

NATIONAL BANKSHARES INC  
Form 10-K  
March 13, 2019

Table of Contents

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K**

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the Fiscal Year Ended December 31, 2018

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number: 0-15204

**NATIONAL BANKSHARES, INC.**

(Exact name of registrant as specified in its charter)

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

P.O. Box 90002

Blacksburg, VA 24062-9002

(540) 951-6300

(Address and telephone number of principal executive offices)

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such period that the registrant was required to submit files). Yes  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  Non-accelerated filer  Smaller reporting company   
Emerging growth company

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

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

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

**DOCUMENTS INCORPORATED BY REFERENCE**

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

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

Table of Contents

**NATIONAL BANKSHARES, INC. AND SUBSIDIARIES**

Form 10-K

Index

**Part I**

**Page**

Item 1. <u>Business</u>	3
Item 1A. <u>Risk Factors</u>	10
Item 1B. <u>Unresolved Staff Comments</u>	14
Item 2. <u>Properties</u>	14
Item 3. <u>Legal Proceedings</u>	14
Item 4. <u>Mine Safety Disclosures</u>	14

**Part II**

Item 5. <u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	14
Item 6. <u>Selected Financial Data</u>	16
Item 7. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	17
Item 7A. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	45
Item 8. <u>Financial Statements and Supplementary Data</u>	46
Item 9. <u>Changes In and Disagreements With Accountants on Accounting and Financial Disclosure</u>	93
Item 9A. <u>Controls and Procedures</u>	93
Item 9B. <u>Other Information</u>	94

**Part III**

Item 10. <u>Directors, Executive Officers and Corporate Governance</u>	94
Item 11. <u>Executive Compensation</u>	95

Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	95
Item 13. <u>Certain Relationships and Related Transactions, and Director Independence</u>	95
Item 14. <u>Principal Accounting Fees and Services</u>	95
<b><u>Part IV</u></b>	
Item 15. <u>Exhibits, Financial Statement Schedules</u>	96
Item 16. <u>Summary Information</u>	97
<b><u>Signatures</u></b>	98
<b><u>Index of Exhibits</u></b>	100

Table of Contents

**Part I**

\$ in thousands, except per share data

**Item 1. Business**

**History and Business**

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

**The National Bank of Blacksburg**

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

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

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

The Bank’s loan policy is updated and approved by the Board of Directors annually and disseminated to lending and loan portfolio management personnel to ensure consistent lending practices. The policy communicates the Company’s risk tolerance by prescribing underwriting guidelines and procedures, including approval limits and hierarchy,

documentation standards, requirements for collateral and loan-to-value limits, debt coverage, overall credit-worthiness and guarantor support.

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

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

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

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

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

Table of Contents

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

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

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

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

*Consumer Loans.* Consumer loans include loans secured by automobiles, loans to consumers secured by other non-real estate collateral and loans to consumers that are unsecured. Automobile loans include loans secured by new or used automobiles. We originate automobile loans on a direct basis. During 2018 and years prior, automobile loans were also originated on an indirect basis through selected dealerships. This program has been discontinued in 2019. We require borrowers to maintain collision insurance on automobiles securing consumer loans. Our procedures for underwriting consumer loans include an assessment of an applicant’s overall financial capacity, including credit history and the ability to meet existing obligations and payments on the proposed loan. An applicant’s creditworthiness is the primary consideration, and if the loan is secured by an automobile or other collateral, the underwriting process also includes a comparison of the value of the collateral security to the proposed loan amount.

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

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



**National Bankshares Financial Services, Inc.**

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

Table of Contents**Operating Revenue**

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

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

**Market Area**

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

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

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

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

## **Competition**

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

## Table of Contents

### **Cybersecurity**

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

### **Organization and Employment**

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

### **Regulation, Supervision and Government Policy**

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

**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 its financial condition, operations and management. The Commission may also make examinations of any bank holding company and its subsidiaries and must approve the acquisition of ownership or control of more than 5% of the voting shares of any Virginia bank or bank holding company.

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

Table of Contents

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

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

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

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

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

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

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

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

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

## Table of Contents

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

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

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

## **The National Bank of Blacksburg**

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



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

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

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

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

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

*Deposit Insurance.* NBB has deposits that are insured by the FDIC. The FDIC maintains a Deposit Insurance Fund (“DIF”) that is funded by risk-based insurance premium assessments on insured depository institutions. Assessments are determined based upon several factors, including the level of regulatory capital and the results of regulatory

examinations. The FDIC may adjust assessments if the insured institution's risk profile changes or if the size of the DIF declines in relation to the total amount of insured deposits. Beginning April 1, 2011, an institution's assessment base became consolidated total assets less its average tangible equity as defined by the FDIC. The FDIC has authority to impose (and has imposed during the recent financial crisis) special measures to boost the deposit insurance fund such as prepayments of assessments and additional special assessments.

Table of Contents

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

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

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

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

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

*Ability-to-Repay and Qualified Mortgage Rule.* Pursuant to the Dodd-Frank Act, the CFPB amended Regulation Z as implemented by the Truth in Lending Act, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers' ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the covered transaction; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) the monthly debt-to-income ratio or residual income; and (viii) credit history. Alternatively,

the mortgage lender can originate “qualified mortgages,” which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a “qualified mortgage” is a mortgage loan without negative amortization, interest-only payments, balloon payments or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Qualified mortgages that are “higher-priced” (e.g. subprime loans) create a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not “higher-priced” (e.g. prime loans) are given a safe harbor of compliance. The Company is predominantly an originator of compliant qualified mortgages.

### **Monetary Policy**

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

### **Other Legislative and Regulatory Concerns**

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

Table of Contents

**Company Website**

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

Item 1A. Risk Factors

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

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

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

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

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

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

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

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

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

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

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

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

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

Table of Contents

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