

NEW PEOPLES BANKSHARES INC
Form 10-K
April 01, 2019

United States

Securities and Exchange Commission

Washington, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For fiscal year ended December 31, 20178

Commission File Number 000-33411

Virginia 31-1804543
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

67 Commerce Drive 24260
Honaker, VA
(Address of principal executive offices) (Zip Code)

67 Commerce DriveJ4260

Honaker, VA (Zip Code)

(Address of principal executive offices)

Registrant's telephone number, including area code **(276) 873-7000**

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

None

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

Common Stock - \$2 Par Value

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

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

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

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

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

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

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if smaller reporting company) Smaller reporting company

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

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The aggregate market value of the common stock held by non-affiliates, based on the last reported sales price of \$1.97 per share on the last business day of the second quarter of 2018 was \$20,634,570.

The number of shares outstanding of the registrant's common stock was 23,922,086 as of March 27, 2019.

DOCUMENTS INCORPORATED BY REFERENCE:

The Proxy Statement for New Peoples Bankshares, Inc.'s 2019 Annual Meeting to Shareholders, is incorporated into Items 10 through 14 of this form 10-K.

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PART I

Item 1. Business

General

New Peoples Bankshares, Inc. (New Peoples or Company) is a Virginia financial holding company headquartered in Honaker, Virginia. From January 1, 2009 to March 3, 2016, New Peoples was a bank holding company. On March 4, 2016 the Federal Reserve Bank of Richmond approved New Peoples' election to become a financial holding company. Our business is conducted primarily through New Peoples Bank, Inc., a Virginia banking corporation (the Bank). The Bank has a division doing business as New Peoples Financial Services which offers investment services through its broker-dealer relationship with Infinex Investments, Inc. NPB Insurance Services, Inc. (NPB Insurance) is a subsidiary of the Bank and generates revenue through the referral of insurance services.

The Bank, headquartered in Honaker, Virginia, offers a range of banking and related financial services focused primarily on serving individuals, small to medium size businesses, and the professional community. We strive to serve the banking needs of our customers while developing personal, hometown relationships with them. Our board of directors believes that marketing customized banking services enables us to establish a niche in the financial services marketplace where we do business.

We provide professionals and small and medium size businesses in our market area with responsive and technologically enabled banking services. These services include loans that are priced on a deposit relationship basis, easy access to our decision makers, and quick and innovative action necessary to meet a customer's banking needs. Our capitalization and lending limit enable us to satisfy the credit needs of a large portion of the targeted market segment. When a customer needs a loan that exceeds our lending limit, we try to find other financial institutions to participate in the loan with us.

Our History

The Bank was incorporated under the laws of the Commonwealth of Virginia on December 9, 1997 and began operations on October 28, 1998. On September 27, 2001, the shareholders of the Bank approved a plan of reorganization under which they exchanged their shares of Bank common stock for shares of New Peoples common stock. On November 30, 2001, the reorganization was completed and the Bank became New Peoples' wholly-owned subsidiary.

In June 2003, New Peoples formed two new wholly-owned subsidiaries, NPB Financial Services, Inc. (renamed NPB Insurance Services, Inc. in June 2012) and NPB Web Services, Inc. (NPB Web), an inactive web design and hosting company.

The Bank, through its division New Peoples Financial services, offers fixed and variable annuities, fee based asset management and other investment products through a broker/dealer relationship with Infinex Investments, Inc.

In July 2004, NPB Capital Trust I was formed by New Peoples to issue \$11.3 million in trust preferred securities.

In September 2006, NPB Capital Trust 2 was formed by New Peoples to issue \$5.2 million in trust preferred securities.

On June 7, 2017, NPB Insurance Services, Inc. purchased a 39% membership interest in Lonesome Pine Title Agency, LLC, which provides title insurance. Another member of the agency is a related party to the Company.

Branch Locations

After a period of significant branch expansion between 2000 and 2008, we have consolidated some of our branch operations to improve efficiency. Currently, in addition to our headquarters in Honaker, Virginia we have 18 full service branches located in three states: Virginia - Abingdon, Big Stone Gap, Bluefield, Bristol, Castlewood, Chilhowie, Clintwood, Gate City, Grundy, Haysi, Lebanon, Pounding Mill, Tazewell, Weber City and Wise; West Virginia - Princeton (2); and Kingsport, Tennessee. We have 1 limited services branch in Pound, Virginia. We also have loan production offices, as of December 31, 2018, in Jonesborough and Kingsport, Tennessee.

Our Market Areas

Our primary market area consists of southwestern Virginia, southern West Virginia and northeastern Tennessee. Specifically, we operate in the southwestern Virginia counties of Russell, Scott, Washington, Tazewell, Buchanan, Dickenson, Wise, and Smyth; Mercer county in southern West Virginia and the northeastern Tennessee counties of Sullivan and Washington (collectively, the “Tri-State Area”). The close proximity and mobile nature of individuals and businesses in adjoining counties and nearby cities in Virginia, West Virginia and Tennessee place these markets within our Bank’s targeted trade area, as well.

Accessibility to Interstates I-77, I-81, I-26, I-64 and I-75, as well as major state and U.S. highways including US 19, US 23, US 58, US 460 and US 421, make the area an ideal location for businesses to serve markets in the Mid-Atlantic, Southeast and Midwest. The area is strategically located midway between Atlanta-Pittsburgh, Charlotte-Cincinnati, and Richmond-Louisville, and is within a day’s drive of more than half of the U.S. population. A regional airport located in Bristol, Tennessee serves the area with commercial flights to and from major cities in the United States. Commercial rail service providers include CSX Transportation and Norfolk Southern Railways.

The Tri-State Area has a diversified economy supported by natural resources, which include coal, natural gas, limestone, and timber; agriculture; healthcare; education; technology; manufacturing and services industries. Predominantly, the market is comprised of locally-owned and operated small businesses. Considerable investments in high-technology communications, high-speed broadband network and infrastructure have been made which has opened the area to large technology companies and future business development potential for new and existing businesses. Industries are taking advantage of the low cost of doing business, training opportunities, available workforce and an exceptional quality of life experience for employers and employees alike.

Internet Site

We have our internet banking site at www.newpeoplesbank.com. The site includes a customer service area that contains branch and Interactive Teller Machine (ITM) locations, product descriptions and current interest rates offered on deposit accounts. Customers with internet access can apply for loans, open deposit accounts online, access account balances, make transfers between accounts, enter stop payment orders, order checks, and use an optional bill paying service.

Available Information

We file annual, quarterly, and current reports, proxy statements and other information with the Securities and Exchange Commission (the SEC). The SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers, like us, that file electronically with the SEC. Our SEC filings are filed electronically and are available to the public online at the SEC's web site at www.sec.gov. We also provide a link to our filings on the SEC website, free of charge, through our internet website www.npbankshares.com under "Investor Relations." We also make available free of charge on or through our internet website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

Banking Services

General. We accept deposits, make consumer and commercial loans, issue drafts, and provide other services customarily offered by a commercial bank, such as business and personal checking and savings accounts, walk-up tellers, drive-in windows, and 24-hour interactive teller machines. The Bank is a member of the Federal Reserve System and its deposits are insured under the Federal Deposit Insurance Act (the FDIA) to the maximum limit.

Loans. Generally, we offer a full range of short-to-medium term commercial, 1-4 family residential mortgages and personal loans. Commercial loans include both secured and unsecured loans for working capital (including inventory and receivables), business expansion (including acquisition of real estate and improvements) and purchase of equipment and machinery. Consumer loans may include secured and unsecured loans for financing automobiles, home improvements, education, personal investments and other purposes.

Our lending activities are subject to a variety of lending limits imposed by state law. While differing limits may apply in certain circumstances based on the type of loan or the nature of the borrower (including the borrower's relationship to the Bank), the Bank generally is subject to a loans-to-one-borrower limit of an amount equal to 15% of its capital and surplus plus the allowance for loan losses. The Bank voluntarily may choose to impose a policy limit on loans to a single borrower that is less than the legal lending limit.

We obtain short-to-medium term commercial and personal loans through direct solicitation of business owners and continued business from existing customers. Completed loan applications are reviewed by our loan officers. As part of the application process, information is obtained concerning the income, financial condition, employment and credit history of the applicant. If commercial real estate is involved, information is also obtained concerning cash flow after debt service. Loan quality is analyzed based on the Bank's experience and its credit underwriting guidelines.

Loans by type as a percentage of total loans are as follows:

	December 31,				
	2018	2017	2016	2015	2014
Commercial, financial and agricultural	15.20%	13.35%	11.75%	10.76%	10.99%
Real estate – construction	6.42%	5.80%	5.50%	3.33%	3.37%
Real estate – commercial	25.74%	24.89%	22.05%	22.34%	23.62%
Real estate – residential	48.15%	51.59%	55.97%	58.00%	56.37%
Installment loans to individuals	4.37%	4.37%	4.73%	5.57%	5.65%
Total	100.00%	100.00%	100.00%	100.00%	100.00%

Commercial Loans. We make commercial loans to qualified businesses in our market area. Our commercial lending consists primarily of commercial and industrial loans to finance accounts receivable, inventory, property, plant and equipment. Commercial business loans generally have a higher degree of risk than residential mortgage loans, but have commensurately higher yields. Residential mortgage loans are generally made on the basis of the borrower's ability to make repayment from employment and other income and are secured by real estate whose value tends to be easily ascertainable. In contrast, commercial business loans typically are made on the basis of the borrower's ability to make repayment from cash flow from its business and are secured by business assets, such as commercial real estate, accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself.

Further, the collateral for commercial business loans may depreciate over time and cannot be appraised with as much precision as residential real estate. To manage these risks, our underwriting guidelines generally require us to secure commercial loans with both the assets of the borrowing business and other additional collateral and guarantees that may be available. In addition, we actively monitor certain measures of the borrower, including advance rate, cash flow, collateral value and other appropriate credit factors.

Residential Mortgage Loans. Our residential mortgage loans consist of residential first and second mortgage loans, residential construction loans, home equity lines of credit and term loans secured by first and second mortgages on the residences of borrowers for home improvements, education and other personal expenditures. We make mortgage loans with a variety of terms, including fixed and floating or variable rates and a variety of maturities.

Under our underwriting guidelines, residential mortgage loans are generally made on the basis of the borrower's ability to make repayment from employment and other income and are secured by real estate whose value tends to be easily ascertainable. These loans are made consistent with our appraisal policies and real estate lending policies, which detail maximum loan-to-value ratios and maturities.

Construction Loans. Construction lending entails significant additional risks, compared to residential mortgage lending. Construction loans often involve larger loan balances concentrated with single borrowers or groups of related borrowers. Construction loans also involve additional risks attributable to the fact that loan funds are advanced upon the security of property under construction, which is of uncertain value prior to the completion of construction. Thus, it is more difficult to evaluate the total loan funds required to complete a project and related loan-to-value ratios accurately. To minimize the risks associated with construction lending, loan-to-value limitations for residential, multi-family and non-residential construction loans are in place. These are in addition to the usual credit analysis of borrowers. Management feels that the loan-to-value ratios help to minimize the risk of loss and to compensate for normal fluctuations in the real estate market. Maturities for construction loans generally range from 4 to 12 months for residential property and from 6 to 18 months for non-residential and multi-family properties.

Consumer Loans. Our consumer loans consist primarily of installment loans to individuals for personal, family and household purposes. The specific types of consumer loans that we make include home improvement loans, debt consolidation loans and general consumer lending. Consumer loans entail greater risk than residential mortgage loans do, particularly in the case of consumer loans that are unsecured, such as lines of credit, or secured by rapidly depreciating assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. The remaining deficiency often does not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans. A borrower may also be able to assert against the Bank as an assignee any claims and defenses that it has against the seller of the underlying collateral.

Our underwriting policy for consumer loans seeks to limit risk and minimize losses, primarily through a careful analysis of the borrower. In evaluating consumer loans, we require our lending officers to review the borrower's level and stability of income, past credit history and the impact of these factors on the ability of the borrower to repay the loan in a timely manner. In addition, we maintain an appropriate margin between the loan amount and collateral value.

Deposits. We offer a variety of deposit products for both individual and business customers. These include demand deposit, interest-bearing demand deposit, savings deposit, money market, health savings and individual retirement ("IRA") deposit accounts. In addition, we offer certificates of deposit with terms ranging from 7 days to 60 months, including IRAs with terms ranging from 12 months to 60 months.

Investment Services. We offer a variety of investment services for both individual and business customers. These services include fixed income products, variable annuities, mutual funds, indexed certificates of deposit, individual retirement accounts, long term care insurance, employee group benefit plans, college savings plans, financial planning, managed money accounts, and estate planning. We offer these services through our broker-dealer relationship with Infinex Investments, Inc.

Other Bank Services. Other bank services include safe deposit boxes, cashier's checks, certain cash management services, direct deposit of payroll and social security checks and automatic drafts for various accounts. We offer ATM card services that can be used by our customers throughout our service area and other regions. We also offer consumer and commercial VISA credit card services. Electronic banking services include debit cards, internet banking, telephone banking, mobile banking, remote deposit capture, merchant transaction processing and wire transfers.

We do not presently anticipate obtaining trust powers, but we are able to provide similar services through our affiliation with Infinex Investments, Inc. Additionally, we have initiated programs of differentiator presentations

focusing on such issues as financial literacy, elder abuse and planning for special needs individuals. We believe that these types of programs assist our local communities and highlight the skills of our financial service providers.

Competition

The banking business is highly competitive. We compete as a financial intermediary with other commercial banks, credit unions, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market mutual funds and other financial institutions operating in the southwestern Virginia, southern West Virginia, and eastern Tennessee market area and elsewhere. Our market area is a highly competitive, highly branched banking market.

Competition in the market area for loans to small businesses and professionals, the Bank's target market, is intense, and pricing is important. Many of our larger competitors have substantially greater resources and lending limits than we have. They offer certain services, such as extensive and established branch networks and trust services that we do not expect to provide or will not provide in the near future. Moreover, larger institutions operating in the market area have access to borrowed funds at lower costs than are available to us. Deposit competition among institutions in the market area also is strong. As a result, it is possible that we may have to pay above-market rates to attract or retain deposits.

While pricing is important, our principal method of competition is service. As a community banking organization, we strive to serve the banking needs of our customers while developing personal, hometown relationships with them. As a result, we provide a significant amount of service and a range of products without the fees that customers can expect from larger banking institutions.

According to a market share report prepared by the Federal Deposit Insurance Corporation (the FDIC), as of June 30, 2018, the most recent date for which market share information is available, the Bank’s deposits as a percentage of total deposits in its major market areas were as follows:

County or City	% of Market
Scott County, VA	35.16%
Dickenson County, VA	27.54%
Russell County, VA	25.12%
Wise County, VA	11.07%
Tazewell County, VA	9.12%
Buchanan County, VA	8.06%
Smyth County, VA	4.29%
Washington County, VA	3.39%
City of Bristol, VA	1.86%
Mercer County, WV	6.66%
City of Kingsport, TN	1.22%

Employees

As of December 31, 2018, we had 254 total employees, of which 240 were full-time employees. None of our employees is covered by a collective bargaining agreement, and we consider relations with employees to be excellent.

Supervision and Regulation

General. As a financial holding company, we are subject to regulation under the Bank Holding Company Act of 1956, as amended (“BHCA”), and the examination and reporting requirements of the Board of Governors of the Federal Reserve System (the “Federal Reserve”). We are also subject to Chapter 13 of the Virginia Banking Act, as amended (“Virginia Act”). As a state-chartered commercial bank, the Bank is subject to regulation, supervision and examination by the Virginia State Corporation Commission’s Bureau of Financial Institutions (“BFI”). As a member of the Federal Reserve System, the Bank is also subject to regulation, supervision and examination by the Federal Reserve. Other federal and state laws, including various consumer protection and compliance laws, govern the activities of the Bank, such as the investments that it makes and the aggregate amount of loans that it may grant to one borrower.

The following description summarizes the most significant federal and state laws applicable to New Peoples and its subsidiaries. To the extent that statutory or regulatory provisions are described, the description is qualified in its

entirety by reference to that particular statutory or regulatory provision.

The Bank Holding Company Act. Under the BHCA, the Federal Reserve examines New Peoples periodically. New Peoples is also required to file periodic reports and provide any additional information that the Federal Reserve may require. Activities at the bank holding company level are generally limited to:

- banking, managing or controlling banks;
- furnishing services to or performing services for its subsidiaries; and
- engaging in other activities that the Federal Reserve has determined by regulation or order to be so closely related to banking as to be a proper incident to these activities.

Thus, the activities we can engage in are restricted as a matter of law.

With some limited exceptions, the BHCA requires every bank holding company to obtain the prior approval of the Federal Reserve before:

- acquiring substantially all the assets of any bank;
- acquiring direct or indirect ownership or control of any voting shares of any bank if after such acquisition it would own or control more than 5% of the voting shares of such bank (unless it already owns or controls the majority of such shares); or

- merging or consolidating with another bank holding company.

As a result, our ability to engage in certain strategic activities is conditioned on regulatory approval.

In addition, and subject to some exceptions, the BHCA and the Change in Bank Control Act require Federal Reserve approval prior to any person or company acquiring “control” of a bank holding company as defined in the statutes and regulations. These requirements make it more difficult for control of our company to change or for us to acquire substantial investments.

Financial Holding Company. As of March 4, 2016 the Company qualified as a financial holding company (“FHC”). The Gramm-Leach-Bliley Act created this category of bank holding companies. FHC’s may directly or indirectly through subsidiaries engage in financial activities and activities “incidental” or “complementary” to financial activities. Generally, a FHC need not give prior notice of acquisitions or activities, but must notify the Federal Reserve within 30 days after the event.

The BHCA provides a long list of “financial” activities such as underwriting, brokering or selling insurance; providing financial or investment advice; underwriting; dealing in or making a market in securities.

There are other potential “financial” activities in which the Federal Reserve is permitted to designate as permitted financial or incidental to financial activities.

We do not currently undertake activities specifically permitted to us as a FHC.

The Virginia Act. As a bank holding company registered with the BFI, we must provide the BFI with information concerning our financial condition, operations and management, among other reports required by the BFI. New Peoples is also examined by the BFI in addition to its Federal Reserve examinations. Similar to the BHCA, the Virginia Act requires that the BFI approve the acquisition of direct or indirect ownership or control of more than 5% of the voting shares of any Virginia bank or bank holding company like us.

Payment of Dividends. New Peoples is a separate legal entity that derives the majority of its revenues from dividends paid to it by its subsidiaries. The Bank is subject to laws and regulations that limit the amount of dividends it can pay. In addition, both New Peoples and the Bank are subject to various regulatory restrictions relating to the payment of dividends, including requirements to maintain capital at or above regulatory minimums. Banking regulators have

indicated that banking organizations should generally pay dividends only if the organization’s net income available to common shareholders over the past year has been sufficient to fully fund the dividends and the prospective rate of earnings retention appears consistent with the organization’s capital needs, asset quality and overall financial condition. The FDIC has the general authority to limit the dividends paid by FDIC insured banks if the FDIC deems the payment to be an unsafe and unsound practice. The FDIC has indicated that paying dividends that deplete a bank’s capital base to an inadequate level would be an unsound and unsafe banking practice.

Capital Adequacy. The final rule adopted by the federal banking regulators in 2013 implementing the Basel III regulatory capital reforms established new prompt corrective action requirements for all banks and includes a new Common Equity Tier 1 (“CET1”) risk-based capital measure. Because the Company is considered a “small bank holding company” by the Federal Reserve, the new regulatory capital requirements apply only to the Bank. The risk-based capital and leverage capital requirements under the final rule are set forth in the following table:

	Total Risk Based Capital Ratio	Tier 1 Risk Based Capital Ratio	CET1 Risk Based Capital Ratio	Leverage Ratio
Well Capitalized	≥ 10%	≥ 8%	≥ 6.5%	≥ 5%
Adequately Capitalized	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%
Undercapitalized	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%
Significantly Undercapitalized	≥ 6%	≥ 4%	≥ 3%	≥ 3%
Critically Undercapitalized	Tangible equity to total assets ≤ 2%			

The final rule also sets forth a capital ratio phase-in schedule. The remaining phase-in provisions for banks with \$250 billion or less in total assets are set forth in the following table:

	Effective as of	
	January 1,	
	2018	2019
Minimum Leverage Ratio	4.00%	4.00%
Minimum CET1 Risk Based Capital Ratio	4.50%	4.50%
Capital Conservation Buffer ⁽¹⁾	1.875%	2.50%
Minimum Tier CET1 Risk Based Capital Ratio with Capital Conservation Buffer	6.375%	7.00%
Minimum Tier 1 Risk Based Capital Ratio	6.00%	6.00%
Minimum Tier 1 Risk Based Capital Ratio with Capital Conservation Buffer	7.875%	8.50%
Minimum Total Risk Based Capital Ratio	8.00%	8.00%
Minimum Total Risk Based Capital Ratio with Capital Conservation Buffer	9.875%	10.50%

The capital conservation buffer must be maintained in order for a banking organization to avoid being subject to (1) limitations on capital distributions, including dividend payments, and discretionary bonus payments to executive officers.

The final rule includes comprehensive guidance with respect to the measurement of risk-weighted assets. For residential mortgages, Basel III retains the risk-weights contained in the current capital rules which assign a risk-weight of 50% to most first-lien exposures and 100% to other residential mortgage exposures. The final rule increases the risk-weights associated with certain on-balance sheet assets, such as high volatility commercial real estate loans, and loans that are more than 90 days past due or in nonaccrual status. Capital requirements also increase for certain off-balance sheet exposures including, for example, loan commitments with an original maturity of one year or less.

Under the final rule, certain banking organizations, including the Company and the Bank, are permitted to make a one-time election to continue the current treatment of excluding from regulatory capital most accumulated other comprehensive income (“AOCI”) components, including amounts relating to unrealized gains and losses on available-for-sale debt securities and amounts attributable to defined benefit post-retirement plans. Institutions that elect to exclude most AOCI components from regulatory capital under Basel III will be able to avoid volatility that would otherwise be caused by things such as the impact of fluctuations in interest rates on the fair value of available-for-sale debt securities. The Company and the Bank elected to exclude AOCI components from regulatory capital under Basel III.

Failure to meet capital guidelines could subject a bank to a variety of enforcement remedies, including issuance of a capital directive, the termination of deposit insurance by the FDIC, a prohibition on taking brokered deposits and certain other restrictions on its business. As described below, the FDIC can impose substantial additional restrictions upon FDIC-insured depository institutions that fail to meet applicable capital requirements as set forth above.

The FDIA requires the federal regulatory agencies to take “prompt corrective action” if a depository institution does not meet minimum capital requirements as set forth above. Generally, a receiver or conservator for a bank that is “critically undercapitalized” must be appointed within specific time frames. The regulations also provide that a capital restoration plan must be filed within 45 days of the date a bank is deemed to have received notice that it is “undercapitalized,” “significantly undercapitalized” or “critically undercapitalized.” Any holding company for a bank required to submit a capital restoration plan must guarantee the lesser of (i) an amount equal to 5% of the bank’s assets at the time it was notified or deemed to be undercapitalized by a regulator, or (ii) the amount necessary to restore the bank to adequately capitalized status. This guarantee remains in place until the bank is notified that it has maintained adequately capitalized status for specified time periods. Additional measures with respect to undercapitalized institutions include a prohibition on capital distributions, growth limits and restrictions on activities.

In 2018 the Economic Growth, Regulatory Reform and Consumer Protection Act (“EGRRCPA”) became effective. Pursuant to the EGRRCPA the regulators have proposed a single “Community Bank Leverage Ratio” which would eliminate the four required capital ratios disclosed above for qualifying and electing banks and require the disclosure of a single leverage ratio based on the new Community Capital Leverage Ratio.

For further detail on capital and capital ratios see discussion under “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” sections, “Capital Resources” and “Liquidity,” contained in Item 7, and in Note 21, “Capital,” to the accompanying Consolidated Financial Statements contained in Item 8.

Other Safety and Soundness Regulations. There are a number of obligations and restrictions imposed on bank holding companies and their bank subsidiaries by federal law and regulatory policy that are designed to reduce potential loss exposure to the depositors of such depository institutions and to the FDIC insurance funds in the event that the depository institution is insolvent or is in danger of becoming insolvent. For example, the Federal Reserve requires a bank holding company to serve as a source of financial strength to its subsidiary depository institutions and to commit resources to support such institutions in circumstances where it might not do so otherwise. These requirements can restrict the ability of bank holding companies to deploy their capital as they otherwise might.

Interstate Banking and Branching. Banks in Virginia may branch without geographic restriction. Current federal law authorizes interstate acquisitions of banks and bank holding companies without geographic limitation. Bank holding companies may acquire banks in any state without regard to state law except for state laws requiring a minimum time a bank must be in existence to be acquired. The Virginia Act generally permits out of state bank holding companies or banks to acquire Virginia banks or bank holding companies subject to regulatory approval. These laws have the effect of increasing competition in banking markets.

Monetary Policy. The commercial banking business is affected not only by general economic conditions but also by the monetary policies of the Federal Reserve. The Federal Reserve’s monetary policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future. In view of unsettled conditions in the national and international political environment, economy and money markets, as well as governmental fiscal and monetary policies their impact on interest rates, deposit levels, loan demand or the business and earnings of the Bank is unpredictable.

Federal Reserve System. Depository institutions that maintain transaction accounts or nonpersonal time deposits are subject to reserve requirements. These reserve requirements are subject to adjustment by the Federal Reserve. Because required reserves must be maintained in the form of vault cash or in a non-interest-bearing account at, or on behalf of, a Federal Reserve Bank, the effect of the reserve requirement is to reduce the amount of the institution’s interest-earning assets.

Transactions with Affiliates. Transactions between banks and their affiliates are governed by Sections 23A and 23B of the Federal Reserve Act. These provisions restrict the amount and provide conditions with respect to loans, investments, transfers of assets and other transactions between New Peoples and the Bank.

Loans to Insiders. The Bank is subject to rules on the amount, terms and risks associated with loans to executive officers, directors, principal shareholders and their related interests.

Community Reinvestment Act. Under the Community Reinvestment Act, depository institutions have an affirmative obligation to assist in meeting the credit needs of their market areas, including low and moderate-income areas, consistent with safe and sound banking practice. The Community Reinvestment Act emphasizes the delivery of bank products and services through branch locations in its market areas and requires banks to keep data reflecting their efforts to assist in its community's credit needs. Depository institutions are periodically examined for compliance with the Community Reinvestment Act and are periodically assigned ratings in this regard. Banking regulators consider a depository institution's Community Reinvestment Act rating when reviewing applications to establish new branches, undertake new lines of business, and/or acquire part or all of another depository institution. An unsatisfactory rating can significantly delay or even prohibit regulatory approval of a proposed transaction by a bank holding company or its depository institution subsidiaries. A bank holding company will not be permitted to become a financial holding company and no new activities authorized under the GLBA (see below) may be commenced by a holding company or by a bank financial subsidiary if any of its bank subsidiaries received less than a "satisfactory" rating in its latest Community Reinvestment Act examination. The Bank received a rating of "Satisfactory" at its last Community Reinvestment Act performance evaluation, as of June 13, 2016.

Gramm-Leach-Bliley Act of 1999. The Gramm-Leach-Bliley Act of 1999 ("GLBA") covers a broad range of issues, including a repeal of most of the restrictions on affiliations among depository institutions, securities firms and insurance companies.

For example, the GLBA permits unrestricted affiliations between banks and securities firms. It also permits bank holding companies to elect to become financial holding companies, which can engage in a broad range of financial services including securities activities such as underwriting, dealing, investment, merchant banking, insurance underwriting, sales and brokerage activities. In order to become a financial holding company, a bank holding company and all of its affiliated depository institutions must be well-capitalized, well-managed and have at least a satisfactory Community Reinvestment Act rating. On March 4, 2016 the Federal Reserve Bank of Richmond approved New Peoples' election to convert to a financial holding company.

Essentially as discussed above, GLBA removed many of the limitations on affiliations between commercial banks and their holding companies and other financially related business that had been in place since the Depression. Recently, this effect of GLBA has been the subject of controversy and cited as one of the causes of the financial services crisis. As a result, The Dodd-Frank Act (as discussed later) addressed some of the criticized aspects of GLBA.

The GLBA also provides that the states continue to have the authority to regulate insurance activities, but prohibits the states in most instances from preventing or significantly interfering with the ability of a bank, directly or through an affiliate, to engage in insurance sales, solicitations or cross-marketing activities.

USA Patriot Act. The USA Patriot Act provides for the facilitation of information sharing among governmental entities and financial institutions for the purpose of combating terrorism and money laundering. Regulatory authorities must consider the effectiveness of a financial institution's anti-money laundering activities, for example, its procedures for effective customer identification, when reviewing bank mergers and acquisitions. The Patriot Act, particularly as it relates to money laundering, is a significant focus of regulators and as a result there is substantial additional regulatory oversight to insure compliance with it. Various other laws and regulations require the Bank to cooperate with governmental authorities in respect to counter-terrorism activities. Although it does create a reporting obligation and cost of compliance for the Bank, the USA Patriot Act has not materially affected New Peoples' products, services or other business activities.

Privacy and Fair Credit Reporting. Financial institutions, such as the Bank, are required to disclose their privacy policies to customers and consumers and require that such customers or consumers be given a choice (through an opt-out notice) to forbid the sharing of nonpublic personal information about them with nonaffiliated third persons. The Bank also requires business partners with whom it shares such information to assure the Bank that they have adequate security safeguards and to abide by the redisclosure and reuse provisions of applicable law. In addition to adopting federal requirements regarding privacy, individual states are authorized to enact more stringent laws relating to the use of customer information. To date, Virginia has not done so. These privacy laws create compliance obligations and potential liability for the Bank.

Sarbanes-Oxley Act. The Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") is intended to increase corporate responsibility, provide enhanced penalties for accounting and auditing improprieties by publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities law. The changes required by the Sarbanes-Oxley Act and its implementing regulations are intended to allow shareholders to monitor the performance of companies and their directors more easily and effectively.

The Sarbanes-Oxley Act generally applies to all domestic companies, such as New Peoples, that file periodic reports with the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934, as amended. The Sarbanes-Oxley Act includes significant additional disclosure requirements and expanded corporate governance rules and the SEC has adopted extensive additional disclosures, corporate governance provisions and other related rules pursuant to it. New Peoples has expended, and will continue to expend, considerable time and money in complying

with the Sarbanes-Oxley Act.

Federal Deposit Insurance Corporation. The Bank's deposits are insured by the Deposit insurance Fund, as administered by the FDIC, to the maximum amount permitted by law, now \$250,000 per depositor.

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

The Dodd-Frank Act contains provisions designed to reform mortgage lending, which includes the requirement of additional disclosures for consumer mortgages. The EGRRCPA modified a number of these requirements, including, for smaller institutions (under \$10 billion) that qualify, a safe harbor for compliance with the "ability to pay" requirements for consumer mortgage loans. The CFPB has implemented mortgage lending regulations to carry out its mandate. In addition, the Federal Reserve has issued new rules, effective October 1, 2011, which had the effect of limiting the fees charged to merchants by credit card companies for debit card transactions. The result of these rules is to limit the amount of interchange fee income available explicitly to larger banks and indirectly to us. The Dodd-Frank Act also contains provisions that affect corporate governance and executive compensation. The Dodd-Frank Act provisions themselves are extensive; however, there is much uncertainty concerning the ultimate impact of this legislation. Several federal agencies, including the Federal Reserve, the CFPB and the Securities and Exchange Commission, have been in the process of issuing final regulations implementing major portions of the legislation and this process will be affected by the EGRRCPA which rolls back many provisions of the Dodd-Frank Act. (See below)

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

Other Laws. Banks and other depository institutions also are subject to numerous consumer-oriented laws and regulations. These laws, which include the Truth in Lending Act, the Truth in Savings Act, the Real Estate Settlement Procedures Act, the Electronic Funds Transfer Act, the Equal Credit Opportunity Act, the Fair and Accurate Credit Transactions Act of 2003 and the Fair Housing Act, require compliance by depository institutions with various disclosure and consumer information handling requirements. These and other similar laws result in significant costs to financial institutions and create potential liability for financial institutions, including the imposition of regulatory penalties for inadequate compliance.

Future Regulatory Uncertainty. Because federal and state regulation of financial institutions changes regularly and is the subject of constant legislative debate, New Peoples cannot forecast how regulation of financial institutions may change in the future and impact its operations. New Peoples fully expects that the financial institution industry will remain heavily regulated notwithstanding the regulatory relief that has been recently adopted.

Subsequent Events

We have considered subsequent events through the date of the financial statements in this Form 10-K.

Item 1A. Risk Factors

Not applicable.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

At December 31, 2018, the Company's net investment in premises and equipment in service was \$24.2 million. Our main office and operations center are located in Honaker, Virginia. This location contains a full service branch, and a separate administration and operations center.

The Bank owns 15 of its full service branches, including its headquarters office, and its one limited service branch, as well as its loan production office in Tennessee. The locations of these branches are described in Item 1. On May 31, 2017, the Bank sold its Abingdon, Bristol, Gate City and Castlewood, Virginia properties recognizing a gain of \$2.6 million. In connection with the sale of these four properties, the Bank on May 31, 2017 entered into commercial lease agreements for the properties (the "Leases"), which allowed the Bank to continue to service customers from these locations. The Leases, which commenced on June 1, 2017, provide the Bank with use of the properties for an initial term of fifteen (15) years. For additional discussion of these leases see Note 17, Leasing Activities, in Notes to the Consolidated Financial Statements. Aside from the retail branch offices, we own a building in Bristol, Virginia that serves as our call center and Interactive Teller Machine network operations site.

The Bank entered into a commercial lease for office space in Kingsport, TN for use as a loan production office, which opened in January 2018. For additional discussion of this lease see Note 17, Leasing Activities, in Notes to the Consolidated Financial Statements.

In May 2018, a site in Princeton, West Virginia that had been used as an administrative office opened as a full service branch, as our second customer service location in this market.

During 2018 we limited activity at the Jonesborough loan production office; and in February 2019 determined that the site would be permanently closed by early in the second quarter of the year. The ITM at this site will be removed and redeployed.

The Bank owns a location in Dungannon, Virginia that is now currently being leased, but was formerly used as a branch until its closure during 2010. A closed office in Bland Virginia was sold in May 2018. Four other closed branches (Bluewell, West Virginia, Bristol, Norton and Jonesville, Virginia) that are vacant but may be used for future banking offices again.

We believe that all of our properties are maintained in good operating condition and are suitable and adequate for our operational needs.

Item 3. Legal Proceedings

In the course of operations, we may become a party to legal proceedings. As disclosed in Note 20 of the Consolidated Financial Statements, 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 4. Mine Safety Disclosures

Not applicable.

PART II

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

(a) Market Information

Computershare Investor Services is the stock transfer agent for New Peoples Bankshares, Inc. The common stock of New Peoples is quoted on the Over The Counter Bulletin Board (OTCBB) under the symbol "NWPP". The volume of trading of shares of common stock is very limited. Trades in our common stock occur sporadically on a local basis and typically small volumes of stock are traded. Over-the-Counter market quotations reflect inter-dealer prices without retail mark up, mark down or commissions and may not necessarily represent actual transactions.

The most recent sales price of which management is aware was \$1.53 per share on March 27, 2018.

(b) Holders

On March 27, 2018, there were approximately 4,427 shareholders of record.

(c) Dividends

In order to preserve capital we have not paid cash dividends to our shareholders. Any declaration of dividends in the future will depend on our earnings, capital requirements, growth strategies, and compliance with regulatory mandates principally at the Bank level since the Company's primary source of income is dividends which it would receive from the Bank. We are subject to certain dividend restrictions and capital requirements imposed by the Federal Reserve Bank as well as Virginia banking statutes and regulations. We do not anticipate paying a dividend on our common stock in the foreseeable future as the Company continues to have a retained deficit. Earnings will continue to be retained to build capital and position the Company to pay a dividend to its shareholders as soon as practicable. See Notes 16 and 21 of the Notes to the Consolidated Financial Statements for further discussion of dividend limitations and capital requirements.

Item 6. Selected Financial Data

Not applicable.

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

Caution About Forward Looking Statements

We make forward looking statements in this annual report that are subject to 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. 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. The forward-looking information is based on various factors and was derived using numerous assumptions. Important factors that may cause actual results to differ from projections include:

- the success or failure of our efforts to implement our business plan;
- any required increase in our regulatory capital ratios;
- satisfying other regulatory requirements that may arise from examinations, changes in the law and other similar factors;
- deterioration of asset quality;
- fluctuations of real estate values in our markets;
- our ability to attract and retain talent;
- demographical changes in our markets which negatively impact the local economy;
- the uncertain outcome of enacted legislation to stabilize the U.S. financial system such as Dodd-Frank;
- the successful management of interest rate risk;
- the successful management of liquidity;
- changes in general economic and business conditions in our market area;
- credit risks inherent in making loans such as a borrower's ability to repay;
- competition with other banks and financial institutions, and companies outside of the banking industry, including online lenders and those companies that have substantially greater access to capital and other resources;
- demand, development and acceptance of new products and services we have offered or may offer;
- technology utilized by us;
- our ability to successfully manage cyber security;
- our reliance on third-party vendors and correspondent banks;
- changes in generally accepted accounting principles;
- changes in governmental regulations, tax rates and similar matters; and,
- other risks which may be described in our future filings with the SEC.

Because of these uncertainties, our actual future results may be materially different from the results indicated by these forward looking statements. In addition, our past results of operations do not necessarily indicate our future results. We expressly disclaim any obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

General

The following commentary discusses major components of our business and presents an overview of our consolidated financial position at December 31, 2018 and 2017 as well as results of operations for the years ended December 31, 2018 and 2017. This discussion should be reviewed in conjunction with the consolidated financial statements and accompanying notes and other statistical information presented elsewhere in this Form 10-K.

New Peoples generates a significant amount of its income from the net interest income earned by the Bank. Net interest income is the difference between interest income and interest expense. Interest income depends on the volume of interest-earning assets outstanding during the period and the interest rates earned thereon. The Bank's interest expense is a function of the average amount of interest-bearing deposits and borrowed money outstanding during the period and the interest rates paid thereon. The quality of the assets further influences the amount of interest income lost on nonaccrual loans and the amount of additions to the allowance for loan losses. The Bank also generates noninterest income from service charges on deposit accounts and commissions on insurance and investment products sold.

Critical Accounting Policies

Certain critical accounting policies affect the more significant judgments and estimates used in the preparation of our financial statements. Our most critical accounting policies relate to our provision for loan losses and the calculation of our deferred tax asset and valuation allowance.

The provision for loan losses reflects the estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our borrowers were to further deteriorate, resulting in an impairment of their ability to make payments, our estimates would be updated, and additional provisions could be required. For further discussion of the estimates used in determining the allowance for loan losses, we refer you to the section on “Provision for Loan Losses” in this discussion.

Deferred tax assets or liabilities are computed based upon the difference between financial statement and income tax bases of assets and liabilities using the enacted marginal tax rate. In the past, the Company provided a valuation allowance on its net deferred tax assets where it was deemed more likely than not such assets will not be realized. At December 31, 2018 and 2017, the Company had no valuation allowance on its net deferred tax assets.

The Company recognizes the tax benefit from an uncertain tax position only if it is more likely than not the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such positions are then measured based on the largest benefit that has a greater than 50% likelihood of being realized upon settlement. For further discussion of the deferred tax asset and valuation allowance, we refer you to the section on “Deferred Tax Assets and Income Taxes” in this discussion.

The Company early adopted ASU No. 2016-02 Leases (Topic 842). This ASU revised certain aspects of recognition, measurement, presentation, and disclosure of leasing transactions.

For further discussion of our other critical accounting policies, see Note 2, Summary of Significant Accounting Policies, to our Consolidated Financial Statements, found in Item 8 to this annual report on Form 10-K.

Cyber Security

The Company, primarily through the Bank, depends on its ability to continuously process, record and monitor a large number of customer transactions and customer, public and regulatory expectations regarding operational and information security have increased over time. Accordingly, its and its subsidiaries' operational systems and infrastructure must continue to be safeguarded and monitored for potential failures, disruptions and breakdowns. Although the Company has business continuity plans and other safeguards in place, disruptions or failures in the physical infrastructure or operating systems that support its businesses and customers, or cyber-attacks or security breaches of the networks, systems or devices on which customers' personal information is stored and that customers use to access the Company's and its subsidiaries' products and services could result in customer attrition, regulatory fines, penalties or intervention, reputational damage, reimbursement or other compensation costs, and/or additional compliance costs, any of which could materially adversely affect the Company's results of operations or financial condition.

Although to date the Company has not experienced any material losses relating to cyber-attacks or other information security breaches, there can be no assurance that it or its subsidiaries will not suffer such losses in the future. The Company's risk and exposure to these matters remains heightened because of, among other things, the evolving nature of these threats, our plans to continue to implement our Internet banking and mobile banking channel strategies and develop additional remote connectivity solutions to serve our customers when and how they want to be served. As a result, cybersecurity and the continued development and enhancement of the Company's controls, processes and practices, designed to protect its and its subsidiaries' systems, computers, software, data and networks from attack, damage or unauthorized access, remain a priority for the Company. As cyber threats continue to evolve, the Company may be required to expend significant additional resources to continue to modify or enhance its protective measures or to investigate and remediate any information security vulnerabilities.

In late February 2018, the SEC issued guidelines governing the manner in which public companies report cybersecurity breaches to investors. The federal bank regulatory agencies and state laws govern the manner in which banks report cybersecurity breaches to affected customers.

Overview

At December 31, 2018, total assets were \$682.1 million, total loans were \$547.1 million, and total deposits were \$596.0 million. The Company's consolidated net income for the year ended December 31, 2018 was \$919 thousand, or basic income per share of \$0.04 as compared to a net income of \$3.1 million, or basic income per share of \$0.13, for the year ended December 31, 2017. This is a decrease of \$2.2 million, or \$0.09 per share. This decrease was mainly driven by a one-time decrease in gains on leaseback transactions of \$2.6 million, an increase in non-interest expense of \$1.6 million, but partially offset by an increase in net interest income of \$1.4 million. The provision for loan losses decreased by \$198 thousand to \$252 thousand for 2018, as compared to 2017. The \$1.4 million increase in net interest income represents a 6.26% increase for 2018 over 2017, and is due primarily to the \$2.2 million increase in interest and fees on loans, a result of increased loan volume during 2018. The \$1.6 million increase in noninterest expenses is primarily due to an increase in salaries, benefits and occupancy expense. The Company's key performance indicators are as follows:

	December 31,		
	2018	2017	2016
Return on average assets	0.14%	0.47%	0.15%
Return on average equity	1.83%	6.30%	2.00%
Average equity to average assets ratio	7.43%	7.52%	7.59%

Highlights from the year 2018 include:

- Loans increased \$34.1 million, or 6.64%;
- Provision for loan losses was \$252 thousand for 2018 as compared to \$450 thousand for 2017;
- Decrease in nonperforming assets of \$2.1 million, or 14.68%;
- Deposits increased \$13.4 million, or 2.31%;
- Net interest margin of 3.94%;
- Opened a new branch in Princeton, West Virginia and a loan production office in Kingsport, Tennessee; and
- Book value per share of \$2.14 as of December 31, 2018.

Total assets increased \$15.4 million in 2018, or 2.32%, from \$666.7 million at December 31, 2017. Loans showed an increase of \$34.1 million, or 6.64%, as a result of our efforts to grow the loan portfolio. Going forward, we anticipate total assets increasing due to our plan to conservatively and prudently grow the loan portfolio, as we were able to accomplish in 2018 and 2017. OREO decreased \$922 thousand, or 13.44%, in 2018 to \$5.9 million at December 31, 2018 from \$6.9 million at December 31, 2017. Bank owned life insurance remained stable at \$4.5 million.

On the liability side of the balance sheet, total deposits increased \$13.4 million, or 2.31%, to \$596.0 million, due mainly to growth in non-interest bearing deposits of \$9.7 million. We anticipate total deposits to increase as we focus

on growth in the future. FHLB advances decreased \$558 thousand to \$7.0 million while trust preferred securities remained unchanged at \$16.5 million.

As a result of the discussed sale and leaseback transactions, as of December 31, 2018 the Company recognized right-to-use assets – operating leases of approximately \$4.9 million, along with corresponding lease liabilities of approximately \$4.9 million effectively offsetting the balance sheet effect of these transactions. This accounting treatment resulted from the early adoption of ASU No. 2016-02 Leases (Topic 842). This ASU revised certain aspects of recognition, measurement, presentation, and disclosure of leasing transactions.

Total equity was \$51.3 million at December 31, 2018, an increase of \$277 thousand, or 0.54%. The Bank's capital ratios at December 31, 2018 as compared to December 31, 2017, respectively were as follows: Tier 1 leverage ratio of 9.59% versus 9.56%; Tier 1 risk based capital ratio of 13.29% versus 14.05%; total risk based capital ratio of 14.39% versus 15.30%; and common equity Tier 1 capital ratio of 13.29% versus 14.05%. The Bank is considered well-capitalized under regulatory guidelines. As noted above, these capital measurements will no longer apply to the Bank if it elects to comply with the Community Bank Leverage Ratio discussed above.

Expenses related to other real estate owned properties were \$1.0 million in 2018 compared to \$1.4 million in 2017. During 2018 we recorded writedowns on other real estate owned properties in the amount of \$543 thousand compared to \$758 thousand in 2017. During 2018 we had a net loss on the sale of other real estate owned of \$135 thousand compared to a net loss of \$64 thousand in 2017.

Total loans increased \$34.1 million in 2018, or 6.64%, to \$547.1 million at December 31, 2018 as compared to \$513.0 million at December 31, 2017. The main driver in this increase in total loans is our strategy is to grow and diversify the loan portfolio. To assist in these efforts, we added several commercial lenders, over the past two years, mostly focused in the Tri-Cities market of Bristol, VA and TN, Kingsport, TN, and Johnson City, TN; and Princeton, West Virginia. In the first quarter of 2018, we opened a loan production office in Kingsport, TN and in the second quarter we opened a new branch location in Princeton, WV. We expect the trend in total loan growth we have experienced in 2018 to continue at least in the near term, but not necessarily at the rate experienced in 2018. Loan growth in general is subject to economic conditions, customer demand, and competition in our markets.

Asset quality continued to improve during 2018, as OREO and nonaccrual loans both decreased in 2018. Nonperforming assets, which include nonaccrual loans, loans past due 90 days or greater still accruing interest, and other real estate owned, decreased \$2.1 million, or 14.68%, from \$14.4 million to \$12.3 million during 2018. \$1.9 million of this decrease was the result of 4 nonperforming loans which were sold to further reduce the high level of nonaccrual loans with proceeds of \$1.54 million received. Total nonperforming assets represented 1.80% and 2.16% of total assets at December 31, 2018 and December 31, 2017, respectively. There were no loans past due 90 days or greater and still accruing interest at December 31, 2018 or 2017. The makeup of these assets is primarily loans secured by commercial real estate, residential mortgages, and farmland as well as other real estate owned properties. We continue undertaking extensive and more aggressive measures to work out problem credits and liquidate foreclosed properties in an effort to accelerate a reduction of nonperforming assets. Our goal is to reduce the nonperforming assets being mindful of the impact to earnings and capital; however, we may recognize some losses and reductions in the allowance for loan loss as we expedite the resolution of these problem assets.

Our allowance for loan losses at December 31, 2018 was \$5.3 million, or 0.98% of total loans, as compared to \$6.2 million, or 1.21% of total loans at December 31, 2017. Impaired loans decreased \$4.7 million, or 36.9%, to \$8.0 million with an estimated allowance of \$318 thousand for potential losses at December 31, 2018 as compared to \$12.6 million in impaired loans with an estimated allowance of \$1.2 million at the end of 2017. A provision for loan losses of \$252 thousand was recorded in 2018, down from \$450 thousand in 2017. Net loans charged off in 2018 were \$1.1 million, or 0.21% of average loans, compared to \$326 thousand, or 0.07% of average loans, in 2017. The allowance for loan losses is being maintained at a level that management deems appropriate to absorb any potential future losses and known impairments within the loan portfolio whether or not the losses are actually ever realized. We continue to adjust the allowance for loan loss model to best reflect the risks in the portfolio and the improvements made in our internal policies and procedures; however, future provisions may be deemed necessary.

Net Interest Income and Net Interest Margin

The Company's primary source of income, net interest income, increased \$1.4 million, or 6.26% from 2017 to 2018. The increase in net interest income is due primarily to the \$2.2 million increase in interest income on loans during 2018, due to increased loan volume during 2018. While we have been successful, over the past year in our strategy to grow the loan portfolio, and reduce reliance on residential mortgage loans by increasing the level of commercial and commercial real estate credits, such growth may not continue at the pace seen in 2018. With new commercial lenders added during the past two years, and the opening of the Kingsport, Tennessee loan production office and expanding our presence in Princeton, West Virginia, we believe, going forward, new increased volume will outpace the monthly loan paydowns and maturities. Investment interest income increased by \$63 thousand, or 4.21%, in 2018 compared to 2017.

The increase in interest income was partially offset by a \$1.1 million increase in interest expense including a \$687 thousand increase in interest expense on time deposits, due to several deposit acquisition efforts during 2018, competitive pressure and a general rise in interest rates. With the opening, in the second quarter, of our second branch

office in Princeton, West Virginia, we offered a promotional CD within that market. In December we offered another promotional certificate of deposit across our entire market area, in celebration of our 20th anniversary. Both of these efforts while mitigating the general decline in time deposits, also contributed to the overall increase in the cost of funds. Aside from the promotional time deposit products offered during the year, we also had occasion to match rates offered by competing financial institutions for various existing customers. Also during the year we modified one of our tiered money market account products to offer a more competitive rate of interest to attract and retain commercial and higher net worth customers. Lastly, the general rise in interest rates impacted interest paid on borrowed funds, specifically interest on trust preferred securities which increased \$180 thousand or 30.45% year-over-year.

While the growth in earning assets, principally loans, was the primary driver in the increase in net interest income for 2018, increases in the general interest rate environment resulted from four increases in the federal funds rate during the year. As a result, the prime interest rate rose to 5.5% by year-end 2018 an increase of 100 bps. This followed the 75 bps increase in the federal funds rate during 2017. While the increase in the general rate environment resulted in higher returns on new and variable rate earning assets, it also fostered an increase in rates paid on interest bearing liabilities as the general increase in interest rates coupled with increasing competition for deposits. So while our return on earning assets increased 14bps to 4.63% during 2018, our cost of interest bearing liabilities rose 21bps to .94%. Recent indications are that there may be no increases to the federal funds rate during 2019.

One other item that may impact our future interest rate structure is the pending end of the use of LIBOR as a benchmark interest rate in 2021. We use LIBOR in pricing some of our interest earning assets and liabilities, including our trust preferred securities. At this time it appears that LIBOR will be replaced by the Secured Overnight Financing Rate (SOFR) which is a transparent measure of the cost of borrowing cash overnight collateralized by Treasury securities. Regardless of whether SOFR or some other benchmark rate replaces LIBOR we do not anticipate that the change will have a material impact on our ability to negotiate and price earning assets and liabilities.

Nonaccrual loans were \$6.4 million at December 31, 2018 compared to \$7.6 million at December 31, 2017. This represents a decrease of \$1.2 million, or 15.80%. In 2018, four nonperforming or underperforming loans totaling 1.9 million were sold after determining that it was more cost effective to dispose of the accounts rather than continue to pursue collection efforts. Charge-offs of \$365 thousand were recorded against the allowance for loan losses. In 2017, 65 nonperforming loans totaling \$3.9 million were sold to reduce the high level of nonaccrual loans with proceeds of \$3.6 million received. Charge offs of \$256 thousand associated with the sold nonperforming loans were realized and fully absorbed by the allowance for loan losses during 2017. Although nonaccrual loans decreased during 2018, the continued high volume of nonaccrual loans negatively affects interest income as these loans are nonearning assets. Interest income and cash receipts on impaired loans are handled differently depending on whether or not the loan is on nonaccrual status. If the impaired loan is not on nonaccrual status, the interest income on the loan is computed using the effective interest method. When doubt about the collectability of a loan exists, it is the Bank's policy to stop accruing interest on that loan under the following circumstances: (a) whenever we are advised by the borrower that scheduled payment or interest payments cannot be met, (b) when conditions indicate that payment of principal and interest can no longer be expected, or (c) when any such loan becomes delinquent for 90 days and is not both well secured and in the process of collection. All interest accrued but not collected on loans that are placed on nonaccrual or charged off are reversed against interest income in the current period except in the case of a nonaccrual loan that is well secured and in the process of collection, in which case, the interest accrued but not collected is not reversed. The interest on these loans is accounted for on the cash basis or cost-recovery method until qualifying for return to accrual. Generally, loans are returned to accrual status when all the principal and interest amounts contractually due are brought current, six consecutive timely payments are made, and prospects for future contractual payments are

reasonably assured.

Our net interest margin remained unchanged at 3.94% for the year ended December 31, 2018 compared to the same period in 2017. Unless we are able to continue to increase the volume of our interest-earning assets going forward, while controlling our cost of funds, we may experience compression on the net interest margin as new and renewed loans are often being repriced at lower interest rates while we anticipate an increase on interest rates paid on deposits, particularly time deposits as rates paid and competition for deposits both increased during 2018. The effect of higher rates and competition are expected to continue in 2019. Regardless of any increases in the general interest rate environment going forward, increases effected in 2018 will have a carryover effect on the cost of renewing time deposits and any future borrowed funds.

The following table shows the rates paid on earning assets and deposit liabilities for the periods indicated.

Net Interest Margin Analysis

Average Balances, Income and Expense, and Yields and Rates

(Dollars in thousands)

	For the Year Ended December 31, 2018			For the Year Ended December 31, 2017			For the Year Ended December 31, 2016		
	Average Balance	Income/ Expense	Yields/ Rates	Average Balance	Income/ Expense	Yields/ Rates	Average Balance	Income/ Expense	Yields/ Rates
ASSETS									
Loans (1), (2), (3)	\$ 526,077	\$ 26,376	5.01%	\$ 488,425	\$ 24,163	4.95%	\$ 457,268	\$ 22,644	4.95%
Federal funds sold	160	4	2.50%	75	1	1.33%	14	-	0.00%
Interest bearing deposits	19,644	379	1.93%	15,735	192	1.22%	12,835	84	0.65%
Other investments (3)	68,706	1,714	2.49%	75,069	1,637	2.18%	84,080	1,618	1.92%
Total Earning Assets	614,527	28,473	4.63%	579,304	25,993	4.49%	554,197	24,346	4.39%
Less: Allowance for loans losses	(5,551)			(6,136)			(6,849)		
Non-earning assets	66,648			79,107			83,030		
Total Assets	\$ 675,614			\$ 652,275			\$ 630,376		

LIABILITIES AND STOCKHOLDERS' EQUITY

Deposits

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Demand – Interest bearing	\$ 37,896	0.15%	\$ 35,235	\$ 48	0.14%	\$ 39,834	0.13%
Savings and money market	131,292	0.28%	124,826	187	0.15%	115,213	0.14%
Time deposits	257,262	1.14%	255,986	2,234	0.87%	250,296	0.70%
Other Borrowings	9,610	1.54%	9,830	151	1.54%	8,508	1.81%
Trust Preferred Securities	16,497	4.69%	16,496	593	3.59%	16,496	3.08%
Total interest bearing liabilities	452,536	0.94%	442,373	3,213	0.73%	430,342	0.61%
Non-interest bearing deposits	164,923		154,356			149,350	
Other liabilities	7,906		6,468			2,849	
Total Liabilities	625,385		603,197			582,546	
Stockholders' Equity	50,229		49,078			47,830	
Total Liabilities and Stockholders' Equity	\$ 675,614		\$ 652,275			\$ 630,376	
Net Interest Income	\$ 24,208		\$ 22,780			\$ 21,726	
Net Interest Margin	3.94%		3.94%			3.92%	
Net Interest Spread	3.69%		3.76%			3.78%	

(1) Non-accrual loans have been included in the average balance of loans outstanding.

(2) Loan fees have been included in interest income on loans.

(3) Tax exempt income is not significant and has been treated as fully taxable.

Net interest income is affected by changes in both average interest rates and average volumes of interest-earning assets and interest-bearing liabilities. The following table sets forth the amounts of the total changes in interest income and expense which can be attributed to rate (change in rate multiplied by old volume) and volume (change in volume multiplied by old rate) for the periods indicated.

Volume and Rate

Analysis

(Dollars in thousands)

	2018 Compared to 2017 Increase (Decrease)	2017 Compared to 2016 Increase (Decrease)				
--	--	--	--	--	--	--

	Volume Effect	Rate Effect	Change in Interest Income/ Expense	Volume Effect	Rate Effect	Change in Interest Income/ Expense
Interest Income:						
Loans	\$1,859	\$354	\$2,213	\$1,543	\$(24)	\$1,519
Federal funds sold	1	2	3		1	1
Interest bearing deposits	48	139	187	19	89	108
Other investments	(139)	216	77	(173)	192	19
Total Earning Assets	1,769	711	2,480	1,389	258	1,647
Interest Bearing Liabilities:						
Demand	4	3	7	(6)	4	(2)
Savings and money market	10	171	181	14	7	21
Time deposits	11	676	687	40	452	492
Other borrowings	(3)	-	(3)	24	(27)	(3)
Trust Preferred Securities	-	180	180	-	85	85
Total Interest Bearing Liabilities	21	1,031	1,052	72	521	593
Change in Net Interest Income	\$1,748	\$(320)	\$1,428	\$1,317	\$(263)	\$1,054

Loans

Our primary source of income comes from interest earned on loans. Total loans increased \$34.1 million in 2018, or 6.64%, to \$547.1 million at December 31, 2018 as compared to \$513.0 million at December 31, 2017. Loans rated substandard decreased \$4.6 million, or 38.79%, to \$7.3 million at December 31, 2018 from \$11.9 million at December 31, 2017. The main driver in this increase in total loans is our strategy to grow and diversify the loan portfolio.

Loans receivable outstanding are summarized as follows:

Loan Portfolio

(Dollars in thousands)	December 31,				
	2018	2017	2016	2015	2014
Commercial, financial and agricultural	\$83,135	\$68,506	\$55,073	\$47,490	\$50,273
Real estate – construction	35,119	29,763	25,755	14,672	15,439
Real estate – commercial	140,862	127,688	103,331	98,569	108,062
Real estate – residential	263,442	264,640	262,282	255,870	257,947
Installment loans to individuals	24,538	22,411	22,188	24,568	25,828
Total	\$547,096	\$513,008	\$468,629	\$441,169	\$457,549

Our loan maturities as of December 31, 2018 are shown in the following table:

Maturities of Loans

(Dollars in thousands)	Less than One Year	One to Five Years	After Five Years	Total
Commercial, financial and agricultural	\$23,241	\$37,002	\$22,892	\$83,135
Real estate – construction	3,129	12,530	19,460	35,119
Real estate – commercial	9,047	59,622	72,193	140,862
Real estate – residential	14,843	43,179	205,420	263,442
Installment loans to individuals	5,704	17,177	1,657	24,539
Total	\$55,964	\$169,510	\$321,622	\$547,096
Loans with fixed rates	\$52,813	\$157,011	\$154,326	\$364,150
Loans with variable rates	3,151	12,499	16,7296	18,2946
Total	\$55,964	\$169,510	\$321,622	\$547,096

Provision for Loan Losses

The methodology we use to calculate the allowance for loan losses is considered a critical accounting policy. The adequacy of the allowance for loan losses is based upon management's judgment and analysis. The following factors are included in our evaluation of determining the adequacy of the allowance: risk characteristics of the loan portfolio, current and historical loss experience, concentrations and internal and external factors such as general economic conditions.

The allowance for loan losses decreased to \$5.3 million at December 31, 2018 as compared to \$6.2 million at December 31, 2017. The allowance for loan losses at the end of 2018 was approximately 0.98% of total loans as compared to 1.21% at the end of 2017. Provisions for loan losses of \$252 thousand were recorded during 2018 and \$450 thousand in 2017. Loans charged off, net of recoveries, were \$1.1 million, or 0.21% of average loans, for the year ended December 31, 2018, compared to \$326 thousand, or 0.07% of average loans, in 2017. The allowance for loan losses is being maintained at a level that management deems appropriate to absorb any potential future losses and known impairments within the loan portfolio whether or not the losses are actually ever realized. We continue to adjust the allowance for loan loss model to best reflect the risks in the portfolio and the improvements made in our internal policies and procedures; however, future provisions may be deemed necessary.

Loans in non-accrual status present higher risks of default. We have experienced a decrease in nonaccrual loans in 2018. At December 31, 2018, there were 100 loans in non-accrual status totaling \$6.4 million, or 1.16% of total loans.

At December 31, 2017, there were 97 loans in non-accrual status totaling \$7.6 million, or 1.47% of total loans. The amounts of interest that would have been recognized on these loans were \$500 thousand and \$591 thousand in the years 2018 and 2017, respectively. In 2017, 65 nonperforming loans totaling \$3.9 million were sold to further reduce the high level of nonaccrual loans with proceeds of \$3.6 million received. Charge offs of \$256 thousand associated with the sold nonperforming loans were realized and fully absorbed by the allowance for loan losses during 2017. There were no loans past due 90 days or greater and still accruing interest at December 31, 2018 and 2017, respectively. We do not have any commitments to lend additional funds to non-performing debtors.

A majority of our loans are collateralized by real estate located in our market area. It is our policy to sufficiently collateralize loans to help minimize loss exposures in case of default. However, during the last economic downturn, the real estate values in the Bank's market materially declined which negatively impacted the Bank. Since that economic downturn, real estate values have somewhat stabilized. While we consider our market area to be somewhat diverse, certain areas are more reliant upon agriculture, coal mining and natural gas. As a result, increased risk of loan impairments is possible due to the volatile nature of the coal mining and natural gas industries. While the coal industry has been impacted by the increase in natural gas supplies from "fracking", recent changes in the regulatory environment have aided the coal industry. We do not foresee a major impact upon the Bank unless an additional severe economic downturn occurs which we believe is not highly likely. However, should the regulatory environment change to revert back to prior standards the coal industry in our market area could be adversely impacted. We are monitoring these industries. We consider these factors to be the primary higher risk characteristics of the loan portfolio.

Commercial and commercial real estate loans are initially risk rated by the originating loan officer. If deterioration in the financial condition of the borrower and/or his or her capacity to repay the debt occurs, the loan may be downgraded by the loan officer. Guidance for the risk rate grading is established by the regulatory authorities who periodically review the Bank's loan portfolio for compliance. Classifications used by the Bank are Pass, Special Mention, Substandard, Doubtful and Loss.

In regard to our consumer and consumer real estate loan portfolio, the Company uses the guidance found in the Uniform Retail Credit Classification and Account Management Policy which affects our estimate of the allowance for loan losses. Under this approach, a consumer or consumer real estate loan must initially have a credit risk grade of Pass or better. Subsequently, if the loan becomes contractually 90 days past due or the borrower files for bankruptcy protection, the loan is downgraded to Substandard and placed in nonaccrual status. If the loan is unsecured upon being deemed Substandard, the entire loan amount is charged-off.

For non 1-4 family residential loans that are 90 days past due or greater or in bankruptcy, the collateral value less estimated liquidation costs is compared to the loan balance to calculate any potential deficiency. If the collateral is sufficient, then no charge-off is necessary. If a deficiency exists, then upon the loan becoming contractually 120 days past due, the deficiency is charged-off against the allowance for loan loss. In the case of 1-4 family residential or home equity loans, upon the loan becoming 120 days past due, a current value is obtained and after application of an estimated liquidation discount, a comparison is made to the loan balance to calculate any deficiency. Subsequently, any noted deficiency is then charged-off against the allowance for loan loss when the loan becomes contractually 180 days past due. If the customer has filed bankruptcy, then within 60 days of the bankruptcy notice, any calculated deficiency is charged-off against the allowance for loan loss. Collection efforts continue by means of repossessions or foreclosures, and upon bank ownership, liquidation ensues.

All loans classified as substandard, doubtful or loss are individually reviewed for impairment in accordance with ASC 310-10-35. In evaluating impairment, a current appraisal is generally used to determine if the collateral is sufficient. Appraisals are typically less than a year old and have to be independently reviewed to be relied upon. If the appraisal is not current, we perform a useful life review of the appraisal to determine if it is reasonable. If this review determines that the appraisal is not reasonable, then a new appraisal is ordered. Impaired loans decreased to \$8.0 million with \$1.3 million requiring a valuation allowance of \$318 thousand at December 31, 2018 as compared to \$12.6 million with \$3.8 million requiring a valuation allowance of \$1.2 million at December 31, 2017. Management is aggressively working to reduce the impaired credits at minimal loss.

In determining the component of our allowance in accordance with the Contingencies topic of the Accounting Standards Codification (“ASC 450”), we do not directly consider the potential for outdated appraisals since that portion of our allowance is based on the analysis of the performance of loans with similar characteristics, external and internal risk factors. We consider the overall quality of our underwriting process in our internal risk factors, but the need to update appraisals is associated with loans identified as impaired under the Receivables topic of the Accounting Standards Codification (“ASC 310”). If an appraisal is older than one year, a new external certified appraisal may be obtained and used to determine impairment. If an exposure exists, a specific allowance is directly made for the amount of the potential loss in addition to estimated liquidation and disposal costs. The evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

Following is a summary of non-accrual, past due loans greater than 90 days still accruing interest, and restructured loans:

Non-Accrual, Past Due, and Restructured Loans

(Dollars in thousands)

	December 31,				
	2018	2017	2016	2015	2014
Non-accruing loans					
Commercial, financial and agricultural	\$1,719	\$1,868	\$1,086	\$1,244	\$6,554
Real estate – construction	157	470	319	436	332
Real estate – commercial	784	2,035	3,403	4,358	6,222
Real estate – residential	3,702	3,143	8,521	8,768	8,707
Installment loans to individuals	7	48	76	41	46
Total Non-accruing loans	6,369	7,564	13,405	14,847	21,861
Loans past due 90 days or more and still accruing	-	-	-	-	-
Troubled debt restructurings (accruing)	4,909	4,932	7,310	7,198	4,249
Total	\$11,278	\$12,496	\$20,715	\$22,045	\$26,110
Percent of total loans	2.06%	2.44%	4.42%	5.00%	5.71%

The above table includes \$522 thousand and \$1.9 million in nonaccrual loans as of December 31, 2018 and 2017, respectively, which have been classified as troubled debt restructurings. No troubled debt restructurings were past due 90 days or more and still accruing as of December 31, 2018 and 2017. There were \$5.4 million in loans classified as troubled debt restructurings as of December 31, 2018, as compared to \$6.9 million in loans classified as troubled debt restructurings as of December 31, 2017.

In addition to impaired loans, the remaining loan portfolio is evaluated based on net charge-off history, economic conditions, and internal processes. To calculate the net charge-off history factor, we perform a 12-quarter look-back and use the average net charge offs as a percentage of the loan balances. To calculate the economic conditions factor, we use current economic data which includes national and local regional unemployment information, local housing price changes, gross domestic product growth, and interest rates. Lastly, we also evaluate our internal processes of underwriting and consider the inherent risks present in the portfolio due to past and present lending practices. As economic conditions, performance of our loans, and internal processes change, it is possible that future increases or decreases may be needed to the allowance for loan losses. The following table provides a summary of the activity in the allowance for loan losses.

Analysis of the Allowance for Loan Losses

(Dollars in thousands)

Activity	For the Years Ended				
	December 31,				
	2018	2017	2016	2015	2014
Beginning Balance	\$6,196	\$6,072	\$7,493	\$9,922	\$13,080
Provision charged to expense	252	450	(500)	(2,200)	-
Advances made on loans with					
off balance sheet provision	-	-	-	-	-
Loan Losses:					
Commercial, financial and agricultural	(675)	(64)	(67)	(182)	(894)
Real estate – construction	(96)	(1)	(5)	(226)	(292)
Real estate – commercial	(334)	(179)	(557)	(724)	(2,190)
Real estate – residential	(290)	(714)	(738)	(1,127)	(1,104)
Installment loans to individuals	(75)	(147)	(83)	(101)	(79)
Total loan losses	(1,470)	(1,105)	(1,450)	(2,360)	(4,559)
Recoveries:					
Commercial, financial and agricultural	157	519	172	1,629	550
Real estate – construction	11	-	26	215	236
Real estate – commercial	73	193	220	147	427
Real estate – residential	73	48	87	99	148
Installment loans to individuals	44	19	24	41	40
Total recoveries	358	779	529	2,131	1,401
Net charge offs	(1,112)	(326)	(921)	(229)	(3,158)

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Balance at End of Period	\$5,336	\$6,196	\$6,072	\$7,493	\$9,922
Net charge offs as a % of average loans	0.21%	0.07%	0.20%	0.05%	0.67%

We have allocated the allowance according to the amount deemed to be reasonably necessary to provide for the possibility of losses being incurred within each of the categories of loans. The allocation of the allowance as shown in the following table should not be interpreted as an indication that loan losses in future years will occur in the same proportions or that the allocation indicates future loan loss trends. Furthermore, the portion allocated to each loan category is not the total amount available for future losses that might occur within such categories since the total allowance is a general allowance applicable to the entire portfolio.

The allocation of the allowance for loan losses is based on our judgment of the relative risk associated with each type of loan. We have allocated 26% of the allowance to commercial real estate loans, which constituted 25.75% of our loan portfolio at December 31, 2018. This allocation decreased when compared to the 32% in 2017 due to the \$13.2 million increase in commercial real estate loans during the year. We have allocated 47% of the allowance to residential real estate loans, which constituted 48.15% of our loan portfolio at December 31, 2018. This allocation increased by \$20 thousand compared to December 31, 2017.

Both residential and commercial real estate loans are secured by real estate whose value tends to be easily ascertainable. These loans are made consistent with appraisal policies and real estate lending policies, which detail maximum loan-to-value ratios and maturities.

We have allocated 4% of the allowance to real estate construction loans, which constituted 6.42% of our loan portfolio at December 31, 2018. Construction loans are secured by real estate with values that are dependent upon market and economic conditions. Values may not always be easily ascertainable as evidenced by the current market conditions. These loans are made consistent with appraisal policies and real estate lending policies which detail maximum loan-to-value ratios and maturities.

We have allocated 15% of the allowance to commercial loans, which constituted 15.20% of our loan portfolio at December 31, 2018. Our allocation increased as a percentage of the allowance for loan losses due to the \$14.6 million increase in commercial loans during 2018.

We have allocated 3% of the allowance to consumer installment loans, which constituted 4.49% of our loan portfolio at December 31, 2018, which was comparable to the 2% allocation we had in 2017.

The following table shows the balance and percentage of our allowance for loan losses (or “ALLL”) allocated to each major category of loans.

Allocation of the Allowance for Loan Losses

December 31, 2014 through December 31, 2018

(Dollars in thousands)

	December 31, 2018			December 31, 2017			December 31, 2016		
	Amount	% of ALLL	% of Loans	Amount	% of ALLL	% of Loans	Amount	% of ALLL	% of Loans
Commercial	\$775	15%	15.20%	\$1,098	18%	13.35%	\$622	10%	11.75%
R/E–const.	202	4%	6.42%	191	3%	5.80%	346	6%	5.50%
R/E–comm.	1,386	26%	25.75%	1,989	32%	24.89%	1,625	27%	22.05%
R/E–resid.	2,526	47%	48.15%	2,506	41%	51.59%	2,617	43%	55.97%
Installment	172	3%	4.49%	156	2%	4.37%	123	2%	4.73%
Unallocated	275	5%		256	4%		739	12%	
Total	\$5,336	100%	100.00%	\$6,196	100%	100.00%	\$6,072	100%	100.00%
	December 31, 2015			December 31, 2014					
		% of ALLL	% of Loans		% of ALLL	% of Loans			

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	Amount			Amount		
Commercial	\$1,066	14%	10.76%	\$1,496	15%	10.99%
R/E-const.	332	4%	3.33%	199	2%	3.37%
R/E-comm.	2,384	36%	22.34%	4,418	45%	23.62%
R/E-resid.	2,669	32%	58.00%	2,726	27%	56.37%
Installment	128	2%	5.57%	171	2%	5.65%
Unallocated	914	12%		912	9%	
Total	\$7,493	100%	100.00%	\$9,922	100%	100.00%

Other Real Estate Owned

Other real estate owned (“OREO”) decreased \$922 thousand or 13.44%, to \$5.9 million at December 31, 2018 from \$6.9 million at December 31, 2017. All properties are available for sale by commercial and residential realtors under the direction of our Special Assets division. Our aim is to reduce the level of OREO in order to reduce the level of nonperforming assets at the Bank, while keeping in mind the impact to earnings and capital. In both 2018 and 2017, pricing adjustments were made to make certain properties more marketable, which, in some cases, reduced the price below the fair value of the property (which is based on an appraisal less estimated disposition costs) or were the result of auctions on several of our older properties. During 2018, we recorded OREO writedowns of \$543 thousand as compared to \$758 thousand in 2017. Of the \$758 thousand in OREO writedowns during 2017, \$116 thousand of the writedowns were due to auctions we held on some of our OREO properties.

During 2018 we added \$1.7 million in OREO properties as a result of settlement of foreclosed loans, offset by sales of \$1.4 million with net losses totaling \$135 thousand. During 2017, we added \$3.1 million in OREO properties as a result of settlement of foreclosed loans, which was offset by sales of \$6.2 million with net losses totaling \$64 thousand. As previously discussed we continue to take an aggressive approach toward liquidating properties to reduce our level of foreclosed properties by making pricing adjustments and holding auctions on some of our older properties. We expect to continue these efforts in 2019, which could result in additional losses, while reducing future carrying costs.

Although the properties remain for sale and are actively marketed, we do have lease agreements on certain other real estate owned properties which are generating rental income at market rates. Rental income on OREO properties was \$205 thousand in 2018, a decrease of \$27 thousand, or 11.61%, when compared to the \$232 thousand recognized in 2017.

Investment Securities

Total investment securities decreased \$11.7 million, or 16.43%, to \$59.4 million at December 31, 2018 from \$71.1 million at December 31, 2017. All securities are classified as available-for-sale for liquidity purposes. No securities were sold during 2018. However, paydowns on mortgage backed securities totaled \$11.2 million. In 2017 we sold \$3.2 million in investment securities resulting in no net realized gains. These sales were executed to provide liquidity to fund our loan growth during 2017 and to take advantage of gains in the investment portfolio as deemed appropriate. Investment securities with a carrying value of \$8.0 million and \$11.0 million at December 31, 2018 and 2017, were pledged to secure public deposits and for other purposes required by law.

Our strategy is to invest excess funds in investment securities to increase interest income while providing for liquidity instead of other short term investment options, such as federal funds sold and overnight deposits with the Federal Reserve Bank. Due to loan demand during 2018, most funds resulting from securities maturities and repayments were used to fund the loan portfolio. We anticipate maintaining or slightly increasing the size of the portfolio during 2019. The portfolio is comprised of, what we believe to be, short to mid-term investments, as mortgage backed securities and collateralized mortgage obligations generally repay at a faster rate than their contractual maturities. The carrying values of investment securities and the different types of investments are shown in the following table:

Investment Securities Portfolio

(Dollars in thousands)

December 31, Available for Sale	2018	2017	2016
	Fair Value	Fair Value	Fair Value

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	Amortized Cost		Amortized Cost		Amortized Cost	
U.S. Government Agencies	\$ 19,755	\$ 19,389	\$ 23,986	\$ 23,844	\$ 24,821	\$ 24,632
Taxable municipals	4,428	4,313	4,466	4,397	2,340	2,292
Corporate bonds	5,422	5,320	5,437	5,579	3,600	3,749
Mortgage backed securities	31,366	30,385	37,950	37,268	39,941	39,338
Total Securities AFS	\$ 60,971	\$ 59,407	\$ 71,839	\$ 71,088	\$ 70,702	\$ 70,011

The fair value of our investment portfolio is substantially affected by changes in interest rates, which could result in realized losses if we have to sell the securities and recognize the loss in a rising interest rate environment due to Federal Reserve actions, U.S. fiscal policies or other factors affecting market interest rates. At December 31, 2018 we had an unrealized loss in our investment portfolio totaling \$751 thousand as compared to a \$691 thousand unrealized loss at December 31, 2017. The \$60 thousand decrease in fair value is mainly due to changes in interest rates during 2018. We have reviewed our investment portfolio and no investment security is deemed to have an other than temporary impairment. We monitor our portfolio regularly and use it to maintain liquidity, manage interest rate risk and enhance earnings.

The amortized cost, fair value and weighted average yield of investment securities at December 31, 2018 are shown by contractual maturity and do not reflect principal paydowns for amortizing securities in the following schedule. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars are in thousands)	Maturities of Securities		
	Amortized Cost	Fair Value	Weighted Average Yield
<u>Securities Available for Sale</u>			
Due in one year or less	\$15	\$16	0.79%
Due after one year through five years	5,090	5,015	2.53%
Due after five years through ten years	13,638	13,318	3.35%
Due after ten years	42,228	41,058	2.50%
Total	\$60,971	\$59,407	2.69%

Bank Owned Life Insurance

At both December 31, 2018 and 2017, we had an aggregate total cash surrender value of \$4.5 million on life insurance policies covering current and former key officers. In December 2017 several policies were surrendered, due to their lagging financial performance. In 2017, this transaction resulted in net proceeds of \$7.6 million after the effect of a tax penalty of \$318 thousand.

Total income for the policies during 2018 and 2017 was \$57 thousand and \$115 thousand, respectively.

Deposits

Total deposits were \$596.0 million at December 31, 2018, an increase of \$13.4 million, or 2.31%, from \$582.5 million at December 31, 2017. Most of the increase has been in non-interest bearing deposits which are our least cost deposit funding source. During 2018, we experienced an increase in non-interest bearing deposits of \$9.7 million, while all types of interest bearing deposits increased \$3.8 million. Due to competitive pressures, the recent rise in interest rates, and our need for funding, we expect to see an uptick on the interest we pay on deposits in 2019.

Core deposits, which are mainly transaction accounts, commercial relationships and savings products, increased as noninterest bearing deposits grew 6.25%, or \$9.7 million, from \$154.6 million at December 31, 2017 to \$164.3 million at December 31, 2018. Interest-bearing demand deposit accounts remained essentially unchanged at \$34.6 million. Savings and money market deposits increased \$13.3 million, or 11.02%, to \$134.3 million at December 31, 2018 as compared to \$121.0 million at December 31, 2017. Overall, we continue to maintain core deposits through attractive consumer and commercial deposit products and strong ties with our customer base and communities.

Time deposits of \$100,000 or more equaled approximately 19.32% of deposits at the end of 2018 and 21.16% of deposits at the end of 2017.

We have brokered deposits totaling \$2.8 million that mature in 2019. These deposits were used to fund a particular 10 year balloon mortgage product and are not expected to be renewed at maturity. Internet accounts are limited to customers located in our primary market area and the surrounding geographical area. The average balance of and the average rate paid on deposits is shown in the net interest margin analysis table in the “Net Interest Income and Net Interest Margin” section above. Total Certificate of Deposit Registry Service (“CDARS”) time deposits were \$10.7 million and \$21.2 million in 2018 and 2017, respectively.

Maturities of time deposits of \$100,000 or more outstanding are summarized as follows:

Maturities of Time Deposits of \$100 Thousand and More	
(Dollars in thousands)	
December 31, 2018	
Three months or less	\$17,104
Over three months through six months	28,270
Over six months through twelve months	13,240
Over one year	56,528
Total	\$115,142

Noninterest Income

For 2018, noninterest income decreased to \$7.6 million from \$9.8 million for the same period in 2017, a decrease of \$2.2 million, or 22.66%. This decrease was primarily due to the \$2.6 million non-recurring gain recognized on the sale and leaseback transactions completed during 2017. Services charges decreased \$72 thousand during 2018, primarily due to changes in recording and waiving fees in our nonsufficient funds / overdraft fee income related to the optional overdraft protection services we offer. For 2018 we segregated card processing and interchange fees which had previously been included in service charge income. For 2018 card processing and interchange revenue totaled \$2.8 million and increase of \$220 thousand or 8.50% from 2017. The ratio of noninterest income as a percentage of average assets decreased to 1.13% in 2018 as compared to 1.51% in 2017. The decrease is attributed to the impact of the sale leaseback transaction during 2017. Although the year-to-date percentage decreased from 2017 to 2018, other non-interest income revenues increased in 2018 on potentially recurring business lines. Financial services fees for 2018 were \$603 thousand, an increase of \$391 thousand, or 184.43%, from the \$212 thousand realized in 2017. Title insurance company revenue increased \$30 thousand from \$21 thousand to \$51 thousand. The addition of new registered representatives and an increased focus on delivering these services attributed to the increased year-over-year revenue. In addition, a greater focus on secondary market mortgage origination is expected to generate additional revenues in the future.

Noninterest Expense

Noninterest expenses increased \$1.6 million, or 5.41%, to \$30.5 million in 2018. Salaries and employee benefits increased from \$13.5 million in 2017 to \$14.2 million in 2018, an increase of \$688 thousand, or 5.09%, despite not recording a profit sharing accrual of approximately \$250,000, as was recognized in 2017. This increase was primarily due to several factors, including annual pay increases and strategic hires made throughout the year, along with the impact of the increased cost of health insurance, and the opening of the Princeton West Virginia office. Group insurance costs increased \$221 thousand or 61.15%. Approximately \$200,000 of this increase related to costs related to adjusting the accrued expense to allow us to exit our current health insurance plan. For 2019, while we continue to self-insure our principal health care benefits, we have retained a new plan administrator who will assist us in monitoring claims and work with our employees in obtaining the best outcomes. While this change may not result in immediate reductions, we believe that over the next few years, this change will aid in improving employee care and moderating costs. Total full time equivalent employees have decreased to 250 at December 31, 2018 from 255 at December 31, 2017, a decrease of 5, or 1.96%. During 2018, we continued reorganizing our processes to help us achieve greater efficiencies. We also made a large investment in training our employees. We anticipate the number of full time equivalent employees to decrease through attrition in the future as a result of these improved processes and training.

Occupancy and equipment expenses increased \$408 thousand to \$5.2 million during 2018. We incurred lease expense of \$450 thousand during 2018 as a result of the sale lease back transactions as compared to \$263 thousand in 2017. The increase in lease expense was partially offset by depreciation savings on these properties of \$46 thousand. During

the year we wrote down obsolete or disposed equipment and software of \$56 thousand along with additional depreciation of \$68 thousand on ITMs as we adjusted the remaining useful lives. The increase in ITM depreciation will continue for the foreseeable future. Equipment maintenance costs increased \$45 thousand due to the additions of the Oakvale branch office and the Kingsport LPO, coupled with the routine increases of such expenses. The new sites accounted for \$26 thousand of the overall increase. Our reliance on ITMs, cash recyclers and coin counters to improve the customer experience and create operational efficiencies carries with it the costs related to recurring maintenance and repairs. We believe that the ITMs provide additional convenience by offering teller services from 7 AM to 7 PM Monday through Saturday. We anticipate the addition of the ITMs will create efficiencies going forward as usage continues to increase. In addition, we have been transitioning our bank branches to the universal banker model. This model utilizes staff in multiple job functions versus staffing specialized in one area. To help accommodate this model, investments in video conferencing, cash recyclers, and other technological tools have been implemented. Although costs have increased, as we continue to grow, these costs should remain relatively constant and staffing costs in this area should decline in the future.

Expenses related to other real estate owned and repossessed assets showed a decline of \$418 thousand, or 29.00%, from \$1.4 million in 2017 to \$1.0 million in 2018. Foreclosed properties decreased in 2018 to \$5.9 million at December 31, 2018 from \$6.9 million at December 31, 2017. During 2018 we recorded net OREO writedowns of \$545 thousand compared to \$758 thousand in 2017. These writedowns were primarily the result of price reductions that helped us in securing sales that reduced our other real estate owned by \$922 thousand during the year. During 2018, we had net losses on the sale of OREO of \$135 thousand compared to \$64 thousand in 2017. Based on the reduced level of other real estate owned, we expect that costs related to holding and disposing of these properties will decrease in 2019 and future periods.

Other operating expenses increased \$227 thousand or 2.78% to \$8.4 million for 2018 from \$8.2 million in 2017. Printing and supplies increased year-over-year by \$160 thousand due to a writedown of obsolete or misapplied inventory items totaling \$168 thousand. Other expenses increased \$498 thousand due to a write-off of advanced escrow and other costs determined to be unrecoverable totaling \$220 thousand, and an adjustment to prepaid excise and franchise taxes of \$244 thousand. Neither the supplies, advanced escrow nor tax adjustments are expected to be repeated going forward. Had these transactions not occurred, other operating expenses for 2018 would have decreased \$405 thousand from 2017, due a decrease in legal and professional fees and the reduction in OREO expenses previously discussed.

Our efficiency ratio, a non-GAAP measure, which is defined as noninterest expense divided by the sum of net interest income plus noninterest income, was 95.85% in 2018 as compared to 88.69% in 2017. The increase in this ratio largely relates to the nonrecurring other operating expense items incurred during 2018, discussed above, along with the loss of the impact of the gain on the sale leaseback transaction from 2017 in 2018. We continue to seek opportunities to operate more efficiently through the use of technology, improving processes, reducing nonperforming assets and increasing productivity. For 2019 we have initiated a review of existing and renewing contractual relationships to determine if we are maximizing these products and services.

Income Taxes and Deferred Tax Assets

Income taxes were \$149 thousand in 2018, compared to \$144 thousand in 2017. The effective tax rates were 14.0%, and 4.4% for 2018 and 2017, respectively. The effective tax rate for the periods differed from the federal statutory rate of 21.0% for 2018 and 34.0% for 2017 principally as a result of tax-exempt income from loans as well as earnings from bank owned life insurance. The lower effective tax rate in 2017 when compared to 2018 is the result the reversal of a previously recorded valuation allowance of \$5.3 million against the deferred tax asset due to improved earnings which more than offset a \$318 thousand penalty related to the surrender of several bank owned life insurance policies and \$4.0 million of additional income tax expense recorded in 2017 related to the reduction in the carrying value of the net deferred tax asset due to the lowering of the federal corporate tax rate to 21%. For 2017 after excluding the impact of the reversal of the valuation allowance, the remeasurement of deferred tax items and the insurance surrender penalty, the effective tax would have been 33.9%.

Deferred tax assets represent the future tax benefit of future deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the recorded deferred tax assets to net realizable value. The Company has evaluated positive and negative evidence to assess the realizability of its deferred taxes. Based on the evidence, including taxable income projections, the Company believes it is more likely than not that its deferred tax assets will be realizable. As a result the Company reversed the valuation allowance of \$5.3 million during 2017. Accordingly, the Company did not include a valuation allowance against its deferred tax assets as of December 31, 2018 and 2017.

Tax positions are evaluated in a two-step process. The Company first determines whether it is more likely than not that a position will be sustained upon examination. If a tax position meets the more-likely-than-not recognition threshold, it is then measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured as the largest amount of benefit that is greater than 50% likely of being recognized. The Company classifies interest and penalties as a component of income tax expense.

As of December 31, 2018, the Company had Federal and state net operating loss carryforward amounts of approximately \$17.2 million and \$1.2 million, respectively. These amounts are not limited pursuant to IRC Section 382. The Company is subject to examination in the United States and multiple state jurisdictions. Open tax years for examination are 2015 – 2018.

Capital Resources

Our total capital at the end of 2018 was \$51.3 million compared to \$51.0 million in 2017. The increase was \$277 thousand, or 0.54%. Book value per common share was \$2.14 at December 31, 2018 compared to \$2.13 at December 31, 2017.

The Company meets the eligibility criteria for a small bank holding company in accordance with the Federal Reserve Board's Small Bank Holding Company Policy Statement issued in February 2015, and does not report consolidated regulatory capital. The Bank continues to be subject to various capital requirements administered by banking agencies.

The Bank's capital levels are characterized as "well-capitalized" under the Basel III Capital Rules. The capital adequacy ratios for the Bank are set forth below:

Capital Adequacy Ratios

		December 31,	
	Well-Capitalized Regulatory Threshold	2018	2017
Tier 1 leverage	5.00%	9.59%	9.56%
Common equity tier 1	6.50%	13.30%	14.05%
Tier 1 risk-based capital	8.00%	13.30%	14.05%
Total risk-based capital	10.00%	14.39%	15.30%

The ratios mentioned above for the Bank comply with the Federal Reserve rules to align with the Basel III Capital requirements effective January 1, 2015. As a result of these new rules the Bank is now subject to a Common Equity Tier 1 ratio set out above.

Under Basel III Capital requirements, beginning January 1, 2016, a capital conservation buffer of 0.625% became effective. The capital conservation buffer is 1.25% as of December 31, 2018 and the Bank met that requirement with a buffer of 6.39%. The capital conservation buffer will be gradually increased through January 1, 2019 to 2.5%. Banks will be required to maintain levels that meet the required minimum plus the capital conservation buffer in order to make distributions, such as dividends, or discretionary bonus payments. As noted above, if the Bank qualifies and elects to comply with the new Community Bank Leverage Ratio the above capital measurements would no longer apply to us.

Total assets increased in 2018 and we anticipate asset levels to increase in the future due to an emphasis on growing the loan portfolio and the core deposit base of the Bank. Under current economic conditions, we believe it is prudent to continue to increase capital to support planned asset growth while being able to absorb potential losses that may occur if asset quality deteriorates further. Based upon projections, we believe our earnings will be sufficient to support the Bank's planned asset growth.

No cash dividends have been paid historically and we do not anticipate paying a cash dividend in the foreseeable future as the Company continues to have a retained deficit. Earnings will continue to be retained to build capital and position the Company to pay a dividend to its shareholders as soon as practicable.

Liquidity

We closely monitor our liquidity and our liquid assets in the form of cash, due from banks, federal funds sold and unpledged available-for-sale investments. Collectively, those balances were \$79.5 million at December 31, 2018, down from \$92.8 million at December 31, 2017. A surplus of short-term assets are maintained at levels management deems adequate to meet potential liquidity needs during 2018.

At December 31, 2018, all of our investments are classified as available-for-sale, providing an additional source of liquidity in the amount of \$51.4 million, which is net of the \$8.0 million of securities pledged as collateral. This will serve as a source of liquidity while yielding a higher return when compared to other short term investment options, such as federal funds sold and overnight deposits with the Federal Reserve Bank. Total investment securities decreased \$11.7 million, or 16.43%, to \$59.4 million at December 31, 2018 from \$71.1 million at December 31, 2017.

A \$60 thousand decrease in fair market value resulted in a net unrealized loss of \$751 thousand at December 31, 2018 compared to the net unrealized loss at December 31, 2017, which was \$691 thousand. This unrealized loss of \$751 thousand could negatively impact earnings if the investment portfolio had to be quickly liquidated.

Our loan to deposit ratio was 91.80% at December 31, 2018 and 88.06% at year-end 2017.

Available third party sources of liquidity remain intact at December 31, 2018 which includes the following: our line of credit with the Federal Home Loan Bank of Atlanta (“FHLB”) totaling \$139.6 million, the brokered certificates of deposit markets, internet certificates of deposit, and the discount window at the Federal Reserve Bank of Richmond. We have \$20.0 million in unsecured federal funds lines of credit from three correspondent banks as of December 31, 2018, which gives us an additional source of liquidity.

We have used our line of credit with FHLB to issue letters of credit totaling \$17.0 million to the Treasury Board of Virginia for collateral on public funds. No draws on the letters of credit have been issued. The letters of credit are considered draws on our Federal Home Loan Bank line of credit. An additional \$115.6 million was available on December 31, 2018 on the \$139.6 million line of credit, which is secured by a blanket lien on our residential real estate loans.

We have access to the brokered deposits market. As of December 31, 2018, we had \$2.8 million in brokered time deposits at an interest rate of 4.10%. These brokered time deposits mature during the first quarter of 2019 and we do not intend to renew or replace these funds. With the exception of CDARS time deposits, we have no other brokered deposits. As of December 31, 2018 we had no CDARS one way buys outstanding compared to \$5.0 million at December 31, 2017.

We are a member of an internet certificate of deposit network whereby we may obtain funds from other financial institutions at auction. We may invest funds through this network as well. Currently, we only intend to use this source of liquidity in a liquidity crisis event.

The Bank has access to additional liquidity through the Federal Reserve Bank’s Discount Window for overnight funding needs. We may collateralize this line with investment securities and loans at our discretion; however, we do not anticipate using this funding source except as a last resort.

With the on-balance sheet liquidity and other external sources of funding, we believe the Bank has adequate liquidity and capital resources to meet our requirements and needs for the foreseeable future. However, liquidity can be further affected by a number of factors such as counterparty willingness or ability to extend credit, regulatory actions and customer preferences, etc., some of which are beyond our control.

During the capital raise in 2012, common stock warrants were issued to investors. The warrants were immediately exercisable through December 2017 at a price of \$1.75 per share. During 2016, 375 warrants were exercised, and in 2017, 636,364 warrants were exercised which resulted in additional liquidity to the Company of \$1.1 million. The remaining 245,614 of unexercised common stock warrants expired on December 20, 2017. The funds resulting from

the exercise of the warrants will be used to pay operating expenses and trust preferred interest payments. The Company is making quarterly interest payments on the trust preferred securities.

Financial Instruments with Off-Balance-Sheet Risk

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

A summary of the contract amount of the Bank's exposure to off-balance-sheet risk as of December 31, 2018 and 2017 is as follows:

(Dollars in thousands)	2018	2017
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$55,144	\$38,540
Standby letters of credit	2,798	2,519

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

Unfunded commitments under lines of credit are commitments for possible future extensions of credit to existing customers. Those lines of credit may not actually be drawn upon to the total extent to which the Bank is committed.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. The credit risk involved in issuing letters of

credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds certificates of deposit, deposit accounts, and real estate as collateral supporting those commitments for which collateral is deemed necessary.

Interest Sensitivity

At December 31, 2018, we had a negative cumulative gap rate sensitivity ratio of 31.40% for the one year re-pricing period, compared to 35.69% at December 31, 2017. A negative cumulative gap generally indicates that net interest income would improve in a declining interest rate environment as liabilities re-price more quickly than assets. Conversely, net interest income would likely decrease in periods during which interest rates are increasing. The below table is based on contractual maturities and does not take into consideration prepayment speeds of investment securities and loans nor does it factor decay rates for non-maturity deposits. When considering these prepayment speed and decay rate assumptions, along with our ability to control the repricing of a significant portion of the deposit portfolio, we are in a position to increase interest income in a rising interest rate environment. Management reviews our interest rate risk profile quarterly and believes that the current position presents acceptable risk.

Interest Sensitivity Analysis

December 31, 2018

(Dollars in thousands)

	1- 90 Days	91-365 Days	1-3 Years	4-5 Years	6-15 Years	Over 15 Years	Total
Uses of funds:							
Loans	\$70,391	\$40,843	\$94,433	\$169,413	\$119,192	\$52,824	\$547,096
Federal funds sold	264	-	-	-	-	-	264
Deposits with banks	15,572	-	-	-	-	-	15,572
Investments	8,258	1,056	4,280	4,601	23,738	17,474	59,407
Bank owned life insurance	4,514	-	-	-	-	-	4,514
Total earning assets	\$8,999	41,899	\$98,713	\$174,014	\$142,930	\$70,298	\$626,853
Sources of funds:							
Interest Bearing DDA	\$4,875	\$-	\$-	\$-	\$-	\$	