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

# FORM 10-Q

**[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2021
**[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ________ to ________

Commission File Number 0-15204

# NATIONAL BANKSHARES, INC.

(Exact name of registrant as specified in its charter)

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

101 Hubbard Street
Blacksburg, Virginia 24062-9002
(Address of principal executive offices)

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

(Not applicable)
(Former name, former address and former fiscal year, if changed since last report)

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

| Title of each class | Trading Symbol(s) | Name of each exchange on which registered |
|---|---|---|
| **Common Stock, par value $1.25 per share** | **NKSH** | **Nasdaq Capital Market** |

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

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

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 the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b–2 of the Exchange Act.

Large accelerated filer [ ] Accelerated filer [] Non-accelerated filer [x] Smaller reporting company [x] 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 Exchange Act). Yes [ ] No [x]

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

Outstanding shares of common stock at May 10 2021
6,205,358

**NATIONAL BANKSHARES, INC.**
Form 10-Q
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**Item 1. Financial Statements**

**Part I**
**Financial Information**
National Bankshares, Inc.
Consolidated Balance Sheets

| (in thousands, except share and per share data) | | (Unaudited) March 31, 2021 | | December 31, 2020 |
|---|---|---|---|---|
| **Assets** | | | | |
| Cash and due from banks | $ | **12,677** | $ | 13,147 |
| Interest-bearing deposits | | **135,142** | | 120,725 |
| Securities available for sale, at fair value | | **571,359** | | 546,742 |
| Restricted stock, at cost | | **845** | | 1,279 |
| Loans held for sale | | **424** | | 866 |
| Loans: | | | | |
| Loans, net of unearned income and deferred fees and costs | | **779,360** | | 768,799 |
| Less allowance for loan losses | | **(8,536)** | | (8,481) |
| Loans, net | | **770,824** | | 760,318 |
| Premises and equipment, net | | **9,955** | | 10,035 |
| Accrued interest receivable | | **5,367** | | 5,028 |
| Other real estate owned, net | | **957** | | 1,553 |
| Goodwill | | **5,848** | | 5,848 |
| Bank-owned life insurance | | **36,650** | | 36,444 |
| Other assets | | **18,162** | | 17,688 |
| **Total assets** | $ | **1,568,210** | $ | 1,519,673 |
| | | | | |
| **Liabilities and Stockholders' Equity** | | | | |
| Noninterest-bearing demand deposits | $ | **319,126** | $ | 276,793 |
| Interest-bearing demand deposits | | **766,582** | | 763,293 |
| Savings deposits | | **183,231** | | 167,475 |
| Time deposits | | **89,649** | | 89,582 |
| Total deposits | | **1,358,588** | | 1,297,143 |
| Accrued interest payable | | **49** | | 56 |
| Other liabilities | | **20,504** | | 21,867 |
| Total liabilities | | **1,379,141** | | 1,319,066 |
| Commitments and contingencies | | | | |
| | | | | |
| **Stockholders' Equity** | | | | |
| Preferred stock, no par value, 5,000,000 shares authorized; none issued and outstanding | | **-** | | - |
| Common stock of $1.25 par value. Authorized 10,000,000 shares; issued and outstanding 6,320,188 shares at March 31, 2021 and 6,432,020 shares at December 31, 2020 | | **7,900** | | 8,040 |
| Retained earnings | | **190,462** | | 189,547 |
| Accumulated other comprehensive income (loss), net | | **(9,293)** | | 3,020 |
| Total stockholders' equity | | **189,069** | | 200,607 |
| **Total liabilities and stockholders' equity** | $ | **1,568,210** | $ | 1,519,673 |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc.
Consolidated Statements of Income
Three Months Ended March 31, 2021 and 2020
(Unaudited)

| (in thousands, except share and per share data) | March 31, 2021 | March 31, 2020 |
|---|---|---|
| **Interest Income** | | |
| Interest and fees on loans | **$ 8,550** | $ 8,466 |
| Interest on interest-bearing deposits | **28** | 217 |
| Interest on securities – taxable | **1,783** | 2,356 |
| Interest on securities – nontaxable | **521** | 349 |
| Total interest income | **10,882** | 11,388 |
| | | |
| **Interest Expense** | | |
| Interest on time deposits | **90** | 559 |
| Interest on other deposits | **765** | 1,237 |
| Total interest expense | **855** | 1,796 |
| Net interest income | **10,027** | 9,592 |
| Provision for loan losses | **50** | 479 |
| Net interest income after provision for loan losses | **9,977** | 9,113 |
| | | |
| **Noninterest Income** | | |
| Service charges on deposit accounts | **469** | 582 |
| Other service charges and fees | **41** | 39 |
| Credit and debit card fees | **434** | 306 |
| Trust income | **415** | 434 |
| BOLI income | **206** | 221 |
| Gain on sale of mortgage loans | **137** | 94 |
| Other income | **627** | 439 |
| Realized securities gain, net | **5** | 20 |
| Total noninterest income | **2,334** | 2,135 |
| | | |
| **Noninterest Expense** | | |
| Salaries and employee benefits | **3,906** | 3,873 |
| Occupancy, furniture and fixtures | **488** | 450 |
| Data processing and ATM | **778** | 791 |
| FDIC assessment | **83** | - |
| Net costs of other real estate owned | **37** | 22 |
| Franchise taxes | **335** | 343 |
| Other operating expenses | **909** | 988 |
| Total noninterest expense | **6,536** | 6,467 |
| Income before income taxes | **5,775** | 4,781 |
| Income tax expense | **1,009** | 802 |

*(continued)*

| | | | | |
|---|---|---|---|---|
| **Net Income** | **$** | **4,766** | $ | 3,979 |
| Basic net income per common share | **$** | **0.74** | $ | 0.61 |
| Fully diluted net income per common share | **$** | **0.74** | $ | 0.61 |
| Weighted average number of common shares outstanding – basic and diluted | | **6,407,685** | | 6,489,574 |
| Dividends declared per common share | | **-** | | - |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc.
Consolidated Statements of Comprehensive Income (Loss)
Three Months Ended March 31, 2021 and 2020
(Unaudited)

| (in thousands) | March 31, 2021 | March 31, 2020 |
|---|---|---|
| Net Income | **$ 4,766** | $ 3,979 |
| | | |
| **Other Comprehensive Income (Loss), Net of Tax** | | |
| Unrealized holding gain (loss) on available for sale securities net of tax of ($3,271) and $1,028 for the periods ended March 31, 2021 and 2020, respectively | **(12,309)** | 3,870 |
| Reclassification adjustment for gain included in net income, net of tax of ($1) for the period ended March 31, 2021 and ($4) for the period ended March 31, 2020 | **(4)** | (16) |
| Other comprehensive income (loss), net of tax | **(12,313)** | 3,854 |
| **Total Comprehensive Income (Loss)** | **$ (7,547)** | $ 7,833 |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc.
Consolidated Statements of Changes in Stockholders' Equity
Three Months Ended March 31, 2021 and 2020
(Unaudited)

| **(in thousands, except share data)** | **Common Stock** | **Retained Earnings** | **Accumulated Other Comprehensive Loss** | **Total** |
|---|---|---|---|---|
| Balances at December 31, 2019 | $ 8,112 | $ 184,120 | $ (8,506) | $ 183,726 |
| Net income | - | 3,979 | - | 3,979 |
| Other comprehensive income, net of tax of $1,024 | - | - | 3,854 | 3,854 |
| Balances at March 31, 2020 | $ 8,112 | 188,099 | (4,652) | 191,559 |
| | | | | |
| Balances at December 31, 2020 | $ 8,040 | $ 189,547 | $ 3,020 | $ 200,607 |
| Net income | - | 4,766 | - | 4,766 |
| Common stock repurchased, 111,832 shares | (140) | (3,851) | - | (3,991) |
| Other comprehensive loss, net of tax of ($3,272) | - | - | (12,313) | (12,313) |
| **Balances at March 31, 2021** | **$ 7,900** | **$ 190,462** | **$ (9,293)** | **$ 189,069** |

See accompanying notes to consolidated financial statements.

National Bankshares, Inc.
Consolidated Statements of Cash Flows
Three Months Ended March 31, 2021 and 2020
(Unaudited)

| (in thousands) | March 31, 2021 | March 31, 2020 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Net income | **$ 4,766** | $ 3,979 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | **50** | 479 |
| Depreciation of bank premises and equipment | **164** | 176 |
| Amortization of premiums and accretion of discounts, net | **416** | 193 |
| Gain on sales and calls of securities available for sale, net | **(5)** | (20) |
| Loss and write-down on other real estate owned, net | **26** | 4 |
| Increase in cash value of bank-owned life insurance | **(206)** | (221) |
| Origination of mortgage loans held for sale | **(6,266)** | (6,428) |
| Proceeds from sale of mortgage loans held for sale | **6,845** | 5,639 |
| Gain on sale of mortgage loans held for sale | **(137)** | (94) |
| Net change in: | | |
| Accrued interest receivable | **(339)** | 5 |
| Other assets | **1,340** | 625 |
| Accrued interest payable | **(7)** | (7) |
| Other liabilities | **106** | 883 |
| Net cash provided by operating activities | **6,753** | 5,213 |
| | | |
| **Cash Flows from Investing Activities** | | |
| Net change in interest-bearing deposits | **(14,417)** | 4,983 |
| Proceeds from calls, principal payments, sales and maturities of securities available for sale | **15,331** | 53,872 |
| Purchase of securities available for sale | **(55,944)** | (52,923) |
| Net change in restricted stock | **434** | (59) |
| Purchase of loan participations | **(951)** | (18) |
| Collection of loan participations | **93** | 87 |
| Loan originations and principal collections, net | **(9,761)** | 3,720 |
| Proceeds from sale of other real estate owned | **570** | 24 |
| Proceeds from disposal of repossessed assets | **-** | 27 |
| Recoveries on loans charged off | **52** | 73 |
| Proceeds from sale and purchases of premises and equipment, net | **(84)** | (1,315) |
| Net cash provided by (used in) investing activities | **(64,677)** | 8,471 |

*(continued)*

| | | | | |
|---|---|---|---|---|
| **Cash Flows from Financing Activities** | | | | |
| Net change in time deposits | | **67** | | (4,230) |
| Net change in other deposits | | **61,378** | | (7,340) |
| Common stock repurchased | | **(3,991)** | | - |
| Net cash provided by (used in) financing activities | | **57,454** | | (11,570) |
| Net change in cash and due from banks | | **(470)** | | 2,114 |
| Cash and due from banks at beginning of period | | **13,147** | | 10,290 |
| Cash and due from banks at end of period | **$** | **12,677** | $ | 12,404 |
| | | | | |
| **Supplemental Disclosures of Cash Flow Information** | | | | |
| Interest paid on deposits | **$** | **862** | $ | 1,803 |
| Income taxes paid | | **-** | | - |
| | | | | |
| **Supplemental Disclosure of Noncash Activities** | | | | |
| Loans charged against the allowance for loan losses | **$** | **47** | $ | 175 |
| Loans transferred to other real estate owned | | **-** | | - |
| Loans transferred to repossessed assets | | **11** | | 4 |
| Unrealized net gain (loss) on securities available for sale | | **(15,585)** | | 4,878 |
| Lease liabilities arising from obtaining right-of-use assets | | **-** | | - |

See accompanying notes to consolidated financial statements.

**National Bankshares, Inc.**
**Notes to Consolidated Financial Statements**
**March 31, 2021**
**(Unaudited)**

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

**Note 1: General**

The consolidated financial statements of National Bankshares, Inc. (“NBI”) and its wholly-owned subsidiaries, The National Bank of Blacksburg (the “Bank” or “NBB”) and National Bankshares Financial Services, Inc. (“NBFS”) (collectively, the “Company”), conform to accounting principles generally accepted in the United States of America (“U.S. GAAP”) and to general practices within the banking industry. The accompanying interim period consolidated financial statements are unaudited; however, in the opinion of management, all adjustments consisting of normal recurring adjustments, which are necessary for a fair presentation of the consolidated financial statements, have been included. The results of operations for the three month period ended March 31, 2021 are not necessarily indicative of results of operations for the full year or any other interim period. The interim period consolidated financial statements and financial information included in this Form 10-Q should be read in conjunction with the notes to consolidated financial statements included in the Company’s 2020 Form 10-K. The Company posts all reports required to be filed under the Securities Exchange Act of 1934 on its web site at www.nationalbankshares.com.

Risks and Uncertainties

Over the past year, the COVID-19 pandemic and efforts to reduce its spread have caused significant disruptions in the U.S. economy and negatively impacted financial activity in the Company’s market. The Company’s business is dependent upon the willingness and ability of its employees and customers to conduct banking and other financial transactions. If the global response to contain COVID-19 escalates further or is unsuccessful, the Company could experience a material adverse effect on its business, financial condition, results of operations and cash flows. While it is not possible to know the full extent of the impact COVID-19 will have on the Company’s operations, the Company is disclosing potentially material items of which it is aware.

*Financial position and results of operations*

The pandemic led to declines in two key income categories during 2020: interest income and overdraft fee income. Interest income was impacted by modification requests and by a decreased interest rate environment. During the first quarter of 2021, the number of modification requests that reduce interest income vastly decreased, though loan refinance and securities call activity spurred by the low interest rates continue to impact interest income, with reinvestment opportunities at lower rates. The Company does not expect the Federal Reserve to increase rates in the near future. If the pandemic’s evolution brings new or worsened economic impacts, these income categories and others may be negatively affected.

*Lending operations and accommodations to borrowers*

Modifications to loans for borrowers affected by COVID-19 provided payment relief. Depending on the demonstrated need of the borrower, the Company provided payment extensions, periods of interest only payments to otherwise amortizing loans, and interest rate reductions. The Company is monitoring loans with payment extensions, with special attention to loans with payment extensions that exceed 90 days, as well as subsequent requests for modifications to determine whether changes in risk ratings, accrual status or designation as a troubled debt restructuring (“TDR”) is warranted. If eventual credit losses are identified on these or other loans, accrued interest and fee income would be reversed at the time the loss is identified. If the loans are fully or partially charged off, future requirements for the provision for loan losses will increase. At this time, the Company is unable to project the materiality of such an impact, but recognizes economic declines may affect its borrowers’ ability to repay in future periods. The Company is closely monitoring the crisis and expects to continue to work with customers when warranted in order to preserve income potential and customer base.

With the passage of the Paycheck Protection Program (“PPP”), administered by the Small Business Administration (“SBA”), the Company is actively participating in assisting its customers through the program. It is the Company’s understanding that loans funded through the PPP program are fully guaranteed by the U.S. government and that the majority of these loans will ultimately be forgiven by the SBA in accordance with the terms of the program. Should those circumstances change, the Company could be required to establish additional allowance for loan loss through provision for loan loss charged to earnings.

*Credit*

The Company is working with customers directly affected by COVID-19, providing short-term assistance in accordance with regulatory guidelines. As a result of the current economic environment caused by the COVID-19 pandemic, the Company is engaging in more frequent communication with borrowers to better understand their situation and the challenges faced, allowing it to respond proactively as needs and issues arise. Should economic conditions worsen, the Company could experience further increases in its

required allowance for loan loss and record additional loan loss expense. It is possible that the Company's asset quality measures could worsen at future measurement periods if effects of the COVID-19 pandemic are prolonged.

*Asset valuation*

Currently, the Company does not expect COVID-19 to affect its ability to account timely for the assets on its balance sheet; however if the impact of the pandemic worsens, valuation procedures in future periods could be negatively affected. While certain valuation assumptions and judgments will change to account for pandemic-related circumstances, such as widening credit spreads, the Company does not anticipate significant changes in methodology used to determine the fair value of assets measured in accordance with U.S. GAAP.

The Company tests goodwill for impairment annually, usually during the fourth quarter using September 30 information, unless facts and circumstances indicate the need for more frequent impairment testing. If the evolution of the pandemic or other adverse events cause a sustained decline in the Company's stock price or the occurrence of what management deems to be a triggering event, under certain circumstances prescribed by U.S. GAAP, the Company will perform goodwill impairment testing as needed, which may be more frequently than annually. In the event that testing indicates that all or a portion of goodwill is impaired, a non-cash charge for the amount of such impairment would be recorded to earnings.

*Capital and liquidity*

While the Company believes that it has sufficient capital to withstand an extended economic recession brought about by COVID-19, its reported and regulatory capital ratios could be adversely impacted by further credit losses.

The Company maintains access to multiple sources of liquidity. Wholesale funding markets are currently available to the Company. If the uncertainty caused by the COVID-19 pandemic results in volatile or elevated funding costs for an extended period of time and if it becomes necessary for the Company to access wholesale funding, the Company's net interest margin could be adversely affected. Deposits have increased since the beginning of the pandemic, however, if an extended recession causes large numbers of the Company's deposit customers to withdraw their funds, the Company might become more reliant on volatile or more expensive sources of funding.

Accounting Standards Adopted as of January 1, 2021

In December 2019, the FASB issued ASU 2019-12, "Income Taxes (Topic 740) – Simplifying the Accounting for Income Taxes." The amendments are expected to reduce cost and complexity related to the accounting for income taxes by removing specific exceptions to general principles in Topic 740 (eliminating the need for an organization to analyze whether certain exceptions apply in a given period) and improving financial statement preparers' application of certain income tax-related guidance. This ASU is part of the FASB's simplification initiative to make narrow-scope simplifications and improvements to accounting standards through a series of short-term projects. ASU 2019-12 was effective for the Company on January 1, 2021. The adoption of ASU 2019-12 did not have a material impact on the Company's consolidated financial statements.

In January 2020, the FASB issued ASU 2020-01, "Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815)—Clarifying the Interactions between Topic 321, Topic 323, and Topic 815 (a consensus of the Emerging Issues Task Force)." The ASU is based on a consensus of the Emerging Issues Task Force and is expected to increase comparability in accounting for these transactions. ASU 2016-01 made targeted improvements to accounting for financial instruments, including providing an entity the ability to measure certain equity securities without a readily determinable fair value at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. Among other topics, the amendments clarify that an entity should consider observable transactions that require it to either apply or discontinue the equity method of accounting. ASU 2020-01 was effective for the Company on January 1, 2021. The adoption of ASU 2020-01 did not have a material impact on the Company's consolidated financial statements.

In October 2020, the FASB issued ASU 2020-08, "Codification Improvements to Subtopic 310-20, Receivables – Nonrefundable fees and Other Costs." This ASU clarifies that an entity should reevaluate whether a callable debt security is within the scope of ASC paragraph 310-20-35-33 for each reporting period. ASU 2020-08 was effective for the Company on January 1, 2021. The adoption of ASU 2020-08 did not have a material impact on the Company's consolidated financial statements.

Recent Accounting Pronouncements

In June 2016, the FASB issued Accounting Standards Update (ASU) No. 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The FASB has issued multiple updates to ASU 2016-13 as codified in Topic 326, including ASU's 2019-04, 2019-05, 2019-10, 2019-11, 2020-02, and 2020-03. These

ASU's have provided for various minor technical corrections and improvements to the codification as well as other transition matters. Smaller reporting companies who file with the U.S. Securities and Exchange Commission ("SEC") and all other entities who do not file with the SEC are required to apply the guidance for fiscal years, and interim periods within those years, beginning after December 15, 2022. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements. Management is working to ensure readiness and compliance with the standard and has implemented coding of the loan portfolio to enable appropriate segregation and data integrity, analyzed correlations for forecasting, determined methodologies, and selected a vendor to provide a platform. Management has prepared multiple concurrent models using the Current Expected Credit Losses ("CECL") methodology and will continue to refine assumptions that impact the calculation prior to the effective date.

Effective November 25, 2019, the SEC adopted Staff Accounting Bulletin ("SAB") 119. SAB 119 updated portions of SEC interpretative guidance to align with FASB Accounting Standards Codification ("ASC 326"), "Financial Instruments – Credit Losses." It covers topics including (1) measuring current expected credit losses; (2) development, governance, and documentation of a systematic methodology; (3) documenting the results of a systematic methodology; and (4) validating a systematic methodology.

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

**Note 2: Loan Portfolio**

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

| | **March 31, 2021** | December 31, 2020 |
|---|---|---|
| Real estate construction | **$ 42,570** | $ 42,266 |
| Consumer real estate | **186,906** | 181,782 |
| Commercial real estate | **392,461** | 393,115 |
| Commercial non-real estate | **87,258** | 78,771 |
| Public sector and IDA | **39,788** | 40,983 |
| Consumer non-real estate | **32,261** | 33,110 |
| Gross loans | **781,244** | 770,027 |
| Less unearned income and deferred fees and costs | **(1,884 )** | (1,228 ) |
| Loans, net of unearned income and deferred fees and costs | **$ 779,360** | $ 768,799 |

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

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

Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts will not be collected when due according to the contractual terms of the loan agreement. Impaired loans are those loans that have been modified in a TDR and larger, usually non-homogeneous loans that are in nonaccrual or exhibit payment history or financial status that indicate that collection probably will not occur when due according to the loan's terms. Generally, impaired loans are given risk ratings that indicate higher risk, such as "classified" or "special mention." Impaired loans are individually evaluated to determine appropriate reserves and are measured at the lower of the invested amount or the fair value. Impaired loans that are not TDRs and for which fair value measurement indicates an impairment loss are designated nonaccrual. A TDR loan that maintains current status for at least six months may accrue interest. Please refer to the Company's 2020 Form 10-K, Note 1: Summary of Significant Accounting

Policies for additional information on evaluation of impaired loans and associated specific reserves, and policies regarding nonaccruals, past due status and charge-offs.

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

Collectively Evaluated Loans

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

*Portfolio Segments and Classes*

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

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

*Historical Loss Rates*

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

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

*Risk Factors*

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

The analysis of certain factors results in standard allocations to all segments and classes. These factors include the risk from changes in lending policies, loan officers' average years of experience, and economic factors including unemployment levels, bankruptcy rates, interest rate environment, and competition/legal/regulatory environments. Also applied to all segments and classes is an economic factor implemented to address COVID-19 uncertainty: national unemployment filings. Typically the Company applies to the allowance calculation economic data specific to its market area. However, since local data is not available timely and historical analysis determined that local unemployment filings were closely correlated to national unemployment filings, the Company elected to allocate based upon national unemployment filings.

Factors analyzed for each class, with resultant allocations based upon the level of risk assessed for each class, include the risk from changes in loan review, levels of past due loans, levels of nonaccrual loans, current class balance as a percentage of total loans,

and the percentage of high risk loans within the class. High risk loans include junior liens, interest only and high loan to value loans. During the 4th quarter of 2020 the Company implemented a new factor to account for potential increased risk of loans that have received multiple modifications and were still in the modification period at the reporting date. Additionally, factors specific to each segment are analyzed and result in allocations to the segment. Factor allocations applied to each class are increased for loans rated special mention and increased to a greater extent for loans rated classified. Please refer to the Company's 2020 Form 10-K, Note 1: Summary of Significant Accounting Policies for a discussion of risk factors pertinent to each class.

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

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

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

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

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

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

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

**Activity in the Allowance for Loan Losses for the Three Months Ended March 31, 2021**

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non-Real Estate | Public Sector and IDA | Consumer Non-Real Estate | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Balance, December 31, 2020 | **$ 503** | **$ 2,165** | **$ 3,853** | **$ 670** | **$ 339** | **$ 555** | **$ 396** | **$ 8,481** |
| Charge-offs | **-** | **-** | **-** | **-** | **-** | **(47)** | **-** | **(47)** |
| Recoveries | **-** | **-** | **12** | **2** | **-** | **38** | **-** | **52** |
| Provision for (recovery of) loan losses | **8** | **201** | **(3)** | **(38)** | **(28)** | **(50)** | **(40)** | **50** |
| **Balance, March 31, 2021** | **$ 511** | **$ 2,366** | **$ 3,862** | **$ 634** | **$ 311** | **$ 496** | **$ 356** | **$ 8,536** |

**Activity in the Allowance for Loan Losses for the Three Months Ended March 31, 2020**

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non-Real Estate | Public Sector and IDA | Consumer Non-Real Estate | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Balance, December 31, 2019 | $ 400 | $ 1,895 | $ 2,559 | $ 555 | $ 478 | $ 650 | $ 326 | $ 6,863 |
| Charge-offs | - | (44) | - | (65) | - | (66) | - | (175) |
| Recoveries | - | - | 12 | 1 | - | 60 | - | 73 |
| Provision for (recovery of) loan losses | (25) | 219 | 29 | 230 | 33 | (25) | 18 | 479 |
| **Balance, March 31, 2020** | $ 375 | $ 2,070 | $ 2,600 | $ 721 | $ 511 | $ 619 | $ 344 | $ 7,240 |

**Activity in the Allowance for Loan Losses for the Year Ended December 31, 2020**

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non-Real Estate | Public Sector and IDA | Consumer Non-Real Estate | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Balance, December 31, 2019 | $ 400 | $ 1,895 | $ 2,559 | $ 555 | $ 478 | $ 650 | $ 326 | $ 6,863 |
| Charge-offs | - | (85) | (15) | (372) | - | (248) | - | (720) |
| Recoveries | - | 18 | 145 | 9 | - | 175 | - | 347 |
| Provision for (recovery of) loan losses | 103 | 337 | 1,164 | 478 | (139) | (22) | 70 | 1,991 |
| **Balance, December 31, 2020** | $ 503 | $ 2,165 | $ 3,853 | $ 670 | $ 339 | $ 555 | $ 396 | $ 8,481 |

**Allowance for Loan Losses as of March 31, 2021**

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non-Real Estate | Public Sector and IDA | Consumer Non-Real Estate | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Individually evaluated for impairment | **$ -** | **$ 2** | **$ -** | **$ 16** | **$ -** | **$ -** | **$ -** | **$ 18** |
| Collectively evaluated for impairment | **511** | **2,364** | **3,862** | **618** | **311** | **496** | **356** | **8,518** |
| **Total** | **$ 511** | **$ 2,366** | **$ 3,862** | **$ 634** | **$ 311** | **$ 496** | **$ 356** | **$ 8,536** |

**Allowance for Loan Losses as of December 31, 2020**

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non-Real Estate | Public Sector and IDA | Consumer Non-Real Estate | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Individually evaluated for impairment | $ - | $ 2 | $ - | $ 73 | $ - | $ - | $ - | $ 75 |
| Collectively evaluated for impairment | 503 | 2,163 | 3,853 | 597 | 339 | 555 | 396 | 8,406 |
| **Total** | $ 503 | $ 2,165 | $ 3,853 | $ 670 | $ 339 | $ 555 | $ 396 | $ 8,481 |

**Loans as of March 31, 2021**

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non-Real Estate | Public Sector and IDA | Consumer Non- Real Estate | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Individually evaluated for impairment | **$ -** | **$ 193** | **$ 3,919** | **$ 826** | **$ -** | **$ 1** | **$ -** | **$ 4,939** |
| Collectively evaluated for impairment | **42,570** | **186,713** | **388,542** | **86,432** | **39,788** | **32,260** | **-** | **776,305** |
| **Total** | **$ 42,570** | **$ 186,906** | **$ 392,461** | **$ 87,258** | **$ 39,788** | **$ 32,261** | **$ -** | **$ 781,244** |

**Loans as of December 31, 2020**

| | Real Estate Construction | Consumer Real Estate | Commercial Real Estate | Commercial Non-Real Estate | Public Sector and IDA | Consumer Non-Real Estate | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Individually evaluated for impairment | $ - | $ 194 | $ 3,856 | $ 851 | $ - | $ 2 | $ - | $ 4,903 |
| Collectively evaluated for impairment | 42,266 | 181,588 | 389,259 | 77,920 | 40,983 | 33,108 | - | 765,124 |
| **Total** | $ 42,266 | $ 181,782 | $ 393,115 | $ 78,771 | $ 40,983 | $ 33,110 | $ - | $ 770,027 |

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

| | As of and for the | | |
|---|---|---|---|
| | Three Months Ended March 31, | | Year Ended December 31, |
| | **2021** | **2020** | **2020** |
| Ratio of allowance for loan losses to the end of period loans, net of unearned income and deferred fees and costs[1] | **1.10 %** | 0.99% | 1.10 % |
| Ratio of net charge-offs to average loans, net of unearned income and deferred fees and costs[2] | **0.00 %** | 0.06% | 0.05 % |

[1] The ratio of the allowance for loan losses to the end of period loans, net of unearned income and deferred fees and costs at March 31, 2021 and December 31, 2020 include government-guaranteed SBA PPP loans, which do not require an allowance for loan losses. Excluding the PPP loans, the ratio would be 1.16% at both dates.
[2] Net charge-offs are on an annualized basis.

A summary of nonperforming assets follows.

| | March 31, | | December 31, |
|---|---|---|---|
| | **2021** | **2020** | **2020** |
| Nonperforming assets: | | | |
| Nonaccrual loans | **$ 784** | $ 261 | $ 846 |
| Restructured loans in nonaccrual | **2,907** | 3,191 | 2,839 |
| Total nonperforming loans | **3,691** | 3,452 | 3,685 |
| Other real estate owned, net | **957** | 1,584 | 1,553 |
| Total nonperforming assets | **$ 4,648** | $ 5,036 | $ 5,238 |
| Ratio of nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned | **0.60 %** | 0.69% | 0.68 % |
| Ratio of allowance for loan losses to nonperforming loans[1] | **231.27 %** | 209.73% | 230.15 % |

[1] The Company defines nonperforming loans as nonaccrual loans and restructured loans that are nonaccrual. Loans 90 days past due and still accruing and accruing restructured loans are excluded.

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

| | March 31, | | December 31, |
|---|---|---|---|
| | **2021** | **2020** | **2020** |
| Loans past due 90 days or more and still accruing | **$ 12** | $ 170 | $ 17 |
| Ratio of loans past due 90 days or more and still accruing to loans, net of unearned income and deferred fees and costs | **0.00 %** | 0.02% | 0.00 % |
| Accruing restructured loans | **$ 1,378** | $ 1,592 | $ 1,410 |
| Impaired loans: | | | |
| Impaired loans with no valuation allowance | **$ 4,564** | $ 4,557 | $ 3,858 |
| Impaired loans with a valuation allowance | **375** | 1,114 | 1,045 |
| Total impaired loans | **$ 4,939** | $ 5,671 | $ 4,903 |
| Valuation allowance | **(18)** | (110) | (75) |
| Impaired loans, net of allowance | **$ 4,921** | $ 5,561 | $ 4,828 |
| Average recorded investment in impaired loans[1] | **$ 4,956** | $ 5,677 | $ 5,093 |
| Interest income recognized on impaired loans, after designation as impaired | **$ 46** | $ 26 | $ 54 |
| Amount of income recognized on a cash basis | **$ -** | $ - | $ - |

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

Nonaccrual loan relationships that meet the Company's balance threshold of $250 and all TDRs are designated as impaired. The Company also designates as impaired other loan relationships that meet the Company's balance threshold of $250 and for which the Company does not expect to collect according to the note's contractual terms. No interest income was recognized on nonaccrual loans for the three months ended March 31, 2021 or March 31, 2020 or for the year ended December 31, 2020.

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

| | Impaired Loans as of March 31, 2021 | | | | |
|---|---|---|---|---|---|
| | Principal Balance | Total Recorded Investment[1] | Recorded Investment[1] for Which There is No Related Allowance | Recorded Investment[1] for Which There is a Related Allowance | Related Allowance |
| **Consumer Real Estate[2]** | | | | | |
| Investor-owned residential real estate | **$ 193** | **$ 193** | **$ -** | **$ 193** | **$ 2** |
| **Commercial Real Estate[2]** | | | | | |
| Commercial real estate, owner-occupied | **3,846** | **3,265** | **3,265** | **-** | **-** |
| Commercial real estate, other | **654** | **654** | **654** | **-** | **-** |
| **Commercial Non-Real Estate[2]** | | | | | |
| Commercial and industrial | **826** | **826** | **644** | **182** | **16** |
| **Consumer Non-Real Estate[2]** | | | | | |
| Automobile | **1** | **1** | **1** | **-** | **-** |
| **Total** | **$ 5,520** | **$ 4,939** | **$ 4,564** | **$ 375** | **$ 18** |

[1] Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.
[2] Only classes with impaired loans are shown.

| | Impaired Loans as of December 31, 2020 | | | | |
|---|---|---|---|---|---|
| | Principal Balance | Total Recorded Investment[1] | Recorded Investment[1] for Which There is No Related Allowance | Recorded Investment[1] for Which There is a Related Allowance | Related Allowance |
| **Consumer Real Estate[2]** | | | | | |
| Investor-owned residential real estate | $ 194 | $ 194 | $ - | $ 194 | $ 2 |
| **Commercial Real Estate[2]** | | | | | |
| Commercial real estate, owner occupied | 3,752 | 3,202 | 3,202 | - | - |
| Commercial real estate, other | 654 | 654 | 654 | - | - |
| **Commercial Non-Real Estate[2]** | | | | | |
| Commercial and industrial | 851 | 851 | - | 851 | 73 |
| **Consumer Non-Real Estate[2]** | | | | | |
| Automobile | 2 | 2 | 2 | - | - |
| **Total** | $ 5,453 | $ 4,903 | $ 3,858 | $ 1,045 | $ 75 |

[1] Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.
[2] Only classes with impaired loans are shown.

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

| | For the Three Months Ended March 31, 2021 | |
|---|---|---|
| | Average Recorded Investment[1] | Interest Income Recognized |
| **Consumer Real Estate[2]** | | |
| Investor-owned residential real estate | **$ 194** | **$ 3** |
| **Commercial Real Estate[2]** | | |
| Commercial real estate, owner occupied | **3,269** | **38** |
| Commercial real estate, other | **654** | **-** |
| **Commercial Non-Real Estate[2]** | | |
| Commercial and industrial | **838** | **5** |
| **Consumer Non-Real Estate[2]** | | |
| Automobile | **1** | **-** |
| **Total** | **$ 4,956** | **$ 46** |

| | For the Three Months Ended March 31, 2020 | |
|---|---|---|
| | Average Recorded Investment[1] | Interest Income Recognized |
| **Consumer Real Estate[2]** | | |
| Equity lines | $ 100 | $ 2 |
| Residential closed-end first liens | 22 | - |
| Investor-owned residential real estate | 487 | 4 |
| **Commercial Real Estate[2]** | | |
| Commercial real estate, owner occupied | 3,309 | 6 |
| Commercial real estate, other | 838 | 8 |
| **Commercial Non-Real Estate[2]** | | |
| Commercial and industrial | 917 | 6 |
| **Consumer Non-Real Estate[2]** | | |
| Automobile | 4 | - |
| **Total** | $ 5,677 | $ 26 |

(1) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.
(2) Only classes with impaired loans are shown.

| | For the Year Ended December 31, 2020 | |
|---|---|---|
| | Average Recorded Investment[1] | Interest Income Recognized |
| **Consumer Real Estate[2]** | | |
| Investor-owned residential real estate | $ 196 | $ 13 |
| **Commercial Real Estate[2]** | | |
| Commercial real estate, owner occupied | 3,217 | 19 |
| Commercial real estate, other | 790 | - |
| **Commercial Non-Real Estate[2]** | | |
| Commercial and industrial | 887 | 22 |
| **Consumer Non-Real Estate[2]** | | |
| Automobile | 3 | - |
| **Total** | $ 5,093 | $ 54 |

(1) Recorded investment is net of charge-offs and interest paid while a loan is in nonaccrual status.
(2) Only classes with impaired loans are shown.

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

An analysis of past due and nonaccrual loans follows.

**March 31, 2021**

| | 30 – 89 Days Past Due and Accruing | 90 or More Days Past Due | 90 or More Days Past Due and Accruing | Nonaccruals[2] |
|---|---|---|---|---|
| **Real Estate Construction[1]** | | | | |
| Construction, other | **$ 16** | **$ -** | **$ -** | **$ -** |
| **Consumer Real Estate[1]** | | | | |
| Equity lines | **29** | **-** | **-** | **-** |
| Residential closed-end first liens | **403** | **62** | **-** | **62** |
| Investor-owned residential real estate | **163** | **-** | **-** | **-** |
| **Commercial Real Estate[1]** | | | | |
| Commercial real estate, owner-occupied | **-** | **461** | **-** | **2,907** |
| Commercial real estate, other | **-** | **654** | **-** | **654** |
| **Commercial Non-Real Estate[1]** | | | | |
| Commercial and industrial[3] | **874** | **48** | **-** | **68** |
| **Consumer Non-Real Estate[1]** | | | | |
| Credit cards | **4** | **1** | **1** | **-** |
| Automobile | **97** | **-** | **-** | **-** |
| Other consumer loans | **218** | **11** | **11** | **-** |
| **Total** | **$ 1,804** | **$ 1,237** | **$ 12** | **$ 3,691** |

(1) Only classes with past due or nonaccrual loans are shown.
(2) Includes current and past due loans in nonaccrual status. Includes impaired loans in nonaccrual status.
(3) Includes SBA PPP loans past due 30-89 days of $3

**December 31, 2020**

| | 30 – 89 Days Past Due and Accruing | 90 or More Days Past Due | 90 or More Days Past Due and Accruing | Nonaccruals[2] |
|---|---|---|---|---|
| **Consumer Real Estate[1]** | | | | |
| Residential closed-end first liens | $ 365 | $ 62 | $ - | $ 62 |
| Investor-owned residential real estate | 106 | - | - | - |
| **Commercial Real Estate[1]** | | | | |
| Commercial real estate, owner occupied | 15 | 571 | - | 2,941 |
| Commercial real estate, other | - | 654 | - | 654 |
| **Commercial Non-Real Estate[1]** | | | | |
| Commercial and industrial | 730 | 27 | - | 28 |
| **Consumer Non-Real Estate[1]** | | | | |
| Credit cards | 7 | 3 | 3 | - |
| Automobile | 144 | 1 | 1 | - |
| Other consumer loans | 130 | 13 | 13 | - |
| **Total** | $ 1,497 | $ 1,331 | $ 17 | $ 3,685 |

[1] Only classes with past due or nonaccrual loans are shown.
[2] Includes current and past due loans in nonaccrual status. Includes impaired loans in nonaccrual status.

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

Credit quality indicators, which the Company terms risk grades, are assigned through the Company's credit review function for larger loans and selective review of loans that fall below credit review thresholds. Loans that do not indicate heightened risk are graded as "pass." Consumer loans are risk graded "classified" when they become 60 days past due. Loans that are not consumer loans that appear to have elevated credit risk because of frequent or persistent past due status, which is less than 75 days, or that show weakness in the borrower's financial condition are risk graded "special mention." Loans that are not consumer loans with frequent or persistent delinquency exceeding 75 days or that exhibit a higher level of weakness in the borrower's financial condition are graded classified. Classified loans have regulatory risk ratings of "substandard" and "doubtful." Allocations are increased by 50% and by 100% for loans with grades of "special mention" and "classified," respectively.

Determination of risk grades was completed for the portfolio as of March 31, 2021 and December 31, 2020.

The following displays collectively evaluated loans by credit quality indicator.

**March 31, 2021**

| | Pass[1] | Special Mention[1] | Classified[1] |
|---|---|---|---|
| **Real Estate Construction** | | | |
| Construction, 1-4 family residential | $ 8,902 | $ - | $ - |
| Construction, other | 33,668 | - | - |
| **Consumer Real Estate** | | | |
| Equity lines | 13,486 | - | 29 |
| Residential closed-end first liens | 94,684 | 65 | 343 |
| Residential closed-end junior liens | 2,902 | - | - |
| Investor-owned residential real estate | 74,468 | 632 | 104 |
| **Commercial Real Estate** | | | |
| Multifamily residential real estate | 90,194 | 261 | - |
| Commercial real estate owner-occupied | 144,790 | 543 | 37 |
| Commercial real estate, other | 146,197 | 6,520 | - |
| **Commercial Non-Real Estate** | | | |
| Commercial and industrial | 86,363 | - | 69 |
| **Public Sector and IDA** | | | |
| States and political subdivisions | 39,788 | - | - |
| **Consumer Non-Real Estate** | | | |
| Credit cards | 4,437 | - | - |
| Automobile | 11,666 | - | 17 |
| Other consumer | 16,134 | - | 6 |
| **Total** | $ 767,679 | $ 8,021 | $ 605 |

[1] Excludes impaired, if any.

The following displays collectively evaluated loans by credit quality indicator.

**December 31, 2020**

| | Pass[1] | Special Mention[1] | Classified[1] |
|---|---|---|---|
| **Real Estate Construction** | | | |
| Construction, 1-4 family residential | $ 8,195 | $ - | $ - |
| Construction, other | 34,071 | - | - |
| **Consumer Real Estate** | | | |
| Equity lines | 13,903 | - | - |
| Residential closed-end first liens | 92,241 | 66 | 284 |
| Residential closed-end junior liens | 3,003 | - | - |
| Investor-owned residential real estate | 71,450 | 641 | - |
| **Commercial Real Estate** | | | |
| Multifamily residential real estate | 87,455 | 265 | - |
| Commercial real estate owner-occupied | 146,900 | 543 | 140 |
| Commercial real estate, other | 147,436 | 6,520 | - |
| **Commercial Non-Real Estate** | | | |
| Commercial and industrial | 77,892 | - | 28 |
| **Public Sector and IDA** | | | |
| States and political subdivisions | 40,983 | - | - |
| **Consumer Non-Real Estate** | | | |
| Credit cards | 4,665 | - | - |
| Automobile | 12,024 | - | 6 |
| Other consumer | 16,398 | - | 15 |
| **Total** | $ 756,616 | $ 8,035 | $ 473 |

[1] Excludes impaired, if any.

Sales, Purchases and Reclassification of Loans

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

**Troubled Debt Restructurings**

From time to time the Company modifies loans that result in TDR designation. Total TDRs amounted to $4,285 at March 31, 2021, $4,249 at December 31, 2020, and $4,783 at March 31, 2020. All of the Company’s TDR loans are fully funded and no further increase in credit is available.

*TDRs Designated During the Reporting Period*

During the three months ended March 31, 2021 the Company designated one loan as a TDR. During the three months ended March 31, 2020, the Company designated no additional loans as TDRs. The restructuring completed during the three-month period ended March 31, 2021 shifted the payment structure from interest-only to amortizing and reduced the interest rate to provide cash flow relief. No principal or interest was forgiven. The impairment measurement at March 31, 2021 was based upon the collateral method and did not result in a specific allocation.

The following table presents restructurings by class that occurred during the three month period ended March 31, 2021.

| | Restructurings That Occurred During the Three Months Ended March 31, 2021 | | |
|---|---|---|---|
| | **Number of Contracts** | **Pre-Modification Outstanding Principal Balance** | **Post-Modification Outstanding Principal Balance** |
| **Commercial Real Estate** | | | |
| Commercial real estate owner-occupied | **1** | **$ 102** | **$ 102** |
| **Total** | **1** | **$ 102** | **$ 102** |

*Defaulted TDRs*

The Company analyzed its TDR portfolio for loans that defaulted during the three month periods ended March 31, 2021 and March 31, 2020, and that were modified within 12 months prior to default. The Company designates three circumstances that indicate default: one or more payments that occur more than 90 days past the due date, charge-off, or foreclosure after the date of restructuring.

Of the Company's TDRs at March 31, 2021 and March 31, 2020, none of the defaulted TDRs were modified within 12 months prior to default. All of the defaulted TDRs were in nonaccrual status as of March 31, 2021 and March 31, 2020.

*COVID-19 Related Modifications*

In order to aid borrowers negatively impacted by the COVID-19 pandemic, the Company provided modifications to qualifying loans. The CARES Act, passed at the beginning of the pandemic, Consolidated Appropriations Act ("CAA"), passed in December 2020, and regulatory guidance specify criteria that, if met, provide an election not to designate the loans as TDRs. All of the Company's COVID-19 related modifications met the criteria and were not designated TDR. As of March 31, 2021, no loans were found to have exceeded the criteria, and none were designated TDR.

**Note 4: Securities**

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

| | March 31, 2021 | | | |
|---|---|---|---|---|
| | **Amortized Costs** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Values** |
| **Available for Sale:** | | | | |
| U.S. Government agencies and corporations | **$ 131,670** | **$ 2,933** | **$ 4,378** | **$ 130,225** |
| States and political subdivisions | **199,874** | **3,706** | **4,395** | **199,185** |
| Mortgage-backed securities | **236,732** | **3,293** | **229** | **239,796** |
| Corporate debt securities | **2,001** | **152** | **-** | **2,153** |
| **Total securities available for sale** | **$ 570,277** | **$ 10,084** | **$ 9,002** | **$ 571,359** |

| | December 31, 2020 | | | |
|---|---|---|---|---|
| | **Amortized Costs** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Values** |
| **Available for Sale:** | | | | |
| U.S. Government agencies and corporations | $ 86,859 | $ 4,477 | $ 173 | $ 91,163 |
| States and political subdivisions | 196,435 | 7,778 | 252 | 203,961 |
| Mortgage-backed securities | 244,780 | 4,473 | 78 | 249,175 |
| Corporate debt securities | 2,001 | 442 | - | 2,443 |
| **Total securities available for sale** | $ 530,075 | $ 17,170 | $ 503 | $ 546,742 |

The amortized cost and fair value of single maturity securities available for sale at March 31, 2021, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay

obligations with or without call or prepayment penalties. Mortgage-backed securities included in these totals are categorized by final maturity.

| | March 31, 2021 | | | |
|---|---|---|---|---|
| | Amortized Cost | | Fair Value | |
| **Available for Sale:** | | | | |
| Due in one year or less | **$** | **3,072** | **$** | **3,115** |
| Due after one year through five years | | **5,438** | | **5,573** |
| Due after five years through ten years | | **178,874** | | **179,196** |
| Due after ten years | | **382,893** | | **383,475** |
| **Total securities available for sale** | **$** | **570,277** | **$** | **571,359** |

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

| | March 31, 2021 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Less Than 12 Months | | | | 12 Months or More | | | |
| | Fair Value | | Unrealized Loss | | Fair Value | | Unrealized Loss | |
| **Temporarily Impaired Securities:** | | | | | | | | |
| U.S. Government agencies and corporations | **$** | **89,509** | **$** | **4,378** | **$** | **-** | **$** | **-** |
| States and political subdivisions | | **89,706** | | **4,198** | | **4,092** | | **197** |
| Mortgage-backed securities | | **12,287** | | **229** | | **-** | | **-** |
| **Total** | **$** | **191,502** | **$** | **8,805** | **$** | **4,092** | **$** | **197** |

| | December 31, 2020 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Less Than 12 Months | | | | 12 Months or More | | | |
| | Fair Value | | Unrealized Loss | | Fair Value | | Unrealized Loss | |
| **Temporarily Impaired Securities:** | | | | | | | | |
| U.S. Government agencies and corporations | $ | 28,798 | $ | 173 | $ | - | $ | - |
| States and political subdivisions | | 32,353 | | 249 | | 635 | | 3 |
| Mortgage-backed securities | | 8,816 | | 76 | | 4,060 | | 2 |
| **Total** | $ | 69,967 | $ | 498 | $ | 4,695 | $ | 5 |

The Company had 183 securities with a fair value of $195,594 that were temporarily impaired at March 31, 2021. The total unrealized loss on these securities was $9,002. Of the temporarily impaired total, 3 securities with a fair value of $4,092 and an unrealized loss of $197 have been in a continuous loss position for 12 months or more. The Company has determined that these securities are temporarily impaired at March 31, 2021 for the reasons set out below.

States and political subdivisions. Three securities with an unrealized loss of $197 and a fair value of $4,092 have been in a continuous loss position for more than 12 months. The Company reviewed financial statements and cash flows for the securities. The Company's analysis determined that the unrealized loss is the result of interest rate and market fluctuations and not associated with impaired financial status. The contractual terms of the investments do not permit the issuers to settle the securities at a price less than the cost basis of the investment. Because the Company does not intend to sell the investments and it is not likely that the Company will be required to sell the investments before recovery of amortized cost basis, which may be at maturity, the Company does not consider the investments to be other-than-temporarily impaired.

*Restricted Stock*

The Company held restricted stock of $845 as of March 31, 2021 and $1,279 at December 31, 2020. Restricted stock is reported separately from available for sale securities. As a member bank of the Federal Reserve system and the Federal Home Loan Bank of Atlanta ("FHLB"), NBB is required to maintain certain minimum investments in the common stock of those entities. Required levels of investment are based upon NBB's capital, current borrowings, and a percentage of qualifying assets. The correspondents provide

calculations that require the Company purchase or sell stock back to the correspondents. The stock is held by member institutions only and is not actively traded.

Redemption of FHLB stock is subject to certain limitations and conditions. At its discretion, the FHLB may declare dividends on the stock. In addition to dividends, NBB also benefits from its membership with FHLB through eligibility to borrow from the FHLB, using as collateral NBB's capital stock investment in the FHLB and qualifying NBB real estate mortgage loans totaling $565,842 at March 31, 2021. Management reviews for impairment based upon the ultimate recoverability of the cost basis of the FHLB stock, and at March 31, 2021, management did not determine any impairment.

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

**Note 5: Defined Benefit Plan**

Components of Net Periodic Benefit Cost:

| | Pension Benefits Three Months Ended March, 31 | |
|---|---|---|
| | **2021** | **2020** |
| Service cost | **$ 361** | $ 270 |
| Interest cost | **184** | 205 |
| Expected return on plan assets | **(555)** | (420) |
| Amortization of prior service cost | **(3)** | (27) |
| Recognized net actuarial loss | **208** | 177 |
| Net periodic benefit cost | **$ 195** | $ 205 |

The service cost component of net periodic benefit cost is included in salaries and employee benefits expense in the consolidated statements of income. All other components are included in other noninterest expense in the consolidated statements of income. For the three months ended March 31, 2021, the Company did not make a contribution to the defined benefit plan.

**Note 6: Fair Value Measurements**

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

Level 1 – Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 – Valuation is based on observable inputs including:

- quoted prices in active markets for similar assets and liabilities,
- quoted prices for identical or similar assets and liabilities in less active markets,
- inputs other than quoted prices that are observable, and
- model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 – Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Accounting guidance for fair value excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Consequently, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company as of March 31, 2021 and December 31, 2020.

The following describes the valuation techniques used by the Company to measure certain financial assets and liabilities recorded at fair value on a recurring and non-recurring basis in the financial statements:

**Financial Instruments Measured at Fair Value on a Recurring Basis**

*Securities Available for Sale*

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

The following tables present the balances of financial assets measured at fair value on a recurring basis as of March 31, 2021 and December 31, 2020.

| | | Fair Value Measurements at March 31, 2021 Using | | |
|---|---|---|---|---|
| **Description** | **Balance as of March 31, 2021** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| U.S. Government agencies and corporations | **$ 130,225** | **$ -** | **$ 130,225** | **$ -** |
| States and political subdivisions | **199,185** | **-** | **199,185** | **-** |
| Mortgage-backed securities | **239,796** | **-** | **239,796** | **-** |
| Corporate debt securities | **2,153** | **-** | **2,153** | **-** |
| Total securities available for sale | **$ 571,359** | **$ -** | **$ 571,539** | **$ -** |

| | | Fair Value Measurements at December 31, 2020 Using | | |
|---|---|---|---|---|
| **Description** | **Balance as of December 31, 2020** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| U.S. Government agencies and corporations | $ 91,163 | $ - | $ 91,163 | $ - |
| States and political subdivisions | 203,961 | - | 203,961 | - |
| Mortgage-backed securities | 249,175 | - | 249,175 | - |
| Corporate debt securities | 2,443 | - | 2,443 | - |
| Total securities available for sale | $ 546,742 | $ - | $ 546,742 | $ - |

The Company's securities portfolio is valued using Level 2 inputs. The Company relies on a third party vendor to provide market valuations. The inputs used to determine value include: benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data including market research publications. The third-party vendor also monitors market indicators, industry activity and economic events as part the valuation process. Central to the final valuation is the assumption that the indicators used are representative of the fair value of securities held within the Company's portfolio. Level 2 inputs are subject to a certain degree of uncertainty and changes in these assumptions or methodologies in the future, if any, may impact securities fair value, deferred tax assets or liabilities, or expense.

*Interest Rate Loan Contracts and Forward Contracts*

The Company originates consumer real estate loans which it intends to sell to a correspondent lender. Interest rate loan contracts and forward contracts result from originating loans held for sale and are derivatives reported at fair value. The Company enters interest rate lock commitments with customers who apply for a loan which it intends to sell to a correspondent lender. The interest rate loan contract ends when the loan closes or the customer withdraws their application. Fair value of the interest rate loan contracts is based upon the correspondent lender's pricing quotes at the report date. Fair value is adjusted for the estimated probability of the loan closing with the borrower.

At the time the Company enters into an interest rate loan contract with a customer, it also enters into a best efforts forward sales commitment with the correspondent lender. If the loan has been closed and funded, the best efforts commitment converts to a mandatory forward sales commitment. Fair value is based on the gain or loss that would occur if the Company were to pair-off the transaction with the investor at the measurement date. This is a level 3 input. The Company has elected to measure and report best efforts commitments at fair value.

Interest rate loan contracts and forward contracts are valued based on quotes from the correspondent lender at the reporting date. Pricing changes daily and if a loan has not been sold to the correspondent by the next reporting date, the fair value may be different from that reported currently. Changes in fair value measurement impacts net income.

| | | Fair Value Measurements at March 31, 2021 Using | | |
|---|---|---|---|---|
| **Description** | **Balance as of March 31, 2021** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| Interest rate loan contracts | **$ (1)** | **$ -** | **$ -** | **$ (1)** |
| Forward contracts | **$ 1** | **$ -** | **$ -** | **$ 1** |

| | | Fair Value Measurements at December 31, 2020 Using | | |
|---|---|---|---|---|
| **Description** | **Balance as of December 31, 2020** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| Interest rate loan contracts | $ 1 | $ - | $ - | $ 1 |
| Forward contracts | $ (11) | $ - | $ - | $ (11) |

| **March 31, 2021** | **Valuation Technique** | **Unobservable Input** | **Range (Weighted Average)** |
|---|---|---|---|
| Interest rate loan contracts | Market approach | Pull-through rate | **83.00%**(1) |
| Forward contracts | Market approach | Pull-through rate | **83.00%** (1) |
| | | | |
| Interest rate loan contracts | Market approach | Current reference price | **101.57%**(2) |
| Forward contracts | Market approach | Current reference price | **98.51% - 101.57% (99.30%)** |

(1) All contracts are valued using the same pull-through rate.
(2) Interest rate loan contracts at March 31, 2021 included a single loan.

| **December 31, 2020** | **Valuation Technique** | **Unobservable Input** | **Range (Weighted Average)** |
|---|---|---|---|
| Interest rate loan contracts | Market approach | Pull-through rate | 87.02%(1) |
| Forward contracts | Market approach | Pull-through rate | 87.02% (1) |
| | | | |
| Interest rate loan contracts | Market approach | Current reference price | 101.91% - 103.02% (102.55%)(2) |
| Forward contracts | Market approach | Current reference price | 101.91% - 103.19% (102.67%)(2) |

(1) All contracts are valued using the same pull-through rate.
(2) Current reference prices were weighted by the relative amount of the loan.

**Financial Instruments Measured at Fair Value on a Non-Recurring Basis**

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

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

*Loans Held for Sale*

Loans held for sale are carried at the lower of cost or fair value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale

(Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale at March 31, 2021 or December 31, 2020.

*Impaired Loans*

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

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

Loans measured using the fair value of collateral method may be categorized in Level 2 or Level 3. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. Most collateral is real estate. The Company bases collateral method fair valuation upon the "as-is" value of independent appraisals or evaluations. Valuations for impaired loans secured by residential 1-4 family properties with outstanding principal balances greater than $250 are based on an appraisal. Appraisals are also used to value impaired loans secured by commercial real estate with outstanding principal balances greater than $500. Collateral-method impaired loans secured by residential 1-4 family property with outstanding principal balances of $250 or less, or secured by commercial real estate with outstanding principal balances of $500 or less, are valued using an appraisal or a real estate evaluation prepared by a third party.

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

If a current appraisal uses unobservable data as part of the assessment, the value of the collateral is classified as Level 3.

The following table summarizes the Company's impaired loans that were measured at fair value on a nonrecurring basis at March 31, 2021 and at December 31, 2020.

| | | | Carrying Value | | |
|---|---|---|---|---|---|
| **Date** | **Description** | **Balance** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| | Assets: | | | | |
| March 31, 2021 | Impaired loans net of valuation allowance | **$ 357** | **$ -** | **$ -** | **$ 357** |
| December 31, 2020 | Impaired loans net of valuation allowance | 970 | - | - | 970 |

The following table presents information about Level 3 Fair Value Measurements for March 31, 2021 and December 31, 2020.

| Impaired Loans | Valuation Technique | Unobservable Input | Range (Weighted Average[(1)]) |
|---|---|---|---|
| March 31, 2021 | Present value of cash flows | Discount rate | **6.00% – 6.50% (6.26%)** |
| December 31, 2020 | Present value of cash flows | Discount rate | 5.50% –6.50% (5.78%) |

(1) Unobservable inputs were weighted by the relative fair value of the impaired loans.

At March 31, 2021 and December 31, 2020, all impaired loans measured at fair value on a nonrecurring basis were measured using the present value of cash flows. The loans at each date are TDRs and the discount rate is the contractual rate that was in effect

prior to modification to TDR status. Inherent in the measurement of impaired loans using the present value of cash flows method are judgements and assumptions, including the appropriateness of the discount rate and the projections of cash flows. Cash flows in the future may differ from those used in the measurement. Future changes in cash flow assumptions or if the loans are charged off may result in greater losses than estimated at the reporting dates. An increase in the impairment measurement or a charge-off would increase the provision for loan losses.

*Other Real Estate Owned*

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

The following table summarizes the Company's OREO that was measured at fair value on a nonrecurring basis.

| | | | Carrying Value | | |
|---|---|---|---|---|---|
| **Date** | **Description** | **Balance** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| | Assets: | | | | |
| March 31, 2021 | OREO net of valuation allowance | **$ 957** | **$ -** | **$ -** | **$ 957** |
| December 31, 2020 | OREO net of valuation allowance | 1,553 | - | - | 1,553 |

The following tables present information about Level 3 Fair Value Measurements for March 31, 2021 and December 31, 2020.

| **March 31, 2021** | **Valuation Technique** | **Unobservable Input** | **Range (Weighted Average)** |
|---|---|---|---|
| OREO | Discounted appraised value | Selling cost | **6.20%**[(3)] |

| **December 31, 2020** | **Valuation Technique** | **Unobservable Input** | **Range (Weighted Average[(1)])** |
|---|---|---|---|
| OREO | Discounted appraised value | Selling cost | 4.00%[(2)] – 9.23% (4.54%) |
| OREO | Discounted appraised value | Discount for lack of marketability and age of appraisal | 0.00% – 7.66% (0.62%)[(1)] |

(1) Discounts were weighted by the relative appraised value of the OREO properties.
(2) The appraised value is discounted by selling costs if the OREO property is listed with a realtor and if appraised value exceeds the list price, less estimated selling costs. Selling costs do not discount appraised value if the Company markets the OREO property independently or if the OREO property is listed with a realtor and the list price less estimated selling costs exceeds appraised value.
(3) As of March 31, 2021 OREO was composed of a single property.

At March 31, 2021 and December 31, 2020, OREO properties were measured using appraised value, and if applicable, discounted by selling costs, lack of marketability and age of appraisal. Determining the discount to appraisals for selling cost and lack of marketability and age of the appraisal relies on certain key assumptions and judgements.

Discounts for selling costs and in some instances, marketability, result when the Company markets OREO properties via local realtors. The Company works with the realtor to determine the list price, which may be set at appraised value or at a different amount based on the realtor's advice and management's judgement of marketability. Selling costs for improved land generally are estimated at 6% of the list price, and for raw land at 10% of the list price. If the final sale price is different from the list price, the amount of selling costs will also be different from those estimated. Discounts for age may be applied if current appraisals cannot be obtained prior to reporting dates. The most recent appraised value available may be discounted based upon management judgement.

There is uncertainty in determining discounts to appraised value. Future changes to marketability assumptions or updated appraisals may indicate in a lower fair value, with a corresponding impact to net income. The current COVID-19 pandemic and associated economic crisis may negatively affect the value of the Company's OREO and may result in additional OREO properties. Ultimate proceeds from the sale of OREO property may be less than the estimated fair value, reducing net income.

**Fair Value Summary**

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company's financial instruments as of March 31, 2021 and December 31, 2020. For cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For non-marketable equity securities, the carrying amount is a reasonable estimate of fair value as these securities can only be redeemed or sold at their par value and only to the respective issuing government-supported institution or to another member institution. For financial liabilities such as noninterest-bearing demand, interest-bearing demand, and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity. Fair values are estimated using the exit price notion.

| | March 31, 2021 | | | |
|---|---|---|---|---|
| | Carrying Amount | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| Financial Assets: | | | | |
| Cash and due from banks | $ 12,677 | $ 12,677 | $ - | $ - |
| Interest-bearing deposits | 135,142 | 135,142 | - | - |
| Securities | 571,359 | - | 571,359 | - |
| Restricted securities | 845 | - | 845 | - |
| Loans held for sale | 424 | - | 424 | - |
| Loans, net | 770,824 | - | - | 765,123 |
| Accrued interest receivable | 5,367 | - | 5,367 | - |
| Bank-owned life insurance | 36,650 | - | 36,650 | - |
| Forward contracts | 1 | - | - | 1 |
| Financial Liabilities: | | | | |
| Deposits | $ 1,358,588 | $ - | $ 1,268,939 | $ 89,827 |
| Accrued interest payable | 49 | - | 49 | - |
| Interest rate loan contracts | 1 | - | - | 1 |

| | December 31, 2020 | | | |
|---|---|---|---|---|
| | Carrying Amount | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| Financial Assets: | | | | |
| Cash and due from banks | $ 13,147 | $ 13,147 | $ - | $ - |
| Interest-bearing deposits | 120,725 | 120,725 | - | - |
| Securities | 546,742 | - | 546,742 | - |
| Restricted securities | 1,279 | - | 1,279 | - |
| Loans held for sale | 866 | - | 866 | - |
| Loans, net | 760,318 | - | - | 752,624 |
| Accrued interest receivable | 5,028 | - | 5,028 | - |
| Bank-owned life insurance | 36,444 | - | 36,444 | - |
| Interest rate loan contracts | 1 | - | - | 1 |
| Financial Liabilities: | | | | |
| Deposits | $ 1,297,143 | $ - | $ 1,207,561 | $ 89,681 |
| Accrued interest payable | 56 | - | 56 | - |
| Forward contracts | 11 | - | - | 11 |

**Note 7: Components of Accumulated Other Comprehensive Income (Loss)**

| | Net Unrealized Gain on Securities | Adjustments Related to Pension Benefits | Accumulated Other Comprehensive Income (Loss) |
|---|---|---|---|
| **Balance at December 31, 2019** | $ 76 | $ (8,582) | $ (8,506) |
| Unrealized holding gain on available for sale securities, net of tax of $1,028 | 3,870 | - | 3,870 |
| Reclassification adjustment, net of tax of ($4) | (16) | - | (16) |
| **Balance at March 31, 2020** | $ 3,930 | $ (8,582) | $ (4,652) |
| | | | |
| **Balance at December 31, 2020** | $ 13,167 | $ (10,147) | $ 3,020 |
| Unrealized holding loss on available for sale securities, net of tax of ($3,271) | (12,309) | - | (12,309) |
| Reclassification adjustment, net of tax of ($1) | (4) | - | (4) |
| **Balance at March 31, 2021** | **$ 854** | **$ (10,147)** | **$ (9,293)** |

**Note 8: Revenue Recognition**

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

*Service Charges on Deposit Accounts*

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

*Other Service Charges and Fees*

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

*Credit and Debit Card Fees*

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

*Trust Income*

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

*Insurance and Investment*

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

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

The following presents noninterest income, segregated by revenue streams in-scope and out-of-scope of Topic 606, for the three months ended March 31, 2021 and 2020.

| | March 31, 2021 | | March 31, 2020 | |
|---|---|---|---|---|
| **Noninterest Income** | | | | |
| *In-scope of Topic 606:* | | | | |
| Service charges on deposit accounts | **$** | **469** | $ | 582 |
| Other service charges and fees | | **41** | | 39 |
| Credit and debit card fees | | **434** | | 306 |
| Trust income | | **415** | | 434 |
| Insurance and Investment (included within Other Income on the Consolidated Statements of Income) | | **398** | | 98 |
| Noninterest Income (in-scope of Topic 606) | **$** | **1,757** | $ | 1,459 |
| Noninterest Income (out-of-scope of Topic 606) | | **577** | | 676 |
| Total noninterest income | **$** | **2,334** | $ | 2,135 |

**Note 9: Leases**

The Company's leases are recorded under ASC Topic 842, "Leases". The Company examines its contracts to determine whether they are or contain a lease. A contract with a lease is further examined to determine whether the lease is a short-term, operating or finance lease. As permitted by ASC Topic 842, the Company elected not to capitalize short-term leases, defined by the standard as leases with terms of 12 months or less. The Company also elected the practical expedient not to separate non-lease components from lease components within a single contract.

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

*Lease payments*

Lease payments for short-term leases are recognized as lease expense on a straight-line basis over the lease term, or for variable lease payments, in the period in which the obligation was incurred. Payments for leases with terms longer than 12 months are included in the determination of the lease liability. Payments may be fixed for the term of the lease or variable. If the lease agreement provides a known escalator, such as a specified percentage increase per year or a stated increase at a specified time, the variable payment is included in the cash flows used to determine the lease liability. If the variable payment is based upon an unknown escalator, such as the

consumer price index at a future date, the increase is not included in the cash flows used to determine the lease liability. The Company elected the practical expedient provided by Topic 842 not to allocate consideration in a contract between lease and non-lease components

Two of the Company's leases provide known escalators that are included in the determination of the lease liability. One lease has an annual escalator based on the consumer price index-urban ("CPI-U"). The remaining leases do not have variable payments during the term of the lease.

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

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

The Company's lease right of use asset is included in other assets and the lease liability is included in other liabilities. The following tables present information about leases:

| | March 31, 2021 | December 31, 2020 |
|---|---|---|
| Lease liability | **$ 1,941** | $ 2,016 |
| Right-of-use asset | **$ 1,921** | $ 1,998 |
| Weighted average remaining lease term | **6.60 years** | 6.81 years |
| Weighted average discount rate | **3.05%** | 3.04% |

| | For the Three Months Ended March 31, | |
|---|---|---|
| | 2021 | 2020 |
| **Lease Expense** | | |
| Operating lease expense | **$ 93** | $ 93 |
| Short-term lease expense | **1** | 1 |
| Total lease expense | **$ 94** | $ 94 |
| | | |
| Cash paid for amounts included in lease liabilities | **$ 92** | $ 91 |
| Right-of-use assets obtained in exchange for operating lease liabilities commencing during the period | **$ -** | $ - |

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

| **Undiscounted Cash Flow for the Period** | **As of March 31, 2021** |
|---|---|
| Nine months ending December 31, 2021 | **$ 272** |
| Twelve months ending December 31, 2022 | **352** |
| Twelve months ending December 31, 2023 | **352** |
| Twelve months ending December 31, 2024 | **334** |
| Twelve months ending December 31, 2025 | **244** |
| Twelve months ending December 31, 2026 | **211** |
| Thereafter | **393** |
| Total undiscounted cash flows | **$ 2,158** |
| Less: discount | **(217)** |
| Lease liability | **$ 1,941** |

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

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**
$ in thousands, except per share data

The purpose of this discussion and analysis is to provide information about the financial condition and results of operations of the Company. Please refer to the financial statements and other information included in this report as well as the Company's 2020 Annual Report on Form 10-K for an understanding of the following discussion and analysis. References in the following discussion and analysis to "we" or "us" refer to the Company unless the context indicates that the reference is to the Bank.

**Cautionary Statement Regarding Forward-Looking Statements**

We make forward-looking statements in this Form 10-Q 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 and local 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, the Consumer Financial Protection Bureau and the Federal Deposit Insurance Corporation ("FDIC"), and the impact of any policies or programs implemented pursuant to financial reform legislation,
- unanticipated increases in the level of unemployment in the Company's market,
- 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 market,
- the real estate market in the Company's market,
- laws, regulations and policies impacting financial institutions,
- technological risks and developments, and cyber-threats, attacks or events,
- the Company's technology initiatives,
- steps the Company takes in response to the COVID-19 pandemic, the severity and duration of the pandemic, the uncertainty regarding new variants of COVID-19 that have emerged, the speed and efficacy of vaccine and treatment developments, the impact of loosening or tightening of government restrictions, the pace of recovery when the pandemic subsides and the heightened impact it has on many of the risks described herein,
- performance by the Company's counterparties or vendors,
- applicable accounting principles, policies and guidelines, and
- business disruption and/or impact due to the coronavirus or similar pandemic diseases.

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

The COVID-19 pandemic and measures implemented to reduce its spread have had international impacts. The effect on the Company's market area has been similar to that experienced by many areas across the nation, with decreased business activity, higher unemployment rates, and record filings of unemployment claims. While vaccine roll-out and other measures provide some positive indicators, the length of economic downturn is not yet known. An extended economic downturn will negatively impact business activity within the Company's market and could lead to a higher rate of delinquent loans, charge-offs, and reduced interest and fee income.

**Cybersecurity**

As a financial institution, NBI is subject to cybersecurity risks. Cybersecurity risks have expanded with the pandemic as fraudsters seek to take advantage of customer concerns and changes to work environment. The Company has not suffered any losses or breaches due to the pandemic.

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. We do not offer online account openings or loan originations, limit the dollar amount of online banking transfers to other banks, do not permit customers to submit address changes or wire requests through online banking, require a special vetting process for commercial customers who wish to originate ACH transfers, and limit certain functionalities of mobile banking. The Company also requires assurances from key vendors regarding their cybersecurity. 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.

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.

**Response to COVID-19 Pandemic**

The global COVID-19 pandemic has affected the global economy for approximately one year. The Company has complied with national, state and local guidelines to help reduce the spread of the virus, including implementing social distancing measures for employees and serving customers primarily through digital channels, drive-thrus and ATMs, and in person when requested. We have determined to reopen our lobbies in May. Current analysis of our transactions has not shown a decline. Controls over cash and physical assets have remained in place and internal controls over financial reporting and disclosure have been maintained.

The Company continues to monitor the impact of the pandemic on significant estimates, including the allowance for loan losses, valuation of goodwill, valuation of OREO, other-than-temporary impairment of securities and pension obligations, as well as lease right-of-use assets. The impact to the allowance for loan losses is discussed under the "Asset Quality" section. Analysis as of March 31, 2021 did not indicate negative impacts to the valuation of OREO, other-than-temporary impairment of securities, pension obligations or lease right-of-use assets.

The Company also continues to monitor increased threats of fraud, including schemes against employees new to remote working arrangements, fraud related to state unemployment insurance and COVID-19 related scams against customers.

The Company's business relies on positive relationships with customers. At this time, we feel our customer relationships remain strong and our team remains ready to provide banking services. The Company has a robust business continuity plan, and partners with vendors whom we believe also have robust business continuity plans. In implementing its business continuity plan to address the COVID-19 pandemic, the Company has not incurred material expenditures and does not anticipate material expenditures. In the event that we experience high infection rates within our staff, our ability to serve our customers would be adversely impacted for a certain period. We have implemented many measures to protect the health of our employees and continue to monitor the situation closely. Further, all critical functions are cross-trained as part of our business continuity preparedness.

The following discusses our financial position and results of operations for the three month period ended March 31, 2021 and where appropriate, the impact of the COVID-19 pandemic, as well as potential future impact.

## Non-GAAP Financial Measures

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

*Return on Average Assets and Return on Average Equity*

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

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

| $ in thousands | Three months ended March 31, | |
|---|---|---|
| | **2021** | **2020** |
| Net Income | **$ 4,766** | $ 3,979 |
| Items deemed non-recurring by management: | | |
| Less: partnership income [(1)], net of tax of ($98) in 2021 and ($65) in 2020 | **(369)** | (244) |
| Securities gains, net of tax of ($1) in 2021 and ($4) in 2020 | **(4)** | (16) |
| Adjusted net income | **4,393** | 3,719 |
| Adjusted net income, annualized | **17,816** | 14,958 |
| Items deemed non-recurring by management: | | |
| Add: partnership income, net of tax of $98 in 2021 and $65 in 2020 | **369** | 244 |
| Add: Securities gains, net of tax of $1 in 2021 and $4 in 2020 | **4** | 16 |
| Annualized net income for ratio calculation | **$ 18,189** | $ 15,218 |

(1) During the first quarter of each year, the Company adjusts its basis in partnership interests. During 2021 and 2021, the adjustment resulted in recognition of a gain. During 2021, the Company also received a one-time payout from a partnership interest, recognized in income. Partnership income is removed from income prior to annualization in order to avoid distortion, and added back to income after annualization.

*Net Interest Margin*

The Company uses the net interest margin to measure profit on interest generating activities, as a percentage of total interest-earning assets. The net interest margin is calculated by dividing annualized taxable equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax equivalent net interest income is considered in the calculation of this ratio. Tax equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit is 21%. The reconciliation of tax equivalent net interest income, which is not a measurement under U.S. GAAP, to net interest income, is reflected in the table below.

| $ in thousands | Three months ended March 31, | |
|---|---|---|
| | **2021** | **2020** |
| GAAP measures: | | |
| Interest and fees on loans | **$ 8,550** | $ 8,466 |
| Interest on interest-bearing deposits | **28** | 217 |
| Interest and dividends on securities - taxable | **1,783** | 2,356 |
| Interest on securities - nontaxable | **521** | 349 |
| Total interest income | **$ 10,882** | $ 11,388 |
| | | |
| Interest on deposits | **$ 855** | $ 1,796 |
| Net interest income | **$ 10,027** | $ 9,592 |
| | | |
| Non-GAAP measures: | | |
| Tax benefit on nontaxable loan income | **$ 75** | $ 123 |
| Tax benefit on nontaxable securities income | **170** | 96 |
| Total tax benefit on nontaxable interest income | **$ 245** | $ 219 |
| Total tax equivalent net interest income | **$ 10,272** | $ 9,811 |
| Total tax equivalent net interest income, annualized | **$ 41,659** | $ 39,460 |

*Efficiency Ratio*

The efficiency ratio is computed by dividing noninterest expense by the sum of net interest income on a tax-equivalent basis and noninterest income, excluding certain items management deems unusual or non-recurring. The tax rate used to calculate fully taxable equivalent basis is 21%. This is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational efficiency. The components of the efficiency ratio calculation are summarized in the following table.

| $ in thousands | Three months ended March 31, | | | |
|---|---|---|---|---|
| | 2021 | | 2020 | |
| Noninterest expense | **$** | **6,536** | $ | 6,467 |
| | | | | |
| Taxable-equivalent net interest income | **$** | **10,272** | $ | 9,811 |
| Noninterest income | | **2,334** | | 2,135 |
| Less: partnership income | | **(467)** | | (309) |
| Less: realized securities gains | | **(5)** | | (20) |
| Total income for ratio calculation | **$** | **12,134** | $ | 11,617 |
| | | | | |
| Efficiency ratio | | **53.87%** | | 55.67% |

*Noninterest Margin*

The Company uses the noninterest margin to evaluate net noninterest expense. A lower noninterest margin indicates more effective expense management in relation to noninterest income generation. The noninterest margin is calculated as noninterest expense less noninterest income (excluding realized securities gain/loss, net), annualizing the difference, and dividing by average year-to-date assets. The annualization process excludes significant one-time items to prevent distortion. The reconciliation of adjusted noninterest income and adjusted noninterest expense, which are not measurements under GAAP, is reflected in the table below.

| | Three months ended March 31, | | | |
|---|---|---|---|---|
| | 2021 | | 2020 | |
| Noninterest expense under GAAP | **$** | **6,536** | $ | 6,467 |
| | | | | |
| Noninterest income under GAAP | **$** | **2,334** | $ | 2,135 |
| Less: partnership income [(1)] | | **(467)** | | (309) |
| Less: realized securities gains, net | | **(5)** | | (20) |
| Noninterest income for ratio calculation, non-GAAP | **$** | **1,862** | $ | 1,806 |
| | | | | |
| Net noninterest expense, non-GAAP | **$** | **4,674** | $ | 4,661 |
| Net noninterest expense, non-GAAP, annualized | | **18,956** | | 18,746 |
| Add back: partnership income | | **467** | | 309 |
| Net noninterest expense, non-GAAP, annualized, adjusted | | **19,423** | | 19,055 |
| Average assets | **$** | **1,530,908** | $ | 1,312,427 |
| Noninterest margin | | **1.27%** | | 1.45% |

(1) During the first quarter of each year, the Company adjusts its basis in partnership interests. During 2021 and 2020, the adjustment resulted in recognition of a gain. During 2021, the Company also received a one-time payout from a partnership interest, recognized in income. Partnership income is removed from income prior to annualization in order to avoid distortion, and added back to income after annualization.

## Critical Accounting Policies

### General

The Company's financial statements are prepared in accordance with U.S. 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, 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 TDR. Impaired loans that are not TDRs with an estimated impairment loss are placed on nonaccrual status. TDRs 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 the fair value of collateral ("collateral method"), the present value of future cash flows ("cash flow method"), or observable market price. The Company applies the collateral method to collateral-dependent loans, loans for which foreclosure is imminent and to loans for which the fair value of collateral is a more reliable estimate of fair value. The cash flow method is applied to loans that are not collateral dependent and for which cash flows may be estimated.

The Company bases collateral method fair valuation upon the "as-is" value of independent appraisals or evaluations. Valuations for impaired loans secured by residential 1-4 family properties with outstanding principal balances greater than $250 are based on an appraisal. Appraisals are also used to value impaired loans secured by commercial real estate with outstanding principal balances greater than $500. Collateral-method impaired loans secured by residential 1-4 family property with outstanding principal balances of $250 or less, or secured by commercial real estate with outstanding principal balances of $500 or less, are valued using a real estate evaluation prepared by a third party.

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

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

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

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

TDRs are impaired loans and are measured for impairment under the same valuation methods as other impaired loans. TDRs 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 TDRs 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 eight quarters. The look-back period of eight quarters is applied consistently among all classes.

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

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

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

*Estimation of the allowance for loan losses*

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

The estimate of the allowance for March 31, 2021 considered market conditions as of March 31, 2021 where possible, and the most recent available information when data was not available as of March 31, 2021, portfolio conditions and levels of delinquencies at March 31, 2021, and net charge-offs in the eight quarters prior to the quarter ended March 31, 2021. Some of the available economic data lags the reporting date by one to three months. Delinquency levels at March 31, 2021 are lower than they might otherwise have been due to modifications granted to qualifying borrowers in accordance with regulatory guidance and legislative provisions in the CARES Act and CAA, including loan payment extensions, interest only periods and rate reductions to borrowers. Past due status will not occur during the period in which a payment is extended. Providing an interest only period affords borrowers lower payments during the interest only period. When extension periods and interest only periods expire, there may be increases in past dues that will increase the requirement for the allowance for loan loss. Management used its best judgement and efforts in incorporating possible impacts as of March 31, 2021 in estimating the allowance for loan losses, but if the current economic challenges worsen, the ultimate amount of loss could vary from that estimate. For additional discussion of the allowance, see Note 3 to the consolidated financial statements and "Asset Quality," and "Provision and Allowance for Loan Losses."

**Goodwill**

Goodwill is subject to at least an annual assessment for impairment by applying a fair value based test. The Company contracts with a third party valuation expert to perform impairment testing in the fourth quarter of each year. The Company's most recent impairment test was performed using data from September 30, 2020. 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. The analysis did not result in an impairment assessment.

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.

**Pension Plan**

The Company's actuary determines plan obligations and annual pension plan 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.

**Overview**

National Bankshares, Inc. is a financial holding company that was organized in 1986 under the laws of Virginia and is registered under the Bank Holding Company Act of 1956. NBI has two wholly-owned subsidiaries, the National Bank of Blacksburg and National Bankshares Financial Services, Inc. NBB is a community bank and does business as National Bank from twenty-five office locations and one loan production office. NBB is the source of nearly all of the Company's revenue. NBFS does business as National Bankshares Investment Services and National Bankshares Insurance Services. Income from NBFS is not significant at this time, nor is it expected to be so in the near future.

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

**Lending**

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

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

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

The Bank's loan policy is updated and approved by the Board of Directors annually and disseminated to lending and loan portfolio management personnel to ensure consistent lending practices. The policy communicates the Company's risk tolerance by prescribing underwriting guidelines and procedures, including approval limits and hierarchy, documentation standards, requirements for collateral and loan-to-value limits, debt coverage, overall creditworthiness 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 (often referred to as the "debt service coverage ratio") 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 Bank provides both long and short term loans to municipalities and other governmental entities within its geographical footprint. Borrowers include general taxing authorities such as a city or county, industrial/economic development authorities or utility authorities. Repayment sources are derived from taxation, such as property taxes and sales taxes, or revenue from the project financed with the loan. The Company's underwriting considers local economic and population trends, reserves and liabilities, including pension liabilities.

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

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

Consumer real estate mortgages may have fixed interest rates for the entire term of the loan or variable interest rates subject to change after the first, third, or fifth year. Variable rates are based on the weekly average yield of United States Treasury Securities and are underwritten at fully-indexed rates. We do not offer certain high risk loan products such as interest only consumer mortgage loans, hybrid loans, payment option adjustable rate mortgages ("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. 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.

*SBA Paycheck Protection Program.* The SBA Paycheck Protection Program provides loans to aid small businesses in maintaining their payroll for up to 24 weeks. Through the program, banks may fund loans to qualifying borrowers with the expectation that the SBA will either pay off the loans and forgive the borrower's debt, or guarantee the loans until the borrower pays off the debt. The loans bear a contractual interest rate of 1%, bolstered by an origination fee to be recognized over the life of the loan. Loans that are forgiven or paid off prior to maturity result in recognition of the outstanding origination fee at the date of forgiveness or payoff. The Company has assisted local businesses through the PPP by providing 1,164 loans totaling $80,999 since the program's inception in April of 2020. To date, 544 PPP loans with original balances totaling $35,862 have been forgiven or paid off. As of March 31, 2021, the Company held $43,631 in PPP loans, net of deferred fees and costs. The current application period ends May 31, 2021.

**Other Products and Services**

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

## Performance Summary

The following table presents the Company's key performance ratios for the three months ended March 31, 2021 and March 31, 2020 and the year ended December 31, 2020. The measures for March 31, 2021 and March 31, 2020 are annualized, except for basic and fully diluted earnings per share.

| | Three Months Ended March 31, 2021 | Three Months Ended March 31, 2020 | Twelve Months Ended December 31, 2020 |
|---|---|---|---|
| Return on average assets [(1)] | **1.19%** | 1.16% | 1.15% |
| Return on average equity [(1)] [(4)] | **9.30%** | 8.03% | 8.21% |
| Basic and fully diluted earnings per share [(4)] | **$ 0.74** | $ 0.61 | $ 2.48 |
| Net interest margin [(2)] | **2.89%** | 3.20% | 2.98% |
| Noninterest margin [(3)] | **1.27%** | 1.45% | 1.22% |
| Efficiency ratio [(5)] | **53.87%** | 55.67% | 53.46% |

(1) Return on average assets and return on average equity are non-GAAP measures. Components of U.S. GAAP net income that are deemed non-recurring by management are removed prior to annualizing the adjusted net income. The adjusted net income is annualized. Items deemed non-recurring by management are added back to the annualized adjusted net income, and the total is divided by average assets for return on average assets, or divided by average equity for return on average equity. See "Non-GAAP Financial Measures" above.

(2) Net interest margin is a non-GAAP measure. Tax advantaged portions of net interest income are adjusted to their fully-taxable equivalent basis and divided by average earning assets. See "Non-GAAP Financial Measures" above.

(3) Noninterest margin is a non-GAAP measure. Noninterest income is adjusted for items deemed by management to be non-recurring and securities gains and losses. Adjusted noninterest income is subtracted from noninterest expense and the difference is annualized, then non-recurring items are added back and the sum is divided by average year-to-date assets. See "Non-GAAP Financial Measures" above.

(4) During the three months ended March 31, 2021, the Company repurchased 111,832 shares under its publicly announced stock repurchase plan. The repurchase reduced shareholders equity by $3,991. See "Non-GAAP Financial Measures" above.

(5) The efficiency ratio is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational efficiency. Such information is not prepared in accordance with GAAP and should not be viewed as a substitute for GAAP. See "Non-GAAP Financial Measures" above.

## Growth

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

| | March 31, 2021 | December 31, 2020 | Percent Change |
|---|---|---|---|
| Interest-bearing deposits | **$ 135,142** | $ 120,725 | 11.94 **%** |
| Securities available for sale and restricted stock | **572,204** | 548,021 | 4.41 **%** |
| Loans, net | **770,824** | 760,318 | 1.38 **%** |
| Deposits | **1,358,588** | 1,297,143 | 4.74 **%** |
| Total assets | **1,568,210** | 1,519,673 | 3.19 **%** |

## Asset Quality

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

| | March 31, 2021 | March 31, 2020 | December 31, 2020 |
|---|---|---|---|
| Nonperforming loans | **$ 3,691** | $ 3,452 | $ 3,685 |
| Loans past due 90 days or more, and still accruing | **12** | 170 | 17 |
| Other real estate owned | **957** | 1,584 | 1,553 |
| Allowance for loan losses to loans net of unearned income and deferred fees and costs | **1.10%** | 0.99% | 1.10% |
| Allowance for loan losses net of unearned income and deferred fees and costs, excluding SBA PPP loans | **1.16%** | N/A | 1.16% |
| Net charge-off ratio | **0.00%** | 0.06% | 0.05% |
| Ratio of nonperforming assets to loans, net of unearned income and deferred fees and costs, plus other real estate owned | **0.60%** | 0.69% | 0.68% |
| Ratio of allowance for loan losses to nonperforming loans | **231.27%** | 209.73% | 230.15% |

The Company's risk analysis at March 31, 2021 determined an allowance for loan losses of $8,536 or 1.10% of loans net of unearned income and deferred fees and costs. Included in loans net of unearned income and deferred fees and costs are $43,631 in PPP loans. Because PPP loans are guaranteed by the U.S. Small Business Administration, they are not included in the calculation for the allowance for loan losses. If the PPP loans are removed from loans net of unearned income and deferred fees and costs, the allowance ratio is 1.16%. The allowance at December 31, 2020 was $8,481 or 1.10% of loans net of unearned income and deferred fees and costs.

The determination of the appropriate level for the allowance for loan losses resulted in a provision of $50 for the three months ended March 31, 2021, compared with a provision of $479 for the three month period ended March 31, 2020. 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**

Individually evaluated impaired loans at March 31, 2021 were $4,939 gross and $4,940 net of unearned income and deferred fees and costs, with specific allocations to the allowance for loan losses of $18. Individually evaluated impaired loans totaled $4,903 gross and $4,905 net of unearned income and deferred fees and costs, with specific allocations to the allowance for loan losses totaling $75 at December 31, 2020. The specific allocation is determined based on criteria particular to each impaired loan.

The impact of the COVID-19 pandemic continues to present great uncertainty and may lead to additional loans designated as impaired in future quarters. Cash flow assumptions associated with impaired loans measured under the cash flow method may be impacted if borrowers are further distressed by the economic impacts of the pandemic, resulting in lower measurements and higher funding requirements for the allowance for loan losses. Real estate activity in the Company's market over the most recent 12 months has been robust. However, if the pandemic suppresses real estate activity, real estate values could decline, causing reduced collateral values for impaired loans measured under the collateral method and potential charge-offs.

Individually evaluated impaired loans include TDRs. In the ordinary course of business, the Company grants modification requests when deemed appropriate. Modifications may be granted for competitive reasons or to strengthen repayment prospects for borrowers who may or may not be experiencing financial difficulty. The Company reviews all modifications to determine whether, at the time of the modification, the borrower is experiencing financial difficulty and whether the Company provided a concession that it would not otherwise consider. Loans with modifications that meet these criteria are designated TDR.

The CARES Act, the CAA and regulatory agencies provided guidance allowing banks to forego TDR designation for COVID-19 related accommodations to loans that meet certain criteria. In accordance with the guidance, the Company did not designate TDR status for modifications to loans impacted by the pandemic that met the criteria. Additional tracking mechanisms implemented at the beginning of the pandemic continue to aid the Company in monitoring COVID-19 related modifications.

As the pandemic continues, some borrowers who received COVID-19 related modifications have requested subsequent accommodations. When the Company grants subsequent modifications to a loan that received a COVID-19 modification, management assesses risk rating and accrual status for the loan. Every modification is reviewed for TDR indicators with additional evaluation and documentation requirements for all COVID-19 related modifications to loans over $250,000.

**Collectively Evaluated Loans**

Collectively evaluated loans totaled $776,305 gross and $774,421 net of unearned income and deferred fees and costs, with an allowance of $8,518 or 1.10% of loans net of unearned income and deferred fees and costs at March 31, 2021. Excluding PPP loans, the collectively evaluated allowance ratio was 1.16% at March 31, 2021. At December 31, 2020, collectively evaluated loans totaled $765,124 gross and $763,894 net of unearned income and deferred fees and costs, with an allowance of $8,406 or 1.10%. Excluding PPP loans, the collectively evaluated allowance ratio was 1.16% at December 31, 2020.

Collectively evaluated loans are divided into classes based upon risk characteristics. In order to calculate the allowance for collectively evaluated loans, the Company applies to each loan class a historical net charge-off rate for the class, 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 changes to internal Company policies and changes in management.

*Net Charge-Offs*

Net charge-off rates for each class are averaged over eight quarters and applied to the class balance. 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.

On a portfolio level, the Company experienced a net recovery of loan losses of $5 for the three months ended March 31, 2021. Net charge-offs for the three months ended March 31, 2020 were $102 or 0.06% of average loans, while net charge-offs for the 12 months ended December 31, 2020 were $373 or 0.05% of average loans.

The eight-quarter average historical loss rate was 0.05% as of March 31, 2021, 0.07% as of December 31, 2020 and 0.08% as of March 31, 2020.

*Economic Factors*

Economic factors influence credit risk and impact the allowance for loan loss. The Company considers economic indicators within its market area, including: unemployment, business and personal bankruptcy filings, the residential vacancy rate and the inventory of new and existing homes.

The Company sources economic data pertinent to its market from the most recently available publications. However, some economic indicators lag the report date by one to three months. In periods of low volatility, lagging indicators are accepted as reasonably representative of current conditions. The COVID-19 pandemic has introduced significant uncertainty which results in the need for greater timeliness in information.

To incorporate timely information to the assessment of economic impact to credit risk, at the beginning of the pandemic the Company implemented a qualitative factor for national unemployment filings. Unemployment filings for the Company's market area is not available on a timely basis, however national data is available on a timely basis and historical analysis shows a strong correlation between national and local unemployment filings. National unemployment claims escalated sharply beginning in the latter half of March 2020. Weekly claims peaked at the beginning of April 2020 and have fallen since, but for the three months ended March 31, 2021, remain approximately four times pre-pandemic levels. The Company assessed this as a significant impact to credit risk at March 31, 2021.

The Company continues to monitor the most recently available economic indicators for its market and their effect on credit risk. As of March 31, 2021, the unemployment rate for the Company's market area was measured as of January 31, 2021 and increased from the measurement available at December 31, 2020, increasing the allocation to the allowance for loan losses.

Business and personal bankruptcy filing data was available as of December 2020. 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. Compared with data available at December 31, 2020, business and personal bankruptcies were slightly lower and resulted in slightly lower allocations.

Residential vacancy rates and housing inventory impact the Company's residential construction customers and the consumer real estate market. Higher levels increase credit risk. The residential vacancy rate at March 31, 2021 was measured as of the fourth quarter of 2020 and while still lower than normal levels, worsened slightly from the data incorporated into the December 31, 2020 calculation, resulting in a higher allocation. Housing inventory data was available as of March 31, 2021. Levels were similar to those at December 31, 2020, resulting in a similar allocation.

*Asset Quality Indicators*

Asset quality indicators, including past due levels, nonaccrual levels and internal risk ratings, are evaluated at the class level.

The Company provided COVID-19 related accommodations to qualifying borrowers without which additional loans may have been included in past due data at March 31, 2021. The Company followed its normal risk rating practices and in keeping with the regulatory guidance, did not automatically downgrade the risk rating on loans that received COVID-19 accommodations. Without the regulatory provision, additional loans may have been included in criticized assets as of March 31, 2021.

Loans past due and loans designated nonaccrual indicate heightened credit risk. Increases in past due and nonaccrual loans increase the required level of the allowance for loan losses and decreases in past due and nonaccrual loans reduce the required level of the allowance for loan losses.

Accruing loans past due 30-89 days were 0.23% of total loans net of unearned income and deferred fees and costs at March 31, 2021, an increase from 0.19% at December 31, 2020. Accruing loans past due 90 days or more were 0.00% of total loans, net of unearned income and deferred fees and costs at March 31, 2021 and December 31, 2020. Nonaccrual loans at March 31, 2021 were 0.47% of total loans net of unearned income and deferred fees and costs, slightly lower than 0.48% at December 31, 2020.

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 $8,021 at March 31, 2021, slightly lower than $8,035 at December 31, 2020. Collectively evaluated loans rated classified were $605 at March 31, 2021, an increase from $473 at December 31, 2020.

*Other Factors*

The Company considers other factors that impact credit risk, including the interest rate environment, the competitive, legal and regulatory environments, changes in lending policies and loan review, changes in management, and high risk loans, as well as a factor added to measure the risk from loans that received a COVID-19 modification and then received a subsequent COVID-19 modification.

The interest rate environment impacts variable rate loans. If interest rates increase, the payment on variable rate loans increases, which may increase credit risk. The interest rate environment is at a low level as of March 31, 2021, unchanged from the level at December 31, 2020. The low level of interest rates indicates no additional credit risk.

The competitive, legal and regulatory environments were evaluated for changes that would impact credit risk. Higher competition for loans increases credit risk, while lower competition decreases credit risk. Competition remained at similar levels to those at December 31, 2020. The legal and regulatory environments remain in a similar posture to that at December 31, 2020.

Lending policies, loan review procedures and management's experience influence credit risk. Since December 31, 2020, there have been no changes to the Company's lending policies or loan review procedures, or changes in management's experience.

Levels of high risk loans are considered in the determination of the level of the allowance for loan loss. High risk loans are defined by the Company as loans secured by junior liens, interest only loans and loans with a high loan-to-value ratio. A decrease in the level of high risk loans within a class decreases the required allocation for the loan class, and an increase in the level of high risk loans within a class increases the required allocation for the loan class. Total high risk loans decreased $10,752 or 9.50% from the level at December 31, 2020, resulting in a decreased allocation.

In light of COVID-19 related modifications, the Company considers the impact to credit risk of certain loans granted COVID-19 related modifications. The loans captured in the analysis were granted COVID-19 related modifications subsequent to initial COVID-19 related modifications, have not yet emerged from the modification period and are flagged by credit review procedures for additional monitoring. The loans within this population at March 31, 2021 decreased significantly from December 31, 2020, resulting in a decreased allocation.

*Unallocated Surplus*

In addition to funding the allowance for loan losses based upon data analysis, the Company has the option to fund an unallocated surplus in excess to the calculated requirement, based upon management judgement. The Company's policy permits an unallocated surplus of between 0% and 5% of the calculated requirement. The unallocated surplus at March 31, 2021 is $356 or 4.4% in excess of the calculated requirement. The unallocated surplus at December 31, 2020 was $396 or 4.9% in excess of the calculated requirement. The surplus provides some mitigation of the uncertainty surrounding the impact of COVID-19.

**Conclusion**

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 most recently available data showed improvements that decreased the required level of the allowance for loan losses at March 31, 2021 from December 31, 2020 including loans considered high risk, business and personal bankruptcy filings and certain loans with COVID-19 related modifications. Other indicators showed worsening from levels at December 31, 2020 and increased the required level of the allowance for loan losses, including the unemployment rate and some asset quality indicators. Continued high national unemployment filings contributed to the allowance for loan losses. The Company also maintained its unallocated surplus at 4.4% to mitigate some of the uncertainty caused by the pandemic. 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 as of December 31, 2020.

Please refer to Note 3: Allowance for Loan Losses, Nonperforming Assets and Impaired Loans for further information on collectively evaluated loans, individually evaluated impaired loans and the unallocated portion of the allowance for loan losses.

The following table discloses the OREO in physical possession and in process at each reporting date:

| Other Real Estate Owned[1] | March 31, 2021 | March 31, 2020 | December 31, 2020 |
|---|---|---|---|
| Real estate construction | **$ 957** | $ 1,443 | $ 1,443 |
| Consumer real estate | **-** | 141 | 110 |
| Total other real estate owned | **$ 957** | $ 1,584 | $ 1,553 |
| | | | |
| Loans in process of foreclosure | **$ 734** | $ 558 | $ 1,344 |

(1) Net of valuation allowance.

OREO decreased $596 from December 31, 2020 and $627 from March 31, 2020. As of March 31, 2021, loans in various stages of foreclosure totaled $734, of which $80 are secured by residential real estate. Loans currently in the process of foreclosure may impact OREO in future quarters. It is not possible to accurately predict the future total of OREO because property sold at foreclosure may be acquired by third parties and OREO properties are regularly marketed and sold.

The Company continues to monitor risk levels within the loan portfolio. As of March 31, 2021, the effect of the COVID-19 pandemic has not impacted real estate values in the Company's market. If the pandemic increases unemployment in the Company's market, real estate values could decline, causing reduced collateral values for existing OREO properties which may result in loss recognition. The Company is working diligently with borrowers to provide payment relief, however if the pandemic results in increased foreclosures, OREO properties will increase.

## Modifications and TDRs

### Modifications

In the ordinary course of business the Company modifies loan terms on a case-by-case basis, including consumer and commercial loans, for a variety of reasons. Modifications may include rate reductions, payment extensions of varying lengths of time, a change in amortization term or method or other arrangements. Payment extensions allow borrowers temporary payment relief and result in extending the original contractual maturity by the number of months for which the extension was granted. The Company may grant payment 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. 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 extension period at contractual maturity, the modification is not designated a TDR.

Modifications to consumer loans generally involve short-term payment extensions to accommodate specific, temporary circumstances. Modifications to commercial loans may include, but are not limited to, changes in interest rate, maturity, amortization and financial covenants. 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 TDRs. During the three months ended March 31, 2021, the Company provided 244 modifications for competitive reasons to loans totaling $34,209. The modifications were not TDRs and were not related to COVID-19. For the three months ended March 31, 2020, the Company provided non-TDR modifications for competitive reasons to 273 loans totaling $37,350. For the twelve months ended December 31, 2020, the Company provided non-TDR modifications for competitive reasons to 1,047 loans totaling $152,681.

### COVID-19 Modifications

The COVID-19 pandemic has negatively impacted a significant number of the Company's borrowers, and is likely to continue to adversely impact some borrowers for the foreseeable future. Since the pandemic began in March 2020, the Company provided modifications related to COVID-19 financial difficulty, including payment extensions and interest only periods. Under the CARES Act, CAA and regulatory guidance, modifications (generally of no more than six months in duration) to loans that were not more than 30 days past due as of December 31, 2019 are not considered for TDR designation. The modifications met the requirements specified and as such were not designated as TDRs. The Company followed its normal risk rating and nonaccrual designation procedures and did not automatically downgrade or designate as nonaccrual if the loan was modified for COVID-19 related difficulty.

The following tables provide information regarding COVID-19 related modifications for the three months ended March 31, 2021 and March 31, 2020, and the 12 months ended December 31, 2020.

**Three Months Ended March 31, 2021**

| Modifications To Borrowers Experiencing COVID-19 Related Financial Difficulty | Number | Amount (in thousands) | |
|---|---|---|---|
| Payment extensions[(1)] | **31** | **$** | **12,074** |
| Interest-only period for amortizing loans[(1)] | **8** | | **22,135** |
| Total | **39** | **$** | **34,209** |

**Three Months Ended March 31, 2020**

| Modifications To Borrowers Experiencing COVID-19 Related Financial Difficulty | Number | Amount (in thousands) | |
|---|---|---|---|
| Rate reductions [(2)] | 1 | $ | 16 |
| Payment extensions [(1)] | 62 | | 31,589 |
| Maturity date extensions | 1 | | 315 |
| Total | 64 | $ | 31,920 |

**Twelve Months Ended December 31, 2020**

| Modifications To Borrowers Impacted by the COVID-19 Pandemic | Number | Amount (in thousands) | |
|---|---|---|---|
| Rate reductions [(2)] | 5 | $ | 442 |
| Payment extensions [(1)] | 350 | | 121,676 |
| Maturity date extension | 2 | | 729 |
| Interest-only period for amortizing loans [(1)] | 31 | | 59,982 |
| Total | 388 | $ | 182,829 |

(1) Modifications for payment extensions and interest-only periods are governed by an agreements that provide a date at which the modifications will expire.
(2) Rate reductions were granted to qualifying loans and are permanent for the remaining term of the loan. Rate reductions were provided to alleviate COVID-19 hardship and also to remain competitive in the current low interest rate environment.

*Methodology*

A loan that received multiple modifications as part of one request, for instance, a rate reduction and a payment extension, is presented only under one modification category. A loan that was modified pursuant to a first request and then was modified subsequently pursuant to a separate request is included for each of the requests. For example, a loan that received a payment extension under a first request and a rate reduction under a second request is counted in the rate reduction category and again in the payment extension category.

*Subsequent Requests for Modification*

Certain borrowers who received initial COVID-19 related modifications requested and were granted a subsequent modification. Of the COVID-19 related modifications provided from the beginning of the pandemic in March 2020 through March 31, 2021, 147 loans totaling $103,693 were recipients of initial and subsequent modifications. If borrowers continue to suffer adverse impacts from the pandemic and the Company's analysis indicates a modification will bolster the prospect of full repayment in the future, the Company expects to continue to work with borrowers. Future concessions may result in a loan being designated TDR, impaired and/or nonaccrual, and may result in a downgrade in the risk rating, based upon individual borrower circumstances and regulatory and accounting guidance.

*Loans Remaining Within the Modification Period at March 31, 2021*

Of the loans modified for pandemic related hardships, 13 loans remained in their modification period at March 31, 2021: seven loans totaling $7.8 million remained in deferral and another six loans totaling $14.4 million remained on interest-only payments. To account for the possible increase in credit risk from loans that have not emerged from their modification period, the Company added an allocation to the allowance for loan losses.

*TDR Designation*

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. Restructuring generally results in a loan with either lower payments or a maturity extended beyond that originally required, and is expected to result in a lower risk of loss associated with nonperformance than the pre-modified loan. The Company restructured loan terms for certain qualified financially distressed borrowers who agreed to work in good faith and demonstrated the ability to make the restructured payments.

The determination of whether a modification should be designated a TDR requires consideration of all facts and circumstances surrounding the transaction. With the exception of borrowers who fall under the CARES Act and CAA discussed above, 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 TDRs. Concessions may include one or a combination of the following: a reduction of the stated interest rate below market rate for loans of similar terms and credit quality, an extension of the maturity date at an interest rate below a comparable market rate, restructuring an amortizing loan to interest only for a period, or forgiveness of principal or accrued interest.

All TDR loans are individually evaluated for impairment for purposes of determining the allowance for loan losses. TDR loans that do not demonstrate current payments for at least six months are maintained on nonaccrual until the borrower demonstrates sustained repayment history under the restructured terms and continued repayment is not in doubt. Otherwise, interest income is recognized using a cost recovery method.

The Company's TDRs were $4,285 at March 31, 2021, an increase from $4,249 at December 31, 2020. Accruing TDR loans amounted to $1,378 at March 31, 2021 and $1,410 at December 31, 2020. The following tables present the past due status of TDRs as of the dates indicated.

| | TDR Status as of March 31, 2021 | | | | |
|---|---|---|---|---|---|
| | | Accruing | | | |
| | Total TDR Loans | Current | 30-89 Days Past Due | 90+ Days Past Due | Nonaccrual |
| Consumer real estate | $ 193 | $ 193 | $ - | $ - | $ - |
| Commercial real estate | 3,265 | 358 | - | - | 2,907 |
| Commercial non-real estate | 826 | 182 | 644 | - | - |
| Consumer non-real estate | 1 | 1 | - | - | - |
| Total TDR Loans | $ 4,285 | $ 734 | $ 644 | $ - | $ 2,907 |

| | TDR Status as of December 31, 2020 | | | | |
|---|---|---|---|---|---|
| | | Accruing | | | |
| | Total TDR Loans | Current | 30-89 Days Past Due | 90+ Days Past Due | Nonaccrual |
| Consumer real estate | $ 194 | $ 194 | $ - | $ - | $ - |
| Commercial real estate | 3,202 | - | 363 | - | 2,839 |
| Commercial non-real estate | 851 | 188 | 663 | - | - |
| Consumer non-real estate | 2 | 1 | - | 1 | - |
| Total TDR Loans | $ 4,249 | $ 383 | $ 1,026 | $ 1 | $ 2,839 |

Please refer to Note 3: Allowance for Loan Losses, Nonperforming Assets and Impaired Loans for information on TDRs.

## Net Interest Income

The net interest income analysis for the three months ended March 31, 2021 and 2020 follows:

| | Three Months Ended | | | | | |
|---|---|---|---|---|---|---|
| | March 31, 2021 | | | March 31, 2020 | | |
| | Average Balance | Interest | Average Yield/ Rate | Average Balance | Interest | Average Yield/ Rate |
| Interest-earning assets: | | | | | | |
| Loans, net [1][2][3][4] | **$ 770,182** | **$ 8,625** | **4.54 %** | $ 731,353 | $ 8,589 | 4.72 % |
| Taxable securities [5][6] | **467,963** | **1,783** | **1.55 %** | 397,836 | 2,356 | 2.38 % |
| Nontaxable securities [1][5] | **82,398** | **691** | **3.40 %** | 37,295 | 445 | 4.80 % |
| Interest-bearing deposits | **119,311** | **28** | **0.10 %** | 66,583 | 217 | 1.31 % |
| Total interest-earning assets | **$ 1,439,854** | **$ 11,127** | **3.13 %** | $ 1,233,067 | $ 11,607 | 3.79 % |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | **$ 762,524** | **$ 718** | **0.38 %** | $ 630,467 | $ 1,115 | 0.71 % |
| Savings deposits | **174,599** | **47** | **0.11 %** | 147,344 | 122 | 0.33 % |
| Time deposits | **88,103** | **90** | **0.41 %** | 126,269 | 559 | 1.78 % |
| Total interest-bearing liabilities | **$ 1,025,226** | **$ 855** | **0.34 %** | $ 904,080 | $ 1,796 | 0.80 % |
| Net interest income and interest rate spread | | **$ 10,272** | **2.79 %** | | $ 9,811 | 2.99 % |
| Net yield on average interest-earning assets | | | **2.89 %** | | | 3.20 % |

(1) Interest on nontaxable loans and securities is computed on a fully taxable equivalent basis using a Federal income tax rate of 21%.
(2) Included in interest income are loan fees of $558 and $21 for the three months ended March 31, 2021 and 2020, respectively.
(3) Nonaccrual loans are included in average balances for yield computations.
(4) Includes loans held for sale.
(5) Daily averages are shown at amortized cost.
(6) Includes restricted stock.

The net interest margin decreased 31 basis points when the three month periods ended March 31, 2021 and March 31, 2020 are compared. The low interest rate environment that impacted net interest income for the three months ended March 31, 2021 began with Federal Reserve rate cuts on March 3 and March 16, 2020, decreasing the target Fed Funds rate from 1.75% to 0.25%. The Company reacted by reducing interest rates on customer deposits. The cost of interest-bearing liabilities decreased from 0.80% for the three months ended March 31, 2020 to 0.34% for the three months ended March 31, 2021. The Company also experienced high levels of calls on securities and loan refinance activity that resulted in a decrease in the yield on earning assets(1) from 3.79% for the three months ended March 31, 2020 to 3.13% for the three months ended March 31, 2021. The Company's yield on earning assets and cost of funds are largely dependent on the interest rate environment.

Fees and interest income from PPP loans helped increase the net interest margin. For the three months ended March 31, 2021, PPP loans increased average loans by $38,222. Interest on PPP loans totaled $100 and net fees recognized in interest income totaled $550. If PPP loans are excluded, the net interest margin for the three months ended March 31, 2021 would have been 2.71%. Net deferred fees on PPP loans at March 31, 2021 were $1,506.

## Provision and Allowance for Loan Losses

The calculation of the allowance for loan losses resulted in a provision for loan losses of $50 for the three month period ended March 31, 2021, compared with a provision for loan losses of $479, for the same period ended March 31, 2020. The provision for loan losses is the result of a detailed analysis to estimate an adequate allowance for loan losses. The ratio of the allowance for loan losses to total loans at March 31, 2021 was 1.10%, compared with 1.10% at December 31, 2020 and 0.99% at March 31, 2020. The net charge-off ratio was 0.00% (annualized) for the three months ended March 31, 2021, 0.06% (annualized) for the three months ended March 31, 2020 and 0.05% for the year ended December 31, 2020. See "Asset Quality" for additional information.

**Noninterest Income**

| | Three Months Ended | | |
|---|---|---|---|
| | **March 31, 2021** | **March 31, 2020** | **Percent Change** |
| Service charges on deposits | **$ 469** | $ 582 | **(19.42) %** |
| Other service charges and fees | **41** | 39 | **5.13 %** |
| Credit and debit card fees | **434** | 306 | **41.83 %** |
| Trust fees | **415** | 434 | **(4.38) %** |
| BOLI income | **206** | 221 | **(6.79) %** |
| Gain on sale of mortgage loans | **137** | 94 | **45.74 %** |
| Other income | **627** | 439 | **42.82 %** |
| Realized securities gain, net | **5** | 20 | **(75.00) %** |

Service charges on deposit accounts decreased 19.42% for the three month period ended March 31, 2021 when compared with the same period ended March 31, 2020, primarily due to decreased nonsufficient funds and overdraft charges. The COVID-19 pandemic amplified a trend of increased vigilance and caution in customer deposit activity to avoid overdrafts and other fees.

Other service charges and fees increased 5.13% when the three month period ended March 31, 2021 is compared with the same period ended March 31, 2020. Other service charges include charges for official checks, income from the sale of checks to customers, safe deposit box rent, fees for letters of credit and the income earned from commissions on the sale of credit life, accident and health insurance. Other service charges and fees benefitted from an updated fee structure implemented during the third quarter of 2020.

Credit and debit card fees are presented net of interchange expense. Credit and debit card fees increased $128 for the three month period ended March 31, 2021 when compared with the same period last year. Credit and debit card fees are based on volume and other factors.

Income from trust fees decreased $19 for the three month period ended March 31, 2021, compared with the same period ended March 31, 2020. Trust income varies depending on the total assets held in trust accounts, the type of accounts under management and financial market conditions.

Bank owned life insurance ("BOLI") income decreased $15 for the three month period ended March 31, 2021 when compared with the same period ended March 31, 2020.

Gain on sale of mortgage loans increased $43 or 45.74% from $94 for the three months ended March 31, 2020 to $137 for the three months ended March 31, 2021. The Company originates consumer real estate mortgage loans to be kept in portfolio and to be sold on the secondary market under best efforts contracts. Beginning at the end of March 2020, the pandemic and a low interest rate environment spurred robust consumer real estate purchase and refinance activity.

Other income includes revenue from investment and insurance sales and other miscellaneous components. These areas fluctuate with market conditions and competitive factors. Other income increased $188 for the three months ended March 31, 2021 when compared with the same period ended March 31, 2020, primarily due to the receipt of a one-time bonus payment from a partnership investment.

The Company realized a gain of $5 on the call and sale of securities during the three month period ended March 31, 2021 and realized a gain of $20 during the three month period ended March 31, 2020. Net realized securities gains and losses are market driven.

## Noninterest Expense

| | Three Months Ended | | |
|---|---|---|---|
| | **March 31, 2021** | **March 31, 2020** | **Percent Change** |
| Salaries and employee benefits | **$ 3,906** | $ 3,873 | **0.85 %** |
| Occupancy, furniture and fixtures | **488** | 450 | **8.44 %** |
| Data processing and ATM | **778** | 791 | **(1.64)%** |
| FDIC assessment | **83** | - | **100.00 %** |
| Net costs of other real estate owned | **37** | 22 | **68.18 %** |
| Franchise taxes | **335** | 343 | **(2.33)%** |
| Other operating expenses | **909** | 988 | **(8.00)%** |

Total noninterest expense increased $69 or 1.07% for the three month period ended March 31, 2021 when compared with the same period of 2020.

Salaries and employee benefits increased $33 or 0.85% for the three month period ended March 31, 2021 when compared with the same period in 2020. This expense category includes employee salaries, payroll taxes, insurance and fringe benefits, employee stock ownership plan contribution accruals, the service component of net periodic pension cost, and salary continuation expenses.

Occupancy, furniture and fixtures expense increased $38 or 8.44% when the three month periods ended March 31, 2021 and March 31, 2020 are compared.

Data processing and ATM expense decreased $13 for the three month period ended March 31, 2021, compared with the same period in 2020.

Federal Deposit Insurance (“FDIC”) assessment expense increased $83 for the three month period ended March 31, 2021 when compared with the same period of 2020. The FDIC assessment is accrued based on a method provided by the FDIC. During the third quarter of 2019, the FDIC notified the Bank that it was eligible to use small bank assessment credits. The credits fully offset the Bank’s September 30, 2019, December 31, 2019 and March 31, 2020 assessment payments. The calculation is based on average assets divided by average tangible equity and incorporates risk-based factors to determine the amount of the assessment.

Net costs of OREO increased $15 for the three month period ended March 31, 2021, compared with the same period in 2020. The cost of OREO includes maintenance costs as well as valuation write-downs and gains and losses on the sale of properties. The expense varies with the number of properties, the maintenance required and changes in the real estate market. OREO properties are accounted for at fair value less cost to sell upon foreclosure and are thereafter periodically appraised to determine market value. Declines in market value are recognized through valuation expense. There were no write downs on OREO properties during the three months ended March 31, 2020 and March 31, 2019. The Company recognized a loss on the sale of OREO of $26 for the three months ended March 31, 2021 and $4 for the three months ended March 31, 2020.

Franchise tax expense decreased $8 or 2.33% when the three month period ended March 31, 2021 is compared with the three month period ended March 31, 2020. Franchise tax is primarily based on capital levels of the subsidiary bank.

The category of other operating expenses includes noninterest expense items such as professional services, stationery and supplies, telephone costs, postage, charitable donations, losses and other expenses. Other operating expense decreased $79 or 8.00% for the three month period ended March 31, 2021, compared with the same period of 2020.

**Cybersecurity Risks**

The Company considers cybersecurity rick to be one of the greatest risks to its business. The Company has a program to identify, mitigate and manage its cybersecurity risks. The program includes penetration testing and vulnerability assessment, technological defenses such as antivirus software, patch management, firewall management, email and web protections, an intrusion prevention system, a cybersecurity insurance policy which covers some but not all losses arising from cybersecurity breaches, as well as ongoing employee training. The costs of these measures were $98 for the three months ended March 31, 2021 and $93 for the three months ended March 31, 2020. These costs are included in various categories of noninterest expense.

## Income Tax

Income tax expense for the first three months of 2021 was $1,009, compared with $802 for the first three months of 2020. The Company’s federal statutory corporate tax rate is 21%. The Company’s effective tax rate for the three month period ended March 31, 2021 was 17.47%, compared with 16.77% for the three month period ended March 31, 2020.

## Balance Sheet

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

| Assets | March 31, 2021 | December 31, 2020 | Percent Change |
|---|---|---|---|
| Interest-bearing deposits | **$ 119,311** | $ 81,639 | **46.14 %** |
| Securities available for sale and restricted stock | **559,411** | 474,934 | **17.79 %** |
| Loans, net | **760,823** | 760,641 | **0.02 %** |
| Total assets | **1,530,908** | 1,403,671 | **9.06 %** |
| **Liabilities and stockholders' equity** | | | |
| Noninterest-bearing demand deposits | **$ 289,803** | $ 248,392 | **16.67 %** |
| Interest-bearing demand deposits | **762,524** | 669,383 | **13.91 %** |
| Savings deposits | **174,599** | 158,334 | **10.27 %** |
| Time deposits | **88,103** | 112,463 | **(21.66)%** |
| Stockholders' equity | **195,595** | 195,768 | **(0.09)%** |

## Securities

Securities available for sale are measured at fair value on a recurring basis. Market conditions at March 31, 2021 are reflected in the presentation of securities available for sale. While we do not expect significant changes in future judgements or methodologies used to determine the fair value of the securities portfolio, market volatility associated with the COVID-19 pandemic, or any future national or global concern, will impact the value of securities. Management regularly monitors the quality of the securities portfolio and closely follows the uncertainty in the economy and the volatility of financial markets. The value of individual securities will be written down if the decline in fair value is considered to be other than temporary based upon the totality of circumstances. See Note 4: Securities for additional information.

## Loans

| | March 31, 2021 | December 31, 2020 | Percent Change |
|---|---|---|---|
| Real estate construction loans | **$ 42,570** | $ 42,266 | **0.72 %** |
| Consumer real estate loans | **186,906** | 181,782 | **2.82 %** |
| Commercial real estate loans | **392,461** | 393,115 | **(0.17)%** |
| Commercial non-real estate loans | **87,258** | 78,771 | **10.77 %** |
| Public sector and IDA | **39,788** | 40,983 | **(2.92)%** |
| Consumer non-real estate | **32,261** | 33,110 | **(2.56)%** |
| Less: unearned income and deferred fees and costs | **(1,884)** | (1,228) | **(53.42)%** |
| Loans, net of unearned income and deferred fees and costs | **$ 779,360** | $ 768,799 | **1.37 %** |

The Company's loans, net of unearned income and deferred fees and costs, increased $10,561 or 1.37% from $768,799 at December 31, 2020 to $779,360 at March 31, 2021. Real estate construction, consumer real estate, and commercial non-real estate increased from December 31, 2020 while commercial real estate, public sector and IDA loans and consumer non real estate loans decreased. Included in commercial non-real estate loans are PPP loans of $45,137 at March 31, 2021 and $36,903 at December 31, 2020. Loan demand other than PPP loans has softened due to unemployment and decreased economic activity, as well as hiring freezes at universities within the Company's market area, all stemming from the COVID-19 pandemic.

**Deposits**

| | March 31, 2021 | December 31, 2020 | Percent Change |
|---|---|---|---|
| Noninterest-bearing demand deposits | $ **319,126** | $ 276,793 | **15.29 %** |
| Interest-bearing demand deposits | **766,582** | 763,293 | **0.43 %** |
| Saving deposits | **183,231** | 167,475 | **9.41 %** |
| Time deposits | **89,649** | 89,582 | **0.07 %** |
| Total deposits | $ **1,358,588** | $ 1,297,143 | **4.74 %** |

Total deposits increased $61,445 or 4.74% from $1,297,143 at December 31, 2020 to $1,358,588 at March 31, 2021. Deposits do not include any brokered deposits.

**Liquidity**

Liquidity measures the Company's ability to meet its financial commitments at a reasonable cost. Demands on the Company's liquidity include funding additional loan demand and accepting withdrawals of existing deposits. The Company has diverse liquidity sources, including customer and purchased deposits, customer repayments of loan principal and interest, sales, calls and maturities of securities, Federal Reserve discount window borrowing, short-term borrowing, and FHLB advances. At March 31, 2021, the Bank did not have discount window borrowings, short-term borrowings, or FHLB advances. To assure that short-term borrowing is readily available, the Company tests accessibility annually.

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

Regulatory capital levels at the subsidiary bank determine the Bank's ability to use purchased deposits and the Federal Reserve discount window. At March 31, 2021, the Bank is considered well capitalized and does not have any restrictions on purchased deposits or borrowing ability at the Federal Reserve discount window.

The Company monitors factors that may increase its liquidity needs. Some of these factors include deposit trends, large depositor activity, maturing deposit promotions, interest rate sensitivity, maturity and repricing timing gaps between assets and liabilities, the level of unfunded loan commitments, loan growth and share repurchase activity within the Company's own stock. At March 31, 2021, 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 March 31, 2021, 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 March 31, 2021, the loan to deposit ratio was 57.37%. 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.

The Company's liquidity position was strong prior to the COVID-19 pandemic and has increased due to government transfer payments and softened loan demand. In response to the pandemic, the Federal Reserve and the FHLB have increased their credit offerings in order to support member banks. Further, securities with an amortized cost of $3,072 will mature within one year or less, and up to $77,418 may be called. The Company is closely monitoring liquidity as the impact of the pandemic evolves.

## Capital Resources

Total stockholders' equity at March 31, 2021 was $189,069, a decrease of $11,538 or 5.75%, from the $200,607 at December 31, 2020. On June 1, 2020, the Company's Board of Directors approved the repurchase of up to 1,000,000 shares of the Company's common stock. The authorization began June 1, 2020 and expires May 31, 2021. During the first three months of 2021, the Company repurchased 111,832 shares under the program. The repurchases reduced shareholders equity by $3,991. The Company did not repurchase any shares during the quarter ended March 31, 2020. The Company's subsidiary bank is subject to various capital requirements administered by banking agencies. Risk based capital ratios for the Bank are shown in the following tables.

| | NBB | Regulatory Capital Minimum Ratios | Regulatory Capital Minimum Ratios with Capital Conservation Buffer |
|---|---|---|---|
| Common Equity Tier I Capital Ratio | **18.80**% | 4.50% | 7.00 % |
| Tier I Capital Ratio | **18.80**% | 6.00% | 8.50 % |
| Total Capital Ratio | **19.73**% | 8.00% | 10.50 % |
| Leverage Ratio | **11.48**% | 4.00% | 4.00 % |

Risk-based capital ratios are calculated in compliance with FDIC rules based on Basel III capital requirements. Banks are subject to an additional capital conservation buffer in order to make capital distributions or discretionary bonus payments. The Bank's ratios are well above the required minimums and the capital conservation buffer at March 31, 2021.

## Off-Balance Sheet Arrangements

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

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

The Company sells mortgages on the secondary market. Our agreement with the purchaser provides for strict underwriting and documentation requirements. Violation of the representations and warranties of the agreement would entitle the purchaser to recourse provisions. The Company has determined that its risk in this area is not significant because of a low volume of secondary market mortgage loans and high underwriting standards. The Company estimates a potential loss reserve for recourse provisions that is not material as of March 31, 2021. To date, no recourse provisions have been invoked. If funds were needed, the Company would access the same sources as noted above for funding lines and letters of credit.

There were no material changes in off-balance sheet arrangements during the three months ended March 31, 2021, except for normal seasonal fluctuations in the total of mortgage loan commitments.

## Contractual Obligations

The Company had no finance lease or purchase obligations and no long-term debt at March 31, 2021.

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

The Company considers interest rate risk to be a significant market risk and has systems in place to measure the exposure of net interest income to adverse movement in interest rates. Interest rate shock analyses provide management with an indication of potential economic loss due to future rate changes. There have not been any changes which would significantly alter the results disclosed as of December 31, 2020 in the Company's 2020 Form 10-K.

## Item 4. Controls and Procedures

The Company's management evaluated, with the participation of the Company's principal executive officer and principal financial officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on that evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective as of March 31, 2021 to ensure that information required to be disclosed in the reports that the Company

files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified by the Company's management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) during the three months ended March 31, 2021 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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

## Part II

## Other Information

### Item 1. Legal Proceedings

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

### Item 1A. Risk Factors

Please refer to the "Risk Factors" previously disclosed in Item 1A of our 2020 Annual Report on Form 10-K and the factors discussed under "Cautionary Statement Regarding Forward-Looking Statements" in Part I. Item 2 of this Form 10-Q.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

**Purchases of Equity Securities by the Issuer**

Share repurchase activity during the three months ended March 31, 2021 was as follows:

| Period | Total Number of Shares Purchased(1) | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Program(1) | Number of Shares that May Yet Be Purchased Under the Program(1) |
|---|---|---|---|---|
| January 1, 2021 – January 31, 2021 | --- | --- | --- | 942,446 |
| February 1, 2021 – February 28, 2021 | 25,900 | 33.22 | 25,900 | 916,546 |
| March 1, 2021 – March 31, 2021 | 85,932 | 36.43 | 85,932 | 830,614 |
| Total | 111,832 | 35.69 | 111,832 | |

(1) In May 2020, the Company announced the Board of Directors had authorized a 1,000,000 share repurchase program. The authorization began June 1, 2020 and expires May 31, 2021. The Company's share repurchase program does not obligate it to acquire any specific number of shares.

### Item 3. Defaults Upon Senior Securities

None.

### Item 4. Mine Safety Disclosures

Not applicable.

### Item 5. Other Information

None.

**Item 6. Exhibits**

**Index of Exhibits**

| Exhibit No. | Description | |
|---|---|---|
| 3(i) | Amended and Restated Articles of Incorporation of National Bankshares, Inc. | (incorporated herein by reference to Exhibit 3.1 of the Form 8-K for filed on March 16, 2006) |
| 3(ii) | Amended and Restated Bylaws of National Bankshares, Inc. | (incorporated herein by reference to Exhibit 3(ii) of the Form 8-K filed on April 14, 2021) |
| 4 | Specimen copy of certificate for National Bankshares, Inc. common stock | (incorporated herein by reference to Exhibit 4(a) of the Annual Report on Form 10-K for fiscal year ended December 31, 1993) |
| +31(i) | Section 302 Certification of Chief Executive Officer | Filed herewith |
| +31(ii) | Section 302 Certification of Chief Financial Officer | Filed herewith |
| +32(i) | 18 U.S.C. Section 1350 Certification of Chief Executive Officer | Filed herewith |
| +32(ii) | 18 U.S.C. Section 1350 Certification of Chief Financial Officer | Filed herewith |
| +101 | The following materials from National Bankshares, Inc.'s Quarterly Report on Form 10-Q for the period ended March 31, 2021 are formatted in XBRL (Extensible Business Reporting Language), furnished herewith: (i) Consolidated Balance Sheets at March 31, 2021 and December 31, 2020; (ii) Consolidated Statements of Income for the three month periods ended March 31, 2021 and 2020; (iii) Consolidated Statements of Comprehensive Income for the three month periods ended March 31, 2021 and 2020; (iv) Consolidated Statements of Changes in Stockholders' Equity for the three months ended March 31, 2021 and 2020; (v) Consolidated Statements of Cash Flows for the three months ended March 31, 2021 and 2020; and (vi) Notes to Consolidated Financial Statements. | Filed herewith |

**Signatures**

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

NATIONAL BANKSHARES, INC.

Date: May 12, 2021

/s/ F. Brad Denardo
By: F. Brad Denardo
Chairman, President and Chief Executive Officer
(Principal Executive Officer)

Date: May 12, 2021

/s/ David K. Skeens
By: David K. Skeens
Treasurer and Chief Financial Officer
(Principal Financial Officer)
(Principal Accounting Officer)

Exhibit 31(i)

CERTIFICATIONS

I, F. Brad Denardo, certify that:

1. I have reviewed this quarterly report on Form 10-Q of National Bankshares, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a–15(e) and 15d–15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a–15(f) and 15d–15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 12, 2021

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

Exhibit 31(ii)

CERTIFICATIONS

I, David K. Skeens, certify that:

1. I have reviewed this quarterly report on Form 10-Q of National Bankshares, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a–15(e) and 15d–15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a–15(f) and 15d–15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 12, 2021

/s/ David K. Skeens

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

Exhibit 32 (i)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350

In connection with the Quarterly Report on Form 10-Q of National Bankshares, Inc. for the quarter ended March 31, 2021, I, F. Brad Denardo, President and Chief Executive Officer (Principal Executive Officer) of National Bankshares, Inc., hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief, that:

(1) such Form 10-Q for the quarter ended March 31, 2021, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in such Form 10-Q for the quarter ended March 31, 2021, fairly presents, in all material respects, the financial condition and results of operations of National Bankshares, Inc.

/s/ F. Brad Denardo

F. Brad Denardo
Chairman, President and Chief Executive Officer
(Principal Executive Officer)
May 12, 2021

Exhibit 32 (ii)

CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350

In connection with the Quarterly Report on Form 10-Q of National Bankshares, Inc. for the quarter ended March 31, 2021, I, David K. Skeens, Treasurer and Chief Financial Officer (Principal Financial Officer) of National Bankshares, Inc., hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief, that:

(1) such Form 10-Q for the quarter ended March 31, 2021, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in such Form 10-Q for the quarter ended March 31, 2021, fairly presents, in all material respects, the financial condition and results of operations of National Bankshares, Inc.

/s/ David K. Skeens
David K. Skeens
Treasurer and
Chief Financial Officer
(Principal Financial Officer)
May 12, 2021