185**	**34,694**
Total	**124,977**	**233,115**	**56,534**	**415,626**
Less loans with predetermined interest rates	**(17,360)**	**(31,037)**	**(7,974)**	**(56,371)**
Loans with adjustable rates	**$108,617**	**$202,078**	**$48,560**	**$359,255**

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C. Risk Elements

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

	December 31,				
	2017	**2016**	**2015**	**2014**	**2013**
Nonaccrual loans:					
Real estate construction	**$---**	$---	$---	$---	$---
Consumer real estate	**6**	256	14	164	198
Commercial real estate	**---**	698	1,146	3,087	5,383
Commercial non real estate	**---**	217	883	748	128
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**---**	---	---	---	23
Total nonaccrual loans	**$6**	$1,168	$2,043	$3,999	$5,732
Restructured loans (TDR Loans) in nonaccrual					
Real estate construction	**$---**	$270	$718	$---	$---
Consumer real estate	**145**	---	---	---	201
Commercial real estate	**2,602**	4,390	3,921	5,288	651
Commercial non real estate	**15**	24	---	---	---
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**1**	3	---	---	---
Total restructured loans in nonaccrual	**$2,763**	$4,687	$4,639	$5,288	$852
Total nonperforming loans	**$2,769**	$5,855	$6,682	$9,287	$6,584
Other real estate owned, net	**2,817**	3,156	4,165	4,744	4,712
Total nonperforming assets	**$5,586**	$9,011	$10,847	$14,031	$11,296
Accruing loans past due 90 days or more:					
Real estate construction	**$---**	$---	$---	$---	$---
Consumer real estate	**11**	42	145	82	128
Commercial real estate	**---**	---	---	102	---
Commercial non real estate	**---**	---	---	---	---
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**40**	21	11	23	62
Total accruing loans past due 90 days or more	**$51**	$63	$156	$207	$190
Accruing restructured loans:					
Real estate construction	**$---**	$---	$---	$---	$---
Consumer real estate	**947**	877	962	819	579
Commercial real estate	**2,948**	2,892	7,645	5,192	5,552
Commercial non real estate	**1,214**	---	207	29	60
Public sector and IDA	**---**	---	---	---	---
Consumer non real estate	**25**	---	---	---	---
Total accruing restructured loans	**$5,134**	$3,769	$8,814	$6,040	$6,191

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

Loan Loss Data Table

	2017	2016	2015
Provision for loan losses	**$157**	$1,650	$2,009
Net charge-offs to average net loans	**0.08 %**	0.26 %	0.32 %
Allowance for loan losses to loans, net of unearned income and deferred fees	**1.19 %**	1.28 %	1.34 %
Allowance for loan losses to nonperforming loans	**286.20 %**	141.76 %	124.17 %
Allowance for loan losses to nonperforming assets	**141.87 %**	92.11 %	76.49 %
Nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned	**0.83 %**	1.38 %	1.74 %
Nonaccrual loans	**$6**	$1,168	$2,043
Restructured loans in nonaccrual status	**2,763**	4,687	4,639
Other real estate owned, net	**2,817**	3,156	4,165
Total nonperforming assets	**$5,586**	$9,011	$10,847
Accruing loans past due 90 days or more	**$51**	$63	$156

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

Total impaired loans at December 31, 2017 were $11,924, of which $2,763 were in nonaccrual status. Impaired loans at December 31, 2016 and 2015 were $9,173 and $15,346, of which $5,404 and $6,532 were in nonaccrual status, respectively.

The ratio of the allowance for loan losses to total nonperforming loans improved from 141.76% in 2016 to 286.20% in 2017. The Company believes the allowance for loan losses is adequate for the credit risk inherent in the loan portfolio.

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D. Modifications and Troubled Debt Restructurings ("TDRs")

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

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

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

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

Modifications Made During the 12 Months Ended December 31, 2017

to Borrowers Not Experiencing Financial Difficulty

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

Modifications Made During the 12 Months Ended December 31, 2016

to Borrowers Not Experiencing Financial Difficulty

Modification	**Number of Loans Modified**	**Total Amount Modified**
Rate reductions for competitive purposes	73	$ 34,080
Payment extensions for less than 3 months	142	2,475
Maturity date extensions of more than 3 months and up to 6 months	219	20,781
Maturity date extensions of more than 6 months and up to 12 months	274	13,277
Maturity date extensions of more than 12 months	17	3,073
Advances on non-revolving loans or recapitalization	2	177
Change in amortization term or method	26	2,292
Renewal of expired Home Equity Line of Credit loans to additional 10 years	19	678
Renewal of single-payment notes	244	4,722
Total modifications that do not constitute TDRs	1,016	$ 81,555

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Modifications Made During the 12 Months Ended December 31, 2015

to Borrowers Not Experiencing Financial Difficulty

Modification	Number of Loans Modified	Total Amount Modified
Rate reductions for competitive purposes	70	$ 38,417
Payment extensions for less than 3 months	115	2,486
Maturity date extensions of more than 3 months and up to 6 months	260	30,257
Maturity date extensions of more than 6 months and up to 12 months	260	15,613
Maturity date extensions of more than 12 months	6	330
Advances on non-revolving loans or recapitalization	2	566
Change in amortization term or method	20	2,580
Renewal of expired Home Equity Line of Credit loans to additional 10 years	25	597
Renewal of single-payment notes	235	4,144
Total modifications that do not constitute TDRs	993	$ 94,990

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

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

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

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

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The Company had $7,897 in TDRs as of December 31, 2017 and $8,456 as of December 31, 2016. Accruing TDR loans amounted to $5,134 at December 31, 2017 compared to $3,769 at December 31, 2016.

Restructuring generally results in loans with either lower payments or an extended maturity beyond that originally required, and are expected to have a lower risk of loss due to nonperformance than loans classified as nonperforming. In 2017, the Company modified loans in troubled debt restructurings that, directly prior to restructuring, totaled $1,387 and that have total principal balances of $1,369 as of December 31, 2017. Some of the Company’s restructured loans defaulted during the twelve months ended December 31, 2017. The Company defines default as a delay in one payment of more than 90 days or foreclosure after the date of restructuring. All of the restructured loans that defaulted had been modified more than twelve months prior to default.

In 2016, the Company modified loans in troubled debt restructurings that, directly prior to restructuring, totaled $3,042 and that had total principal balances of $2,761 as of December 31, 2016. All of the restructured loans that defaulted in 2016 had been modified more than twelve months prior to default.

Please refer to Note 5 for information on the effect of default on the allowance for loan losses.

	TDR Delinquency Status as of December 31, 2017				
			Accruing		
	Total TDR Loans	**Current**	**30-89 Days Past Due**	**90+ Days Past Due**	**Nonaccrual**
Real estate construction	**$---**	**$ ---**	**$ ---**	**$ ---**	**$ ---**
Consumer real estate	**1,092**	**773**	**174**	**---**	**145**
Commercial real estate	**5,550**	**2,948**	**---**	**---**	**2,602**
Commercial non real estate	**1,229**	**1,214**	**---**	**---**	**15**
Public sector and IDA	**---**	**---**	**---**	**---**	**---**
Consumer non real estate	**26**	**25**	**---**	**---**	**1**
Total TDR Loans	**$7,897**	**$ 4,960**	**$ 174**	**$ ---**	**$ 2,763**

	TDR Delinquency Status as of December 31, 2016				
			Accruing		
	Total TDR Loans	**Current**	**30-89 Days Past Due**	**90+ Days Past Due**	**Nonaccrual**
Real estate construction	$270	$ ---	$ ---	$ ---	$ 270
Consumer real estate	877	717	160	---	---
Commercial real estate	7,282	2,892	---	---	4,390
Commercial non real estate	24	---	---	---	24

Public sector and IDA	---	---	---	---	---
Consumer non real estate	3	---	---	---	3
Total TDR Loans	$8,456	$ 3,609	$ 160	$ ---	$ 4,687

	TDR Delinquency Status as of December 31, 2015				
			Accruing		
	Total TDR Loans	Current	30-89 Days Past Due	90+ Days Past Due	Nonaccrual
Real estate construction	$718	$ ---	$ ---	$ ---	$ 718
Consumer real estate	962	784	178	---	---
Commercial real estate	11,566	7,645	---	---	3,921
Commercial non real estate	207	207	---	---	---
Public sector and IDA	---	---	---	---	---
Consumer non real estate	---	---	---	---	---
Total TDR Loans	$13,453	$ 8,636	$ 178	$ ---	$ 4,639

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Summary of Loan Loss Experience

A. Analysis of the Allowance for Loan Losses

The following tabulation shows average loan balances at the end of each period; changes in the allowance for loan losses arising from loans charged off and recoveries on loans previously charged off by loan category; and additions to the allowance which have been charged to operating expense:

	December 31,				
	2017	**2016**	**2015**	**2014**	**2013**
Average loans, net of unearned income and deferred fees and costs	**$653,364**	$621,654	$619,745	$592,944	$585,991
Allowance for loan losses at beginning of year	**8,300**	8,297	8,263	8,227	8,349
Charge-offs:					
Real estate construction	**---**	29	---	2	184
Consumer real estate	**146**	133	205	222	256
Commercial real estate	**139**	488	1,114	1,201	64
Commercial non real estate	**82**	883	490	89	968
Public Sector and IDA	**---**	---	---	---	---
Consumer non real estate	**452**	273	311	346	348
Total loans charged off	**819**	1,806	2,120	1,860	1,820
Recoveries:					
Real estate construction	**---**	---	---	---	44
Consumer real estate	**1**	2	2	---	1
Commercial real estate	**131**	83	49	50	25
Commercial non real estate	**23**	10	1	132	18
Public Sector and IDA	**---**	---	---	---	---
Consumer non real estate	**132**	64	93	73	79
Total recoveries	**287**	159	145	255	167
Net loans charged off	**532**	1,647	1,975	1,605	1,653
Provision charged to operations	**157**	1,650	2,009	1,641	1,531
Allowance for loan losses at end of year	**$7,925**	$8,300	$8,297	$8,263	$8,227
Net charge-offs to average loans net of unearned income and deferred fees and costs	**0.08** %	0.26 %	0.32 %	0.27 %	0.28 %

The Company charges off commercial real estate loans at the time that a loss is confirmed. When delinquency status or other information indicates that the borrower will not repay the loan, the Company considers collateral value based upon a current appraisal or internal evaluation. Any loan amount in excess of collateral value is charged off and the collateral is taken into other real estate owned.

Management analyzes many factors to determine the appropriate level for the allowance for loan losses and resultant provision expense, including the historical loss rate, the quality of the loan portfolio as determined by management, diversification as to type of loans in the portfolio, internal policies and economic factors. Management considers net charge-offs over the most recent eight quarters to determine the historical loss rate to be applied to the calculation. The historical loss rate contributes significantly to the required level for the allowance for loan losses.

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B. Allocation of the Allowance for Loan Losses

The allowance for loan losses has been allocated according to the amount deemed necessary to provide for anticipated losses within the categories of loans for the years indicated as follows:

	December 31, 2017			**2016**			**2015**			**2014**			**2013**		
	Allowance Amount	**Percent of Loans in Each Category to Total Loans(1)**		**Allowance Amount**	**Percent of Loans in Each Category to Total Loans(1)**		**Allowance Amount**	**Percent of Loans in Each Category to Total Loans(1)**		**Allowance Amount**	**Percent of Loans in Each Category to Total Loans(1)**		**Allowance Amount**	**Percent of Loans in Each Category to Total Loans(1)**	
Real estate construction	**$337**	**5.19**	**%**	$438	5.60	%	$576	7.78	%	$612	7.52	%	$863	7.70	%
Consumer real estate	**2,027**	**24.97**	**%**	1,830	24.32	%	1,866	23.15	%	1,662	24.25	%	1,697	24.39	%
Commercial real estate	**3,044**	**50.91**	**%**	3,738	51.88	%	4,109	49.92	%	3,537	51.25	%	3,685	52.17	%
Commercial non real estate	**1,072**	**6.06**	**%**	1,063	6.02	%	655	6.06	%	1,475	5.51	%	989	5.24	%
Public sector and IDA	**419**	**7.69**	**%**	330	7.01	%	436	8.28	%	327	6.82	%	132	5.74	%
Consumer non real estate	**707**	**5.18**	**%**	644	5.17	%	627	4.81	%	602	4.65	%	576	4.76	%
Unallocated	**319**			257			28			48			285		
	$7,925	**100.00**	**%**	$8,300	100.00	%	$8,297	100.00	%	$8,263	100.00	%	$8,227	100.00	%

(1) Loans are presented on a gross basis.

An analysis of the allowance for loan losses by impairment basis follows:

	December 31, 2017		**2016**		**2015**	
Impaired loans(1)	**$11,924**		$9,173		$15,346	
Allowance related to impaired loans(1)	**177**		26		45	
Allowance to impaired loans(1)	**1.48**	**%**	0.27	%	0.29	%

Non-impaired loans(1)	**656,758**	639,373	604,538
Allowance related to non-impaired loans(1)	**7,748**	8,274	8,252
Allowance to non-impaired loans(1)	**1.18 %**	1.29 %	1.37 %
Total gross loans	**668,682**	648,546	619,884
Less: unearned income and deferred fees and costs	**(613)**	(794)	(876)
Loans, net of unearned income and deferred fees and costs	**668,069**	647,752	619,008
Allowance for loan losses, total	**7,925**	8,300	8,297
Allowance as a percentage of loans, net of unearned income and deferred fees and costs	**1.19 %**	1.28 %	1.34 %

(1) Loans are presented on a gross basis.

Individually-evaluated impaired loans are valued using the appraised value of the underlying collateral or the present value of cash flows for each loan. Valuation procedures for impaired loans resulted in a required reserve for impaired loans of $177 at December 31, 2017, $26 at December 31, 2016 and $45 at December 31, 2015. The amount of the individual impaired loan balance that exceeds the fair value is accrued in the allowance for loan losses.

Management's analysis of the loan portfolio and pertinent economic conditions resulted in a determination of the allowance for loan losses for collectively-evaluated loans of $7,748 or 1.18% at December 31, 2017, $8,275 or 1.30% at December 31, 2016, and $8,252 or 1.37% at December 31, 2015. The allowance for collectively-evaluated loans is determined by applying historical charge-off percentages, as well as additional accruals for internal and external credit risk factors to groups of collectively-evaluated loans. The ratio decreased from 2016 to 2017 due to a decreased charge-off ratio, down from 0.26% for the twelve months ended December 31, 2016 to 0.08% for the year ended December 31, 2017. Also contributing to the reduced allowance requirement were improved asset quality indicators, lower levels of high risk loans and favorable economic indicators. The ratio decreased from 2015 to 2016 due to decreases in net charge-offs. When compared with 2015, the level of the allowance for loan losses for 2016 also benefitted from improvements in asset quality, high risk loans and economic indicators.

The unallocated portion of the reserve was $319 at December 31, 2017, $257 at December 31, 2016 and $28 at December 31, 2015. The unallocated portion of the reserve is the amount that exceeds the calculated requirement for the allowance for loan losses. The Company's policy permits an unallocated reserve of up to 5% in excess of the required level for the allowance for loan losses.

The total calculated allowance for loan losses of $7,925 at December 31, 2017, $8,300 as of December 31, 2016 and $8,297 as of December 31, 2015 indicated provision charges for loan losses of $157 for the twelve months ended December 31, 2017, $1,650 for the twelve months ended December 31, 2016 and $2,009 for the twelve months ended December 31, 2015. Please refer to the discussion under "Provision and Allowance for Loan Losses" for additional information on the determination of the allowance for loan loss.

Securities

The fair value of securities available for sale was $331,387, an increase of $27,105 or 8.91% from December 31, 2016. The amortized cost of securities held to maturity was $127,164 at December 31, 2017 and $134,957 at December 31, 2016, a decrease of $7,793 or 5.77%.

Additional information about securities available for sale and securities held to maturity can be found in Note 3 of the Notes to Consolidated Financial Statements.

The securities portfolio is subject to the volatility and risk in the financial markets. The risk in financial markets affects the Company in the same way that it affects other institutional and individual investors. The Company's investment portfolio includes corporate bonds. If, because of economic hardship, the corporate issuers were to default, there could be a delay in the payment of interest, or there could be a loss of principal and accrued interest. To date, there have been no defaults in any of the corporate bonds held in the portfolio. The Company's investment portfolio also contains a large percentage of municipal bonds. If economic forces reduce the ability of states and municipalities to make scheduled principal and interest payments on their outstanding indebtedness, or if their income from taxes and other sources declines significantly, states and municipalities could default on their bond obligations. There have been no defaults among the municipal bonds in the Company’s investment portfolio. The fair value of our bond portfolio is affected by interest rates. The fair value of available for sale securities is reflected on the Company's balance sheet, while held to maturity securities are reported at amortized cost.

In making investment decisions, management follows internal policy guidelines that help to limit risk by specifying parameters for both security quality and industry and geographic concentrations. Management regularly monitors the quality of the investment portfolio and tracks changes in financial markets. The value of individual securities will be written down if a decline in fair value is considered to be other than temporary, given the totality of the circumstances.

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Maturities and Associated Yields

The following table presents the maturities for securities available for sale and held to maturity at their carrying values as of December 31, 2017 and weighted average yield for each range of maturities.

$ in thousands, except percent data	**Maturities and Yields December 31, 2017**					
	< 1 Year	**1-5 Years**	**5-10 Years**	**> 10 Years**	**None**	**Total**
Available for Sale:						
U.S. Government agencies	**$32,026**	**$185,782**	**$66,677**	**$23,234**	**$---**	**$307,719**
	1.10 %	**1.49 %**	**2.39 %**	**3.33 %**	**---**	**1.78 %**
Mortgage-backed securities	**$10**	**$71**	**$162**	**$416**	**$---**	**$659**
	4.84 %	**5.00 %**	**5.62 %**	**5.47 %**	**---**	**5.44 %**
States and political subdivision – nontaxable (1)	**$1,202**	**$2,145**	**$3,670**	**$9,817**	**$---**	**$16,834**
	5.75 %	**5.84 %**	**5.39 %**	**4.13 %**	**---**	**4.73 %**
Corporate	**$---**	**$1,007**	**$---**	**$5,168**	**$---**	**$6,175**
	---	**2.48 %**	**---**	**4.15 %**	**---**	**3.88 %**
Other securities	**$---**	**$---**	**$---**	**$---**	**$---**	**$---**
	---	**---**	**---**	**---**	**---**	**---**
Total	**$33,238**	**$189,005**	**$70,509**	**$38,635**	**$---**	**$331,387**
	1.27 %	**1.55 %**	**2.55 %**	**3.67 %**	**---**	**1.98 %**
Restricted stock:						
Restricted stock	**$---**	**$---**	**$---**	**$---**	**$1,200**	**$1,200**
	---	**---**	**---**	**---**	**4.92 %**	**4.92 %**
Held to Maturity:						
U.S. Government agencies	**$---**	**$2,999**	**$---**	**$935**	**$---**	**$3,934**
	---	**3.75 %**	**---**	**3.54 %**	**---**	**3.70 %**
Mortgage-backed securities	**$---**	**$---**	**$117**	**$92**	**$---**	**$209**
	---	**---**	**5.13 %**	**6.08 %**	**---**	**5.55 %**
States and political subdivision – nontaxable (1)	**$11,906**	**$20,422**	**$25,125**	**$64,586**	**$---**	**$122,039**
	6.53 %	**6.35 %**	**5.05 %**	**4.99 %**	**---**	**5.38 %**
Corporate	**$---**	**$982**	**$---**	**$---**	**$---**	**$982**
	---	**2.40 %**	**---**	**---**	**---**	**2.40 %**
Total	**$11,906**	**$24,403**	**$25,242**	**$65,613**	**$---**	**$127,164**
	6.53 %	**5.87 %**	**5.05 %**	**4.97 %**	**---**	**5.31 %**

(1) Rates shown represent weighted average yield on a fully taxable basis.

The majority of mortgage-backed securities and collateralized mortgage obligations held at December 31, 2017 were backed by U.S. agencies. Certain holdings are required to be periodically subjected to the Federal Financial Institution Examination Council's (FFIEC) high risk mortgage security test. These tests address possible fluctuations in the average life and variances caused by the change in rate times the change in volume that have been allocated to rate and volume changes proportional to the relationship of the absolute dollar amounts of the change in each. Except for U.S. Government securities, the Company has no securities with any issuer that exceeds 10% of stockholders' equity.

Deposits

Total deposits increased by $16,292 or 1.56%, from $1,043,442 at December 31, 2016 to $1,059,734 at December 31, 2017. Total deposits grew $24,583, or 2.41%, from $1,018,859 at December 31, 2015 to December 31, 2016. A portion of the increase in both 2017 and 2016 is attributable to a higher level of municipal deposits. The increases in total deposits for 2017 and 2016 were internally generated and not the result of acquisitions.

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A. Average Amounts of Deposits and Average Rates Paid

Average amounts and average rates paid on deposit categories are presented below:

	Year Ended December 31,					
	2017		2016		2015	
	Average Amounts	Average Rates Paid	Average Amounts	Average Rates Paid	Average Amounts	Average Rates Paid
Noninterest-bearing demand deposits	**$178,708**	**---**	$170,344	---	$159,829	---
Interest-bearing demand deposits	**598,661**	**0.56 %**	567,971	0.55 %	525,864	0.55 %
Savings deposits	**140,997**	**0.17 %**	134,982	0.23 %	127,534	0.32 %
Time deposits	**120,220**	**0.45 %**	140,490	0.50 %	163,370	0.53 %
Average total deposits	**$1,038,586**	**0.40 %**	$1,013,787	0.41 %	$976,597	0.43 %

B. Time Deposits of $250 or More

The following table sets forth time certificates of deposit and other time deposits of $250 or more:

	December 31, 2017				
	3 Months or Less	Over 3 Months Through 6 Months	Over 6 Months Through 12 Months	Over 12 Months	Total
Total time deposits of $250 or more	**$1,587**	**$ 1,215**	**$ 6,565**	**$ 4,666**	**$14,033**

Derivatives and Market Risk Exposures

The Company is not a party to derivative financial instruments with off-balance sheet risks such as futures, forwards, swaps, and options. The Company is a party to financial instruments with off-balance sheet risks such as commitments to extend credit, standby letters of credit, and recourse obligations in the normal course of business to meet the financing needs of its customers. See Note 14, of Notes to Consolidated Financial Statements for additional information relating to financial instruments with off-balance sheet risk. Management does not plan any future involvement in high risk derivative products. The Company has investments in mortgage-backed securities, principally GNMA’s and FNMA’s, with a fair value of approximately $889. See Note 3 of Notes to Consolidated Financial Statements for additional information relating to securities.

The Company’s securities and loans are subject to credit and interest rate risk, and its deposits are subject to interest rate risk. Management considers credit risk when a loan is granted and monitors credit risk after the loan is granted. The Company maintains an allowance for loan losses to absorb losses in the collection of its loans. See Note 5 of Notes to Consolidated Financial Statements for information relating to the allowance for loan losses. See Note 15 of Notes to Consolidated Financial Statements for information relating to concentrations of credit risk. The Company has an asset/liability program to manage its interest rate risk. This program provides management with information related to the rate sensitivity of certain assets and liabilities and the effect of changing rates on profitability and capital accounts.

The effects of changing interest rates are primarily managed through adjustments to the loan portfolio and deposit base, to the extent competitive factors allow. The investment portfolio is generally longer term. Adjustments for asset and liability management are made when securities are called or mature and funds are subsequently reinvested. Securities may be sold for reasons related to credit quality or regulatory limitations, and in limited circumstances, securities available for sale have been disposed of for interest rate risk management. No trading activity for this purpose is planned in the foreseeable future, though it does remain an option.

While the asset/liability planning program is designed to protect the Company over the long term, it does not provide near-term protection from interest rate shocks, as interest rate sensitive assets and liabilities do not by their nature move up or down in tandem in response to changes in the overall rate environment. The Company’s profitability in the near term may be temporarily negatively affected in a period of rapidly rising or rapidly falling rates, because it takes some time for the Company to change its rates to adjust to a new interest rate environment. See Note 16 of Notes to Consolidated Financial Statements for information relating to fair value of financial instruments and comments concerning interest rate sensitivity.

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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 December 31, 2017, the bank did not have discount window borrowings, short-term borrowings, or FHLB advances. To assure that short-term borrowing is readily available, the Company tests accessibility annually.

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

Regulatory capital levels determine the Company’s ability to use purchased deposits and the Federal Reserve discount window. At December 31, 2017, the Company is considered well capitalized and does not have any restrictions on purchased deposits or borrowing ability at the Federal Reserve discount window.

The Company monitors factors that may increase its liquidity needs. Some of these factors include deposit trends, large depositor activity, maturing deposit promotions, interest rate sensitivity, maturity and repricing timing gaps between assets and liabilities, the level of unfunded loan commitments and loan growth. At December 31, 2017, 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 December 31, 2017, 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 December 31, 2017, the loan to deposit ratio was 63.04%, slightly below policy levels. The investment strategy takes into consideration the term of the investment, and securities in the available for sale portfolio are laddered based upon projected funding needs.

In the normal course of business, we enter into certain contractual obligations, including obligations to make future payments on lease arrangements, contractual commitments with depositors, and service contracts. The table below presents our significant contractual obligations as of December 31, 2017, except for pension and other postretirement benefit plans, which are included in Note 8, "Employee Benefit Plans," to the Consolidated Financial Statements in this Form 10-K.

Payments Due by Period

	Total	Less Than 1 Year	1-3 Years	4-5 Years	More Than 5 Years
Time deposits	**$114,884**	**$76,285**	**$32,370**	**$6,180**	**$ 49**
Purchase obligations [1]	**7,106**	**3,089**	**3,517**	**500**	**---**
Operating leases	**779**	**292**	**289**	**68**	**130**
Total	**$122,769**	**$79,666**	**$36,176**	**$6,748**	**$ 179**

(1) Includes contracts with a minimum annual payment of $100

As of December 31, 2017, the Company was not aware of any other known trends, events or uncertainties that have or are reasonably likely to have a material impact on our liquidity. As of December 31, 2017, the Company has no material commitments for long-term debt or for capital expenditures.

Recent Accounting Pronouncements

See Note 1 of Notes to Consolidated Financial Statements for information relating to recent accounting pronouncements.

Capital Resources

Total stockholders' equity at December 31, 2017 was $184,896, an increase of $6,633, or 3.72%, from the $178,263 at December 31, 2016. The largest component of 2017 stockholders' equity was retained earnings of $185,893, which included net income of $14,092, offset by dividends of $8,141. Total stockholders' equity increased by $6,149 or 3.57%, from $172,114 on December 31, 2015 to $178,263 on December 31, 2016.

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Risk based capital ratios are shown in the following tables.

	Ratios at December 31, 2017		Regulatory Capital Minimum Ratios		Regulatory Capital Minimum Ratios with Capital Conservation Buffer	
Common Equity Tier I Capital Ratio	**23.562**	**%**	**4.500**	**%**	**5.750**	**%**
Tier I Capital Ratio	**23.562**	**%**	**6.000**	**%**	**7.250**	**%**
Total Capital Ratio	**24.542**	**%**	**8.000**	**%**	**9.250**	**%**
Leverage Ratio	**15.424**	**%**	**4.000**	**%**	**4.000**	**%**

	Ratios at December 31, 2016		Regulatory Capital Minimum Ratios		Regulatory Capital Minimum Ratios with Capital Conservation Buffer	
Common Equity Tier I Capital Ratio	25.420	%	4.500	%	5.125	%
Tier I Capital Ratio	25.420	%	6.000	%	6.625	%
Total Capital Ratio	26.575	%	8.000	%	8.625	%
Leverage Ratio	15.121	%	4.000	%	4.000	%

Risk-based capital ratios are calculated in compliance with Federal Reserve rules based on Basel III capital requirements. The Company's ratios are well above the required minimums at December 31, 2017 and December 31, 2016.

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

Off-Balance Sheet Arrangements

The Company's off-balance sheet arrangements at December 31, 2017 are detailed in the table below.

	Payments Due by Period				
	Total	Less Than 1 Year	1-3 Years	4-5 Years	More Than 5 Years

Commitments to extend credit	**$161,222**	**$161,222**	**$ ---**	**$ ---**	**$ ---**
Standby letters of credit	**16,351**	**16,351**	**---**	**---**	**---**
Mortgage loans with potential recourse	**14,130**	**14,130**	**---**	**---**	**---**
Operating leases	**779**	**292**	**289**	**68**	**130**
Total	**$192,482**	**$191,995**	**$ 289**	**$ 68**	**$ 130**

In the normal course of business the Company's banking affiliate extends lines of credit to its customers. Amounts drawn upon these lines vary at any given time depending on the business needs of the customers.

Standby letters of credit are also issued to the bank's customers. There are two types of standby letters of credit. The first is a guarantee of payment to facilitate customer purchases. The second type is a performance letter of credit that guarantees a payment if the customer fails to perform a specific obligation. Revenue from these letters was approximately $57 in 2017.

While it would be possible for customers to fully draw on approved lines of credit and for beneficiaries to call all letters of credit, historically this has not occurred. In the event of a sudden and substantial draw on these lines, the Company has its own lines of credit from which it can draw funds. A sale of loans or investments would also be an option.

The Company sells mortgages on the secondary market subject to recourse agreements. The mortgages originated must meet strict underwriting and documentation requirements for the sale to be completed. The Company estimates a potential loss reserve for recourse provisions. The amount is not material as of December 31, 2017. To date, no recourse provisions have been invoked.

Operating leases are for buildings used in the Company's day-to-day operations.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Information about market risk is set forth above in the "Interest Rate Sensitivity" and "Derivatives and Market Risk Exposure" sections of the Management's Discussion and Analysis.

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Item 8. Financial Statements and Supplementary Data

Consolidated Balance Sheets

$ in thousands, except per share data	**December 31, 2017**	**2016**
Assets		
Cash and due from banks	$***12,926***	$*13,974*
Interest-bearing deposits	***51,233***	*80,268*
Securities available for sale, at fair value	***331,387***	*304,282*
Securities held to maturity (fair value of $130,113 at December 31, 2017 and $137,692 at December 31, 2016)	***127,164***	*134,957*
Restricted stock	***1,200***	*1,170*
Mortgage loans held for sale	***260***	*478*
Loans:		
Real estate construction loans	***34,694***	*36,345*
Consumer real estate loans	***166,965***	*157,718*
Commercial real estate loans	***340,414***	*336,457*
Commercial non real estate loans		