PEOPLES BANCORP OF NORTH CAROLINA INC
Form DEF 14A
March 25, 2019

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 14A

(Rule 14a-101)

Proxy Statement Pursuant to Section 14(a)
of the Securities Exchange Act of 1934

Filed by the Registrant [X ]

Filed by a Party other than the Registrant [ ]

Check the appropriate box:

[ ] Preliminary Proxy Statement
[X] Definitive Proxy Statement
[ ] Definitive Additional Materials
[ ] Soliciting Material Pursuant to §240.14a-1
[ ] Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

Peoples Bancorp of North Carolina, Inc.
(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

[X] No fee required.

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(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):
(4) Proposed maximum aggregate value of transaction:
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(4) Date Filed:

Notice of 2019 Annual Meeting,
Proxy Statement and
Annual Report

PEOPLES BANCORP OF NORTH CAROLINA, INC.

PROXY STATEMENT

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PEOPLES BANCORP OF NORTH CAROLINA, INC.
Post Office Box 467
518 West C Street
Newton, North Carolina 28658-0467
(828) 464-5620

NOTICE OF 2019 ANNUAL MEETING OF SHAREHOLDERS
To Be Held on May 2, 2019

NOTICE IS HEREBY GIVEN that the 2019 Annual Meeting of Shareholders of Peoples Bancorp of North Carolina, Inc. (the "Company") will be held as follows:

| | |
|---|---|
| Place: | Catawba Country Club<br>1154 Country Club Road<br>Newton, North Carolina |
| Date: | May 2, 2019 |
| Time: | 11:00 a.m., Eastern Time |

The purposes of the Annual Meeting are to consider and vote upon the following matters:

To elect ten persons who will serve as members of the Board of Directors until the 2020 Annual Meeting of Shareholders or until their successors are duly elected and qualified;

To participate in an advisory (non-binding) vote to approve the compensation of the Company's named executive officers, as disclosed in the Proxy Statement;

To participate in an advisory (non-binding) vote on the frequency in which shareholders approve the compensation of the Company's named executive officers.

To ratify the appointment of Elliott Davis, PLLC as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2019; and

To consider and act on any other matters that may properly come before the Annual Meeting or any adjournment.

The Board of Directors has established March 8, 2019, as the record date for the determination of shareholders entitled to notice of and to vote at the Annual Meeting. If an insufficient number of shares is present in person or by proxy to constitute a quorum at the time of the Annual Meeting, the Annual Meeting may be adjourned in order to permit further solicitation of proxies by the Company.

Your vote is important and will help protect your account from escheatment. We urge you to vote as soon as possible so that your shares may be voted in accordance with your wishes. You may vote by executing and returning your proxy card in the accompanying envelope, or by voting electronically over the Internet or by telephone. Please refer to the proxy card enclosed for information on voting electronically. If you attend the Annual Meeting, you may vote in person and the proxy will not be used.

By Order of the Board of Directors,
Lance A. Sellers
President and Chief Executive Officer
Newton, North Carolina
March 25, 2019

PEOPLES BANCORP OF NORTH CAROLINA, INC.

PROXY STATEMENT

Annual Meeting of Shareholders
To Be Held On May 2, 2019

This Proxy Statement is being mailed to our shareholders on or about March 25, 2019, for solicitation of proxies by the Board of Directors of Peoples Bancorp of North Carolina, Inc. Our principal executive offices are located at 518 West C Street, Newton, North Carolina 28658. Our telephone number is (828) 464-5620.

In this Proxy Statement, the terms "we," "us," "our" and the "Company" refer to Peoples Bancorp of North Carolina, Inc. The term "Bank" means Peoples Bank, our wholly-owned, North Carolina-chartered bank subsidiary. The terms "you" and "your" refer to the shareholders of the Company.

Important Notice Regarding the Availability of Proxy Materials for the Shareholder Meeting to Be Held on May 2, 2019. The Notice, Proxy Statement and the Annual Report to Shareholders for the year ended December 31, 2018 are also available at https://www.snl.com/IRWebLinkX/GenPage.aspx?IID=4050385&GKP=202713
You may also access the above off-site website by going to www.peoplesbanknc.com and click on the link.

INFORMATION ABOUT THE ANNUAL MEETING

Your vote is very important. For this reason, our Board of Directors is requesting that you allow your common stock to be represented at the 2019 Annual Meeting of Shareholders by the proxies named on the enclosed proxy card.

| | |
|---|---|
| When is the Annual Meeting? | May 2, 2019, at 11 a.m., Eastern Time. |
| Where will the Annual Meeting be held? | At the Catawba Country Club, 1154 Country Club Road, Newton, North Carolina. |
| What items will be voted on at the Annual Meeting? | 1. ELECTION OF DIRECTORS. To elect ten directors to serve until the 2020 Annual Meeting of Shareholders.<br><br>2. PARTICIPATION IN ADVISORY VOTE ("SAY ON PAY"). To participate in an advisory (non-binding) vote to approve the compensation of the Company's named executive officers, as disclosed in the Proxy Statement.<br><br>3. PARTICIPATION IN ADVISORY VOTE ("SAY ON FREQUENCY"). To participate in an advisory (non-binding) vote to determine the frequency in which shareholders approve the compensation of the Company's named executive officers, as disclosed in the Proxy Statement |

1

4.
RATIFICATION OF SELECTION OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM. To ratify the appointment of Elliott Davis, PLLC ("Elliott Davis") as the Company's independent registered public accounting firm for fiscal year 2019.

5.
OTHER BUSINESS. To consider any other business as may properly come before the Annual Meeting or any adjournment.

**Who can vote?**

Only holders of record of our common stock at the close of business on March 8, 2019 (the “Record Date”) will be entitled to notice of and to vote at the Annual Meeting and any adjournment of the Annual Meeting. On the Record Date, there were 5,997,136 shares of our common stock outstanding and entitled to vote and 658 shareholders of record.

**How do I vote by proxy?**

You may vote your shares by marking, signing and dating the enclosed proxy card and returning it in the enclosed postage-paid envelope or by voting electronically over the Internet or by telephone using the information on the proxy card. If you return your signed proxy card before the Annual Meeting, the proxies will vote your shares as you direct. The Board of Directors has appointed proxies to represent shareholders who cannot attend the Annual Meeting in person.

For the election of directors, you may vote for (1) all of the nominees, (2) none of the nominees, or (3) all of the nominees except those you designate. If a nominee for election as a director becomes unavailable for election at any time at or before the Annual Meeting, the proxies will vote your shares for a substitute nominee. For each other item of business, you may vote “FOR” or “AGAINST” or you may “ABSTAIN” from voting.

If you return your signed proxy card but do not specify how you want to vote your shares, the proxies will vote them “FOR” the election of all of our nominees for directors and “FOR” all other proposals presented in this Proxy Statement in accordance with recommendations from the Board of Directors.

If your shares are held in the name of a broker or other nominee (i.e., held in “street name”), you will need to obtain a proxy instruction card from the broker holding your shares and return the card as directed by your broker. Your broker is not permitted to vote on your behalf on the election of directors unless you provide specific instructions by following the instructions from your broker about voting your shares by telephone or Internet or completing and returning the voting instruction card provided by your broker. For your vote to be counted in the election of directors you will need to communicate your voting decision to your bank, broker or other holder of record before the date of the Annual Meeting.

We are not aware of any other matters to be brought before the Annual Meeting. If matters other than those discussed above are properly brought before the Annual Meeting, the proxies may vote your shares in accordance with their best judgment.

| | |
|---|---|
| How do I change or revoke my proxy? | You can change or revoke your proxy at any time before it is voted at the Annual Meeting in any of three ways: (1) by delivering a written notice of revocation to the Secretary of the Company; (2) by delivering another properly signed proxy card to the Secretary of the Company with a more recent date than your first proxy card or by changing your vote by telephone or the Internet; or (3) by attending the Annual Meeting and voting in person. You should deliver your written notice or superseding proxy to the Secretary of the Company at our principal executive offices listed above. |
| How many votes can I cast? | You are entitled to one vote for each share held as of the Record Date on each nominee for election and each other matter presented for a vote at the Annual Meeting. You may not vote your shares cumulatively in the election of directors. |
| How many votes are required to approve the proposals? | If a quorum is present at the Annual Meeting, each director nominee will be elected by a plurality of the votes cast in person or by proxy. If you withhold your vote on a nominee, your shares will not be counted as having voted for that nominee. The proposal to ratify the appointment of the Company's independent registered public accounting firm for 2019 will be approved if the votes cast in favor exceed the votes cast in opposition.<br><br>The proposal to approve the compensation of the Company's named executive officers is advisory only; however, the Company's Compensation Committee will consider the outcome of the vote when evaluating compensation arrangements for executive compensation.<br><br>The proposal to vote on the frequency in which the shareholders approve the compensation of the Company's named executive officers is advisory only; however the Board of Directors will consider the outcome of the vote when determining the frequency in which the compensation of the Company's named executive officers is submitted to the shareholders for approval.<br><br>Any other matters properly coming before the Annual Meeting for a vote will require the affirmative vote of the holders of a majority of the shares represented in person or by proxy at the Annual Meeting and entitled to vote on that matter.<br><br>In the event there are insufficient votes present at the Annual Meeting for a quorum or to approve or ratify any proposal, the Annual Meeting may be adjourned in order to permit the further solicitation of proxies. |

**What constitutes a "quorum" for the Annual Meeting?**

A majority of the outstanding shares of our common stock entitled to vote at the Annual Meeting, present in person or represented by proxy, constitutes a quorum (a quorum is necessary to conduct business at the Annual Meeting). Your shares will be considered part of the quorum if you have voted your shares by proxy or by telephone or Internet. Abstentions, broker non-votes and votes withheld from any director nominee count as shares present at the Annual Meeting for purposes of determining a quorum.

**Who pays for the solicitation of proxies?**

We will pay the cost of preparing, printing and mailing materials in connection with this solicitation of proxies. In addition to solicitation by mail, our officers, directors and regular employees, as well as those of the Bank, may make solicitations personally, by telephone or otherwise without additional compensation for doing so. We reserve the right to engage a proxy solicitation firm to assist in the solicitation of proxies for the Annual Meeting. We will, upon request, reimburse brokerage firms, banks and others for their reasonable out-of-pocket expenses in forwarding proxy materials to beneficial owners of stock or otherwise in connection with this solicitation of proxies.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The Exchange Act requires that any person who acquires the beneficial ownership of more than five percent (5%) of the Company's common stock notify the Securities and Exchange Commission (the "SEC") and the Company. Following is certain information, as of the Record Date, regarding those persons or groups who held of record, or who are known to the Company to own beneficially, more than five percent (5%) of the Company's outstanding common stock.

| Name and Address of Beneficial Owner | Amount and Nature of Beneficial Ownership1 | Percent of Class2 |
|---|---|---|
| Christine S. Abernethy<br>P.O. Box 386<br>Newton, NC 28658 | 725,338 3 | 12.09 % |
| Tontine Financial Partners, LP<br>55 Railroad Avenue, 3rd Floor<br>Greenwich, CT 06830-6378 | 387,936 4 | 6.47 % |
| Tontine Management, LLC<br>55 Railroad Avenue<br>Greenwich, CT 06830 | 387,936 5 | 6.47 % |
| Tontine Asset Associates, LLC<br>55 Railroad Avenue<br>Greenwich, CT 06830 | 144,475 6 | 2.41 % |
| Jeffrey L. Gendell<br>55 Railroad Avenue<br>Greenwich, CT 06830 | 532,411 7 | 8.88 % |

1
Unless otherwise noted, all shares are owned directly of record by the named individuals, by their spouses and minor children, or by other entities controlled by the named individuals. Voting and investment power is not shared unless otherwise indicated.

2
Based upon a total of 5,997,136 shares of common stock outstanding as of the Record Date.

3
Carolina Glove Company, Inc. owns 118,363 shares of common stock. These shares are included in the calculation of Ms. Abernethy's total beneficial ownership interest. Ms. Abernethy owns approximately 50% of the stock of Carolina Glove Company, Inc. The business is operated by a family committee. Ms. Abernethy has no active day-to-day participation in the business affairs of Carolina Glove Company, Inc.

4
Based on a Schedule 13G/A (Amendment No. 8) filed by Tontine Financial Partners, L.P., Tontine Management, LLC, Tontine Overseas Associates, LLC, Tontine Asset Associates, LLC and Jeffrey L. Gendell with the SEC on February 14, 2019 (the "2019 Schedule 13G/A"). Represents the number of shares of common stock owned directly by Tontine Financial Partners, L.P.

5
Based on the 2019 Schedule 13G/A, Tontine Management, LLC is the general partner of Tontine Financial Partners, L.P. Represents the number of shares of common stock owned by Tontine Financial Partners, L.P.

6
Based on the 2019 Schedule 13G/A, Tontine Asset Associates, LLC is the general partner of Tontine Capital Overseas Master Fund II, LP. Represents the number of shares of common stock owned by Tontine Capital Overseas Master Fund II, LP.

7
Represents the number of shares of common stock owned directly by Tontine Financial Partners, L.P. and Tontine Capital Overseas Master Fund II, LP.

5

Set forth below is certain information, as of the Record Date (unless otherwise indicated), regarding those shares of common stock owned beneficially by each of the persons who currently serves as a member of the Board of Directors, is a nominee for election to the Board of Directors at the Annual Meeting, or is a named executive officer of the Company. Also shown is the number of shares of common stock owned by the directors and executive officers of the Company as a group.

| Name and Address | Amount and Nature of Beneficial Ownership1 | | Percentage of Class2 | |
|---|---|---|---|---|
| James S. Abernethy<br>Post Office Box 327<br>Newton, NC 28658 | 157,369 | 3 | 2.62 | % |
| Robert C. Abernethy<br>Post Office Box 366<br>Newton, NC 28658 | 172,386 | 4 | 2.87 | % |
| William D. Cable, Sr.<br>Post Office Box 467<br>Newton, NC 28658 | 22,984 | | * | |
| Douglas S. Howard<br>Post Office Box 587<br>Denver, NC 28037 | 19,673 | 5 | * | |
| A. Joseph Lampron, Jr.<br>Post Office Box 467<br>Newton, NC 28658 | 16,803 | | * | |
| John W. Lineberger, Jr.<br>Post Office Box 481<br>Lincolnton, NC 28092 | 4,352 | | * | |
| Gary E. Matthews<br>210 First Avenue South<br>Conover, NC 28613 | 25,701 | | * | |
| Billy L. Price, Jr., M.D.<br>540 11th Ave. Place NW<br>Hickory, NC 28601 | 9,868 | | * | |
| Larry E. Robinson<br>Post Office Box 723<br>Newton, NC 28658 | 66,799 | 6 | 1.11 | % |
| Lance A. Sellers<br>Post Office Box 467<br>Newton, NC 28658 | 25,510 | | * | |
| William Gregory Terry<br>Post Office Box 610<br>Newton, NC 28658 | 19,498 | | * | |
| Dan Ray Timmerman, Sr.<br>Post Office Box 1148<br>Conover, NC 28613 | 97,410 | 7 | 1.62 | % |
| Benjamin I. Zachary<br>Post Office Box 277<br>Taylorsville, NC 28681 | 108,820 | 8 | 1.81 | % |

6

| | | | |
|---|---|---|---|
| All current directors and nominees and executive officers as a group (13 people) | 676,732 | 9 | 11.28 % |

*Does not exceed one percent of the common stock outstanding.

_____

1
Unless otherwise noted, all shares are owned directly of record by the named individuals, by their spouses and minor children, or by other entities controlled by the named individuals. Voting and investment power is not shared unless otherwise indicated.

2
Based upon a total of 5,997,136 shares of common stock outstanding as of the Record Date.

3
Includes 70,441 shares of common stock owned by Alexander Railroad Company. Mr. J. Abernethy is Vice President, Secretary and Chairman of the Board of Directors of Alexander Railroad Company.

4
Includes 6,988 shares of common stock owned by Mr. R. Abernethy's spouse, for which Mr. R. Abernethy disclaims beneficial ownership.

5
Includes 495 shares of common stock owned by Mr. Howard's spouse, for which Mr. Howard disclaims beneficial ownership.

6
Includes 19,344 shares of common stock owned by Mr. Robinson's spouse, for which Mr. Robinson disclaims beneficial ownership.

7
Includes 2,994 shares of common stock owned by Timmerman Manufacturing, Inc. Mr. Timmerman is a shareholder, director, Chairman of the Board and the Chief Executive Officer of Timmerman Manufacturing, Inc.

8
Includes 70,441 shares of common stock owned by Alexander Railroad Company. Mr. Zachary is President, Treasurer, General Manager and a Director of Alexander Railroad Company.

9
The 70,441 shares owned by Alexander Railroad Company and attributed to Mr. J. Abernethy and Mr. Zachary are only included once in calculating this total.

Directors James S. Abernethy and Robert C. Abernethy are brothers and are sons of Christine S. Abernethy, who owns in excess of ten percent (10%) of the common stock of the Company.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires the Company's executive officers and directors, and persons who own more than ten percent (10%) of the common stock, to file reports of ownership and changes in ownership with the

SEC. Executive officers, directors and greater than ten percent (10%) beneficial owners are required by SEC regulations to furnish the Company with copies of all Section 16(a) forms they file.

Based solely on a review of the copies of such forms furnished to the Company and written representations from the Company's executive officers and directors, the Company believes that during the fiscal year ended December 31, 2018, its executive officers and directors and greater than ten percent (10%) beneficial owners complied with all applicable Section 16(a) filing requirements.

## PROPOSAL 1
## ELECTION OF DIRECTORS

Our Board of Directors has set its number at ten members. Our current Bylaws provide that in order to be eligible for consideration at the Annual Meeting of Shareholders, all nominations of directors, other than those made by the Governance Committee or the Board of Directors, must be in writing and must be delivered to the Secretary of the Company not less than 50 days nor more than 90 days prior to the meeting at which such nominations will be made; provided, however, that if less than 60 days' notice of the meeting is given to the shareholders, such nominations must be delivered to the Secretary of the Company not later than the close of business on the tenth day following the day on which the notice of meeting was mailed.

Information about the nominees for election to the Board of Directors for a one-year term until the 2020 Annual Meeting of Shareholders appears below. All of the nominees are currently serving on the Board of Directors.

Director Nominees

James S. Abernethy, age 64 (as of February 1, 2019), is employed by Carolina Glove Company, Inc., a glove manufacturing company as its Vice President. Mr. Abernethy continues to serve as President and Assistant Secretary of Midstate Contractors, Inc., a paving company and also as Vice President, Secretary and Chairman of the Board of Directors of Alexander Railroad Company. He has served as a director of the Company since 1992. Mr. Abernethy has a total of 26 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the North Carolina Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Abernethy earned a business administration degree from Gardner Webb University in North Carolina. Over his 26 years of service on the Board of Directors, Mr. Abernethy has served on all the Bank's and the Company's committees.

Robert C. Abernethy, age 68 (as of February 1, 2019), is employed by Carolina Glove Company, Inc., a glove manufacturing company, as its President, Secretary and Treasurer. Mr. Abernethy continues to serve as Secretary and Assistant Treasurer of Midstate Contractors, Inc., a paving company. He has served as a director of the Company since 1976 and as Chairman since 1991. Mr. Abernethy has a total of 42 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the North Carolina Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Abernethy earned a B.S. degree from Gardner Webb University in North Carolina. He serves on the Finance Committee and Investment Committee of Grace United Church of Christ. Mr. Abernethy also serves on the board of directors of Carolina Glove Company, Inc. and Midstate Contractors, Inc. both privately held companies.

Douglas S. Howard, age 60 (as of February 1, 2019), is employed by Denver Equipment Company of Charlotte, Inc. as Vice President and Treasurer. Mr. Howard is currently serving as the Chairman of the Catawba Valley Medical Group. He has served as a director of the Company since 2004. Mr. Howard has a total of 20 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Howard also serves as the Chairman of the Board of Trustees of Catawba Valley Medical Center.

John W. Lineberger, Jr., age 68 (as of February 1, 2019), is employed by Lincoln Bonded Warehouse Company, a commercial warehousing facility, as President. He has served as a director of the Company since 2004. Mr. Lineberger has a total of 14 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Lineberger earned a B.S. degree in business administration from Western Carolina University.

Gary E. Matthews, age 63 (as of February 1, 2019), is employed by Matthews Construction Company, Inc. as its President and a Director. He has served as a director of the Company since 2001. Mr. Matthews has a total of 17 years of banking experience, is a graduate of the North Carolina Bank Directors' College, and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Matthews is also a director of Conover Metal Products, a privately held company. Mr. Matthews earned a B.S. degree in civil engineering/construction from North Carolina State University.

Billy L. Price, Jr., M.D., age 62 (as of February 1, 2019), is a Practitioner of Internal Medicine at BL Price Jr Medical Consultants, PLLC. Dr. Price served on the Board of Trustees of Catawba Valley Medical Center through 2018. He has served as a director of the Company since 2004. Dr. Price has a total of 14 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Dr. Price was previously the owner/pharmacist of Conover Drug Company. He is also a Medical Director of Healthgram Medical, a private company. Dr. Price earned a B.S. degree in pharmacy from the University of North Carolina at Chapel Hill and his MD from East Carolina University School of Medicine. He serves as Medical Director and Assistant Professor to Lenoir Rhyne University Physician Assistants Master of Science Program.

Larry E. Robinson, age 73 (as of February 1, 2019), is a shareholder, director and President of The Blue Ridge Distributing Company, Inc., a beer and wine distributor. He is also a director and member of the Board of Directors of United Beverages of North Carolina, LLC, a malt beverage beer distributor. He has served as a director of the Company since 1993. Mr. Robinson has a total of 25 years of banking experience and is a graduate of the North Carolina Bank Directors' College. Mr. Robinson attended Western Carolina University and received an Associate Degree in Business and Accounting from Catawba Valley Community College in North Carolina.

William Gregory Terry, age 51 (as of February 1, 2019), is President of DFH Holdings and Operator/General Manager of Drum & Willis-Reynolds Funeral Homes and Crematory. He has served as a director of the Company since 2004. Mr. Terry has a total of 14 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Terry graduated with a B.S. degree in business management from Clemson University in South Carolina. Mr. Terry serves on numerous civic and community boards.

Dan Ray Timmerman, Sr., age 71 (as of February 1, 2019), is a shareholder, director, Chairman of the Board of Directors and the Chief Executive Officer of Timmerman Manufacturing, Inc., a wrought iron furniture, railings and gates manufacturer. He has served as a director of the Company since 1995. Mr. Timmerman has a total of 23 years of banking experience and is a graduate of the North Carolina Bank Directors' College and attended the initial Advanced Directors' Training session offered by the NC Bank Directors' College in association with the College of Management at North Carolina State University. Mr. Timmerman earned a B.S. degree in business administration with a concentration in accounting from Lenoir-Rhyne University in North Carolina. Mr. Timmerman serves as member of the Board of the Catawba County Economic Development Commission.

Benjamin I. Zachary, age 62 (as of February 1, 2019), is employed by Alexander Railroad Company as its President, Treasurer, General Manager and Director. He has served as a director of the Company since 1995. Mr. Zachary has a total of 23 years of banking experience and is a graduate of the North Carolina Bank Directors' College. Mr. Zachary earned a B.S. degree in business administration with a concentration in accounting from the University of North Carolina at Chapel Hill. He worked as a CPA for a national accounting firm for eight years following graduation where his assignments included financial statement audits of several banks. Mr. Zachary is a member of the Taylorsville Rotary Club and has served as Treasurer for the Taylorsville Rotary Club and its Foundation.

We have no reason to believe that any of the nominees for election will be unable or will decline to serve if elected. In the event of death or disqualification of any nominee or the refusal or inability of any nominee to serve as a director, however, the proxies will vote for the election of another person as they determine in their discretion or may allow the vacancy to remain open until filled by the Board of Directors. In no circumstance will any proxy be voted for more than two nominees who are not named in this Proxy Statement. Properly executed and returned proxies, unless revoked, will be voted as directed by you or, in the absence of direction, will be voted in favor of the election of the recommended nominees. An affirmative vote of a plurality of votes cast at the Annual Meeting is necessary to elect a

nominee as a director.

THE BOARD OF DIRECTORS RECOMMENDS YOU VOTE “FOR” ALL OF THE NOMINEES NAMED ABOVE AS DIRECTORS

Executive Officers of the Company

During 2018, our executive officers were:

Lance A. Sellers, age 56 (as of February 1, 2019), serves as the President and Chief Executive Officer of the Company and the Bank. Prior to becoming the President and Chief Executive Officer of the Company and the Bank, Mr. Sellers served as Executive Vice President and Assistant Corporate Secretary of the Company and Executive Vice President and Chief Credit Officer of the Bank. He has been employed by the Company and the Bank since 1998. Mr. Sellers has a total of 34 years of banking experience. He is a graduate of the University of North Carolina at Chapel Hill and served as a senior credit officer at a regional bank headquartered in North Carolina.

William D. Cable, Sr., age 50 (as of February 1, 2019), serves as Executive Vice President, Assistant Corporate Treasurer and Corporate Secretary of the Company and Executive Vice President and Chief Operating Officer of the Bank. He has been employed by the Company and the Bank since 1995, where he has served as Senior Vice President-Information Services. Mr. Cable has a total of 27 years of banking experience. Prior to joining the Company, Mr. Cable was a regulatory examiner with the Federal Deposit Insurance Corporation. He is a graduate of Western Carolina University and the School of Banking of the South at Louisiana State University.

A. Joseph Lampron, Jr., age 64 (as of February 1, 2019), serves as Executive Vice President, Chief Financial Officer, Corporate Treasurer and Assistant Corporate Secretary of the Company and Executive Vice President and Chief Financial Officer of the Bank. He has been employed by the Company and the Bank since 2001. Mr. Lampron is a graduate of the University of North Carolina at Chapel Hill and upon graduation worked as a certified public accountant with a national accounting firm. His work with the firm included audits of banks and thrift institutions. Mr. Lampron has also served as Chief Financial Officer of a thrift institution and as a senior change manager in the finance group of a large North Carolina bank. Mr. Lampron has a total of 39 years of banking experience.

How often did our Board of Directors meet during 2018

Our Board of Directors held 14 meetings during 2018. All incumbent directors attended more than 75% of the total number of meetings of the Board of Directors and its committees on which they served during the year.

What is our policy for director attendance at Annual Meetings?

Although it is customary for all of our directors to attend Annual Meetings of Shareholders, we have no formal policy in place requiring attendance. All members of the Board of Directors attended our 2018 Annual Meeting of Shareholders held on May 3, 2018.

How can you communicate with the Board or its members?

We do not have formal procedures for shareholder communication with our Board of Directors. In general, our directors and officers are easily accessible by telephone, postal mail or e-mail. Any matter intended for your Board of Directors, or any individual director, can be directed to Lance Sellers, our President and Chief Executive Officer, or Joe Lampron, our Chief Financial Officer, at our principal executive offices at 518 West C Street, Newton, North Carolina 28658. You also may direct correspondence to our Board of Directors, or any of its members, in care of the Company at the foregoing address. Your communication will be forwarded to the intended recipient unopened.

Board Leadership Structure and Risk Oversight

Our Company and the Bank have traditionally operated with separate Chief Executive Officer and Chairman of the Board of Directors positions. We believe it is our Chief Executive Officer’s responsibility to manage the Company and

the Chairman's responsibility to lead the Board of Directors. Robert Abernethy is currently serving as Chairman of the Board of Directors, and James Abernethy is currently serving as the Vice Chairman of the Board of Directors. Other than Directors Lineberger and Matthews, all of the members of the Board of Directors are independent under applicable

NASDAQ listing requirements. The Company has five standing committees: Executive, Loan Sub-Committee, Governance, Audit and Compensation. The Chief Executive Officer serves on the Executive Committee. addition to the above-named committees has a Loan Committee and a Loan Sub-Committee. The duties of the Company's committees are described below. Each of the Company's and the Bank's committees considers risk within its area of responsibility. The Audit Committee and the full Board of Directors focus on the Company's most significant risks in the areas of liquidity, credit, interest rate and general risk management strategy. The Board of Directors sets policy guidelines in the areas of loans and asset/liability management which are reviewed on an on-going basis. While the Board of Directors oversees the Company's risk management, the Company's and the Bank's management are responsible for day-to-day risk management following the dictates of the policy decisions set by the Board of Directors.

The Governance Committee, as part of its annual review, evaluates the Board of Directors leadership structure and performance and reports its findings to the whole Board of Directors. The Board of Directors believes that having separate persons serving as Chief Executive Officer and Chairman and all independent directors provides the optimal board leadership structure for the Company and its shareholders.

Code of Business Conduct and Ethics

The Company and the Bank have a Code of Business Conduct and Ethics for its directors, officers and employees. The Code of Business Conduct and Ethics requires that individuals avoid conflicts of interest, comply with all laws and other legal requirements, conduct business in an honest and ethical manner and otherwise act with integrity and in the best interests of the Company and the Bank. The Code of Business Conduct and Ethics is a guide to help ensure that all employees live up to the highest ethical standards of behavior.

A copy of the Code of Business Conduct and Ethics is available on the Bank's website (www.peoplesbanknc.com) under Investor Relations.

As is permitted by SEC rules, the Company intends to post on its website any amendment to or waiver from any provision in the Code of Business Conduct and Ethics that applies to the Chief Executive Officer, the Chief Financial Officer, the Controller, or persons performing similar functions, and that relates to any element of the standards enumerated in the rules of the SEC.

Diversity of the Board of Directors

The Company and the Bank do not have written diversity policies. However, the Company and the Bank value diversity in society, and believe that the virtues and pursuit of diversity are just as important within the Company and the Bank. The Company and the Bank adhere to a policy prohibiting discrimination and harassment on the basis of legally protected characteristics, including sex, pregnancy, race, color, religion, national origin, veteran status, age, and disability. While there are currently no women or minorities serving on the Board of Directors, any qualified candidate receives equal consideration.

How can a shareholder nominate someone for election to the Board of Directors

Our Bylaws provide that in order to be eligible for consideration at the Annual Meeting of Shareholders, all nominations of directors, other than those made by the Governance Committee or the Board of Directors, must be in writing and must be delivered to the Secretary of the Company not less than 50 days nor more than 90 days prior to the meeting at which such nominations will be made. However, if less than 60 days' notice of the meeting is given to the shareholders, such nominations must be delivered to the Secretary of the Company not later than the close of business on the tenth day following the day on which the notice of meeting was mailed.

The Board of Directors may disregard any nominations that do not comply with these requirements. Upon the instruction of the Board of Directors, the inspector of voting for the Annual Meeting may disregard all votes cast for a nominee if the nomination does not comply with these requirements. Written notice of nominations should be directed to the Secretary of the Company.

Who serves on the Board of Directors of the Bank?

The Bank has ten directors currently serving on its Board of Directors, who are the same people who are currently directors of the Company.

Board Committees

During 2018, our Board of Directors had five standing committees, the Audit and Enterprise Risk Committee, the Governance Committee, the Compensation Committee, the Executive Committee and the Loan Sub-Committee. The voting members of these Committees are appointed by the Board of Directors annually from among its members. Certain of our executive officers also serve as non-voting, advisory members of these committees.

Executive Committee Executive Committee. The Executive Committee performs duties as assigned by the full Board of Directors. Actions taken by the Executive Committee must be approved by the full Board of Directors. The following persons currently serve on the Executive Committee: Directors R. Abernethy, J. Abernethy, Lineberger, Robinson and Terry, as well as the President and Chief Executive Officer of the Company in a non-voting capacity. It meets on an “as needed” basis and did not meet during 2018.

Governance Committee Governance Committee. The Governance Committee is responsible for developing and maintaining the corporate governance policy, as well as acting as the nominating committee for the Board of Directors. The following persons currently serve on the Governance Committee: Directors R. Abernethy, J. Abernethy, Howard, Terry, and Timmerman. All of the members of the Governance Committee are independent as defined in the applicable NASDAQ listing standards. The Board of Directors determines on an annual basis each director’s independence.

The Governance Committee, serving as the nominating committee of the Board of Directors, interviews candidates for membership to the Board of Directors, recommends candidates to the full Board of Directors, slates candidates for shareholder votes, and fills any vacancies on the Board of Directors which occur between shareholder meetings. The Governance Committee’s identification of candidates for director typically results from the business interactions of the members of the Governance Committee or from recommendations received from other directors or from the Company’s management.

If a shareholder recommends a director candidate to the Governance Committee in accordance with the Company’s Bylaws, the Governance Committee will consider the candidate and apply the same considerations that it would to its own candidates. The recommendation of a candidate by a shareholder should be made in writing, addressed to the attention of the Governance Committee at the Company’s corporate headquarters. The recommendation should include a description of the candidate’s background, his or her contact information, and any other information the shareholder considers useful and appropriate for the Governance Committee’s consideration of the candidate. The criteria which have been established by the Governance Committee as bearing on the consideration of a candidate’s qualification to serve as a director include the following: the candidate’s ethics, integrity, involvement in the community, success in business, relationship with the Bank, investment in the Company, place of residence (i.e., proximity to the Bank’s market area), and financial expertise.

The Governance Committee met once during the year ended December 31, 2018.

The Governance Committee has a written charter which is reviewed annually, and amended as needed, by the Governance Committee. A copy of the Governance Committee Charter is available onthe Bank’s website (www.peoplesbanknc.com) under Investor Relations.

Audit and Enterprise Risk Committee Audit and Enterprise Risk Committee. The Company has a separately designated standing Audit and Risk Enterprise Committee (the “Audit Committee”) which was established in accordance with Section 3(a)(58)(A) of the Exchange Act. The Audit Committee’s responsibilities include oversight of enterprise risk. The Audit Committee has a written charter which is reviewed annually, and amended as needed, by the Audit Committee. A copy of the Audit Committee Charter is available on the Bank’s website (www.peoplesbanknc.com) under Investor Relations. The

following persons currently serve on the Audit Committee: Directors R. Abernethy, J. Abernethy, Howard, Price, Timmerman and Zachary.

The Board of Directors has determined that each member of the Audit Committee is independent as that term is defined in the applicable NASDAQ listing standards and the SEC's regulations. The Board of Directors determines on an annual basis each director's independence. In addition, the Board of Directors has determined that each member of the Audit Committee qualifies as an "audit committee financial expert" based on each of the member's educational background and business experience.

The Audit Committee meets at least quarterly and, among other responsibilities, oversees (i) the independent auditing of the Company; (ii) the system of internal controls that management has established; and (iii) the quarterly and annual financial information to be provided to shareholders and the SEC. The Audit Committee met eight times during the year ended December 31, 2018.

Audit Committee Report. The Audit Committee has reviewed and discussed the audited financial statements with management of the Company and has discussed with the independent auditors the matters required to be discussed by Auditing Standards No. 16 as amended (AICPA, Professional Standards, Vol. 1 AU section 380) as adopted by the Public Company Accounting Oversight Board in Rule 3200T. In addition, the Audit Committee has received the written disclosures and the letter from the independent accountants required by the applicable requirements of the Public Company Accounting Oversight Board regarding the independent accountant's communications with the Audit Committee concerning independence, and has discussed with the independent accountant the independent accountant's independence. Based upon these reviews and discussions, the Audit Committee recommended to the Board of Directors that the audited financial statements be included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2018 for filing with the SEC.

| | |
|---|---|
| Robert C. Abernethy | Dan R. Timmerman, Sr. |
| Benjamin I. Zachary | James S. Abernethy |
| Douglas S. Howard | Billy L Price, Jr. MD, Committee Chair |

Compensation Committee. The Company's Compensation Committee is responsible for developing, reviewing, implementing and maintaining the Bank's salary, bonus, and incentive award programs and for making recommendations to the Company's and the Bank's Board of Directors regarding compensation of the executive officers. Upon recommendation from the Compensation Committee, the Company's Board of Directors ultimately determines such compensation.

All of the members of the Compensation Committee are independent as defined in the applicable NASDAQ's listing standards. The Board of Directors determines on an annual basis each director's independence. The following persons currently serve on the Compensation Committee: Directors R. Abernethy, J. Abernethy, Howard, Terry and Timmerman. The Compensation Committee met three times during the year ended December 31, 2018.

The Compensation Committee has a written charter which is reviewed annually, and amended as needed, by the Compensation Committee. A copy of the Compensation Committee's Charter is available on the Bank's website (www.peoplesbanknc.com) under Investor Relations.

Compensation Committee Interlocks and Insider Participation. No member of the Compensation Committee is now, or formerly was, an officer or employee of the Company or the Bank. None of the named executive officers serve as a member of the board of directors of another entity whose executive officers or directors serve on the Company's Board of Directors.

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Compensation Committee Report. The Compensation Committee has reviewed and discussed the Compensation Discussion and Analysis in this Proxy Statement with management and has recommended that it be included in this Proxy Statement and our Annual Report on Form 10-K filed with the SEC for the year ended December 31, 2018.

Compensation Committee
Robert C. Abernethy
James S. Abernethy
Douglas S. Howard
William Gregory Terry
Dan R. Timmerman, Sr., Committee Chair

Compensation Discussion and Analysis

The following Compensation Discussion and Analysis provides information with respect to the compensation paid during the year ended December 31, 2018 to our President and Chief Executive Officer, Lance A. Sellers, our Chief Financial Officer, A. Joseph Lampron, Jr. and William D. Cable, Sr. (together, our "named executive officers").

Compensation Committee Processes and Procedures. The Compensation Committee assists the Board of Directors in determining appropriate compensation levels for the members of the Board of Directors and our named executive officers. It also has strategic and administrative responsibility for a broad range of compensation issues. It seeks to ensure that we compensate key management employees effectively and in a manner consistent with the Compensation Committee's stated compensation strategy and relevant requirements of various regulatory entities. A part of these responsibilities is overseeing the administration of executive compensation and employee benefit plans, including the design, selection of participants, establishment of performance measures, and evaluation of awards pursuant to our annual and long-term incentive programs.

Compensation Philosophy. The overall objective of our executive compensation program is to align total compensation so that the individual executive believes it is fair and equitable and provides the highest perceived value to our shareholders and to that individual. In order to accomplish this overall objective, our executive compensation program is designed to: (i) attract qualified executives necessary to meet our needs as defined by the Company's strategic plans, and (ii) retain and motivate executives whose performance supports the achievement of our long-term plans and short-term goals. The executive compensation program is founded upon the idea that a strong, performance-oriented compensation program, which is generally consistent with the practices of our peers, is a key ingredient in becoming a leading performer among financial institutions of similar size, and is, therefore, in the best interests of our shareholders.

The Compensation Committee considers a number of factors specific to each executive's role when determining the amount and mix of compensation to be paid. These factors are:

compensation of the comparable executives at comparable financial institutions;

financial performance of the Company (especially on a "net operating" basis, which excludes the effect of one-time gains and expenses) over the most recent fiscal year and the prior three years;

composition of earnings;

asset quality relative to the banking industry;

responsiveness to the economic environment;

the Company's achievement compared to its corporate, financial, strategic and operational objectives and business plans; and

cumulative shareholder return.

Elements of the Executive Compensation Program. The Company's and the Bank's compensation program consists of the following elements:

Base Salary. The salaries of our named executive officers are designed to provide a reasonable level of compensation that is affordable to the Company and fair to the executive. Salaries are reviewed annually, and adjustments, if any, are made based on the review of competitive salaries in our peer group, as well as an evaluation of the individual officer's responsibilities, job scope, and individual performance. For example, we assess each officer's success in achieving budgeted earnings and return ratios, business conduct and integrity, and leadership and team building skills.

Annual Cash Incentive Awards. We believe that annual cash incentive awards encourage our named executive officers to achieve short-term targets that are critical to achievement of our long-term strategic plan. The Bank has a Management Incentive Plan for officers of the Bank. Participants in the Management Incentive Plan are recommended annually by the President and Chief Executive Officer to the Bank's Board of Directors. Each individual's incentive pool is determined by a formula which links attainment of corporate budget with attainment of individual goals and objectives. Incentives under the Management Incentive Plan are paid annually. No named executive officer earned or was paid a cash incentive under the Management Incentive Plan during the fiscal year ended December 31, 2018.

Discretionary Bonus and Service Awards. From time to time the Compensation Committee may recommend to the Board of Directors that additional bonuses be paid based on accomplishments that significantly exceed expectations during the fiscal year. These bonuses are totally discretionary as to who will receive a bonus and the amount of any such bonus. In 2018, the Compensation Committee recommended, and the Board of Directors approved, discretionary bonuses as follows: $90,000 for Mr. Sellers; $55,000 for Mr. Lampron; and $50,000 for Mr. Cable. These discretionary bonuses were paid in January of 2019. Under the Service Recognition Program, the Bank gives service awards to each employee and director for every five years of service with the Bank to promote longevity of service for both directors and employees. Service awards are made in the form of shares of the Company's common stock plus cash in the amount necessary to pay taxes on the award. The number of shares awarded increases with the number of years of service to the Bank.

Long-Term Equity Incentive Awards. The Company maintains the 2009 Omnibus Stock Ownership and Long Term Incentive Plan ("Omnibus Plan"), under which it is permitted to grant incentive stock options, restricted stock, restricted stock units, stock appreciation rights, book value shares, and performance units. The purpose of the Omnibus Plan is to promote the interests of the Company by attracting and retaining directors and employees of outstanding ability and to provide executives of the Company greater incentive to make material contributions to the success of the Company by providing them with stock-based compensation which will increase in value based upon the market performance of the common stock and/or the corporate achievement of financial and other performance objectives.

In making its decision to grant awards to the Company's named executive officers under the Omnibus Plan, the Compensation Committee considers all elements of such named executive officer's compensation. In considering the number of awards to grant to the Company's named executive officers, the Compensation Committee considers each named executive officer's contribution to the Company's performance.

The Company did not grant any plan-based awards to its named executive officers during the fiscal year ended December 31, 2018. See "Outstanding Equity Awards at Fiscal Year-End" on page 19 of this Proxy Statement and "Option Exercises and Stock Vested" on page 19 of this Proxy Statement for information on grants and vesting of restricted stock units to the named executed officers during the fiscal years ended December 31, 2012, 2013, 2014, 2015 and 2017. See "Omnibus Plan and Long Term Incentive Plan" starting on page 22 of this Proxy Statement for additional information on the Omnibus Plan.

Supplemental Executive Retirement Agreements. The Bank provides non-qualified supplemental executive retirement benefit in the form of Amended and Restated Executive Salary Continuation Agreements with Messrs. Sellers, Lampron and Cable. The Committee's goal is to provide competitive retirement benefits given the restrictions on

executives within tax-qualified plans. In prior years, the Compensation Committee worked with a compensation consultant in analyzing the possible benefits of using supplemental retirement benefits to address the issues of internal and external equity in terms of retirement benefits offered to all employees at the Company as a percentage of

final average pay and executives in our peer group. In connection with the non-qualified supplemental executive retirement benefits, the Bank purchased life insurance contracts on the lives of the named executive officers. The increase in cash surrender value of the life insurance contracts constitutes the Bank's contribution to the plan each year. The Bank will pay benefits to participating officers for a period between 13 years and the life of the officer. The Bank is the sole owner of all of the insurance contracts.

Profit Sharing Plan and 401(k) Plan. The Bank has a Profit Sharing Plan and 401(k) Plan for all eligible employees. The Bank made no contribution to the Profit Sharing Plan for the year ended December 31, 2018. No investments in Bank stock have been made by the plan. Under the Bank's 401(k) Plan, the Bank matches employee contributions to a maximum of 4.00% of annual compensation. The Bank's 2018 contribution to the 401(k) Plan pursuant to this formula was approximately $670,000. All contributions to the 401(k) Plan are tax deferred. The Profit Sharing Plan and 401(k) Plan permit participants to choose from investment funds which are selected by a committee comprised of senior management. Employees are eligible to participate in both the 401(k) Plan and Profit Sharing Plan beginning in the second month of employment. Both plans are now "safe harbor" plans, and all participants are immediately 100% vested in all employer contributions.

Deferred Compensation Plan. The Bank maintains a non-qualified deferred compensation plan for directors and certain officers. Eligible officers selected by the Bank's Board of Directors may elect to contribute a percentage of their compensation to the plan. Participating officers may elect to invest their deferred compensation in a restricted list of investment funds. The Bank may make matching or other contributions to the plan as well, in amounts determined at the discretion of the Bank. Participants are fully vested in all amounts contributed to the plan by them or on their behalf. The Bank has established a Rabbi Trust to hold the accrued benefits of the participants under the plan. There are no "above-market" returns provided for in this plan. The Bank made no contributions to the plan in 2018. Benefits under the plan are payable in the event of the participant's retirement, death, termination, or as a result of hardship. Benefit payments may be made in a lump sum or in installments, as selected by the participant.

Employment Agreements. The Company has employment agreements with each named executive officer, which the Board of Directors believes serve a number of functions, including (i) retention of the executive team; (ii) mitigation of any uncertainty about future employment and continuity of management in the event of a change in control; and (iii) protection of the Company and customers through non-compete and non-solicitation covenants. Additional information regarding the employment agreements, including a description of key terms may be found starting on page 21 of this Proxy Statement.

Other Benefits. Executive officers are entitled to participate in fringe benefit plans offered to employees including health and dental insurance plans and life, accidental death and dismemberment and long-term disability plans. In addition, the Bank has paid country club dues for each named executive officer and provides a car allowance to Mr. Sellers.

The above elements of each named executive officer's compensation are not inter-related. For example, if vesting standards on restricted stock awards are not achieved, the executive's base salary is not increased to make up the difference. Similarly, the value of previously granted options is not considered by the Compensation Committee in recommending the other elements of the compensation package.

The Compensation Committee did not engage a compensation consultant during the year ended December 31, 2018. The President and Chief Executive Officer of the Company and the Bank makes recommendations to the Committee regarding the compensation of the executive officers other than his own. The President and Chief Executive Officer participates in the deliberations, but not in the decisions, of the Compensation Committee regarding compensation of executive officers. He does not participate in the Compensation Committee's discussion or decisions regarding his own compensation. The Compensation Committee reports its actions to the Board of Directors and keeps written minutes of its meetings, which minutes are maintained with the books and records of the Company.

The Compensation Committee also considers the results of the shareholders' non-binding vote on executive compensation. At the 2013 Annual Meeting of Shareholders, 52% of the shareholders who voted at the 2013 Annual

Meeting of Shareholders elected to review the executive compensation of the Company's named executive officers once every three years. As a result, the Company submitted, in a non-binding advisory proposal, the executive compensation of the Company's named executive officers at the 2016 Annual Meeting of Shareholders. At the 2016 Annual Meeting of Shareholders, 94% of the shareholders who voted at the 2016 Annual Meeting of Shareholders approved the executive compensation of the Company's named executive officers as presented to the shareholders in the 2016 proxy statement. The Company, pursuant to this Proxy Statement, submits a vote to the shareholders on the compensation of its named executive officers and the frequency on which shareholders review such compensation.

2018 Compensation Disclosure Ratio of the Median Annual Total Compensation of All Company Employees to the Annual Total Compensation of the Company's Chief Executive Officer

We believe our executive compensation program must be consistent and internally equitable to motivate our employees to perform in ways that enhance shareholder value. We are committed to internal pay equity, and the Compensation Committee monitors the relationship between the pay of our executive officers and the pay of our non-executive employees. The Compensation Committee reviewed a comparison of our Chief Executive Officer's annual total compensation in fiscal year 2018 to that of all other Company employees (including all employees of the Bank) for the same period. The calculation of annual total compensation of all employees was determined in the same manner as the "Total Compensation" shown for our Chief Executive Officer in the "Summary Compensation Table" on page 18 of this Proxy Statement.

The calculation below includes all employees as of October 31, 2018.

The 2018 compensation disclosure ratio of the median annual total compensation of all Company employees to the annual total compensation of the Company's chief executive officer is as follows:

| | |
|---|---|
| Median Annual Total Compensation of All Employees (excluding Lance A. Sellers, Chief Executive Officer) | $45,051 |
| Annual Total Compensation of Lance A. Sellers, Chief Executive Officer | $517,278 |
| Ratio of the Median Annual Total Compensation of All Employees to the Annual Total Compensation of Lance A. Sellers, Chief Executive Officer | 11.48 |

Summary Compensation Table

The executive officers of the Company are not paid any cash compensation by the Company. However, the executive officers of the Company also are executive officers of the Bank and receive compensation from the Bank. The table on the following page show, for the fiscal years ended December 31, 2018, 2017 and 2016, the cash compensation received by, as well as certain other compensation paid or accrued for those years, to each named executive officer.

SUMMARY COMPENSATION TABLE

| Name and Principal Position | Year | Salary($) | Bonus($) | Stock Awards($)1 | Change in Pension Value and Nonqualified Deferred Compensation Earnings($) | All Other Compensation($)2 | Total($) |
|---|---|---|---|---|---|---|---|
| Lance A. Sellers | 2018 | 328,760 | 90,000 | - | 68,064 | 30,454 | 517,278 |
| President and Chief | 2017 | 319,185 | 55,000 | - | 62,493 | 29,080 | 465,758 |
| Executive Officer | 2016 | 319,185 | 50,000 | - | 57,312 | 31,775 | 458,271 |
| A. Joseph Lampron, Jr. | 2018 | 210,009 | 55,000 | - | 120,772 | 22,224 | 408,005 |
| Executive Vice President, | 2017 | 203,892 | 45,000 | - | 112,658 | 23,020 | 384,570 |
| Chief Financial Officer | 2016 | 197,653 | 40,000 | - | 102,893 | 24,307 | 365,153 |
| William D. Cable, Sr. | 2018 | 216,125 | 50,000 | - | 26,837 | 24,365 | 317,327 |
| Executive Vice President, | 2017 | 209,830 | 45,000 | - | 24,608 | 24,506 | 303,944 |
| Chief Operating Officer | 2016 | 203,179 | 40,000 | - | 22,540 | 25,500 | 291,759 |

1 Amount represents the aggregate grant date fair value computed in accordance with FASB ASC Topic 718. See Note 1 in the Notes to the Company's Consolidated Financial Statements included in the Company's Annual Report, which Annual Report is attached here to as Appendix A.
2 All other compensation is comprised of the following:

| Name and Principal Position | Year | Employer Match($) | Car Allowance($) | Country Club Dues($) | Split Dollar Death Benefit($) | Group Term Life($)(a) | Disability and LTC Premiums($)(b) | Dividends Accrued on Restricted Stock Units($) | Other($) |
|---|---|---|---|---|---|---|---|---|---|

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Lance A. Sellers President and Chief Executive Officer | 2018 | 11,000 | 2,888 | 3,730 | 539 | 2,900 | 5,628 | 1,270 | 2,500(c) |
| | 2017 | 10,800 | 2,888 | 3,636 | 501 | 3,456 | 5,628 | 2,171 | 0 |
| | 2016 | 10,600 | 4,113 | 3,576 | 480 | 2,376 | 5,628 | 5,002 | 0 |
| A. Joseph Lampron, Jr. Executive Vice President, Chief Financial Officer | 2018 | 10,610 | 0 | 3,630 | 1,359 | 3,688 | 1,984 | 952 | 0 |
| | 2017 | 10,800 | 0 | 3,460 | 1,234 | 3,951 | 1,984 | 1,591 | 0 |
| | 2016 | 9,096 | 0 | 3,380 | 1,139 | 3,863 | 1,984 | 3,570 | 1,275(d) |
| William D. Cable, Sr. Executive Vice President, Chief Operating Officer | 2018 | 10,795 | 0 | 3,730 | 463 | 2.050 | 6,375 | 952 | 0 |
| | 2017 | 10,675 | 0 | 3,636 | 433 | 1,796 | 6,375 | 1,591 | 0 |
| | 2016 | 8,699 | 0 | 4,676 | 405 | 1,775 | 6,375 | 3,570 | 0 |

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(a)
Represents amounts paid by the Bank for premiums on group term life insurance in excess of $50,000 for each named executive officer.

(b)
Represents amounts paid by the Bank for premiums on disability and long-term care insurance for each named executive officer.

(c)
In 2018, Mr. Sellers received 68 shares for 20 years of service with the Bank and $528 in cash to pay taxes associated with the award under the Bank’s Service Recognition Program.

(d)
In 2016, Mr. Lampron received 42 shares for 15 years of service with the Bank and $288 in cash to pay the taxes associated with the award under the Bank’s Service Recognition Program.

Grants of Plan-Based Awards

The Company did not grant any plan-based awards to the named executive officers during the fiscal year ended December 31, 2018.

Outstanding Equity Awards at Fiscal Year End

The following table shows certain information for those outstanding equity awards at December 31, 2018.

OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END TABLE

| | Stock Awards | | | |
|---|---|---|---|---|
| Name | Number of Shares or Units of Stock That Have Not Vested (#) | Market Value of Shares or Units of Stock That Have Not Vested ($) | Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#) | Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested(3) ($) |
| Lance A. Sellers | -- | -- | 2,442(1) | 59,731 |
| A. Joseph Lampron, Jr. | -- | -- | 1,832(2) | 44,798 |
| William D. Cable, Sr. | -- | -- | 1,832(2) | 44,798 |

(1) Represents 2,442 restricted stock units (adjusted for the 10% stock dividend granted in December 2017) that were granted on February 19, 2015 (with a grant date fair value for each restricted stock unit of $16.36 on February 19, 2015 (adjusted for the 10% stock dividend granted in December 2017)) and vested on February 19, 2019.

(2) Represents 1,832 restricted stock units (adjusted for the 10% stock dividend granted in December 2017) that were granted on February 19, 2015 (with a grant date fair value for each restricted stock unit of $16.36 on February 19, 2015 (adjusted for the 10% stock dividend granted in December 2017)) and vested on February 19, 2019.

(3) Based on a stock price of $24.46 per share on December 31, 2018.

Option Exercises and Stock Vested

No stock options or restricted stock units vested for each Messrs. Sellers, Lampron and Cable during the fiscal year ended December 31, 2018.

Pension Benefits

The following table shows, for the fiscal year ended December 31, 2018, the pension benefits paid or earned by Messrs. Sellers, Lampron and Cable.

PENSION BENEFITS TABLE

| Name | Plan Name | Number of Years Credited Service | Present Value of Accumulated Benefit($) | Payments During Last Fiscal Year($) |
|---|---|---|---|---|
| Lance A. Sellers | Amended and Restated Executive Salary Continuation Agreement1 | 17 | 501,171 | -- |
| A. Joseph Lampron, Jr. | Amended and Restated Executive Salary Continuation Agreement1,2 | 17 | 758,505 | -- |
| William D. Cable, Sr. | Amended and Restated Executive Salary Continuation Agreement1 | 17 | 188,590 | -- |

1 The Bank entered into Amended and Restated Executive Salary Continuation Agreement with Messrs. Sellers, Lampron and Cable effective on December 18, 2008. The Amended and Restated Executive Salary Continuation Agreements for Messrs. Sellers, Lampron and Cable were further amended on December 10, 2014, and such amendments were memorialized in a First Amendment to the Amended and Restated Executive Salary Continuation Agreements effective February 16, 2018. Unless a separation from service or a change in control (as defined in the Amended and Restated Executive Salary Continuation Agreements) occurs before the retirement age set forth in each Amended and Restated Executive Salary Continuation Agreement, the Amended and Restated Executive Salary Continuation Agreements provide for an annual supplemental retirement benefit to be paid to each of the named executive officers in 12 equal monthly installments payable on the first day of each month, beginning with the month immediately after the month in which the named executive officer attains the normal retirement age and for the named executive officer’s lifetime, or if longer, a 13-year term. Under the terms of the Amended and Restated Executive Salary Continuation Agreements, Mr. Sellers will receive an annual supplemental retirement benefit of $130,495, Mr. Lampron will receive an annual supplemental retirement benefit of $76,554 and Mr. Cable will receive an annual supplemental retirement benefit of $93,872.

2 As of December 31, 2018, Mr. Lampron was the only named executive officer eligible to withdraw funds from the plan. Mr. Lampron, if he elected, could withdrawal 100% of the annual benefit of $76,554.

Nonqualified Deferred Compensation

The below table shows the compensation deferred by Messrs. Lampron and Cable during the year ended December 31, 2018. Mr. Sellers elected not to defer any portion of his compensation during the year ended December 31, 2018.

NONQUALIFIED DEFERRED COMPENSATION TABLE

| Name | Executive Contributions in the Last FY ($)(1) | Registrant Contributions In Last FY ($) | Aggregate Earnings in Last FY ($)(2) | Aggregate Withdrawals/ Distributions ($) | Aggregate Balance at Last FYE ($)(3) |
|---|---|---|---|---|---|
| A. Joseph Lampron, Jr. | $6,612 | -- | $(49,297) | 0 | $212,773 |
| William D. Cable, Sr. | $17,830 | -- | $(84,529) | 0 | $488,990 |

(1)
The above contributions were based on the named executive officer's deferral elections and the salaries shown in the Summary Compensation Table. The salaries in the Summary Compensation Table include these contributions.
(2)
This column reflects earnings or losses on plan balances in 2018. Earnings may increase or decrease depending on the performance of the elected hypothetical investment options. Earnings on these plans are not "above-market" and thus are not reported in the Summary Compensation Table. Plan balances may be hypothetically invested in various mutual funds and common stock as described below. Investment returns on those funds and common stock ranged from (19.6%) to 2.40% for the year ended December 31, 2018.
(3)
This column represents the year-end balances of the named executive officer's nonqualified deferred compensation accounts. These balances include contributions that were included in the Summary Compensation Tables in previous years. Amounts in this column include earnings that were not previously reported in the Summary Compensation Table because they were not "above-market" earnings.

Employment Agreements

On January 22, 2015, the Company, the Bank and each of (i) Lance A. Sellers, the President and Chief Executive Officer of the Company and the Bank, (ii) A. Joseph Lampron, Jr., Executive Vice President and Chief Financial Officer of the Bank and Executive Vice President, Chief Financial Officer and Corporate Treasurer of the Company and (iii) William D. Cable, Sr., Executive Vice President and Chief Operating Officer of the Bank and Executive Vice President, Assistant Corporate Treasurer and Assistant Corporate Secretary of the Company executed an Employment Agreement which replaced and superseded such executive's prior employment agreement (collectively, the "Employment Agreements").

Each Employment Agreement provides for an initial term of 36 months beginning on January 22, 2015 (the "Effective Date"). On the first anniversary of the Effective Date and on each anniversary thereafter (the "Renewal Date"), each Employment Agreement shall be extended automatically for one additional year unless the Board of Directors of the Company (or the executive determines, and prior to the Renewal Date sends to the other party written notice, that the term shall not be extended. If the Board of Directors of the Company decides not to extend the term, the Employment Agreement shall nevertheless remain in force until its existing term expires. Under the Employment Agreements, the Bank will pay Mr. Sellers a base salary at the rate of at least $311,400 per year, Mr. Lampron a base salary at the rate of at least $193,125 per year and Mr. Cable a base salary at the rate of at least $198,750 per year ("Base Salary"). The Bank will review each executive's total compensation at least annually and in its sole discretion may adjust an

executive's total compensation from year to year, but during the term of the Employment Agreement, Mr. Sellers's Base Salary may not decrease below $311,400, Mr. Lampron's Base Salary may not decrease below $193,125 and Mr. Cable's Base Salary may not decrease below $198,750; provided, however, that periodic increases in Base Salary, once granted, may not be subject to revocation. In addition, the Employment Agreements provide for discretionary bonuses and participation in other management incentive, pension, profit-sharing, medical and retirement plans maintained by the Bank, as well as fringe benefits normally associated with such executive's office.

Under the Employment Agreements, each executive's employment will terminate automatically upon death. Otherwise, the Company and the Bank may terminate each executive's employment for "cause", "without cause" or in the

event of a “disability” (each as defined in the Employment Agreements). In addition, each executive may voluntarily terminate his employment upon 60 days prior written notice to the Company and the Bank or for “good reason” (as defined in the Employment Agreement). Under the Employment Agreements, if the Company and the Bank terminate an executive’s employment “without cause”, or an executive terminates his employment for “good reason”, in each case, other than in connection with a change of control, then in each case, the executive would be entitled to receive certain severance payments and access to welfare benefit plans as more particularly set forth in the Employment Agreements. Under the Employment Agreements, in the event that the Company and the Bank terminate an executive’s employment “without cause”, or an executive terminates his employment for “good reason”, in any such case at the time of or within one year after a Change of Control, then the executive will be entitled to receive certain change in control payments as more particularly set forth in the Employment Agreements.

In addition, each Employment Agreement contains certain restrictive covenants prohibiting the executive from competing against the Company and the Bank or soliciting the Company’s or the Bank’s customers for a period of time following termination of employment, all as more particularly set forth in the Employment Agreements.

Potential Payments upon Termination or Change in Control

Each of the Employment Agreements provide that in the event the Company terminates the employment of a named executive officers Without Cause (as defined in the Employment Agreements), or the officer terminates his or her employment for Good Reason (as defined in the Employment Agreements), in any such case during the employment and at the time of or within one year after a “change of control” (as defined in the Employment Agreements), the officer will be entitled to receive the following payments and benefits: (1) the Company will pay the officer the aggregate of the following amounts: (a) the sum of his accrued obligations; (b) the greater of his base salary, divided by 365 and multiplied by the number of days remaining in the employment period, or an amount equal to 2.99 times his base salary; and (c) the product of his aggregate cash bonus for the last completed fiscal year, and a fraction, the numerator of which is the number of days in the current fiscal year through the date of termination, and the denominator of which is 365; (2) all restricted stock or restricted stock unit awards previously granted to the executive and which have not already become vested and released from restrictions on transfer and repurchase an forfeiture rights, either as a result of the change of control or otherwise, shall immediately vest and be released from such restrictions as of the change of control termination date; and (3) all options previously granted to the officer that are unvested as of the change of control termination date will be deemed vested, fully exercisable and non-forfeitable as of the change of control termination date (other than transfer restrictions applicable to incentive stock options) and all previously granted options that are vested, but unexercised, on the change of control termination date will remain exercisable, in each case for the period during which they would have been exercisable absent the termination of his or her employment, except as otherwise specifically provided by the Internal Revenue Code; and (4) his benefits under all benefit plans that are non-qualified plans will be 100% vested, regardless of his age or years of service, as of the change of control termination date.

If the named executive officers were terminated on December 31, 2018, “without cause” or for “good reason” at the time of or within one year after a “change of control”, Mr. Sellers, Mr. Lampron and Mr. Cable would have been entitled to receive compensation of approximately $1,256,000, $795,000 and $798,000, respectively, pursuant to their Employment Agreements. These amounts are calculated based on each officer’s 2018 base salary and bonus as shown in the Summary Compensation Table. In addition, if a “change in control” (as defined in the Omnibus Plan) had occurred on December 31, 2018, all unvested restricted stock units previously granted to each of Mr. Sellers, Mr. Lampron and Mr. Cable would have vest immediately. On December 31, 2018, these unvested restricted stock units had a fair market value of $59,731, $44,798 and $44,798, respectively.

Omnibus Stock Option and Long Term Incentive Plan

The purpose of the Omnibus Plan is to promote the interests of the Company by attracting and retaining directors and employees of outstanding ability and to provide executive and other key employees of the Company and its subsidiaries greater incentive to make material contributions to the success of the Company by providing them with stock-based compensation which will increase in value based upon the market performance of the common stock and/or the corporate achievement of financial and other performance objectives.

Rights Which May Be Granted. Under the Omnibus Plan, the Committee may grant or award eligible participants stock options, rights to receive restricted shares of common stock, restricted stock units, performance units (each equivalent to one share of common stock), SARs, and/or book value shares. These grants and awards are referred to herein as "Rights." All Rights must be granted or awarded by February 19, 2019, the tenth anniversary of the date the Board of Directors adopted the Omnibus Plan. The Board of Directors has provided for 360,000 shares of the Company's common stock to be included in the Omnibus Plan to underlie Rights which may be granted thereunder.

Options. Options granted under the Omnibus Plan to eligible directors and employees may be either incentive stock options ("ISOs") or non-qualified stock options ("NSOs"). The exercise price of an ISO or NSO may not be less than 100% of the last-transaction price for the common stock quoted by the NASDAQ Stock Market on the date of grant.

Restricted Stock and Restricted Stock Units. The Committee may award Rights to acquire shares of common stock or restricted stock units, subject to certain transfer restrictions ("Restricted Stock" or "Restricted Stock Unit") to eligible participants under the Omnibus Plan for such purchase price per share, if any, as the Committee, in its discretion, may determine appropriate. The Committee will determine the expiration date for each Restricted Stock or Restricted Stock Unit award, up to a maximum of ten years from the date of grant. In the Committee's discretion, it may specify the period or periods of time within which each Restricted Stock or Restricted Stock Unit award will first become exercisable, which period or periods may be accelerated or shortened by the Committee. Under the terms of the Omnibus Plan, the Committee also has the discretion to pay out awards of Restricted Stock or Restricted Stock Units in the Company's common stock, cash or a combination of stock and cash.

Performance Units. Under the Omnibus Plan, the Committee may grant to eligible directors and employees awards of long term incentive performance units, each equivalent in value to one share of common stock ("Units"). Except as otherwise provided, Units awarded may be distributed only after the end of a performance period of two or more years, as determined by the Committee, beginning with the year in which the awards are granted.

The percentage of the Units awarded that are to be distributed will depend on the level of financial and other performance goals achieved by the Company during the performance period. The Committee may adopt one or more performance categories in addition to, or in substitution for, a performance category or may eliminate all performance categories other than financial performance.

As soon as practicable after each performance period, the percentage of Units awarded that are to be distributed, based on the levels of performance achieved, will be determined and distributed to the recipients of such awards in the form of a combination of shares of common stock and cash or cash only. Units awarded, but which the recipients are not entitled to receive, will be cancelled.

In the event of the death or disability of a Unit recipient prior to the end of any performance period, the number of Units awarded for such performance period will be reduced in proportion to the number of months remaining in the performance period after the date of death or disability. The remaining portion of the award, if any, may, in the discretion of the Committee, be adjusted based upon the levels of performance achieved prior to the date of death or disability, and distributed within a reasonable time after death or disability. In the event a recipient of Units ceases to be an eligible director or employee for any reason other than death or disability, all Units awarded, but not yet distributed, will be cancelled.

In the event of a change in control (as that term is defined in the Omnibus Plan), any outstanding Units will immediately and automatically be reduced as appropriate to reflect a shorter performance period.

An amount equal to the dividend payable on one share of common stock (a "dividend equivalent credit") will be determined and credited on the payment date to each Unit recipient's account for each Unit awarded and not yet

distributed or cancelled. Such amount will be converted within the account to an additional number of Units equal to the number of shares of common stock which could be purchased at the last-transaction price of the common stock on the NASDAQ Market on the dividend payment date.

No dividend equivalent credits or distribution of Units may be credited or made if, at the time of crediting or distribution, (i) the regular quarterly dividend on the common stock has been omitted and not subsequently paid or there exists any default in payment of dividends on any such outstanding shares of common stock; (ii) the rate of dividends on the common stock is lower than at the time the Units to which the dividend equivalent credit relates were awarded, adjusted for certain changes; (iii) estimated consolidated net income of the Company for the twelve-month period preceding the month the dividend equivalent credit or distribution would otherwise have been made is less than the sum of the amount of the dividend equivalent credits and Units eligible for distribution under the Omnibus Plan in that month plus all dividends applicable to such period on an accrual basis, either paid, declared or accrued at the most recently paid rate, on all outstanding shares of common stock; or (iv) the dividend equivalent credit or distribution would result in a default in any agreement by which the Company is bound.

If an extraordinary event occurs during a performance period which significantly alters the basis upon which the performance levels were established, the Committee may make adjustments which it deems appropriate in the performance levels. Such events may include changes in accounting practices, tax, financial institution laws or regulations or other laws or regulations, economic changes not in the ordinary course of business cycles, or compliance with judicial decrees or other legal requirements.

Stock Appreciation Rights. The Omnibus Plan provides that the Committee may award to eligible directors and employees Rights to receive cash based upon increases in the market price of common stock over the last transaction price of the common stock on the NASDAQ Stock Market (the “Base Price”) on the date of the award. The Committee may adjust the Base Price of a stock appreciation right (“SAR”) based upon the market value performance of the common stock in comparison with the aggregate market value performance of a selected index or at a stated annual percentage rate. The expiration date of a SAR may be no more than ten years from the date of award.

Each SAR awarded by the Committee may be exercisable immediately or may become vested over such period or periods as the Committee may establish, which periods may be accelerated or shortened in the Committee’s discretion. Each SAR awarded will terminate upon the expiration date established by the Committee, termination of the employment or directorship of the SAR recipient, or in the event of a change in control, as described above in connection with the termination of Options.

Book Value Shares. The Omnibus Plan provides that the Committee may award to eligible directors and eligible employees long term incentive units, each equivalent in value to the book value of one share of common stock on the date of award (“Book Value Shares”). The Committee will specify the period or periods of time within which each Book Value Share will vest, which period or periods may be accelerated or shortened by the Committee. Upon redemption, the holder of a Book Value Share will receive an amount equal to the difference between the book value of the common stock at the time the Book Value Share is awarded and the book value of the common stock at the time the Book Value Share is redeemed, adjusted for the effects of dividends, new share issuances, and mark-to-market valuations of the Company’s investment securities portfolio in accordance with generally accepted accounting principles.

The expiration date of each Book Value Share awarded will be established by the Committee, up to a maximum of ten years from the date of award. However, awards of Book Value Shares will terminate earlier in the same manner as described above in connection with the termination of Options.

Adjustments. In the event the outstanding shares of the common stock are increased, decreased, changed into or exchanged for a different number or kind of securities as a result of a stock split, reverse stock split, stock dividend, recapitalization, merger, share exchange acquisition, or reclassification, appropriate proportionate adjustments will be made in (i) the aggregate number or kind of shares which may be issued pursuant to exercise of, or which underlie, Rights; (ii) the exercise or other purchase price, or Base Price, and the number and/or kind of shares acquirable under, or underlying, Rights; and (iii) rights and matters determined on a per share basis under the Omnibus Plan. Any such

adjustment will be made by the Committee, subject to ratification by the Board of Directors. As described above, the Base Price of a SAR may also be adjusted by the Committee to reflect changes in a selected index. Except with regard to Units and Book Value Shares awarded under the Omnibus Plan, no adjustment in the Rights will be required by reason of the issuance of common stock, or securities convertible into common stock, by the Company for cash or the issuance of

shares of common stock by the Company in exchange for shares of the capital stock of any corporation, financial institution or other organization acquired by the Company or a subsidiary thereof in connection therewith.

Any shares of common stock allocated to Rights granted under the Omnibus Plan which are subsequently cancelled or forfeited will be available for further allocation upon such cancellation or forfeiture.

Director Compensation

Directors' Fees. Members of the Company's Board of Directors receive no fees or compensation for their service. However, all members of the Board of Directors are also directors of the Bank and are compensated for that service.

During the year ended December 31, 2018, each director received a fee of $1,000 for each Bank Board of Directors meeting attended, an additional fee of $750 for each committee meeting attended and a retainer of $12,000. In addition, the Chairman of the Bank's Board of Directors received an additional $250 per meeting attended and the chairpersons of each committee received an additional $150 per meeting attended. Directors receive $500 for special meetings held via conference call in lieu of the Board of Director and committee meeting fees set forth above.

Directors who are members of the Board of Directors of Real Estate Advisory Services, Inc., Peoples Investment Services, Inc. and PB Real Estate Holdings, LLC, and Community Bank Real Estate Solutions, LLC, subsidiaries of the Bank, receive $750 per meeting.

The Bank maintains a Service Recognition Program, under which directors, officers and employees are eligible for awards. Under the Service Recognition Program, directors, officers and employees are awarded a combination of common stock of the Company and cash in the amount necessary to pay taxes on the award, with the amount of the award based upon the length of service to the Bank. Any common stock awarded under the Service Recognition Program is purchased by the Bank on the open market, and no new shares are issued by the Company under the Service Recognition Program.

Directors' Stock Benefits Plan. Members of the Board of Directors are eligible to participate in the Company's Omnibus Plan. On March 22, 2012, the Company granted 891 Restricted Stock Units, each Restricted Stock Unit being comprised of the right to receive one share of the Company's common stock, to each director. The Restricted Stock Units awarded to directors on March 22, 2012 vested in full on March 22, 2017, and upon vesting, each Restricted Stock Unit had a market value of $25.91 for a total value of $23,085, which was distributed to each director in a combination of stock or cash, as chosen by each director. On May 23, 2013, the Company granted 891 Restricted Stock Units, each Restricted Stock Unit being comprised of the right to receive one share of the Company's common stock, to each director. The Restricted Stock Units awarded to directors on May 23, 2013 vested in full on May 23, 2017, and upon vesting, each Restricted Stock Unit had a market value of $24.94 for a total value of $22,218, which was distributed to each director in a combination of stock or cash, as chosen by each director. On February 20, 2014, the Company granted 715 Restricted Stock Units, each Restricted Stock Unit being comprised of the right to receive one share of the Company's common stock, to each director. The Restricted Stock Units awarded to directors on February 20, 2014 vested in full on February 20, 2017, and upon vesting, each Restricted Stock Unit had a market value of $24.78 for a total value of $17,719, which was distributed to each director in a combination of stock or cash, as chosen by each director. On February 19, 2015, the Company granted 413 Restricted Stock Units, each unit being comprised of the right to receive one share of the Company's common stock, to each director. The Restricted Stock Units awarded to directors on February 19, 2015 vested in full on February 19, 2019. The number of Restricted Stock Units granted and the grant date fair value of each Restricted Stock Unit have been restated to reflect the 10% stock dividend issued in December, 2017. The Company did not grant any plan-based awards to directors during the fiscal year ended December 31, 2018.

Directors' Deferred Compensation Plan. The Bank maintains a non-qualified deferred compensation plan for all of its directors. The Bank's directors are also directors of the Company. Under the deferred compensation plan, each director may defer all or a portion of his fees to the plan each year. The director may elect to invest the deferred compensation in a restricted list of investment funds. The Bank may make matching contributions to the plan for the benefit of the director from time to time at the discretion of the Bank. Directors are fully vested in all amounts they

contribute to the plan and in any amounts contributed by the Bank. The Bank has established a Rabbi Trust to hold the directors' accrued benefits under the plan. There are no "above-market" returns provided for in the deferred compensation plan. The Bank made no contributions to this plan in 2018.

Benefits under the plan are payable in the event of the director's death, resignation, removal, failure to be re-elected, retirement or in cases of hardship. Directors may elect to receive deferred compensation payments in one lump sum or in installments.

Directors' Supplemental Retirement Plan. The Bank maintains a non-qualified supplemental retirement benefits plan for all its directors. The supplemental retirement benefits plan is designed to provide a retirement benefit to the directors while at the same time minimizing the financial impact on the Bank's earnings. Under the supplemental retirement benefits plan, the Company purchased life insurance contracts on the lives of each director. The increase in cash surrender value of the contracts constitutes the Company's contribution to the supplemental retirement benefits plan each year. The Bank will pay annual benefits to each director for 15 years beginning upon retirement from the Board of Directors. The Bank is the sole owner of all of the insurance contracts.

The following table reports all forms of compensation paid to or accrued for the benefit of each director during the 2018 fiscal year.

DIRECTOR COMPENSATION

| Name | Fees Earned or Paid in Cash ($) | Stock Awards1 ($) | Option Awards ($) | Non-Equity Incentive Plan Compensation ($) | Change in Pension Value and Nonqualified Deferred Compensation Earnings2 ($) | All Other Compensation3 ($) | Total ($) |
|---|---|---|---|---|---|---|---|
| James S. Abernethy | 33.550 | -- | -- | -- | 8,106 | -- | 41,656 |
| Robert C. Abernethy | 40,200 | -- | -- | -- | 12,273 | -- | 52,473 |
| Douglas S. Howard | 34,300 | -- | -- | -- | 5,032 | -- | 39,332 |
| John W. Lineberger, Jr. | 25,800 | -- | -- | -- | 11,954 | -- | 37,754 |
| Gary E. Matthews | 24,800 | -- | -- | -- | 7,349 | -- | 32.149 |
| Billy L. Price, Jr., M.D. | 32,250 | -- | -- | -- | 6,647 | -- | 38,897 |
| Larry E. Robinson | 26,550 | -- | -- | -- | 6,279 | 3,750 | 36,579 |
| William Gregory Terry | 28,050 | -- | -- | -- | 2,463 | -- | 30,513 |
| Dan Ray Timmerman, Sr. | 36,100 | -- | -- | -- | 6,625 | -- | 42,725 |
| Benjamin I. Zachary | 30,800 | -- | -- | -- | 6.676 | -- | 37,476 |

1

The Company did not grant any plan-based awards to directors during the fiscal year ended December 31, 2018. At December 31, 2018, each director had an aggregate of 413 Restricted Stock Units (as adjusted for the 10% stock dividend granted in December of 2017) outstanding. See information above under the heading “Directors Stock Benefit Plan” for information on each individual grant of restricted stock units.

2

Change in Pension Value and Nonqualified Deferred Compensation Earnings represents the expense accrued by the Bank for each director under the Directors’ Supplemental Retirement Plan as described above.

3

In 2018, Director Robinson received 104 shares of PEBK stock and $750.00 in cash for his 25 years of service as a director under the Bank’s Service Recognition Program.

Indebtedness of and Transactions with Management and Directors

The Company is a “listed issuer” under the rules and regulations of the Exchange Act whose common stock is listed on NASDAQ. The Company uses the definition of independence contained in NASDAQ’s listing standards to determine the independence of its directors and that the Board of Directors and each standing committee of the Board of Directors is in compliance with NASDAQ listing standards for independence.

Certain directors and executive officers of the Bank and their immediate families and associates were customers of and had transactions with the Bank in the ordinary course of business during 2018. All outstanding loans, extensions of credit or overdrafts, endorsements and guarantees outstanding at any time during 2018 to the Bank’s executive officers and directors and their family members were made in the ordinary course of its business. These loans are currently made on substantially the same terms, including interest rates and collateral, as those then prevailing for comparable transactions with persons not related to the lender, and did not involve and directors and their family members were made in the ordinary course of its business. These loans are currently made on substantially the same terms, including interest rates and collateral, as those then prevailing for comparable transactions with persons not related to the lender, and did not involve more than the normal risk of collectability or present any other unfavorable features.

The Board of Directors routinely, and no less than annually, reviews all transactions, direct and indirect, between the Company or the Bank and any employee or director, or any of such person’s immediate family members. The standard applied to such transactions are to review such transactions for comparable market values for similar transactions. All material facts of the transactions and the director’s interest are discussed by all disinterested directors and a decision is made about whether the transaction is fair to the Company and the Bank. A majority vote of all disinterested directors is required to approve the transaction. See “Code of Business Conduct and Ethics” on page 11 of this Proxy Statement. During the fiscal year ended December 31, 2018, there were no related party transactions that would be required to be reported that were not reviewed in accordance with the above.

The Bank leases two of its facilities from Shortgrass Associates, L.L.C. (“Shortgrass”). Director John W. Lineberger, Jr. owns 25% of the membership interests in Shortgrass. Each of the facilities is subject to a 20-year lease between the Bank and Shortgrass. Pursuant to the terms of the leases for the two facilities leased by the Bank, during 2018 the Bank paid a total of $230,232 to Shortgrass in lease payments for these facilities, and the dollar value of Director John W. Lineberger, Jr.’s interest in such lease payments was approximately $57,558 (or 25% x $230,232). The total aggregate dollar value of all lease payments due by the Bank to Shortgrass starting on January 1, 2018 and continuing until the end of each lease, is $906,136, and the total aggregate dollar value of Director John W. Lineberger, Jr.’s interest in all such lease payments is approximately $226,534 (or 25% x $906,136).

The Board of Directors also evaluates the influence family relationships may have on the independence of directors who are related by blood or marriage. Christine S. Abernethy, a greater than ten percent (10%) shareholder of the Company, has two sons, Robert C. Abernethy and James S. Abernethy, who serve on the Board of Directors. All of the non-related directors have determined that the family relationships among Christine S. Abernethy, James S. Abernethy and Robert C. Abernethy do not affect the brothers’ independence as directors.

Equity Compensation Plan Information

The following table sets forth certain information regarding outstanding options and shares for future issuance under the Equity Compensation Plans as of December 31, 2018. Individual equity compensation arrangements are aggregated and included within this table. This table excludes any plan, contract or arrangement that provides for the issuance of options, warrants or other rights that are given to our shareholders on a pro rata basis and any employee benefit plan that is intended to meet the qualification requirements of Section 401(a) of the Internal Revenue Code.

| Plan Category | Number of securities to be issued upon exercise of outstanding option, warrants and rights (1), (2), (3) and (4) | Weighted-average exercise price of outstanding options, warrants and rights (3) | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (5) (6) |
|---|---|---|---|
| | (a) | (b) | (c) |
| Equity compensation plans approved by security holders | 29,526 | $24.46 | 280,933 |
| Equity compensation plans not approved by security holders | - | - | - |
| Total | 29,526 | $24.46 | 280,933 |

(1) Includes 16,583 restricted stock units (adjusted for the 10% stock dividend granted in December of 2017) granted on February 19, 2015 under the Omnibus Plan. These restricted stock grants vested on February 19, 2019.

(2) Includes 5,104

restricted stock units (adjusted for the 10% stock dividend granted in December of 2017) granted on February 18, 2016 under the Omnibus Plan. These restricted stock grants vest on February 20, 2020

(3) Includes 4,144 restricted stock units (adjusted for the 10% stock dividend granted in December, 2017) granted on March 1, 2017 under the Omnibus Plan. The restricted stock grants vest on March 1, 2021.

(4) Includes 3,725 restricted stock units

granted on January 24, 2018 under the Omnibus Plan. These restricted stock units vest on January 24, 2022.

(5) The exercise price used for the grants of restricted stock units under the Omnibus Plan is $24.46, the closing price for the Company's stock on December 31, 2018.

(6) Reflects shares currently reserved for possible issuance under the Omnibus Plan (adjusted for the 10% stock dividend granted in December, 2017).

STOCK PERFORMANCE GRAPH

The following graph compares the Company's cumulative shareholder return on its common stock with a NASDAQ index and with a southeastern bank index. The graph was prepared by S&P Global Market Intelligence, Charlottesville, Virginia, using data as of December 31, 2018

COMPARISON OF SIX-YEAR CUMULATIVE TOTAL RETURNS
Performance Report for
Peoples Bancorp of North Carolina, Inc.

29

PROPOSAL 2
ADVISORY (NON-BINDING) PROPOSAL TO APPROVE THE COMPENSATION OF THE COMPANY'S NAMED EXECUTIVE OFFICERS

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was signed into law on July 21, 2010. The Dodd-Frank Act requires that our shareholders be provided an opportunity to cast a separate advisory vote on the compensation paid to our named executive officers as disclosed in the compensation tables and related matches in this Proxy Statement.

The Company believes that our 2018 compensation policies and procedures are centered on a pay-for-performance culture and are strongly aligned with the long-term interests of our shareholders. These policies and procedures are described in detail in this Proxy Statement.

This proposal, commonly known as a "say-on-pay" proposal, gives you as a shareholder the opportunity to vote on the compensation of our named executive officers through the following resolution:

"RESOLVED, that the shareholders of Peoples Bancorp of North Carolina, Inc. approve the compensation of its Named Executive Officers named in the Summary Compensation Table in this Proxy Statement, as described in the narrative and the tabular disclosure regarding the compensation of the Named Executive Officers contained in this Proxy Statement."

Under the Dodd-Frank Act, your vote on this matter is advisory and will therefore not be binding upon the Board of Directors. However, the Compensation Committee will take the outcome of the vote into account when determining further executive compensation arrangements.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR THE APPROVAL OF THIS PROPOSAL.

PROPOSAL 3
ADVISORY (NON-BINDING) PROPOSAL ON THE FREQUENCY IN WHICH SHAREHOLDERS APPROVE THE COMPENSATION OF THE COMPANY'S NAMED EXECUTIVE OFFICERS

The Company is presenting the following proposal, which gives the shareholders the opportunity to inform the Company as to how often you wish the Company to include a proposal, similar to Proposal 2, in its Proxy Statement. This resolution is required pursuant to the Dodd-Frank Act. While our Board intends to carefully consider the shareholder vote resulting from the proposal, the final vote will not be binding on us and is advisory in nature.

"RESOLVED, that the shareholders wish the company to include an advisory vote on the overall compensation of the Company's named executive officers: (i) every year; (ii) every other year; or (iii) every three years."

The Board of Directors recommends that shareholders vote to hold an advisory vote on the overall compensation of the Company's named executive officers every three years.

The Board of Directors believes the three-year option is best as shareholder feedback would be more useful if the success of a compensation program is judged over a period of time.

THE BOARD OF DIRECTORS RECOMMENDS THAT THE SHAREHOLDERS VOTE TO HOLD AN ADVISORY VOTE ON THE OVERALL COMPENSATION OF THE COMPANY'S NAMED EXECUTIVE OFFICERS EVERY THREE YEARS.

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PROPOSAL 4
RATIFICATION OF SELECTION OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Elliott Davis, our registered independent public accounting firm for the fiscal year ended December 31, 2018, has been appointed by the Audit Committee as our registered independent public accounting firm for the fiscal year ending December 31, 2019, and you are being asked to ratify this appointment. Fees charged by this firm are at rates and upon terms that are customarily charged by other registered independent public accounting firms. A representative of the firm will be present at the Annual Meeting and will have an opportunity to make a statement if he or she desires to do so and to respond to appropriate questions.

Audit Fees Paid to Independent Auditors

The following table represents the approximate fees for professional services rendered by Elliott Davis for the audit of our annual financial statements and review of our financial statements included in our Forms 10-Q for the fiscal years ended December 31, 2018 and 2017 and fees billed for audit-related services, tax services and all other services rendered, for each of such years.

| | Year Ended December 31 | |
|---|---|---|
| | 2018 | 2017 |
| Audit Fees[1] | $194,626 | $188,250 |
| Audit-Related Fees[2] | $10,593 | $10,545 |
| Tax Fees[3] | $38,500 | $23,392 |
| All Other Fees | -- | -- |

_____

1
Includes amounts for the testing of management's assertions regarding internal controls in accordance with the Federal Deposit Insurance Corporation Improvement Act. Audit Fees include amounts for the integrated audit of the consolidated financial statements and internal control over financial reporting (Sarbanes-Oxley Section 404).
2
Represents amounts for the audit of the Company's Profit Sharing and 401(k) Plan and the testing of management's assertions regarding internal controls in accordance with the Federal Deposit Insurance Corporation Improvement Act.
3
Represents amounts for assistance in the preparation of our various federal, state and local tax returns.

All audit related services, tax services and other services giving rise to the fees listed under "Audit-Related Fees", "Tax Fees" and "All Other Fees" in the table above were pre-approved by the Audit Committee, which concluded that the provision of such services was compatible with the maintenance of that firm's independence in the conduct of its auditing functions. The Audit Committee's Charter provides for pre-approval of all audit and non-audit services to be provided by our independent auditors. The Charter authorizes the Audit Committee to delegate to one or more of its members pre-approval authority with respect to permitted services, provided that any such approvals are presented to the Audit Committee at its next scheduled meeting.

THE BOARD OF DIRECTORS RECOMMENDS THAT THE SHAREHOLDERS VOTE FOR RATIFICATION OF THE APPOINTMENT OF ELLIOTT DAVIS AS THE COMPANY'S INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE FISCAL YEAR ENDING DECEMBER 31, 2019.

DATE FOR RECEIPT OF SHAREHOLDER PROPOSALS

It is presently anticipated that the 2020 Annual Meeting of Shareholders of the Company will be held on May 7, 2020. In order for shareholder proposals to be included in the Company's proxy materials for that meeting, such proposals must be received by the Secretary of the Company at the Company's principal executive office no later than November 25, 2019 and meet all other applicable requirements for inclusion in the Proxy Statement.

In the alternative, a shareholder may commence his or her own proxy solicitation and present a proposal from the floor at the 2020 Annual Meeting of Shareholders of the Company. In order to do so, the shareholder must notify the Secretary of the Company in writing, at the Company's principal executive office no later than February 7, 2020, of his or her proposal. If the Secretary of the Company is not notified of the shareholder's proposal by February 7, 2020, the Board of Directors may vote on the proposal pursuant to the discretionary authority granted by the proxies solicited by the Board of Directors for the 2020 Annual Meeting of Shareholders.

OTHER MATTERS

Management knows of no other matters to be presented for consideration at the Annual Meeting or any adjournments thereof. If any other matters shall properly come before the Annual Meeting, it is intended that the proxyholders named in the enclosed form of proxy will vote the shares represented thereby in accordance with their judgment, pursuant to the discretionary authority granted therein.

MISCELLANEOUS

The Annual Report of the Company for the year ended December 31, 2018, which includes financial statements audited and reported upon by the Company's registered independent public accounting firm, is being mailed as Appendix A to this Proxy Statement; however, it is not intended that the Annual Report be deemed a part of this Proxy Statement or a solicitation of proxies.

THE FORM 10-K FILED BY THE COMPANY WITH THE SEC, INCLUDING THE FINANCIAL STATEMENTS AND SCHEDULES THERETO, WILL BE PROVIDED FREE OF CHARGE UPON WRITTEN REQUEST DIRECTED TO: PEOPLES BANCORP OF NORTH CAROLINA, INC., POST OFFICE BOX 467, 518 WEST C STREET, NEWTON, NORTH CAROLINA 28658-0467, ATTENTION: A. JOSEPH LAMPRON, JR.

By Order of the Board of Directors,
Lance A. Sellers
President and Chief Executive Officer
Newton, North Carolina
March 25, 2019

APPENDIX A

ANNUAL REPORT
OF
PEOPLES BANCORP OF NORTH CAROLINA, INC.

PEOPLES BANCORP OF NORTH CAROLINA, INC.

General Description of Business

Peoples Bancorp of North Carolina, Inc. (“Bancorp”), was formed in 1999 to serve as the holding company for Peoples Bank (the “Bank”). Bancorp is a bank holding company registered with the Board of Governors of the Federal Reserve System (the “Federal Reserve”) under the Bank Holding Company Act of 1956, as amended (the “BHCA”). Bancorp’s principal source of income is dividends declared and paid by the Bank on its capital stock, if any. Bancorp has no operations and conducts no business of its own other than owning the Bank. Accordingly, the discussion of the business which follows concerns the business conducted by the Bank, unless otherwise indicated. Bancorp and its wholly owned subsidiary, the Bank, along with the Bank’s wholly owned subsidiaries are collectively called the “Company”.

The Bank, founded in 1912, is a state-chartered commercial bank serving the citizens and business interests of the Catawba Valley and surrounding communities through 20 banking offices, as of December 31, 2018, located in Lincolnton, Newton, Denver, Catawba, Conover, Maiden, Claremont, Hiddenite, Hickory, Charlotte, Cornelius, Mooresville, Raleigh, and Cary North Carolina. The Bank also operates loan production offices in Denver and Durham, North Carolina. At December 31, 2018, the Company had total assets of $1.1 billion, net loans of $797.6 million, deposits of $877.2 million, total securities of $198.9 million, and shareholders’ equity of $123.6 million.

The Bank operates three banking offices focused on the Latino population that were formerly operated as a division of the Bank under the name Banco de la Gente (“Banco”). These offices are now branded as Bank branches and considered a separate market territory of the Bank as they offer normal and customary banking services as are offered in the Bank’s other branches such as the taking of deposits and the making of loans.

The Bank has a diversified loan portfolio, with no foreign loans and few agricultural loans. Real estate loans are predominately variable rate and fixed rate commercial property loans, which include residential development loans to commercial customers. Commercial loans are spread throughout a variety of industries with no one particular industry or group of related industries accounting for a significant portion of the commercial loan portfolio. The majority of the Bank’s deposit and loan customers are individuals and small to medium-sized businesses located in the Bank’s market area. The Bank’s loan portfolio also includes Individual Taxpayer Identification Number (ITIN) mortgage loans generated thorough the Bank’s Banco offices. Additional discussion of the Bank’s loan portfolio and sources of funds for loans can be found in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” on pages A-4 through A-23 of the Annual Report, which is included in this Form 10-K as Exhibit (13).

The operations of the Bank and depository institutions in general are significantly influenced by general economic conditions and by related monetary and fiscal policies of depository institution regulatory agencies, including the Federal Reserve, the Federal Deposit Insurance Corporation (the “FDIC”) and the North Carolina Commissioner of Banks (the “Commissioner”).

The Company’s fiscal year ends December 31. This Form 10-K is also being used as the Bank’s Annual Disclosure Statement under FDIC Regulations. This Form 10-K has not been reviewed, or confirmed for accuracy or relevance by the FDIC.

At December 31, 2018, the Company employed 310 full-time employees and 35 part-time employees, which equated to 334 full-time equivalent employees.

Subsidiaries

The Bank is a subsidiary of the Company. At December 31, 2018, the Bank had four subsidiaries, Peoples Investment Services, Inc., Real Estate Advisory Services, Inc., Community Bank Real Estate Solutions, LLC (“CBRES”) and PB Real Estate Holdings, LLC. Through a relationship with Raymond James Financial Services, Inc., Peoples Investment Services, Inc. provides the Bank’s customers access to investment counseling and non-deposit investment products such as stocks, bonds, mutual funds, tax deferred annuities, and related brokerage services. Real Estate Advisory Services, Inc. provides real estate appraisal and real estate brokerage services. CBRES serves as a “clearing-house” for appraisal services for community banks. Other banks are able to contract with CBRES to find and engage appropriate appraisal companies in the area where the property to be appraised is located. This type of service ensures that the appraisal process remains independent from the financing process within the Bank. PB Real Estate Holdings, LLC acquires, manages and disposes of real property, other collateral and other assets obtained in the ordinary course of collecting debts previously contracted.

In June 2006, the Company formed a wholly owned Delaware statutory trust, PEBK Capital Trust II ("PEBK Trust II"), which issued $20.0 million of guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures. All of the common securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase $20.6 million of junior subordinated debentures of the Company, which pay a floating rate equal to three-month LIBOR plus 163 basis points. The proceeds received by the Company from the sale of the junior subordinated debentures were used in December 2006 to repay the trust preferred securities issued in December 2001 by PEBK Capital Trust, a wholly owned Delaware statutory trust of the Company, and for general purposes. The debentures represent the sole asset of PEBK Trust II. PEBK Trust II is not included in the consolidated financial statements.

The trust preferred securities issued by PEBK Trust II accrue and pay quarterly at a floating rate of three-month LIBOR plus 163 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust II does not have funds with which to make the distributions and other payments. The net combined effect of the trust preferred securities transaction is that the Company is obligated to make the distributions and other payments required on the trust preferred securities.

These trust preferred securities are mandatorily redeemable upon maturity of the debentures on June 28, 2036, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust II, in whole or in part, which became effective on June 28, 2011. As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be the principal amount plus any accrued but unpaid interest.

This report contains certain forward-looking statements with respect to the financial condition, results of operations and business of the Company. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Company and on the information available to management at the time that these disclosures were prepared. These statements can be identified by the use of words like "expect," "anticipate," "estimate" and "believe," variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by the Bank, (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environment and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in the Company's other filings with the Securities and Exchange Commission. The Company undertakes no obligation to update any forward-looking statements.

SELECTED FINANCIAL DATA
Dollars in Thousands Except Per Share Amounts

| | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Summary of Operations | | | | | |
| Interest income | $45,350 | 41,949 | 39,809 | 38,666 | 38,420 |
| Interest expense | 2,146 | 2,377 | 3,271 | 3,484 | 4,287 |
| Net interest income | 43,204 | 39,572 | 36,538 | 35,182 | 34,133 |
| Provision for loan losses | 790 | (507) | (1,206) | (17) | (699) |
| Net interest income after provision for loan losses | 42,414 | 40,079 | 37,744 | 35,199 | 34,832 |
| Non-interest income (1) | 16,166 | 15,364 | 16,236 | 15,256 | 13,824 |
| Non-interest expense (1) | 42,574 | 41,228 | 42,242 | 37,722 | 37,331 |
| Earnings before income taxes | 16,006 | 14,215 | 11,738 | 12,733 | 11,325 |
| Income tax expense | 2,624 | 3,947 | 2,561 | 3,100 | 1,937 |
| Net earnings | $13,382 | 10,268 | 9,177 | 9,633 | 9,388 |
| Selected Year-End Balances | | | | | |
| Assets | $1,093,251 | 1,092,166 | 1,087,991 | 1,038,481 | 1,040,494 |
| Investment securities available for sale | 194,578 | 229,321 | 249,946 | 268,530 | 281,099 |
| Net loans | 797,578 | 753,398 | 716,261 | 679,502 | 640,809 |
| Mortgage loans held for sale | 680 | 857 | 5,709 | 4,149 | 1,375 |
| Interest-earning assets | 1,007,078 | 996,509 | 999,201 | 977,079 | 956,900 |
| Deposits | 877,213 | 906,952 | 892,918 | 832,175 | 814,700 |
| Interest-bearing liabilities | 657,110 | 679,922 | 698,120 | 679,937 | 722,991 |
| Shareholders' equity | $123,617 | 115,975 | 107,428 | 104,864 | 98,665 |
| Shares outstanding | 5,995,256 | 5,995,256 | 5,417,800 | 5,510,538 | 5,612,588 |
| Selected Average Balances | | | | | |
| Assets | $1,094,707 | 1,098,992 | 1,076,604 | 1,038,594 | 1,036,486 |
| Investment securities available for sale | 209,742 | 234,278 | 252,725 | 266,830 | 287,371 |
| Net loans | 777,098 | 741,655 | 703,484 | 669,628 | 631,025 |
| Interest-earning assets | 1,007,484 | 998,821 | 985,236 | 952,251 | 949,537 |
| Deposits | 903,120 | 895,129 | 856,313 | 816,628 | 808,399 |
| Interest-bearing liabilities | 665,165 | 700,559 | 705,291 | 707,611 | 731,786 |
| Shareholders' equity | $123,797 | 116,883 | 113,196 | 106,644 | 96,877 |
| Shares outstanding (2) | 5,995,256 | 5,988,183 | 6,024,970 | 6,115,159 | 6,177,233 |
| Profitability Ratios | | | | | |
| Return on average total assets | 1.22% | 0.93% | 0.85% | 0.93% | 0.91% |
| Return on average shareholders' equity | 10.81% | 8.78% | 8.11% | 9.03% | 9.69% |
| Dividend payout ratio | 23.41% | 25.67% | 22.95% | 16.34% | 10.89% |

| | | | | | |
|---|---|---|---|---|---|
| Liquidity and Capital Ratios (averages) | | | | | |
| Loan to deposit | 86.05% | 82.85% | 82.15% | 82.00% | 78.06% |
| Shareholders' equity to total assets | 11.31% | 10.64% | 10.51% | 10.27% | 9.35% |
| | | | | | |
| Per share of Common Stock (2) | | | | | |
| Basic net earnings | $2.23 | 1.71 | 1.53 | 1.57 | 1.52 |
| Diluted net earnings | $2.22 | 1.69 | 1.50 | 1.56 | 1.51 |
| Cash dividends | $0.52 | 0.44 | 0.35 | 0.25 | 0.16 |
| Book value | $20.62 | 19.34 | 18.03 | 17.30 | 15.98 |

(1)
Appraisal management fee income and expense from the Bank’s subsidiary, CBRES, was reported as a net amount prior to March 31, 2018, which was included in miscellaneous non-interest income. This income and expense is now reported on separate line items under non-interest income and non-interest expense. Prior periods have been restated to reflect this change.

(2)
Average shares outstanding and per share computations have been restated to reflect a 10% stock dividend paid during the fourth quarter of 2017.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS

The following is a discussion of our financial position and results of operations and should be read in conjunction with the information set forth under Item 1A Risk Factors in the Company's annual report on Form 10-K and the Company's consolidated financial statements and notes thereto on pages A-24 through A-68.

Introduction
Management's discussion and analysis of earnings and related data are presented to assist in understanding the consolidated financial condition and results of operations of Peoples Bancorp of North Carolina, Inc. ("Bancorp"), for the years ended December 31, 2018, 2017 and 2016. Bancorp is a registered bank holding company operating under the supervision of the Federal Reserve Board (the "FRB") and the parent company of Peoples Bank (the "Bank"). The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander, Mecklenburg, Iredell, Wake and Durham counties, operating under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation (the "FDIC").

Overview
Our business consists principally of attracting deposits from the general public and investing these funds in commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. Our profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment securities portfolios and our cost of funds, which consists of interest paid on deposits and borrowed funds. Net interest income also is affected by the relative amounts of our interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, a positive interest rate spread will generate net interest income. Our profitability is also affected by the level of other income and operating expenses. Other income consists primarily of miscellaneous fees related to our loans and deposits, mortgage banking income and commissions from sales of annuities and mutual funds. Operating expenses consist of compensation and benefits, occupancy related expenses, federal deposit and other insurance premiums, data processing, advertising and other expenses.

Our operations are influenced significantly by local economic conditions and by policies of financial institution regulatory authorities. The earnings on our assets are influenced by the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System (the "Federal Reserve"), inflation, interest rates, market and monetary fluctuations. Lending activities are affected by the demand for commercial and other types of loans, which in turn is affected by the interest rates at which such financing may be offered. Our cost of funds is influenced by interest rates on competing investments and by rates offered on similar investments by competing financial institutions in our market area, as well as general market interest rates. These factors can cause fluctuations in our net interest income and other income. In addition, local economic conditions can impact the credit risk of our loan portfolio, in that (1) local employers may be required to eliminate employment positions of individual borrowers, and (2) small businesses and commercial borrowers may experience a downturn in their operating performance and become unable to make timely payments on their loans. Management evaluates these factors in estimating the allowance for loan losses and changes in these economic factors could result in increases or decreases to the provision for loan losses.

Our business emphasis has been and continues to be to operate as a well-capitalized, profitable and independent community-oriented financial institution dedicated to providing quality customer service. We are committed to meeting the financial needs of the communities in which we operate. We expect growth to be achieved in our local markets and through expansion opportunities in contiguous or nearby markets. While we would be willing to consider growth by acquisition in certain circumstances, we do not consider the acquisition of another company to be necessary for our continued ability to provide a reasonable return to our shareholders. We believe that we can be more effective

in serving our customers than many of our non-local competitors because of our ability to quickly and effectively provide senior management responses to customer needs and inquiries. Our ability to provide these services is enhanced by the stability and experience of our Bank officers and managers.

The Federal Reserve maintained the Federal Funds rate at 0.25% from December 2008 to December 2015 before increasing the Fed Funds rate nine times since December 2015 to the Fed Funds rate of 2.50% at December 31, 2018. These increases have had a positive impact on earnings in recent periods and should continue to have a positive impact on the Bank’s net interest income in future periods.

The Company plans to open a Loan Production Office in the Ballantyne area of Charlotte, North Carolina during 2019. The Company does not have specific plans for additional offices in 2019 but will continue to look for growth opportunities in nearby markets and may expand if considered a worthwhile opportunity.

On August 31, 2015, the FDIC and the North Carolina Office of the Commissioner of Banks ("Commissioner") issued a Consent Order (the "Order") in connection with compliance by the Bank with the Bank Secrecy Act and its implementing regulations (collectively, the "BSA"). The Order was issued pursuant to the consent of the Bank. In consenting to the issuance of the Order, the Bank did not admit or deny any unsafe or unsound banking practices or violations of law or regulation.

The Order required the Bank to take certain affirmative actions to comply with its obligations under the BSA, including, without limitation, strengthening its Board of Directors' oversight of BSA activities; reviewing, enhancing, adopting and implementing a revised BSA compliance program; completing a BSA risk assessment; developing a revised system of internal controls designed to ensure full compliance with the BSA;reviewing and revising customer due diligence and risk assessment processes, policies and procedures; developing, adopting and implementing effective BSA training programs; assessing BSA staffing needs and resources and appointing a qualified BSA officer;establishing an independent BSA testing program; ensuring that all reports required by the BSA are accurately and properly filed and engaging an independent firm to review past account activity to determine whether suspicious activity was properly identified and reported.

During the third quarter of 2017 the Bank received notice that the Order was terminated effective August 30, 2017.

Summary of Significant and Critical Accounting Policies
The consolidated financial statements include the financial statements of Bancorp and its wholly owned subsidiary, the Bank, along with the Bank's wholly owned subsidiaries, Peoples Investment Services, Inc., Real Estate Advisory Services, Inc. ("REAS"), Community Bank Real Estate Solutions, LLC ("CBRES") and PB Real Estate Holdings, LLC (collectively called the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation.

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of specific accounting guidance. The following is a summary of some of the more subjective and complex accounting policies of the Company. A more complete description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2018 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 2, 2019 Annual Meeting of Shareholders.

The allowance for loan losses reflects management's assessment and estimate of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. The Bank periodically analyzes the loan portfolio in an effort to review asset quality and to establish an allowance for loan losses that management believes will be adequate in light of anticipated risks and loan losses.

Many of the Company's assets and liabilities are recorded using various techniques that require significant judgment as to recoverability. The collectability of loans is reflected through the Company's estimate of the allowance for loan losses. The Company performs periodic and systematic detailed reviews of its lending portfolio to assess overall collectability. In addition, certain assets and liabilities are reflected at their estimated fair value in the consolidated financial statements. Such amounts are based on either quoted market prices or estimated values derived from dealer quotes used by the Company, market comparisons or internally generated modeling techniques. The Company's internal models generally involve present value of cash flow techniques. The various techniques are discussed in greater detail elsewhere in this management's discussion and analysis and the Notes to Consolidated Financial Statements.

There are other complex accounting standards that require the Company to employ significant judgment in interpreting and applying certain of the principles prescribed by those standards. These judgments include, but are not limited to, the determination of whether a financial instrument or other contract meets the definition of a derivative in accordance with U.S. Generally Accepted Accounting Principles ("GAAP").

The disclosure requirements for derivatives and hedging activities are intended to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of, and gains and losses, on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company has an overall interest rate risk management strategy that has, in prior years, incorporated the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. When using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimized the credit risk in derivative instruments by entering into transactions with high-quality counterparties that were reviewed periodically by the Company. The Company did not have any interest rate derivatives outstanding as of December 31, 2018 or 2017.

Management of the Company has made a number of estimates and assumptions relating to reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare the accompanying consolidated financial statements in conformity with GAAP. Actual results could differ from those estimates.

Results of Operations

Summary. The Company reported earnings of $13.4 million or $2.23 basic net earnings per share and $2.22 diluted net earnings per share for the year ended December 31, 2018, as compared to $10.3 million or $1.71 basic net earnings per share and $1.69 diluted net earnings per share for the same period one year ago. The increase in year-to-date net earnings is primarily attributable to an increase in net interest income, an increase in non-interest income and a decrease in income tax expense, which were partially offset by an increase in the provision for loan losses and an increase in non-interest expense, as discussed below.

The Company reported earnings of $10.3 million or $1.71 basic net earnings per share and $1.69 diluted net earnings per share for the year ended December 31, 2017, as compared to $9.2 million or $1.53 basic net earnings per share and $1.50 diluted net earnings per share for the year ended December 31, 2016. The increase in year-to-date net earnings from 2016 to 2017 is primarily attributable to an increase in net interest income and a decrease in non-interest expense, which were partially offset by a decrease in non-interest income and a decrease in the credit to the provision for loan losses, as discussed below. Earnings for the year ended December 31, 2017 were reduced by a charge to income tax expense of $588,000 due to the revaluation of deferred taxes as required due to the passing of the Tax Cuts and Jobs Act (“TCJA”) in December, 2017. Without this charge to earnings, the Company would have had net earnings totaling $10.9 million for the year ended December 31, 2017.

The return on average assets in 2018 was 1.22%, compared to 0.93% in 2017 and 0.85% in 2016. The return on average shareholders’ equity was 10.81% in 2018 compared to 8.78% in 2017 and 8.11% in 2016.

Net Interest Income. Net interest income, the major component of the Company’s net income, is the amount by which interest and fees generated by interest-earning assets exceed the total cost of funds used to carry them. Net interest income is affected by changes in the volume and mix of interest-earning assets and interest-bearing liabilities, as well as changes in the yields earned and rates paid. Net interest margin is calculated by dividing tax-equivalent net interest income by average interest-earning assets, and represents the Company’s net yield on its interest-earning assets.

Net interest income for 2018 was $43.2 million compared to $39.6 million in 2017. The increase in net interest income was primarily due to a $3.4 million increase in interest income, which was primarily attributable to an increase in the average outstanding balance of loans and a 1.00% increase in the prime rate since December 31, 2017, combined with a $231,000 decrease in interest expense, which was primarily attributable to a decrease in the average outstanding balances of Federal Home Loan Bank (“FHLB”) borrowings during the year ended December 31, 2018, as compared to the same period one year ago due to the payoff of remaining FHLB borrowings in October 2017. Net interest income increased to $39.6 million in 2017 from $36.5 million in 2016.

Table 1 sets forth for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest incurred on such amounts and the average rate earned or incurred for the years ended

December 31, 2018, 2017 and 2016. The table also sets forth the average rate earned on total interest-earning assets, the average rate paid on total interest-bearing liabilities, and the net yield on total average interest-earning assets for the same periods. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields and interest income on tax-exempt investments have been adjusted to a tax equivalent basis using an effective tax rate of 22.98% for securities that are both federal and state tax exempt and an effective tax rate of 20.48% for federal tax exempt securities. Non-accrual loans and the interest income that was recorded on non-accrual loans, if any, are included in the yield calculations for loans in all periods reported.

Table 1- Average Balance Table

| | December 31, 2018 | | | December 31, 2017 | | | December 31, 2016 | | |
|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Average Balance | Interest | Yield / Rate | Average Balance | Interest | Yield / Rate | Average Balance | Interest | Yield / Rate |
| Interest-earning assets: | | | | | | | | | |
| Loans | $777,098 | 38,654 | 4.97% | $741,655 | 34,888 | 4.70% | 703,484 | 32,452 | 4.61% |
| Investments - taxable | 71,093 | 1,936 | 2.72% | 64,341 | 1,693 | 2.63% | 78,575 | 1,925 | 2.45% |
| Investments - nontaxable* | 142,832 | 5,508 | 3.86% | 173,069 | 7,314 | 4.23% | 178,379 | 7,577 | 4.25% |
| Other | 16,461 | 304 | 1.85% | 19,756 | 219 | 1.11% | 24,798 | 123 | 0.50% |
| Total interest-earning assets | 1,007,484 | 46,402 | 4.61% | 998,821 | 44,114 | 4.42% | 985,236 | 42,077 | 4.27% |
| Cash and due from banks | 41,840 | | | 53,805 | | | 44,732 | | |
| Other assets | 51,704 | | | 53,557 | | | 59,537 | | |
| Allowance for loan losses | (6,321) | | | (7,191) | | | (8,884) | | |
| Total assets | $1,094,707 | | | 1,098,992 | | | 1,080,621 | | |
| Interest-bearing liabilities: | | | | | | | | | |
| NOW, MMDA & savings deposits | $484,180 | 769 | 0.16% | $481,455 | 598 | 0.12% | 447,582 | 495 | 0.11% |
| Time deposits | 112,398 | 472 | 0.42% | 132,626 | 466 | 0.35% | 150,641 | 586 | 0.39% |
| FHLB borrowings | - | - | - | 16,329 | 662 | 4.05% | 42,903 | 1,661 | 3.87% |
| Trust preferred securities | 20,619 | 790 | 3.83% | 20,619 | 590 | 2.86% | 20,619 | 485 | 2.35% |
| Other | 47,968 | 115 | 0.24% | 49,530 | 61 | 0.12% | 43,546 | 44 | 0.10% |
| Total interest-bearing liabilities | 665,165 | 2,146 | 0.32% | 700,559 | 2,377 | 0.34% | 705,291 | 3,271 | 0.46% |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Demand deposits | 306,544 | | | 281,048 | | | 258,091 | |
| Other liabilities | (799) | | | 502 | | | 4,043 | |
| Shareholders' equity | 123,797 | | | 116,883 | | | 113,196 | |
| Total liabilities and shareholder's equity | $1,094,707 | | | 1,098,992 | | | 1,080,621 | |
| Net interest spread | | $44,256 | 4.29% | | $41,737 | 4.08% | | $38,806 | 3.81% |
| Net yield on interest-earning assets | | | 4.39% | | | 4.18% | | | 3.94% |
| Taxable equivalent adjustment | | | | | | | | |
| Investment securities | | $1,052 | | | $2,165 | | | $2,268 | |
| Net interest income | | $43,204 | | | $39,572 | | | $36,538 | |

*Includes U.S. Government agency securities that are non-taxable for state income tax purposes of $38.0 million in 2018, $40.3 million in 2017 and $38.7 million in 2016. The tax rates of 2.50%, 3.00% and 4.00% were used to calculate the tax equivalent yields on these securities in 2018, 2017 and 2016, respectively.

Changes in interest income and interest expense can result from variances in both volume and rates. Table 2 describes the impact on the Company’s tax equivalent net interest income resulting from changes in average balances and average rates for the periods indicated. The changes in interest due to both volume and rate have been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the changes in each.

Table 2 - Rate/Volume Variance Analysis-Tax Equivalent Basis

| | December 31, 2018 | | | December 31, 2017 | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | Changes in average volume | Changes in average rates | Total Increase (Decrease) | Changes in average volume | Changes in average rates | Total Increase (Decrease) |
| Interest income: | | | | | | |
| Loans: Net of unearned income | $1,715 | 2,051 | 3,766 | 1,778 | 658 | 2,436 |
| Investments - taxable | 181 | 62 | 243 | (362) | 130 | (232) |
| Investments - nontaxable | (1,222) | (584) | (1,806) | (225) | (38) | (263) |
| Other | (49) | 134 | 85 | (40) | 136 | 96 |
| Total interest income | 625 | 1,663 | 2,288 | 1,151 | 886 | 2,037 |
| Interest expense: | | | | | | |
| NOW, MMDA & savings deposits | 4 | 167 | 171 | 40 | 63 | 103 |
| Time deposits | (78) | 84 | 6 | (66) | (54) | (120) |
| FHLB / FRB Borrowings | (331) | (331) | (662) | (1,053) | 54 | (999) |
| Trust Preferred Securities | - | 200 | 200 | - | 105 | 105 |
| Other | (3) | 57 | 54 | 7 | 10 | 17 |
| Total interest expense | (408) | 177 | (231) | (1,072) | 178 | (894) |
| Net interest income | $1,033 | 1,486 | 2,519 | 2,223 | 708 | 2,931 |

Net interest income on a tax equivalent basis totaled $44.3 million in 2018 as compared to $41.7 million in 2017. The net interest rate spread, which represents the rate earned on interest-earning assets less the rate paid on interest-bearing liabilities, was 4.29% in 2018, as compared to a net interest rate spread of 4.08% in 2017. The net yield on interest-earning assets was 4.39% in 2018 and 4.18% in 2017.

Tax equivalent interest income increased $2.3 million in 2018 primarily due to an increase in interest income resulting from an increase in the average outstanding principal balance of loans, which was partially offset by a decrease in the average outstanding balance of investment securities. The average outstanding principal balance of loans increased $35.4 million to $777.1 million in 2018 compared to $741.7 million in 2017. The average outstanding balance of

investment securities decreased $23.5 million to $213.9 million in 2018 compared to $237.4 million in 2017. The yield on interest-earning assets was 4.61% in 2018 compared to 4.42% in 2017.

Interest expense decreased $231,000 in 2018 compared to 2017. The decrease in interest expense is primarily due to a decrease in the average outstanding balance of FHLB borrowings. Average interest-bearing liabilities decreased by $35.4 million to $665.2 million in 2018 compared to $700.6 million in 2017. The cost of funds decreased to 0.32% in 2018 from 0.34% in 2017.

In 2017 net interest income on a tax equivalent basis was $41.7 million compared to $38.8 million in 2016. The net interest spread was 4.08% in 2017 compared to 3.81% in 2016. The net yield on interest-earning assets was 4.18% in 2017 compared to 3.94% in 2016.

Provision for Loan Losses. Provisions for loan losses are charged to income in order to bring the total allowance for loan losses to a level deemed appropriate by management of the Company based on factors such as management’s judgment as to losses within the Bank’s loan portfolio, including the valuation of impaired loans, loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies and management’s assessment of the quality of the loan portfolio and general economic climate.

The provision for loan losses for the year ended December 31, 2018 was an expense of $790,000, as compared to a credit of $507,000 for the year ended December 31, 2017. The increase in the provision for loan losses is primarily attributable to a $44.2 million increase in loans from December 31, 2017 to December 31, 2018. The credits to provision for loan losses for the years ended December 31, 2017 and 2016 resulted from, and were considered appropriate as part of, management’s assessment and estimate of the risks in the total loan portfolio and determination of the total allowance for loan losses. The primary factors contributing to the continued decrease in the allowance for loan losses as a percent of total loans outstanding were the continuing positive trends in indicators of potential losses on loans, primarily non-accrual loans and the reduction in the level of net charge-offs since 2014, as shown in Table 3 below:

Table 3 - Net Charge-off Analysis

| | Net charge-offs/(recoveries) | | | | | Net charge-offs/(recoveries) as a percent of average loans outstanding | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Years ended December 31, | | | | | Years ended December 31, | | | | |
| (Dollars in thousands) | 2018 | 2017 | 2016 | 2015 | 2014 | 2018 | 2017 | 2016 | 2015 | 2014 |
| Real estate loans | | | | | | | | | | |
| Construction and land development | $43 | (14) | (3) | 153 | 456 | 0.05% | (0.02%) | (0.01%) | 0.25% | 0.78% |
| Single-family residential | 10 | 164 | 220 | 584 | 237 | 0.00% | 0.07% | 0.09% | 0.27% | 0.12% |
| Single-family residential - Banco de la Gente non-traditional | - | - | - | 95 | 174 | 0.00% | 0.00% | 0.00% | 0.21% | 0.36% |
| Commercial | 348 | (21) | 299 | 308 | 119 | 0.13% | (0.01%) | 0.12% | 0.13% | 0.05% |
| Multifamily and farmland | 4 | 66 | - | - | - | 0.01% | 0.23% | 0.00% | 0.00% | 0.00% |
| Total real estate loans | 405 | 195 | 516 | 1,140 | 986 | 0.06% | 0.03% | 0.09% | 0.20% | 0.18% |
| Loans not secured by real estate | | | | | | | | | | |
| Commercial loans | 22 | 163 | (25) | (64) | 376 | 0.02% | (0.03%) | (0.03%) | (0.07%) | 0.53% |
| Farm loans | - | - | - | - | - | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Consumer loans (1) | 284 | 319 | 342 | 400 | 358 | 3.11% | 3.10% | 3.38% | 4.00% | 3.63% |
| All other loans | - | - | - | - | - | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Total loans | $711 | 677 | 833 | 1,476 | 1,720 | 0.09% | 0.09% | 0.12% | 0.22% | 0.27% |
| Provision for (reduction of) | | | | | | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| loan losses for the period | $790 | (507) | (1,206) | (17) | (699) |
| Allowance for loan losses at end of period | $6,445 | 6,366 | 7,550 | 9,589 | 11,082 |
| Total loans at end of period | $804,023 | 759,764 | 723,811 | 689,091 | 651,891 |
| Non-accrual loans at end of period | $3,314 | 3,711 | 3,825 | 8,432 | 10,728 |
| Allowance for loan losses as a percent of total loans outstanding at end of period | 0.80% | 0.84% | 1.04% | 1.39% | 1.70% |
| Non-accrual loans as a percent of total loans outstanding at end of period | 0.41% | 0.49% | 0.53% | 1.22% | 1.65% |

(1) The loss ratio for consumer loans is elevated because overdraft charge-offs related to DDA and NOW accounts are reported in consumer loan charge-offs and recoveries. The net overdraft charge-offs are not considered material and are therefore not shown separately.

Please see the section below entitled “Allowance for Loan Losses” for a more complete discussion of the Bank’s policy for addressing potential loan losses.

Non-Interest Income. Non-interest income was $16.2 million for the year ended December 31, 2018, compared to $15.4 million for the year ended December 31, 2017. The increase in non-interest income is primarily attributable to a $893,000 increase in miscellaneous non-interest income, which was partially offset by a $339,000 decrease in mortgage banking income during the year ended December 31, 2018, as compared to the year ended December 31, 2017. The increase in miscellaneous non-interest income is primarily due to a $576,000 increase in net gains associated with the disposal of premises and equipment, as compared to the year ended December 31, 2017. The decrease in mortgage banking income is primarily due to a decrease in mortgage loan volume resulting from an increase in mortgage loan rates.

Non-interest income was $15.4 million for the year ended December 31, 2017, compared to $16.2 million for the year ended December 31, 2016. The decrease in non-interest income is primarily attributable to a $729,000 decrease in gains on the sale of securities, a $341,000 decrease in service charges and fees and a $238,000 decrease in mortgage banking income during the year ended December 31, 2017, as compared to the year ended December 31, 2016.

The Company periodically evaluates its investments for any impairment which would be deemed other-than-temporary. No investment impairments were deemed other-than-temporary in 2018, 2017 or 2016.

Table 4 presents a summary of non-interest income for the years ended December 31, 2018, 2017 and 2016.

Table 4 - Non-Interest Income

| (Dollars in thousands) | 2018 | 2017 | 2016 |
|---|---|---|---|
| Service charges | $4,355 | 4,453 | 4,497 |
| Other service charges and fees | 705 | 593 | 890 |
| Gain on sale of securities | 15 | - | 729 |
| Mortgage banking income | 851 | 1,190 | 1,428 |
| Insurance and brokerage commissions | 824 | 761 | 632 |
| Gain/(loss) on sale and write-down of other real estate | 17 | (239) | 64 |
| Visa debit card income | 3,911 | 3,757 | 3,589 |
| Appraisal management fee income | 3,206 | 3,306 | 3,146 |
| Miscellaneous | 2,282 | 1,543 | 1,261 |
| Total non-interest income | $16,166 | 15,364 | 16,236 |

Non-Interest Expense. Non-interest expense was $42.6 million for the year ended December 31, 2018, as compared to $41.2 million for the year ended December 31, 2017. The increase in non-interest expense was primarily due to a $1.5 million increase in salaries and benefits expense and a $469,000 increase in occupancy expense, which were partially offset by decreases in adverting expense, debit card expense and other non-interest expense, during the year ended December 31, 2018, as compared to the year ended December 31, 2017. The increase in salaries and benefits expense is primarily due to an increase in the number of full-time equivalent employees and annual salary increases. The increase in occupancy expense is primarily due to an increase in depreciation expense during the year ended December 31, 2018, as compared to the year ended December 31, 2017.

Non-interest expense was $41.2 million for the year ended December 31, 2017, as compared to $42.2 million for the year ended December 31, 2016. The decrease in non-interest expense was primarily due to a $1.2 million decrease in professional fees and a $878,000 decrease in other non-interest expense, which were partially offset by a $794,000 increase in salaries and benefits expense during the year ended December 31, 2017, as compared to the year ended December 31, 2016. The decrease in professional fees is primarily due to a $1.5 million decrease in consulting fees resulting from the termination of the Order. The decrease in other non-interest expense is primarily due to a $752,000 decrease in FHLB prepayment penalties and the increase in salaries and benefits expense is primarily due to an increase in the number of full-time equivalent employees, annual salary increases and an increase in expenses associated with restricted stock units due to an increase in the Company’s stock price.

Table 5 presents a summary of non-interest expense for the years ended December 31, 2018, 2017 and 2016.

Table 5 - Non-Interest Expense

| (Dollars in thousands) | 2018 | 2017 | 2016 |
|---|---|---|---|
| Salaries and employee benefits | $21,530 | 20,058 | 19,264 |
| Occupancy expense | 7,170 | 6,701 | 6,765 |
| Office supplies | 503 | 517 | 465 |
| FDIC deposit insurance | 328 | 347 | 494 |
| Visa debit card expense | 994 | 1,248 | 1,141 |
| Professional services | 513 | 451 | 182 |
| Postage | 249 | 258 | 224 |
| Telephone | 678 | 855 | 754 |
| Director fees and expense | 312 | 317 | 326 |
| Advertising | 922 | 1,195 | 1,136 |
| Consulting fees | 1,012 | 785 | 2,257 |
| Taxes and licenses | 288 | 263 | 272 |
| Foreclosure/OREO expense | 58 | 46 | 120 |
| Internet banking expense | 603 | 720 | 710 |
| FHLB advance prepayment penalty | - | 508 | 1,260 |
| Appraisal management fee expense | 2,460 | 2,526 | 2,260 |
| Other operating expense | 4,954 | 4,433 | 4,612 |
| Total non-interest expense | $42,574 | 41,228 | 42,242 |

Income Taxes. The Company reported income tax expense of $2.6 million, $3.9 million and $2.6 million for the years ended December 31, 2018, 2017 and 2016, respectively. The Company's effective tax rates were 16.39%, 28.03% and 21.82% in 2018, 2017 and 2016, respectively. Income tax expense for the year ended December 31, 2017 includes $588,000 additional tax expense due to the revaluation of the Company's deferred tax asset as a result of the TCJA, which reduced the Company's federal corporate tax rate from 34% to 21% effective January 1, 2018.

Liquidity. The objectives of the Company's liquidity policy are to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities and to satisfy regulatory requirements. Both deposit and loan customer cash needs can fluctuate significantly depending upon business cycles, economic conditions and yields and returns available from alternative investment opportunities. In addition, the Company's liquidity is affected by off-balance sheet commitments to lend in the form of unfunded commitments to extend credit and standby letters of credit. As of December 31, 2018, such unfunded commitments to extend credit were $268.7 million, while commitments in the form of standby letters of credit totaled $3.7 million.

The Company uses several funding sources to meet its liquidity requirements. The primary funding source is core deposits, which includes demand deposits, savings accounts and non-brokered certificates of deposits of denominations less than $250,000. The Company considers these to be a stable portion of the Company's liability mix and the result of on-going consumer and commercial banking relationships. As of December 31, 2018, the Company's core deposits totaled $859.2 million, or 98% of total deposits.

The other sources of funding for the Company are through large denomination certificates of deposit, including brokered deposits, federal funds purchased, securities under agreement to repurchase and FHLB borrowings. The Bank is also able to borrow from the FRB on a short-term basis. The Bank's policies include the ability to access wholesale fundingup to 40% of total assets. The Bank's wholesale funding includes FHLB borrowings, FRB borrowings, brokered deposits and internet certificates of deposit. The Company's ratio of wholesale funding to total assets was 0.31% as of December 31, 2018.

The Bank has a line of credit with the FHLB equal to 20% of the Bank's total assets, with no balances outstanding at December 31, 2018. At December 31, 2018, the carrying value of loans pledged as collateral totaled approximately $140.0 million. The remaining availability under the line of credit with the FHLB was $84.9 million at December 31, 2018. The Bank had no borrowings from the FRB at December 31, 2018. The FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At December 31, 2018, the carrying value of loans pledged as collateral to the FRB totaled approximately $442.6 million.

The Bank also had the ability to borrow up to $82.5 million for the purchase of overnight federal funds from six correspondent financial institutions as of December 31, 2018.

The liquidity ratio for the Bank, which is defined as net cash, interest-bearing deposits with banks, federal funds sold and certain investment securities, as a percentage of net deposits and short-term liabilities was 16.09%, 20.62% and 24.78% at December 31, 2018, 2017 and 2016, respectively. The minimum required liquidity ratio as defined in the Bank's Asset/Liability and Interest Rate Risk Management Policy for on balance sheet liquidity was 10% at December 31, 2018, 2017 and 2016.

As disclosed in the Company's Consolidated Statements of Cash Flows included elsewhere herein, net cash provided by operating activities was approximately $17.2 million during 2018. Net cash used in investing activities was $18.6 million during 2018 and net cash used by financing activities was $12.5 million during 2018.

Asset Liability and Interest Rate Risk Management. The objective of the Company's Asset Liability and Interest Rate Risk strategies is to identify and manage the sensitivity of net interest income to changing interest rates and to minimize the interest rate risk between interest-earning assets and interest-bearing liabilities at various maturities. This is done in conjunction with the need to maintain adequate liquidity and the overall goal of maximizing net interest income. Table 6 presents an interest rate sensitivity analysis for the interest-earning assets and interest-bearing liabilities for the year ended December 31, 2018.

Table 6 - Interest Sensitivity Analysis

| (Dollars in thousands) | Immediate | 1-3 months | 4-12 months | Total Within One Year | Over One Year & Non-sensitive | Total |
|---|---|---|---|---|---|---|
| Interest-earning assets: | | | | | | |
| Loans | $284,260 | 12,993 | 16,371 | 313,624 | 490,399 | 804,023 |
| Mortgage loans held for sale | 680 | - | - | 680 | - | 680 |
| Investment securities available for sale | - | 5,261 | 22,383 | 27,644 | 166,934 | 194,578 |
| Interest-bearing deposit accounts | 2,817 | - | - | 2,817 | - | 2,817 |
| Other interest-earning assets | - | - | - | - | 4,980 | 4,980 |
| Total interest-earning assets | 287,757 | 18,254 | 38,754 | 344,765 | 662,313 | 1,007,078 |
| Interest-bearing liabilities: | | | | | | |
| NOW, savings, and money market deposits | 475,223 | - | - | 475,223 | - | 475,223 |
| Time deposits | 11,574 | 13,990 | 36,365 | 61,929 | 41,244 | 103,173 |
| FHLB borrowings | - | - | - | - | - | - |
| Securities sold under agreement to repurchase | 58,095 | - | - | 58,095 | - | 58,095 |
| Trust preferred securities | - | 20,619 | - | 20,619 | - | 20,619 |
| Total interest-bearing liabilities | 544,892 | 34,609 | 36,365 | 615,866 | 41,244 | 657,110 |
| Interest-sensitive gap | $(257,135) | (16,355) | 2,389 | (271,101) | 621,069 | 349,968 |
| Cumulative interest-sensitive gap | $(257,135) | 273,490) | (271,101) | (271,101) | 349,968 | |
| Interest-earning assets as a percentage of interest-bearing liabilities | 52.81% | 52.74% | 106.57% | 55.98% | 1605.84% | |

The Company manages its exposure to fluctuations in interest rates through policies established by the Asset/Liability Committee (“ALCO”) of the Bank. The ALCO meets quarterly and has the responsibility for approving asset/liability management policies, formulating and implementing strategies to improve balance sheet positioning and/or earnings and reviewing the interest rate sensitivity of the Company. ALCO tries to minimize interest rate risk between interest-earning assets and interest-bearing liabilities by attempting to minimize wide fluctuations in net interest income due to interest rate movements. The ability to control these fluctuations has a direct impact on the profitability of the Company. Management monitors this activity on a regular basis through analysis of its portfolios to determine the difference between rate sensitive assets and rate sensitive liabilities.

The Company's rate sensitive assets are those earning interest at variable rates and those with contractual maturities within one year. Rate sensitive assets therefore include both loans and available for sale ("AFS") securities. Rate sensitive liabilities include interest-bearing checking accounts, money market deposit accounts, savings accounts, time deposits and borrowed funds. At December 31, 2018, rate sensitive assets and rate sensitive liabilities totaled $1.0 billion and $657.1 million, respectively.

Included in the rate sensitive assets are $279.1 million in variable rate loans indexed to prime rate subject to immediate repricing upon changes by the Federal Open Market Committee ("FOMC"). The Bank utilizes interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At December 31, 2018, the Bank had $161.4 million in loans with interest rate floors. The floors were in effect on $2.5 million of these loans pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 0.47% higher than the indexed rate on the promissory notes without interest rate floors.

An analysis of the Company's financial condition and growth can be made by examining the changes and trends in interest-earning assets and interest-bearing liabilities. A discussion of these changes and trends follows.

Analysis of Financial Condition

Investment Securities. The composition of the investment securities portfolio reflects the Company's investment strategy of maintaining an appropriate level of liquidity while providing a relatively stable source of income. The investment portfolio also provides a balance to interest rate risk and credit risk in other categories of the balance sheet while providing a vehicle for the investment of available funds, furnishing liquidity, and supplying securities to pledge as required collateral for certain deposits.

All of the Company's investment securities are held in the AFS category. At December 31, 2018, the market value of AFS securities totaled $194.6 million, compared to $229.3 million and $249.9 million at December 31, 2017 and 2016, respectively. Table 7 presents the fair value of the AFS securities held at December 31, 2018, 2017 and 2016.

Table 7 - Summary of Investment Portfolio

| (Dollars in thousands) | 2018 | 2017 | 2016 |
|---|---|---|---|
| U. S. Government sponsored enterprises | $34,634 | 40,380 | 38,222 |
| State and political subdivisions | 107,591 | 133,570 | 141,856 |
| Mortgage-backed securities | 52,103 | 53,609 | 67,585 |
| Corporate bonds | - | 1,512 | 1,533 |
| Trust preferred securities | 250 | 250 | 750 |
| Total securities | $194,578 | 229,321 | 249,946 |

The Company's investment portfolio consists of U.S. Government sponsored enterprise securities, municipal securities, U.S. Government sponsored enterprise mortgage-backed securities, corporate bonds, trust preferred securities and equity securities. AFS securities averaged $209.7 million in 2018, $234.3 million in 2017 and $252.7 million in 2016. Table 8 presents the book value of AFS securities held by the Company by maturity category at December 31, 2018. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields are calculated on a tax equivalent basis. Yields and interest income on tax-exempt investments have been adjusted to a tax equivalent basis using an effective tax rate of 22.98% for securities that are both federal and state tax exempt and an effective tax rate of 20.48% for federal tax exempt securities.

Table 8 - Maturity Distribution and Weighted Average Yield on Investments

| | | | After One Year | | After 5 Years | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | One Year or Less | | Through 5 Years | | Through 10 Years | | After 10 Years | | Totals | |
| (Dollars in thousands) | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield |
| Book value: | | | | | | | | | | |
| U.S. Government sponsored enterprises | $2,356 | -0.86% | 13,956 | 2.01% | 16,307 | 2.94% | 2,737 | 4.34% | 35,356 | 1.35% |
| State and political subdivisions | 19,023 | 3.80% | 66,976 | 3.17% | 15,965 | 3.28% | 3,581 | 3.95% | 105,545 | 3.52% |
| Mortgage-backed securities | 6,215 | 3.29% | 20,056 | 3.29% | 12,534 | 3.34% | 13,340 | 3.33% | 52,145 | 3.30% |
| Trust preferred securities | - | - | - | - | - | - | 250 | 8.11% | 250 | 8.11% |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Total securities | $27,594 | 2.99% | 100,988 | 3.05% | 44,806 | 3.10% | 19,908 | 3.91% | 193,296 | 3.14% |

Loans. The loan portfolio is the largest category of the Company's earning assets and is comprised of commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. The Bank grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg, Wake and Durham counties in North Carolina.

Although the Company has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by real estate, which is dependent upon the real estate market. Real estate mortgage loans include both commercial and residential mortgage loans. At December 31, 2018, the Company had $102.1 million in residential mortgage loans, $106.9 million in home equity loans and $376.6 million in commercial mortgage loans, which include $300.3 million secured by commercial property and $76.3 million secured by residential property. Residential mortgage loans include $34.3 million in non-traditional mortgage loans from the former Banco division of the Bank. All residential mortgage loans are originated as fully amortizing loans, with no negative amortization.

At December 31, 2018, the Bank had $94.1 million in construction and land development loans. Table 9 presents a breakout of these loans.

Table 9 - Construction and Land Development Loans

| (Dollars in thousands) | Number of Loans | Balance Outstanding | Non-accrual Balance |
|---|---|---|---|
| Land acquisition and development - commercial purposes | 44 | $9,777 | - |
| Land acquisition and development - residential purposes | 196 | 19,097 | 1 |
| 1 to 4 family residential construction | 137 | 26,933 | - |
| Commercial construction | 25 | 38,371 | - |
| Total acquisition, development and construction | 402 | $94,178 | 1 |

The mortgage loans originated in the traditional banking offices are generally 15 to 30 year fixed rate loans with attributes that prevent the loans from being sellable in the secondary market. These factors may include higher loan-to-value ratio, limited documentation on income, non-conforming appraisal or non-conforming property type. These loans are generally made to existing Bank customers and have been originated throughout the Bank's seven county service area, with no geographic concentration.

The composition of the Bank's loan portfolio at December 31 is presented in Table 10.

Table 10 -
Loan Portfolio

| | 2018 | | 2017 | | 2016 | | 2015 | | 2014 | |
|---|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Amount | % of Loans | Amount | % of Loans | Amount | % of Loans | Amount | % of Loans | Amount | % of Loans |
| Real estate loans | | | | | | | | | | |
| Construction and land development | $94,178 | 11.71% | 84,987 | 11.19% | 61,749 | 8.53% | 65,791 | 9.55% | 57,617 | 8.84% |
| Single-family residential | 252,983 | 31.47% | 246,703 | 32.47% | 240,700 | 33.25% | 220,690 | 32.03% | 206,417 | 31.66% |
| Single-family residential-Banco de la Gente non-traditional | 34,261 | 4.26% | 37,249 | 4.90% | 40,189 | 5.55% | 43,733 | 6.35% | 47,015 | 7.21% |
| Commercial | 270,055 | 33.59% | 248,637 | 32.73% | 247,521 | 34.20% | 228,526 | 33.16% | 228,558 | 35.06% |
| Multifamily and farmland | 33,163 | 4.12% | 28,937 | 3.81% | 21,047 | 2.91% | 18,080 | 2.62% | 12,400 | 1.90% |
| Total real estate loans | 684,640 | 85.15% | 646,513 | 85.10% | 611,206 | 84.44% | 576,820 | 83.71% | 552,007 | 84.68% |
| Loans not secured by real estate | | | | | | | | | | |
| Commercial loans | 97,465 | 12.12% | 89,022 | 11.71% | 87,596 | 12.11% | 91,010 | 13.22% | 76,262 | 11.71% |
| Farm loans | 926 | 0.12% | 1,204 | 0.16% | - | 0.00% | 3 | 0.00% | 7 | 0.00% |
| Consumer loans | 9,165 | 1.14% | 9,888 | 1.30% | 9,832 | 1.36% | 10,027 | 1.46% | 10,060 | 1.54% |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| All other loans | 11,827 | 1.47% | 13,137 | 1.73% | 15,177 | 2.10% | 11,231 | 1.63% | 13,555 | 2.08% |
| Total loans | 804,023 | 100.00% | 759,764 | 100.00% | 723,811 | 100.00% | 689,091 | 100.00% | 651,891 | 100.00% |
| Less: | | | | | | | | | | |
| Allowance for loan losses | 6,445 | | 6,366 | | 7,550 | | 9,589 | | 11,082 | |
| Net loans | $797,578 | | 753,398 | | 716,261 | | 679,502 | | 640,809 | |

As of December 31, 2018, gross loans outstanding were $804.0 million, compared to $759.8 million at December 31, 2017. Average loans represented 71% and 74% of total earning assets for the years ended December 31, 2018 and 2017, respectively. The Bank had $680,000 and $857,000 in mortgage loans held for sale as of December 31, 2018 and 2017, respectively.

Troubled debt restructured (“TDR”) modified in 2018, past due TDR loans and non-accrual TDR loans totaled $4.7 million and $4.5 million at December 31, 2018 and December 31, 2017, respectively. The terms of these loans have been renegotiated to provide a concession to original terms, including a reduction in principal or interest as a result of the deteriorating financial position of the borrower. There were $92,000 and $21,000 in performing loans classified as TDR loans at December 31, 2018 and December 31, 2017, respectively.

Table 11 identifies the maturities of all loans as of December 31, 2018 and addresses the sensitivity of these loans to changes in interest rates.

Table 11 - Maturity and Repricing Data for Loans

| (Dollars in thousands) | Within one year or less | After one year through five years | After five years | Total loans |
|---|---|---|---|---|
| Real estate loans | | | | |
| Construction and land development | $44,536 | 17,357 | 32,285 | 94,178 |
| Single-family residential | 118,229 | 88,338 | 46,416 | 252,983 |
| Single-family residential- Banco de la Gente stated income | 15,061 | - | 19,200 | 34,261 |
| Commercial | 82,210 | 141,347 | 46,498 | 270,055 |
| Multifamily and farmland | 4,560 | 14,761 | 13,842 | 33,163 |
| Total real estate loans | 264,596 | 261,803 | 158,241 | 684,640 |
| Loans not secured by real estate | | | | |
| Commercial loans | 56,679 | 23,910 | 16,876 | 97,465 |
| Farm loans | 691 | 235 | - | 926 |
| Consumer loans | 5,127 | 3,777 | 261 | 9,165 |
| All other loans | 6,130 | 3,042 | 2,655 | 11,827 |
| Total loans | $333,223 | 292,767 | 178,033 | 804,023 |
| Total fixed rate loans | $19,599 | 245,838 | 178,033 | 443,470 |
| Total floating rate loans | 313,624 | 46,929 | - | 360,553 |
| Total loans | $333,223 | 292,767 | 178,033 | 804,023 |

In the normal course of business, there are various commitments outstanding to extend credit that are not reflected in the financial statements. At December 31, 2018, outstanding loan commitments totaled $272.4 million. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the commitment contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Additional information regarding commitments is provided below in the section entitled “Contractual Obligations and Off-Balance Sheet Arrangements” and in Note 10 to the Consolidated Financial Statements.

Allowance for Loan Losses. The allowance for loan losses reflects management’s assessment and estimate of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. The Bank periodically analyzes the loan portfolio in an effort to review asset quality and to establish an allowance for loan losses that management believes will be adequate in light of anticipated risks and loan losses. In assessing the adequacy of the allowance, size,

quality and risk of loans in the portfolio are reviewed. Other factors considered are:

the Bank's loan loss experience;

the amount of past due and non-performing loans;

specific known risks;

the status and amount of other past due and non-performing assets;

underlying estimated values of collateral securing loans;

current and anticipated economic conditions; and

other factors which management believes affect the allowance for potential credit losses.

Management uses several measures to assess and monitor the credit risks in the loan portfolio, including a loan grading system that begins upon loan origination and continues until the loan is collected or collectability becomes doubtful. Upon loan origination, the Bank's originating loan officer evaluates the quality of the loan and assigns one of eight risk grades. The loan officer monitors the loan's performance and credit quality and makes changes to the credit grade as conditions warrant. When originated or renewed, all loans over a certain dollar amount receive in-depth reviews and risk assessments by the Bank's Credit Administration. Before making any changes in these risk grades, management considers assessments as determined by the third party credit review firm (as described below), regulatory examiners and the Bank's Credit Administration. Any issues regarding the risk assessments are addressed by the Bank's senior credit administrators and factored into management's decision to originate or renew the loan. The Bank's Board of Directors reviews, on a monthly basis, an analysis of the Bank's reserves relative to the range of reserves estimated by the Bank's Credit Administration.

As an additional measure, the Bank engages an independent third party to review the underwriting, documentation and risk grading analyses. This independent third party reviews and evaluates loan relationships greater than $1.0 million, excluding loans in default, and loans in process of litigation or liquidation. The third party's evaluation and report is shared with management and the Bank's Board of Directors.

Management considers certain commercial loans with weak credit risk grades to be individually impaired and measures such impairment based upon available cash flows and the value of the collateral. Allowance or reserve levels are estimated for all other graded loans in the portfolio based on their assigned credit risk grade, type of loan and other matters related to credit risk.

Management uses the information developed from the procedures described above in evaluating and grading the loan portfolio. This continual grading process is used to monitor the credit quality of the loan portfolio and to assist management in estimating the allowance for loan losses. The provision for loan losses charged or credited to earnings is based upon management's judgment of the amount necessary to maintain the allowance at a level appropriate to absorb probable incurred losses in the loan portfolio at the balance sheet date. The amount each quarter is dependent upon many factors, including growth and changes in the composition of the loan portfolio, net charge-offs, delinquencies, management's assessment of loan portfolio quality, the value of collateral, and other macro-economic factors and trends. The evaluation of these factors is performed quarterly by management through an analysis of the appropriateness of the allowance for loan losses.

The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment. When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Bank's loss exposure for each credit, given the appraised value of any underlying collateral. Loans for which specific reserves are provided are excluded from the general allowance calculations as described below.

The general allowance reflects reserves established under GAAP for collective loan impairment. These reserves are based upon historical net charge-offs using the greater of the last two, three, four or five years' loss experience. This charge-off experience may be adjusted to reflect the effects of current conditions. The Bank considers information derived from its loan risk ratings and external data related to industry and general economic trends in establishing reserves.

The unallocated allowance is determined through management's assessment of probable losses that are in the portfolio but are not adequately captured by the other two components of the allowance, including consideration of current economic and business conditions and regulatory requirements. The unallocated allowance also reflects management's acknowledgement of the imprecision and subjectivity that underlie the modeling of credit risk. Due to the subjectivity involved in determining the overall allowance, including the unallocated portion, the unallocated portion may fluctuate from period to period based on management's evaluation of the factors affecting the assumptions used in calculating the allowance.

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the year ended December 31, 2018 as compared to the year ended December 31, 2017. Revisions, estimates and assumptions may be made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

Effective December 31, 2012, certain mortgage loans from the former Banco division of the Bank were analyzed separately from other single family residential loans in the Bank's loan portfolio. These loans are first mortgage loans

made to the Latino market, primarily in Mecklenburg, North Carolina and surrounding counties. These loans are non-traditional mortgages in that the customer normally did not have a credit history, so all credit information was accumulated by the loan officers.

Various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require adjustments to the allowance based on their judgments of information available to them at the time of their examinations. Management believes it has established the allowance for credit losses pursuant to GAAP, and has taken into account the views of its regulators and the current economic environment. Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Bank's loan portfolio as of the date of the financial statements. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

Net charge-offs for 2018, 2017 and 2016 were $711,000, $677,000 and $833,000, respectively. The ratio of net charge-offs to average total loans was 0.09% in 2018, 0.09% in 2017 and 0.12% in 2016. The Bank strives to proactively work with its customers to identify potential problems. If found, the Bank works to quickly recognize identifiable losses and to establish a plan, with the borrower, if possible, to have the loans paid off. This process of early identification increased the levels of charge-offs and provision for loan losses in 2009 through 2013 as compared to historical periods prior to 2009. The years ended December 31, 2016, 2017 and 2018 saw net charge-offs at historically low levels.. The current level of past due and non-accrual loans currently indicate that net charge-offs may remain near these historical lows. The allowance for loan losses was $6.4 million or 0.80% of total loans outstanding at December 31, 2018. For December 31, 2017 and 2016, the allowance for loan losses amounted to $6.4 million or 0.84% of total loans outstanding and $7.6 million, or 1.04% of total loans outstanding, respectively.

Table 12 presents the percentage of loans assigned to each risk grade at December 31, 2018 and 2017.

Table 12 - Loan Risk Grade Analysis

| | Percentage of Loans By Risk Grade | |
|---|---|---|
| Risk Grade | 2018 | 2017 |
| Risk Grade 1 (Excellent Quality) | 0.94% | 1.31% |
| Risk Grade 2 (High Quality) | 25.47% | 26.23% |
| Risk Grade 3 (Good Quality) | 60.85% | 60.67% |
| Risk Grade 4 (Management Attention) | 10.19% | 8.19% |
| Risk Grade 5 (Watch) | 1.72% | 2.54% |
| Risk Grade 6 (Substandard) | 0.84% | 1.04% |
| Risk Grade 7 (Doubtful) | 0.00% | 0.00% |
| Risk Grade 8 (Loss) | 0.00% | 0.00% |

Table 13 presents an analysis of the allowance for loan losses, including charge-off activity.

Table 13 - Analysis of Allowance for Loan Losses

| (Dollars in thousands) | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| Allowance for loan losses at beginning | $6,366 | 7,550 | 9,589 | 11,082 | 13,501 |
| | | | | | |
| Loans charged off: | | | | | |
| Commercial | 54 | 194 | 146 | 38 | 430 |
| Real estate - mortgage | 574 | 315 | 593 | 1,064 | 789 |
| Real estate - construction | 53 | - | 7 | 197 | 884 |
| Consumer | 452 | 473 | 492 | 545 | 534 |
| Total loans charged off | 1,133 | 982 | 1,238 | 1,844 | 2,637 |
| | | | | | |
| Recoveries of losses previously charged off: | | | | | |
| Commercial | 32 | 31 | 170 | 101 | 54 |
| Real estate - mortgage | 212 | 106 | 74 | 77 | 259 |
| Real estate - construction | 10 | 14 | 10 | 45 | 428 |
| Consumer | 168 | 154 | 151 | 145 | 176 |
| Total recoveries | 422 | 305 | 405 | 368 | 917 |
| Net loans charged off | 711 | 677 | 833 | 1,476 | 1,720 |
| | | | | | |
| Provision for loan losses | 790 | (507) | (1,206) | (17) | (699) |
| | | | | | |
| Allowance for loan losses at end of year | $6,445 | 6,366 | 7,550 | 9,589 | 11,082 |
| | | | | | |
| Loans charged off net of recoveries, as a percent of average loans outstanding | 0.09% | 0.09% | 0.12% | 0.22% | 0.27% |
| | | | | | |
| Allowance for loan losses as a percent of total loans outstanding at end of year | 0.80% | 0.84% | 1.04% | 1.39% | 1.70% |

Non-performing Assets. Non-performing assets were $3.3 million or 0.31% of total assets at December 31, 2018, compared to $3.8 million or 0.35% of total assets at December 31, 2017. Non-performing loans include $3.2 million in commercial and residential mortgage loans, $1,000 in construction and land development loans and $99,000 in other loans at December 31, 2018, as compared to $3.6 million in commercial and residential mortgage loans, $14,000 in construction and land development loans and $112,000 in other loans at December 31, 2017. Other real estate owned totaled $27,000 and $118,000 as of December 31, 2018 and 2017, respectively. The Bank had no repossessed assets as of December 31, 2018 and 2017.

At December 31, 2018, the Bank had non-performing loans, defined as non-accrual and accruing loans past due more than 90 days, of $3.3 million or 0.41% of total loans. Non-performing loans at December 31, 2017 were $3.7 million or 0.49% of total loans.

Management continually monitors the loan portfolio to ensure that all loans potentially having a material adverse impact on future operating results, liquidity or capital resources have been classified as non-performing. Should economic conditions deteriorate, the inability of distressed customers to service their existing debt could cause higher levels of non-performing loans. Management expects the level of non-accrual loans to continue to be in-line with the level of non-accrual loans at December 31, 2018 and 2017.

It is the general policy of the Bank to stop accruing interest income when a loan is placed on non-accrual status and any interest previously accrued but not collected is reversed against current income. Generally a loan is placed on non-accrual status when it is over 90 days past due and there is reasonable doubt that all principal will be collected.

A summary of non-performing assets at December 31 for each of the years presented is shown in Table 14.

Table 14 - Non-performing Assets

| (Dollars in thousands) | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Non-accrual loans | $3,314 | 3,711 | 3,825 | 8,432 | 10,728 |
| Loans 90 days or more past due and still accruing | - | - | - | 17 | - |
| Total non-performing loans | 3,314 | 3,711 | 3,825 | 8,449 | 10,728 |
| All other real estate owned | 27 | 118 | 283 | 739 | 2,016 |
| Repossessed assets | - | - | - | - | - |
| Total non-performing assets | $3,341 | 3,829 | 4,108 | 9,188 | 12,744 |
| TDR loans not included in above, (not 90 days past due or on nonaccrual) | 3,173 | 2,543 | 3,337 | 5,102 | 7,217 |
| As a percent of total loans at year end | | | | | |
| Non-accrual loans | 0.41% | 0.49% | 0.53% | 1.22% | 1.65% |
| Loans 90 days or more past due and still accruing | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Total non-performing assets | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| as a percent of total assets at year end | 0.31% | 0.35% | 0.38% | 0.88% | 1.22% |
| | | | | | |
| Total non-performing loans as a percent of total loans at year-end | 0.41% | 0.49% | 0.53% | 1.23% | 1.65% |

Deposits. The Company primarily uses deposits to fund its loan and investment portfolios. The Company offers a variety of deposit accounts to individuals and businesses. Deposit accounts include checking, savings, money market and time deposits. As of December 31, 2018, total deposits were $877.2 million, compared to $907.0 million at December 31, 2017. Core deposits, which include demand deposits, savings accounts and non-brokered certificates of deposits of denominations less than $250,000, amounted to $859.2 million at December 31, 2018, compared to $887.4 million at December 31, 2017.

Time deposits in amounts of $250,000 or more totaled $16.2 million and $18.8 million at December 31, 2018 and 2017, respectively. At December 31, 2018, brokered deposits amounted to $3.4 million as compared to $5.2 million at December 31, 2017. Certificates of deposit participated through the Certificate of Deposit Account Registry Service (“CDARS”) included in brokered deposits amounted to $3.4 million and $5.2 million as of December 31, 2018 and 2017, respectively. Brokered deposits are generally considered to be more susceptible to withdrawal as a result of interest rate changes and to be a less stable source of funds, as compared to deposits from the local market. Brokered deposits outstanding as of December 31, 2018 have a weighted average rate of 0.07% with a weighted average original term of 41 months.

Table 15 is a summary of the maturity distribution of time deposits in amounts of $250,000 or more as of December 31, 2018.

Table 15 - Maturities of Time Deposits of $250,000 or greater

| (Dollars in thousands) | 2018 |
|---|---|
| Three months or less | $4,199 |
| Over three months through six months | 1,347 |
| Over six months through twelve months | 2,176 |
| Over twelve months | 8,517 |
| Total | $16,239 |

Borrowed Funds. The Company has access to various short-term borrowings, including the purchase of federal funds and borrowing arrangements from the FHLB and other financial institutions. There were no FHLB borrowings outstanding at December 31, 2018 and 2017. Average FHLB borrowings for 2018 and 2017 were zero and $16.3 million, respectively. The maximum amount of outstanding FHLB borrowings was $20.0 million in 2017. Additional information regarding FHLB borrowings is provided in Note 6 to the Consolidated Financial Statements.

The Bank had no borrowings from the FRB at December 31, 2018 and 2017. FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At December 31, 2018, the carrying value of loans pledged as collateral totaled approximately $442.6 million.

Securities sold under agreements to repurchase were $58.1 million at December 31, 2018, as compared to $37.8 million at December 31, 2017.

Junior subordinated debentures were $20.6 million as of December 31, 2018 and 2017.

Contractual Obligations and Off-Balance Sheet Arrangements. The Company’s contractual obligations and other commitments as of December 31, 2018 are summarized in Table 16 below. The Company’s contractual obligations include junior subordinated debentures, as well as certain payments under current lease agreements. Other commitments include commitments to extend credit. Because not all of these commitments to extend credit will be drawn upon, the actual cash requirements are likely to be significantly less than the amounts reported for other commitments below.

Table 16 - Contractual Obligations and Other Commitments

| (Dollars in thousands) | Within One Year | One to Three Years | Three to Five Years | Five Years or More | Total |
|---|---|---|---|---|---|

Contractual Cash Obligations

| | | | | | |
|---|---|---|---|---|---|
| Junior subordinated debentures | $- | - | - | 20,619 | 20,619 |
| Operating lease obligations | 734 | 1,416 | 703 | 1,465 | 4,318 |
| Total | $734 | 1,416 | 703 | 22,084 | 24,937 |
| | | | | | |
| Other Commitments | | | | | |
| Commitments to extend credit | $104,152 | 27,335 | 24,902 | 112,319 | 268,708 |
| Standby letters of credit and financial guarantees written | 3,651 | - | - | - | 3,651 |
| Income tax credits | 535 | 101 | 63 | 56 | 755 |
| Total | $108,338 | 27,436 | 24,965 | 112,375 | 273,114 |

The Company enters into derivative contracts to manage various financial risks. A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index or referenced interest rate. Derivative contracts are carried at fair value on the consolidated balance sheet with the fair value representing the net present value of expected future cash receipts or payments based on market interest rates as of the balance sheet date. Derivative contracts are written in amounts referred to as notional amounts, which only provide the basis for calculating payments between counterparties and are not a measure of financial risk. Therefore, the derivative amounts recorded on the balance sheet do not represent the amounts that may ultimately be paid under these contracts. Further discussions of derivative instruments are included above in the section entitled “Asset Liability and Interest Rate Risk Management” beginning on page A-11 and in Notes 1, 10 and 15 to the Consolidated Financial Statements. There were no derivatives at December 31, 2018 or 2017.

Capital Resources. Shareholders' equity was $123.6 million, or 11.31% of total assets, as of December 31, 2018, compared to $116.0 million, or 10.62% of total assets, as of December 31, 2017. The increase in shareholders' equity is primarily due to an increase in retained earnings due to net income.

Average shareholders' equity as a percentage of total average assets is one measure used to determine capital strength. Average shareholders' equity as a percentage of total average assets was 11.31%, 10.64% and 10.51% for 2018, 2017 and 2016, respectively. The return on average shareholders' equity was 10.81% at December 31, 2018 as compared to 8.78% and 8.11% at December 31, 2017 and December 31, 2016, respectively. Total cash dividends paid on common stock were $3.1 million, $2.6 million and $2.1 million during 2018, 2017 and 2016 respectively. The Company did not pay any dividends on preferred stock during 2018 and 2017.

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights.

In 2016, the Company's Board of Directors authorized a stock repurchase program, pursuant to which up to $2.0 million was allocated to repurchase the Company's common stock. Any purchases under the Company's stock repurchase program were made periodically as permitted by securities laws and other legal requirements in the open market or in privately negotiated transactions. The timing and amount of any repurchase of shares were determined by the Company's management, based on its evaluation of market conditions and other factors. The Company has repurchased approximately $2.0 million, or 92,738 shares of its common stock, under this program as of December 31, 2017.

In 2013, the FRB approved its final rule on the Basel III capital standards, which implement changes to the regulatory capital framework for banking organizations. The Basel III capital standards, which became effective January 1, 2015, include new risk-based capital and leverage ratios, which are being phased in from 2015 to 2019. The new minimum capital level requirements applicable to the Company and the Bank under the final rules are as follows: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total risk based capital ratio of 8% (unchanged from previous rules); and (iv) a Tier 1 leverage ratio of 4% (unchanged from previous rules). An additional capital conservation buffer was added to the minimum requirements for capital adequacy purposes beginning on January 1, 2016 at 0.625% and is being phased in through 2019 (increasing by 0.625% on each subsequent January 1, until it reaches 2.5% on January 1, 2019). This will result in the following minimum ratios beginning in 2019: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. Under the final rules, institutions would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained earnings that could be utilized for such actions.

Under the regulatory capital guidelines, financial institutions are currently required to maintain a total risk-based capital ratio of 8.0% or greater, with a Tier 1 risk-based capital ratio of 6.0% or greater and a common equity Tier 1 capital ratio of 4.5% or greater, as required by the Basel III capital standards referenced above. Tier 1 capital is generally defined as shareholders' equity and trust preferred securities less all intangible assets and goodwill. Tier 1 capital at December 31, 2018 and December 31, 2017 includes $20.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 15.46% and 15.32% at December 31, 2018 and December 31, 2017, respectively. Total risk-based capital is defined as Tier 1 capital plus supplementary capital. Supplementary capital, or Tier 2 capital, consists of the Company's allowance for loan losses, not exceeding 1.25% of the Company's risk-weighted assets. Total risk-based capital ratio is therefore defined as the ratio of total capital (Tier 1 capital and Tier 2 capital) to

risk-weighted assets. The Company's total risk-based capital ratio was 16.15% and 16.06% at December 31, 2018 and December 31, 2017, respectively. The Company's common equity Tier 1 capital consists of common stock and retained earnings. The Company's common equity Tier 1 capital ratio was 13.29% and 13.00% at December 31, 2018 and December 31, 2017, respectively. Financial institutions are also required to maintain a leverage ratio of Tier 1 capital to total average assets of 4.0% or greater. The Company's Tier 1 leverage capital ratio was 13.05% and 11.94% at December 31, 2018 and December 31, 2017, respectively.

The Bank's Tier 1 risk-based capital ratio was 15.21% and 15.09% at December 31, 2018 and December 31, 2017, respectively. The total risk-based capital ratio for the Bank was 15.91% and 15.83% at December 31, 2018 and December 31, 2017, respectively. The Bank's common equity Tier 1 capital ratio was 15.21% and 15.09% at December 31, 2018 and December 31, 2017, respectively. The Bank's Tier 1 leverage capital ratio was 12.76% and 11.69% at December 31, 2018 and December 31, 2017, respectively.

A bank is considered to be “well capitalized” if it has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 8.0% or greater, a common equity Tier 1 capital ratio of 6.5% or greater and a leverage ratio of 5.0% or greater. Based upon these guidelines, the Bank was considered to be “well capitalized” at December 31, 2018.

The Company’s key equity ratios as of December 31, 2018, 2017 and 2016 are presented in Table 17.

Table 17 - Equity Ratios

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Return on average assets | 1.22% | 0.93% | 0.85% |
| Return on average equity | 10.81% | 8.78% | 8.11% |
| Dividend payout ratio | 23.41% | 25.67% | 22.95% |
| Average equity to average assets | 11.31% | 10.64% | 10.51% |

Quarterly Financial Data. The Company’s consolidated quarterly operating results for the years ended December 31, 2018 and 2017 are presented in Table 18.

Table 18 - Quarterly Financial Data

| | 2018 | | | | 2017 | | | |
|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands, except per share amounts) | First | Second | Third | Fourth | First | Second | Third | Fourth |
| Total interest income | $10,759 | 11,059 | 11,608 | 11,924 | $10,064 | 10,461 | 10,698 | 10,726 |
| Total interest expense | 467 | 513 | 557 | 609 | 598 | 622 | 650 | 507 |
| Net interest income | 10,292 | 10,546 | 11,051 | 11,315 | 9,466 | 9,839 | 10,048 | 10,219 |
| (Reduction of) provision for loan losses | 31 | 231 | 110 | 418 | (236) | 49 | (218) | (102) |
| Other income | 3,736 | 4,016 | 3,915 | 4,499 | 3,442 | 3,929 | 4,159 | 3,834 |
| Other expense | 10,042 | 10,560 | 10,702 | 11,270 | 10,361 | 9,983 | 10,006 | 10,878 |
| Income before income taxes | 3,955 | 3,771 | 4,154 | 4,126 | 2,783 | 3,736 | 4,419 | 3,277 |
| Income taxes (benefit) | 652 | 595 | 687 | 690 | 578 | 925 | 1,177 | 1,267 |
| Net earnings | 3,303 | 3,176 | 3,467 | 3,436 | 2,205 | 2,811 | 3,242 | 2,010 |
| Basic net earnings per share | $0.55 | 0.53 | 0.58 | 0.57 | $0.36 | 0.47 | 0.54 | 0.34 |
| Diluted net earnings per share | $0.55 | 0.53 | 0.57 | 0.57 | $0.36 | 0.46 | 0.53 | 0.34 |

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk reflects the risk of economic loss resulting from adverse changes in market prices and interest rates. This risk of loss can be reflected in either diminished current market values or reduced potential net interest income in future periods.

The Company's market risk arises primarily from interest rate risk inherent in its lending and deposit taking activities. The structure of the Company's loan and deposit portfolios is such that a significant decline (increase) in interest rates may adversely (positively) impact net market values and interest income. Management seeks to manage the risk through the utilization of its investment securities and off-balance sheet derivative instruments. During the years ended December 31, 2018, 2017 and 2016, the Company used interest rate contracts to manage market risk as discussed above in the section entitled "Asset Liability and Interest Rate Risk Management."

Table 19 presents in tabular form the contractual balances and the estimated fair value of the Company's on-balance sheet financial instruments at their expected maturity dates for the period ended December 31, 2018. The expected maturity categories take into consideration historical prepayment experience as well as management's expectations based on the interest rate environment at December 31, 2018. For core deposits without contractual maturity (i.e. interest-bearing checking, savings, and money market accounts), the table presents principal cash flows based on management's judgment concerning their most likely runoff or repricing behaviors.

Table 19 - Market Risk Table

(Dollars in thousands)

| Loans Receivable | 2019 | 2020 | 2021 | 2022 | 2023 | Thereafter | Total | Fair Value |
|---|---|---|---|---|---|---|---|---|
| Fixed rate | $34,451 | 33,452 | 54,215 | 66,253 | 91,918 | 180,479 | 460,768 | 411,427 |
| Average interest rate | 4.90% | 4.95% | 4.78% | 4.88% | 5.24% | 5.03% | | |
| Variable rate | $65,371 | 31,409 | 22,619 | 22,166 | 33,255 | 169,115 | 343,935 | 344,615 |
| Average interest rate | 6.10% | 5.90% | 6.11% | 6.12% | 5.87% | 5.51% | | |
| Total | | | | | | | 804,703 | 756,042 |
| | | | | | | | | |
| Investment Securities | | | | | | | | |
| Interest bearing cash | $2,817 | - | - | - | - | - | 2,817 | 2,817 |
| Average interest rate | 2.35% | - | - | - | - | - | | |
| Securities available for sale | $21,207 | 18,467 | 16,674 | 22,980 | 22,387 | 92,863 | 194,578 | 194,578 |
| Average interest rate | 4.36% | 4.03% | 4.56% | 4.44% | 4.46% | 4.27% | | |
| Nonmarketable equity securities | $- | - | - | - | - | 4,361 | 4,361 | 4,361 |
| Average interest rate | - | - | - | - | - | 2.87% | | |
| | | | | | | | | |
| Debt Obligations | | | | | | | | |
| Deposits | $58,782 | 21,661 | 14,093 | 2,655 | 3,145 | 776,877 | 877,213 | 857,999 |
| Average interest rate | 0.24% | 0.42% | 0.62% | 0.65% | 0.98% | 0.05% | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Securities sold under agreement to repurchase | $58,095 | - | - | - | - | - | 58,095 | 58,095 |
| Average interest rate | 0.44% | - | - | - | - | - | | |
| Junior subordinated debentures | $- | - | - | - | - | 20,619 | 20,619 | 20,619 |
| Average interest rate | - | - | - | - | - | 4.42% | | |

Table 20 presents the simulated impact to net interest income under varying interest rate scenarios and the theoretical impact of rate changes over a twelve-month period referred to as “rate ramps.” The table shows the estimated theoretical impact on the Company’s tax equivalent net interest income from hypothetical rate changes of plus and minus 1%, 2% and 3% as compared to the estimated theoretical impact of rates remaining unchanged. The table also shows the simulated impact to market value of equity under varying interest rate scenarios and the theoretical impact of immediate and sustained rate changes referred to as “rate shocks” of plus and minus 1%, 2% and 3% as compared to the theoretical impact of rates remaining unchanged. The prospective effects of the hypothetical interest rate changes are based upon various assumptions, including relative and estimated levels of key interest rates. This type of modeling has limited usefulness because it does not allow for the strategies management would utilize in response to sudden and sustained rate changes. Also, management does not believe that rate changes of the magnitude presented are likely in the forecast period presented.

Table 20 - Interest Rate Risk

(Dollars in thousands)

| | Estimated Resulting Theoretical Net Interest Income | |
|---|---|---|
| Hypothetical rate change (ramp over 12 months) | Amount | % Change |
| +3% | $50,196 | 3.32% |
| +2% | $50,008 | 2.94% |
| +1% | $49,363 | 1.61% |
| 0% | $48,582 | 0.00% |
| -1% | $47,315 | -2.61% |
| -2% | $46,160 | -4.99% |
| -3% | $45,727 | -5.88% |

| | Estimated Resulting Theoretical Market Value of Equity | |
|---|---|---|
| Hypothetical rate change (immediate shock) | Amount | % Change |
| +3% | $183,598 | 8.06% |
| +2% | $188,528 | 10.96% |
| +1% | $184,838 | 8.79% |
| 0% | $169,908 | 0.00% |
| -1% | $145,669 | -14.27% |
| -2% | $114,949 | -32.35% |
| -3% | $91,103 | -46.38% |

PEOPLES BANCORP OF NORTH CAROLINA, INC.
Consolidated Financial Statements
December 31, 2018, 2017 and 2016

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Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of Peoples Bancorp of North Carolina, Inc.

Opinion on the Financial Statements
We have audited the accompanying consolidated balance sheets of Peoples Bancorp of North Carolina, Inc. and its subsidiaries (the Company) as of December 31, 2018 and 2017, the related consolidated statements of earnings, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2018, and the related notes to the consolidated financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2018, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 14, 2019 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion
These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Elliott Davis, PLLC

We have served as the Company's auditor since 2015.

Charlotte, North Carolina
March 14, 2019

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of Peoples Bancorp of North Carolina, Inc.:

Opinion on the Internal Control Over Financial Reporting
We have audited Peoples Bancorp of North Carolina, Inc.'s (the Company) internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets of the Company as of December 31, 2018 and 2017, the related consolidated statements of earnings, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2018, and the related notes to the consolidated financial statements and our report dated March 14, 2019 expressed an unqualified opinion.

Basis for Opinion
The Company’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting in the accompanying Management’s Annual Report on Internal Controls over Financial Reporting Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Elliott Davis, PLLC

Charlotte, North Carolina
March 14, 2019

PEOPLES BANCORP OF NORTH CAROLINA, INC.
Consolidated Balance Sheets
December 31, 2018 and December 31, 2017
(Dollars in thousands)

| Assets | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Cash and due from banks, including reserve requirements of $8,918 at 12/31/18 and $7,472 at 12/31/17 | $40,553 | 53,186 |
| Interest-bearing deposits | 2,817 | 4,118 |
| Cash and cash equivalents | 43,370 | 57,304 |
| Investment securities available for sale | 194,578 | 229,321 |
| Other investments | 4,361 | 1,830 |
| Total securities | 198,939 | 231,151 |
| Mortgage loans held for sale | 680 | 857 |
| Loans | 804,023 | 759,764 |
| Less allowance for loan losses | (6,445) | (6,366) |
| Net loans | 797,578 | 753,398 |
| Premises and equipment, net | 18,450 | 19,911 |
| Cash surrender value of life insurance | 15,936 | 15,552 |
| Other real estate | 27 | 118 |
| Accrued interest receivable and other assets | 18,271 | 13,875 |
| Total assets | $1,093,251 | 1,092,166 |
| Liabilities and Shareholders' Equity | | |
| Deposits: | | |
| Noninterest-bearing demand | $298,817 | 285,406 |
| NOW, MMDA & savings | 475,223 | 498,445 |
| Time, $250,000 or more | 16,239 | 18,756 |
| Other time | 86,934 | 104,345 |
| Total deposits | 877,213 | 906,952 |
| Securities sold under agreements to repurchase | 58,095 | 37,757 |
| Junior subordinated debentures | 20,619 | 20,619 |
| Accrued interest payable and other liabilities | 13,707 | 10,863 |
| Total liabilities | 969,634 | 976,191 |

| | | |
|---|---|---|
| Commitments (Note 10) | | |
| | | |
| Shareholders' equity: | | |
| Series A preferred stock, $1,000 stated value; authorized | | |
| 5,000,000 shares; no shares issued and outstanding | - | - |
| Common stock, no par value; authorized | | |
| 20,000,000 shares; issued and outstanding 5,995,256 shares | | |
| at December 31, 2018 and December 31, 2017 | 62,096 | 62,096 |
| Retained earnings | 60,535 | 50,286 |
| Accumulated other comprehensive income | 986 | 3,593 |
| Total shareholders' equity | 123,617 | 115,975 |
| | | |
| Total liabilities and shareholders' equity | $1,093,251 | 1,092,166 |

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC.
Consolidated Statements of Earnings
For the Years Ended December 31, 2018, 2017 and 2016
(Dollars in thousands, except per share amounts)

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Interest income: | | | |
| Interest and fees on loans | $38,654 | 34,888 | 32,452 |
| Interest on due from banks | 304 | 219 | 123 |
| Interest on investment securities: | | | |
| U.S. Government sponsored enterprises | 2,333 | 2,404 | 2,531 |
| States and political subdivisions | 3,877 | 4,236 | 4,454 |
| Other | 182 | 202 | 249 |
| Total interest income | 45,350 | 41,949 | 39,809 |
| Interest expense: | | | |
| NOW, MMDA & savings deposits | 769 | 598 | 495 |
| Time deposits | 472 | 466 | 586 |
| FHLB borrowings | - | 662 | 1,661 |
| Junior subordinated debentures | 790 | 590 | 485 |
| Other | 115 | 61 | 44 |
| Total interest expense | 2,146 | 2,377 | 3,271 |
| Net interest income | 43,204 | 39,572 | 36,538 |
| Provision for (reduction of) loan losses | 790 | (507) | (1,206) |
| Net interest income after provision for loan losses | 42,414 | 40,079 | 37,744 |
| Non-interest income: | | | |
| Service charges | 4,355 | 4,453 | 4,497 |
| Other service charges and fees | 705 | 593 | 890 |
| Gain on sale of securities | 15 | - | 729 |
| Mortgage banking income | 851 | 1,190 | 1,428 |
| Insurance and brokerage commissions | 824 | 761 | 632 |
| Appraisal management fee income | 3,206 | 3,306 | 3,146 |
| Gain (loss) on sales and write-downs of other real estate | 17 | (239) | 64 |
| Miscellaneous | 6,193 | 5,300 | 4,850 |
| Total non-interest income | 16,166 | 15,364 | 16,236 |
| Non-interest expense: | | | |
| Salaries and employee benefits | 21,530 | 20,058 | 19,264 |

| | | | |
|---|---|---|---|
| Occupancy | 7,170 | 6,701 | 6,765 |
| Professional fees | 1,525 | 1,236 | 2,439 |
| Advertising | 922 | 1,195 | 1,136 |
| Debit card expense | 994 | 1,248 | 1,141 |
| FDIC insurance | 328 | 347 | 494 |
| Appraisal management fee expense | 2,460 | 2,526 | 2,260 |
| Other | 7,645 | 7,917 | 8,743 |
| Total non-interest expense | 42,574 | 41,228 | 42,242 |
| | | | |
| Earnings before income taxes | 16,006 | 14,215 | 11,738 |
| | | | |
| Income tax expense | 2,624 | 3,947 | 2,561 |
| | | | |
| Net earnings | $13,382 | 10,268 | 9,177 |
| | | | |
| Basic net earnings per share | $2.23 | 1.71 | 1.53 |
| Diluted net earnings per share | $2.22 | 1.69 | 1.50 |
| Cash dividends declared per share | $0.52 | 0.44 | 0.35 |

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC.
Consolidated Statements of Comprehensive Income
For the Years Ended December 31, 2018, 2017 and 2016
(Dollars in thousands)

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Net earnings | $13,382 | 10,268 | 9,177 |
| Other comprehensive income (loss): | | | |
| Unrealized holding losses on securities available for sale | (3,370) | (355) | (3,274) |
| Reclassification adjustment for gains on securities available for sale included in net earnings | (15) | - | (729) |
| Total other comprehensive loss, before income taxes | (3,385) | (355) | (4,003) |
| Income tax benefit related to other comprehensive loss: | | | |
| Unrealized holding losses on securities available for sale | (774) | (354) | (1,196) |
| Reclassification adjustment for gains on securities available for sale included in net earnings | (4) | - | (284) |
| Total income tax benefit related to other comprehensive loss | (778) | (354) | (1,480) |
| Total other comprehensive loss, net of tax | (2,607) | (1) | (2,523) |
| Total comprehensive income | $10,775 | 10,267 | 6,654 |

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC.
Consolidated Statements of Changes in Shareholders' Equity
For the Years Ended December 31, 2018, 2017 and 2016
(Dollars in thousands)

| | Common Stock Shares | Common Stock Amount | Retained Earnings | Accumulated Other Comprehensive Income | Total |
|---|---|---|---|---|---|
| Balance, December 31, 2015 | 5,510,538 | $46,171 | 53,183 | 5,510 | 104,864 |
| Common stock repurchase | (92,738) | (1,984) | - | - | (1,984) |
| Cash dividends declared on common stock | - | - | (2,106) | - | (2,106) |
| Net earnings | - | - | 9,177 | - | 9,177 |
| Change in accumulated other comprehensive income, net of tax | - | - | - | (2,523) | (2,523) |
| Balance, December 31, 2016 | 5,417,800 | $44,187 | 60,254 | 2,987 | 107,428 |
| Cash dividends declared on common stock | - | - | (2,629) | - | (2,629) |
| 10% stock dividend | 544,844 | 16,994 | (17,000) | - | (6) |
| Restricted stock units exercised | 32,612 | 915 | - | - | 915 |
| Net earnings | - | - | 10,268 | - | 10,268 |
| Change in accumulated other comprehensive income due to Tax Cuts and Jobs Act | - | - | (607) | 607 | - |
| Change in accumulated other comprehensive income, net of tax | - | - | - | (1) | (1) |
| Balance, December 31, 2017 | 5,995,256 | $62,096 | 50,286 | 3,593 | 115,975 |
| Cash dividends declared on common stock | - | - | (3,133) | - | (3,133) |
| Net earnings | - | - | 13,382 | - | 13,382 |
| Change in accumulated other comprehensive income, net of tax | - | - | - | (2,607) | (2,607) |
| Balance, December 31, 2018 | 5,995,256 | $62,096 | 60,535 | 986 | 123,617 |

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC.
Consolidated Statements of Cash Flows
For the Years Ended December 31, 2018, 2017 and 2016
(Dollars in thousands)

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net earnings | $13,382 | 10,268 | 9,177 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | | |
| Depreciation, amortization and accretion | 4,571 | 5,018 | 5,423 |
| Provision for (reduction of) loan losses | 790 | (507) | (1,206) |
| Deferred income taxes | 78 | 2,120 | 1,097 |
| Gain on sale of investment securities | (15) | - | (729) |
| Gain on sale of other real estate | (17) | - | (81) |
| Write-down of other real estate | - | 239 | 17 |
| Gain on sale of premises and equipment | (544) | - | - |
| Restricted stock expense | 85 | 592 | 932 |
| Proceeds from sales of loans held for sale | 35,922 | 59,193 | 67,764 |
| Origination of loans held for sale | (35,745) | (54,341) | (69,324) |
| Change in: | | | |
| Cash surrender value of life insurance | (384) | (600) | (406) |
| Other assets | (3,695) | (3,982) | (636) |
| Other liabilities | 2,759 | 594 | 211 |
| Net cash provided by operating activities | 17,187 | 18,594 | 12,239 |
| Cash flows from investing activities: | | | |
| Purchases of investment securities available for sale | (34,692) | (10,014) | (12,707) |
| Proceeds from sales, calls and maturities of investment securities available for sale | 48,241 | 10,162 | 4,053 |
| Proceeds from paydowns of investment securities available for sale | 15,556 | 17,202 | 20,675 |
| Purchases of other investments | (2,611) | (45) | (255) |
| Proceeds from paydowns of other investment securities | 117 | - | - |
| Net change in FHLB stock | (4) | 850 | 1,256 |
| Net change in loans | (45,094) | (36,748) | (36,116) |
| Purchases of premises and equipment | (1,742) | (5,557) | (1,610) |
| Proceeds from sale of premises and equipment | 1,410 | - | - |
| Proceeds from sale of other real estate and repossessions | 232 | 44 | 1,083 |
| Net cash used by investing activities | (18,587) | (24,106) | (23,621) |

| | | | |
|---|---|---|---|
| Cash flows from financing activities: | | | |
| Net change in deposits | (29,739) | 14,034 | 60,743 |
| Net change in securities sold under agreement to repurchase | 20,338 | 1,323 | 8,560 |
| Proceeds from FHLB borrowings | - | 1 | 6,000 |
| Repayments of FHLB borrowings | - | (20,001) | (29,500) |
| Proceeds from FRB borrowings | 1 | 1 | 1 |
| Repayments of FRB borrowings | (1) | (1) | (1) |
| Proceeds from Fed Funds Purchased | 4,277 | 187 | 9,112 |
| Repayments of Fed Funds Purchased | (4,277) | (187) | (9,112) |
| Common stock repurchased | - | - | (1,984) |
| Cash dividends paid in lieu of fractional shares | - | (6) | - |
| Cash dividends paid on common stock | (3,133) | (2,629) | (2,106) |
| Net cash (used) provided by financing activities | (12,534) | (7,278) | 41,713 |
| Net change in cash and cash equivalents | (13,934) | (12,790) | 30,331 |
| Cash and cash equivalents at beginning of period | 57,304 | 70,094 | 39,763 |
| Cash and cash equivalents at end of period | $43,370 | 57,304 | 70,094 |

PEOPLES BANCORP OF NORTH CAROLINA, INC.
Consolidated Statements of Cash Flows, continued
For the Years Ended December 31, 2018, 2017 and 2016
(Dollars in thousands)

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Supplemental disclosures of cash flow information: | | | |
| Cash paid during the year for: | | | |
| Interest | $2,128 | 2,526 | 3,415 |
| Income taxes | $1,163 | 2,408 | 2,028 |
| Noncash investing and financing activities: | | | |
| Change in unrealized (loss) gain on investment securities available for sale, net | $(2,607) | (1) | (2,523) |
| Transfer of loans to other real estate and repossessions | $124 | 118 | 563 |
| Issuance of accrued restricted stock units | $- | (915) | - |

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC.

Notes to Consolidated Financial Statements

(1)
Summary of Significant Accounting Policies

Organization
Peoples Bancorp of North Carolina, Inc. (“Bancorp”) received regulatory approval to operate as a bank holding company on July 22, 1999, and became effective August 31, 1999. Bancorp is primarily regulated by the Board of Governors of the Federal Reserve System, and serves as the one-bank holding company for Peoples Bank (the “Bank”).

The Bank commenced business in 1912 upon receipt of its banking charter from the North Carolina Commissioner of Banks (the “Commissioner”). The Bank is primarily regulated by the Commissioner and the Federal Deposit Insurance Corporation (the “FDIC”) and undergoes periodic examinations by these regulatory agencies. The Bank, whose main office is in Newton, North Carolina, provides a full range of commercial and consumer banking services primarily in Catawba, Alexander, Lincoln, Mecklenburg, Iredell, Wake and Durham counties in North Carolina.

Peoples Investment Services, Inc. is a wholly owned subsidiary of the Bank and began operations in 1996 to provide investment and trust services through agreements with an outside party.

Real Estate Advisory Services, Inc. (“REAS”) is a wholly owned subsidiary of the Bank and began operations in 1997 to provide real estate appraisal and property management services to individuals and commercial customers of the Bank.

Community Bank Real Estate Solutions, LLC (“CBRES”) is a wholly owned subsidiary of the Bank and began operations in 2009 as a “clearing house” for appraisal services for community banks. Other banks are able to contract with CBRES to find and engage appropriate appraisal companies in the area where the property is located.

PB Real Estate Holdings, LLC (“PBREH”) is a wholly owned subsidiary of the Bank and began operation in 2015. PBREH acquires, manages and disposes of real property, other collateral and other assets obtained in the ordinary course of collecting debts previously contracted.

The Bank operates three banking offices focused on the Latino population that were formerly operated as a division of the Bank under the name Banco de la Gente (“Banco”). These offices are now branded as Bank branches and considered a separate market territory of the Bank as they offer normal and customary banking services as are offered in the Bank’s other branches such as the taking of deposits and the making of loans.

Principles of Consolidation
The consolidated financial statements include the financial statements of Bancorp and its wholly owned subsidiary, the Bank, along with the Bank’s wholly owned subsidiaries, Peoples Investment Services, Inc., REAS, CBRES and PBREH (collectively called the “Company”). All significant intercompany balances and transactions have been eliminated in consolidation.

Basis of Presentation
The accounting principles followed by the Company, and the methods of applying these principles, conform with accounting principles generally accepted in the United States of America (“GAAP”) and with general practices in the banking industry. In preparing the financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts in the financial statements. Actual results could differ significantly from these estimates. Material estimates common to the banking industry that are particularly susceptible

to significant change in the near term include, but are not limited to, the determination of the allowance for loan losses and valuation of real estate acquired in connection with or in lieu of foreclosure on loans.

Cash and Cash Equivalents

Cash, due from banks and interest-bearing deposits are considered cash and cash equivalents for cash flow reporting purposes.

Investment Securities
There are three classifications the Company is able to classify its investment securities: trading, available for sale, or held to maturity. Trading securities are bought and held principally for sale in the near term. Held to maturity securities are those securities for which the Company has the ability and intent to hold until maturity. All other securities not included in trading or held to maturity are classified as available for sale. At December 31, 2018 and 2017, the Company classified all of its investment securities as available for sale.

Available for sale securities are recorded at fair value. Unrealized holding gains and losses, net of the related tax effect, are excluded from earnings and are reported as a separate component of shareholders' equity until realized.

Management evaluates investment securities for other-than-temporary impairment on an annual basis. A decline in the market value of any investment below cost that is deemed other-than-temporary is charged to earnings for the decline in value deemed to be credit related and a new cost basis in the security is established. The decline in value attributed to non-credit related factors is recognized in comprehensive income.

Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to the yield. Realized gains and losses for securities classified as available for sale are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

Other Investments
Other investments include equity securities with no readily determinable fair value. These investments are carried at cost.

Mortgage Loans Held for Sale
Mortgage loans held for sale are carried at lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value.

Loans
Loans that management has the intent and ability to hold for the foreseeable future or until maturity are reported at the principal amount outstanding, net of the allowance for loan losses. Interest on loans is calculated by using the simple interest method on daily balances of the principal amount outstanding. The recognition of certain loan origination fee income and certain loan origination costs is deferred when such loans are originated and amortized over the life of the loan.

A loan is impaired when, based on current information and events, it is probable that all amounts due according to the contractual terms of the loan will not be collected. Impaired loans are measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or at the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent.

Accrual of interest is discontinued on a loan when management believes, after considering economic conditions and collection efforts, that the borrower's financial condition is such that collection of interest is doubtful. Interest previously accrued but not collected is reversed against current period earnings.

Allowance for Loan Losses
The allowance for loan losses reflects management's assessment and estimate of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. The Bank periodically analyzes the loan portfolio in an effort to review asset quality and to establish an allowance for loan losses that management believes will be adequate

in light of anticipated risks and loan losses. In assessing the adequacy of the allowance, size, quality and risk of loans in the portfolio are reviewed. Other factors considered are:

the Bank’s loan loss experience;

the amount of past due and non-performing loans;

specific known risks;

the status and amount of other past due and non-performing assets;

underlying estimated values of collateral securing loans;

current and anticipated economic conditions; and

other factors which management believes affect the allowance for potential credit losses.

Management uses several measures to assess and monitor the credit risks in the loan portfolio, including a loan grading system that begins upon loan origination and continues until the loan is collected or collectability becomes doubtful. Upon loan origination, the Bank's originating loan officer evaluates the quality of the loan and assigns one of eight risk grades. The loan officer monitors the loan's performance and credit quality and makes changes to the credit grade as conditions warrant. When originated or renewed, all loans over a certain dollar amount receive in-depth reviews and risk assessments by the Bank's Credit Administration. Before making any changes in these risk grades, management considers assessments as determined by the third party credit review firm (as described below), regulatory examiners and the Bank's Credit Administration. Any issues regarding the risk assessments are addressed by the Bank's senior credit administrators and factored into management's decision to originate or renew the loan. The Bank's Board of Directors reviews, on a monthly basis, an analysis of the Bank's reserves relative to the range of reserves estimated by the Bank's Credit Administration.

As an additional measure, the Bank engages an independent third party to review the underwriting, documentation and risk grading analyses. This independent third party reviews and evaluates loan relationships greater than $1.0 million, excluding loans in default, and loans in process of litigation or liquidation. The third party's evaluation and report is shared with management and the Bank's Board of Directors.

Management considers certain commercial loans with weak credit risk grades to be individually impaired and measures such impairment based upon available cash flows and the value of the collateral. Allowance or reserve levels are estimated for all other graded loans in the portfolio based on their assigned credit risk grade, type of loan and other matters related to credit risk.

Management uses the information developed from the procedures described above in evaluating and grading the loan portfolio. This continual grading process is used to monitor the credit quality of the loan portfolio and to assist management in estimating the allowance for loan losses. The provision for loan losses charged or credited to earnings is based upon management's judgment of the amount necessary to maintain the allowance at a level appropriate to absorb probable incurred losses in the loan portfolio at the balance sheet date. The amount each quarter is dependent upon many factors, including growth and changes in the composition of the loan portfolio, net charge-offs, delinquencies, management's assessment of loan portfolio quality, the value of collateral, and other macro-economic factors and trends. The evaluation of these factors is performed quarterly by management through an analysis of the appropriateness of the allowance for loan losses.

The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment. When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Bank's loss exposure for each credit, given the appraised value of any underlying collateral. Loans for which specific reserves are provided are excluded from the general allowance calculations as described below.

The general allowance reflects reserves established under GAAP for collective loan impairment. These reserves are based upon historical net charge-offs using the greater of the last two, three, four or five years' loss experience. This charge-off experience may be adjusted to reflect the effects of current conditions. The Bank considers information derived from its loan risk ratings and external data related to industry and general economic trends in establishing reserves.

The unallocated allowance is determined through management's assessment of probable losses that are in the portfolio but are not adequately captured by the other two components of the allowance, including consideration of current economic and business conditions and regulatory requirements. The unallocated allowance also reflects management's acknowledgement of the imprecision and subjectivity that underlie the modeling of credit risk. Due to the subjectivity

involved in determining the overall allowance, including the unallocated portion, the unallocated portion may fluctuate from period to period based on management's evaluation of the factors affecting the assumptions used in calculating the allowance.

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the year ended December 31, 2018 as compared to the year ended December 31, 2017. Revisions, estimates and assumptions may be made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

Effective December 31, 2012, certain mortgage loans from the former Banco division of the Bank were analyzed separately from other single family residential loans in the Bank's loan portfolio. These loans are first mortgage loans made to the Latino market, primarily in Mecklenburg, North Carolina and surrounding counties. These loans are non-traditional mortgages in that the customer normally did not have a credit history, so all credit information was accumulated by the loan officers.

Various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require adjustments to the allowance based on their judgments of information available to them at the time of their examinations. Management believes it has established the allowance for credit losses pursuant to GAAP, and has taken into account the views of its regulators and the current economic environment. Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Bank's loan portfolio as of the date of the financial statements. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

Mortgage Banking Activities
Mortgage banking income represents net gains from the sale of mortgage loans and fees received from borrowers and loan investors related to the Bank's origination of single-family residential mortgage loans.

Mortgage loans serviced for others are not included in the accompanying balance sheets. The unpaid principal balances of mortgage loans serviced for others was approximately $866,000, $1.0 million and $1.4 million at December 31, 2018, 2017 and 2016, respectively.

The Bank originates certain fixed rate mortgage loans and commits these loans for sale. The commitments to originate fixed rate mortgage loans and the commitments to sell these loans to a third party are both derivative contracts. The fair value of these derivative contracts is immaterial and has no effect on the recorded amounts in the financial statements.

Premises and Equipment
Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed primarily using the straight-line method over the estimated useful lives of the assets. When assets are retired or otherwise disposed, the cost and related accumulated depreciation are removed from the accounts, and any gain or loss is reflected in earnings for that period. The cost of maintenance and repairs that do not improve or extend the useful life of the respective asset is charged to earnings as incurred, whereas significant renewals and improvements are capitalized. The range of estimated useful lives for premises and equipment are generally as follows:

| | |
|---|---|
| Buildings and improvements | 10 - 50 years |
| Furniture and equipment | 3 - 10 years |

Other Real Estate
Foreclosed assets include all assets received in full or partial satisfaction of a loan. Foreclosed assets are reported at fair value less estimated selling costs. Any write-downs at the time of foreclosure are charged to the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management, and a valuation allowance is established if fair value less estimated selling costs declines below carrying value. Costs relating to the development and improvement of the property are capitalized. Revenues and expenses from operations are included in other expenses. Changes in the valuation allowance are included in loss on sale and write-down of other real estate.

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Additionally, the recognition of future tax benefits, such as net operating loss carryforwards, is required to the extent that the realization of such benefits is more likely than not to occur. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which the assets and liabilities are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expense in the period that includes the enactment date.

In the event the future tax consequences of differences between the financial reporting bases and the tax bases of the Company’s assets and liabilities results in a deferred tax asset, an evaluation of the probability of being able to realize the future benefits indicated by such asset is required. A valuation allowance is provided for the portion of

the deferred tax asset when it is more likely than not that some portion or all of the deferred tax asset will not be realized. In assessing the realizability of a deferred tax asset, management considers the scheduled reversals of deferred tax liabilities, projected future taxable income, and tax planning strategies.

Tax effects from an uncertain tax position can be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more likely than not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Previously recognized tax positions that no longer meet the more likely than not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. The Company assessed the impact of this guidance and determined that it did not have a material impact on the Company's financial position, results of operations or disclosures.

Derivative Financial Instruments and Hedging Activities
In the normal course of business, the Company enters into derivative contracts to manage interest rate risk by modifying the characteristics of the related balance sheet instruments in order to reduce the adverse effect of changes in interest rates. All material derivative financial instruments are recorded at fair value in the financial statements. The fair value of derivative contracts related to the origination of fixed rate mortgage loans and the commitments to sell these loans to a third party is immaterial and has no effect on the recorded amounts in the financial statements.

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of, and gains and losses on, derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

On the date a derivative contract is entered into, the Company designates the derivative as a fair value hedge, a cash flow hedge, or a trading instrument. Changes in the fair value of instruments used as fair value hedges are accounted for in the earnings of the period simultaneous with accounting for the fair value change of the item being hedged. Changes in the fair value of the effective portion of cash flow hedges are accounted for in other comprehensive income rather than earnings. Changes in fair value of instruments that are not intended as a hedge are accounted for in the earnings of the period of the change.

If a derivative instrument designated as a fair value hedge is terminated or the hedge designation removed, the difference between a hedged item's then carrying amount and its face amount is recognized into income over the original hedge period. Likewise, if a derivative instrument designated as a cash flow hedge is terminated or the hedge designation removed, related amounts accumulated in other accumulated comprehensive income are reclassified into earnings over the original hedge period during which the hedged item affects income.

The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted

transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

The Company formally documents all hedging relationships, including an assessment that the derivative instruments are expected to be highly effective in offsetting the changes in fair values or cash flows of the hedged items.

Advertising Costs
Advertising costs are expensed as incurred.

Stock-Based Compensation

The Company has an Omnibus Stock Ownership and Long Term Incentive Plan that was approved by shareholders on May 7, 2009 (the "Plan") whereby certain stock-based rights, such as stock options, restricted stock, restricted stock units, performance units, stock appreciation rights or book value shares, may be granted to eligible directors and employees. A total of 280,933 shares are currently reserved for possible issuance under the Plan. All stock-based rights under the Plan must be granted or awarded by May 7, 2019 (i.e., ten years from the Plan effective date).

The Company granted 32,465 restricted stock units under the Plan at a grant date fair value of $7.18 per share during the first quarter of 2012, of which 5,891 restricted stock units were forfeited by the executive officers of the Company as required by the agreement with the U.S. Department of the Treasury in conjunction with the Company's participation in the Capital Purchase Program under the Troubled Asset Relief Program. In July 2012, the Company granted 5,891 restricted stock units at a grant date fair value of $7.50 per share. The Company granted 29,475 restricted stock units under the Plan at a grant date fair value of $10.82 per share during the second quarter of 2013. The Company granted 23,162 restricted stock units under the Plan at a grant date fair value of $14.27 per share during the first quarter of 2014. The Company granted 16,583 restricted stock units under the Plan at a grant date fair value of $16.34 per share during the first quarter of 2015. The Company granted 5,544 restricted stock units under the Plan at a grant date fair value of $16.91 per share during the first quarter of 2016. The Company granted 4,114 restricted stock units under the Plan at a grant date fair value of $25.00 per share during the first quarter of 2017. The Company granted 3,725 restricted stock units under the Plan at a grant date fair value of $31.43 per share during the first quarter of 2018. The number of restricted stock units granted and grant date fair values have been restated to reflect the 10% stock dividend during the fourth quarter of 2017. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (five years from the grant date for the 2012 grants, four years from the grant date for the 2013, 2015, 2016, 2017 and 2018 grants and three years from the grant date for the 2014 grants). The amount of expense recorded each period reflects the changes in the Company's stock price during such period. As of December 31, 2018, the total unrecognized compensation expense related to the restricted stock unit grants under the Plan was $165,000.

The Company recognized compensation expense for restricted stock units granted under the Plan of $85,000, $592,000 and $932,000 for the years ended December 31, 2018, 2017 and 2016, respectively.

Net Earnings Per Share

Net earnings per common share is based on the weighted average number of common shares outstanding during the period while the effects of potential common shares outstanding during the period are included in diluted earnings per common share. The average market price during the year is used to compute equivalent shares.

The reconciliations of the amounts used in the computation of both "basic earnings per common share" and "diluted earnings per common share" for the years ended December 31, 2018, 2017 and 2016 are as follows:

For the year ended December 31, 2018

| | Net Earnings (Dollars in thousands) | Weighted Average Number of Shares | Per Share Amount |
|---|---|---|---|
| Basic earnings per share | $13,382 | 5,995,256 | $2.23 |
| Effect of dilutive securities: | | | |
| Restricted stock units | - | 20,240 | |
| | $13,382 | 6,015,496 | $2.22 |

Diluted earnings per
share

For the year ended December 31, 2017

| | Net Earnings (Dollars in thousands) | Weighted Average Number of Shares | Per Share Amount |
|---|---|---|---|
| Basic earnings per share | $10,268 | 5,988,183 | $1.71 |
| Effect of dilutive securities: | | | |
| Restricted stock units | - | 74,667 | |
| Diluted earnings per share | $10,268 | 6,062,850 | $1.69 |

For the year ended December 31, 2016

| | Net Earnings (Dollars in thousands) | Weighted Average Number of Shares | Per Share Amount |
|---|---|---|---|
| Basic earnings per share | $9,177 | 6,024,970 | $1.53 |
| Effect of dilutive securities: | | | |
| Restricted stock units | - | 77,807 | |
| Diluted earnings per share | $9,177 | 6,102,777 | $1.50 |

In November 2017, the Board of Directors of the Company declared a 10% stock dividend. As a result of the stock dividend, each shareholder received one new share of stock for every ten shares of stock they held as of the record date of December 4, 2017. The payable date for the stock dividend was December 15, 2017. All previously reported per share amounts have been restated to reflect this stock dividend.

Recent Accounting Pronouncements

The following tables provide a summary of Accounting Standards Updates (“ASU”) issued by the Financial Accounting Standards Board (“FASB”)that the Company has recently adopted.

Recently Adopted Accounting Guidance

| ASU | Description | Effective Date | Effect on Financial Statements or Other Significant Matters |
|---|---|---|---|
| ASU 2014-09: Revenue from Contracts with Customers | Provides guidance on the recognition of revenue from contracts with customers. The core principle of this guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity | January 1, 2018 | See section titled "ASU 2014-09" below for a despription of the effect on the Company’s results of operations, financial position and disclosures. |

| | | | |
|---|---|---|---|
| | receives or expects to receive. | | |
| ASU 2016-01: Recognition and Measurement of Financial Assets and Financial Liabilities | Addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. | January 1, 2018 | The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2017-01: Clarifying the Definition of a Business | Adds guidance to assist companies and other reporting organizations with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. | January 1, 2018 | The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2017-05: Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets | Clarifies the scope of established guidance on nonfinancial asset derecognition (issued as part of the new revenue standard, ASU 2014-09, Revenue from Contracts with Customers), as well as the accounting for partial sales of nonfinancial assets. | January 1, 2018 | The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures. |

| ASU | Description | Effective Date | Effect on Financial Statements or Other Significant Matters |
|---|---|---|---|
| ASU 2017-07: Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Costs | Amended the requirements related to the income statement presentation of the components of net periodic benefit cost for an entity's sponsored defined benefit pension and other postretirement plans. | January 1, 2018 | The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2017-09: Scope of Modification Accounting | Amended the requirements related to changes to the terms or conditions of a share-based payment award. | January 1, 2018 | The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2017-13: Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842) | Updated the Revenue from Contracts with Customers and the Leases Topics of the Accounting Standards Codification ("ASC"). The amendments incorporate into the ASC recent Securities Exchange Commission ("SEC") guidance about certain public business entities ("PBEs") electing to use the non-PBE effective dates solely to adopt the FASB's new standards on revenue and leases. | Effective upon issuance | The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2017-14: Income Statement—Reporting Comprehensive, Income (Topic 220), Revenue Recognition (Topic 605), and Revenue from Contracts with Customers (Topic 606) | Incorporates into the ASC recent SEC guidance related to revenue recognition. | Effective upon issuance | The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2018-02: Income Statement (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income | Requires companies to reclassify the stranded effects in other comprehensive income to retained earnings as a result of the change in the tax rates under the Tax Cuts and Jobs Act ("TCJA"). | Effective upon issuance | The Company opted to early adopt this pronouncement by retrospective application to each period in which the effect of the change in the tax rate under the TCJA is recognized. The impact of the reclassification from other comprehensive income to retained earnings at December 31, 2017 was $607,000. |
| ASU 2018-03: Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities | Clarifies certain aspects of the guidance issued in ASU 2016-01. | January 1, 2018 | The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2018-04: Investments—Debt Securities (Topic 320) and Regulated Operations (Topic | Incorporates recent SEC guidance which was issued in order to make the relevant interpretive guidance | Effective upon issuance | The adoption of this guidance did not have a material impact on the Company's results of operations, |

| | | | |
|---|---|---|---|
| 980): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 117 and SEC Release No. 33-9273 (SEC Update) | consistent with current authoritative accounting and auditing guidance and SEC rules and regulation. | | financial position or disclosures. |
| ASU 2018-05: Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118 (SEC Update) | Incorporates recent SEC guidance related to the income tax accounting implications of the TCJA. | Effective upon issuance | The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2018-06: Codification Improvements to Topic 942: Financial Services—Depository and Lending | Eliminates a reference to the Office of the Comptroller of the Currency's Banking Circular 202, Accounting for Net Deferred Tax Charges, from the ASC. The Office of the Comptroller of the Currency published the guidance in 1985 but has since rescinded it. | Effective upon issuance | The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures. |

ASU 2014-09

The Company has applied ASU 2014-09 using a modified retrospective approach. The Company's revenue is comprised of net interest income and noninterest income. The scope of ASU 2014-09 explicitly excludes net interest income as well as many other revenues for financial assets and liabilities including loans, leases, securities, and derivatives. Accordingly, the majority of the Company's revenues are not affected. Appraisal management fee income and expense from the Bank's subsidiary, CBRES, was reported as a net amount prior to March 31, 2018, which was included in miscellaneous non-interest income. This income and expense is now reported on separate line items under non-interest income and non-interest expense. See below for additional information related to revenue generated from contracts with customers.

Revenue and Method of Adoption

The majority of the Company's revenue is derived primarily from interest income from receivables (loans) and securities. Other revenues are derived from fees received in connection with deposit accounts, investment advisory, and appraisal services. On January 1, 2018, the Company adopted the requirements of ASU 2014-09. The core principle of the new standard is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

The Company adopted ASU 2014-09 using the modified retrospective transition approach which does not require restatement of prior periods. The method was selected as there were no material changes in the timing of revenue recognition resulting in no comparability issues with prior periods. This adoption method is considered a change in accounting principle requiring additional disclosure of the nature of and reason for the change, which is solely a result of the adoption of the required standard. When applying the modified retrospective approach under ASU 2014-09, the Company has elected, as a practical expedient, to apply this approach only to contracts that were not completed as of January 1, 2018. A completed contract is considered to be a contract for which all (or substantially all) of the revenue was recognized in accordance with revenue guidance that was in effect before January 1, 2018. There were no uncompleted contracts as of January 1, 2018 for which application of the new standard required an adjustment to retained earnings.

The following disclosures involve the Company's material income streams derived from contracts with customers which are within the scope of ASU 2014-09. Through the Company's wholly-owned subsidiary, PIS, the Company contracts with a registered investment advisor to perform investment advisory services on behalf of the Company's customers. The Company receives commissions from this third party investment advisor based on the volume of business that the Company's customers do with such investment advisor. Total revenue recognized from these contracts for the year ended December 31, 2018 was $823,000. The Company utilizes third parties to contract with the Company's customers to perform debit and credit card clearing services. These third parties pay the Company commissions based on the volume of transactions that they process on behalf of the Company's customers. Total revenue recognized for the year ended December 31, 2018 from the contract with these third parties was $3.9 million. Through the Company's wholly-owned subsidiary, REAS, the Company provides property appraisal services for negotiated fee amounts on a per appraisal basis. Total revenue recognized for the year ended December 31, 2018 from these contracts with customers was $597,000. Through the Company's wholly-owned subsidiary, CBRES, the Company provides appraisal management services. Total revenue recognized for the year ended December 31, 2018 from these contracts with customers was $3.2 million. Due to the nature of the Company's relationship with the customers that the Company provides services, the Company does not incur costs to obtain contracts and there are no material incremental costs to fulfill these contracts that should be capitalized.

Disaggregation of Revenue. The Company's portfolio of services provided to the Company's customers consists of over 50,000 active contracts. The Company has disaggregated revenue according to timing of the transfer of service. Total revenue for the year ended December 31, 2018 derived from contracts in which services are transferred at a point in

time was approximately $8.5 million. None of the Company's revenue is derived from contracts in which services are transferred over time. Revenue is recognized as the services are provided to the customers. Economic factors impacting the customers could affect the nature, amount, and timing of these cash flows, as unfavorable economic conditions could impair the customers' ability to provide payment for services. For the Company's deposit contracts, this risk is mitigated as the Company generally deducts payments from customers' accounts as services are rendered. For the Company's appraisal services, the risk is mitigated in that the appraisal is not released until payment is received.

Contract Balances. The timing of revenue recognition, billings, and cash collections results in billed accounts receivable on the balance sheet. Most contracts call for payment by a charge or deduction to the respective customer account but there are some that require a receipt of payment from the customer.

For fee per transaction contracts, the customers are billed as the transactions are processed. The Company has no contracts in which

customers are billed in advance for services to be performed. These types of contracts would create contract liabilities or deferred revenue, as the customers pay in advance for services. There are no contract liabilities or accounts receivables balances that are material to the Company's balance sheet.

Performance Obligations. A performance obligation is a promise in a contract to transfer a distinct good or service to the customer, and is the unit of account in ASU 2014-09. A contract's transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied. Performance obligations are satisfied as the service is provided to the customer at a point in time. There are no significant financing components in the Company's contracts. Excluding deposit and appraisal service revenues which are primarily billed at a point in time as a fee for services incurred, all other contracts within the scope of ASU 2014-09 contain variable consideration in that fees earned are derived from market values of accounts which determine the amount of consideration to which the Company is entitled. The variability is resolved when the services are provided. The contracts do not include obligations for returns, refunds, or warranties. The contracts are specific to the amounts owed to the Company for services performed during a period should the contracts be terminated.

Significant Judgements. All of the Company's contracts create performance obligations that are satisfied at a point in time excluding some immaterial deposit revenues. Revenue is recognized as services are billed to the customers. Variable consideration does exist for contracts related to the Company's contract with its registered investment advisor as some revenues earned pursuant to that contract are based on market values of accounts at the end of the period.

The following tables provide a summary of ASU's issued by the FASB that the Company has not adopted as of December 31, 2018, which may impact the Company's financial statements.

Recently Issued Accounting Guidance Not Yet Adopted

| ASU | Description | Effective Date | Effect on Financial Statements or Other Significant Matters |
|---|---|---|---|
| ASU 2016-02: Leases | Increases transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. | January 1, 2019 | The Company expects to adopt this guidance using the modified retrospective method and practical expedients for transition. The practical expedients allow the Company to largely account for its existing leases consistent with current guidance except for the incremental balance sheet recognition for lessees. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures. The Company epects to record an increase in assets and liabilities of approximatley $4.4 million as a result of recording lease contracts where the Company is lessee and expects to adopt the new guidance prospectively as of January 1, 2019 and to not restate comparative periods. |
| ASU 2016-13: Measurement of Credit Losses on Financial Instruments | Provides guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. | January 1, 2020 Early adoption permitted | The Company will apply this guidance through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. The Company is still evaluating the impact of this guidance on its consolidated financial statements. The Company has formed a Current Expected Credit Losses ("CECL") committee and implemented a model from a third-party vendor for running CECL calculations. The Company is currently developing CECL |

| | | | |
|---|---|---|---|
| | | | model assumptions and comparing results to current allowance for loan loss calculations. The Company plans to run parallel calculations leading up to the effective date of this guidance to ensure it is prepared for implementation by the effective date. In addition to the Company's allowance for loan losses, it will also record an allowance for credit losses on debt securities instead of applying the impairment model currently utilized. The amount of the adjustments will be impacted by each portfolio's composition and credit quality at the adoption date as well as economic conditions and forecasts at that time. |
| ASU 2017-04: Simplifying the Test for Goodwill Impairment | Provides guidance to simplify the accounting related to goodwill impairment. | January 1, 2020 | The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2017-08: Premium Amortization on Purchased Callable Debt Securities | Amended the requirements related to the amortization period for certain purchased callable debt securities held at a premium. | January 1, 2019 | The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures. |

| ASU | Description | Effective Date | Effect on Financial Statements or Other Significant Matters |
|---|---|---|---|
| ASU 2018-11: Leases (Topic 842): Targeted Improvements | Intended to reduce costs and ease implementation of ASU 2016-02. | January 1, 2019 | The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2018-13: Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement (Topic 820) | Updates the disclosure requirements on fair value measurements in ASC 820, Fair Value Measurement. | January 1, 2020 | The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2018-14: Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans (Subtopic 715-20) | Updates disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. | January 1, 2021 | The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2018-15: Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40) | Reduces complexity of the accounting for costs of implementing a cloud computing service arrangement. | January 1, 2020 | The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2018-16: Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes | Expand the list of U.S. benchmark interest rates permitted in the application of hedge accounting. | January 1, 2019 | The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2018-17: Targeted Improvements to Related Party Guidance for Variable Interest Entities | Amended the Consolidation topic of the ASC for determining whether a decision-making fee is a variable interest. The amendments require organizations to consider indirect interests held through related parties under common control on a proportional basis rather than as the equivalent of a direct interest in its entirety. | January 1, 2020 Early adoption permitted | The Company does not intend to adopt this guidance early. The adoption of this guidance is not expected to have a material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2018-18: Clarifying the Interaction between Topic 808 and Topic 606 | Clarifies the interaction between the guidance for certain collaborative arrangements and the new revenue recognition financial accounting and reporting standard. | January 1, 2020 Early adoption permitted | The Company does not intend to adopt this guidance early. The adoption of this guidance is not expected to have a |

| | | | |
|---|---|---|---|
| | | | material impact on the Company's results of operations, financial position or disclosures. |
| ASU 2018-19: Codification Improvements to Topic 326, Financial Instruments—Credit Losses | Aligns the implementation date of the topic for annual financial statements of nonpublic companies with the implementation date for their interim financial statements. The guidance also clarifies that receivables arising from operating leases are not within the scope of the topic, but rather, should be accounted for in accordance with the leases topic. | January 1, 2020 Early adoption permitted | See comments for ASU 2016-13 above. |
| ASU 2018-20: Narrow- Scope Improvements for Lessors | Provides narrow-scope improvements for lessors, that provide relief in the accounting for sales, use and similar taxes, the accounting for other costs paid by a lessee that may benefit a lessor, and variable payments when contracts have lease and non-lease components. | January 1, 2019 | See comments for ASU 2016-02 above. |

Other accounting standards that have been issued or proposed by FASB or other standards-setting bodies are not expected to have a material impact on the Company's results of operations, financial position or disclosures.

Reclassification

Certain amounts in the 2017 and 2016 consolidated financial statements have been reclassified to conform to the 2018 presentation.

(2)
Investment Securities

Investment securities available for sale at December 31, 2018 and 2017 are as follows:

(Dollars in thousands)

| | December 31, 2018 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Mortgage-backed securities | $52,145 | 516 | 558 | 52,103 |
| U.S. Government sponsored enterprises | 35,356 | 71 | 793 | 34,634 |
| State and political subdivisions | 105,545 | 2,089 | 43 | 107,591 |
| Trust preferred securities | 250 | - | - | 250 |
| Total | $193,296 | 2,676 | 1,394 | 194,578 |

(Dollars in thousands)

| | December 31, 2017 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Mortgage-backed securities | $53,124 | 814 | 329 | 53,609 |
| U.S. Government sponsored enterprises | 40,504 | 140 | 264 | 40,380 |
| State and political subdivisions | 129,276 | 4,310 | 16 | 133,570 |
| Corporate bonds | 1,500 | 12 | - | 1,512 |
| Trust preferred securities | 250 | - | - | 250 |
| Total | $224,654 | 5,276 | 609 | 229,321 |

The current fair value and associated unrealized losses on investments in debt securities with unrealized losses at December 31, 2018 and 2017 are summarized in the tables below, with the length of time the individual securities have been in a continuous loss position.

(Dollars in thousands)

December 31, 2018

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Mortgage-backed securities | $6,932 | 56 | 17,670 | 502 | 24,602 | 558 |
| U.S. Government sponsored enterprises | 1,784 | 69 | 25,172 | 724 | 26,956 | 793 |
| State and political subdivisions | 4,815 | 26 | 1,578 | 17 | 6,393 | 43 |
| Total | $13,531 | 151 | 44,420 | 1,243 | 57,951 | 1,394 |

(Dollars in thousands)

December 31, 2017

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Mortgage-backed securities | $8,701 | 75 | 11,259 | 254 | 19,960 | 329 |
| U.S. Government sponsored enterprises | 12,661 | 98 | 10,067 | 166 | 22,728 | 264 |
| State and political subdivisions | 798 | 2 | 1,501 | 14 | 2,299 | 16 |
| Total | $22,160 | 175 | 22,827 | 434 | 44,987 | 609 |

At December 31, 2018, unrealized losses in the investment securities portfolio relating to debt securities totaled $1.4 million. The unrealized losses on these debt securities arose due to changing interest rates and are considered

to be temporary. From the December 31, 2018 tables above, 11 out of 130 securities issued by state and political subdivisions contained unrealized losses and 31 out of 46 securities issued by U.S. Government sponsored enterprises, including mortgage-backed securities, contained unrealized losses. These unrealized losses are considered temporary because of acceptable financial condition and results of operations on each security and the repayment sources of principal and interest on U.S. Government sponsored enterprises, including mortgage-backed securities, are government backed.

The Company periodically evaluates its investments for any impairment which would be deemed other-than-temporary. No investment impairments were deemed other-than-temporary in 2018, 2017 or 2016.

The amortized cost and estimated fair value of investment securities available for sale at December 31, 2018, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

December 31, 2018

(Dollars in thousands)

| | Amortized Cost | Estimated Fair Value |
|---|---|---|
| Due within one year | $21,379 | 21,426 |
| Due from one to five years | 80,932 | 82,325 |
| Due from five to ten years | 32,271 | 32,174 |
| Due after ten years | 6,569 | 6,550 |
| Mortgage-backed securities | 52,145 | 52,103 |
| Total | $193,296 | 194,578 |

During 2018, proceeds from sales of securities available for sale were $36.0 million and resulted in gross gains of $15,000. No securities available for sale were sold during the year ended December 31, 2017. During 2016, proceeds from sales of securities available for sale were $1.5 million and resulted in gross gains of $729,000.

Securities with a fair value of approximately $93.0 million and $105.6 million at December 31, 2018 and 2017, respectively, were pledged to secure public deposits, Federal Home Loan Bank of Atlanta (“FHLB”) borrowings and for other purposes as required by law.

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. There is a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The table below presents the balance of securities available for sale, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of December 31, 2018 and 2017.

(Dollars in thousands)

December 31, 2018

| | Fair Value Measurements | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation |
|---|---|---|---|---|
| Mortgage-backed securities | $52,103 | - | 52,103 | - |
| U.S. Government sponsored enterprises | $34,634 | - | 34,634 | - |
| State and political subdivisions | $107,591 | - | 107,591 | - |
| Trust preferred securities | $250 | - | - | 250 |

(Dollars in thousands)

December 31, 2017

| | Fair Value Measurements | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation |
|---|---|---|---|---|
| Mortgage-backed securities | $53,609 | - | 53,609 | - |
| U.S. Government sponsored enterprises | $40,380 | - | 40,380 | - |
| State and political subdivisions | $133,570 | - | 133,570 | - |
| Corporate bonds | $1,512 | - | 1,512 | - |
| Trust preferred securities | $250 | - | - | 250 |

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities.

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the year ended December 31, 2018.

(Dollars in thousands)

| | Investment Securities Available for Sale |
|---|---|
| | Level 3 Valuation |
| Balance, beginning of period | $250 |
| Change in book value | - |
| Change in gain/(loss) realized and unrealized | - |
| Purchases/(sales and calls) | - |
| Transfers in and/or (out) of Level 3 | - |
| Balance, end of period | $250 |
| Change in unrealized gain/(loss) for assets still held in Level 3 | $- |

(3)
Loans

Major classifications of loans at December 31, 2018 and 2017 are summarized as follows:

(Dollars in thousands)

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Real estate loans: | | |
| Construction and land development | $94,178 | 84,987 |
| Single-family residential | 252,983 | 246,703 |
| Single-family residential - Banco de la Gente non-traditional | 34,261 | 37,249 |
| Commercial | 270,055 | 248,637 |
| Multifamily and farmland | 33,163 | 28,937 |
| Total real estate loans | 684,640 | 646,513 |

| | | |
|---|---|---|
| Loans not secured by real estate: | | |
| Commercial loans | 97,465 | 89,022 |
| Farm loans | 926 | 1,204 |
| Consumer loans | 9,165 | 9,888 |
| All other loans | 11,827 | 13,137 |
| Total loans | 804,023 | 759,764 |
| Less allowance for loan losses | 6,445 | 6,366 |
| Net loans | $797,578 | 753,398 |

The above table includes deferred costs, net of deferred fees, totaling $1.6 million at December 31, 2018 and 2017.

The Bank grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg, Wake and Durham counties of North Carolina. Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by improved and unimproved real estate, the value of which is dependent upon the real estate market. Risk characteristics of the major components of the Bank’s loan portfolio are discussed below:

Construction and land development loans – The risk of loss is largely dependent on the initial estimate of whether the property's value at completion equals or exceeds the cost of property construction and the availability of take-out financing. During the construction phase, a number of factors can result in delays or cost overruns. If the estimate is inaccurate or if actual construction costs exceed estimates, the value of the property securing the loan may be insufficient to ensure full repayment when completed through a permanent loan, sale of the property, or by seizure of collateral. As of December 31, 2018, construction and land development loans comprised approximately 12% of the Bank's total loan portfolio.

Single-family residential loans – Declining home sales volumes, decreased real estate values and higher than normal levels of unemployment could contribute to losses on these loans. As of December 31, 2018, single-family residential loans comprised approximately 36% of the Bank's total loan portfolio, including Banco single-family residential non-traditional loans which were approximately 4% of the Bank's total loan portfolio.

Commercial real estate loans – Repayment is dependent on income being generated in amounts sufficient to cover operating expenses and debt service. These loans also involve greater risk because they are generally not fully amortizing over a loan period, but rather have a balloon payment due at maturity. A borrower's ability to make a balloon payment typically will depend on being able to either refinance the loan or timely sell the underlying property. As of December 31, 2018, commercial real estate loans comprised approximately 34% of the Bank's total loan portfolio.

Commercial loans – Repayment is generally dependent upon the successful operation of the borrower's business. In addition, the collateral securing the loans may depreciate over time, be difficult to appraise, be illiquid, or fluctuate in value based on the success of the business. As of December 31, 2018, commercial loans comprised approximately 12% of the Bank's total loan portfolio.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The following tables present an age analysis of past due loans, by loan type, as of December 31, 2018 and 2017:

December 31, 2018

(Dollars in thousands)

| | Loans 30-89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due Loans | Total Current Loans | Total Loans | Accruing Loans 90 or More Days Past Due |
|---|---|---|---|---|---|---|
| Real estate loans: | | | | | | |
| Construction and land development | $3 | - | 3 | 94,175 | 94,178 | - |
| Single-family residential | 4,162 | 570 | 4,732 | 248,251 | 252,983 | - |
| Single-family residential - Banco de la Gente non-traditional | 4,627 | 580 | 5,207 | 29,054 | 34,261 | - |
| Commercial | 228 | - | 228 | 269,827 | 270,055 | - |
| Multifamily and farmland | - | - | - | 33,163 | 33,163 | - |
| Total real estate loans | 9,020 | 1,150 | 10,170 | 674,470 | 684,640 | - |
| Loans not secured by real estate: | | | | | | |
| Commercial loans | 445 | 90 | 535 | 96,930 | 97,465 | - |
| Farm loans | - | - | - | 926 | 926 | - |
| Consumer loans | 99 | 4 | 103 | 9,062 | 9,165 | - |
| All other loans | - | - | - | 11,827 | 11,827 | - |
| Total loans | $9,564 | 1,244 | 10,808 | 793,215 | 804,023 | - |

December 31, 2017

(Dollars in thousands)

| | Loans 30-89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due Loans | Total Current Loans | Total Loans | Accruing Loans 90 or More Days Past Due |
|---|---|---|---|---|---|---|
| Real estate loans: | | | | | | |
| Construction and land development | $277 | - | 277 | 84,710 | 84,987 | - |
| Single-family residential | 3,241 | 193 | 3,434 | 243,269 | 246,703 | - |
| Single-family residential - Banco de la Gente non-traditional | 4,078 | 465 | 4,543 | 32,706 | 37,249 | - |
| Commercial | 588 | - | 588 | 248,049 | 248,637 | - |
| Multifamily and farmland | - | 12 | 12 | 28,925 | 28,937 | - |
| Total real estate loans | 8,184 | 670 | 8,854 | 637,659 | 646,513 | - |
| Loans not secured by real estate: | | | | | | |
| Commercial loans | 53 | 100 | 153 | 88,869 | 89,022 | - |
| Farm loans | - | - | - | 1,204 | 1,204 | - |
| Consumer loans | 113 | 5 | 118 | 9,770 | 9,888 | - |
| All other loans | - | - | - | 13,137 | 13,137 | - |
| Total loans | $8,350 | 775 | 9,125 | 750,639 | 759,764 | - |

The following table presents the Bank’s non-accrual loans as of December 31, 2018 and 2017:

(Dollars in thousands)

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Real estate loans: | | |
| Construction and land development | $1 | 14 |

| | | |
|---|---|---|
| Single-family residential | 1,530 | 1,634 |
| Single-family residential - Banco de la Gente non-traditional | 1,440 | 1,543 |
| Commercial | 244 | 396 |
| Multifamily and farmland | - | 12 |
| Total real estate loans | 3,215 | 3,599 |
| | | |
| Loans not secured by real estate: | | |
| Commercial loans | 89 | 100 |
| Consumer loans | 10 | 12 |
| Total | $3,314 | 3,711 |

At each reporting period, the Bank determines which loans are impaired. Accordingly, the Bank's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan that is collateral-dependent is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by REAS, a subsidiary of the Bank. REAS is staffed by certified appraisers that also perform appraisals for other companies. Factors, including the assumptions and techniques utilized by the appraiser, are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. An allowance for each impaired loan that is not collateral dependent is calculated based on the present value of projected cash flows. If the recorded investment in the impaired loan exceeds the present value of projected cash flows, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under $250,000 are not individually evaluated for impairment with the exception of the Bank's troubled debt restructured ("TDR") loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Impaired loans collectively evaluated for impairment totaled $4.8 million and $4.9 million at December 31, 2018 and 2017, respectively. Accruing impaired loans were $22.8 million and $24.6 million at December 31, 2018 and December 31, 2017, respectively. Interest income recognized on accruing impaired loans was $1.3 million and $1.4 million for the years ended December 31, 2018 and 2017, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as non-accrual.

The following tables present the Bank's impaired loans as of December 31, 2018, 2017 and 2016:

December 31, 2018

(Dollars in thousands)

| | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Recorded Investment in Impaired Loans | Related Allowance | Average Outstanding Impaired Loans | YTD Interest Income Recognized |
|---|---|---|---|---|---|---|---|
| Real estate loans: | | | | | | | |
| Construction and land development | $281 | - | 279 | 279 | 5 | 327 | 19 |
| Single-family residential | 5,059 | 422 | 4,188 | 4,610 | 32 | 6,271 | 261 |
| Single-family residential - Banco de la Gente non-traditional | 16,424 | - | 15,776 | 15,776 | 1,042 | 14,619 | 944 |
| Commercial | 1,995 | - | 1,925 | 1,925 | 17 | 2,171 | 111 |
| Total impaired real estate loans | 23,759 | 422 | 22,168 | 22,590 | 1,096 | 23,388 | 1,335 |
| Loans not secured by real estate: | | | | | | | |
| Commercial loans | 251 | 89 | 1 | 90 | - | 96 | - |
| Consumer loans | 116 | - | 113 | 113 | 2 | 137 | 7 |
| Total impaired loans | $24,126 | 511 | 22,282 | 22,793 | 1,098 | 23,621 | 1,342 |

December 31, 2017

(Dollars in thousands)

| | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Recorded Investment in Impaired Loans | Related Allowance | Average Outstanding Impaired Loans | YTD Interest Income Recognized |
|---|---|---|---|---|---|---|---|
| Real estate loans: | | | | | | | |
| Construction and land development | $282 | - | 277 | 277 | 6 | 253 | 17 |
| Single-family residential | 5,226 | 1,135 | 3,686 | 4,821 | 41 | 5,113 | 265 |
| Single-family residential - Banco de la Gente non-traditional | 17,360 | - | 16,805 | 16,805 | 1,149 | 16,867 | 920 |
| Commercial | 2,761 | 807 | 1,661 | 2,468 | 1 | 3,411 | 148 |
| Multifamily and farmland | 78 | - | 12 | 12 | - | 28 | - |
| Total impaired real estate loans | 25,707 | 1,942 | 22,441 | 24,383 | 1,197 | 25,672 | 1,350 |
| Loans not secured by real estate: | | | | | | | |
| Commercial loans | 264 | 100 | 4 | 104 | - | 149 | 3 |
| Consumer loans | 158 | - | 154 | 154 | 2 | 194 | 9 |
| Total impaired loans | $26,129 | 2,042 | 22,599 | 24,641 | 1,199 | 26,015 | 1,362 |

December 31, 2016

(Dollars in thousands)

| | Unpaid Contractual Principal | Recorded Investment With No | Recorded Investment With | Recorded Investment in Impaired | Related Allowance | Average Outstanding Impaired | YTD Interest Income Recognized |
|---|---|---|---|---|---|---|---|

| | Balance | Allowance | Allowance | Loans | | Loans | |
|---|---|---|---|---|---|---|---|
| Real estate loans: | | | | | | | |
| Construction and land development | $282 | - | 278 | 278 | 11 | 330 | 13 |
| Single-family residential | 5,354 | 703 | 4,323 | 5,026 | 47 | 7,247 | 164 |
| Single-family residential - Banco de la Gente non-traditional | 18,611 | - | 18,074 | 18,074 | 1,182 | 17,673 | 861 |
| Commercial | 3,750 | 1,299 | 2,197 | 3,496 | 166 | 4,657 | 152 |
| Multifamily and farmland | 78 | - | 78 | 78 | - | 78 | - |
| Total impaired real estate loans | 28,075 | 2,002 | 24,950 | 26,952 | 1,406 | 29,985 | 1,190 |
| Loans not secured by real estate: | | | | | | | |
| Commercial loans | 27 | - | 27 | 27 | - | 95 | - |
| Consumer loans | 211 | - | 202 | 202 | 3 | 222 | 8 |
| Total impaired loans | $28,313 | 2,002 | 25,179 | 27,181 | 1,409 | 30,302 | 1,198 |

The fair value measurements for mortgage loans held for sale, impaired loans and other real estate on a non-recurring basis at December 31, 2018 and 2017 are presented below. The Company’s valuation methodology is discussed in Note 15.

(Dollars in thousands)

| | Fair Value Measurements December 31, 2018 | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation |
|---|---|---|---|---|
| Mortgage loans held for sale | $680 | - | - | 680 |
| Impaired loans | $21,695 | - | - | 21,695 |
| Other real estate | $27 | - | - | 27 |

(Dollars in thousands)

| | Fair Value Measurements December 31, 2017 | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation |
|---|---|---|---|---|
| Mortgage loans held for sale | $857 | - | - | 857 |
| Impaired loans | $23,442 | - | - | 23,442 |
| Other real estate | $118 | - | - | 118 |

Changes in the allowance for loan losses for the year ended December 31, 2018 were as follows:

(Dollars in thousands)

| | Real Estate Loans | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Construction and Land Development | Single-Family Residential | Single-Family Residential - Banco de la Gente Non-traditional | Commercial | Multifamily and Farmland | Commercial | Farm | Consumer and All Other | Unallocated |
| Allowance for loan losses: | | | | | | | | | |
| Beginning balance | $804 | 1,812 | 1,280 | 1,193 | 72 | 574 | - | 155 | 476 |
| Charge-offs | (53) | (116) | - | (453) | (5) | (54) | - | (452) | - |
| Recoveries | 10 | 106 | - | 105 | 1 | 32 | - | 168 | - |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Provision | 52 | (477) | (103) | 433 | 15 | 74 | - | 290 | 506 |
| Ending balance | $813 | 1,325 | 1,177 | 1,278 | 83 | 626 | - | 161 | 982 |
| | | | | | | | | | |
| Ending balance: individually evaluated for impairment | $- | - | 1,023 | 15 | - | - | - | - | - |
| Ending balance: collectively evaluated for impairment | 813 | 1,325 | 154 | 1,263 | 83 | 626 | - | 161 | 982 |
| Ending balance | $813 | 1,325 | 1,177 | 1,278 | 83 | 626 | - | 161 | 982 |
| | | | | | | | | | |
| Loans: Ending balance | $94,178 | 252,983 | 34,261 | 270,055 | 33,163 | 97,465 | 926 | 20,992 | - |
| | | | | | | | | | |
| Ending balance: individually evaluated for impairment | $96 | 1,779 | 14,310 | 1,673 | - | 89 | - | - | - |
| Ending balance: collectively evaluated for impairment | $94,082 | 251,204 | 19,951 | 268,382 | 33,163 | 97,376 | 926 | 20,992 | - |

Changes in the allowance for loan losses for the year ended December 31, 2017 were as follows:

(Dollars in thousands)

| | Real Estate Loans | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Construction and Land Development | Single-Family Residential | Single-Family Residential - Banco de la Gente Non-traditional | Commercial | Multifamily and Farmland | Commercial | Farm | Consumer and All Other | Unallocat |
| Allowance for loan losses: | | | | | | | | | |
| Beginning balance | $1,152 | 2,126 | 1,377 | 1,593 | 52 | 675 | - | 204 | 371 |
| Charge-offs | - | (249) | - | - | (66) | (194) | - | (473) | - |
| Recoveries | 14 | 85 | - | 21 | - | 31 | - | 154 | - |
| Provision | (362) | (150) | (97) | (421) | 86 | 62 | - | 270 | 105 |
| Ending balance | $804 | 1,812 | 1,280 | 1,193 | 72 | 574 | - | 155 | 476 |
| Ending balance: individually evaluated for impairment | $- | - | 1,093 | 37 | - | - | - | - | - |
| Ending balance: collectively evaluated for impairment | 804 | 1,812 | 187 | 1,156 | 72 | 574 | - | 155 | 476 |
| Ending balance | $804 | 1,812 | 1,280 | 1,193 | 72 | 574 | - | 155 | 476 |
| Loans: Ending balance | $84,987 | 246,703 | 37,249 | 248,637 | 28,937 | 89,022 | 1,204 | 23,025 | - |
| Ending balance: individually | | | | | | | | | |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| evaluated for impairment | $98 | 1,855 | 15,460 | 2,251 | - | 100 | - | - | - |
| Ending balance: collectively evaluated for impairment | $84,889 | 244,848 | 21,789 | 246,386 | 28,937 | 88,922 | 1,204 | 23,025 | - |

Changes in the allowance for loan losses for the year ended December 31, 2016 were as follows:

(Dollars in thousands)

| | Real Estate Loans | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Construction and Land Development | Single-Family Residential | Single-Family Residential - Banco de la Gente Non-traditional | Commercial | Multifamily and Farmland | Commercial | Farm | Consumer and All Other | Unallocated |
| Allowance for loan losses: | | | | | | | | | |
| Beginning balance | $2,185 | 2,534 | 1,460 | 1,917 | - | 842 | - | 172 | 479 |
| Charge-offs | (7) | (275) | - | (318) | - | (146) | - | (492) | - |
| Recoveries | 10 | 55 | - | 19 | - | 170 | - | 151 | - |
| Provision | (1,036) | (188) | (83) | (25) | 52 | (191) | - | 373 | (108) |
| Ending balance | $1,152 | 2,126 | 1,377 | 1,593 | 52 | 675 | - | 204 | 371 |
| Ending balance: individually evaluated for impairment | $- | - | 1,160 | 159 | - | - | - | - | - |
| Ending balance: collectively evaluated for impairment | 1,152 | 2,126 | 217 | 1,434 | 52 | 675 | - | 204 | 371 |
| Ending balance | $1,152 | 2,126 | 1,377 | 1,593 | 52 | 675 | - | 204 | 371 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Loans: | | | | | | | | | |
| Ending balance | $61,749 | 240,700 | 40,189 | 247,521 | 21,047 | 87,596 | - | 25,009 | - |
| Ending balance: individually | | | | | | | | | |
| evaluated for impairment | $- | 935 | 16,718 | 3,648 | - | - | - | - | - |
| Ending balance: collectively evaluated for impairment | $61,749 | 239,765 | 23,471 | 243,873 | 21,047 | 87,596 | - | 25,009 | - |

The Bank utilizes an internal risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 1 to 8. These risk grades are evaluated on an ongoing basis. A description of the general characteristics of the eight risk grades is as follows:

Risk Grade 1 – Excellent Quality: Loans are well above average quality and a minimal amount of credit risk exists. CD or cash secured loans or properly margined actively traded stock or bond secured loans would fall in this grade.

Risk Grade 2 – High Quality: Loans are of good quality with risk levels well within the Company’s range of acceptability. The organization or individual is established with a history of successful performance though somewhat susceptible to economic changes.

Risk Grade 3 – Good Quality: Loans of average quality with risk levels within the Company's range of acceptability but higher than normal. This may be a new organization or an existing organization in a transitional phase (e.g. expansion, acquisition, market change).

Risk Grade 4 – Management Attention: These loans have higher risk and servicing needs but still are acceptable. Evidence of marginal performance or deteriorating trends is observed. These are not problem credits presently, but may be in the future if the borrower is unable to change its present course.

Risk Grade 5 – Watch: These loans are currently performing satisfactorily, but there has been some recent past due history on repayment and there are potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Company's position at some future date.

Risk Grade 6 – Substandard: A Substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or the collateral pledged (if there is any). There is a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. There is a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Risk Grade 7 – Doubtful: Loans classified as Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.

Risk Grade 8 – Loss: Loans classified as Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be realized in the future. Loss is a temporary grade until the appropriate authority is obtained to charge the loan off.

The following tables present the credit risk profile of each loan type based on internally assigned risk grades as of December 31, 2018 and 2017.

December 31, 2018

(Dollars in thousands)

| | Real Estate Loans | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Construction and Land Development | Single-Family Residential | Single-Family Residential - Banco de la Gente Non-traditional | Commercial | Multifamily and Farmland | Commercial | Farm | Consumer | All Other | Total |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| 1- Excellent Quality | $504 | 5,795 | - | - | - | 605 | - | 673 | - | 7,57 |
| 2- High Quality | 24,594 | 128,588 | - | 25,321 | 395 | 20,520 | - | 3,229 | 2,145 | 204 |
| 3- Good Quality | 59,549 | 92,435 | 13,776 | 211,541 | 27,774 | 69,651 | 785 | 4,699 | 8,932 | 489 |
| 4- Management Attention | 5,707 | 19,200 | 15,012 | 30,333 | 3,906 | 6,325 | 141 | 529 | 750 | 81,9 |
| 5- Watch | 3,669 | 3,761 | 2,408 | 2,616 | 1,088 | 264 | - | 18 | - | 13,8 |
| 6- Substandard | 155 | 3,204 | 3,065 | 244 | - | 100 | - | 17 | - | 6,78 |
| 7- Doubtful | - | - | - | - | - | - | - | - | - | - |
| 8- Loss | - | - | - | - | - | - | - | - | - | - |
| Total | $94,178 | 252,983 | 34,261 | 270,055 | 33,163 | 97,465 | 926 | 9,165 | 11,827 | 804 |

December 31, 2017
(Dollars in thousands)

| | Real Estate Loans | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Construction and Land Development | Single-Family Residential | Single-Family Residential - Banco de la Gente Non-traditional | Commercial | Multifamily and Farmland | Commercial | Farm | Consumer | All Other | Tot |
| 1- Excellent Quality | $152 | 8,590 | - | - | - | 446 | - | 791 | - | 9, |
| 2- High Quality | 20,593 | 120,331 | - | 34,360 | 561 | 17,559 | - | 3,475 | 2,410 | 19 |
| 3- Good Quality | 53,586 | 89,120 | 14,955 | 196,439 | 25,306 | 65,626 | 1,085 | 5,012 | 9,925 | 46 |
| 4- Management Attention | 4,313 | 20,648 | 15,113 | 13,727 | 1,912 | 5,051 | 119 | 562 | 802 | 62 |
| 5- Watch | 6,060 | 4,796 | 3,357 | 3,671 | 1,146 | 223 | - | 23 | - | 19 |
| 6- Substandard | 283 | 3,218 | 3,824 | 440 | 12 | 117 | - | 25 | - | 7, |
| 7- Doubtful | - | - | - | - | - | - | - | - | - | - |
| 8- Loss | - | - | - | - | - | - | - | - | - | - |
| Total | $84,987 | 246,703 | 37,249 | 248,637 | 28,937 | 89,022 | 1,204 | 9,888 | 13,137 | 75 |

TDR loans modified in 2018, past due TDR loans and non-accrual TDR loans totaled $4.7 million and $4.5 million at December 31, 2018 and December 31, 2017, respectively. The terms of these loans have been renegotiated to provide a concession to original terms, including a reduction in principal or interest as a result of the deteriorating financial position of the borrower. There were $92,000 and $21,000 in performing loans classified as TDR loans at December 31, 2018 and December 31, 2017, respectively.

The following table presents an analysis of loan modifications during the year ended December 31, 2018:

Year ended December 31,
2018

(Dollars in thousands)

| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|---|---|---|---|
| Real estate loans: | | | |
| Single-family residential | 2 | $94 | 94 |
| Total TDR loans | 2 | $94 | 94 |

During the year ended December 31, 2018, two loans were modified that were considered to be new TDR loans. The interest rate was modified on these TDR loans.

The following table presents an analysis of loan modifications during the year ended December 31, 2017:

Year ended December 31,
2017

(Dollars in thousands)

| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|---|---|---|---|
| Real estate loans: | | | |
| Single-family residential | 2 | $22 | 22 |
| Total TDR loans | 2 | $22 | 22 |

During the year ended December 31, 2017, two loans were modified that were considered to be new TDR loans. The interest rate was modified on these TDR loans.

There were no TDR loans with a payment default occurring within 12 months of the restructure date, and the payment default occurring during the years ended December 31, 2018 and 2017. TDR loans are deemed to be in default if they become past due by 90 days or more.

(4)
Premises and Equipment

Major classifications of premises and equipment at December 31, 2018 and 2017 are summarized as follows:

(Dollars in thousands)

| | 2018 | 2017 |
|---|---|---|
| Land | $3,456 | 3,700 |
| Buildings and improvements | 19,357 | 19,312 |
| Furniture and equipment | 22,315 | 21,115 |
| Construction in process | 381 | 847 |
| Total premises and equipment | 45,509 | 44,974 |
| Less accumulated depreciation | 27,059 | 25,063 |
| Total net premises and equipment | $18,450 | 19,911 |

The Company recognized approximately $2.3 million in depreciation expense for the year ended December 31, 2018. Depreciation expense was approximately $2.1 million and $2.1 million for the years ended December 31, 2017 and 2016, respectively.

The Company had $544,000 net gains on the sale of premises and equipment for the year ended December 31, 2018, which was primarily due to the sale of a Bank building that housed primarily administrative staff. Staff working at this location have been relocated to other Bank locations.

(5)
Time Deposits

At December 31, 2018, the scheduled maturities of time deposits are as follows:

(Dollars in thousands)

| | |
|---|---|
| 2019 | $61,723 |
| 2020 | 21,566 |
| 2021 | 14,121 |
| 2022 | 2,618 |
| 2023 and thereafter | 3,145 |
| Total | $103,173 |

At December 31, 2018 and 2017, the Bank had approximately $3.4 million and $5.2 million, respectively, in time deposits purchased through third party brokers, including certificates of deposit participated through the Certificate of Deposit Account Registry Service (“CDARS”) on behalf of local customers. CDARS balances totaled $3.4 million and $5.2 million as of December 31, 2018 and 2017, respectively. The weighted average rate of brokered deposits as of December 31, 2018 and 2017 was 0.07% and 0.07%, respectively.

(6)
Federal Home Loan Bank and Federal Reserve Bank Borrowings

The Bank had no borrowings from the FHLB at December 31, 2018 and 2017. FHLB borrowings are collateralized by a blanket assignment on all residential first mortgage loans, home equity lines of credit and loans secured by multi-family real estate that the Bank owns. At December 31, 2018, the carrying value of loans pledged as collateral totaled approximately $140.0 million. The remaining availability under the line of credit with the FHLB was $84.9 million at December 31, 2018.

The Bank is required to purchase and hold certain amounts of FHLB stock in order to obtain FHLB borrowings. No ready market exists for the FHLB stock, and it has no quoted market value. The stock is redeemable at $100 per share subject to certain limitations set by the FHLB. The Bank owned $982,000 and $978,000 of FHLB stock, included in other investments, at December 31, 2018 and 2017, respectively.

The Bank prepaid FHLB borrowings totaling $20.0 million in 2017 with prepayment penalties totaling $508,000.

As of December 31, 2018 and 2017, the Bank had no borrowings from the Federal Reserve Bank (“FRB”). FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At December 31, 2018, the carrying value of loans pledged as collateral totaled approximately $442.6 million. Availability under the line of credit with the FRB was $335.8 million at December 31, 2018.

(7)
Junior Subordinated Debentures

In June 2006, the Company formed a second wholly owned Delaware statutory trust, PEBK Capital Trust II (“PEBK Trust II”), which issued $20.0 million of guaranteed preferred beneficial interests in the Company’s junior subordinated deferrable interest debentures. All of the common securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase $20.6 million of junior subordinated debentures of the Company. The proceeds received by the Company from the sale of the junior subordinated debentures were used to repay in December 2006 the trust preferred securities issued in December 2001 by PEBK Capital Trust, a wholly owned Delaware statutory trust of the Company, and for general purposes. The debentures represent the sole assets of PEBK Trust II. PEBK Trust II is not included in the consolidated financial statements.

The trust preferred securities issued by PEBK Trust II accrue and pay interest quarterly at a floating rate of three-month LIBOR plus 163 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust II does not have funds with which to make the distributions and other payments. The net combined effect of all the documents entered into in connection with the trust preferred securities is that the Company is liable to make the distributions and other payments required on the trust preferred securities.

These trust preferred securities are mandatorily redeemable upon maturity of the debentures on June 28, 2036, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by PEBK Trust II, in whole or in part, which became effective on June 28, 2011. As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be the principal amount plus any accrued but unpaid interest.

(8)
Income Taxes

On December 22, 2017, the President of the United States signed into law the TCJA. The TCJA includes a number of changes to existing U.S. tax laws that impact the Company, most notably a reduction of the U.S. corporate income tax rate from 34 percent to 21 percent for tax years beginning after December 31, 2017.

The Company recognized the income tax effects of the TCJA in its 2017 financial statements in accordance with Staff Accounting Bulletin No. 118, which provides SEC staff guidance for the application of ASC Topic 740, Income Taxes, in the reporting period in which the TCJA was signed into law. As such, the Company’s financial results reflect the income tax effects of the TCJA for which the accounting under ASC Topic 740 is complete and provisional amounts for those specific income tax effects of the TCJA for which the accounting under ASC Topic 740 is incomplete but a reasonable estimate could be determined. The Company did not identify items for which the income tax effects of the TCJA have not been completed and a reasonable estimate could not be determined as of December 31, 2017.

The provision for income taxes is summarized as follows:

(Dollars in thousands)

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Current expense | $2,546 | 1,827 | 1,464 |
| Deferred income tax expense | 78 | 2,120 | 1,097 |
| Total income tax | $2,624 | 3,947 | 2,561 |

The differences between the provision for income taxes and the amount computed by applying the statutory federal income tax rate to earnings before income taxes are as follows:

(Dollars in thousands)

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Tax expense at statutory rate (21% in 2018) | $3,361 | 4,833 | 3,991 |
| State income tax, net of federal income tax effect | 358 | 307 | 339 |
| Tax-exempt interest income | (990) | (1,594) | (1,681) |
| Increase in cash surrender value of life insurance | (81) | (136) | (138) |
| Nondeductible interest and other expense | 23 | 46 | 78 |
| Impact of TCJA | - | 588 | - |
| Other | (47) | (97) | (28) |
| Total | $2,624 | 3,947 | 2,561 |

The following summarizes the tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities. The net deferred tax asset is included as a component of other assets at December 31, 2018 and 2017.

(Dollars in thousands)

| | 2018 | 2017 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for loan losses | $1,481 | 1,463 |
| Accrued retirement expense | 1,119 | 1,073 |
| Federal credit carryforward | - | 88 |
| Restricted stock | 262 | 243 |
| Accrued bonuses | 211 | 171 |
| Interest income on nonaccrual loans | 1 | 5 |
| Other than temporary impairment | - | 9 |
| Total gross deferred tax assets | 3,074 | 3,052 |
| Deferred tax liabilities: | | |
| Deferred loan fees | 379 | 365 |
| Accumulated depreciation | 610 | 498 |
| Prepaid expenses | 10 | 14 |
| Other | 5 | 28 |
| Unrealized gain on available for sale securities | 294 | 1,072 |
| Total gross deferred tax liabilities | 1,298 | 1,977 |
| Net deferred tax asset | $1,776 | 1,075 |

The Company measures deferred tax assets and liabilities using enacted tax rates that will apply in the years in which the temporary differences are expected to be recovered or paid. Accordingly, the Company’s deferred tax assets and liabilities were remeasured to reflect the reduction in the U.S. corporate income tax rate from 34 percent to 21 percent, resulting in a $588,000 increase in income tax expense for the year ended December 31, 2017 and a corresponding $588,000 decrease in net deferred tax assets as of December 31, 2017.

The Company has analyzed the tax positions taken or expected to be taken in its tax returns and has concluded that it has no liability related to uncertain tax positions.

The Company’s Federal income tax filings for years 2015 through 2018 were at year end 2018 open to audit under statutes of limitations by the Internal Revenue Service. The Company's North Carolina income tax returns are currently under audit for tax years 2014-2016, tax years 2017 and 2018 are open to audit under the statutes of limitations by the North Carolina Department of Revenue.

(9)
Related Party Transactions

The Company conducts transactions with its directors and executive officers, including companies in which they have beneficial interests, in the normal course of business. It is the policy of the Company that loan transactions with directors and officers are made on substantially the same terms as those prevailing at the time made for comparable loans to other persons. The following is a summary of activity for related party loans for 2018 and 2017:

(Dollars in thousands)

| | 2018 | 2017 |
|---|---|---|
| Beginning balance | $3,679 | 4,503 |
| New loans | 8,030 | 5,879 |
| Repayments | (8,517) | (6,703) |
| Ending balance | $3,192 | 3,679 |

At December 31, 2018 and 2017, the Company had deposit relationships with related parties of approximately $31.6 million and $26.6 million, respectively.

A director of the Company is an officer and partial owner of the construction company that renovated the Bank's Corporate Center located at 518 West C Street, Newton, North Carolina during 2017. During 2017 the Company paid a total of approximately $2.6 million to this construction company for such renovation work. The Company did not make any payments to this construction company during 2018.

A director of the Company has a membership interest in a company that leases two branch facilities to the Bank. The Bank's lease payments for these facilities totaled $230,000 and $215,000 during 2018 and 2017, respectively.

(10)
Commitments and Contingencies

The Company leases various office spaces for banking and operational facilities and equipment under operating lease arrangements. Future minimum lease payments required for all operating leases having a remaining term in excess of one year at December 31, 2018 are as follows:

(Dollars in thousands)

| Year ending December 31, | |
|---|---|
| 2019 | $820 |
| 2020 | 809 |
| 2021 | 793 |
| 2022 | 501 |
| 2023 | 393 |
| Thereafter | 1,624 |
| Total minimum obligation | $4,940 |

Total rent expense was approximately $785,000, $756,000 and $752,000 for the years ended December 31, 2018, 2017 and 2016, respectively.

The Bank is 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, standby letters of credit and financial guarantees. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

The 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 and financial guarantees written 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.

In most cases, the Bank requires collateral or other security to support financial instruments with credit risk.

(Dollars in thousands)

| | Contractual Amount | |
|---|---|---|
| | 2018 | 2017 |

Financial instruments whose contract amount represent credit risk:

| | | |
|---|---|---|
| Commitments to extend credit | $268,708 | 233,972 |
| Standby letters of credit and financial guarantees written | $3,651 | 3,325 |

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 and because they may expire without being drawn upon, the total commitment amount of $272.4 million does not necessarily represent future cash requirements.

Standby letters of credit and financial guarantees written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to businesses in the Bank’s delineated market area. 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 real estate, equipment, automobiles and customer deposits as collateral supporting those commitments for which collateral is deemed necessary.

In the normal course of business, the Company is a party (both as plaintiff and defendant) to a number of lawsuits. In the opinion of management and counsel, none of these cases should have a material adverse effect on the financial position of the Company.

Bancorp and the Bank have employment agreements with certain key employees. The agreements, among other things, include salary, bonus, incentive compensation, and change in control provisions.

The Company has $82.5 million available for the purchase of overnight federal funds from six correspondent financial institutions as of December 31, 2018.

At December 31, 2017, the Bank committed to invest $3.0 million in an income tax credit partnership owning and developing two multifamily housing developments in Charlotte, North Carolina, with $1.5 million allocated to each property. The Bank has funded $2.4 million of this commitment at December 31, 2018.

(11)
Employee and Director Benefit Programs

The Company has a profit sharing and 401(k) plan for the benefit of substantially all employees subject to certain minimum age and service requirements. Under the 401(k) plan, the Company matched employee contributions to a maximum of 4.00% of annual compensation in 2016, 2017 and 2018. The Company's contribution pursuant to this formula was approximately $670,000, $622,000 and $565,000 for the years 2018, 2017 and 2016, respectively. Investments of the 401(k) plan are determined by a committee comprised of senior management. No investments in Company stock have been made by the 401(k) plan. Contributions to the 401(k) plan are vested immediately.

In December 2001, the Company initiated a postretirement benefit plan to provide retirement benefits to key officers and its Board of Directors and to provide death benefits for their designated beneficiaries. Under the postretirement benefit plan, the Company purchased life insurance contracts on the lives of the key officers and each director. The increase in cash surrender value of the contracts constitutes the Company's contribution to the postretirement benefit plan each year. Postretirement benefit plan participants are to be paid annual benefits for a specified number of years commencing upon retirement. Expenses incurred for benefits relating to the postretirement benefit plan were approximately $423,000, $411,000 and $428,000 for the years 2018, 2017 and 2016, respectively.

The Company is currently paying medical benefits for certain retired employees. The Company did not incur any postretirement medical benefits expense in 2018, 2017 and 2016 due to an excess accrual balance.

The following table sets forth the change in the accumulated benefit obligation for the Company's two postretirement benefit plans described above:

(Dollars in thousands)

| | 2018 | 2017 |
|---|---|---|
| Benefit obligation at beginning of period | $4,361 | 4,174 |
| Service cost | 362 | 348 |
| Interest cost | 70 | 68 |
| Benefits paid | (227) | (229) |
| Benefit obligation at end of period | $4,566 | 4,361 |

The amounts recognized in the Company's Consolidated Balance Sheet as of December 31, 2018 and 2017 are shown in the following two tables:

(Dollars in thousands)

| | 2018 | 2017 |
|---|---|---|
| Benefit obligation | $4,566 | 4,361 |
| Fair value of plan assets | - | - |

(Dollars in thousands)

| | 2018 | 2017 |
|---|---|---|
| Funded status | $(4,566) | (4,361) |
| Unrecognized prior service cost/benefit | - | - |
| Unrecognized net actuarial loss | - | - |
| Net amount recognized | $(4,566) | (4,361) |
| Unfunded accrued liability | $(4,566) | (4,361) |
| Intangible assets | - | - |
| Net amount recognized | $(4,566) | (4,361) |

Net periodic benefit cost of the Company's postretirement benefit plans for the years ended December 31, 2018, 2017 and 2016 consisted of the following:

(Dollars in thousands)

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Service cost | $362 | 348 | 346 |
| Interest cost | 70 | 68 | 67 |
| Net periodic cost | $432 | 416 | 413 |
| Weighted average discount rate assumption used to determine benefit obligation | 5.49% | 5.49% | 5.47% |

The Company paid benefits under the two postretirement plans totaling $227,000 and $229,000 during the years ended December 31, 2018 and 2017, respectively. Information about the expected benefit payments for the Company's two postretirement benefit plans is as follows:

(Dollars in thousands)

Year ending December 31,

| | |
|---|---|
| 2019 | $235 |
| 2020 | $353 |
| 2021 | $353 |
| 2022 | $342 |
| 2023 | $342 |
| Thereafter | $8,709 |

(12)
Regulatory Matters

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios of capital in relation to both on- and off-balance sheet items at various risk weights. Total capital consists of two tiers of capital. Tier 1 capital includes common shareholders' equity and trust preferred securities less adjustments for intangible assets. Tier 2 capital consists of the allowance for loan losses, up to 1.25% of risk-weighted assets and other adjustments. Management believes, as of December 31, 2018, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2018, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the table below. There have been no conditions or events since that notification that management believes have changed the Bank's category.

In 2013, the Federal Reserve Board approved its final rule on the Basel III capital standards, which implement changes to the regulatory capital framework for banking organizations. The Basel III capital standards, which became effective January 1, 2015, include new risk-based capital and leverage ratios, which are being phased in from 2015 to 2019. The new minimum capital level requirements applicable to the Company and the Bank under the final rules are as follows: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total risk based capital ratio of 8% (unchanged from previous rules); and (iv) a Tier 1 leverage ratio of 4% (unchanged from previous rules). An additional capital conservation buffer was added to the minimum requirements for capital adequacy purposes beginning on January 1, 2016 at 0.625% and is being phased in through 2019 (increasing by 0.625% on each subsequent January 1, until it reaches 2.5% on January 1, 2019). This will result in the following minimum ratios beginning in 2019: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. Under the final rules, institutions would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained earnings that could be utilized for such actions.

The Company's and the Bank's actual capital amounts and ratios are presented below:

(Dollars in thousands)

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2018: | | | | | | |
| Total Capital (to Risk-Weighted Assets) | | | | | | |
| Consolidated | $149,076 | 16.15% | 91,133 | 9.88% | N/A | N/A |
| Bank | $146,640 | 15.91% | 90,995 | 9.88% | 92,147 | 10.00% |

| | | | | | | |
|---|---|---|---|---|---|---|
| Tier 1 Capital (to Risk-Weighted Assets) | | | | | | |
| Consolidated | $142,631 | 15.46% | 72,676 | 7.88% | N/A | N/A |
| Bank | $140,195 | 15.21% | 72,566 | 7.88% | 73,717 | 8.00% |
| Tier 1 Capital (to Average Assets) | | | | | | |
| Consolidated | $142,631 | 13.05% | 43,723 | 4.00% | N/A | N/A |
| Bank | $140,195 | 12.76% | 43,950 | 4.00% | 54,937 | 5.00% |
| | | | | | | |
| Common Equity Tier 1 (to Risk-Weighted Assets) | | | | | | |
| | | | | | | |
| Consolidated | $122,631 | 13.29% | 58,833 | 6.38% | N/A | N/A |
| Bank | $140,195 | 15.21% | 58,744 | 6.38% | 59,895 | 6.50% |

(Dollars in thousands)

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2017: | | | | | | |
| Total Capital (to Risk-Weighted Assets) | | | | | | |
| Consolidated | $138,492 | 16.06% | 79,758 | 9.25% | N/A | N/A |
| Bank | $136,299 | 15.83% | 79,627 | 9.25% | 86,084 | 10.00% |
| Tier 1 Capital (to Risk-Weighted Assets) | | | | | | |
| Consolidated | $132,126 | 15.32% | 62,513 | 7.25% | N/A | N/A |
| Bank | $129,933 | 15.09% | 62,411 | 7.25% | 68,867 | 8.00% |
| Tier 1 Capital (to Average Assets) | | | | | | |
| Consolidated | $132,126 | 11.94% | 44,255 | 4.00% | N/A | N/A |
| Bank | $129,933 | 11.69% | 44,475 | 4.00% | 55,594 | 5.00% |
| Common Equity Tier 1 (to Risk-Weighted Assets) | | | | | | |
| Consolidated | $112,126 | 13.00% | 49,579 | 5.75% | N/A | N/A |
| Bank | $129,933 | 15.09% | 49,498 | 5.75% | 55,954 | 6.50% |

(13)
Shareholders' Equity

Shareholders' equity was $123.6 million, or 11.31% of total assets, as of December 31, 2018, compared to $116.0 million, or 10.62% of total assets, as of December 31, 2017. The increase in shareholders' equity is primarily due to an increase in retained earnings due to net income.

Annualized return on average equity for the year ended December 31, 2018 was 10.81% compared to 8.78% for the year ended December 31, 2017. Total cash dividends paid on common stock were $3.1 million and $2.6 million for the years ended December 31, 2018 and 2017, respectively.

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights. The Board of Directors does not currently anticipate issuing shares of preferred stock.

In 2016, the Company's Board of Directors authorized a stock repurchase program, pursuant to which up to $2 million was allocated to repurchase the Company's common stock. Any purchases under the Company's stock repurchase program were made periodically as permitted by securities laws and other legal requirements in the open market or in privately negotiated transactions. The timing and amount of any repurchase of shares were determined by the Company's management, based on its evaluation of market conditions and other factors. The Company repurchased approximately $2.0 million, or 92,738 shares of its common stock, under this program as of December 31, 2017.

(14)
Other Operating Income and Expense

Miscellaneous non-interest income for the years ended December 31, 2018, 2017 and 2016 included the following items:

(Dollars in thousands)

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Visa debit card income | $3,911 | 3,757 | 3,589 |
| Bank owned life insurance income | 384 | 400 | 407 |
| Gain (loss) on sale of capital assets | 544 | (32) | - |
| Other | 1,354 | 1,175 | 854 |
| | $6,193 | 5,300 | 4,850 |

Other non-interest expense for the years ended December 31, 2018, 2017 and 2016 included the following items:

(Dollars in thousands)

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| ATM expense | $542 | 673 | 658 |
| Consulting | 1,012 | 785 | 2,257 |
| Data processing | 466 | 426 | 418 |
| Deposit program expense | 586 | 539 | 371 |
| Dues and subscriptions | 421 | 354 | 451 |
| FHLB advance prepayment penalty | - | 508 | 1,260 |
| Internet banking expense | 603 | 720 | 710 |
| Office supplies | 503 | 517 | 465 |
| Telephone | 678 | 855 | 754 |
| Other | 2,834 | 2,540 | 1,399 |
| | $7,645 | 7,917 | 8,743 |

(15)
Fair Value of Financial Instruments

The Company is required to disclose fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company's financial instruments are detailed below. Where quoted prices are not available, fair values are based on estimates using discounted cash flows and other valuation techniques. The use of discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following disclosures should not be considered a surrogate of the liquidation value of the Company, but rather a good faith estimate of the increase or decrease in the value of financial instruments held by the Company since purchase, origination, or issuance.

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Cash and Cash Equivalents

For cash, due from banks and interest-bearing deposits, the carrying amount is a reasonable estimate of fair value. Cash and cash equivalents are reported in the Level 1 fair value category.

Investment Securities Available for Sale

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Fair values for investment securities with quoted market prices are reported in the Level 1 fair value category. Fair value measurements obtained from independent pricing services are reported in the Level 2 fair value category. All other fair value measurements are reported in the Level 3 fair value category.

Other Investments

For other investments, the carrying value is a reasonable estimate of fair value. Other investments are reported in the Level 3 fair value category.

Mortgage Loans Held for Sale

Mortgage loans held for sale are carried at lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value. Mortgage loans held for sale are reported in the Level 3 fair value category.

Loans
The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. For variable rate loans, the carrying amount is a reasonable estimate of fair value. Loans are reported in the Level 3 fair value category, as the pricing of loans is more subjective than the pricing of other financial instruments.

Cash Surrender Value of Life Insurance
For cash surrender value of life insurance, the carrying value is a reasonable estimate of fair value. Cash surrender value of life insurance is reported in the Level 2 fair value category.

Other Real Estate
The fair value of other real estate is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. Other real estate is reported in the Level 3 fair value category.

Deposits
The fair value of demand deposits, interest-bearing demand deposits and savings is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. Deposits are reported in the Level 2 fair value category.

Securities Sold Under Agreements to Repurchase
For securities sold under agreements to repurchase, the carrying value is a reasonable estimate of fair value. Securities sold under agreements to repurchase are reported in the Level 2 fair value category.

FHLB Borrowings
The fair value of FHLB borrowings is estimated based upon discounted future cash flows using a discount rate comparable to the current market rate for such borrowings. FHLB borrowings are reported in the Level 2 fair value category.

Junior Subordinated Debentures
Because the Company's junior subordinated debentures were issued at a floating rate, the carrying amount is a reasonable estimate of fair value. Junior subordinated debentures are reported in the Level 2 fair value category.

Commitments to Extend Credit and Standby Letters of Credit
Commitments to extend credit and standby letters of credit are generally short-term and at variable interest rates. Therefore, both the carrying value and estimated fair value associated with these instruments are immaterial.

Limitations
Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on many judgments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial instruments include deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of unrealized gains and

losses can have a significant effect on fair value estimates and have not been considered in the estimates.

The fair value presentation for recurring assets is presented in Note 2. There were no recurring liabilities at December 31, 2018 and 2017. The fair value presentation for non-recurring assets is presented in Note 3. There were no non-recurring liabilities at December 31, 2018 and 2017. The carrying amount and estimated fair value of the Company’s financial instruments at December 31, 2018 and 2017 are as follows:

(Dollars in thousands)

| | | Fair Value Measurements at December 31, 2018 | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Level 1 | Level 2 | Level 3 | Total |
| Assets: | | | | | |
| Cash and cash equivalents | $43,370 | 43,370 | - | - | 43,370 |
| Investment securities available for sale | $194,578 | - | 194,328 | 250 | 194,578 |
| Other investments | $4,361 | - | - | 4,361 | 4,361 |
| Mortgage loans held for sale | $680 | - | - | 680 | 680 |
| Loans, net | $797,578 | - | - | 748,917 | 748,917 |
| Cash surrender value of life insurance | $15,936 | - | 15,936 | - | 15,936 |
| Liabilities: | | | | | |
| Deposits | $877,213 | - | - | 857,999 | 857,999 |
| Securities sold under agreements to repurchase | $58,095 | - | 58,095 | - | 58,095 |
| Junior subordinated debentures | $20,619 | - | 20,619 | - | 20,619 |

(Dollars in thousands)

| | | Fair Value Measurements at December 31, 2017 | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Level 1 | Level 2 | Level 3 | Total |
| Assets: | | | | | |
| Cash and cash equivalents | $57,304 | 57,304 | - | - | 57,304 |
| Investment securities available for sale | $229,321 | - | 229,071 | 250 | 229,321 |
| Other investments | $1,830 | - | - | 1,830 | 1,830 |
| Mortgage loans held for sale | $857 | - | - | 857 | 857 |
| Loans, net | $753,398 | - | - | 735,837 | 735,837 |
| Cash surrender value of life insurance | $15,552 | - | 15,552 | - | 15,552 |
| Liabilities: | | | | | |
| Deposits | $906,952 | - | - | 894,932 | 894,932 |

| | | | | | |
|---|---|---|---|---|---|
| Securities sold under agreements to repurchase | $37,757 | - | 37,757 | - | 37,757 |
| Junior subordinated debentures | $20,619 | - | 20,619 | - | 20,619 |

(16)
Peoples Bancorp of North Carolina, Inc. (Parent Company Only) Condensed Financial Statements

Balance Sheets
December 31, 2018 and 2017
(Dollars in thousands)

| Assets | 2018 | 2017 |
|---|---|---|
| Cash | $689 | 428 |
| Interest-bearing time deposit | 1,000 | 1,000 |
| Investment in subsidiaries | 141,181 | 133,781 |
| Investment in PEBK Capital Trust II | 619 | 619 |
| Investment securities available for sale | 250 | 250 |
| Other assets | 533 | 546 |
| Total assets | $144,272 | 136,624 |
| Liabilities and Shareholders' Equity | | |
| Junior subordinated debentures | $20,619 | 20,619 |
| Liabilities | 36 | 30 |
| Shareholders' equity | 123,617 | 115,975 |
| Total liabilities and shareholders' equity | $144,272 | 136,624 |

Statements of Earnings
For the Years Ended December 31, 2018, 2017 and 2016
(Dollars in thousands)

| Revenues: | 2018 | 2017 | 2016 |
|---|---|---|---|
| Interest and dividend income | $4,544 | 1,839 | 4,569 |
| Gain on sale of securities | - | - | 405 |
| Total revenues | 4,544 | 1,839 | 4,974 |
| Expenses: | | | |
| Interest | 790 | 590 | 485 |
| Other operating expenses | 678 | 725 | 513 |

| | | | |
|---|---|---|---|
| Total expenses | 1,468 | 1,315 | 998 |
| Income before income tax benefit and equity in undistributed earnings of subsidiaries | 3,076 | 524 | 3,976 |
| Income tax benefit | 299 | 434 | 178 |
| Income before equity in undistributed earnings of subsidiaries | 3,375 | 958 | 4,154 |
| Equity in undistributed earnings of subsidiaries | 10,007 | 9,310 | 5,023 |
| Net earnings | $13,382 | 10,268 | 9,177 |

Statements of Cash Flows
For the Years Ended December 31, 20178, 2017 and 2016
(Dollars in thousands)

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net earnings | $13,382 | 10,268 | 9,177 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | | |
| Equity in undistributed earnings of subsidiaries | (10,007) | (9,310) | (5,023) |
| Gain on sale of investment securities | - | - | (405) |
| Change in: | | | |
| Other assets | 13 | (272) | 61 |
| Other liabilities | 6 | 5 | 5 |
| Net cash provided by operating activities | 3,394 | 691 | 3,815 |
| Cash flows from investing activities: | | | |
| Proceeds from calls and maturities of investment securities available for sale | - | 500 | 669 |
| In kind transfer from parent to Bank | - | - | 10 |
| Net cash provided by investing activities | - | 500 | 679 |
| Cash flows from financing activities: | | | |
| Cash dividends paid on common stock | (3,133) | (2,629) | (2,106) |
| Cash in lieu stock dividend | - | (6) | - |
| Stock repurchase | - | - | (1,984) |
| Proceeds from exercise of restricted stock units | - | 915 | - |
| Net cash used by financing activities | (3,133) | (1,720) | (4,090) |
| Net change in cash | 261 | (529) | 404 |
| Cash at beginning of year | 428 | 957 | 553 |
| Cash at end of year | $689 | 428 | 957 |
| Noncash investing and financing activities: | | | |
| Change in unrealized gain on investment securities | | | |

| | | | |
|---|---|---|---|
| available for sale, net | $(2,607) | (1) | (2,523) |

(17)
Quarterly Data

| (Dollars in thousands, except per share amounts) | First | Second | Third | Fourth | First | Second | Third | Fourth |
|---|---|---|---|---|---|---|---|---|
| Total interest income | $10,759 | 11,059 | 11,608 | 11,924 | $10,064 | 10,461 | 10,698 | 10,726 |
| Total interest expense | 467 | 513 | 557 | 609 | 598 | 622 | 650 | 507 |
| Net interest income | 10,292 | 10,546 | 11,051 | 11,315 | 9,466 | 9,839 | 10,048 | 10,219 |
| (Reduction of) provision for loan losses | 31 | 231 | 110 | 418 | (236) | 49 | (218) | (102) |
| Other income | 3,736 | 4,016 | 3,915 | 4,499 | 3,442 | 3,929 | 4,159 | 3,834 |
| Other expense | 10,042 | 10,560 | 10,702 | 11,270 | 10,361 | 9,983 | 10,006 | 10,878 |
| Income before income taxes | 3,955 | 3,771 | 4,154 | 4,126 | 2,783 | 3,736 | 4,419 | 3,277 |
| Income taxes (benefit) | 652 | 595 | 687 | 690 | 578 | 925 | 1,177 | 1,267 |
| Net earnings | 3,303 | 3,176 | 3,467 | 3,436 | 2,205 | 2,811 | 3,242 | 2,010 |
| Basic net earnings per share | $0.55 | 0.53 | 0.58 | 0.57 | $0.36 | 0.47 | 0.54 | 0.34 |
| Diluted net earnings per share | $0.55 | 0.53 | 0.57 | 0.57 | $0.36 | 0.46 | 0.53 | 0.34 |

DIRECTORS AND OFFICERS OF THE COMPANY

DIRECTORS

Robert C. Abernethy – Chairman
Chairman of the Board, Peoples Bancorp of North Carolina, Inc. and Peoples Bank;
President, Secretary and Treasurer, Carolina Glove Company, Inc. (glove manufacturer)
Secretary and Assistant Treasurer, Midstate Contractors, Inc. (paving company)

James S. Abernethy
Vice President, Carolina Glove Company, Inc. (glove manufacturer)
President and Assistant Secretary, Midstate Contractors, Inc. (paving company)
Vice President, Secretary and Chairman of the Board of Directors, Alexander Railroad Company

Douglas S. Howard
Vice President and Treasurer, Denver Equipment Company of Charlotte, Inc.

John W. Lineberger, Jr.
President, Lincoln Bonded Warehouse Company (commercial warehousing facility)

Gary E. Matthews
President and Director, Matthews Construction Company, Inc. (general contractor)

Billy L. Price, Jr. MD
Practitioner of Internal Medicine, BL Price Jr. Medical Consultants, PLLC

Larry E. Robinson
Shareholder, Director, Chairman of the Board and Chief Executive Officer, The Blue Ridge Distributing Co., Inc. (beer and wine distributor)
Director and member of the Board of Directors, United Beverages of North Carolina, LLC (beer distributor)

William Gregory (Greg) Terry
President, DFH Holdings
Operator/General Manager, Drum & Willis-Reynolds Funeral Homes and Crematory

Dan Ray Timmerman, Sr.
Chairman of the Board and Chief Executive Officer, Timmerman Manufacturing, Inc. (wrought iron furniture, railings and gates manufacturer)

Benjamin I. Zachary
President, Treasurer, General Manager and Director, Alexander Railroad Company

OFFICERS

Lance A. Sellers
President and Chief Executive Officer

A. Joseph Lampron, Jr.

Executive Vice President, Chief Financial Officer, Corporate Treasurer and Assistant Corporate Secretary

William D. Cable, Sr.
Executive Vice President, Corporate Secretary and Assistant Corporate Treasurer