

2023

NORTH STATE BANCORP

CONSOLIDATED FINANCIAL STATEMENTS

NORTH STATE BANCORP
INDEX TO THE CONSOLIDATED FINANCIAL STATEMENTS

	<u>Page No.</u>
Independent Auditors' Report	2
Consolidated Balance Sheets as of December 31, 2023 and 2022	4
Consolidated Statements of Operations for the years ended December 31, 2023 and 2022.....	5
Consolidated Statements of Comprehensive Income for the years ended December 31, 2023 and 2022.....	6
Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2023 and 2022.....	7
Consolidated Statements of Cash Flows for the years ended December 31, 2023 and 2022.....	8
Notes to Consolidated Financial Statements.....	10



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Independent Auditor's Report

Shareholders and the Board of Directors
North State Bancorp
Raleigh, North Carolina

Opinion

We have audited the consolidated financial statements of North State Bancorp (the "Company"), which comprise the consolidated balance sheets as of December 31, 2023 and 2022, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2023 and 2022, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

We have also audited in accordance with auditing standards generally accepted in the United States of America (GAAS), the Company's internal control over financial reporting as of December 31, 2023, based on the criteria established in *Internal Control—Integrated Framework (2013)*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 27, 2024 expressed an unmodified opinion thereon.

Change in Accounting Principle

As discussed in Note B to the consolidated financial statements, the Company changed its method of accounting for its allowance for credit losses effective January 1, 2023 due to the adoption of Accounting Standards Update No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* ("ASU 2016-13").

Basis for Opinion

We conducted our audits in accordance with GAAS. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are required to be independent of the Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.



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In preparing the consolidated financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the Company's ability to continue as a going concern within one year after the date that these consolidated financial statements are available to be issued.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not absolute assurance, and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the consolidated financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the consolidated financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

FORVIS, LLP

**Tysons, Virginia
March 27, 2024**

NORTH STATE BANCORP
CONSOLIDATED BALANCE SHEETS
December 31, 2023 and 2022

	2023	2022
	<i>(Dollars in thousands)</i>	
ASSETS		
Cash and due from banks	\$ 11,536	\$ 11,912
Interest-earning deposits with banks	76,104	122,816
Certificates of deposit with banks	101	101
Investment securities available for sale, at fair value	5,760	3,221
Investment securities held to maturity, net of allowance for credit losses of \$55 in 2023 and \$0 in 2022	53,203	53,050
Loans held for sale, at fair value	5,240	4,797
Loans held for investment	1,146,810	1,044,841
Less allowance for credit losses	6,962	7,543
Net loans	1,139,848	1,037,298
Accrued interest receivable	5,095	3,683
Federal Home Loan Bank and Federal Reserve stock, at cost	6,831	1,785
Premises and equipment, net	32,900	28,029
Bank owned life insurance	22,181	22,064
Other assets	18,511	15,600
Total Assets	\$ 1,377,310	\$ 1,304,356
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Demand	\$ 427,377	\$ 505,069
Savings, money market and NOW	678,489	637,943
Time	48,547	45,829
Total deposits	1,154,413	1,188,841
Accrued interest payable	1,830	423
Short-term borrowings	188	264
Long-term borrowings, net	134,020	34,151
Accrued expenses and other liabilities	10,529	9,802
Total Liabilities	1,300,980	1,233,481
Commitments	-	-
Shareholders' equity:		
Preferred stock, no par value, 1,000,000 shares authorized, none issued	-	-
Common stock, no par value; 8,136,382 shares authorized; 6,544,438 and 6,361,718 shares issued and outstanding, December 31, 2023 and December 31, 2022, respectively	17,227	14,214
Retained earnings	59,730	57,344
Accumulated other comprehensive loss	(627)	(683)
Total Shareholders' Equity	76,330	70,875
Total Liabilities and Shareholders' Equity	\$ 1,377,310	\$ 1,304,356

See accompanying notes.

NORTH STATE BANCORP
CONSOLIDATED STATEMENTS OF OPERATIONS
Years Ended December 31, 2023 and 2022

	December 31,	
	2023	2022
	<i>(Dollars in thousands, except per share data)</i>	
INTEREST INCOME		
Loans	\$ 56,159	\$ 44,344
Loans held for sale	364	263
Investments	1,209	962
Dividends and interest-earning deposits	4,956	4,211
Total interest income	62,688	49,780
INTEREST EXPENSE		
Savings, money market and NOW	11,456	1,915
Time deposits	992	408
Short-term borrowings	3	2
Long-term borrowings	2,916	1,463
Total interest expense	15,367	3,788
Net interest income	47,321	45,992
(RECOVERY OF) PROVISION FOR CREDIT LOSSES	(586)	665
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	47,907	45,327
NON-INTEREST INCOME		
Fees from mortgage operations	3,096	4,403
Fees and gains on sales from SBA operations	2,109	3,573
Other	3,448	3,359
Total non-interest income	8,653	11,335
NON-INTEREST EXPENSE		
Salaries and employee benefits	24,850	24,665
Occupancy and equipment	3,609	3,621
Data processing and other outsourced services	8,255	7,339
Net cost of foreclosed assets	12	1
Other	8,757	7,968
Total non-interest expense	45,483	43,594
NET INCOME	\$ 11,077	\$ 13,068
NET INCOME PER COMMON SHARE:		
Basic	\$ 1.71	\$ 2.08
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:		
Basic	6,472,706	6,268,942

See accompanying notes.

NORTH STATE BANCORP
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
Years Ended December 31, 2023 and 2022

	December 31,	
	2023	2022
	<i>(Dollars in thousands)</i>	
Net income	\$ 11,077	\$ 13,068
Other comprehensive income (loss):		
Investment securities:		
Unrealized holding gain (loss) on available for sale securities	56	(652)
Total other comprehensive income (loss)	56	(652)
Comprehensive income	\$ 11,133	\$ 12,416

See accompanying notes.

NORTH STATE BANCORP
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years Ended December 31, 2023 and 2022

	<u>Common Stock</u>			Accumulated other comprehensive income (loss)	Total shareholders' equity
	<u>Shares</u>	<u>Amount</u>	<u>Retained earnings</u>		
			<i>(Dollars in thousands)</i>		
Balance as of December 31, 2021	6,184,714	\$ 11,215	\$ 53,973	\$ (31)	\$ 65,157
Net income	-	-	13,068	-	13,068
Other comprehensive loss	-	-	-	(652)	(652)
Cash distributions to shareholders	-	-	(9,697)	-	(9,697)
Capital Reinvestment Plan	136,721	2,262	-	-	2,262
Issuance of common stock	40,283	737	-	-	737
Balance as of December 31, 2022	6,361,718	\$ 14,214	\$ 57,344	\$ (683)	\$ 70,875
Net income	-	-	11,077	-	11,077
Cumulative effect of adoption of ASC 326	-	-	9	-	9
Other comprehensive income	-	-	-	56	56
Cash distributions to shareholders	-	-	(8,700)	-	(8,700)
Capital Reinvestment Plan	158,665	2,615	-	-	2,615
Issuance of common stock	24,055	398	-	-	398
Balance as of December 31, 2023	6,544,438	\$ 17,227	\$ 59,730	\$ (627)	\$ 76,330

See accompanying notes.

NORTH STATE BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2023 and 2022

	December 31,	
	2023	2022
	<i>(Dollars in thousands)</i>	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 11,077	\$ 13,068
Adjustments to reconcile net income to net cash used by operating activities:		
(Recovery of) provision for credit losses	(586)	665
Depreciation and net amortization	1,536	2,078
Amortization of debt issuance costs	47	47
Net amortization of premiums and discounts on investment securities	464	423
Originations of loans held for sale	(207,293)	(279,816)
Proceeds from sales of loans held for sale	145,999	195,116
Gain on sale of loans held for sale	(3,096)	(4,403)
Issuance of common stock for board compensation	398	737
Income from bank owned life insurance	(379)	(362)
Gain on sale of foreclosed assets	(27)	-
Changes in assets and liabilities:		
(Increase) decrease in other assets	(792)	507
Increase in accrued interest receivable	(1,412)	(930)
Increase in accrued expenses and other liabilities	319	16
Increase in accrued interest payable	1,407	29
Net cash used in operating activities	(52,338)	(72,825)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities, calls, and repayments of investment securities available for sale	503	370
Proceeds from maturities, calls, and repayments of investments securities held to maturity	-	940
Purchases of investment securities held to maturity	(3,657)	(10,843)
Proceeds from bank owned life insurance	262	483
Purchase of Federal Home Loan Bank and Federal Reserve stock	(5,046)	(155)
Net increase in loans	(40,482)	(35,312)
Purchases of premises and equipment	(6,055)	(5,894)
Proceeds from sales of foreclosed assets	493	-
Net cash used in investing activities	(53,982)	(50,411)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net (decrease) increase in short term borrowings	(76)	25
Repayment of long-term borrowings	(179)	(78)
Proceeds from issuance of long-term borrowings	100,000	-
Issuance of common stock from Capital Reinvestment Plan	2,615	2,262
Net decrease in deposit accounts	(34,428)	(110,014)
Cash distributions to shareholders	(8,700)	(9,697)
Net cash provided by (used in) financing activities	59,232	(117,502)

See accompanying notes.

NORTH STATE BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
Years Ended December 31, 2023 and 2022

	December 31,	
	2023	2022
	<i>(Dollars in thousands)</i>	
NET DECREASE IN CASH AND CASH EQUIVALENTS	\$ (47,088)	\$ (240,738)
CASH AND CASH EQUIVALENTS BEGINNING	134,829	375,567
CASH AND CASH EQUIVALENTS ENDING	<u>87,741</u>	<u>134,829</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Interest paid	\$ 13,913	\$ 3,712
SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING ACTIVITIES		
Unrealized gain (loss) on investment securities available for sale	\$ 56	\$ (652)
Transfer of loans to foreclosed assets	466	-
Transfer of mortgage loans held for sale to held for investment	63,947	91,524
Change in unexchanged common stock	-	(3)
Loans sold - settlement in process	2,954	-
Initial right of use assets recognized upon adoption of ASC 842	-	4,151
Initial lease liabilities recognized upon adoption of ASC 842	-	4,246

See accompanying notes.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

NOTE A - ORGANIZATION AND OPERATIONS

On June 28, 2002, North State Bancorp (the “Company”) was formed as a holding company for North State Bank (the “Bank”). Upon formation, one share of the Company’s \$1.00 par value common stock was exchanged for each of the outstanding shares of the Bank’s \$5.00 par value common stock. On May 9, 2007, the Company’s shareholders approved the decrease in the Company’s par value of common stock from \$1.00 per share to no par value per share. The Company currently has no operations and conducts no business on its own other than owning the Bank, North State Statutory Trust I, North State Statutory Trust II and North State Statutory Trust III, all of which are wholly owned by the Company. The Company is subject to the rules and regulations of the Federal Reserve Bank and the North Carolina Commissioner of Banks. During 2015, the Company’s Board of Directors approved a plan of reorganization providing for the reorganization of the Company’s ownership that would permit the Company to qualify for an election under Subchapter S of the Internal Revenue Code of 1986 (“IRC”).

The Bank was incorporated May 25, 2000, and began banking operations on June 1, 2000. The Bank is engaged in general commercial and retail banking in central North Carolina, principally Wake County, and in southeast North Carolina in New Hanover County, operating under the banking laws of North Carolina and the rules and regulations of the Federal Reserve Bank and the North Carolina Commissioner of Banks. The Bank undergoes periodic examinations by those regulatory authorities. The Bank’s wholly owned subsidiary, North State Wealth Advisors, Inc., offered wealth management and brokerage services through December 31, 2023, at which time it ceased operations. North State Bank Mortgage (“NSB Mortgage”), a division of the Bank, began operations during February 2010, for the purpose of originating and selling single-family, residential first mortgage loans. During 2016, the Bank established a small business lending services division. A significant portion of the loans originated (generally 75%) are guaranteed by the Small Business Administration (“SBA”) under the 7(a) Loan Program. At management’s discretion, the guaranteed portion of these 7(a) loans is sold in the secondary market. In October of 2017, the Bank’s wholly owned subsidiary, North State Title, LLC purchased a 5% interest in North Carolina Title Center, LLC, a title insurance agency.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements include the accounts and transactions of North State Bancorp and its wholly owned subsidiary North State Bank. All significant intercompany transactions and balances are eliminated in consolidation. North State Bancorp and its subsidiary are collectively referred to herein as the “Company”.

Under Financial Accounting Standards Board (“FASB”) accounting standards for the consolidation of variable interest entities, North State Statutory Trust I, North State Statutory Trust II and North State Statutory Trust III are not included in the Company’s consolidated financial statements. The junior subordinated debentures issued by the Company to the three Trusts are included in long-term borrowings and the Company’s equity interest in the three Trusts is included in other assets.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for credit losses and valuation of foreclosed assets.

Cash and Cash Equivalents and Certificates of Deposit with Other Banks

For presentation purposes in the consolidated statements of cash flows, cash and cash equivalents include cash and due from banks and interest-earning deposits with banks (including certificates of deposit with other banks). As discussed in Note J - Borrowings, the Company’s long-term FHLB advances are secured by cash of \$850,000 and certain 1-4 family real estate loans pledged with a lendable collateral value of \$125.4 million and short-term repurchase agreements are secured by cash of \$1.0 million. Certificates of deposit with other banks have a maturity of April 24, 2024, and bear an interest rate of 3.0%. All investments in certificates of deposit are with FDIC insured financial institutions and none exceed the maximum insurable amount of \$250 thousand.

Investment Securities

Available for sale securities are reported at fair value and consist of mortgage-backed securities not classified as trading securities or as held to maturity securities. Unrealized holding gains and losses on available for sale securities are reported in other comprehensive income. Gains and losses on the sale of available for sale securities are determined using the specific-identification method and are recorded in other noninterest income on a trade date basis. The classification of securities is generally determined at the date of

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

purchase. Bonds for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for premiums and discounts that are recognized in interest income using a method that approximates the interest method over the period to maturity.

Under ASC 326 declines in the fair value of available for sale securities below their cost would result in write-downs of the individual securities to their fair value via an allowance for credit losses. The Company evaluates all available for sale securities in an unrealized loss position on a quarterly basis, or more frequently if economic or market conditions warrant. If the Company has the intent to sell the security or it is more likely than not that the Company will be required to sell the security, the security is written down to fair value and the entire loss is recorded in earnings.

If either of the above criteria is not met, the Company evaluates whether the decline in fair value is the result of credit losses or other factors. In making the assessment, the Company may consider various factors including the length of time and extent to which the security has been in a loss position, performance of any underlying collateral, downgrades in the ratings of the security by a rating agency, the failure of the issuer to make scheduled principal or interest payments and adverse conditions specifically related to the security. If the evaluation indicates that a credit loss exists, the present value of cash flows expected to be collected are compared to the amortized cost basis of the security and any excess is recorded as an allowance for credit loss, limited by the amount that the fair value is less than the amortized cost basis. Any amount of unrealized loss that has not been recorded through an allowance for credit loss is recognized in other comprehensive income.

Changes in the allowance for credit loss are recorded as provision for (or recovery of) credit loss expense. Losses are charged against the allowance for credit loss when management believes an available for sale security is confirmed to be uncollectible or when either of the criteria regarding intent or requirement to sell is met. As of December 31, 2023, there was no allowance for credit loss related to the available for sale portfolio. Accrued interest receivable on available for sale debt securities, included in Accrued Interest Receivable in the consolidated balance sheets, totaled approximately \$18,000 as of December 31, 2023, and was excluded from the estimate of credit losses.

Held to maturity investments are reported at their amortized cost less allowance for credit losses. The Company measures expected credit losses on held to maturity debt securities on an individual basis by major security type. Accrued interest receivable on held to maturity debt securities, included in Accrued Interest Receivable in the consolidated balance sheets, totaled approximately \$432,000 as of December 31, 2023, and was excluded from the estimate of credit losses.

The estimate of expected credit losses is primarily based on the ratings assigned to the securities by debt rating agencies and the historical loss rates associated with those ratings expressed as a lifetime probability of default and a lifetime loss given default. The Company then multiplies those loss rates, as adjusted for any modifications to reflect current conditions and reasonable and supportable forecasts as considered necessary, by the remaining book value of each individual security to arrive at a lifetime expected loss amount. Management classifies the held to maturity portfolio into the following major security types: municipal bonds and corporate bonds. The municipal bonds held by the Company are highly rated by major rating agencies. As such, the allowance for credit losses recorded was approximately \$2,000 as of December 31, 2023, for municipal bonds and the majority of the allowance for credit losses relates to the corporate bonds as they generally carry lower bond ratings. The allowance for credit losses recorded was approximately \$53,000 as of December 31, 2023, for corporate bonds.

Certain equity security investments that do not have readily determinable fair values and for which the Company does not exercise significant influence are carried at cost. The Company has investments in the stock of the Federal Home Loan Bank of Atlanta (“FHLB”) and the Federal Reserve Bank (“FRB”) as a requirement for membership. All the equity securities are reviewed for impairment at least annually or sooner if events or changes in circumstances indicate the carrying value may not be recoverable. As of December 31, 2023, and 2022, the stock in these equity securities totaled \$6.8 million and \$1.8 million, respectively. Due to redemption provisions, the Company estimates that fair value equals cost.

Loans Held for Sale

Mortgage loans held for sale represent single-family, residential first mortgage loans on a pre-sold basis originated by our mortgage division. Generally, commitments to sell these loans are made after the intent to proceed with mortgage applications are initiated with borrowers, and all necessary components of the loan are approved according to secondary market underwriting standards of the investor that purchases the loan. Upon closing, these loans, together with their servicing rights, are sold to mortgage loan investors under prearranged terms. Beginning in 2022, loans held for sale were valued under a fair value option with changes in fair value reflected in current period earnings. The Company recognizes certain origination and service release fees from the sale, which are included in fees from mortgage operations. The fair value of loans held for sale is based on the loan amount, the interest rate and other

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

characteristics of the underlying loan, any discount or fees to be collected from the borrower, the price at which the loan may be sold, and the value of service released premiums. Fair value adjustments on loans held for sale are classified and included in the loans held for sale balance.

The Company is exposed to certain risks relating to its ongoing mortgage origination business. The Company enters into both best-efforts and mandatory delivery contracts with mortgage loan investors. For best-efforts contracts, the Company will deliver individual mortgage loans. Under a best-efforts contract, the Company is not contractually obligated to deliver a maximum principal amount of mortgage loans and is not required to pay a “pair off” fee on any delivery shortfall. Because the best-efforts contract does not have a specified underlying or determinable notional amount or does not require net settlement, the contract does not meet the definition of a derivative. Beginning in 2022, the Company elected to account for best-efforts interest rate lock commitments under a fair value option with changes in fair value reflected in ‘Fees from mortgage operations’. The period of time between the issuance of a loan commitment and the closing and sale of the loan generally ranges from 30 to 60 days. The Company had a notional amount of \$7.8 million and \$4.6 million of best-efforts commitments as of December 31, 2023, and 2022, respectively. ASC 825 *Financial Instruments* allows but does not require financial instruments to be recorded at fair value under the ‘fair value option’. Loans held for sale and best-efforts interest rate lock commitments meet the definition of a financial instrument and the Company has elected to account for these financial instruments at fair value.

The Company also will enter into mandatory delivery contracts with mortgage loan investors where the Company commits to deliver a specified principal amount of mortgage loans to an investor at a specified price on or before a specified date. Failure to deliver the amount of mortgages necessary to fulfill the commitment by the specified date could result in the Company being obligated to pay a “pair off” fee, (depending on market conditions at the specified time of delivery, the investor may not charge a pair off fee). Based on these characteristics, the mandatory delivery contract meets the definition of a derivative at the time the Company enters the contract. As such, the Company accounts for these derivatives at fair value with changes in the fair value reflected in ‘Fees from mortgage operations’. The Company had a notional amount of \$6.9 million and \$3.2 million of open mandatory delivery commitments as of December 31, 2023, and 2022, respectively.

The fair value of interest rate lock commitments is based on the loan amount, the interest rate and other characteristics of the underlying loan, the price at which the loan may be sold, discount points and fees to be collected from the borrower, the value of service release premiums, estimated pull-through, and an estimate of direct costs to complete the interest rate lock into a closed loan. The gains and losses from the future sales of the mortgages are recognized when the Company and the borrower enter into the interest rate lock commitment and the resulting gain or loss is recorded in fees from mortgage operations. Fair value adjustments on best-efforts interest rate lock commitments are classified and included in the other assets balance. Fair value adjustments on mandatory delivery interest rate lock commitments are reported gross and are classified and included in the other assets and other liabilities balances.

Beginning in 2022, the Company began working with a third-party specializing in hedging the mortgage pipeline, specifically hedging the fair value of mandatory delivery interest rate lock commitments in which the Company has essentially taken the ‘long’ position. To hedge the ‘long’ position, the Company sells (or goes ‘short’) TBA mortgage-backed securities (mandatory forward loan commitments or ‘hedge instruments’). In order to do this, the Company, assisted by a third-party, matches up like notional amounts and interest rates to best hedge the change in fair value that occurs due to the natural movement of interest rates. The Company had a notional amount of \$6.8 million and \$4.5 million of open hedge instruments as of December 31, 2023, and 2022, respectively. Fair value adjustments on hedge instruments are reported gross and are classified and included in the other assets and other liabilities balances.

The Company accounts for mandatory delivery interest rate lock commitments and their associated hedge instruments as free-standing derivatives which require fair value on a recurring basis. Since these are accounted for as free-standing derivatives, hedge accounting under ASC 815 *Derivatives and Hedging* does not apply and there is no impact to Other Comprehensive Income.

For more information on loans held for sale, interest rate lock commitments, and hedge instruments, please refer to Note O – Fair Value Measurements.

Loans

Originated commercial and retail loans for which management has the intent and ability to hold for the foreseeable future are classified as held for investment and carried at the principal amount outstanding net of any unearned income, charge-offs and unamortized fees and costs. Nonrefundable fees collected and certain direct costs incurred related to loan originations are deferred and

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

recorded as an adjustment to loans outstanding. The net amount of the nonrefundable fees and costs is amortized to interest income over the contractual lives using methods that approximate a constant yield. Interest income is recorded as earned on an accrual basis.

The Company provides loans guaranteed by the U.S. Small Business Administration (“SBA”) for the purchase of businesses, business startups, business expansion, equipment, and working capital. All SBA loans are underwritten and documented as prescribed by the SBA. SBA loans are generally fully amortizing and have maturity dates and amortizations of up to 25 years. SBA loans may be originated and held for interest income purposes or, at management’s discretion, the portion of SBA loans that are guaranteed can be sold at a gain in the secondary market. If a guaranteed portion of an SBA loan is sold, the servicing rights are retained. The portion of SBA loans that are retained (the unguaranteed portion) are also adjusted for a retained discount to reflect the effective interest rate on the retained unguaranteed portion of the loans if a sale takes place. Additionally, the Company defers direct origination costs on these loans. When a guaranteed portion of a loan is sold, the guaranteed portion of the deferred cost is recognized in the income statement as a reduction in the overall gain on sale as well as an increase in the retained discount. The remaining deferred cost on the unguaranteed portion amortizes into interest income in a manner which reflects the effective interest rate on the retained unguaranteed portion of the loan. The net value of the retained loans is included in the appropriate loan classification for disclosure purposes. These loans are primarily commercial real estate or commercial and industrial.

The Small Business Administration Paycheck Protection Program (“PPP”) is central to the Coronavirus Aid Relief and Economic Security Act (the “CARES Act”), which was passed on March 27, 2020 (“Round 1”), in response to the outbreak of coronavirus (“COVID-19”) and was supplemented with subsequent legislation. Overseen by the United States Treasury Department, the program offers cash-flow assistance to nonprofit and small business employers through guaranteed loans for expenses incurred between prescribed dates. Borrowers are eligible for forgiveness of principal and accrued interest on PPP loans to the extent that the proceeds were used to cover eligible payroll costs, interest costs, rent, and utility costs over a period of between eight and 24-weeks after the loan is made if the borrower retains its employees and their compensation levels. The CARES Act authorized the SBA to temporarily guarantee these loans. The SBA began processing forgiveness payments during the fourth quarter of 2020. The Consolidated Appropriations Act 2021 was signed into law during the fourth quarter of 2020 and contained provisions for a second round of funding of SBA-PPP loans (“Round 2”). The Company participated in both rounds of PPP. PPP loan origination fee income is capitalized into the carrying amount of the loans and is deferred and recognized over the life of the loan (or up unto forgiveness, whichever comes first) and accrete into interest income using the effective interest method. As of December 31, 2022, the Company had approximately \$4,000 in unpaid principal balance of PPP loans. During 2023, the remaining balance of PPP loans was repaid.

Unsecured loans are charged off against the Company’s allowance for credit losses as soon as the loan becomes uncollectible. Unsecured loans are considered uncollectible when no regularly scheduled monthly payment has been made within three months and the analysis of the borrower and any guarantors would indicate no further support can be provided, the loan matured over 90 days ago and has not been renewed or extended or the borrower files for bankruptcy. Secured loans are considered uncollectible when the liquidation of collateral is deemed to be the most likely source of repayment and the collateral or guarantors are deemed unable to repay any shortfall. Once secured loans reach 90 days past due, they are placed into non-accrual status. If the loan is deemed to be solely collateral dependent, the principal balance is written down immediately to reflect the current market valuation based on current independent appraisal/evaluation. Included in the write-down is the estimated expense to liquidate the property and typically an additional allowance for the foreclosure discount. Generally, if the loan is unsecured the loan must be charged-off in full while if it is secured the loan is charged down to the net liquidation value of the collateral.

Loans, including individually evaluated loans, are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. Loans that are current or past due less than 90 days may also be classified as nonaccrual if repayment in full of principal and/or interest is in doubt (as determined by the contractual terms of the note). Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in accordance with the contractual terms.

While a loan (including an individually evaluated loan) is classified as nonaccrual and the future collectability of the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to the principal outstanding. When the future collectability of the recorded loan balance is not in doubt, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged-off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate. Receipts in excess of that amount are recorded as recoveries to the allowance for credit losses until prior charge-offs have been fully recovered.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

Modifications to borrowers experiencing financial difficulty take the form of loans that have been modified due to deterioration in the borrower's financial condition, resulting in more favorable terms for the borrower. From time to time, the Company may modify certain loans to borrowers who are experiencing financial difficulty. In some cases, these modifications may result in new loans. Loan modifications to borrowers experiencing financial difficulty may be in the form of a principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension or a combination thereof, among other things. Accrual of interest is continued for modified loans when the borrower was performing prior to the modification and there is reasonable assurance of repayment and continued performance under the modified terms. Accrual of interest on modified loans in nonaccrual status is resumed when the borrower has established a sustained period of performance under the modified terms of at least six months.

Allowance for Credit Losses on Loans

The allowance for credit losses is a valuation account that is deducted from the loans' amortized cost basis to present the net amount expected to be collected on the loans. Loans are charged off against the allowance when the Company believes the loan to be uncollectible. Subsequent recoveries, if any, are credited to the allowance. Expected recoveries do not exceed the aggregate of amounts previously charged off and expected to be charged off. Accrued interest receivable is excluded from the estimate of credit losses.

The allowance for credit losses represents the Company's estimate of lifetime credit losses inherent in loans as of the balance sheet date. The allowance for credit losses is estimated by the Company using relevant available information, from both internal and external sources, relating to past events, current conditions, and reasonable and supportable forecasts.

The Company measures expected credit losses for loans on a pooled basis when similar risk characteristics exist. The Company has chosen segments based on the federal call report codes belonging to every loan, which is consistent with the segmentation used under the incurred-loss model. The allowance for credit losses on loans for each segment is calculated using a Discounted Cash Flow (DCF) methodology. The DCF methodology also incorporates macroeconomic forecasts to project expected losses. A third-party forecast is utilized to project defaults for two years into the future, followed by a one-year reversion period to the historical long run average loss rate for the remainder of the portfolio life.

Loans that do not share similar risk characteristics with loans in their pool are evaluated on an individual basis. The Company individually reviews loans that are experiencing financial difficulty. These collateral dependent loans are evaluated based on the fair value of the underlying collateral, as repayment of the loan is expected to be made through the operation or sale of the collateral. When the Company determines that foreclosure is probable and the borrower is experiencing financial difficulty, the expected credit losses are based on the fair value of collateral at the reporting date and adjusted for selling costs as appropriate.

Additionally, the allowance for credit losses on loans calculation includes subjective adjustments for qualitative risk factors that are likely to cause estimated credit losses to differ from historical experience. These qualitative adjustments may increase or reduce reserve levels and include adjustments for lending management's experience and risk tolerance, loan review and audit results, asset quality and portfolio trends, loan portfolio growth, industry concentrations, trends in underlying collateral, external factors and economic conditions not already captured.

While the Company uses the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the assumptions used in making the evaluations. In addition, regulatory examiners may require the Company to recognize adjustments to the allowance for credit losses based on their judgments about information available to them at the time of their examination.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets which are 3 to 10 years for furniture and equipment and 30 to 40 years for buildings. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. Repair and maintenance costs are charged to operational expense as incurred and additions and improvements to premises and equipment are capitalized. Upon sale or retirement, the cost and related accumulated depreciation are removed from the accounts and any gains or losses are reflected in current operations. Long-lived depreciable assets are evaluated periodically for impairment when events or changes in circumstances indicate the carrying amount may not be recoverable.

The Company leases certain office equipment under a finance lease. In 2022, the Company adopted *ASU 2016-02, Leases (Topic 842)* related to accounting for leases as further discussed below. Under the standards, for finance leases other than those considered to be short-term, the Company recognizes lease right-of-use assets and related lease liabilities. Such amounts are reported as components of

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

premises and equipment and other borrowings, respectively, on our accompanying consolidated balance sheet. The Company does not recognize short-term finance leases on our balance sheet. A short-term finance lease has an original term of 12 months or less and does not have a purchase option that is likely to be exercised.

In recognizing finance lease right-of-use assets and related lease liabilities, the Company accounts for lease and non-lease components (such as taxes) separately as such amounts are generally readily determinable under our lease contract. Lease payments over the expected term are discounted using our incremental borrowing rates for borrowings of similar terms.

Leases

The Company leases certain office facilities under operating leases. The Company also owns certain office facilities which are leased to outside parties under operating lessor leases; however, such leases are not significant. In 2022, the Company adopted *ASU 2016-02, Leases (Topic 842)* related to accounting for leases. Under the standards, for operating leases other than those considered to be short-term, the Company recognizes lease right-of-use assets and related lease liabilities. Such amounts are reported as components of other assets and other liabilities, respectively, on our accompanying consolidated balance sheet. The Company does not recognize short-term operating leases on our balance sheet. A short-term operating lease has an original term of 12 months or less and does not have a purchase option that is likely to be exercised.

In recognizing operating lease right-of-use assets and related lease liabilities, the Company accounts for lease and non-lease components (such as taxes, insurance, and common area maintenance costs) separately as such amounts are generally readily determinable under our lease contracts. Lease payments over the expected term are discounted using our incremental borrowing rates for borrowings of similar terms. The Company also considers renewal and termination options in the determination of the term of the lease. If it is reasonably certain that a renewal or termination option will be exercised, the effects of such options are included in the determination of the expected lease term. Generally, the Company cannot be reasonably certain about whether or not it will renew a lease until such a time the lease is within the last two years of the existing lease term. When the Company is reasonably certain that a renewal option will be exercised, the Company measures/remeasures the right-of-use asset and related lease liability using the lease payments specified for the renewal period.

Foreclosed Assets

Assets acquired through, or in lieu of, foreclosure are held for sale and are initially recorded at fair value less anticipated selling costs at the date of foreclosure, establishing a new cost basis. Principal and interest losses existing at the time of acquisition of such assets are charged against the allowance for credit losses and interest income, respectively. The initial recorded value may be subsequently reduced by additional valuation allowances, which are charged to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. Costs related to the improvement of the property are capitalized, whereas those related to holding the property are expensed. Revenue and expenses from operations and changes in the valuation allowance are included in other expenses. The Company did not have any foreclosed assets as of December 31, 2023, and 2022, respectively. As of December 31, 2023, there were no loans in the process of foreclosure. As of December 31, 2022, there was one loan totaling approximately \$3 million in process of foreclosure.

Bank Owned Life Insurance

Bank owned life insurance is carried at cash surrender value as determined by the insurer. The carrying value of life insurance approximates fair value.

Income Taxes

During 2015, the Company's Board of Directors approved a plan of reorganization providing for the reorganization of the Company's ownership that would permit the Company to qualify for an election under Subchapter S of the Internal Revenue Code of 1986 ("IRC"). The change in tax election enables the Company to take advantage of the favorable tax treatment afforded such entities under amendments to the IRC contained in the Small Business Jobs Protection Act of 1996 and subsequent amendments. The effect of an S Corporation election is to eliminate one level of taxation. Under an S Corporation election, corporate income, gains, and losses are passed through to the shareholders and each shareholder's pro rata share of Company income is reported on the shareholders' returns whether or not any cash or property is actually distributed to shareholders. The Company was approved for Subchapter S status with the Internal Revenue Service effective date of January 1, 2016.

SBA Servicing Assets

All sales of SBA-guaranteed loans are executed on a servicing retained basis, and the Company retains the rights and obligations to service the loans. The standard sale structure under the SBA Secondary Participation Guaranty Agreement provides for the Company to retain a portion of the cash flow from the interest payment received on the loan. This cash flow is commonly known as a servicing

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

spread. SBA regulations require the lender to retain a minimum of 100 basis points in servicing spread for any guaranteed loan sold for a premium. The minimum servicing spread is further defined as a minimum service fee of 40 basis points and a minimum premium protection fee of 60 basis points. The servicing spread is recognized as a servicing asset to the extent the spread exceeds adequate compensation for the servicing function. Industry practice recognizes adequate compensation for servicing SBA loans as the minimum service fee of 40 basis points. The fair value of the servicing asset is measured at the discounted present value of the premium protection fee over the expected life of the related loan using appropriate discount rates and prepayment assumptions based on industry statistics. SBA servicing assets are initially recognized at fair value and amortized over the expected life of the related loans using the level yield method as a reduction of the servicing income recognized from the servicing spread. The servicing rights are periodically evaluated for impairment based upon the fair value of the rights as compared to carrying amount. If a temporary impairment exists, the servicing asset is written down through a valuation allowance and is charged against servicing income. Loans serviced for others are not included in the consolidated balance sheets. The valuation allowance totaled approximately \$0, and \$217,000, as of December 31, 2023, and 2022, respectively.

Earnings Per Common Share

Basic earnings per share represent income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. The Company did not have any potential dilutive common shares for the years ended December 31, 2023, and December 31, 2022.

Debt Issuance Costs

Incremental costs directly incurred to issue the Company's subordinated debt are recorded, net of cumulative amortization, on the Company's consolidated balance sheets as a direct reduction of the carrying value of the related debt. The amortization is recorded as an adjustment to the yield in the Statement of Operations.

Unfunded Commitments

Financial instruments include off-balance sheet credit instruments, such as unfunded commitments to make loans and commercial letters of credit issued to meet customer financing needs. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for off-balance sheet loan commitments is represented by the contractual amount of those instruments. Such financial instruments are recorded when they are funded.

The Company records an allowance for credit losses on unfunded commitments, unless the commitments to extend credit are unconditionally cancellable, through a charge to provision for credit losses in the Company's consolidated income statements. The allowance for credit losses on unfunded commitments is estimated by loan segment at each balance sheet date under the current expected credit loss model using the same methodologies as portfolio loans, taking into consideration the likelihood that funding will occur as well as any third-party guarantees. The allowance for unfunded commitments is included in other liabilities on the Company's consolidated balance sheets.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on investment securities available for sale and unrealized holding gains on hedge instruments are reported as a separate component of the equity section of the balance sheet. Such items, along with net income, are components of total comprehensive income. The Company's only component of accumulated other comprehensive income was unrealized gains and losses on available for sale securities.

Derivative Instruments

The Company's deposit and loan activities are vulnerable to interest rate risk. The associated variability in cash flows may impact the results of operations of the Company. The Company's hedging strategy is generally intended to take advantage of opportunities to reduce, to the extent possible, unpredictable cash flows. The Company may employ a variety of common derivative products that are instruments used by financial institutions to manage interest rate risk. The financial instruments that may be used as part of a hedging strategy include swaps, caps, floors, and collars. As of December 31, 2023, and 2022, respectively, the Company did not have any derivatives that would qualify for hedge accounting under ASC 815.

The Company does not enter into derivative financial instruments for speculative or trading purposes. Through its mortgage operations, the Company does enter into mandatory delivery interest rate lock commitments and forward sales of TBA mortgage-backed securities (hedge instruments). Such interest rate lock commitments and hedge instruments represent derivative instruments which are required to be carried at fair value and recorded on a gross basis as other assets and other liabilities. For more information, refer to the 'Loans Held for Sale' section of Note B – Summary of Significant Accounting Policies above.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

Segment Reporting

Management is required by accounting pronouncements governing the disclosures about segments of an enterprise and related information to report selected financial and descriptive information about reportable operating segments. It also establishes standards for related disclosures about products and services, geographic areas, and major customers. Generally, disclosures are required for segments internally identified to evaluate performance and resource allocation. Included as a division of the Bank, NSB Mortgage and our SBA division are reported as separate segments as well as the parent company. Segment information regarding the Bank, NSB Mortgage, SBA and the parent company are fully described in Note R – Business Segment Information. The Company has no foreign operations or customers.

Revenue Recognition

Management is required by accounting pronouncements governing the recognition of revenue which require an entity to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the Company expects to be entitled in exchange for those goods or services.

Subsequent Events

The Company has evaluated subsequent events through March 27, 2024.

Recently Issued Accounting Pronouncements

FASB ASU 2023-01, “Leases (Topic 842): Common Control Arrangements.” ASU 2023-01 requires entities to amortize leasehold improvements associated with common control leases over the useful life to the common control group. ASU 2023-01 also provides certain practical expedients applicable to private companies and not-for-profit organizations. The ASU is effective for all entities for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, and its adoption is not expected to have a material effect on our consolidated financial statements.

FASB ASU No. 2023-02, “Investments - Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method.” ASU 2023-02 is intended to improve the accounting and disclosures for investments in tax credit structures. ASU 2023-02 allows entities to elect to account for qualifying tax equity investments using the proportional amortization method, regardless of the program giving rise to the related income tax credits. Previously, this method was only available for qualifying tax equity investments in low-income housing tax credit structures. The ASU is effective for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years. Early adoption is permitted, and its adoption is not expected to have a material effect on our consolidated financial statements.

FASB ASU 2022-01 – Derivatives and Hedging (Topic 815): Fair Value Hedging – Portfolio Layer Method: This ASU expands the scope of assets eligible for portfolio layer method hedging to include all financial assets. The amendments remove the requirement that all assets in the closed portfolio have a contractual maturity date on or after the earliest-ending hedge period. The amendments require an entity to maintain fair value hedge basis adjustments at the closed portfolio level for a currently designated hedge and prohibits an entity from considering portfolio layer method fair value hedge basis adjustments on a currently designated hedge in its determination of credit losses. When a breach occurs (that is, the aggregate amount of the hedged layers currently exceeds the amount of the closed portfolio), an entity is required to present the fair value hedge basis adjustments with a breach in interest income and disclose the amount along with the circumstances that led to the breach. The effective date for this guidance is for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. The Company does not anticipate that the impact the adoption of this guidance will have on its consolidated financial statements will be material.

FASB ASU 2022-03 – Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions: This ASU clarifies that a contractual restriction on the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, is not considered in measuring fair value. It clarifies that an entity cannot recognize and measure a contractual sale restriction as a separate unit of account. The amendments include various disclosure requirements. The effective date for this guidance is for fiscal years beginning after December 15, 2024. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance. The Company does not anticipate that the impact the adoption of this guidance will have on its consolidated financial statements will be material.

FASB ASU 2021-08 – Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers: This ASU was issued to improve the accounting for acquired revenue contracts with customers in a business combination. Under current GAAP, an acquirer generally recognizes contract assets acquired and contract liabilities assumed in a business combination at the acquisition date fair value. This ASU will now require an acquirer to recognize and measure contract

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

assets acquired and contract liabilities assumed in a business combination in accordance with FASB Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, as if it had originated the contracts. The effective date for this guidance is for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. The ASU should be applied prospectively to business combinations occurring on or after the effective date of the amendments. The Company does not anticipate that the impact the adoption of this guidance will have on its consolidated financial statements will be material.

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

Recently Adopted Accounting Pronouncements

FASB ASU 2016-13, Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (CECL): In June 2016, the FASB issued new guidance that replaces the incurred loss impairment methodology in current standards with an expected credit loss methodology and requires consideration of a broader range of information to determine credit loss estimates. The guidance requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts and requires enhanced disclosures related to the significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. In addition, the guidance amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The guidance will be effective for the Company for the years beginning after December 15, 2022, including interim periods within those fiscal years.

The Company adopted ASC 326 and all related subsequent amendments thereto effective January 1, 2023, using the modified retrospective approach for all financial assets measured at amortized cost and off-balance sheet credit exposures (unfunded commitments). The adoption for credit losses on loans decreased the allowance for credit losses on loans by approximately \$563,000, which is presented as an increase to net loans held for investment. Additionally, the adoption of ASC 326 resulted in an increase in the allowance for credit losses on unfunded loan commitments of approximately \$477,000, which is recorded within Other Liabilities. The Company recorded an allowance for credit losses for held to maturity securities of \$77,000, which is presented as a reduction to securities held to maturity. The Company recorded a net increase to retained earnings of approximately \$9,000 as of January 1, 2023, for the cumulative effect of adopting CECL, which reflects the transition adjustments noted above. Results for reporting periods beginning after January 1, 2023, are presented under CECL while prior period amounts continue to be reported in accordance with previously applicable accounting standards ("Incurred Loss"). As a practical expedient, the Company has excluded interest receivable from the credit loss analysis under CECL for all applicable financial instruments.

The Company adopted ASC 326 using the prospective transition approach for debt securities for which other-than-temporary impairment had been recognized prior to January 1, 2023. As of December 31, 2022, the Company did not have any other-than-temporarily impaired investment securities. Therefore, upon adoption of ASC 326, the Company determined that an allowance for credit losses on available for sale securities was not necessary.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

The following table presents the impact of ASC 326 adoption as of January 1, 2023.

<u>Allowance for Credit Losses</u>	<u>January 1, 2023</u>	<u>December 31, 2022</u>	<u>Impact of</u>
	<u>As Reported Under ASC 326</u>	<u>Pre-ASC 326 Adoption</u>	<u>ASC 326 Adoption</u>
	<i>(Dollars in thousands)</i>		
Assets			
Securities held to maturity			
Corporate bonds	\$ 75	\$ -	\$ 75
Municipal bonds	2	-	2
Securities held to maturity, total	77	-	77
Loans held for investment			
Residential construction	194	347	(153)
Commercial construction, all land development and other land loans	412	322	90
Residential properties	1,017	921	96
Residential mortgage (1)	839	914	(75)
Commercial real estate - other	3,276	3,265	11
Commercial and industrial	1,210	1,693	(483)
Consumer and other	32	81	(49)
Loans held for investment, total	6,980	7,543	(563)
Liabilities			
Allowance for credit losses for unfunded commitments	477	-	477
Total	\$ 7,534	\$ 7,543	\$ (9)

In concurrence with the adoption of CECL, the Company also adopted ASU 2022-02, “Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures” (“ASU 2022-02”) effective January 1, 2023. The amendments in ASU 2022-02 enhanced disclosures for loan modifications made for borrowers experiencing financial difficulty and eliminated the Troubled Debt Restructurings (“TDR”) accounting guidance for financial institutions that have adopted CECL. The adoption of this guidance did not have a material impact as there were no modified loans during the year ended December 31, 2023.

ASC 848, “Reference Rate Reform,” was set forth to eliminate certain reference rates and introduce new reference rates that are based on a larger, more liquid population of observable transactions that are less vulnerable to manipulation. The reference rate reform discontinues the use of certain widely used reference rates such as the London Interbank Offered Rate, or LIBOR. In response to likely challenges arising from contract modifications due to reference rate reform, the Financial Accounting Standards Board (the “FASB”) issued ASU 2020-04, “Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting,” in March 2020 to provide optional expedients and exceptions for applying GAAP to contract modifications. As such, modifications to debt contracts may be accounted for as a continuation of the existing contract by prospectively adjusting the effective interest rate. This amendment could be applied beginning March 12, 2020, through a sunset date of December 31, 2022. In December 2022, the FASB issued ASU 2022-06, “Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848.” These amendments extend the period of time preparers can utilize the reference rate reform relief guidance in Topic 848. The objective of the guidance in Topic 848 is to provide relief during the temporary transition period, so the FASB included a sunset provision based on expectations of when LIBOR would cease being published. In 2021, the UK Financial Conduct Authority delayed the intended cessation date of certain tenors of USD LIBOR to June 30, 2023. To ensure the relief provided in Topic 848 covers the period of time during which a significant number of modifications may take place, ASU 2022-06 defers the sunset date from December 31, 2022, to December 31, 2024, after which entities will no longer be permitted to apply the relief in Topic 848. ASU 2022-06 was effective upon issuance. The Company no longer holds or issues loan contracts that reference LIBOR. As of July 1, 2023, all loan contracts that previously referenced LIBOR had been modified. The Company does not anticipate a material financial impact as a result of these modifications.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

NOTE C - INVESTMENT SECURITIES

The following table presents the amortized cost and fair value of securities available for sale and securities held to maturity with gross unrealized gains and losses as of December 31, 2023, and 2022, respectively.

	As of December 31, 2023				
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value	
	<i>(Dollars in thousands)</i>				
Securities available for sale:					
Government-sponsored residential mortgage-backed securities	\$ 6,387	\$ -	\$ 627	\$ 5,760	
Total securities available for sale	<u>\$ 6,387</u>	<u>\$ -</u>	<u>\$ 627</u>	<u>\$ 5,760</u>	
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value	Allowance for credit losses
	<i>(Dollars in thousands)</i>				
Securities held to maturity:					
Corporate bonds	\$ 2,750	\$ -	\$ 308	\$ 2,442	\$ 53
Municipal bonds	50,508	36	3,054	47,490	2
Total securities held to maturity	<u>\$ 53,258</u>	<u>\$ 36</u>	<u>\$ 3,362</u>	<u>\$ 49,932</u>	<u>\$ 55</u>
	As of December 31, 2022				
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value	
	<i>(Dollars in thousands)</i>				
Securities available for sale:					
Government-sponsored residential mortgage-backed securities	\$ 3,904	\$ -	\$ 683	\$ 3,221	
Total securities available for sale	<u>\$ 3,904</u>	<u>\$ -</u>	<u>\$ 683</u>	<u>\$ 3,221</u>	
Securities held to maturity:					
Corporate bonds	\$ 2,750	\$ -	\$ 319	\$ 2,431	
Municipal bonds	50,300	10	4,102	46,208	
Total securities held to maturity	<u>\$ 53,050</u>	<u>\$ 10</u>	<u>\$ 4,421</u>	<u>\$ 48,639</u>	

All unrealized losses on investment securities are considered by management to be temporary given the credit ratings on these investment securities, the interest rate environment, and the Company's intent and ability to hold these securities to maturity. As of December 31, 2023, the Company's available for sale securities included five Government-sponsored residential mortgage-backed securities with unrealized losses of approximately \$627,000. The unrealized losses on held to maturity securities as of December 31, 2023, relate to ninety nine tax-exempt municipal bonds; four corporate securities; and one taxable municipal bond with combined unrealized losses of approximately \$3.4 million. As of December 31, 2022, the Company's available for sale securities included three Government-sponsored residential mortgage-backed securities with unrealized losses of approximately \$683,000. The unrealized losses on held to maturity securities as of December 31, 2022, relate to one-hundred-three tax-exempt municipal bonds; four corporate securities; and one taxable municipal bond with combined unrealized losses of approximately \$4.4 million.

As of December 31, 2023, the Company does not intend to sell the municipal or corporate bonds with unrealized losses prior to maturity and it is more likely than not the Company will not be required to sell any of these securities in unrealized loss positions prior

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

to maturity, they are not deemed to be other than temporarily impaired. When evaluating an investment for credit losses, management considers, among other things: the length of time and the extent to which the fair value has been in a loss position; the financial condition of the issuer through the review of credit ratings and, if necessary, corporate financial statements; adverse conditions specifically related to the security such as past due principal or interest; underlying assets that collateralize the debt security; other economic conditions and demographics; and the intent and the ability of the Company to hold the investment until the loss position is recovered. Any unrealized losses were largely due to increases in market interest rates over the yields available at the time of purchase. The fair value is expected to recover as the bonds approach their maturity date or market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality, but that the losses are temporary in nature.

The following table presents the gross unrealized losses on and fair values of the Company's investments as of December 31, 2023, and 2022, respectively, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position.

	As of December 31, 2023					
	Less than 12 months		12 months of more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	<i>(Dollars in thousands)</i>					
Securities available for sale:						
Government-sponsored residential mortgage-backed securities	\$ 2,724	\$ 30	\$ 3,036	\$ 597	\$ 5,760	\$ 627
Total temporarily impaired securities	<u>\$ 2,724</u>	<u>\$ 30</u>	<u>\$ 3,036</u>	<u>\$ 597</u>	<u>\$ 5,760</u>	<u>\$ 627</u>
Securities held to maturity:						
Corporate bonds	\$ -	\$ -	\$ 2,442	\$ 308	\$ 2,442	\$ 308
Municipal bonds	5,681	71	38,152	2,983	43,833	3,054
Total temporarily impaired securities	<u>\$ 5,681</u>	<u>\$ 71</u>	<u>\$ 40,594</u>	<u>\$ 3,291</u>	<u>\$ 46,275</u>	<u>\$ 3,362</u>
	<i>(Dollars in thousands)</i>					
	As of December 31, 2022					
	Less than 12 months		12 months of more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	<i>(Dollars in thousands)</i>					
Securities available for sale:						
Government-sponsored residential mortgage-backed securities	\$ 510	\$ 45	\$ 2,711	\$ 638	\$ 3,221	\$ 683
Total temporarily impaired securities	<u>\$ 510</u>	<u>\$ 45</u>	<u>\$ 2,711</u>	<u>\$ 638</u>	<u>\$ 3,221</u>	<u>\$ 683</u>
Securities held to maturity:						
Corporate bonds	\$ 1,159	\$ 91	\$ 1,272	\$ 228	\$ 2,431	\$ 319
Municipal bonds	29,281	1,112	16,927	2,990	46,208	4,102
Total temporarily impaired securities	<u>\$ 30,440</u>	<u>\$ 1,203</u>	<u>\$ 18,199</u>	<u>\$ 3,218</u>	<u>\$ 48,639</u>	<u>\$ 4,421</u>

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

The following table presents the amortized cost and fair values of securities available for sale and securities held to maturity as of December 31, 2023, by contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	<u>As of December 31, 2023</u>	
	<u>Amortized</u>	<u>Fair</u>
	<u>Cost</u>	<u>Value</u>
	<i>(Dollars in thousands)</i>	
Securities available for sale:		
Government-sponsored residential mortgage-backed securities:		
Due after five but within ten years	\$ 445	\$ 412
Due after ten years	<u>5,942</u>	<u>5,348</u>
Total securities available for sale	<u>\$ 6,387</u>	<u>\$ 5,760</u>
Securities held to maturity:		
Corporate bonds:		
Due after five but within ten years	\$ 2,750	\$ 2,442
	<u>\$ 2,750</u>	<u>\$ 2,442</u>
Municipal bonds:		
Due after one but within five years	\$ 13,947	\$ 13,638
Due after five but within ten years	22,585	20,989
Due after ten years	<u>13,976</u>	<u>12,863</u>
	<u>\$ 50,508</u>	<u>\$ 47,490</u>
Total securities held to maturity:	<u>\$ 53,258</u>	<u>\$ 49,932</u>

No securities were pledged as of December 31, 2023, or 2022. There were no security sales during the years ended December 31, 2023, or 2022.

The following table presents the activity in the allowance for credit losses for debit securities held-to-maturity by major security type for the year ended December 31, 2023.

	<u>As of December 31, 2023</u>	
	<u>Corporate</u>	<u>Municipal</u>
	<u>bonds</u>	<u>bonds</u>
	<i>(Dollars in thousands)</i>	
Allowance for credit losses:		
Beginning balance, prior to adoption of ASC 326	\$ -	\$ -
Impact of adopting ASC 326	75	2
(Recovery of) provision for credit losses	(22)	-
Charge-offs	-	-
Recoveries	<u>-</u>	<u>-</u>
Ending balance	<u>\$ 53</u>	<u>\$ 2</u>

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

NOTE D – LOANS

The following table presents a summary of loans segregated by loan category as of December 31, 2023, and 2022.

	As of December 31,	
	2023	2022
	<i>(Dollars in thousands)</i>	
Real estate secured loans:		
Residential construction	\$ 49,789	\$ 68,446
Commercial construction, all land development and other land loans	70,891	56,496
Residential properties	165,916	159,784
Residential mortgage (1)	234,092	180,379
Commercial real estate - other	509,230	474,155
Total real estate secured loans	<u>1,029,918</u>	<u>939,260</u>
Other non-real estate loans and leases:		
Commercial and industrial	114,228	102,312
Consumer and other	2,664	3,269
Total loans held for investment	<u>\$ 1,146,810</u>	<u>\$ 1,044,841</u>
Single-family residential mortgages held for sale	<u>\$ 5,240</u>	<u>\$ 4,797</u>

(1) Single-family residential mortgages originated through NSB Mortgage held for investment.

Loans are primarily funded in Wake County and New Hanover County in North Carolina. Real estate loans can be affected by the condition of the local real estate market. Commercial and installment loans can be affected by the local economic conditions. Included in the loan balances above are net unamortized loan costs of approximately \$3.2 million and \$2.7 million, respectively, as of December 31, 2023, and 2022. PPP loans are included in the 'Commercial and industrial' line item and total approximately \$0 and \$4,000, respectively as of December 31, 2023, and 2022.

The following describes the risk characteristics relevant to each of the portfolio segments.

Residential construction

The Company provides financing to builders for the construction of speculative and pre-sold custom homes, and from time to time, financing for custom homes where the home buyer is the borrower. Residential construction loans typically are for periods of 12 months or less and the homes are sold to consumers who obtain permanent financing. The loans are underwritten utilizing independent appraisals, sensitivity analysis of absorption and financial analysis of the borrower.

Commercial construction

Commercial real estate construction and land development loans are also underwritten utilizing independent appraisals, sensitivity analysis of absorption and financial analysis of the general contractors and borrowers. Commercial construction loans are generally based upon estimates of costs and value associated with the as-completed project. These estimates may be inaccurate. The loans often involve the disbursement of substantial funds with the repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans or sales of developed property.

All construction loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, government regulation of real property, general economic conditions, and the availability of long-term financing.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

Residential properties

Residential real estate secured loans are subject to underwriting based on the purpose of the loan. Residential real estate properties secured by income-producing property typically have a loan-to-value ratio of 85% or less. Residential real estate properties secured by the primary residence of the borrower typically have a loan-to-value ratio of less than 90%. Also included are loans that are underwritten and secured by second liens and home equity lines of credit which are revolving extensions of credit that are secured by first or second liens on owner-occupied residential real estate.

Residential mortgage

Residential mortgage loans represent one-to-four family loans originated through NSB Mortgage and selected by the Company to be retained in its portfolio. These loans are subject to strict underwriting standards which, at a minimum, comply with Freddie Mac and/or Fannie Mae guidelines and have moderate loan-to-value ratios, typically 80% or less, and with credit scores typically exceeding 720. Additionally, for competitive reasons the Company retains individual jumbo mortgages originated through NSB Mortgage with similar underwriting guidelines outlined above. Loan balance size for jumbo qualification is updated annually. For 2023, jumbo mortgages began at \$726,200 and higher. The Company also has a construction-to-permanent (C2P) financing loan product and once the construction phase has been completed, the loans convert to residential mortgages and become a part of this portfolio segment.

Commercial real estate - other

Commercial real estate secured loans are subject to underwriting standards that focus on proper loan to value and cash flow to meet debt service coverage requirements. Commercial real estate lending typically involves higher loan principal amounts, and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the lease income on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in real estate markets or the general economy. The properties securing the Company's commercial real estate portfolio are either owner occupied, or non-owner occupied. Owner-occupied properties include professional practices, retail establishments, service companies and churches. Non-owner-occupied properties include office, retail, industrial and multi-family rental properties. Management monitors and evaluates commercial real estate loans based on collateral, market area and risk grade criteria. The Company also utilizes third-party experts to provide insight and guidance about economic conditions and trends within its market areas.

Commercial and industrial

Non-real estate secured commercial and industrial loans are underwritten after evaluating and understanding the borrowers' ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Management examines current and projected cash flows of the borrower to determine the ability of the borrower to repay its obligation as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower and tertiary, as applicable, the guarantors. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable, inventory or equipment and usually incorporate a personal guarantee. In the case of loans secured by accounts receivable, the availability of the funds for repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Included in commercial and industrial is a small lease portfolio. The primary risk associated with lease financing is the ability of borrowers to achieve business results consistent with those projected at origination. Failure to achieve these projections presents risk the borrower will be unable to service the debt consistent with the contractual terms of the lease. Additionally, SBA loans and PPP loans are included within this category.

Consumer and other

Consumer and other loans include automobile loans, boat, and recreational vehicle financing, other secured or unsecured loans and loans to tax exempt entities. Consumer loans generally carry greater risk than other loans, even if secured, if the collateral consists of rapidly depreciating assets such as automobiles and equipment. Consumer loan collections are sensitive to job loss, illness, and other personal factors. The Company manages risks inherent in consumer and other lending by following established credit guidelines and underwriting practices designed to minimize the risk of loans.

The Company maintains an independent loan review function that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to management and the board of directors. The loan review process compliments and reinforces the risk identification and assessment decisions made by bankers and credit personnel, as well as the Company's policies and procedures.

The Company also originates single-family, residential mortgage loans that have been approved by investors in the secondary market which are included on the consolidated balance sheet under the caption "loans held for sale." The Company recognizes certain

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

origination and service release fees from sales, which are included in non-interest income on the consolidated statements of operations. Further, the Company elected to account for loans held for sale at fair value with changes in fair value included in non-interest income on the consolidated statements of operations. As of December 31, 2023, and 2022, loans held for sale were \$5.2 million and \$4.8 million, respectively.

Related party loans

The Company engages in loan transactions with its directors and executive officers. Such loans were made in the ordinary course of business and on substantially the same terms and collateral requirements as those for comparable transactions prevailing at the time and did not involve more than the normal risk of collectability or present other unfavorable features.

The following table presents a roll-forward of related party loans for the years ending December 31, 2023, and 2022.

	2023	2022
	<i>(Dollars in thousands)</i>	
Balance, beginning of year	\$ 38,034	\$ 33,208
Additional borrowings	20,606	18,314
Loan repayments	(19,455)	(13,488)
Balance, end of year	<u>\$ 39,185</u>	<u>\$ 38,034</u>
Unused lines of credit	<u>\$ 22,360</u>	<u>\$ 12,721</u>

Nonaccrual loans

Nonaccrual loans as of December 31, 2023, were \$1.9 million compared to \$6.0 million as of December 31, 2022. The approximate amount of interest income foregone on nonaccrual loans during the year was \$182,000 and \$418,000 for the years ending December 31, 2023, and 2022, respectively.

The following table presents the composition of nonaccrual loans by class as of December 31, 2023.

	As of December 31, 2023		
	Nonaccrual Loans with No Allowance	Nonaccrual Loans with an Allowance	Total Nonaccrual Loans
	<i>(Dollars in thousands)</i>		
Residential construction	\$ -	\$ -	\$ -
Commercial construction, all land development and other land loans	-	-	-
Residential properties	-	-	-
Residential mortgage (1)	-	307	307
Commercial real estate - other	1,024	102	1,126
Commercial and industrial	380	81	461
Consumer and other	-	-	-
Total loans held for investment	<u>\$ 1,404</u>	<u>\$ 490</u>	<u>\$ 1,894</u>

(1) Single-family residential mortgages originated through NSB Mortgage held for investment.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

Past due loans

The following table presents an aging analysis of past due loans segregated by loan class as of December 31, 2023, and 2022, respectively.

	As of December 31, 2023				
	30 - 89 Days Past Due	Over 90 Days (1)	Total Past Due	Current	Total Loans
	<i>(Dollars in thousands)</i>				
Real estate secured loans:					
Residential construction	\$ -	\$ -	\$ -	\$ 49,789	\$ 49,789
Commercial construction, all land development and land loans	-	-	-	70,891	70,891
Residential properties	600	-	600	165,316	165,916
Residential mortgage (2)	-	307	307	233,785	234,092
Commercial real estate - other	253	1,126	1,379	507,851	509,230
Total real estate secured loans	853	1,433	2,286	1,027,632	1,029,918
Other non-real estate loans and leases:					
Commercial and industrial	303	461	764	113,464	114,228
Consumer and other	-	-	-	2,664	2,664
Total	\$ 1,156	\$ 1,894	\$ 3,050	\$ 1,143,760	\$ 1,146,810
	As of December 31, 2022				
	30 - 89 Days Past Due	Over 90 Days (1)	Total Past Due	Current	Total Loans
	<i>(Dollars in thousands)</i>				
Real estate secured loans:					
Residential construction	\$ -	\$ -	\$ -	\$ 68,446	\$ 68,446
Commercial construction, all land development and land loans	-	-	-	56,496	56,496
Residential properties	71	-	71	159,713	159,784
Residential mortgage (2)	-	-	-	180,379	180,379
Commercial real estate - other	215	5,390	5,605	468,550	474,155
Total real estate secured loans	286	5,390	5,676	933,584	939,260
Other non-real estate loans and leases:					
Commercial and industrial	101	602	703	101,609	102,312
Consumer and other	-	-	-	3,269	3,269
Total	\$ 387	\$ 5,992	\$ 6,379	\$ 1,038,462	\$ 1,044,841

(1) All in nonaccrual status.

(2) Single-family residential mortgages originated through NSB Mortgage, held for investment.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

Credit Quality Indicators

As part of the on-going monitoring of the credit quality of the Company's loan portfolio, management examines certain credit quality indicators which consider the risk of payment performance, overall portfolio quality utilizing weighted-average risk rating, general economic factors, net charge-offs, non-performing loans, and the level of classified loans. All loans risk rated "substandard", "doubtful" and "loss" are reviewed on an individual basis for probable losses.

A description of our credit quality indicators follows:

Pass – loans with acceptable credit quality and moderate risk.

Special mention – This grade is intended to be temporary and includes loans (1) with potential weaknesses if left uncorrected could result in deterioration or (2) classified as substandard accruing or substandard nonaccruing that have made improvements to their financial profile but do not yet meet the definition of a pass grade.

Substandard, accruing – These loans have a well-defined weakness where the accrual of interest has not been stopped. The defined weakness may make default or principal exposure likely but not certain. These loans are likely to be dependent on collateral liquidation or a secondary source of repayment.

Substandard, nonaccruing – These assets have well defined weaknesses that jeopardize the liquidation of the debt and are past due over 90 days. The institution may sustain loss if the weaknesses are not corrected. These loans are inadequately protected by the paying capacity of the borrower, any guarantors or of the collateral pledged. These loans are individually analyzed for impairment.

Doubtful – These loans have all the weaknesses of substandard, nonaccruing plus the added characteristic that the weaknesses make collection or liquidation in full based on currently existing facts, conditions and values, highly questionable and improbable.

Loss – These loans are considered uncollectable and of such little value that their continuance as a bankable asset 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 the asset even though partial recovery may be affected in the future.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

The following table presents the Company's recorded investment in loans by credit quality indicators by year of origination as of December 31, 2023.

December 31, 2023	Term Loans by Year of Origination				Revolving	Total
	2023	2022	2021	Prior		
	<i>(Dollars in thousands)</i>					
Residential construction						
Pass	\$ 33,458	\$ 14,875	\$ 1,456	\$ -	\$ -	\$ 49,789
Special mention	-	-	-	-	-	-
Substandard accruing	-	-	-	-	-	-
Substandard nonaccruing	-	-	-	-	-	-
Total residential construction	33,458	14,875	1,456	-	-	49,789
Commercial construction, all land development and other land loans						
Pass	\$ 23,882	\$ 20,473	\$ 8,944	\$ 4,962	\$ 12,580	\$ 70,841
Special mention	-	-	-	50	-	50
Substandard accruing	-	-	-	-	-	-
Substandard nonaccruing	-	-	-	-	-	-
Total commercial construction, all land development and other land loans	23,882	20,473	8,944	5,012	12,580	70,891
Residential properties						
Pass	\$ 23,678	\$ 44,679	\$ 37,552	\$ 24,329	\$ 34,913	\$ 165,151
Special mention	-	-	267	498	-	765
Substandard accruing	-	-	-	-	-	-
Substandard nonaccruing	-	-	-	-	-	-
Total residential properties	23,678	44,679	37,819	24,827	34,913	165,916
Residential mortgage (1)						
Pass	\$ 27,395	\$ 92,412	\$ 64,773	\$ 49,205	\$ -	\$ 233,785
Special mention	-	-	-	-	-	-
Substandard accruing	-	-	-	-	-	-
Substandard nonaccruing	307	-	-	-	-	307
Total residential mortgage (1)	27,702	92,412	64,773	49,205	-	234,092
Commercial real estate - other						
Pass	\$ 57,629	\$ 97,073	\$ 93,891	\$ 251,141	\$ 3,268	\$ 503,002
Special mention	-	201	212	4,689	-	5,102
Substandard accruing	-	-	-	-	-	-
Substandard nonaccruing	-	-	-	1,126	-	1,126
Total commercial real estate - other	57,629	97,274	94,103	256,956	3,268	509,230
Commercial and industrial						
Pass	\$ 32,957	\$ 27,662	\$ 13,431	\$ 26,930	\$ 12,284	\$ 113,264
Special mention	-	-	66	437	-	503
Substandard accruing	-	-	-	-	-	-
Substandard nonaccruing	-	-	-	461	-	461
Total commercial and industrial	32,957	27,662	13,497	27,828	12,284	114,228
Consumer and other						
Pass	\$ 658	\$ 666	\$ 194	\$ 1,002	\$ 144	\$ 2,664
Special mention	-	-	-	-	-	-
Substandard accruing	-	-	-	-	-	-
Substandard nonaccruing	-	-	-	-	-	-
Total consumer and other	658	666	194	1,002	144	2,664
Total loans	\$ 199,964	\$ 298,041	\$ 220,786	\$ 364,830	\$ 63,189	\$ 1,146,810

(1) Single-family residential mortgages originated through NSB Mortgage held for investment.

During the twelve months ended December 31, 2023, there was one loan totaling \$49,000 that converted from revolving to term.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

The following table presents gross charge-offs by origination date as of December 31, 2023.

December 31, 2023	Gross Loan Charge-offs by Year of Origination					Revolving	Total
	2023	2022	2021	Prior			
	<i>(Dollars in thousands)</i>						
Residential construction	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial construction, all land development and other land loans	-	-	-	-	-	-	-
Residential properties	-	-	-	-	-	-	-
Residential mortgage (1)	-	-	-	-	-	-	-
Commercial real estate - other	-	-	31	-	-	-	31
Commercial and industrial	-	-	4	96	-	-	100
Consumer and other	-	-	-	-	15	-	15
Total charge-offs	\$ -	\$ -	\$ 35	\$ 96	\$ 15	\$ 146	

(1) Single-family residential mortgages originated through NSB Mortgage held for investment.

The following table presents the Company's recorded investment in loans by credit quality indicators as of December 31, 2022.

	As of December 31, 2022							Total
	Real Estate Loans				Non-Real Estate Loans			
	Construction		Residential	Residential	Commercial & Industrial	Consumer & Other		
	Residential	Commercial	Properties	Mortgage (1)				
	<i>(Dollars in thousands)</i>							
Pass	\$ 68,446	\$ 56,436	\$ 158,579	\$ 180,379	\$ 464,603	\$ 101,616	\$ 3,269	\$ 1,033,328
Special mention	-	60	1,205	-	4,162	94	-	5,521
Substandard nonaccruing	-	-	-	-	5,390	602	-	5,992
Total by exposure	\$ 68,446	\$ 56,496	\$ 159,784	\$ 180,379	\$ 474,155	\$ 102,312	\$ 3,269	\$ 1,044,841

(1) Single-family residential mortgages originated through NSB Mortgage, held for investment.

Modifications to loans generally occur when a borrower is experiencing, or is expected to experience, financial difficulties in the near term. As a result, a concessionary modification with more favorable terms that would not otherwise be considered may be granted to the borrower with the intent to prevent further difficulties and improve the likelihood of recovery of the loan. In some cases, these modifications may result in new loans. Loan modifications to borrowers experiencing financial difficulty may be in the form of a principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension or a combination thereof, among other things. The Company does not generally forgive principal as part of a loan modification. Also, when possible, additional collateral or guarantor support is obtained when modifying the loan. All modified loans to borrowers experiencing financial difficulty are individually reviewed and analyzed for impairment during management's monthly evaluation of the allowance for credit losses on loans. Any individually analyzed reserve for credit losses is based on the present value of expected cash flows or the fair value of the collateral or the loan's observable market price.

There were no modifications for borrowers experiencing financial difficulty during the year ending December 31, 2023. Additionally, there were no defaults on modified loans to borrowers experiencing financial difficulty during the year ending December 31, 2023. There were no modifications resulting in new TDRs during the year ending December 31, 2022. Additionally, there were no TDR defaults during the year ending December 31, 2022.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

NOTE E - ALLOWANCE FOR CREDIT LOSSES ON LOANS

The following table presents activity related to the allowance for credit losses on loans by loan category for the year ended December 31, 2023, under the CECL methodology. Allocation of a portion of the allowance to one class of loan does not preclude its availability to absorb losses in other classes.

	As of and for the Year Ended December 31, 2023								
	Real Estate Loans					Non-Real Estate Loans			Total
	Construction		Residential	Residential	Commercial	Commercial &	Consumer &		
	Residential	Commercial	Properties	Mortgage (1)		Industrial	Other		
Allowance for credit losses:	<i>(Dollars in thousands)</i>								
Beginning balance, prior to adoption of ASC 326	\$ 347	\$ 322	\$ 921	\$ 914	\$ 3,265	\$ 1,693	\$ 81	\$ 7,543	
Impact of adopting ASC 326	(153)	90	96	(75)	11	(483)	(49)	(563)	
Charge-offs	-	-	-	-	(31)	(100)	(15)	(146)	
Recoveries	-	-	-	-	94	528	-	622	
Credit loss (recovery) expense	(123)	20	(35)	151	(281)	(238)	12	(494)	
Ending balance	<u>\$ 71</u>	<u>\$ 432</u>	<u>\$ 982</u>	<u>\$ 990</u>	<u>\$ 3,058</u>	<u>\$ 1,400</u>	<u>\$ 29</u>	<u>\$ 6,962</u>	

Prior to the adoption of ASU 2016-13 on January 1, 2023, the Company calculated the allowance for loan losses under the incurred loss methodology. The following table presents disclosures related to the allowance for loan losses for the year ended December 31, 2022.

	As of and for the Year Ended December 31, 2022								
	Real Estate Loans					Non-Real Estate Loans			Total
	Construction		Residential	Residential	Commercial	Commercial &	Consumer &		
	Residential	Commercial	Properties	Mortgage (1)		Industrial	Other		
Allowance for loan losses:	<i>(Dollars in thousands)</i>								
Beginning balance	\$ 294	\$ 279	\$ 799	\$ 775	\$ 2,902	\$ 1,615	\$ 78	\$ 6,742	
Charge-offs	-	-	-	-	(298)	(21)	-	(319)	
Recoveries	-	-	-	-	152	303	-	455	
Provision (recovery)	53	43	122	139	509	(204)	3	665	
Ending balance	<u>\$ 347</u>	<u>\$ 322</u>	<u>\$ 921</u>	<u>\$ 914</u>	<u>\$ 3,265</u>	<u>\$ 1,693</u>	<u>\$ 81</u>	<u>\$ 7,543</u>	
Ending balance, individually evaluated for impairment	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	
Ending balance, collectively evaluated for impairment	<u>\$ 347</u>	<u>\$ 322</u>	<u>\$ 921</u>	<u>\$ 914</u>	<u>\$ 3,265</u>	<u>\$ 1,693</u>	<u>\$ 81</u>	<u>\$ 7,543</u>	
Loans:									
Ending balance	<u>\$ 68,446</u>	<u>\$ 56,496</u>	<u>\$ 159,784</u>	<u>\$ 180,379</u>	<u>\$ 474,155</u>	<u>\$ 102,312</u>	<u>\$ 3,269</u>	<u>\$ 1,044,841</u>	
Ending balance, individually evaluated for impairment	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 199</u>	<u>\$ -</u>	<u>\$ 5,390</u>	<u>\$ 650</u>	<u>\$ -</u>	<u>\$ 6,239</u>	
Ending balance, collectively evaluated for impairment	<u>\$ 68,446</u>	<u>\$ 56,496</u>	<u>\$ 159,585</u>	<u>\$ 180,379</u>	<u>\$ 468,765</u>	<u>\$ 101,662</u>	<u>\$ 3,269</u>	<u>\$ 1,038,602</u>	

(1) Single-family residential mortgages originated through NSB Mortgage, held for investment.

During 2020 through 2022, due to the potential economic impact of COVID-19, the Bank created a special purpose general reserve category to address loans that may have a collective heightened risk due to the industry in which they operate or from government-mandated closures and/or limitations. This general reserve was established using management's expectation of borrower performance and based upon a COVID-19 residual risk assessment surrounding the different industries in which the Company's borrowers operate. The COVID-19 general reserve totaled approximately \$643,000 of the total \$7.5 million allowance for loan losses as of December 31, 2022. With the adoption of CECL on January 1, 2023, the COVID-19 general reserve is no longer a part of the overall allowance for credit losses as of December 31, 2023, as the model used for CECL incorporates elements of risk attributes related to the loan portfolio and also blends in macroeconomic variables.

A loan may be individually assessed for determining the allowance for credit losses when it is determined that it does not share similar risk characteristics with other assets. Loans that are on nonaccrual status will be reviewed to determine if they will be individually, rather than collectively, assessed. If the loan is deemed to be collateral dependent, it will be individually assessed. Collateral dependent loans are loans for which the repayment is expected to be provided substantially through the operation or sale of the collateral and the borrower is experiencing financial difficulty. Collateral dependent loans require an analysis of the collateral. The fair value of the collateral is discounted by liquidation costs. If the discounted fair value of the collateral is greater than the amortized loan balance, no allowance is required. Otherwise, the difference between the balance and the collateral is charged off if deemed uncollectible.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

The following table presents the amortized cost of collateral dependent loans and any related allowance as of December 31, 2023.

	As of December 31, 2023	
	Amortized Cost	Allowance for Credit Losses
	<i>(Dollars in thousands)</i>	
Real estate secured loans:		
Residential mortgage (1)	\$ 307	\$ 28
Commercial real estate - other	1,175	22
Total real estate secured loans	<u>1,482</u>	<u>50</u>
Other non-real estate loans and leases:		
Commercial and industrial	561	181
Total loans held for investment	<u>\$ 2,043</u>	<u>\$ 231</u>

(1) Single-family residential mortgages originated through NSB Mortgage held for investment.

Impaired loans

Prior to the adoption of ASU 2016-13, loans were considered impaired when, based on current information and events, it was probable the Company would be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement. Impaired loans include loans on nonaccrual status and troubled debt restructurings. The Company individually assessed for impairment all nonaccrual loans and troubled debt restructurings. If a loan was deemed impaired, a specific valuation allowance was allocated, if necessary, so that the loan was reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment was expected solely from the collateral.

The following table presents information regarding impaired loans segregated by loan class as of and for the year ended December 31, 2022.

	As of December 31, 2022				For the year ended December 31, 2022	
	Unpaid Principal Balance	Partial Charge-offs	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
	<i>(Dollars in thousands)</i>					
Impaired with no related allowance recorded:						
Real estate secured loans:						
Residential properties	\$ 199	\$ -	\$ 199	\$ -	\$ 199	\$ 7
Commercial real estate - other	5,665	(275)	5,390	-	5,721	152
Total real estate secured loans	<u>5,864</u>	<u>(275)</u>	<u>5,589</u>	<u>-</u>	<u>5,920</u>	<u>159</u>
Other non-real estate loans and leases:						
Commercial and industrial	\$ 1,076	\$ (426)	\$ 650	\$ -	\$ 686	\$ 8
Total impaired with no related allowance recorded:	<u>\$ 6,940</u>	<u>\$ (701)</u>	<u>\$ 6,239</u>	<u>\$ -</u>	<u>\$ 6,606</u>	<u>\$ 167</u>
Impaired with a related allowance recorded:						
Total impaired with a related allowance recorded:	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Total impaired						
Commercial	\$ 6,741	\$ (701)	\$ 6,040	\$ -	\$ 6,407	\$ 160
Residential	199	-	199	-	199	7
Total	<u>\$ 6,940</u>	<u>\$ (701)</u>	<u>\$ 6,239</u>	<u>\$ -</u>	<u>\$ 6,606</u>	<u>\$ 167</u>

As of December 31, 2022, the recorded investment in loans considered impaired totaled \$6.2 million. There were no specific reserves for probable losses on impaired loan balances noted above. Management analyzed \$6.2 million of impaired loans and determined the collateral to be adequate and no additional specific reserve allowance was necessary after recording approximately \$701,000 in life-to-

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

date partial charge-offs. Total impaired loans as of December 31, 2022, include \$48,000 of restructured but still accruing loans and no restructured nonaccrual loans.

Each loan risk rated “substandard”, “doubtful” and “loss” is reviewed to determine if it is an impaired loan. If a loan is determined to be impaired, it is removed from its homogeneous group and individually analyzed for impairment. Other groups of loans based on facts and circumstances may also be selected for impairment review. If a loan is impaired, a specific reserve allowance is allocated if necessary. Interest payments on impaired loans are typically applied to principal. Impaired loans are charged off in full or in part when losses are confirmed.

NOTE F - PREMISES AND EQUIPMENT

Premises and equipment are stated at cost, less accumulated depreciation. Leasehold improvements are amortized over the lives of the respective leases or the estimated useful life of the leasehold improvement, whichever is less. For financial reporting purposes, depreciation is computed by the straight-line method over the estimated useful lives of the assets. Costs of maintenance and repairs are charged to expense as incurred. Costs of replacing structural parts of major units are considered individually and are expensed or capitalized as the facts dictate. Land is carried at cost. Right-of-use assets that are recognized at the initial adoption of a lease arrangement are included in premises and equipment for finance type leases. More information regarding finance type leases can be found in Note J – Borrowings.

The following table presents a summary of premises and equipment as of December 31, 2023, and 2022.

	As of December 31,	
	2023	2022
	<i>(Dollars in thousands)</i>	
Land	\$ 6,755	\$ 6,755
Buildings	31,110	26,057
Leasehold improvements	1,426	1,591
ROU asset finance type lease	611	611
Furniture, fixtures and equipment	7,581	10,528
	<u>47,483</u>	<u>45,542</u>
Accumulated depreciation	<u>(14,583)</u>	<u>(17,513)</u>
Total	<u>\$ 32,900</u>	<u>\$ 28,029</u>

Depreciation and amortization expense totaled approximately \$1.2 million and \$1.1 million for the years ended December 31, 2023, and 2022, respectively, and is included in occupancy and equipment expense.

As the business case arises, assets may be sold or disposed of in the normal course of business. Net gains on sale or disposal are recognized in other income while net losses on sale or disposal are recognized in other expense. There were no gains or losses on the disposal of fixed assets for the years ended December 31, 2023, and 2022, respectively.

The Company leases certain office equipment under a finance lease. For finance leases other than those considered to be short-term, the Company recognizes lease right-of-use assets and related lease liabilities. Such amounts are reported as components of premises and equipment and other borrowings, respectively, on our accompanying consolidated balance sheet. The Company does not recognize short-term finance leases on our balance sheet. A short-term finance lease has an original term of 12 months or less and does not have a purchase option that is likely to be exercised.

The Company’s finance lease relates to one contract to lease copiers and printers, with a remaining term of approximately three years. Where lease extensions exist and are considered reasonably certain to be exercised, such extensions are included in the lease terms. As of December 31, 2023, net finance lease ROU assets totaled approximately \$407,000 and operating lease liabilities totaled approximately \$416,000, compared to \$560,000 and \$563,000 as of December 31, 2022, respectively. Lease costs, which comprise both amortization and interest expense components, associated with this finance lease totaled approximately \$169,000 and \$58,000 for

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

the years ended December 31, 2023, and 2022, respectively. The Company currently does not have any related party finance lease agreements.

NOTE G – OPERATING LEASES

Operating lease liabilities, which are included in other liabilities, reflect the Company's obligation to make future lease payments. Lease terms typically comprise contractual terms but may include extension options reasonably certain of being exercised at lease inception. Payments are discounted using the rate the Company would pay to borrow amounts equal to the lease payments over the lease term (the Company's incremental borrowing rate). The Company does not separate lease and non-lease components for contracts in which it is the lessee. Operating lease expense, which is comprised of amortization of the ROU asset and the implicit interest accreted on the operating lease liability, is recognized on a straight-line basis over the lease term, while variable lease payments are recognized as incurred. Common area maintenance and other executory costs are the main components of variable lease payments. Operating and variable lease expenses are recorded in net occupancy expense on the Consolidated Statements of Operations.

Operating lease right-of-use (ROU) assets, which are included in other assets, represent the Company's right to use an underlying asset during the lease term and, like operating lease liabilities, are recognized at lease commencement based on the present value of the remaining lease payments using the Company's incremental borrowing rate at the time of lease commencement. ROU assets are further adjusted for any lease incentives.

The Company's operating leases relate to three office locations, with remaining terms of approximately one to eleven years. Where lease extensions exist and are considered reasonably certain to be exercised, such extensions are included in the lease terms. As of December 31, 2023, net operating lease ROU assets totaled approximately \$2.4 million and operating lease liabilities totaled approximately \$2.5 million, compared to \$3.0 million and \$3.1 million as of December 31, 2022, respectively. Lease costs associated with all operating leases totaled approximately \$774,000 and \$760,000 for the years ended December 31, 2023, and 2022, respectively. The Company currently does not have any related party operating lease agreements.

The following table summarizes other information related to our operating leases as of and for the years ended December 31, 2023, and 2022.

	For the year ended December 31,	
	2023	2022
	<i>(In thousands except percent and period data)</i>	
Cash paid for amounts included in the measurement of lease liabilities		
Operating cash flows from operating leases	\$ 650	\$ 623
Right-of-use assets obtained in exchange for new operating lease liabilities	2,361	2,963
Weighted-average remaining lease term - operating leases, in years	8.8	8.7
Weighted-average discount rate - operating leases	1.9%	2.0%

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

The following table summarizes the maturity of remaining lease liabilities as of December 31, 2023.

	As of December 31,	
	<i>(Dollars in thousands)</i>	
2024	\$	665
2025		307
2026		165
2027		169
2028		173
2029 and thereafter		1,234
Total lease payments		2,713
Less: interest		(230)
Present value of lease liabilities	\$	2,483

NOTE H – DEPOSITS

The aggregate amount of time deposits in denominations of \$250,000 or more as of December 31, 2023, and 2022, was approximately \$21.6 million and \$19.4 million, respectively.

The following table presents the scheduled maturities of time deposits as of December 31, 2023.

	As of December 31, 2023		
	Less than \$250,000	\$250,000 or more	Total
	<i>(Dollars in thousands)</i>		
2024	\$ 21,955	\$ 19,970	\$ 41,925
2025	3,564	831	4,395
2026	942	-	942
2027	304	-	304
2028	219	762	981
2029	-	-	-
	<u>\$ 26,984</u>	<u>\$ 21,563</u>	<u>\$ 48,547</u>

NOTE I – SERVICING ASSETS

Loans serviced for others are not included in the Company's consolidated balance sheets. The unpaid principal balances of the loans serviced for others was \$119.8 million and \$125.9 million as of December 31, 2023, and 2022, respectively. Servicing rights totaled \$1.8 million and \$1.8 million as of December 31, 2023, and 2022, respectively, and are included under other assets on the Company's consolidated balance sheets. Amortization of servicing rights is based upon an effective yield method and can be accelerated by early loan payoffs. Amortization totaled approximately \$557,000 and \$763,000 for the years ended December 31, 2023, and 2022, respectively.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

NOTE J – BORROWINGS

The following table presents a summary of borrowings as of December 31, 2023, and 2022.

	As of December 31,	
	2023	2022
	<i>(Dollars in thousands)</i>	
Short-term borrowings		
Repurchase agreements	\$ 188	\$ 264
	<u>\$ 188</u>	<u>\$ 264</u>
Long-term borrowings		
FHLB advances	\$ 100,456	\$ 488
Right of use liability - finance lease	416	563
Subordinated debentures	18,000	18,000
Junior subordinated debentures	15,465	15,465
Less debt issuance costs	(317)	(365)
Long-term borrowings, net	<u>\$ 134,020</u>	<u>\$ 34,151</u>

The following table presents a summary of the trust preferred securities and related junior subordinated debentures outstanding as of December 31, 2023, and 2022.

	2023	2022	Maturity Date	Interest Rate
	<i>(Dollars in thousands)</i>			
North State Statutory Trust I	\$ 5,155	\$ 5,155	4/17/2034	3 mo CME Term SOFR plus 3.05%, resets quarterly
North State Statutory Trust II	5,155	5,155	4/15/2035	3 mo CME Term SOFR plus 1.91%, resets quarterly
North State Statutory Trust III	5,155	5,155	12/15/2037	3 mo CME Term SOFR plus 2.75%, resets quarterly
	<u>\$ 15,465</u>	<u>\$ 15,465</u>		

The following table presents a summary of the subordinated debentures outstanding as of December 31, 2023, and 2022.

	2023	2022	Maturity Date	Interest rate
	<i>(Dollars in thousands)</i>			
Fixed-to-Floating rate subordinated notes	\$ 18,000	\$ 18,000	11/1/2030	Fixed 4.125% through November 1, 2025, thereafter, 3 mo SOFR plus 390.5 basis points, resets quarterly

Short-term Borrowings

The Company had \$188,000 and \$264,000, respectively, of repurchase agreements outstanding as of December 31, 2023, and 2022. Securities sold under agreements to repurchase generally mature within one to four days from the transaction date and are secured by \$1.0 million cash as of December 31, 2023, and 2022. These repurchase agreements are due within one year and are classified as short-term borrowings in the accompanying consolidated balance sheets. Interest rates for repurchase agreements were set at 0.05% as of December 31, 2023.

As of and throughout the years ended December 31, 2023, and 2022, the Company had no outstanding Federal Home Loan Bank (“FHLB”) short-term advances. Currently, any advances are secured by loans available for collateralization.

As of December 31, 2023, the Company had pre-approved available lines of credit totaling approximately \$471.7 million with various financial institutions and the Federal Reserve for borrowing on a short-term basis, with no short-term amounts outstanding at that date. These lines are subject to annual renewals with varying interest rates.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

Long-term Borrowings

As of December 31, 2023, and 2022, the Company had \$100.5 million and \$488,000, respectively, outstanding balances in the form of long-term FHLB advances. Four advances totaling \$455,722, are fully maturing on October 7, 2025, and fund a qualified Community Investment Program loan. The Company pays 2.00% interest for the advance with the loan earning 4.00%. This advance is secured by \$850,000 in cash as of December 31, 2023, and 2022. On October 31, 2023, the Company borrowed an additional \$100.0 million from the FHLB in the form of a 2-year fixed rate hybrid credit. The borrowing carries an interest rate of 5.23% and will mature on October 31, 2025. This advance is secured by certain 1-4 family real estate loans pledged with a lendable collateral value of \$125.4 million.

The Company leases certain office equipment under a finance lease. In 2022, the Company adopted *ASU 2016-02, Leases (Topic 842)* related to accounting for leases and under the new standards, for finance leases other than those considered to be short-term, the Company recognizes lease right-of-use assets and related lease liabilities. Such amounts are reported as components of premises and equipment and other borrowings, respectively, on the accompanying consolidated balance sheets. The Company does not recognize short-term finance leases on the balance sheet. A short-term finance lease has an original term of 12 months or less and does not have a purchase option that is likely to be exercised. As of December 31, 2023, the Company had one finance lease for the use of copiers and printers. The initial lease liability was approximately \$611,000 at inception, and the current amount remaining is approximately \$416,000. The maturity date is August of 2026 and the discount rate calculated by the Company is 3.39%. The discount rate was calculated by using information on various sources of funds available to the Company with like duration.

On March 17, 2004, the Company issued \$5.2 million of junior subordinated debentures to North State Statutory Trust I (“Trust I”) in exchange for the proceeds of trust preferred securities issued by Trust I. On December 15, 2005, the Company issued \$5.2 million of junior subordinated debentures to North State Statutory Trust II (“Trust II”) in exchange for the proceeds of trust preferred securities issued by Trust II. On November 28, 2007, the Company issued \$5.2 million of junior subordinated debentures to North State Statutory Trust III (“Trust III”) in exchange for the proceeds of trust preferred securities issued by Trust III. The Company owns all the outstanding common securities of Trust I, Trust II and Trust III. The junior subordinated deferrable interest debentures are included in long-term borrowings and the Company’s equity interests in Trust I, Trust II and Trust III are included in other assets.

On October 29, 2020, the Company issued \$18 million of fixed-to-floating rate subordinated notes, maturing November 1, 2030, if not previously redeemed. Interest on the notes is 4.125% per annum through November 1, 2025, payable semi-annually in arrears. From November 2, 2025, until the maturity date or early redemption date, the interest rate resets quarterly to an interest rate per annum equal to the then current three-month SOFR rate plus 390.5 basis points, payable quarterly in arrears. Interest on the subordinated notes is payable semi-annually on May 1 and November 1 of each year through November 1, 2025, and quarterly thereafter on February 1, May 1, August 1 and November 1 of each year through the maturity date or early redemption date. The first interest payment was made on May 1, 2021. The notes include redemption options for the Company beginning with the interest payment date of November 1, 2025, to redeem the subordinated notes in whole or in part upon giving required notice to the holders at a redemption price equal to 100% of the principal amount plus accrued and unpaid interest. Additionally, the Company has the option to redeem the notes due to a special event such as a change or prospective change in law that would prevent the deduction of the interest for federal tax purposes; or a subsequent event that could preclude the subordinated notes from being recognized as Tier 2 capital for regulatory capital purposes; or the Company could be required to register as an investment company. The subordinated notes are included in long-term borrowings and qualify as Tier 2 capital up to the redemption date. To qualify for Tier 2 capital, the subordinated notes must have an original weighted average maturity of at least five years and capital inclusion in Tier 2 capital will be discounted 20% each year after the remaining maturity is five years or less.

The junior subordinated debentures for Trust I pay interest quarterly at an annual rate, reset quarterly, equal to 3-month Term SOFR plus 3.05%. The debentures became redeemable in whole or in part on June 17, 2009, and on any January 17, April 17, July 17, or October 17 thereafter. Redemption is mandatory on April 17, 2034. The Company has fully and unconditionally guaranteed the repayment of the trust preferred securities. The Company’s obligation under the guarantee is unsecured and subordinate to senior and subordinated indebtedness of the Company.

The junior subordinated debentures for Trust II pay interest quarterly at an annual rate, reset quarterly, equal to 3-month Term SOFR plus 1.91%. The debentures became redeemable in whole or in part on March 15, 2011, and on any January 15, April 15, July 15, or October 15 thereafter. Redemption is mandatory on April 15, 2035. The Company has fully and unconditionally guaranteed the repayment of the trust preferred securities. The Company’s obligation under the guarantee is unsecured and subordinate to senior and subordinated indebtedness of the Company.

The junior subordinated debentures for Trust III pay interest quarterly at an annual rate, reset quarterly, equal to 3-month Term SOFR plus 2.75%. The debentures are redeemable in whole or in part on March 15, 2013, and on any January 15, April 15, July 15, or

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

October 15 thereafter. Redemption is mandatory on December 15, 2037. The Company has fully and unconditionally guaranteed the repayment of the trust preferred securities. The Company’s obligation under the guarantee is unsecured and subordinate to senior and subordinated indebtedness of the Company.

Current Federal Reserve rules limit the aggregate amount of restricted core capital elements, including trust preferred securities that can be included in Tier 1 capital to not more than 25% of total core capital elements, net of goodwill, less any associated tax liability. Amounts of restricted core capital elements in excess of this limit may be included in Tier 2 capital. However, the aggregate amount of certain restricted core capital elements (including trust preferred securities), term subordinated debt and limited life preferred stock that can be included in Tier 2 capital is limited to 50% of Tier 1 capital.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) changed the ability of bank holding companies to issue trust preferred securities and continue to count them as Tier 1 capital. Bank holding companies with total assets of less than \$15 billion as of December 31, 2009, are permitted to include trust preferred securities issued before May 19, 2010, as Tier 1 capital. As such, the Company’s existing trust preferred securities are grandfathered as Tier 1 capital under the Dodd-Frank Act.

NOTE K - INCOME TAXES

There were no uncertain tax positions as of December 31, 2023, or 2022. The Company changed tax status to an S Corporation effective January 1, 2016. An S Corporation income, gains and losses are passed directly to the shareholders of the Company in proportion to their per share ownership. As of January 1, 2021, the Company was no longer subject to federal corporate level taxation on unrealized built-in gains since the five-year recognition period has fully lapsed. The Company does business in various states outside of its home state of North Carolina. State income tax returns are being filed, where appropriate, with applicable taxing jurisdictions. The majority of states adhere to the Federal pass-through tax treatment of state related income. Any C Corporation (or similar) income taxes paid at the state level are immaterial for financial statement purposes.

NOTE L – OTHER NON-INTEREST INCOME AND OTHER NON-INTEREST EXPENSE

The following table presents the major components of non-interest income for the years ended December 31, 2023, and 2022.

	For the year ended December 31,	
	2023	2022
	<i>(Dollars in thousands)</i>	
Merchant and other loan fees	\$ 341	\$ 541
Service charges and fees on deposit accounts	1,143	1,126
Income from bank owned life insurance	379	362
Other	1,585	1,330
Total other non-interest income	<u>\$ 3,448</u>	<u>\$ 3,359</u>

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

The following table presents the major components of non-interest expense for the years ended December 31, 2023, and 2022.

	For the year ended December 31,	
	2023	2022
	<i>(Dollars in thousands)</i>	
Professional fees	\$ 735	\$ 661
Postage, printing & office supplies	271	239
Advertising and promotion	1,123	1,010
Telecommunications	596	484
Directors fees	833	1,181
FDIC insurance premiums	1,074	1,200
Mortgage processing costs	110	170
Donations	1,333	795
Other	2,682	2,228
Total other non-interest expense	<u>\$ 8,757</u>	<u>\$ 7,968</u>

NOTE M – CAPITAL & REGULATORY MATTERS

The Bank, as a North Carolina banking corporation, may pay cash dividends to the Company only out of undivided profits as determined pursuant to North Carolina General Statutes Section 53-87. In conjunction with the Company’s S Corporation election, the Bank has and intends to declare dividends to the Company in an amount sufficient for the Company to pay distributions to its shareholders and service its debt obligations. However, the Bank is subject to strict regulatory and legal guidelines regarding capital adequacy, dividend policies and other restrictions and rules. Regulatory authorities may limit payment of dividends by any bank when it is determined that such limitation is in the public interest and is necessary to ensure financial soundness of the bank. During the years ending December 31, 2023, and 2022, the Bank distributed cash dividends to the Company of \$10.8 million and \$9.7 million, respectively.

The Company has and intends to declare distributions in an amount at least sufficient to enable shareholders to pay federal income tax and state income tax. The Company is dependent on dividends from the Bank and is subject to strict regulatory restrictions like the Bank. During the years ending December 31, 2023, and 2022, the Company declared cash distributions to shareholders of \$8.7 million and \$9.7 million, respectively.

In 2022, the Company began the Capital Reinvestment Plan through which shareholders are given the option of spending up to fifty percent of their quarterly distributions to purchase additional shares in the Company each quarter. During 2023, the Company raised approximately \$2.6 million from the sale of 158,665 shares at a price of \$16.35 to \$16.55 per share as a result of the Capital Reinvestment Plan. During 2022, the Company raised approximately \$2.3 million from the sale of 136,721 shares at a price of \$16.55 per share as a result of the Capital Reinvestment Plan. The proceeds are credited to additional paid in capital within the equity portion of the accompanying consolidated balance sheets.

The Bank is subject to various regulatory capital requirements administered by federal and state 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 consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies. As of December 31, 2023, 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 amounts and ratios. There are no conditions or events since that notification that management believes have changed the Bank’s category.

In July 2013, the Federal Reserve Board approved and published the final Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations. The Basel III Capital Rules, among other things, (i) introduce Common Equity Tier 1 (“CET1”) as a new capital measure, (ii) specify that Tier 1 capital consists of CET1 and “Additional Tier 1 capital” instruments

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions from and adjustments to capital as compared to existing regulations. The Basel III Capital Rules were effective for the Bank on January 1, 2015, and are fully phased in as of December 31, 2023, and 2022. CET1 capital for the Bank consists of common stock, related paid-in capital, and retained earnings. In connection with the adoption of the Basel III Capital Rules, the Company elected to opt-out of the requirement to include most components of accumulated other comprehensive income in CET1. CET1 for the Bank is reduced by goodwill and intangible assets (intangible assets excluding MSAs and goodwill).

Basel III limits capital distributions and certain discretionary bonus payments if the banking organization does not hold a “capital conservation buffer” consisting of 2.50% of CET1 capital, Tier 1 capital and total capital to risk-weighted assets in addition to the amount necessary to meet minimum risk-based capital requirements. The capital conservation buffer was fully phased in as of January 1, 2019. Basel III requires (i) a minimum ratio of CET1 capital to risk-weighted assets of at least 4.50%, plus a 2.50% capital conservation buffer, (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.00%, plus the capital conservation buffer, (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.00%, plus the 2.50% capital conservation buffer and (iv) a minimum leverage ratio of 4.00%.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios, as prescribed by regulations, of Total capital to risk-weighted assets, Tier I capital to risk-weighted assets, and CET 1 capital to risk-weighted assets, as well as Tier I capital to average assets. As of December 31, 2023, and 2022, the Bank met the respective capital adequacy requirements.

The following table presents information regarding the Bank’s capital and capital ratios as of December 31, 2023, and 2022, respectively.

	Actual		Minimum to be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio
<i>(Dollars in thousands)</i>				
As of December 31, 2023				
Total capital to risk-weighted assets	\$ 116,465	11.08%	\$ 105,070	10.00%
Tier I capital to risk-weighted assets	109,041	10.38%	84,056	8.00%
CET1 to risk-weighted assets	109,041	10.38%	68,295	6.50%
Tier I capital to average assets	109,041	7.87%	69,312	5.00%
As of December 31, 2022				
Total capital to risk-weighted assets	\$ 111,285	11.60%	\$ 95,927	10.00%
Tier I capital to risk-weighted assets	103,742	10.81%	76,742	8.00%
CET1 to risk-weighted assets	103,742	10.81%	62,352	6.50%
Tier I capital to average assets	103,742	7.73%	67,103	5.00%

The Bank had a capital conservation buffer of 3.08 percent as of December 31, 2023. This buffer exceeded the 2.50 percent requirement and, therefore, results in no limit on distributions.

The Bank qualifies as a U.S. Department of Housing and Urban Development, or HUD, approved Title II supervised mortgagee and issues mortgages insured by HUD. For the years ended December 31, 2023, and 2022, the Bank was required to maintain \$1 million in baseline adjusted net worth plus an additional net worth of one percent of the total volume in excess of \$25 million of FHA single family insured mortgages originated, underwritten, purchased, or serviced during the prior fiscal year, up to a maximum required net worth of \$2.5 million. The Company complied with the net worth requirements as of December 31, 2023, and 2022.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

NOTE N – OFF-BALANCE SHEET RISK

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

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer’s creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company, upon extension of credit is based on management’s credit evaluation of the borrower. Collateral obtained varies but may include real estate, stocks, bonds, and certificates of deposit.

The allowance for credit losses related to unfunded commitments totaled \$408,000 and \$0 as of December 31, 2023, and 2022, respectively. There was a recovery of credit losses related to unfunded commitments totaling \$69,000 and \$0 for the years ended December 31, 2023, and 2022, respectively. Provision for credit losses on unfunded commitments is a component of ‘Provision for credit losses’ on the Consolidated Statements of Operations. The Company adopted ASU 2016-13, *Financial Instruments-Credit Losses* (Topic 326) on January 1, 2023, and recorded an initial allowance for credit losses related to unfunded commitments of \$477,000 with an offset to retained earnings.

The following table presents the activity in the allowance for credit losses for unfunded commitments for the year ended December 31, 2023.

	<u>As of December 31, 2023</u>
	<u>Unfunded</u>
	<u>commitments</u>
	<i>(Dollars in thousands)</i>
Allowance for credit losses:	
Beginning balance, prior to adoption of ASC 326	\$ -
Impact of adopting ASC 326	477
(Recovery of) provision for credit losses	(69)
Charge-offs	-
Recoveries	-
Ending balance	<u>\$ 408</u>

The following table presents a summary of the contractual amount of the Company’s exposure to off-balance sheet credit risk as of December 31, 2023.

	<u>December 31, 2023</u>
	<i>(Dollars in thousands)</i>
Financial instruments whose contract amounts represent credit risk:	
Undisbursed lines of credit	\$ 177,685
Other commitments to extend credit	60,342
Letters of credit	2,724
Commitments to originate mortgage loans, fixed and variable	<u>14,728</u>
	<u>\$ 255,479</u>

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

NOTE O - FAIR VALUE MEASUREMENTS

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available-for-sale, best-efforts interest rate lock commitments, mandatory delivery interest rate lock commitments, loans held for sale, and hedge instruments in an open position are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record other assets at fair value on a nonrecurring basis, such as loans individually evaluated to determine an allowance for credit losses, servicing assets, foreclosed assets, and collateral assignment split-dollar loan receivables (CASD). The nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. The Company groups its financial assets and financial liabilities measured at fair value into 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 – Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Level 1 also includes U.S. Treasury, other U.S. government and agency mortgage-backed securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 – Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party services for identical or comparable assets or liabilities.

Level 3 – Valuations for assets and liabilities that are derived from other valuation methodologies, including option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or brokered facilitated transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

Valuation of Assets and Liabilities Reported at Fair Value in Financial Statements

The fair value of a financial instrument is the estimated amount at which the instrument could be exchanged in an orderly transaction between knowledgeable, unrelated, willing parties. The estimated fair value of a financial instrument may differ from the amount that could be realized if sold in an immediate sale such as a forced transaction. Additionally, the valuation of investments is more subjective when markets are less liquid due to the lack of market-based inputs, which may increase the potential that the estimated fair value of an investment is not reflective of the price at which an actual transaction would occur.

The following is a description of valuation methodologies used by the Company for assets and liabilities recorded at fair value, either on a recurring or nonrecurring basis.

Investment Securities Available for Sale

Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds, and corporate debt securities.

Interest Rate Lock Commitments

The Company enters into best-efforts and mandatory delivery interest rate lock commitments, and these are recorded at fair value on a recurring basis. Changes in the interest rate lock commitments subjected to recurring fair value adjustments are affected by changes in fallout rates and changes in the prevailing secondary market prices for like-kind mortgage loans. Additionally, the fair value of interest rate lock commitments is based on servicing rate premium, origination income net of originations costs, and changes in loan pricing between the commitment date and period end, typically month end. The fallout rate measures the likelihood that an interest rate lock commitment will ultimately not become a closed loan held for sale. Factors contributing to the fallout rate include changes in prevailing interest rates from the time of the interest rate lock commitment as well as other factors such as lower than anticipated appraised values. As of December 31, 2023, the fallout rate averaged approximately 9% and the amount of fair value associated with these interest rate lock commitments was approximately \$149,000. As of December 31, 2022, the fallout rate averaged approximately 9% and the amount of fair value associated with these interest rate lock commitments was approximately \$74,000. The fair value

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

associated with interest rate lock commitments is included in other assets for best-efforts and included in other assets, other liabilities, or both, for mandatory delivery as these are booked on a gross basis.

Loans Held for Sale

Loans held for sale are recorded at fair value on a recurring basis. Fair values of loans held for sale are based on commitments on hand from investors or, if commitments have not yet been obtained, prevailing market rates. When the fair value of the loans held for sale is based on an observable market rate or current commitments from investors, the Company records the loans held for sale as nonrecurring Level 2. As of December 31, 2023, and 2022, the amount of fair value adjustments associated with loans held for sale was approximately \$93,000 and \$57,000, respectively.

Open Hedge Positions in TBA Mortgage-Backed Securities

Open Hedge positions in TBA mortgage-backed securities are recorded at fair value on a recurring basis. Changes in the open hedge positions are subjected to recurring fair value adjustments and are affected by changes in the market interest rates which impact prevailing secondary market prices for like-kind securities. As such, these changes in fair value based on interest rates run counter to the changes in the fair values of mandatory delivery interest rate lock commitments, thus creating a hedge against interest rate movements. The fair value associated with open hedge positions in TBA mortgage-backed securities is included in other assets, other liabilities, or both, as these are booked on a gross basis. As of December 31, 2023, the amount of fair value associated with open hedge positions was approximately negative \$28,000. As of December 31, 2022, the amount of fair value associated with open hedge positions was approximately \$16,000.

Loans Individually Evaluated to Determine an Allowance for Credit Losses

The Company does not record loans held for investment at fair value on a recurring basis. However, from time to time, certain loans are evaluated on an individual basis as they have different attributes than other loans within their loan pools, and an allowance for credit losses may need to be established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered evaluated individually. Once a loan is identified, management measures the credit loss in accordance with accounting standards. The fair value of such loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value or discounted cash flows. Those individually evaluated loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. As of December 31, 2023, the Company's loans identified for individual evaluation were evaluated primarily based on the fair value of the collateral. Such loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3. The unobservable inputs include collateral discounts in a range of 5% to 20% of appraised value. The valuation techniques for the Level 3 loans are consistent with techniques used in prior periods. Loans individually evaluated to determine an allowance for credit losses represent collateral dependent loans that were remeasured and reported at fair value through a specific allocation of the allowance for credit losses on loans based upon the fair value of the underlying collateral.

Foreclosed Assets

Foreclosed assets are adjusted to fair value, less estimated costs to sell, upon transfer of the loans to other real estate owned. The initial recorded value may be subsequently reduced by additional valuation allowances, which are charged to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3. The unobservable inputs include collateral discounts in a range of 5% to 20% of appraised values as well as an estimated cost to sell range of 6% to 8%. The valuation techniques for the Level 3 foreclosed assets are consistent with techniques used in prior periods.

SBA Servicing Rights

SBA servicing rights are initially recorded at fair value when loans are sold with servicing retained. These assets are then amortized in proportion to and over the period of estimated net servicing income. The servicing rights are periodically evaluated for impairment based upon the fair value of the servicing rights compared to their respective carrying amounts. The Company estimates the fair value of its servicing rights using discounted cash flow models incorporating numerous assumptions from the perspective of a market

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

participant including servicing income, servicing costs, market discount rates and prepayment speeds. As a result of the valuation inputs, servicing rights are classified within Level 3 of the valuation hierarchy.

Collateral Assignment Split-Dollar Loan Receivable (CASD)

CASD loan receivables are initially recorded at fair value when the transaction is first initiated. On a nonrecurring basis, the receivables are evaluated for accounting purposes and measured at fair value, and when the cash surrender value plus the sum of the premium deposit accounts fall below the initial CASD loan receivable, an expense is recorded on the income statement in personnel expense with the valuation allowance being the offset. Cash surrender values are quotes provided by the insurers of the life insurance policies and are based on inputs readily available to the insurers such as account age, amount of contributions paid in, market performance of investments, and any surrender fees associated with the policies. As a result, CASD loan receivables are classified within Level 2 of the valuation hierarchy.

The following tables present the balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2023, and 2022, respectively.

	As of December 31, 2023			
	Total	Level 1	Level 2	Level 3
	<i>(Dollars in thousands)</i>			
Assets:				
Securities available for sale:				
Government-sponsored residential mortgage-backed securities	\$ 5,760	\$ -	\$ 5,760	\$ -
Total securities available for sale	<u>\$ 5,760</u>	<u>\$ -</u>	<u>\$ 5,760</u>	<u>\$ -</u>
Mortgage banking activities:				
Best efforts interest rate lock commitments	\$ 58	\$ -	\$ -	\$ 58
Mandatory delivery interest rate lock commitments	93	-	-	93
Loans held for sale	5,240	-	5,240	-
Open hedge positions in TBA mortgage-backed securities	2	-	-	2
Total mortgage banking activities - assets	<u>\$ 5,393</u>	<u>\$ -</u>	<u>\$ 5,240</u>	<u>\$ 153</u>
Liabilities:				
Mortgage banking activities:				
Open hedge positions in TBA mortgage-backed securities	\$ 30	\$ -	\$ -	\$ 30
Mandatory delivery interest rate lock commitments	2	-	-	2
Total mortgage banking activities - liabilities	<u>\$ 32</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 32</u>

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

	As of December 31, 2022			
	Total	Level 1	Level 2	Level 3
	<i>(Dollars in thousands)</i>			
Assets:				
Securities available for sale:				
Government-sponsored residential mortgage-backed securities	\$ 3,221	\$ -	\$ 3,221	\$ -
Total securities available for sale	<u>\$ 3,221</u>	<u>\$ -</u>	<u>\$ 3,221</u>	<u>\$ -</u>
Mortgage banking activities:				
Best efforts interest rate lock commitments	\$ 34	\$ -	\$ -	\$ 34
Mandatory delivery interest rate lock commitments	40	-	-	40
Loans held for sale	4,797	-	4,797	-
Open hedge positions in TBA mortgage-backed securities	28	-	-	28
Total mortgage banking activities - assets	<u>\$ 4,899</u>	<u>\$ -</u>	<u>\$ 4,797</u>	<u>\$ 102</u>
Liabilities:				
Mortgage banking activities:				
Open hedge positions in TBA mortgage-backed securities	\$ 12	\$ -	\$ -	\$ 12
Total mortgage banking activities - liabilities	<u>\$ 12</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 12</u>

The following table presents all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the years ended December 31, 2023, and 2022, respectively.

	For the year ended December 31,	
	2023	2022
	<i>(Dollars in thousands)</i>	
Balance, beginning of year	\$ 90	\$ 555
(Losses) gains included in fees from mortgage operations	31	(465)
Balance, end of year	<u>\$ 121</u>	<u>\$ 90</u>

The Company may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets that are measured at the lower of cost or market that were recognized at fair value when fair value fell below the carrying amount as of the end of the period under measurement.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

The following table presents the balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2023, and 2022, respectively.

	As of December 31, 2023			
	Total	Level 1	Level 2	Level 3
	<i>(Dollars in thousands)</i>			
Individually evaluated loans	\$ 928	\$ -	\$ -	\$ 928
Servicing assets	\$ 1,754	\$ -	\$ -	\$ 1,754
Collateral assignment split-dollar loan receivables	\$ 8,189	\$ -	\$ 8,189	\$ -
	<i>(Dollars in thousands)</i>			
	As of December 31, 2022			
	Total	Level 1	Level 2	Level 3
	<i>(Dollars in thousands)</i>			
Servicing assets	\$ 1,797	\$ -	\$ -	\$ 1,797
Collateral assignment split-dollar loan receivables	\$ 8,338	\$ -	\$ 8,338	\$ -

NOTE P - EMPLOYEE AND DIRECTOR BENEFIT PLANS

401(k) and ESOP Retirement Plan

The Company has maintained a qualified 401(k) plan for regular full or part-time eligible employees since June 1, 2000. On January 1, 2015, the Company amended its 401(k) plan and adopted a combined 401(k) and Employee Stock Ownership Plan (“ESOP”). The plan as amended consists of two components (1) a qualified stock bonus plan (ESOP component) and (2) a qualified cash or deferred arrangement, of which no part of can be invested in Company stock, (401(k) component). The purposes of the plan, as restated, are to enable eligible employees to (a) contribute up to an annual maximum as determined under the Internal Revenue Code, (b) share in the growth and prosperity of the Company, (c) accumulate capital for their future economic security, and (d) acquire beneficial stock ownership interests in the Company. In addition, the board of directors can authorize additional discretionary contributions to the plan.

In 2023, and 2022, the Company matched 100% of employee contributions, not exceeding 6% of the participants’ eligible compensation, by contributing to the participant’s 401(k) with the funds directed into the participants’ choice of investments.

The expense related to the 401(k) and ESOP plan contributions for the years ended December 31, 2023, and 2022, totaled approximately \$1.0 million and \$1.0 million, respectively.

Employment Agreements

The Company has entered into an employment agreement with its chief executive officer to ensure a stable and competent management base. This agreement provides for benefits as spelled out in the contract and cannot be terminated by the Board of Directors, except for cause, without prejudicing the officer’s right to receive certain vested rights, including compensation. In the event of a change in control of the Company, as outlined in the agreement, the acquirer will be bound by the terms of this contract.

In addition, the Company entered into two “separation benefit agreements” during 2012 and 2017 with its chief executive officer. Both of the “separation benefit agreements” are fully vested as of December 31, 2023. During 2013 and 2015 the Company entered into “separation benefit and executive bonus agreements” with select officers of the Company. Total compensation expense related to all the separation and bonus agreements totaled approximately \$121,000 and \$53,000, respectively, for the years ended December 31, 2023, and 2022. The liability related to the “separation benefit agreements” was \$3.1 million and \$3.1 million, respectively, as of December 31, 2023, and 2022.

The Company has entered into agreements with four executive officers and three non-executive officers that provides for severance pay benefits in the event of a change in control of the Company that results in the termination of such officers or diminished compensation, duties, or benefits.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

In 2022, the Company entered into agreements with four executive officers and three non-executive officers to ensure a stable and competent management base. The agreements provide for each employee to receive a loan which will fund a premium deposit account which is held at North State Bank. Each year policy premiums are paid out of the premium deposit accounts and into life insurance products. This arrangement is known as a collateral assignment split-dollar (CASD) loan agreement. Generally, the employees are vested by the fourth anniversary of the effective date. The Company will recover its premiums plus additional amounts in installments during the Executive's lifetime and/or from the policy proceeds at the Executive's death pursuant to the terms of the agreements. Employees' taxes for this benefit are paid for by the Company and the amounts are based on the long-term Applicable Federal Rate in effect on the respective loan dates which is characterized as imputed income to the employees and treated as ordinary income for tax purposes. After termination of employment, the Company has no obligation to continue paying taxes on behalf of the employees. Rather, the employees may take distributions from their policies to pay any taxes owed. Importantly, there are no future funding obligations, i.e., the Company is not required to pay any additional amounts into the policies or the premium deposit accounts. The Company is not obligated under any circumstance to maintain a life insurance policy on the employees' lives. Finally, notwithstanding any provision of the agreements to the contrary, benefits to the employees are available solely through the life insurance policies. The employee's sole recourse is with the insurer and not with the Company. As a result, since no amounts are guaranteed to the employees and the Company has no obligation to pay additional amounts, liability accounting is not required under GAAP. Instead, an asset account for the CASD loan receivable is set up along with a contra account for a valuation allowance. These accounts reside within other assets. Periodically, the arrangements are evaluated for accounting purposes, and when the cash surrender value plus the sum of the premium deposit accounts fall below the initial CASD loan receivable, an expense is recorded on the income statement in personnel expense with the valuation allowance being the offset.

Total compensation expense related to the CASD loan agreements totaled approximately \$271,000 and \$286,000, respectively, for the years ended December 31, 2023, and 2022. The net CASD loan receivable asset was \$8.2 million and \$8.3 million, respectively, as of December 31, 2023, and 2022. The balance in the premium deposit accounts was \$6.1 million and \$7.3 million, respectively, as of December 31, 2023, and 2022.

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

NOTE Q - PARENT COMPANY FINANCIAL DATA

The following tables present the condensed financial statements of North State Bancorp as of and for the years ended December 31, 2023, and 2022, respectively.

Condensed Statements of Financial Condition
December 31, 2023 and 2022

	2023	2022
	<i>(Dollars in thousands)</i>	
Assets		
Cash and due from banks	\$ 183	\$ 45
Investment in North State Bank	109,006	103,635
Investment in North State Statutory Trust I	155	155
Investment in North State Statutory Trust II	155	155
Investment in North State Statutory Trust III	155	155
Other assets	-	-
Total Assets	<u>\$ 109,654</u>	<u>\$ 104,145</u>
Liabilities and Shareholders' equity		
Other liabilities	\$ 176	\$ 169
Long-term borrowings	33,148	33,101
Shareholders' equity		
Common stock	17,227	14,214
Retained earnings	59,730	57,344
Accumulated other comprehensive loss	(627)	(683)
Total shareholders' equity	<u>76,330</u>	<u>70,875</u>
Total liabilities and shareholders' equity	<u>\$ 109,654</u>	<u>\$ 104,145</u>

Condensed Statements of Operations
Years Ended December 31, 2023 and 2022

	2023	2022
	<i>(Dollars in thousands)</i>	
Equity in undistributed earnings of bank subsidiary	\$ 2,691	\$ 5,279
Dividends received from bank subsidiary	10,757	9,655
Interest income	36	19
Interest expense	(1,988)	(1,444)
Other expense	(419)	(441)
Net income	<u>\$ 11,077</u>	<u>\$ 13,068</u>

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

Condensed Statements of Cash Flows
Years Ended December 31, 2023 and 2022

	<u>2023</u>	<u>2022</u>
	<i>(Dollars in thousands)</i>	
Cash flows from operating activities:		
Net income	\$ 11,077	\$ 13,068
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization	47	47
Issuance of common stock for board compensation	398	737
Equity in undistributed earnings of subsidiary	(2,691)	(5,279)
Changes in assets and liabilities:		
Decrease in other assets	-	3
Increase in other liabilities	7	25
Net cash provided by operating activities	<u>8,838</u>	<u>8,601</u>
Cash flows from financing activities:		
Issuance of common stock from Capital Reinvestment Plan	2,615	2,262
Downstream of capital to bank subsidiary	(2,615)	(2,262)
Cash distributions to shareholders	(8,700)	(9,697)
Net cash used in financing activities	<u>(8,700)</u>	<u>(9,697)</u>
Net decrease in cash and cash equivalents	138	(1,096)
Cash and cash equivalents, beginning	45	1,141
Cash and cash equivalents, ending	<u>\$ 183</u>	<u>\$ 45</u>

NORTH STATE BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2023 and 2022

NOTE R – BUSINESS SEGMENT INFORMATION

The Company has four reportable business segments, the Bank, NSB Mortgage, SBA, and the parent Company. The Bank is engaged in general commercial and retail banking in central and coastal North Carolina. The Bank operates six full-service banking offices located in Wake County and one full-service office in Wilmington, New Hanover County, North Carolina. NSB Mortgage, a division of the Bank, originates and sells single-family residential first mortgage loans. SBA, another division of our Bank, originates and sells loans (generally 75%) guaranteed by the Small Business Administration. The remaining segment consists of activities of the parent Company. Eliminations necessary to accurately report the operations of the Company are also included.

The following table presents selected segment reporting information as of and for the years ended December 31, 2023, and 2022, respectively.

	As of or for the Year Ended December 31, 2023					
	Bank	NSB Mortgage	SBA	Parent Company	Eliminations	Total Company
	<i>(Dollars in thousands)</i>					
Interest income	\$ 49,485	\$ 8,674	\$ 4,493	\$ 36	\$ -	\$ 62,688
Interest expense	13,371	-	8	1,988	-	15,367
Net interest income	36,114	8,674	4,485	(1,952)	-	47,321
Recovery of credit losses	(586)	-	-	-	-	(586)
Net interest income after provision for credit losses	36,700	8,674	4,485	(1,952)	-	47,907
Noninterest income	3,387	3,096	2,170	-	-	8,653
Noninterest expense	35,923	6,638	2,503	419	-	45,483
Net income (loss)	<u>\$ 4,164</u>	<u>\$ 5,132</u>	<u>\$ 4,152</u>	<u>\$ (2,371)</u>	<u>\$ -</u>	<u>\$ 11,077</u>
Total assets	\$ 1,095,178	\$ 240,642	\$ 41,025	\$ 109,654	\$ (109,189)	\$ 1,377,310
Net loans	871,330	234,092	34,426	-	-	1,139,848
Loans held for sale	-	5,240	-	-	-	5,240
Goodwill	-	141	-	-	-	141
	<i>(Dollars in thousands)</i>					
	As of or for the Year Ended December 31, 2022					
	Bank	NSB Mortgage	SBA	Parent Company	Eliminations	Total Company
	<i>(Dollars in thousands)</i>					
Interest income	\$ 39,839	\$ 5,029	\$ 4,893	\$ 19	\$ -	\$ 49,780
Interest expense	2,339	-	5	1,444	-	3,788
Net interest income	37,500	5,029	4,888	(1,425)	-	45,992
Provision for loan losses	665	-	-	-	-	665
Net interest income after provision for loan losses	36,835	5,029	4,888	(1,425)	-	45,327
Noninterest income	3,070	4,403	3,862	-	-	11,335
Noninterest expense	33,384	7,380	2,389	441	-	43,594
Net income (loss)	<u>\$ 6,521</u>	<u>\$ 2,052</u>	<u>\$ 6,361</u>	<u>\$ (1,866)</u>	<u>\$ -</u>	<u>\$ 13,068</u>
Total assets	\$ 1,072,010	\$ 186,262	\$ 45,619	\$ 104,145	\$ (103,680)	\$ 1,304,356
Net loans	814,110	180,379	42,809	-	-	1,037,298
Loans held for sale	-	4,797	-	-	-	4,797
Goodwill	-	141	-	-	-	141