

Section 1: 10-K (FORM 10-K)

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

FORM 10-K

ANNUAL REPORT UNDER SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended **December 31, 2018**

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission File Number: 2-88927

FIRST KEYSTONE CORPORATION

(Exact name of registrant as specified in its Charter)

Pennsylvania

(State or other jurisdiction of incorporation)

23-2249083

(I.R.S. Employer Identification Number)

111 West Front Street Berwick, Pennsylvania

(Address of principal executive offices)

18603

(Zip Code)

Registrant's telephone number, including area code: **(570) 752-3671**

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act: **Common Stock, par value \$2.00 per share**

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes No

Indicate by check mark whether the Registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

Yes No

Indicate by check mark if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-K contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes No

The aggregate market value of the registrant's outstanding voting common stock held by non-affiliates on June 30, 2018 determined by using a per share closing price on that date of \$26.50 as quoted on the Over the Counter Market, was \$130,935,652.

At March 1, 2019, there were 5,764,710 shares of Common Stock, \$2.00 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's 2019 definitive Proxy Statement are incorporated by reference in Part III of this Report.

FIRST KEYSTONE CORPORATION
FORM 10-K

Table of Contents

| | Page |
|---|-------------|
| Part I | |
| <u>Item 1.</u> <u>Business</u> | <u>2</u> |
| <u>Item 1A.</u> <u>Risk Factors</u> | <u>11</u> |
| <u>Item 1B.</u> <u>Unresolved Staff Comments</u> | <u>18</u> |
| <u>Item 2.</u> <u>Properties</u> | <u>19</u> |
| <u>Item 3.</u> <u>Legal Proceedings</u> | <u>19</u> |
| <u>Item 4.</u> <u>Mine Safety Disclosures</u> | <u>19</u> |
| Part II | |
| <u>Item 5.</u> <u>Market for Registrant’s Common Equity and Related Shareholder Matters and Issuer Purchases of Equity Securities</u> | <u>20</u> |
| <u>Item 6.</u> <u>Selected Financial Data</u> | <u>22</u> |
| <u>Item 7.</u> <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>23</u> |
| <u>Item 8.</u> <u>Financial Statements and Supplementary Data</u> | <u>47</u> |
| <u>Item 9.</u> <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u> | <u>95</u> |
| <u>Item 9A.</u> <u>Controls and Procedures</u> | <u>95</u> |
| <u>Item 9B.</u> <u>Other Information</u> | <u>95</u> |
| Part III | |
| <u>Item 10.</u> <u>Directors, Executive Officers and Corporate Governance</u> | <u>96</u> |
| <u>Item 11.</u> <u>Executive Compensation</u> | <u>96</u> |
| <u>Item 12.</u> <u>Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters</u> | <u>96</u> |
| <u>Item 13.</u> <u>Certain Relationships and Related Transactions, and Director Independence</u> | <u>97</u> |
| <u>Item 14.</u> <u>Principal Accountant Fees and Services</u> | <u>97</u> |
| Part IV | |
| <u>Item 15.</u> <u>Exhibits and Financial Statement Schedules</u> | <u>97</u> |
| <u>Item 16.</u> <u>Form 10-K Summary</u> | <u>97</u> |
| <u>Signatures</u> | <u>99</u> |

FIRST KEYSTONE CORPORATION
FORM 10-K

PART I

Forward Looking Statements

In addition to historical information, this Annual Report on Form 10-K contains forward-looking statements, which are included pursuant to the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. Examples of forward-looking statements include, but are not limited to (a) projections or statements regarding future earnings, expenses, net interest income, other income, earnings or loss per share, asset mix and quality, growth prospects, capital structure, and other financial terms, (b) statements of plans and objectives of management or the Board of Directors, and (c) statements of assumptions, such as economic conditions in First Keystone Corporation’s (the “Corporation”) market areas. Such forward-looking statements can be identified by the use of forward-looking terminology such as “believes”, “expects”, “may”, “intends”, “will”, “should”, “anticipates”, or the negative of any of the foregoing or other variations thereon or comparable terminology, or by discussion of strategy.

Forward-looking statements are subject to certain risks and uncertainties such as local economic conditions, competitive factors, and regulatory limitations. Actual results may differ materially from those projected in the forward-looking statements. Such risks, uncertainties and other factors that could cause actual results and experience to differ from those projected include, but are not limited to, the following: ineffectiveness of the business strategy due to changes in current or future market conditions; the effects of economic conditions on current and future customers, specifically the effect of the economy on loan customers’ ability to repay loans; possible impacts of the capital and liquidity requirements of Basel III standards and other regulatory pronouncements, regulations and rules; effects of short- and long-term federal budget and tax negotiations and their effects on economic and business conditions; changes in accounting principles, policies or guidelines as may be adopted by the regulatory agencies as well as the Public Company Accounting Oversight Board and the Financial Accounting Standards Board, and other accounting standards setters; the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating locally, regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone, computer and the internet; governmental monetary and fiscal policies, as well as legislative and regulatory changes; the effects of new laws and regulations, specifically the impact of the Tax Cuts and Jobs Act, the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities and interest rate protection agreements, as well as interest rate risks; information technology difficulties, including technological changes; challenges in establishing and maintaining operations in new markets; volatilities in the securities markets; acquisitions and integration of acquired businesses; the failure of assumptions underlying the establishment of reserves for loan losses and estimations of values of collateral and various financial assets and liabilities; acts of war or terrorism; disruption of credit and equity markets; our ability to manage current levels of impaired assets; deposit flows; the loss of certain key officers; our ability to maintain the value and image of our brand and protect our intellectual property rights; continued relationships with major customers; the potential impact to the Corporation from continually evolving cybersecurity and other technological risks and attacks, including additional costs, reputational damage, regulatory penalties and financial losses; and the effect of general economic conditions and more specifically in the Corporation’s market area.

We caution readers not to place undue reliance on these forward-looking statements. They only reflect management’s analysis as of this date. The Corporation does not revise or update these forward-looking statements to reflect events or changed circumstances. Please carefully review the risk factors described in this document and in other documents the Corporation files from time to time with the Securities and Exchange Commission, including the Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, and any Current Reports on Form 8-K.

ITEM 1. BUSINESS

General

First Keystone Corporation (the “Corporation”) is a Pennsylvania business corporation, and a bank holding company, registered with and supervised by the Board of Governors of the Federal Reserve System. The Corporation was incorporated on July 6, 1983, and commenced operations on July 2, 1984, upon consummation of the acquisition of all of the outstanding stock of First National Bank of Berwick (the predecessor to First Keystone Community Bank). The Corporation has one wholly-owned subsidiary, First Keystone Community Bank (the “Bank”), which has a commercial banking operation and trust department as its major lines of business. Since commencing operations, the Corporation’s business has consisted primarily of managing and supervising the Bank, and its principal source of income has been dividends paid by the Bank. Greater than 98% of the Corporation’s revenue and profit came from the commercial bank subsidiary for the years ended December 31, 2018 and 2017, and was the only reportable segment. At December 31, 2018, the Corporation had total consolidated assets, deposits and stockholders’ equity of approximately \$1 billion, \$672 million and \$117 million, respectively.

The Bank was originally organized in 1864 as a national banking association. On October 1, 2010, the Bank converted from a national banking association to a Pennsylvania chartered commercial bank under the supervision of the Pennsylvania Department of Banking and Securities and the FDIC.

The Bank’s deposits are insured by the Federal Deposit Insurance Corporation (the “FDIC”) to the maximum extent of the law regulated by the FDIC and the Pennsylvania Department of Banking and Securities. The Bank is subject to regulation by the Federal Reserve Board governing reserves required to be maintained against certain deposits and other matters. The Bank is also a member of the Federal Home Loan Bank of Pittsburgh, which is one of the twelve regional cooperative banks comprising the system of Federal Home Loan Banks that lending institutions use to finance housing and economic development in local communities.

The Bank’s legal headquarters are located at 111 West Front Street, Berwick, Pennsylvania, from which it oversees the operations of its nineteen branch locations. These locations consist of five branches within Columbia County, eight branches within Luzerne County, one branch in Montour County, four branches within Monroe County, and one loan production office within Northampton County, Pennsylvania. For further information, please refer to Item 2 – Properties, and Note 11 — Commitments and Contingencies in the notes to the consolidated financial statements.

The Bank is a full service commercial bank providing a wide range of services to individuals and small to medium sized businesses in its Northeastern Pennsylvania market area. The Bank’s commercial banking activities include accepting time, demand and savings deposits and making secured and unsecured commercial, real estate and consumer loans. Additionally, the Bank provides personal and corporate trust and agency services to individuals, corporations and others, including trust investment accounts, investment advisory services, mutual funds, estate planning, and management of pension and profit sharing plans. The Bank’s business is not seasonal in nature. The Bank has no foreign loans or highly leveraged transaction loans, as defined by the Federal Reserve Board. Substantially all of the loans in the Bank’s portfolio have been originated by the Bank. Policies adopted by the Board of Directors are the basis by which the Bank conducts its lending activities.

At December 31, 2018, the Bank had 190 full-time employees and 16 part-time employees. In the opinion of management, the Bank enjoys a satisfactory relationship with its employees. The Bank is not a party to any collective bargaining agreement.

The Corporation’s internet website is www.firstkeystonecorporation.com and the Bank’s internet website is www.fkc.bank.

When we say “we”, “us”, “our” or the “Corporation”, we mean the Corporation on a consolidated basis with the Bank.

Primary Market Areas

The Bank’s primary market area reaches west from Montour county spanning east into Monroe and Northampton counties, encompassing Columbia and Luzerne counties. The bank’s market extends north through Luzerne county and south to Northampton county. Ten other adjoining counties are served, such as Pike and Lehigh. The area served by the Bank includes a mix of rural communities, small to mid-sized towns and cities. The current population of the Bank’s primary five-county footprint has increased 0.4% since 2015 to 874,000 and is estimated to increase 0.5% to 878,000 by 2024. As of June 30, 2018, the FDIC deposit market share data ranked the Bank 9th in the deposit market share out of the top 20 financial institutions in the five-county market, with 2.8% of deposits, which includes the newly added Northampton county market.

The Bank's headquarters, main office, and three of its branch offices are located in Berwick, Pennsylvania. Therefore, the Bank has a very strong presence in the Borough of Berwick, a community with a current population of approximately 10,000. The Bank ranks a commanding first in deposit market share in the Berwick market with 70.4% of deposits as of June 30, 2018, based on data compiled annually by the FDIC.

In the course of attracting and retaining deposits and originating loans, the Bank faces considerable competition. The Bank competes with 57 commercial banks, 5 savings banks and savings and loans associations, and 47 credit unions for traditional banking products, such as deposits and loans in its primary four-county market area. Additionally, the Bank competes with consumer finance companies for loans, mutual funds and other investment alternatives for deposits. The Bank competes for deposits based on the ability to provide a range of competitively priced products, quality service, competitive rates, and convenient locations and hours. The competition among its peers for loan origination generally relates to interest rates offered, products available, ease of process, quality of service, and loan origination fees charged. The economic base of the Bank's market region is developed around small business, health care, educational facilities (college and public schools), light manufacturing industries, and agriculture.

The Bank continues to assess the market area to determine the best way to meet the financial needs of the communities it serves. Management continues to pursue new market opportunities based on a strategic plan to efficiently grow the Bank, improve earnings performance, and bring the Bank's products and services to new customers. Management strategically addresses growth opportunities versus competitive issues by determining the new products and services to be offered, evaluating expansion opportunities of its existing footprint with new locations, as well as investing in the expertise of skilled staffing. The Bank continues to succeed in serving its customers by living up to its motto, "Yesterday's Traditions. Tomorrow's Vision."

Competition - Bank

The Bank's competition is comprised of national, regional, community banking financial institutions and credit unions. The Bank's major competitors in Columbia, Luzerne, Montour, Monroe, Northampton and Lehigh counties are:

- Citizens Bank
- Community Bank, N.A.
- Dime Bank
- Embassy Bank
- ESSA Bank & Trust
- Fidelity Deposit and Discount Bank
- First Columbia Bank & Trust Co.
- FNCB Bank
- First Northern Bank and Trust Co.
- FNB Bank, N.A.
- Honesdale National Bank
- Jersey Shore State Bank
- Lafayette Ambassador Bank
- Landmark Community Bank
- Luzerne Bank
- M & T Bank
- Peoples Security Bank
- Wayne Bank

The Bank is generally competitive with all competing financial institutions in its service area with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

Concentration

The Corporation and the Bank are not dependent on deposits nor exposed by loan concentrations to a single customer or to a small group of customers, such that the loss of any one or more would not have a materially adverse effect on the financial condition of the Corporation or the Bank. The Corporation has been successful in attracting municipal deposits, which make up 15.9% of total deposits at December 31, 2018. The largest municipal deposit customer consisted of a school district with deposit balances amounting to 3.3% of total deposits. The Corporation currently has the ability to utilize liquidity tools, such as wholesale borrowings, to replace reductions in municipal deposits. The customers' ability to repay their loans is generally dependent on the real estate market and general economic conditions prevailing in Pennsylvania, among other factors.

Supervision and Regulation

The Corporation is subject to the jurisdiction of the Securities and Exchange Commission (the "SEC") and of state securities laws for matters relating to the offering and sale of its securities. The Corporation is currently subject to the SEC's rules and regulations relating to companies whose shares are registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act"), as amended.

The Corporation is also subject to the provisions of the Bank Holding Company Act of 1956, as amended, and to supervision by the Federal Reserve Board. The Bank Holding Company Act requires the Corporation to secure the prior approval of the Federal Reserve Board before it owns or controls, directly or indirectly, more than 5% of the voting shares of substantially all of the assets of any institution, including another bank.

The Bank Holding Company Act also prohibits acquisition of control of a bank holding company, such as the Corporation, without prior notice to the Federal Reserve Board. Control is defined for this purpose as the power, directly or indirectly, to direct the management or policies of a bank holding company or to vote 25% (or 10%, if no other person or persons acting on concert, holds a greater percentage of the common stock) or more of the Corporation's common stock.

The Corporation is required to file an annual report with the Federal Reserve Board and any additional information that the Federal Reserve Board may require pursuant to the Bank Holding Company Act. The Federal Reserve Board may also make examinations of the Corporation and any or all of its subsidiaries.

The Bank is subject to federal and state statutes applicable to banks chartered under the banking laws of Pennsylvania and to banks whose deposits are insured by the FDIC. The Bank is subject to supervision, regulation and examination by the Pennsylvania Department of Banking and Securities, the FDIC and the Consumer Financial Protection Bureau.

Federal and state banking laws and regulations govern, among other things, the scope of a bank's business, the investments a bank may make, the reserves against deposits a bank must maintain, loans a bank makes and collateral it takes, and the activities of a bank with respect to mergers and consolidations and the establishment of branches.

As a subsidiary of a bank holding company, the Bank is subject to certain restrictions imposed by the Federal Reserve Act on any extensions of credit to the bank holding company or its subsidiaries, on investments in the stock or other securities of the bank holding company or its subsidiaries and on taking such stock or securities as collateral for loans. The Federal Reserve Act and Federal Reserve Board regulations also place certain limitations and reporting requirements on extensions of credit by a bank to principal shareholders of its parent holding company, among others, and to related interests of such principal shareholders. In addition, such legislation and regulations may affect the terms upon which any person becoming a principal shareholder of a holding company may obtain credit from banks with which the subsidiary bank maintains a correspondent relationship.

Permitted Non-Banking Activities

The Federal Reserve Board permits bank holding companies to engage in non-banking activities so closely related to banking, managing or controlling banks as to be a proper incident thereto. The Corporation does not at this time engage in any of these non-banking activities, nor does the Corporation have any current plans to engage in any other permissible activities in the foreseeable future.

Legislation and Regulatory Changes

From time to time, various types of federal and state legislation have been proposed that could result in additional regulations of, and restrictions on, the business of the Bank. It cannot be predicted whether any such legislation will be adopted or how such legislation would affect the business of the Bank. As a consequence of the extensive regulation of commercial banking activities in the United States, the Bank's business is particularly susceptible to being affected by federal legislation and regulations that may increase the costs of doing business.

From time to time, legislation is enacted which has the effect of increasing the cost of doing business, limiting or expanding permissible activities or affecting the competitive balance between banks and other financial institutions. No prediction can be made as to the likelihood of any major changes or the impact such changes might have on the Corporation and the Bank. Certain changes of potential significance to the Corporation which have been enacted recently and others which are currently under consideration by Congress or various regulatory agencies are discussed below.

Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”)

The FDICIA established five different levels of capitalization of financial institutions, with “prompt corrective actions” and significant operational restrictions imposed on institutions that are capital deficient under the categories. The five categories are:

- well capitalized
- adequately capitalized
- undercapitalized
- significantly undercapitalized, and
- critically undercapitalized.

To be considered well capitalized, an institution must have a total risk-based capital ratio of at least 10%, a tier 1 risk-based capital ratio of at least 8%, a common equity tier 1 risk-based capital ratio of at least 6.5%, a leverage capital ratio of at least 5%, and must not be subject to any order or directive requiring the institution to improve its capital level. An institution falls within the adequately capitalized category if it has a total risk-based capital ratio of at least 8%, a tier 1 risk-based capital ratio of at least 6%, a common equity tier 1 risk-based capital ratio of at least 4.5%, and a leverage capital ratio of at least 4%. Institutions with lower capital levels are deemed to be undercapitalized, significantly undercapitalized or critically undercapitalized, depending on their actual capital levels. In addition, the appropriate federal regulatory agency may downgrade an institution to the next lower capital category upon a determination that the institution is in an unsafe or unsound condition, or is engaged in an unsafe or unsound practice. Institutions are required under the FDICIA to closely monitor their capital levels and to notify their appropriate regulatory agency of any basis for a change in capital category. On December 31, 2018, the Corporation and the Bank exceeded the minimum capital levels of the well capitalized category. See Note 13 — Regulatory Matters.

Regulatory oversight of an institution becomes more stringent with each lower capital category, with certain “prompt corrective actions” imposed depending on the level of capital deficiency.

Other Provisions of the FDICIA

Each depository institution must submit audited financial statements to its primary regulator and the FDIC, whose reports are made publicly available. In addition, the audit committee of each depository institution must consist of outside directors and the audit committee at “large institutions” (as defined by FDIC regulation) must include members with banking or financial management expertise. The audit committee at “large institutions” must also have access to independent outside counsel. In addition, an institution must notify the FDIC and the institution’s primary regulator of any change in the institution’s independent auditor, and annual management letters must be provided to the FDIC and the depository institution’s primary regulator. The regulations define a “large institution” as one with over \$500 million in assets, which does include the Bank. Also, under the rule, an institution’s independent public accountant must examine the institution’s internal controls over financial reporting and perform agreed-upon procedures to test compliance with laws and regulations concerning safety and soundness.

Under the FDICIA, each federal banking agency must prescribe certain safety and soundness standards for depository institutions and their holding companies. Three types of standards must be prescribed:

- asset quality and earnings
- operational and managerial, and
- compensation.

Such standards would include a ratio of classified assets to capital, minimum earnings, and, to the extent feasible, a minimum ratio of market value to book value for publicly traded securities of such institutions and holding companies. Operational and managerial standards must relate to:

- internal controls, information systems and internal audit systems
- loan documentation
- credit underwriting
- interest rate exposure
- asset growth, and
- compensation, fees and benefits.

The FDICIA also sets forth Truth in Savings disclosure and advertising requirements applicable to all depository institutions.

Real Estate Lending Standards. Pursuant to the FDICIA, federal banking agencies adopted real estate lending guidelines which would set loan-to-value (“LTV”) ratios for different types of real estate loans. The LTV ratio is generally defined as the total loan amount divided by the appraised value of the property at the time the loan is originated. If the institution does not hold a first lien position, the total loan amount would be combined with the amount of all junior liens when calculating the ratio. In addition to establishing the LTV ratios, the guidelines require all real estate loans to be based upon proper loan documentation and a recent appraisal or certificate of inspection of the property.

Regulatory Capital Requirements

The federal banking regulators have adopted certain risk-based capital guidelines to assist in the assessment of the capital adequacy of a banking organization’s operations for both transactions reported on the balance sheet as assets and transactions, such as letters of credit, and recourse agreements, which are recorded as off-balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off-balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain U.S. Treasury securities, to 1,250% for assets with high credit risk, such as certain securitization exposures.

The following table presents the Bank’s capital ratios at December 31, 2018.

| | (Dollars In Thousands) | |
|--|------------------------|---------|
| Tier I Capital | \$ | 89,203 |
| Common Equity Tier 1 Capital | \$ | 89,203 |
| Tier II Capital | \$ | 6,862 |
| Total Capital | \$ | 96,065 |
| Adjusted Total Average Assets | \$ | 990,410 |
| Total Adjusted Risk-Weighted Assets ¹ | \$ | 692,434 |
| Tier I Risk-Based Capital Ratio ² | | 12.88% |
| Required Tier I Risk-Based Capital Ratio (plus Capital Buffer) | | 7.88% |
| Excess Tier I Risk-Based Capital Ratio | | 5.00% |
| Common Equity Tier 1 Risk-Based Capital Ratio ³ | | 12.88% |
| Required Common Equity Tier 1 Risk-Based Capital Ratio (plus Capital Buffer) | | 6.38% |
| Excess Common Equity Tier 1 Risk-Based Capital Ratio | | 6.50% |
| Total Risk-Based Capital Ratio ⁴ | | 13.87% |
| Required Total Risk-Based Capital Ratio (plus Capital Buffer) | | 9.88% |
| Excess Total Risk-Based Capital Ratio | | 3.99% |
| Tier I Leverage Ratio ⁵ | | 9.01% |
| Required Tier I Leverage Ratio | | 4.00% |
| Excess Tier I Leverage Ratio | | 5.01% |

¹Includes off-balance sheet items at credit-equivalent values less intangible assets.

²Tier I Risk-Based Capital Ratio is defined as the ratio of Tier I Capital to Total Adjusted Risk-Weighted Assets.

³Common Equity Tier 1 Risk-Based Capital Ratio is defined as the ratio of Common Equity Tier 1 Capital to Total Adjusted Risk-Weighted Assets.

⁴Total Risk-Based Capital Ratio is defined as the ratio of Tier I and Tier II Capital to Total Adjusted Risk-Weighted Assets.

⁵Tier I Leverage Ratio is defined as the ratio of Tier I Capital to Adjusted Total Average Assets.

The Corporation’s capital ratios are not materially different than those of the Bank.

The Corporation’s ability to maintain the required levels of capital is substantially dependent upon the success of the Corporation’s capital and business plans; the impact of future economic events on the Corporation’s loan customers; and the Corporation’s ability to manage its interest rate risk and investment portfolio and control its growth and other operating expenses. See also the information under Capital Strength in Management’s Discussion and Analysis on page 40 of this report.

Regulatory Capital Changes

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The phase-in period for community banking organizations began January 1, 2015, while larger institutions (generally those with assets of \$250 billion or more) were required to comply by January 1, 2014. The final rules call for the following capital requirements:

- A minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5%.
- A minimum ratio of tier 1 capital to risk-weighted assets of 6%.
- A minimum ratio of total capital to risk-weighted assets of 8%.
- A minimum leverage ratio of 4%.

In addition, the final rules establish a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. If a banking organization fails to hold capital above the minimum capital ratios and the capital conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments. The phase-in period for the capital conservation and countercyclical capital buffers for all banking organizations began on January 1, 2016. The capital level required to avoid restrictions on elective distributions applicable to the Bank were as follows:

- A common equity tier 1 capital ratio of 6.375%.
- A tier 1 risk-based capital ratio of 7.875%.
- A total risk-based capital ratio of 9.875%.

As of December 31, 2018, the Bank maintained capital ratios above the required capital conservation buffer.

Under the initially proposed rules, accumulated other comprehensive income (“AOCI”) would have been included in a banking organization’s common equity tier 1 capital. The final rules allow community banks to make a one-time election not to include these additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The Bank elected to opt-out of this item with the filing of the March 31, 2015 Call Report.

The Corporation has assessed the impact of these changes on the regulatory ratios of the Corporation and the Bank on the capital, operations, liquidity and earnings of the Corporation and Bank, and concluded that the new rules did not have a material negative effect.

Effect of Government Monetary Policies

The earnings of the Corporation are and will be affected by domestic economic conditions and the monetary and fiscal policies of the United States government and its agencies.

The Federal Reserve Board has had, and will likely continue to have, an important impact on the operating results of commercial banks through its power to implement national monetary policy in order to, among other things, curb inflation or combat a recession. The Federal Reserve Board has a major effect upon the levels of bank loans, investments and deposits through its open market operations in United States government securities and through its regulations of, among other things, the discount rate on borrowings of member banks and the reserve requirements against member bank deposits. It is not possible to predict the nature and impact of future changes in monetary and fiscal policies.

Effects of Inflation

Inflation has some impact on the Bank’s operating costs. Unlike industrial companies, however, substantially all of the Bank’s assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on the Bank’s performance than the general levels of inflation. Over short periods of time, interest rates may not necessarily move in the same direction or in the same magnitude as prices of goods and services.

Environmental Regulation

There are several federal and state statutes that regulate the obligations and liabilities of financial institutions pertaining to environmental issues. In addition to the potential for attachment of liability resulting from its own actions, a bank may be held liable, under certain circumstances, for the actions of its borrowers, or third parties, when such actions result in environmental problems on properties that collateralize loans held by the bank. Further, the liability has the potential to far exceed the original amount of the loan issued by the Bank. Currently, neither the Corporation nor the Bank is a party to any pending legal proceeding pursuant to any environmental statute, nor are the Corporation and the Bank aware of any circumstances that may give rise to liability under any such statute.

Interest Rate Risk

Federal banking agency regulations specify that the Bank's capital adequacy include an assessment of the Bank's interest rate risk exposure. The standards for measuring the adequacy and effectiveness of a banking organization's Interest Rate Risk ("IRR") management includes a measurement of Board of Directors and senior management oversight, and a determination of whether a banking organization's procedures for comprehensive risk management are appropriate to the circumstances of the specific banking organization. The Bank has internal IRR models that are used to measure and monitor IRR. Additionally, the regulatory agencies have been assessing IRR on an informal basis for several years. For these reasons, the Corporation does not expect the addition of IRR evaluation to the agencies' capital guidelines to result in significant changes in capital requirements for the Bank.

Tax Cuts and Jobs Act

In December 2017, the Tax Cuts and Jobs Act was signed into law. Among other changes, the Tax Cuts and Jobs Act reduced the federal corporate tax rate from 34% to 21% effective January 1, 2018. In 2017, the Corporation recognized certain effects of the tax law changes. U.S. generally accepted accounting principles require companies to revalue their deferred tax assets and liabilities as of the date of enactment, with resulting tax effects accounted for in the reporting period of enactment. Since the enactment took place in December 2017, the Corporation revalued its net deferred tax assets in the fourth quarter of 2017 resulting in an approximate \$379,000 reduction to earnings in 2017.

JOBS Act

In 2012, the Jumpstart Our Business Startups Act (the "JOBS Act") became law. The JOBS Act is aimed at facilitating capital raising by smaller companies, banks and bank holding companies by implementing the following changes:

- Raising the threshold requiring registration under the Exchange Act for banks and bank holdings companies from 500 to 2,000 holders of record;
- Raising the threshold for triggering deregistration under the Exchange Act for banks and bank holding companies from 300 to 1,200 holders of record;
- Raising the limit for Regulation A offerings from \$5 million to \$50 million per year and exempting some Regulation A offerings from state blue sky laws;
- Permitting advertising and general solicitation in Rule 506 and Rule 144A offerings;
- Allowing private companies to use "crowdfunding" to raise up to \$1 million in any 12-month period, subject to certain conditions; and
- Creating a new category of issuer, called an "Emerging Growth Company," for companies with less than \$1 billion in annual gross revenue, which will benefit from certain changes that reduce the cost and burden of carrying out an equity initial public offering and complying with public company reporting obligations for up to five years.

The JOBS Act has not had any application to the Corporation, and management will continue to monitor the implementation rules for potential effects that might benefit the Corporation.

The Gramm-Leach-Bliley Act of 1999

In 1999, the Gramm-Leach-Bliley Act became law, which is also known as the Financial Services Modernization Act. The act repealed some Depression-era banking laws and will permit banks, insurance companies and securities firms to engage in each others' businesses after complying with certain conditions and regulations. The act grants to community banks the power to enter new financial markets as a matter of right that larger institutions have managed to do on an ad hoc basis. At this time, the Corporation has no plans to pursue these additional possibilities.

The Sarbanes-Oxley Act

In 2002, the Sarbanes-Oxley Act became law. The Act was in response to public concerns regarding corporate accountability in connection with recent high visibility accounting scandals. The stated goals of the Sarbanes-Oxley Act are:

- To increase corporate responsibility;
- To provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies; and
- To protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws.

The Sarbanes-Oxley Act generally applies to all companies, both U.S. and non-U.S., that file periodic reports with the SEC under the Exchange Act. The legislation includes provisions, among other things:

- Governing the services that can be provided by a public company's independent auditors and the procedures for approving such services;
- Requiring the chief executive officer and chief financial officer to certify certain matters relating to the company's periodic filings under the Exchange Act;
- Requiring expedited filings of reports by insiders of their securities transactions and containing other provisions relating to insider conflicts of interest;
- Increasing disclosure requirements relating to critical financial accounting policies and their application;
- Increasing penalties for securities law violations; and
- Creating a public accounting oversight board, a regulatory body subject to SEC jurisdiction with broad powers to set auditing, quality control and ethics standards for accounting firms.

Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") became law in July 2010. Dodd-Frank is intended to affect a fundamental restructuring of federal banking regulation. Among other things, Dodd-Frank created a new Financial Stability Oversight Council to identify systemic risks in the financial system and gave federal regulators new authority to take control of and liquidate financial firms. Dodd-Frank additionally created a new independent federal regulator to administer federal consumer protection laws. Dodd-Frank continues to have a significant impact on our business operations as its provisions are amended and requirements are clarified. Community banks have seen an increase in operating and compliance costs and interest expense. Among the provisions that have affected us are the following:

Holding Company Capital Requirements. Dodd-Frank requires the Federal Reserve to apply consolidated capital requirements to bank holding companies that are no less stringent than those currently applied to depository institutions. Under these standards, trust preferred securities will be excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010 by a bank holding company with less than \$15 billion in assets. Dodd-Frank additionally requires that bank regulators issue countercyclical capital requirements so that the required amount of capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness.

Deposit Insurance. Dodd-Frank permanently increases the maximum deposit insurance amount for banks, savings institutions and credit unions to \$250,000 per depositor, and extended unlimited deposit insurance to non-interest bearing transaction accounts through December 31, 2012. Dodd-Frank also broadens the base for FDIC insurance assessments. Assessments will now be based on the average consolidated total assets less tangible equity capital of a financial institution. Dodd-Frank requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Effective one year from the date of enactment, Dodd-Frank eliminated the federal statutory prohibition against the payment of interest on business checking accounts.

Corporate Governance. Dodd-Frank requires publicly traded companies to give stockholders a non-binding vote on executive compensation at least every three years, a non-binding vote regarding the frequency of the vote on executive compensation at least every six years, and a non-binding vote on “golden parachute” payments in connection with approvals of mergers and acquisitions unless previously voted on by shareholders. The SEC has finalized the rules implementing these requirements which took effect on January 21, 2011. Additionally, Dodd-Frank directs the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of \$1.0 billion, regardless of whether the company is publicly traded. Dodd-Frank also gives the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

Prohibition Against Charter Conversions of Troubled Institutions. Effective one year after enactment, Dodd-Frank prohibits a depository institution from converting from a state to federal charter or vice versa while it is the subject of a cease and desist order or other formal enforcement action or a memorandum of understanding with respect to a significant supervisory matter unless the appropriate federal banking agency gives notice of the conversion to the federal or state authority that issued the enforcement action and that agency does not object within 30 days. The notice must include a plan to address the significant supervisory matter. The converting institution must also file a copy of the conversion application with its current federal regulator which must notify the resulting federal regulator of any ongoing supervisory or investigative proceedings that are likely to result in an enforcement action and provide access to all supervisory and investigative information relating thereto.

Interstate Branching. Dodd-Frank authorizes national and state banks to establish branches in other states to the same extent as a bank chartered by that state would be permitted. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks will be able to enter new markets more freely.

Limits on Interstate Acquisitions and Mergers. Dodd-Frank precludes a bank holding company from engaging in an interstate acquisition — the acquisition of a bank outside its home state — unless the bank holding company is both well capitalized and well managed. Furthermore, a bank may not engage in an interstate merger with another bank headquartered in another state unless the surviving institution will be well capitalized and well managed. The previous standard in both cases was adequately capitalized and adequately managed.

Limits on Interchange Fees. Dodd-Frank amends the Electronic Fund Transfer Act to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over \$10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer. On June 29, 2011, the Federal Reserve Board set the interchange rate cap at \$0.24 per transaction. While the restrictions on interchange fees do not affect banks with assets less than \$10 billion, the rule could affect the competitiveness of debit cards issued by smaller banks.

Consumer Financial Protection Bureau. Dodd-Frank created the independent federal agency called the Consumer Financial Protection Bureau (“CFPB”), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB has examination and primary enforcement authority with respect to depository institutions with \$10 billion or more in assets. Smaller institutions are subject to rules promulgated by the CFPB but continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. Dodd-Frank authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower’s ability to repay. In addition, Dodd-Frank will allow borrowers to raise certain defenses to foreclosure if they receive any loan other than a “qualified mortgage” as defined by the CFPB. Dodd-Frank permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

Department of Defense Military Lending Rule

In 2015, the U.S. Department of Defense issued a final rule which restricts pricing and terms of certain credit extended to active duty military personnel and their families. This rule, which was implemented effective October 3, 2016, caps the interest rate on certain credit extensions to an annual percentage rate of 36% and restricts other fees. The rule requires financial institutions to verify whether customers are military personnel subject to the rule. The impact of this final rule, and any subsequent amendments thereto, on the Corporation's lending activities and the Corporation's statements of income or condition has had little or no impact; however, management will continue to monitor the implementation of the rule for any potential side effects on the Corporation's business.

Available Information

The Corporation's common stock is registered under Section 12(g) of the Exchange Act. The Corporation is subject to the informational requirements of the Exchange Act, and, accordingly, files reports, proxy statements and other information with the SEC. The Corporation is an electronic filer with the SEC. The SEC maintains an internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The SEC's internet site address is www.sec.gov.

A copy of the Corporation's Annual Report on Form 10-K may be obtained without charge at www.fkyscorp.com or via email at info@fkcbank.com. Quarterly reports on Form 10-Q, current event reports on Form 8-K, and amendments to these reports, may be obtained without charge via email at info@fkcbank.com. Information may also be obtained via written request to Investor Relations at First Keystone Corporation, Attention: Cheryl Wynings, 111 West Front Street, P.O. Box 289, Berwick, Pennsylvania 18603, or by telephone at 570-752-3671, extension 1175.

ITEM 1A. RISK FACTORS

Investments in the Corporation's common stock involve risk. The market price of the Corporation's common stock may fluctuate significantly in response to a number of factors, including:

The Corporation is subject to interest rate risk.

The Corporation's earnings and cash flows are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond the Corporation's control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, could influence not only the interest the Corporation receives on loans and securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (i) the Corporation's ability to originate loans and obtain deposits, (ii) the fair value of the Corporation's financial assets and liabilities, and (iii) the average duration of the Corporation's mortgage-backed securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, the Corporation's net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on the Corporation's results of operations, any substantial, unexpected, or prolonged change in market interest rates could have a material adverse effect on the Corporation's financial condition and results of operations.

The Corporation is subject to lending risk.

As of December 31, 2018, approximately 72.7% of the Corporation's loan portfolio consisted of Commercial and Industrial loans and Commercial Real Estate loans (including construction loans), both of which include a tax-free component. These types of loans are generally viewed as having more risk of default than Residential Real Estate loans or Consumer loans. Commercial and Industrial and Commercial Real Estate loans are also typically larger than Residential Real Estate loans and Consumer loans. Because the Corporation's loan portfolio contains a significant number of Commercial and Industrial and Commercial Real Estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Corporation's financial condition and results of operations.

If the Corporation's Allowance for Loan Losses is not sufficient to cover actual loan losses, earnings could decrease.

The Corporation's loan customers may not repay their loans according to the terms of their loans, and the collateral securing the payment of their loans may be insufficient to assure repayment. The Corporation may experience significant credit losses, which could have a material adverse effect on its operating results. In determining the amount of the allowance for loan losses, the Corporation reviews its loans and loss and delinquency experience and evaluates economic conditions. If the Corporation's assumptions prove to be incorrect, the allowance for loan losses may not cover inherent losses in its loan portfolio at the date of the financial statements. Material additions to the Corporation's allowance would materially decrease net income. At December 31, 2018, the allowance for loan losses totaled \$6.7 million, representing 1.15% of average total loans.

Although the Corporation believes its underwriting standards are sufficient to manage normal lending risks, it is difficult to assess the future performance of the loan portfolio due to ongoing new originations. The Corporation cannot assure that non-performing loans will not increase or that non-performing or delinquent loans will not adversely affect future performance.

In addition, federal regulators periodically review the Corporation's allowance for loan losses and may require it to increase the allowance for loan losses or recognize further loan charge-offs. Any increase in the allowance for loan losses or loan charge-offs as required by these regulatory agencies could have a material adverse effect on the results of operations and financial condition.

A new accounting standard will result in a significant change in how we recognize credit losses and may have a material impact on our financial condition or results of operations.

In June 2016, the Financial Accounting Standards Board ("FASB") issued an accounting standard update, "Financial Instruments-Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments," which replaces the current "incurred loss" model for recognizing credit losses with an "expected loss" model referred to as the Current Expected Credit Loss ("CECL") model. Under the CECL model, we will be required to present certain financial assets carried at amortized cost, such as loans held for investment and held-to-maturity debt securities, at the net amount expected to be collected. The measurement of expected credit losses is to be based on information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. This measurement will take place at the time the financial asset is first added to the balance sheet and periodically thereafter. This differs significantly from the "incurred loss" model required under current generally accepted accounting principles ("GAAP"), which delays recognition until it is probable a loss has been incurred. Accordingly, we expect that the adoption of the CECL model will materially affect how we determine our allowance for loan losses and could require us to significantly increase our allowance. Moreover, the CECL model may create more volatility in the level of our allowance for loan losses. If we are required to materially increase our level of allowance for loan losses for any reason, such increase could adversely affect our business, financial condition and results of operations. The new CECL standard will become effective for us on January 1, 2020 and for interim periods within that year.

The Corporation's information systems may experience an interruption or breach in security.

The Corporation relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Corporation's customer relationship management, general ledger, deposit, loan and other systems. The Corporation has policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of its information systems; however, there can be no assurance that any such failures, interruptions or security breaches will not occur. While the Corporation maintains insurance coverage that may, subject to policy terms and conditions including significant self-insured deductibles, cover certain aspects of cyber risks, such insurance coverage may be insufficient to cover all losses. The occurrence of any failures, interruptions or security breaches of the Corporation's information systems could damage the Corporation's reputation adversely affecting customer or investor confidence, result in a loss of customer business, subject the Corporation to additional regulatory scrutiny and possible regulatory penalties, or expose the Corporation to civil litigation and possible financial liability, any of which could have a material adverse effect on the Corporation's financial condition and results of operations.

Severe weather, natural disasters, acts of war or terrorism and other external events could significantly impact the Corporation's business.

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on the Corporation's ability to conduct business. Such events could affect the stability of the Corporation's deposit base; impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause the Corporation to incur additional expenses. Severe weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on the Corporation's business, which, in turn, could have a material adverse effect on the Corporation's financial condition and results of operations.

The Corporation operates in a highly competitive industry.

The Corporation faces substantial competition in all areas of its operations from a variety of different competitors, many of which are larger and may have more financial resources and greater technology. Such competitors primarily include national, regional and community banks within the various markets in which the Corporation operates. The Corporation also faces competition from many other types of financial institutions, including, without limitation, credit unions, finance companies, brokerage firms, insurance companies, factoring companies and other financial intermediaries. Also, technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as online account opening, automatic transfer and automatic payment systems. Many of the Corporation's competitors have fewer regulatory constraints and may have lower cost structures.

The Corporation's ability to compete successfully depends on a number of factors, including, among other things:

- The ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets;
- The ability to expand the Corporation's market position;
- The scope, relevance and pricing of products and services offered to meet customer needs and demands;
- The rate at which the Corporation introduces new products and services relative to its competitors;
- Customer satisfaction with the Corporation's level of service; and
- Industry and general economic trends.

Failure to perform in any of these areas could significantly weaken the Corporation's competitive position, which could adversely affect the Corporation's growth and profitability, which, in turn, could have a material adverse effect on the Corporation's financial condition and results of operations.

New lines of business or new products and services may subject the Corporation to additional risks.

From time-to-time, the Corporation may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services, the Corporation may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of the Corporation's system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on the Corporation's business, results of operations and financial condition.

The Basel III capital requirements may require the Corporation to maintain higher levels of capital, which could reduce its profitability.

Basel III targets higher levels of base capital, certain capital buffers and a migration toward common equity as the key source of regulatory capital. Although the new capital requirements are still being phased in and may change substantially before final implementation, Basel III signals a growing effort by domestic and international bank regulatory agencies to require financial institutions, including depository institutions, to maintain higher levels of capital. As Basel III is implemented, regulatory viewpoints could change or require additional capital to support the Corporation's business risk profile prior to final implementation of the Basel III standards. If the Corporation and the Bank are required to maintain higher levels of capital, the Corporation and the Bank may have fewer opportunities to invest capital into interest-earning assets, which could limit the profitable business operations available to the Corporation and the Bank and adversely impact its financial condition and results of operations.

Federal income tax reform could have unforeseen effects on our financial condition and results of operations.

On December 22, 2017, the President of the United States signed into law H.R. 1, originally known as the "Tax Cuts and Jobs Act." The Tax Cuts and Jobs Act includes a number of provisions, including the lowering of the U.S. corporate tax rate from 34 percent to 21 percent, effective January 1, 2018. There are also provisions that may partially offset the benefit of such rate reduction. Financial statement impacts include adjustments for, among other things, the re-measurement of deferred tax assets and liabilities. While there are benefits, there is also substantial uncertainty regarding the details of U.S. Tax Reform. The long-term intended and unintended consequences of Tax Cuts and Jobs Act on our business and on holders of our common shares is uncertain and could be adverse. The Corporation anticipates that the long-term impact of Tax Cuts and Jobs Act may be material to our business, financial condition and results of operations.

If the Corporation concludes that the decline in value of any of its securities is other than temporary, the Corporation will be required to write down the credit-related portion of the impairment of that security through a charge to earnings.

Management reviews its securities portfolio at each quarter-end reporting period to determine whether the fair value is below the current carrying value. When the fair value of any of its investment securities has declined below its carrying value, management is required to assess whether the decline is other than temporary. If management concludes that the decline is other than temporary, management will be required to write down the credit-related portion of the impairment of that security through a charge to earnings. Due to the complexity of the calculations and assumptions used in determining whether an asset is impaired, the impairment disclosed may not accurately reflect the actual impairment in the future.

The changes in control of the United States government and issues relating to debt and the deficit may adversely affect the Corporation.

Due to the Republican Party controlling of the White House, as well as the Republican Party maintaining or losing control of both the House of Representatives and Senate of the United States in future elections, could result in significant changes (or uncertainty) in governmental policies, regulatory environments, spending sentiment and many other factors and conditions, some of which could adversely impact the Corporation's business, financial condition and results of operations.

In addition, as a result of past difficulties of the federal government to reach agreement over federal debt and the ongoing issues connected with the debt ceiling, certain rating agencies placed the United States government's long-term sovereign debt rating on their equivalent of negative watch and announced the possibility of a rating downgrade. The rating agencies, due to constraints related to the rating of the United States, also placed government-sponsored enterprises in which the Corporation invests and receives lines of credit on negative watch and a downgrade of the United States' credit rating would trigger a similar downgrade in the credit rating of these government sponsored enterprises. Furthermore, the credit rating of other entities, such as state and local governments, may also be downgraded should the United States credit rating be downgraded. The impact that a credit rating downgrade may have on the national and local economy could have an adverse effect on the Corporation's financial condition and results of operations.

The Corporation's profitability depends significantly on economic conditions in the Commonwealth of Pennsylvania.

The Corporation's success depends primarily on the general economic conditions of the Commonwealth of Pennsylvania and the specific local markets in which the Corporation operates. Unlike larger national or other regional banks that are more geographically diversified, the Corporation provides banking and financial services to customers primarily in Columbia, Luzerne, Montour, Monroe, and Northampton counties. The local economic conditions in these areas have a significant impact on the demand for the Corporation's products and services as well as the ability of the Corporation's customers to repay loans, the value of the collateral securing loans and the stability of the Corporation's deposit funding sources. Also, a significant decline in general economic conditions could impact the local economic conditions and, in turn, have a material adverse effect on the Corporation's financial condition and results of operations.

The Corporation's future acquisitions could dilute stockholders' ownership and may cause the Corporation to become more susceptible to adverse economic events.

The Corporation may use its common stock to acquire other companies or make investments in banks and other complementary businesses in the future. The Corporation may issue additional shares of common stock to pay for future acquisitions, which would dilute stockholders' ownership interest in the Corporation. Future business acquisitions could be material to the Corporation, and the degree of success achieved in acquiring and integrating these businesses into the Corporation could have a material effect on the value of the Corporation's common stock. In addition, any acquisition could require the Corporation to use substantial cash or other liquid assets or to incur debt. In those events, the Corporation could become more susceptible to economic downturns and competitive pressures.

The Corporation may not be able to attract and retain skilled people.

The Corporation's success depends, in large part, on its ability to attract and retain key people. Competition for the best people in most activities engaged in by the Corporation can be intense and the Corporation may not be able to hire people or to retain them. The unexpected loss of services of one or more of the Corporation's key personnel could have a material adverse impact on the Corporation's business because of their skills, knowledge of the Corporation's market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

The Corporation is subject to extensive government regulation and supervision.

The Corporation, primarily through the Bank, is subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not shareholders. These regulations affect the Corporation's lending practices, capital structure, investment practices, dividend policy and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies could affect the Corporation in substantial and unpredictable ways. Such changes could subject the Corporation to additional costs, limit the types of financial services and products the Corporation may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on the Corporation's business, financial condition and results of operations.

The Corporation is subject to claims and litigation pertaining to fiduciary responsibility.

From time to time, customers make claims and take legal action pertaining to the Corporation's performance of its fiduciary responsibilities. Whether customer claims and legal action related to the Corporation's performance of its fiduciary responsibilities are founded or unfounded, and if such claims and legal actions are not resolved in a manner favorable to the Corporation, they may result in significant financial liability and/or adversely affect the market perception of the Corporation and its products and services as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on the Corporation's financial condition and results of operations.

The trading volume in the Corporation's common stock is less than that of other larger financial services companies.

The Corporation's common stock is not currently listed on a national stock exchange, but traded on the Over the Counter Market. As a result, trading volume is less than that of other larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Corporation's common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Corporation has no control. Given the lower trading volume of the Corporation's common stock, significant sales of the Corporation's common stock, or the expectation of these sales, could cause the Corporation's stock price to fall.

The Corporation's controls and procedures may fail or be circumvented.

Management regularly reviews and updates the Corporation's internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the Corporation's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Corporation's business, results of operations and financial condition.

The Corporation continually encounters technological change.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Corporation's future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in the Corporation's operations. Many of the Corporation's competitors have substantially greater resources to invest in technological improvements. The Corporation may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on the Corporation's business and, in turn, the Corporation's financial condition and results of operations.

The Corporation may need or be compelled to raise additional capital in the future, but that capital may not be available when it is needed and on terms favorable to current shareholders.

Federal banking regulators require the Corporation and Bank to maintain adequate levels of capital to support their operations. These capital levels are determined and dictated by law, regulation and banking regulatory agencies. In addition, capital levels are also determined by the Corporation's management and board of directors, based on capital levels that they believe are necessary to support the Corporation's business operations. The Corporation is evaluating its present and future capital requirements and needs, is developing a comprehensive capital plan and is analyzing capital raising alternatives, methods and options. Even if the Corporation succeeds in meeting the current regulatory capital requirements, the Corporation may need to raise additional capital in the near future to support possible loan losses during future periods or to meet future regulatory capital requirements.

Further, the Corporation's regulators may require it to increase its capital levels. If the Corporation raises capital through the issuance of additional shares of its common stock or other securities, it would likely dilute the ownership interests of current investors and would likely dilute the per-share book value and earnings per share of its common stock. Furthermore, it may have an adverse impact on the Corporation's stock price. New investors may also have rights, preferences and privileges senior to the Corporation's current shareholders, which may adversely impact its current shareholders. The Corporation's ability to raise additional capital will depend on conditions in the capital markets at that time, which are outside its control, and on its financial performance. Accordingly, the Corporation cannot assure the shareholders of its ability to raise additional capital on terms and time frames acceptable to it or to raise additional capital at all. If the Corporation cannot raise additional capital in sufficient amounts when needed, its ability to comply with regulatory capital requirements could be materially impaired. Additionally, the inability to raise capital in sufficient amounts may adversely affect the Corporation's operations, financial condition and results of operations.

The Corporation is subject to environmental liability risk associated with lending activities.

A significant portion of the Corporation's loan portfolio is secured by real property. During the ordinary course of business, the Corporation may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, the Corporation may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require the Corporation to incur substantial expenses and may materially reduce the affected property's value or limit the Corporation's ability to use or sell the affected property. In addition, future laws, or more stringent interpretations or enforcement policies with respect to existing laws, may increase the Corporation's exposure to environmental liability. Although the Corporation has policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on the Corporation's financial condition and results of operations.

The Corporation's ability to pay dividends is subject to limitations.

The Corporation is a bank holding company and its operations are conducted by the Bank, which is a separate and distinct legal entity. Substantially all of the Corporation's assets are held by the Bank.

The Corporation's ability to pay dividends depends on its receipt of dividends from the Bank, its primary source of dividends. Dividend payments from the Bank are subject to legal and regulatory limitations, generally based on net profits and retained earnings, imposed by the various banking regulatory agencies. The ability of banking subsidiaries to pay dividends is also subject to their profitability, financial condition, capital expenditures and other cash flow requirements. There is no assurance that the Bank will be able to pay dividends in the future or that the Corporation will generate adequate cash flow to pay dividends in the future. The Corporation's failure to pay dividends on its common stock could have a material adverse effect on the market price of its common stock.

Pennsylvania Business Corporation Law and various anti-takeover provisions under its Articles of Incorporation and Bylaws could impede the takeover of the Corporation.

Various Pennsylvania laws affecting business corporations may have the effect of discouraging offers to acquire the Corporation, even if the acquisition would be advantageous to shareholders. In addition, the Corporation has various anti-takeover measures in place under its Articles of Incorporation and Bylaws, including a staggered board of directors and the absence of cumulative voting. Any one or more of these measures may impede the takeover of the Corporation without the approval of its Board of Directors and may prevent its shareholders from taking part in a transaction in which they could realize a premium over the current market price of its common stock.

The Corporation's banking subsidiary may be required to pay higher FDIC insurance premiums or special assessments which may adversely affect its earnings.

Since the Great Recession, poor economic conditions and the resulting bank failures increased the costs of the FDIC and depleted its deposit insurance fund. In more recent history, the FDIC fund position has improved and the cost basis has been updated which in some cases can result in decreased costs of the insurance fund. Additional bank failures may prompt the FDIC to increase its premiums above the recently increased levels or to issue special assessments. The Corporation is generally unable to control the amount of premiums or special assessments that its subsidiary is required to pay for FDIC insurance. Any future changes in the calculation or assessment of FDIC insurance premiums may have a material adverse effect on the Corporation's results of operations, financial condition, and its ability to continue to pay dividends on its common stock at the current rate or at all.

The increasing use of social media platforms presents new risks and challenges and our inability or failure to recognize, respond to and effectively manage the accelerated impact of social media could materially adversely impact our business.

There has been a marked increase in the use of social media platforms, including weblogs (blogs), social media websites, and other forms of Internet-based communications which allow individuals access to a broad audience of consumers and other interested persons. Social media practices in the banking industry are evolving, which creates uncertainty and risk of noncompliance with regulations applicable to our business. Consumers value readily available information concerning businesses and their goods and services and often act on such information without further investigation and without regard to its accuracy. Many social media platforms immediately publish the content their subscribers and participants post, often without filters or checks on accuracy of the content posted. Information posted on such platforms at any time may be adverse to our interests and/or may be inaccurate. The dissemination of information online could harm our business, prospects, financial condition, and results of operations, regardless of the information's accuracy. The harm may be immediate without affording us an opportunity for redress or correction.

Other risks associated with the use of social media include improper disclosure of proprietary information, negative comments about our business, exposure of personally identifiable information, fraud, out-of-date information, and improper use by employees and customers. The inappropriate use of social media by our customers or employees could result in negative consequences including remediation costs including training for employees, additional regulatory scrutiny and possible regulatory penalties, litigation or negative publicity that could damage our reputation adversely affecting customer or investor confidence.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The Corporation and its subsidiary occupy nineteen branch properties in Columbia, Luzerne, Montour, Monroe and Northampton counties in Pennsylvania, which are used principally as banking offices.

Properties owned are:

- Main Office located at 111 West Front Street, Berwick, Pennsylvania 18603;
- Salem Office located at 400 Fowler Avenue, Berwick, Pennsylvania 18603;
- Freas Avenue Office located at 701 Freas Avenue, Berwick, Pennsylvania 18603;
- Scott Township Office located at 2301 Columbia Boulevard, Bloomsburg, Pennsylvania 17815;
- Mifflinville Office located at 133 West Third Street, Mifflinville, Pennsylvania 18631;
- Hanover Township Office located at 1540 Sans Souci Parkway, Hanover Township, Pennsylvania 18706;
- Danville Office located at 1049 Bloom Road, Danville, Pennsylvania 17821;
- Mountainhome Office located at 1154 Route 390, Cresco, Pennsylvania 18326;
- Brodheads ville Office located at 2022 Route 209, Brodheads ville, Pennsylvania 18322;
- Swiftwater Office located at 2070 Route 611, Swiftwater, Pennsylvania 18370;
- Plymouth Office located at 463 West Main Street, Plymouth, Pennsylvania 18651;
- Kingston Office located at 299 Wyoming Avenue, Kingston, Pennsylvania 18704;
- Dallas Office located at 2325 Memorial Highway, Dallas, Pennsylvania 18612;
- Shickshinny Office located at 107 South Main Street, Shickshinny, Pennsylvania 18655;
- Stroudsburg Office located at 559 Main Street, Stroudsburg, Pennsylvania 18360;
- Properties located at Second and Market Streets, and Third and Bowman Streets, Berwick, Pennsylvania 18603; and
- 20 ATMs located in Columbia, Luzerne, Montour and Monroe counties.

Properties leased are:

- Briar Creek Office located inside the Giant Market at 50 Briar Creek Plaza, Berwick, Pennsylvania 18603;
- Nescopeck Office located at 437 West Third Street, Nescopeck, Pennsylvania 18635;
- Mountain Top Office located at 18 North Mountain Boulevard, Mountain Top, Pennsylvania 18707 (land parcel is leased and the bank building is owned); and
- Loan Processing Office at 559 Main Street, Suite 114, Bethlehem, Pennsylvania 18018.

ITEM 3. LEGAL PROCEEDINGS

The Corporation and/or the Bank are defendants in various legal proceedings arising in the ordinary course of their business. However, in the opinion of management of the Corporation and the Bank, there are no proceedings pending to which the Corporation and the Bank is a party or to which their property is subject, which, if determined adversely to the Corporation and the Bank, would be material in relation to the Corporation's and Bank's individual profits or financial condition, nor are there any proceedings pending other than ordinary routine litigation incident to the business of the Corporation and the Bank. In addition, no material proceedings are pending or are known to be threatened or contemplated against the Corporation and the Bank by government authorities or others.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Corporation's common stock is traded in the over-the-counter market on the OTC Market under the symbol "FKYS". The following table sets forth:

- The quarterly high and low prices for a share of the Corporation's common stock during the periods indicated as reported to the management of the Corporation;
- Quarterly dividends on a share of the common stock paid with respect to each quarter since January 1, 2017; and
- The quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

MARKET VALUE OF COMMON STOCK

| | High | Low | Per Share Dividend Paid |
|----------------|----------|----------|----------------------------|
| 2018 | | | |
| First quarter | \$ 28.75 | \$ 26.01 | \$ 0.27 |
| Second quarter | \$ 28.99 | \$ 26.25 | \$ 0.27 |
| Third quarter | \$ 27.00 | \$ 25.11 | \$ 0.27 |
| Fourth quarter | \$ 26.50 | \$ 20.31 | \$ 0.27 |
| 2017 | | | |
| First quarter | \$ 26.50 | \$ 24.25 | \$ 0.27 |
| Second quarter | \$ 27.65 | \$ 25.01 | \$ 0.27 |
| Third quarter | \$ 28.25 | \$ 26.50 | \$ 0.27 |
| Fourth quarter | \$ 29.30 | \$ 27.00 | \$ 0.27 |

As of December 31, 2018, the Corporation had approximately 916 shareholders of record.

The Corporation has paid dividends since commencement of business in 1984. It is the present intention of the Corporation's Board of Directors to continue the dividend payment policy. Stock value, cost and availability of external capital, and the Corporation's present and anticipated capital needs are weighed in the process of making a responsible decision. Further dividends must necessarily depend upon earnings, financial condition, appropriate legal restrictions and other factors relevant at the time the Board of Directors of the Corporation considers its dividend policy. Cash available for dividend distributions to shareholders of the Corporation must initially come from dividends paid by the Bank to the Corporation. Therefore, the restrictions on the Bank's dividend payments are directly applicable to the Corporation.

Transfer Agent:

Computershare (800) 368-5948
P.O. Box 30170
College Station, TX 77842-3170

The following brokerage firms make a market in First Keystone Corporation common stock:

RBC Wealth Management (800) 223-4207
Janney Montgomery Scott LLC (800) 526-6397
Stifel Nicolaus & Co. Inc. (800) 679-5446
Boenning & Scattergood, Inc. (800) 883-1212

Dividend Restrictions on the Bank

Generally, as a Pennsylvania state chartered bank, under Pennsylvania banking law, the Bank may only pay dividends out of accumulated net earnings.

Dividend Restrictions on the Corporation

Under the Pennsylvania Business Corporation Law of 1988, as amended, the Corporation may not pay a dividend if, after giving effect thereto, either:

- The Corporation would be unable to pay its debts as they become due in the usual course of business; or
- The Corporation's total assets would be less than its total liabilities.

The determination of total assets and liabilities may be based upon:

- Financial statements prepared on the basis of generally accepted accounting principles;
- Financial statements that are prepared on the basis of other accounting practices and principles that are reasonable under the circumstances; or
- A fair valuation or other method that is reasonable under the circumstances.

ITEM 6. SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)

| | For the Year Ended December 31, | | | | |
|---|---------------------------------|------------|------------|------------|------------|
| | 2018 | 2017 | 2016 | 2015 | 2014 |
| SELECTED FINANCIAL DATA AT YEAR END: | | | | | |
| Total assets | \$ 1,012,000 | \$ 990,121 | \$ 984,283 | \$ 983,489 | \$ 912,353 |
| Total investment securities | 317,614 | 350,218 | 379,641 | 385,267 | 348,722 |
| Net loans | 599,647 | 551,910 | 515,025 | 509,871 | 481,071 |
| Total deposits | 671,553 | 778,146 | 725,982 | 720,598 | 661,562 |
| Total long-term borrowings | 45,000 | 65,000 | 75,116 | 70,232 | 65,339 |
| Total stockholders' equity | 116,756 | 116,719 | 109,685 | 108,438 | 106,271 |
| SELECTED OPERATING DATA: | | | | | |
| Interest income | \$ 35,573 | \$ 32,268 | \$ 31,643 | \$ 31,711 | \$ 31,019 |
| Interest expense | 8,620 | 6,548 | 5,282 | 4,966 | 4,452 |
| Net interest income | 26,953 | 25,720 | 26,361 | 26,745 | 26,567 |
| Provision for loan losses | 200 | 267 | 2,083 | 2,277 | 433 |
| Net interest income after provision for loan losses | 26,753 | 25,453 | 24,278 | 24,468 | 26,134 |
| Non-interest income | 5,562 | 6,171 | 7,387 | 7,697 | 7,902 |
| Non-interest expense | 22,645 | 21,521 | 20,348 | 21,022 | 21,208 |
| Income before income tax expense | 9,670 | 10,103 | 11,317 | 11,143 | 12,828 |
| Income tax expense | 459 | 1,455 | 1,845 | 1,971 | 2,617 |
| Net income | \$ 9,211 | \$ 8,648 | \$ 9,472 | \$ 9,172 | \$ 10,211 |
| PER SHARE DATA: | | | | | |
| Net income | \$ 1.60 | \$ 1.52 | \$ 1.68 | \$ 1.64 | \$ 1.84 |
| Dividends | 1.08 | 1.08 | 1.08 | 1.08 | 1.05 |
| PERFORMANCE RATIOS: | | | | | |
| Return on average assets | 0.92% | 0.86% | 0.96% | 0.96% | 1.13% |
| Return on average equity | 8.05% | 7.54% | 8.23% | 8.43% | 9.90% |
| Dividend payout | 67.26% | 71.05% | 64.30% | 65.79% | 56.95% |
| Average equity to average assets | 11.39% | 11.45% | 11.68% | 11.40% | 11.45% |

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The purpose of Management's Discussion and Analysis of First Keystone Corporation, a bank holding company (the "Corporation"), and its wholly owned subsidiary, First Keystone Community Bank (the "Bank"), is to assist the reader in reviewing the financial information presented and should be read in conjunction with the consolidated financial statements and other financial data contained herein. Refer to Forward Looking Statements on page 1 for detailed information.

RESULTS OF OPERATIONS

Year Ended December 31, 2018 Versus Year Ended December 31, 2017

Net income increased to \$9,211,000 for the year ended December 31, 2018, as compared to \$8,648,000 for the prior year, an increase of 6.5%. Earnings per share, both basic and diluted, for 2018 was \$1.60 as compared to \$1.52 in 2017, an increase of 5.3%. Dividends per share for 2018 and 2017 were \$1.08. The Corporation's return on average assets was 0.92% in 2018 and 0.86% in 2017. Return on average equity increased to 8.05% in 2018 from 7.54% in 2017. Total interest income in 2018 amounted to \$35,573,000, an increase of \$3,305,000 or 10.2% from 2017. Total interest expense of \$8,620,000 increased \$2,072,000 or 31.6% from 2017. The majority of this increase related to an increase in interest paid on short-term borrowings in 2018.

Net interest income, as indicated below in Table 1, increased by \$1,233,000 or 4.8% to \$26,953,000 for the year ended December 31, 2018. The Corporation's net interest income on a fully tax equivalent basis increased by \$954,000, or 3.3% to \$29,574,000 in 2018 as compared to \$28,620,000 in 2017.

Table 1 — Reconciliation of Taxable Equivalent Net Interest Income

(Dollars in thousands)

| | 2018/2017 | | | |
|--|------------------|---------------------|-------|------------------|
| | 2018 | Increase/(Decrease) | | 2017 |
| | | Amount | % | |
| Interest Income | \$ 35,573 | \$ 3,305 | 10.2 | \$ 32,268 |
| Interest Expense | 8,620 | 2,072 | 31.6 | 6,548 |
| Net Interest Income | 26,953 | 1,233 | 4.8 | 25,720 |
| Tax Equivalent Adjustment | 2,621 | (279) | (9.6) | 2,900 |
| Net Interest Income (fully tax equivalent) | <u>\$ 29,574</u> | <u>\$ 954</u> | 3.3 | <u>\$ 28,620</u> |

Table 2 — Average Balances, Rates and Interest Income and Expense*(Dollars in thousands)*

| | 2018 | | | 2017 | | |
|---|---------------------|------------------|--------------|---------------------|------------------|--------------|
| | Average Balance | Interest | Yield/Rate | Average Balance | Interest | Yield/Rate |
| Interest Earning Assets: | | | | | | |
| Loans: | | | | | | |
| Commercial, net ^{1,2,4} | \$ 102,307 | \$ 3,847 | 3.76% | \$ 94,075 | \$ 3,146 | 3.34% |
| Real Estate ^{1,2} | 476,883 | 21,334 | 4.47% | 435,944 | 18,807 | 4.31% |
| Consumer, net ^{1,4} | 5,770 | 498 | 8.63% | 6,035 | 506 | 8.38% |
| Fees on Loans | — | 602 | 0% | — | 598 | 0% |
| Total Loans⁵ | 584,960 | 26,281 | 4.49% | 536,054 | 23,057 | 4.30% |
| Investment Securities: | | | | | | |
| Taxable | 173,936 | 4,631 | 2.66% | 200,943 | 4,351 | 2.17% |
| Tax-Exempt ^{1,3} | 161,374 | 6,803 | 4.22% | 181,698 | 7,437 | 4.09% |
| Total Investment Securities | 335,310 | 11,434 | 3.41% | 382,641 | 11,788 | 3.08% |
| Restricted Investment in Bank Stocks | 6,516 | 443 | 6.80% | 5,847 | 289 | 4.94% |
| Interest-Bearing Deposits in Other Banks | 2,762 | 36 | 1.30% | 2,637 | 34 | 1.29% |
| Total Other Interest Earning Assets | 9,278 | 479 | 5.16% | 8,484 | 323 | 3.81% |
| Total Interest Earning Assets | 929,548 | 38,194 | 4.11% | 927,179 | 35,168 | 3.79% |
| Non-Interest Earning Assets: | | | | | | |
| Cash and Due From Banks | 8,335 | | | 8,294 | | |
| Allowance for Loan Losses | (7,151) | | | (7,445) | | |
| Premises and Equipment | 20,300 | | | 19,171 | | |
| Other Assets | 54,302 | | | 54,786 | | |
| Total Non-Interest Earning Assets | 75,786 | | | 74,806 | | |
| Total Assets | \$ 1,005,334 | | | \$ 1,001,985 | | |
| Interest Bearing Liabilities: | | | | | | |
| Savings, NOW Accounts, and Money Markets | \$ 387,999 | \$ 2,081 | 0.54% | \$ 410,094 | \$ 1,700 | 0.41% |
| Time Deposits | 208,402 | 3,111 | 1.49% | 197,128 | 2,532 | 1.28% |
| Securities Sold U/A to Repurchase | 15,481 | 87 | 0.56% | 21,872 | 89 | 0.41% |
| Short-Term Borrowings | 96,120 | 2,190 | 2.28% | 64,840 | 755 | 1.16% |
| Long-Term Borrowings | 53,740 | 1,151 | 2.14% | 68,180 | 1,472 | 2.16% |
| Total Interest Bearing Liabilities | 761,742 | 8,620 | 1.13% | 762,114 | 6,548 | 0.86% |
| Non-Interest Bearing Liabilities: | | | | | | |
| Demand Deposits | 124,613 | | | 118,621 | | |
| Other Liabilities | 4,514 | | | 6,498 | | |
| Stockholders' Equity | 114,465 | | | 114,752 | | |
| Total Liabilities/Stockholders' Equity | \$ 1,005,334 | | | \$ 1,001,985 | | |
| Net Interest Income Tax Equivalent | | \$ 29,574 | | | \$ 28,620 | |
| Net Interest Spread | | | 2.98% | | | 2.93% |
| Net Interest Margin | | | 3.18% | | | 3.09% |

¹Tax-exempt income has been adjusted to a tax equivalent basis using an incremental rate of 21% in 2018 and 34% in 2017, and statutory interest expense disallowance.

²Includes tax equivalent adjustments on tax-free municipal loans of \$395,000 and \$442,000 for years 2018 and 2017, respectively.

³Includes tax equivalent adjustments on tax-free municipal securities of \$2,226,000 and \$2,458,000 for years 2018 and 2017, respectively.

⁴Installment loans are stated net of unearned interest.

⁵Average loan balances include non-accrual loans. Interest income on non-accrual loans is not included.

NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income. Net interest income is the difference between interest income on earning assets, such as loans and securities, and the interest expense on liabilities used to fund those assets, including deposits and other borrowings. The amount of interest income is dependent upon both the volume of earning assets and the level of interest rates. In addition, the volume of non-performing loans affects interest income. The amount of interest expense varies with the amount of funds needed to support earning assets, interest rates paid on deposits and borrowed funds, and finally, the level of interest free deposits.

Table 2 on the preceding page provides a summary of average outstanding balances of earning assets and interest bearing liabilities with the associated interest income and interest expense as well as average tax equivalent rates earned and paid as of year-end 2018 and 2017.

The yield on earning assets was 4.11% in 2018 and 3.79% in 2017. The rate paid on interest bearing liabilities was 1.13% in 2018 and 0.86% in 2017. This resulted in an increase in our net interest spread to 2.98% in 2018, as compared to 2.93% in 2017.

As Table 2 illustrates, net interest margin, which is interest income less interest expense divided by average earning assets, was 3.18% in 2018 as compared to 3.09% in 2017. Net interest margins are presented on a tax-equivalent basis. In 2018, yield on earning assets increased by 0.32%, from 3.79% to 4.11% while the rate paid on interest bearing liabilities increased 0.27%. As loans were repaid and refinanced, the principal balances were reinvested at higher, current rates. This was the primary cause of the higher yield on loans. The primary reason for the increased yield in the investment portfolio was due to the sale of tax-exempt securities with lower yields along with the purchase of mortgage backed and asset backed securities with higher yields during 2018. Savings, NOW and money market interest expense increased as a result of the Bank branded Keystone Rewards suite of high interest rewards checking and savings accounts. Average short-term borrowings increased \$31,280,000 while the average rate paid on these borrowings increased by 1.12% from 1.16% to 2.28%. Interest income exempt from federal tax was \$5,387,000 in 2018 and \$5,875,000 in 2017. Interest income exempt from federal tax decreased due to the sales of tax-exempt securities and payoff of tax exempt loans. Tax-exempt income has been adjusted to a tax-equivalent basis using an incremental rate of 21% in 2018 and 34% in 2017.

The increase in our net interest margin came from higher earning asset yields in 2018. Fully tax equivalent net interest income increased from 2017 to 2018 by \$954,000 or 3.3% to \$29,574,000. This occurred while the level of average earning assets increased by 0.3%. The Corporation's net interest margin was under pressure when short-term interest rates started to rise since the Corporation continues to be liability sensitive. There will be more liabilities, including deposits, repricing than earning assets (loans and investments). To negate the potential impact of a decreasing net interest margin, the Corporation will continue to focus on attracting lower cost core deposits such as checking, savings and money market accounts thereby reducing its dependence on higher priced certificates of deposit and short-term borrowings.

Throughout 2018, the Federal Reserve increased the federal-funds rate by 1.00%, making the target range between 2.25% and 2.50%, which has a negative impact to the Bank's net interest margin. Short-term borrowing costs have increased in a similar fashion. However, there has been little to no change to deposit funding costs. Asset yields have increased across the curve. The Bank will continue to monitor short-term rate increases in 2018 as well as the slope and position of the yield curve. A steady and continued path of rising interest rates could have an initial negative effect on net interest margin, based on our asset/liability management model. However, indications are that higher interest rates, accompanied by a positively sloped yield curve would serve to increase our net interest margin in the long-term.

Table 3 sets forth changes in interest income and interest expense for the periods indicated for each category of interest earning assets and interest bearing liabilities. Information is provided on changes attributable to (i) changes in volume (changes in average volume multiplied by prior rate); (ii) changes in rate (changes in average rate multiplied by prior average volume); and, (iii) changes in rate and volume (changes in average volume multiplied by change in average rate).

In 2018, the increase in net interest income on a fully tax equivalent basis of \$954,000 resulted from an increase in volume of \$643,000 and an increase of \$311,000 due to changes in rate.

Table 3 — Rate/Volume Analysis*(Dollars in thousands)*

| | 2018 COMPARED TO 2017 | | |
|--------------------------------------|-----------------------|-----------------|-----------------|
| | VOLUME | RATE | NET |
| Interest Income: | | | |
| Loans, Net | \$ 2,104 | \$ 1,120 | \$ 3,224 |
| Taxable Investment Securities | (585) | 865 | 280 |
| Tax-Exempt Investment Securities | (832) | 198 | (634) |
| Restricted Investment in Bank Stocks | 33 | 121 | 154 |
| Other | 2 | — | 2 |
| Total Interest Income | \$ 722 | \$ 2,304 | \$ 3,026 |
| Interest Expense | | | |
| Savings, NOW and Money Markets | \$ (92) | \$ 473 | \$ 381 |
| Time Deposits | 145 | 434 | 579 |
| Securities Sold U/A to Repurchase | (26) | 24 | (2) |
| Short-Term Borrowings | 364 | 1,071 | 1,435 |
| Long-Term Borrowings | (312) | (9) | (321) |
| Total Interest Expense | 79 | 1,993 | 2,072 |
| Net Interest Income | \$ 643 | \$ 311 | \$ 954 |

The change in interest due to both volume and yield/rate has been allocated to change due to volume and change due to yield/rate in proportion to the absolute value of the change in each. Balances on non-accrual loans are included for computational purposes. Interest income on non-accrual loans is not included.

PROVISION FOR LOAN LOSSES

For the year ended December 31, 2018, the provision for loan losses was \$200,000 as compared to \$267,000 for 2017. The decrease in the provision for loan losses in 2018 as compared to 2017 resulted from the Corporation's analysis of the current loan portfolio, including historic losses, past-due trends, economic conditions, and other relevant factors. Net charge-offs by the Corporation for the fiscal years ended December 31, 2018 and 2017 were \$942,000 and \$137,000, respectively. See Allowance for Loan Losses on page 34 for further discussion.

Gross charge-offs amounted to \$1,039,000 at December 31, 2018, as compared to \$333,000 at December 31, 2017. The increased level of charge-offs for the year ended December 31, 2018 was mainly due to two large charge-offs totaling \$548,000 on a non-accrual Commercial Real Estate participation loan to a student housing holding company. A charge-off in the amount of \$342,000 was completed during the second quarter of 2018 to charge the loan balance down to the net realizable value of collateral less costs to sell, as the underlying value of the collateral was determined to be insufficient to cover the loan balance. An additional charge-off in the amount of \$206,000 was completed during the fourth quarter of 2018 as a result of a repurchase of the remaining participants' portions of the loan. The charge-off was completed to reduce the Bank's post-repurchase loan balance down to the net realizable value of collateral less costs to sell, as the underlying value of collateral was deemed to be insufficient to cover the balance of the loan. The large charge-offs contributed to the increased balance of net charge-offs in 2018 but was not indicative of a significant change in asset quality in the overall loan portfolio. See Table 10 – Analysis of Allowance for Loan Losses for further details.

The allowance for loan losses as a percentage of average loans outstanding was 1.15% as of December 31, 2018 and 1.40% as of December 31, 2017.

On a quarterly basis, management performs, and the Corporation's Audit Committee and the Board of Directors review a detailed analysis of the adequacy of the allowance for loan losses. This analysis includes an evaluation of credit risk concentration, delinquency trends, past loss experience, current economic conditions, composition of the loan portfolio, classified loans and other relevant factors.

The Corporation will continue to monitor its allowance for loan losses and make future adjustments to the allowance through the provision for loan losses as conditions warrant. Although the Corporation believes that the allowance for loan losses is adequate to provide for losses inherent in the loan portfolio, there can be no assurance that future losses will not exceed the estimated amounts or that additional provisions will not be required in the future.

The Corporation is subject to periodic regulatory examination by the Pennsylvania Department of Banking and Securities and the FDIC. As part of the examination, the regulators will assess the adequacy of the Corporation's allowance for loan losses and may include factors not considered by the Corporation. In the event that a regulatory examination results in a conclusion that the Corporation's allowance for loan losses is not adequate, the Corporation may be required to increase its provision for loan losses.

NON-INTEREST INCOME

Non-interest income is derived primarily from service charges and fees, ATM and debit card income, trust department revenue, income on bank owned life insurance, gains on sales of mortgage loans and other miscellaneous income. In addition, net securities gains and losses also impact total non-interest income. Table 4 provides the yearly non-interest income by category, along with the amount, dollar changes, and percentage of change.

Non-interest income through December 31, 2018 was \$5,562,000, a decrease of 9.9%, or \$609,000, from 2017. The decrease was due primarily to a decrease in net securities gains. Table 4 provides the major categories of non-interest income and each respective change comparing the last two years.

During 2018, net securities gains decreased \$1,003,000 to a net loss of \$65,000. The Bank has taken gains and losses in the portfolio in 2018 in an effort to increase interest income through partial reinvestment in the investment portfolio and to fund growth in the loan portfolio.

Gains on sales of mortgage loans provided income of \$188,000 in 2018 as compared to \$316,000 in 2017. The decrease in gains on sales of mortgage loans in 2018 was due to a decrease in loans originated with the intent to sell and volume of loans sold. In 2018, the Bank originated \$23,918,000 in residential mortgage loans, of which \$8,926,000 were originated with the intent to sell. This compared unfavorably to 2017 when the Bank originated \$20,843,000 in residential mortgage loans, of which \$11,906,000 were originated with the intent to sell. The Corporation continues to service the majority of mortgages which are sold. This servicing income provides an additional source of non-interest income on an ongoing basis.

Service charges and fees increased by \$256,000 or 14.2% in 2018 as compared to 2017, due to increases in certain deposit account fees and transaction fees implemented in 2018. In addition, ATM and debit card income increased \$171,000 or 12.2%, due to increased transaction volume mainly due to the Bank's Keystone Rewards incentives.

Other income, consisting primarily of safe deposit box rentals, income from the sale of non-deposit investment products, and miscellaneous fees, increased \$59,000, or 29.2% in 2018 as compared to 2017.

Table 4 — Non-Interest Income

(Dollars in thousands)

| | 2018/2017 | | | |
|----------------------------------|-----------|---------------------|---------|----------|
| | 2018 | Increase/(Decrease) | | 2017 |
| | | Amount | % | |
| Trust department | \$ 943 | \$ 63 | 7.2 | \$ 880 |
| Service charges and fees | 2,059 | 256 | 14.2 | 1,803 |
| Bank owned life insurance income | 609 | (27) | (4.2) | 636 |
| ATM and debit card income | 1,567 | 171 | 12.2 | 1,396 |
| Gains on sales of mortgage loans | 188 | (128) | (40.5) | 316 |
| Other | 261 | 59 | 29.2 | 202 |
| Subtotal | 5,627 | 394 | 7.5 | 5,233 |
| Net securities (losses) gains | (65) | (1,003) | (106.9) | 938 |
| Total | \$ 5,562 | \$ (609) | (9.9) | \$ 6,171 |

NON-INTEREST EXPENSE

Total non-interest expense amounted to \$22,645,000, an increase of \$1,124,000, or 5.2% in 2018. Expenses associated with employees (salaries and employee benefits) continue to be the largest non-interest expenditure. Salaries and employee benefits amounted to \$11,770,000 or 52.0% of total non-interest expense in 2018 and \$11,170,000 or 51.9% in 2017. Salaries and employee benefits increased \$600,000, or 5.4% in 2018. The increase in 2018 was primarily due to the addition of new sales positions in the commercial and residential mortgage lending areas, additional staff, normal merit increases and an increase in employee profit sharing contributions. The Corporation experienced a 5.8% increase in medical insurance for its employees in 2018. The number of full time equivalent employees was 195 as of December 31, 2018 and 191 as of December 31, 2017.

Net occupancy expense decreased \$36,000, or 2.0% in 2018 as compared to 2017. Net furniture and equipment and computer expense increased \$21,000, or 1.3% in 2018 compared to 2017.

Professional services increased \$185,000, or 21.4% in 2018 as compared to 2017. The increase in 2018 was the result of additional accounting fees for 2017 out of scope audit work and additional engagements for the form S-3 consent for the Bank's dividend reinvestment plan and 2017 state taxes. There were also higher engagement fees related to income generation consulting, higher legal fees relating to the resignation of an executive officer of the Bank and additional legal expenses associated with the dividend reinvestment plan rescission offer and form S-3 filing.

Pennsylvania shares tax expense increased \$38,000, or 5.1% in 2018 as compared to 2017. FDIC insurance expense decreased \$10,000, or 3.1% in 2018 as compared to 2017. FDIC insurance expense varies with changes in net asset size, risk ratings, and FDIC derived assessment rates.

ATM and debit card fees expense increased \$109,000, or 15.6% in 2018 as compared to 2017. The increase in 2018 was due to higher electronic funds transfer fees caused by increased client usage mainly due to the Bank's Keystone Rewards incentives. Data processing fees increased \$40,000, or 4.0% in 2018 as compared to 2017. The increase in 2018 was primarily due to pricing increases and new products from our main third party data processor.

Foreclosed assets held for resale expense amounted to \$148,000 in 2018 as compared to \$135,000 in 2017. The Corporation incurred costs associated with the maintenance and sales of twelve foreclosed properties in 2017 and thirteen foreclosed properties in 2018.

Advertising expense decreased \$23,000, or 4.3% in 2018 as compared to 2017. The decrease in 2018 was primarily due to decreased newspaper advertising costs.

Other non-interest expense increased \$187,000, or 6.9% in 2018 as compared to 2017. The increase in 2018 was due to an increase in amortization costs on one of the Corporation's low income housing investment properties in 2018.

The overall level of non-interest expense remains low, relative to the Bank's peers (community banks from \$500 million to \$1 billion in assets). In fact, the Bank's total non-interest expense was 2.25% of average assets in 2018 and 2.15% in 2017. The Bank's non-interest expense as a percentage of average assets places the Bank among the leaders in its peer financial institution categories in controlling non-interest expense.

Table 5 — Non-Interest Expense*(Dollars in thousands)*

| | 2018/2017 | | | |
|-----------------------------------|---------------------|-----------------|------------|------------------|
| | Increase/(Decrease) | | | 2017 |
| | 2018 | Amount | % | |
| Salaries and employee benefits | \$ 11,770 | \$ 600 | 5.4 | \$ 11,170 |
| Occupancy, net | 1,741 | (36) | (2.0) | 1,777 |
| Furniture and equipment | 598 | 29 | 5.1 | 569 |
| Computer expense | 1,017 | (8) | (0.8) | 1,025 |
| Professional services | 1,051 | 185 | 21.4 | 866 |
| Pennsylvania shares tax | 780 | 38 | 5.1 | 742 |
| FDIC Insurance | 311 | (10) | (3.1) | 321 |
| ATM and debit card fees | 806 | 109 | 15.6 | 697 |
| Data processing fees | 1,032 | 40 | 4.0 | 992 |
| Foreclosed assets held for resale | 148 | 13 | 9.6 | 135 |
| Advertising | 507 | (23) | (4.3) | 530 |
| Other | 2,884 | 187 | 6.9 | 2,697 |
| Total | \$ 22,645 | \$ 1,124 | 5.2 | \$ 21,521 |

INCOME TAX EXPENSE

Income tax expense for the year ended December 31, 2018, was \$459,000 as compared to \$1,455,000 for the year ended December 31, 2017. The effective income tax rate was 4.7% in 2018 and 14.4% in 2017. The decrease in the effective tax rate for 2018 was due to a decrease in the Corporation's income tax rate from 34% to 21% from the Tax Cuts and Jobs Act of 2017. The Act reduced the Corporation's income tax rate effective January 1, 2018, as well as eliminating the alternative minimum tax. As a result of the reduction in the income tax rate, 2017 income tax expense included an additional income tax provision of \$379,000 related to a reduction in the carrying value of the net deferred tax asset. Management expects the Corporation's income tax provision will continue to be lower in 2019 and on an ongoing basis as a result of the lower tax rate.

FINANCIAL CONDITION**GENERAL**

Total assets increased to \$1,012,000,000 at year-end 2018, an increase of 2.2% from year-end 2017.

Total debt securities decreased \$32,532,000 or 9.3% to \$316,054,000 as of December 31, 2018.

Net loans increased in 2018 from \$551,910,000 to \$599,647,000, a 8.6% increase. Loan demand grew in 2018 as the Bank added loans in the commercial real estate category.

The cash surrender value of bank owned life insurance totaled \$22,963,000 at December 31, 2018, an increase of \$609,000 or 2.7% from 2017.

Investments in low-income housing partnerships were \$2,096,000 at year-end 2018, a decrease of 20.2% from year-end 2017. The Bank became a limited partner in a new real estate venture during 2015 with an initial investment of \$590,000, a second installment of \$1,178,000 in 2016, third and fourth installments in 2017 of \$168,000 and \$84,000, respectively, and a commitment of an additional capital contribution up to \$85,000 over the life of the project. Investing in low-income housing real estate ventures enables the Bank to recognize tax credits and satisfy Community Reinvestment Act initiatives.

As of December 31, 2018, total deposits amounted to \$671,553,000, a decrease of 13.7% from 2017. The decrease in 2018 was primarily due to the declining balances of municipal depositors including the migration of approximately 82% of the deposits of the Bank's largest depositor to a non-bank competitor. Core deposits, which include demand deposits and interest bearing demand deposits (NOWs), money market accounts, savings accounts, and time deposits of individuals, continue to be the Corporation's most significant source of funds.

The Corporation continues to maintain and manage its asset growth. The Corporation's strong equity capital position provides an opportunity to further leverage its asset growth. Borrowings increased in 2018 by \$128,149,000, mainly due to decreased deposit balances and the need to fund growth in the loan portfolio.

Total stockholders' equity increased to \$116,756,000 at December 31, 2018, an increase of \$37,000.

SEGMENT REPORTING

Currently, management measures the performance and allocates the resources of the Corporation as a single segment.

EARNING ASSETS

Earning assets are defined as those assets that produce interest income. By maintaining a healthy asset utilization rate, i.e., the volume of earning assets as a percentage of total assets, the Corporation maximizes income. The earning asset ratio (average interest earning assets divided by average total assets) equaled 92.5% for 2018 and 2017, respectively. This indicates that the management of earning assets is a priority and non-earning assets, primarily cash and due from banks, fixed assets and other assets, are maintained at minimal levels. The primary earning assets are loans and investment securities.

SECURITIES

The Corporation uses securities to not only generate interest and dividend revenue, but also to help manage interest rate risk and to provide liquidity to meet operating cash needs.

The securities portfolio consists of available-for-sale debt securities. No securities were established in a trading account. Available-for-sale debt securities decreased \$32,532,000 or 9.3% to \$316,054,000 in 2018. At December 31, 2018, the net unrealized loss, net of the tax effect, on these securities was \$2,581,000 and was included in stockholders' equity as accumulated other comprehensive (loss) income. Table 6 provides data on the fair value of the Corporation's securities portfolio on the dates indicated. The vast majority of security purchases are allocated as available-for-sale. This provides the Corporation with increased flexibility should there be a need or desire to liquidate a security.

The securities portfolio includes, U.S. treasuries, U.S. government corporations and agencies, corporate debt obligations, mortgage-backed securities, asset backed securities, and obligations of state and political subdivisions, both tax-exempt and taxable.

Available-for-sale debt securities may be sold as part of the overall asset and liability management process. Realized gains and losses are reflected in the results of operations on the Corporation's Consolidated Statements of Income. As of December 31, 2018, the securities portfolio does not contain any off-balance sheet derivatives or trust preferred investments.

Table 6 — Securities

(Dollars in thousands)

| | December 31, | |
|---|-----------------------|-----------------------|
| | 2018 | 2017 |
| | Available for Sale | Available for Sale |
| U.S. Treasury securities | \$ 5,295 | \$ — |
| U. S. Government corporations and agencies | 83,119 | 104,093 |
| Other mortgage backed debt securities | 4,749 | — |
| Obligations of state and political subdivisions | 182,278 | 215,522 |
| Asset backed securities | 14,370 | — |
| Corporate debt securities | 26,243 | 28,971 |
| Total | \$ 316,054 | \$ 348,586 |

The amortized cost and weighted average yield of securities, by contractual maturity, are shown below at December 31, 2018. 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.

Table 7 — Securities Maturity Table*(Dollars in thousands)*

| | December 31, 2018 | | | | | |
|------------------------|------------------------------------|---|---|---|-------------------------------|---------------------------------|
| | Available-For-Sale Debt Securities | | | | | |
| | U.S. Treasury Securities | U.S. Government Corporations & Agencies Obligations ¹ | Other Mortgage Backed Debt Securities ¹ | Obligations of State & Political Subdivisions ² | Asset Backed Securities | Corporate Debt Securities |
| Within 1 Year: | | | | | | |
| Amortized cost | \$ 2,472 | \$ — | \$ — | \$ 1,796 | \$ — | \$ — |
| Weighted average yield | 2.63% | — | — | 3.93% | — | — |
| 1 - 5 Years: | | | | | | |
| Amortized cost | 2,835 | 17,144 | — | 34,900 | — | 17,127 |
| Weighted average yield | 2.21% | 2.03% | — | 2.81% | — | 2.91% |
| 5 - 10 Years: | | | | | | |
| Amortized cost | — | 29,973 | — | 53,209 | 10,046 | 10,170 |
| Weighted average yield | — | 2.33% | — | 3.35% | 4.44% | 2.78% |
| After 10 Years: | | | | | | |
| Amortized cost | — | 37,889 | 4,767 | 92,716 | 4,277 | — |
| Weighted average yield | — | 2.84% | 4.15% | 3.68% | 4.63% | — |
| Total: | | | | | | |
| Amortized cost | \$ 5,307 | \$ 85,006 | \$ 4,767 | \$ 182,621 | \$ 14,323 | \$ 27,297 |
| Weighted average yield | 2.41% | 2.50% | 4.15% | 3.42% | 4.50% | 2.86% |

¹Mortgage-backed securities are allocated for maturity reporting at their original maturity date.

²Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 34% tax rate.

Marketable equity securities consist of common stock investments in other commercial banks and bank holding companies. At December 31, 2018 and 2017, the Corporation had \$1,560,000 and \$1,632,000, respectively, in equity securities recorded at fair value, a decrease of \$72,000 or 4.4%. Prior to January 1, 2018 equity securities were stated at fair value with unrealized gains and losses reported as a separate component of accumulated other comprehensive income (AOCI), net of tax. At December 31, 2017, net unrealized gains, net of tax, of \$634,000 had been recognized in AOCI. On January 1, 2018, the unrealized gains and losses were reclassified out of AOCI and into retained earnings with subsequent changes in fair value being recognized in net income.

LOANS

Total loans increased to \$606,392,000 as of December 31, 2018, as compared to a balance of \$559,397,000 as of December 31, 2017. Table 8 provides data relating to the composition of the Corporation's loan portfolio on the dates indicated. Total loans increased \$46,995,000, or 8.4% in 2018 compared to an increase of \$37,015,000, or 7.1% in 2017.

Steady demand for borrowing by businesses accounted for the 8.4% increase in total loans in 2018 as compared to the 7.1% increase in total loans in 2017. The Commercial and Industrial portfolio decreased \$7,117,000 to \$92,220,000 as of December 31, 2018, as compared to \$99,337,000 at December 31, 2017. The decrease in the Commercial and Industrial portfolio (which includes tax-free Commercial and Industrial loans) was attributed to new loan originations totaling \$14,841,000 and an increase of \$7,615,000 in utilization of existing Commercial and Industrial lines of credit offset by loan payoffs of \$22,801,000 and regular principal payments. The Commercial Real Estate loan portfolio (which includes tax-free Commercial Real Estate loans) increased \$57,506,000 to \$348,476,000 as of December 31, 2018, as compared to \$290,970,000 at December 31, 2017. The increase was mainly the result of \$88,395,000 in new loan originations, offset by \$18,980,000 in loan payoffs in addition to a decrease of \$2,143,000 in utilization of existing Commercial Real Estate lines of credit and regular principal payments and other typical amortization in the loan portfolio. Residential Real Estate loans decreased \$3,184,000 to \$159,741,000 as of December 31, 2018, as compared to \$162,925,000 at December 31, 2017. The decrease was the result of new loan originations totaling \$19,800,000, offset by loan payoffs of \$19,320,000, net loans sold of \$2,286,000 and regular principal payments. Net loans sold in the Residential Real Estate portfolio for the year ended December 31, 2018 consisted of total loans sold during the year ended December 31, 2018 of \$8,760,000, offset with loans opened and sold in the same quarter during any quarter of 2018 which amounted to \$6,474,000. The Corporation continues to originate and sell certain long-term fixed rate residential mortgage loans which conform to secondary market requirements. The Corporation derives ongoing income from the servicing of mortgages sold in the secondary market. The Corporation continues its efforts to lend to creditworthy borrowers despite the continued slow economic conditions.

Management believes that the loan portfolio is well diversified. The total commercial portfolio was \$440,696,000 at December 31, 2018. Of total loans, \$348,476,000 or 57.5% were secured by commercial real estate, primarily lessors of residential buildings and dwellings and lessors of non-residential buildings. We continue to monitor these portfolios.

The largest relationship is comprised of various real estate entities with a mutual owner who is a related party of the bank and began real estate investment and development activities in 1989. The relationship had outstanding loan balances and unused commitments of \$14,013,000 at December 31, 2018. The individual owns a diverse mix of real estate entities which specialize in construction/development projects (which include VA clinics), leasing of commercial office space, and rental of multi-tenant residential units. This relationship is comprised of \$12,888,000 in term debt and three lines of credit totaling \$1,125,000. The relationship is well secured by first lien mortgages on income producing commercial and residential real estate, plus assignment of governmental leases and collateral pledge of cash accounts and marketable securities.

The second largest relationship consists of an electrical contractor that has serviced eastern and northeastern Pennsylvania for over forty years, as well as a related real estate holding company. The guarantor is also a partner in a separate real estate development company that specializes in the renovation and conversion of older buildings into commercial office space. The relationship had \$10,868,000 in outstanding loan balances and unused commitments as of December 31, 2018. The debt is comprised of \$4,763,000 in term debt and three lines of credit totaling \$6,105,000. The loans are secured by commercial real estate, the assignment of rents and leases, and business assets.

The third largest relationship is comprised of multiple first and second lien mortgages relating to the purchase and improvements of several existing hotels. The principal and related owners/guarantors have extensive experience in the hotel industry, owning and operating hotels in various states for over twenty-five years. At December 31, 2018, the relationship had outstanding loan balances and unused commitments of \$9,605,000. The debt is comprised of \$9,475,000 in term debt and three lines of credit totaling \$130,000. The loans are secured by commercial real estate, the assignment of rents and leases, and business assets.

The fourth largest relationship consists of a distributor and marketer of energy products and services including natural gas, propane, butane, and electricity. During 2017, the company undertook to partner with local banks to finance its capital needs while promoting regional economic development. At December 31, 2018, the relationship had outstanding balances of \$8,550,000 which consisted entirely of unsecured term debt. The debt will be utilized for general corporate needs, including upgrades to the company's utility distribution system that will enhance its ability to continue providing safe and reliable natural gas service.

The fifth largest relationship consists of a real estate development/holding company that was established in 2006 to construct a multi-tenant medical complex, as well as the medical-related entities that operate out of the complex. The relationship had outstanding loan balances and unused commitments of \$8,129,000 at December 31, 2018. The debt is comprised of \$7,379,000 in term debt and three lines of credit totaling \$750,000. The relationship is secured by commercial real estate, as well as business assets and the assignment of rents and leases.

All loan relationships in excess of \$1,500,000 are reviewed internally and through an external loan review process on an annual basis. Such review is based upon analysis of current financial statements of the borrower, co-borrowers/guarantors, payment history, and economic conditions.

Overall, the portfolio risk profile as measured by loan grade is considered low risk, as \$584,570,000 or 96.5% of gross loans are graded Pass; \$5,377,000 or 0.9% are graded Special Mention; \$15,572,000 or 2.6% are graded Substandard; and \$0 are graded Doubtful. The rating is intended to represent the best assessment of risk available at a given point in time, based upon a review of the borrower's financial statements, credit analysis, payment history with the Bank, credit history and lender knowledge of the borrower. See Note 4 — Loans and Allowance for Loan Losses for risk grading tables.

Overall, non-pass grades increased to \$20,949,000 at December 31, 2018, as compared to \$16,712,000 at December 31, 2017. Commercial and Industrial non-pass grades decreased to \$1,225,000 as of December 31, 2018, compared to \$1,344,000 as of December 31, 2017. Commercial Real Estate non-pass grades increased to \$18,652,000 as of December 31, 2018 as compared to \$13,724,000 as of December 31, 2017. Residential Real Estate and Consumer non-pass grades decreased to \$1,072,000 as of December 31, 2018, as compared to \$1,644,000 as of December 31, 2017.

The \$4,928,000 increase in the Commercial Real Estate non-pass grade portfolio during the year ended December 31, 2018 was mainly the result of activity associated with two large loans, as well as regular principal payments and other normal fluctuations in the Commercial Real Estate non-pass grade portfolio during the year ended December 31, 2018. A loan in the amount of \$4,296,000 to a real estate developer specializing in commercial office space was downgraded to Special Mention during the fourth quarter of 2018 due to the borrower's decreased ability to service the debt from operating cash flows, which was caused by the loss of a large tenant. The balance of an existing Substandard non-accrual participation loan to a student housing holding company experienced a net increase of \$858,000 from \$2,318,000 at December 31, 2017 to \$3,176,000 at December 31, 2018. The remaining participants' portions of the loan totaling \$1,406,000 were repurchased during the fourth quarter of 2018, which net against a charge-off in the amount of \$342,000 that was completed during the second quarter of 2018 to charge the loan balance down to the net realizable value of collateral less costs to sell, as the underlying value of the collateral was determined to be insufficient to cover the loan balance and an additional charge-off in the amount of \$206,000 that was completed during the fourth quarter of 2018 as a result of the repurchase of the remaining participants' portions of the loan. The charge-off was completed to reduce the Bank's post-repurchase loan balance down to the net realizable value of collateral less costs to sell, as the underlying value of collateral was deemed to be insufficient to cover the balance of the loan.

The Corporation continues to internally underwrite each of its loans to comply with prescribed policies and approval levels established by its Board of Directors.

The classes of the Corporation's loan portfolio net of unearned discount and net deferred loan fees and costs are summarized in Table 8.

Table 8 — Loans

(Dollars in thousands)

| | December 31, | | | | |
|---------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | 2018 | 2017 | 2016 | 2015 | 2014 |
| Commercial and Industrial | \$ 92,220 | \$ 99,337 | \$ 83,573 | \$ 85,074 | \$ 64,656 |
| Commercial Real Estate | 348,476 | 290,970 | 263,519 | 259,018 | 253,922 |
| Residential Real Estate | 159,741 | 162,925 | 169,035 | 166,628 | 163,553 |
| Consumer | 5,955 | 6,165 | 6,255 | 5,890 | 5,330 |
| Total Loans | \$ 606,392 | \$ 559,397 | \$ 522,382 | \$ 516,610 | \$ 487,461 |

The Corporation's maturity and rate sensitivity information related to the loan portfolio is summarized in Table 9.

Table 9 — Loan Maturity and Interest Sensitivity

Loans by Maturity

(Dollars in thousands)

| | December 31, 2018 | | | |
|---------------------------|----------------------|-----------------------|---------------------|-------------------|
| | One Year and Less | After One Year | | Total |
| | | Through Five Years | After Five Years | |
| Commercial and Industrial | \$ 14,677 | \$ 41,636 | \$ 35,907 | \$ 92,220 |
| Commercial Real Estate | 32,856 | 89,610 | 226,010 | 348,476 |
| Residential Real Estate | 11,530 | 41,134 | 107,077 | 159,741 |
| Consumer | 1,710 | 3,497 | 748 | 5,955 |
| Total | \$ 60,773 | \$ 175,877 | \$ 369,742 | \$ 606,392 |

The above data represents the amount of loans receivable at December 31, 2018 which, based on remaining scheduled repayments of principal, are due in the periods indicated.

Loans by Repricing Opportunity

(Dollars in thousands)

| | December 31, 2018 | | | |
|-------------------------------------|----------------------|---|---------------------|-------------------|
| | One Year and Less | After One Year Through Five Years | After Five Years | Total |
| Commercial and Industrial | \$ 32,105 | \$ 46,301 | \$ 13,814 | \$ 92,220 |
| Commercial Real Estate | 76,082 | 230,818 | 41,576 | 348,476 |
| Residential Real Estate | 20,279 | 36,155 | 103,307 | 159,741 |
| Consumer | 2,786 | 3,151 | 18 | 5,955 |
| Total | <u>\$ 131,252</u> | <u>\$ 316,425</u> | <u>\$ 158,715</u> | <u>\$ 606,392</u> |
| Loans with a fixed interest rate | \$ 35,661 | \$ 91,189 | \$ 129,837 | \$ 256,687 |
| Loans with a variable interest rate | 95,591 | 225,236 | 28,878 | 349,705 |
| Total | <u>\$ 131,252</u> | <u>\$ 316,425</u> | <u>\$ 158,715</u> | <u>\$ 606,392</u> |

The above data represents the amount of loans receivable at December 31, 2018 which are due or have the opportunity to reprice in the periods indicated, based on remaining scheduled repayments of principal for fixed rate loans or date of next repricing opportunity for variable rate loans. The fixed and variable portions of the amounts of loans receivable due or repricing in the periods indicated are also summarized above.

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of December 31, 2018, the allowance for loan losses was \$6,745,000 as compared to \$7,487,000 as of December 31, 2017. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for possible loan losses when management believes that the collectability of the principal is unlikely. The risk characteristics of the loan portfolio are managed through various control processes, including credit evaluations of individual borrowers, periodic reviews, and diversification by industry. Risk is further mitigated through the application of lending procedures such as the holding of adequate collateral and the establishment of contractual guarantees.

Management performs a quarterly analysis to determine the adequacy of the allowance for loan losses. The methodology in determining adequacy incorporates specific and general allocations together with a risk/loss analysis on various segments of the portfolio according to an internal loan review process. This assessment results in an allocated allowance. Management maintains its loan review and loan classification standards consistent with those of its regulatory supervisory authority.

Management considers, based upon its methodology, that the allowance for loan losses is adequate to cover foreseeable future losses. However, there can be no assurance that the allowance for loan losses will be adequate to cover significant losses, if any, that might be incurred in the future.

Table 10 contains an analysis of the allowance for loan losses indicating charge-offs and recoveries by year. In 2018, net charge-offs as a percentage of average loans were 0.16% as compared to 0.03% in 2017. Net charge-offs amounted to \$942,000 in 2018 and \$137,000 in 2017. Net charge-offs were significantly higher in 2018 than in 2017 due to two large charge-offs in the Commercial Real Estate portfolio that were completed during the year ended December 31, 2018. The two large charge-offs totaling \$548,000 were completed on a non-accrual Commercial Real Estate participation loan to a student housing holding company. A charge-off in the amount of \$342,000 was completed during the second quarter of 2018 to charge the loan balance down to the net realizable value of collateral less costs to sell, as the underlying value of the collateral was determined to be insufficient to cover the loan balance. An additional charge-off in the amount of \$206,000 was completed during the fourth quarter of 2018 as a result of a repurchase of the remaining participants' portions of the loan. The charge-off was completed to reduce the Bank's post-repurchase loan balance down to the net realizable value of collateral less costs to sell, as the underlying value of collateral was deemed to be insufficient to cover the balance of the loan. These two large charge-offs made up a significant portion of the \$783,000 in charge-offs completed in the Commercial Real Estate portfolio during the year ended December 31, 2018.

Despite significantly higher net charge-offs in 2018 than in 2017, the allowance for loan losses decreased from \$7,487,000 at December 31, 2017 to \$6,745,000 at December 31, 2018 due to a decrease in the historical loss factors utilized in the calculation of the general component of the allowance as related to Commercial and Industrial and Commercial Real Estate loans. The historical loss percentages for these two portfolios decreased due to decreased charge-offs included in the period used to calculate the historical loss factor for each of the respective portfolios at 2018 compared to 2017. The decrease in the historical loss factors related to the calculation of the allowance attributable to the Commercial and Industrial and Commercial Real Estate portfolios contributed significantly to the decrease in the allocated allowance for Commercial and Industrial loans from \$949,000 at December 31, 2017 to \$742,000 at December 31, 2018 and the decrease in the allocated allowance for Commercial Real Estate loans from \$4,067,000 at December 31, 2017 to \$3,700,000 at December 31, 2018. The unallocated component of the allowance also decreased from \$704,000 at December 31, 2017 to \$554,000 at December 31, 2018.

For the year ended December 31, 2018, the provision for loan losses was \$200,000 as compared to \$267,000 for 2017. The net effect of the provision, charge-offs and recoveries resulted in the year-end allowance for loan losses of \$6,745,000 of which 10.7% was attributed to the Commercial and Industrial component, 54.9% attributed to the Commercial Real Estate component, 24.5% attributed to the Residential Real Estate component (primarily residential mortgages), 1.7% attributed to the Consumer component, and 8.2% being the unallocated component (refer to the activity in Note 4 — Loans and Allowance for Loan Losses on page 72.) The Corporation determined that the provision for loan losses made during 2018 was sufficient to maintain the allowance for loan losses at a level necessary for the probable losses inherent in the loan portfolio as of December 31, 2018.

Table 10 — Analysis of Allowance for Loan Losses

(Dollars in thousands)

| | Years Ended December 31, | | | | |
|---|--------------------------|-----------------|-----------------|-----------------|-----------------|
| | 2018 | 2017 | 2016 | 2015 | 2014 |
| Balance at beginning of period | \$ 7,487 | \$ 7,357 | \$ 6,739 | \$ 6,390 | \$ 6,519 |
| Charge-offs: | | | | | |
| Commercial and Industrial | 18 | — | 195 | 2 | 107 |
| Commercial Real Estate | 783 | 189 | 1,200 | 1,759 | 328 |
| Residential Real Estate | 181 | 62 | 61 | 210 | 209 |
| Consumer | 57 | 82 | 38 | 45 | 47 |
| | <u>1,039</u> | <u>333</u> | <u>1,494</u> | <u>2,016</u> | <u>691</u> |
| Recoveries: | | | | | |
| Commercial and Industrial | 31 | 74 | 9 | 22 | 31 |
| Commercial Real Estate | 60 | 103 | — | 59 | 81 |
| Residential Real Estate | — | 9 | 12 | 1 | 14 |
| Consumer | 6 | 10 | 8 | 6 | 3 |
| | <u>97</u> | <u>196</u> | <u>29</u> | <u>88</u> | <u>129</u> |
| Net charge-offs | 942 | 137 | 1,465 | 1,928 | 562 |
| Additions charged to operations | 200 | 267 | 2,083 | 2,277 | 433 |
| Balance at end of period | <u>\$ 6,745</u> | <u>\$ 7,487</u> | <u>\$ 7,357</u> | <u>\$ 6,739</u> | <u>\$ 6,390</u> |
| Ratio of net charge-offs during the period to average loans outstanding during the period | 0.16% | 0.03% | 0.28% | 0.38% | 0.12% |
| Allowance for loan losses to average loans outstanding during the period | 1.15% | 1.40% | 1.42% | 1.32% | 1.36% |

It is the policy of management and the Corporation's Board of Directors to make a provision for both identified and unidentified losses inherent in its loan portfolio. A provision for loan losses is charged to operations based upon an evaluation of the potential losses in the loan portfolio. This evaluation takes into account such factors as portfolio concentrations, delinquency trends, trends of non-accrual and classified loans, economic conditions, and other relevant factors.

The loan review process, which is conducted quarterly, is an integral part of the Bank's evaluation of the loan portfolio. A detailed quarterly analysis to determine the adequacy of the Corporation's allowance for loan losses is reviewed by the Board of Directors.

With the Bank's manageable level of net charge-offs and the additions to the reserve from the provision out of operations, the allowance for loan losses as a percentage of average loans amounted to 1.15% in 2018 and 1.40% in 2017.

Table 11 sets forth the allocation of the Bank's allowance for loan losses by loan category and the percentage of loans in each category to the total allowance for loan losses at the dates indicated. The portion of the allowance for loan losses allocated to each loan category does not represent the total available for future losses that may occur within the loan category, since the total loan loss allowance is a valuation reserve applicable to the entire loan portfolio.

Table 11 — Allocation of Allowance for Loan Losses*(Dollars in thousands)*

| | December 31, | | | | | | | | | |
|---------------------------|-----------------|--------------|-----------------|--------------|-----------------|--------------|-----------------|--------------|-----------------|--------------|
| | 2018 | %* | 2017 | %* | 2016 | %* | 2015 | %* | 2014 | %* |
| Commercial and Industrial | \$ 724 | 11.7 | \$ 949 | 14.0 | \$ 836 | 11.7 | \$ 725 | 11.0 | \$ 542 | 9.4 |
| Commercial Real Estate | 3,700 | 59.8 | 4,067 | 60.0 | 4,421 | 62.0 | 3,983 | 60.5 | 3,176 | 55.2 |
| Residential Real Estate | 1,650 | 26.6 | 1,656 | 24.4 | 1,777 | 24.9 | 1,777 | 27.0 | 1,928 | 33.5 |
| Consumer | 117 | 1.9 | 111 | 1.6 | 95 | 1.4 | 96 | 1.5 | 107 | 1.9 |
| Unallocated | 554 | N/A | 704 | N/A | 228 | N/A | 158 | N/A | 637 | N/A |
| | <u>\$ 6,745</u> | <u>100.0</u> | <u>\$ 7,487</u> | <u>100.0</u> | <u>\$ 7,357</u> | <u>100.0</u> | <u>\$ 6,739</u> | <u>100.0</u> | <u>\$ 6,390</u> | <u>100.0</u> |

*Percentage of allocation in each category to total allocations in the Allowance for Loan Loss Analysis, excluding unallocated.

NON-PERFORMING ASSETS

Table 12 details the Corporation's non-performing assets and impaired loans as of the dates indicated. Generally, a loan is classified as non-accrual and the accrual of interest on such a loan is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan currently is performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against current period income. A modification of a loan constitutes a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession that the Corporation would not otherwise consider. Modifications to loans classified as TDRs generally include reductions in contractual interest rates, principal deferrals and extensions of maturity dates at a stated interest rate lower than the current market for a new loan with similar risk characteristics. While unusual, there may be instances of loan principal forgiveness. Foreclosed assets held for resale represent property acquired through foreclosure, or considered to be an in-substance foreclosure.

Total non-performing assets amounted to \$5,287,000 as of December 31, 2018, as compared to \$6,231,000 as of December 31, 2017. The economy, in particular, high unemployment/labor underutilization rate, weak job markets, unsettled fuel prices and energy costs, and the continued slowness in the housing industry in our market areas had a direct effect on the Corporation's non-performing assets. The Corporation is closely monitoring its Commercial Real Estate portfolio because of the current economic environment. In particular, vacancy rates are rising, while property values in some markets have fallen. Non-accrual loans totaled \$3,896,000 as of December 31, 2018 as compared to \$5,090,000 as of December 31, 2017. The significant decrease in non-accrual loans at December 31, 2018 as compared to December 31, 2017 is attributable to various fluctuations in the non-accrual portfolio during the year ended December 31, 2018. Large decreases to the non-accrual portfolio during the year ended December 31, 2018 consisted of six loans to a plastic processing company focused on non-post-consumer recycling and a related guarantor that carried a combined balance of \$1,519,000 at December 31, 2017 which were returned to accrual status during the fourth quarter of 2018 and a residential mortgage that carried a balance of \$340,000 at December 31, 2017 which was returned to accrual status during third quarter of 2018. These large decreases were net against an increase of \$858,000 on a non-accrual participation loan to a student housing holding company, which resulted from a repurchase of the remaining participants' portions of the loan totaling \$1,406,000 during the fourth quarter of 2018, that was net against charge-offs totaling \$548,000 that were completed during the year ended December 31, 2018. Foreclosed assets held for resale increased to \$1,163,000 as of December 31, 2018 from \$1,071,000 as of December 31, 2017. Loans past-due 90 days or more and still accruing interest amounted to \$228,000 as of December 31, 2018 as compared to \$70,000 as of December 31, 2017. At December 31, 2018, loans past-due 90 days or more and still accruing interest consisted of four Commercial Real Estate loans and one Residential Real Estate loan which were all well secured and in the process of collection as of December 31, 2018.

Non-performing assets to total loans was 0.87% as of December 31, 2018 compared to 1.11% at December 31, 2017. Non-performing assets to total assets was 0.52% as of December 31, 2018 compared to 0.63% at December 31, 2017. The allowance for loan losses to total non-performing assets was 127.58% as of December 31, 2018 as compared to 120.16% as of December 31, 2017. Additional detail can be found in Table 12 – Non-Performing Assets and Impaired Loans and the Loans Receivable on Non-Accrual Status table in Note 4 — Loans and Allowance for Loan Losses. Asset quality is a priority and the Corporation retains a full-time loan review officer to closely track and monitor overall loan quality, along with a full-time workout specialist to manage collection and liquidation efforts.

Potential problem loans are defined as performing substandard loans which are not deemed to be impaired. These loans have characteristics that cause management to have doubts regarding the ability of the borrower to perform under present loan repayment terms and which may result in reporting these loans as non-performing loans in the future. Potential problem loans amounted to \$6,100,000 at December 31, 2018 and 5,043,000 at December 31, 2017.

Impaired loans were \$17,593,000 at December 31, 2018 and \$13,926,000 at December 31, 2017. The largest impaired loan relationship at December 31, 2018 consisted of one performing purchased participation loan to a real estate developer specializing in commercial office space, which was secured by commercial real estate. The loan was downgraded to Special Mention and modified as a TDR during the fourth quarter of 2018 due to the borrower's decreased ability to service the debt from operating cash flows, which was caused by the loss of a large tenant. The maturity date of the loan was extended upon recommendation by the lead bank to afford the borrower additional time to attract a replacement tenant and/or pursue a refinancing of the debt through another lender. The Corporation's share of the loan at December 31, 2018 was \$4,296,000. The discounted cash flow evaluation at December 31, 2018 resulted in no specific allocation of the Bank's share of the participation. The second largest impaired loan relationship at December 31, 2018 consisted of a non-performing participation loan to a student housing holding company which was secured by commercial real estate. The Corporation's share of the loan at December 31, 2018 was \$3,176,000. The loan was downgraded to Substandard and placed on non-accrual status during the third quarter of 2015 due to the borrower's inability to reach a break-even rental income, related to the borrower's failure to meet projected occupancy rates. One participant's share in the amount of \$1,350,000 was repurchased during the third quarter of 2017 and two remaining participants' shares totaling \$1,406,000 were repurchased during the fourth quarter of 2018. The collateral evaluation of the total participation at December 31, 2018 carried a value of \$3,220,000 after considering estimated appraisal adjustments and costs to sell of 15% and considering the total participation outstanding note balance, resulted in no specific allocation. As of December 31, 2018, \$1,904,000 had been charged off in relation to this loan. The third largest impaired loan relationship at December 31, 2018 consisted of one performing loan to a student housing holding company in the amount of \$3,053,000, which was secured by commercial real estate. The loan was downgraded to substandard status and modified as a TDR during the first quarter of 2015 due to the borrower's failure to achieve stabilization and meet projected occupancy rates that was attributed to the overall economic decline in students' disposable income and an increase in enrollment in online courses. The loan experienced a secondary modification during the third quarter of 2016 to extend the repayment term and modify the interest rate. The discounted cash flow evaluation at December 31, 2018 resulted in no specific allocation. As of December 31, 2018, \$943,000 had been charged off in relation to this loan.

The Bank estimates impairment based on its analysis of the cash flows or collateral estimated at fair value less cost to sell. For collateral dependent loans, the estimated appraisal adjustments and cost to sell percentages are determined based on the market area in which the real estate securing the loan is located, among other factors, and therefore, can differ from one loan to another. Of the \$17,593,000 in impaired loans at December 31, 2018, none were located outside the Corporation's primary market area.

The outstanding recorded investment of loans categorized as TDRs was \$13,777,000 as of December 31, 2018, compared to \$9,109,000 as of December 31, 2017. The increase in TDRs at December 31, 2018 as compared to December 31, 2017 is mainly attributable to a loan in the amount of \$4,296,000 to a real estate developer specializing in commercial office space that was modified as a TDR during the fourth quarter of 2018 to extend the maturity date of the loan. Of the forty-two restructured loans at December 31, 2018, nine loans are classified in the Commercial and Industrial portfolio, thirty-one loans are classified in the Commercial Real Estate portfolio, and two loans are classified in the Residential Real Estate portfolio. Troubled debt restructurings at December 31, 2018 consisted of eighteen term modifications beyond the original stated term, five interest rate modifications, and eighteen payment modifications. At December 31, 2018, there was also one troubled debt restructuring that experienced all three types of modification – payment, rate, and term. TDRs are separately evaluated for impairment disclosures, and if necessary, a specific allocation is established. As of December 31, 2018 and 2017, there were \$1,000 and \$2,000, respectively, in specific allocations attributable to the TDRs. There were no unused commitments on TDRs at December 31, 2018 and 2017.

At December 31, 2018, nine Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$499,000 and one Commercial and Industrial loan classified as a TDR with a recorded investment of \$6,000 were not in compliance with the terms of their restructure, compared to December 31, 2017 when six Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$340,000 and one Residential Real Estate loan classified as a TDR with a recorded investment of \$60,000 were not in compliance with the terms of their restructure.

During the year ended December 31, 2018, five Commercial Real Estate loans totaling \$163,000 that were modified as TDRs within the twelve months preceding December 31, 2018 had experienced payment defaults, as compared to the year ended December 31, 2017 when no loans that were modified as TDRs within the twelve months preceding December 31, 2017 had experienced payment defaults.

The Corporation's non-accrual loan valuation procedure for any loans greater than \$250,000 requires an appraisal to be obtained and reviewed annually at year end. A quarterly collateral evaluation is performed which may include a site visit, property pictures and discussions with realtors and other similar business professionals to ascertain current values.

For non-accrual loans less than \$250,000 upon classification and typically at year end, the Corporation completes a Certificate of Inspection, which includes the results of an onsite inspection, insured values, tax assessed values, recent sales comparisons and a review of the previous evaluations.

Improving loan quality is a priority. The Corporation actively works with borrowers to resolve credit problems and will continue its close monitoring efforts in 2018. Excluding the assets disclosed in Table 12 – Non-Performing Assets and Impaired Loans and the Troubled Debt Restructurings section in Note 4 — Loans and Allowance for Loan Losses, management is not aware of any information about borrowers' possible credit problems which cause serious doubt as to their ability to comply with present loan repayment terms.

Should the economic climate no longer continue to be stable or deteriorate further, borrowers may experience difficulty, and the level of impaired loans and non-performing assets, charge-offs and delinquencies could rise and possibly require additional increases in the Corporation's allowance for loan losses.

In addition, regulatory authorities, as an integral part of their examinations, periodically review the allowance for possible loan losses. They may require additions to allowances based upon their judgments about information available to them at the time of examination.

A concentration of credit exists when the total amount of loans to borrowers, who are engaged in similar activities that are similarly impacted by economic or other conditions, exceed 10% of total loans. As of December 31, 2018 and 2017 management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

Table 12 — Non-Performing Assets and Impaired Loans

(Dollars in thousands)

| | December 31, | |
|--|------------------|------------------|
| | 2018 | 2017 |
| Non-performing assets | | |
| Non-accrual loans | \$ 3,896 | \$ 5,090 |
| Foreclosed assets held for resale | 1,163 | 1,071 |
| Loans past-due 90 days or more and still accruing interest | 228 | 70 |
| Total non-performing assets | <u>\$ 5,287</u> | <u>\$ 6,231</u> |
| Impaired loans | | |
| Non-accrual loans | \$ 3,896 | \$ 5,090 |
| Accruing TDRs | 13,697 | 8,836 |
| Total impaired loans | 17,593 | 13,926 |
| Allocated allowance for loan losses | (1) | (327) |
| Net investment in impaired loans | <u>\$ 17,592</u> | <u>\$ 13,599</u> |
| Impaired loans with a valuation allowance | \$ 83 | \$ 2,646 |
| Impaired loans without a valuation allowance | 17,510 | 11,280 |
| Total impaired loans | <u>\$ 17,593</u> | <u>\$ 13,926</u> |
| Allocated valuation allowance as a percent of impaired loans | 0.01% | 2.35% |
| Impaired loans to total loans | 2.90% | 2.49% |
| Non-performing assets to total loans | 0.87% | 1.11% |
| Non-performing assets to total assets | 0.52% | 0.63% |
| Allowance for loan losses to impaired loans | 38.34% | 53.76% |
| Allowance for loan losses to total non-performing assets | 127.58% | 120.16% |

Real estate mortgages comprise 83.8% of the loan portfolio as of December 31, 2018, as compared to 81.1% as of December 31, 2017. Real estate mortgages consist of both residential and commercial real estate loans. The real estate loan portfolio is well diversified in terms of borrowers, collateral, interest rates, and maturities. Also, the residential real estate loan portfolio is largely comprised of fixed rate mortgages. The real estate loans are concentrated primarily in the Corporation's market area and are subject to risks associated with the local economy. The commercial real estate loans typically reprice approximately every three to five years and are also concentrated in the Corporation's market area. The Corporation's loss exposure on its impaired loans continues to be mitigated by collateral positions on these loans. The allocated allowance for loan losses associated with impaired loans is generally computed based upon the related collateral value of the loans. The collateral values are determined by recent appraisals, but are generally discounted by management based on historical dispositions, changes in market conditions since the last valuation and management's expertise and knowledge of the borrower and the borrower's business.

DEPOSITS AND OTHER BORROWED FUNDS

Consumer and commercial retail deposits are attracted primarily by the Bank's eighteen full service office locations, one loan production office, and through its internet banking presence. The Bank offers a broad selection of deposit products and continually evaluates its interest rates and fees on deposit products. The Bank regularly reviews competing financial institutions' interest rates, especially when establishing interest rates on certificates of deposit.

Deposits decreased by \$106,593,000, or 13.7% for the year ending December 31, 2018 as compared to December 31, 2017. The decrease in deposits in 2018 can be attributed to the declining balances of highly rate sensitive municipal depositors and the migration of approximately 82% of the Bank's largest depositor to a non-bank competitor.

The following schedule reflects the remaining maturities of time deposits and other time open deposits of \$100,000 or more at December 31, 2018.

(Dollars in thousands)

| | Time Deposits >\$100,000 | Other Time Open Deposits >\$100,000 |
|---------------------------------|--------------------------------|---|
| Less than or equal to 3 months | \$ 7,186 | \$ — |
| Over 3 months through 6 months | 10,924 | — |
| Over 6 months through 12 months | 25,719 | 855 |
| Over 12 months | 38,217 | — |
| | <u>\$ 82,046</u> | <u>\$ 855</u> |

Total borrowings were \$219,445,000 as of December 31, 2018, compared to \$91,296,000 on December 31, 2017. During 2018, long-term borrowings decreased from \$65,000,000 to \$45,000,000. The decrease in long-term borrowings in 2018 primarily resulted from the maturity of six individual term notes with FHLB.

Short-term debt increased from \$26,296,000 in 2017 to \$174,445,000 as of December 31, 2018 as a result of decreased deposit balances. Short-term borrowings are comprised of federal funds purchased, securities sold under agreements to repurchase, Federal Discount Window and short-term borrowings from FHLB. Short-term borrowings from FHLB are commonly used to offset seasonal fluctuations in deposits.

In connection with FHLB borrowings, Federal Discount Window, and securities sold under agreements to repurchase, the Corporation maintains certain eligible assets as collateral.

The following table shows information about the Corporation's short-term borrowings as of December 31, 2018 and 2017.

Table 13 — Short-Term Borrowings

(Dollars in thousands)

| | 2018 | | | |
|--|----------------------|--------------------|---------------------------------|-----------------|
| | Month End Balance | Average Balance | Maximum Month End Balance | Average Rate |
| Federal funds purchased | \$? — | \$? — | \$? — | 2.19% |
| Securities sold under agreements to repurchase | 12,957 | 15,481 | 19,225 | 0.56% |
| Federal Discount Window | ? — | — | — | 2.19% |
| Federal Home Loan Bank | 161,488 | 96,120 | 161,487 | 2.28% |
| | <u>\$ 174,445</u> | <u>\$ 111,601</u> | <u>\$ 180,712</u> | 2.04% |

(Dollars in thousands)

| | 2017 | | | |
|--|----------------------|--------------------|---------------------------------|-----------------|
| | Month End Balance | Average Balance | Maximum Month End Balance | Average Rate |
| Federal funds purchased | \$ — | \$ — | \$ — | 1.82% |
| Securities sold under agreements to repurchase | 22,844 | 21,872 | 23,452 | 0.41% |
| Federal Discount Window | — | 10 | — | 1.71% |
| Federal Home Loan Bank | 3,452 | 64,830 | 115,445 | 1.16% |
| | <u>\$ 26,296</u> | <u>\$ 86,712</u> | <u>\$ 138,897</u> | 0.97% |

CAPITAL STRENGTH

Normal increases in capital are generated by net income, less cash dividends paid out. Also, the net unrealized gains or losses on investment securities available-for-sale, net of taxes, referred to as accumulated other comprehensive (loss) income, may increase or decrease total equity capital. The total net increase in capital was \$37,000 in 2018 after an increase of \$7,034,000 in 2017. The increase in equity capital in 2018 was due to the retention of \$3,017,000 in earnings and the issuance of new shares through the Corporation's Dividend Reinvestment Program ("DRIP") amounting to \$1,153,000. Accumulated other comprehensive loss decreased \$4,133,000 in 2018 as a result of market fluctuations in the investment portfolio.

The Corporation had 231,612 shares of common stock as of December 31, 2018 and December 31, 2017, at a cost of \$5,709,000, as treasury stock, authorized and issued but not outstanding.

Return on average equity ("ROE") is computed by dividing net income by average stockholders' equity. This ratio was 8.05% for 2018 and 7.54% for 2017. Refer to Performance Ratios on page 22 — Selected Financial Data for a more expanded listing of the ROE.

Adequate capitalization of banks and bank holding companies is required and monitored by regulatory authorities. Table 14 reflects risk-based capital ratios and the leverage ratio for the Bank. The Bank's leverage ratio was 9.01% at December 31, 2018 and 8.84% at December 31, 2017.

The Bank has consistently maintained regulatory capital ratios at or above the "well capitalized" standards. To be categorized as "well capitalized", the Bank must maintain minimum tier 1 risk-based capital, common equity tier 1 risk based capital, total risk-based capital and tier 1 leverage ratios of 8.0%, 6.5%, 10.0% and 5.0%, respectively. For additional information on capital ratios, see Note 13 — Regulatory Matters. The risk-based capital calculation assigns various levels of risk to different categories of bank assets, requiring higher levels of capital for assets with more risk. Also measured in the risk-based capital ratio is credit risk exposure associated with off-balance sheet contracts and commitments.

Table 14 — Capital Ratios

At December 31, 2018 the Bank met the definition of a "well-capitalized" institution under the regulatory framework for prompt corrective action and the minimum capital requirements under Basel III. The following table presents the Bank's capital ratios as of December 31, 2018 and December 31, 2017:

| | December 31, 2018 | December 31, 2017 | To Be Well Capitalized Under Prompt Corrective Action Regulations |
|--|----------------------|----------------------|---|
| Tier 1 leverage ratio (to average assets) | 9.01% | 8.84% | 5.00% |
| Common Equity Tier 1 capital ratio (to risk-weighted assets) | 12.88% | 13.06% | 6.50% |
| Tier 1 risk-based capital ratio (to risk-weighted assets) | 12.88% | 13.06% | 8.00% |
| Total risk-based capital ratio | 13.87% | 14.21% | 10.00% |

Under the final capital rules that became effective on January 1, 2015, there was a requirement for a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not maintain this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement is being phased in over three years beginning in 2016. The capital buffer requirement effectively raises the minimum required common equity tier 1 capital ratio to 7.0%, the tier 1 capital ratio to 8.5%, and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019. Management believes that, as of December 31, 2018, the Corporation would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if all such requirements were currently in effect.

The Corporation's capital ratios are not materially different than those of the Bank.

LIQUIDITY MANAGEMENT

The Corporation's objective is to maintain adequate liquidity to meet funding needs at a reasonable cost and provide contingency plans to meet unanticipated funding needs or a loss of funding sources, while minimizing interest rate risk. Adequate liquidity is needed to provide the funding requirements of depositors' withdrawals, loan growth, and other operational needs.

Sources of liquidity are as follows:

- Growth in the core deposit base;
- Proceeds from sales or maturities of investment securities;
- Payments received on loans and mortgage-backed securities;
- Overnight correspondent bank borrowings on various credit lines;
- Borrowing capacity available from correspondent banks: FHLB, Atlantic Community Bankers Bank ("ACBB"), and Federal Reserve Bank;
- Securities sold under agreements to repurchase; and
- Brokered CDs.

At December 31, 2018, the Corporation had \$313,923,000 in available borrowing capacity at FHLB (which takes into account FHLB long-term notes and FHLB short-term borrowings); the maximum borrowing capacity at ACBB was \$15,000,000 and the maximum borrowing capacity of the Federal Discount Window was \$4,741,000.

The Corporation enters into "Repurchase Agreements" in which it agrees to sell securities subject to an obligation to repurchase the same or similar securities. Because the agreement both entitles and obligates the Corporation to repurchase the assets, the Corporation may transfer legal control of the securities while still retaining effective control. As a result, the repurchase agreements are accounted for as collateralized financing agreements (secured borrowings) and act as an additional source of liquidity. Securities sold under agreements to repurchase were \$12,957,000 at December 31, 2018.

Asset liquidity is provided by investment securities maturing in one year or less, other short-term investments, federal funds sold, and cash and due from banks. The liquidity is augmented by repayment of loans and cash flows from mortgage-backed securities. Liability liquidity is accomplished by maintaining a core deposit base, acquired by attracting new deposits and retaining maturing deposits. Also, short-term borrowings provide funds to meet liquidity needs.

Net cash flows provided by operating activities were \$14,741,000 and \$12,204,000 at December 31, 2018 and 2017, respectively. Net income amounted to \$9,211,000 for the year ended December 31, 2018 and \$8,648,000 for the year ended December 31, 2017. During the years ended December 31, 2018 and 2017, net premium amortization on investment securities amounted to \$3,343,000 and \$4,546,000, respectively. Proceeds (including gains) from sales of mortgage loans originated for resale exceeded net cash utilized for originations of mortgage loans originated for resale by \$22,000 for the year ended December 31, 2018 and net cash utilized for originations of mortgage loans originated for resale exceeded proceeds (including gains) from sales of mortgage loans originated for resale by \$422,000 for the year ended December 31, 2017. Other assets increased \$81,000 during the year ended December 31, 2018 and decreased \$203,000 during the year ended December 31, 2017. Other liabilities decreased \$17,000 and \$313,000 during the years ended December 31, 2018 and 2017, respectively.

Investing activities used \$29,045,000 and \$6,788,000 during the years ended December 31, 2018 and 2017, respectively. Net activity in the available-for-sale securities portfolio (including proceeds from sale, maturities, and redemptions net against purchases) provided cash of \$23,964,000 and \$30,734,000 during the years ended December 31, 2018 and 2017, respectively. Net cash used to originate loans amounted to \$48,203,000 and \$36,506,000 during the years ended December 31, 2018 and 2017, respectively.

Financing activities provided cash of \$16,515,000 during the year ended December 31, 2018 and used cash of \$5,805,000 during the year ended December 31, 2017. Deposits decreased by \$106,593,000 during the year ended December 31, 2018 and increased by \$52,164,000 during the year ended December 31, 2017. Short-term borrowings increased by \$148,149,000 during the year ended December 31, 2018 and decreased by \$42,994,000 during the year ended December 31, 2017. Repayment of long-term borrowings exceeded proceeds from long-term borrowings by \$20,000,000 during the year ended December 31, 2018 and repayment of long-term borrowings amounted to \$10,116,000 for the year ended December 31, 2017. Dividends paid amounted to \$6,194,000 and \$6,145,000 during the years ended December 31, 2018 and 2017, respectively.

Managing liquidity remains an important segment of asset/liability management. The overall liquidity position of the Corporation is maintained by an active asset/liability management committee. The Corporation believes that its core deposit base is stable even in periods of changing interest rates. Liquidity and funds management are governed by policies and measured on a monthly basis. These measurements indicate that liquidity generally remains stable and exceeds the Corporation's minimum defined levels of adequacy. Other than the trends of continued competitive pressures and volatile interest rates, there are no known demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, liquidity increasing or decreasing in any material way.

Table 15 represents scheduled maturities of the Corporation's contractual obligations by time remaining until maturity as of December 31, 2018.

Table 15 — Contractual Obligations

(Dollars in thousands)

| December 31, 2018 | Less than 1 Year | 1 - 3 Years | 4 - 5 Years | Over 5 Years | Total |
|---|---------------------|----------------|----------------|-----------------|------------|
| Time deposits | \$ 96,639 | \$ 74,672 | \$ 25,506 | \$ 475 | \$ 197,292 |
| Securities sold under agreement to repurchase | 12,957 | — | — | — | 12,957 |
| Short-term borrowings | 161,487 | — | — | — | 161,488 |
| Long-term borrowings | 20,000 | 20,000 | 3,000 | 2,000 | 45,000 |
| Operating lease obligations | 123 | 205 | 136 | 2,326 | 2,790 |
| | \$ 291,206 | \$ 94,877 | \$ 28,642 | \$ 4,801 | \$ 419,527 |

Off-Balance Sheet Arrangements

The Corporation is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and, to a lesser extent, standby letters of credit. At December 31, 2018, the Corporation had unfunded outstanding commitments to extend credit of \$107,126,000 and outstanding standby letters of credit of \$3,438,000. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. Please refer to Note 14 — Financial Instruments with Off-Balance Sheet Risk and Concentrations of Credit Risk for a discussion of the nature, business purpose, and importance of the Corporation's off-balance sheet arrangements.

MARKET RISK

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates, exchange rates and equity prices. The Corporation's market risk is composed primarily of interest rate risk. The Corporation's interest rate risk results from timing differences in the repricing of assets, liabilities, off-balance sheet instruments, and changes in relationships between rate indices and the potential exercise of explicit or embedded options.

Increases in the level of interest rates also may adversely affect the fair value of the Corporation's securities and other earning assets. Generally, the fair value of fixed-rate instruments fluctuates inversely with changes in interest rates. As a result, increases in interest rates could result in decreases in the fair value of the Corporation's interest-earning assets, which could adversely affect the Corporation's results of operations if sold, or, in the case of interest-earning assets classified as available-for-sale, the Corporation's stockholders' equity, if retained. Under FASB ASC 320-10, *Investments – Debt Securities*, changes in the unrealized gains and losses, net of taxes, on debt securities classified as available-for-sale are reflected in the Corporation's stockholders' equity. The Corporation does not own any trading assets.

Asset/Liability Management

The principal objective of asset/liability management is to manage the sensitivity of the net interest margin to potential movements in interest rates and to enhance profitability through returns from managed levels of interest rate risk. The Corporation actively manages the interest rate sensitivity of its assets and liabilities. Table 16 presents an interest sensitivity analysis of assets and liabilities as of December 31, 2018. Several techniques are used for measuring interest rate sensitivity. Interest rate risk arises from the mismatches in the repricing of assets and liabilities within a given time period, referred to as a rate sensitivity gap. If more assets than liabilities mature or reprice within the time frame, the Corporation is asset sensitive. This position would contribute positively to net interest income in a rising rate environment. Conversely, if more liabilities mature or reprice, the Corporation is liability sensitive. This position would contribute positively to net interest income in a falling rate environment.

Limitations of interest rate sensitivity gap analysis as illustrated in Table 16 include: a) assets and liabilities which contractually reprice within the same period may not, in fact, reprice at the same time or to the same extent; b) changes in market interest rates do not affect all assets and liabilities to the same extent or at the same time, and c) interest rate sensitivity gaps reflect the Corporation's position on a single day (December 31, 2018 in the case of the following schedule) while the Corporation continually adjusts its interest sensitivity throughout the year. The Corporation's cumulative gap at one year indicates the Corporation is liability sensitive.

Table 16 — Interest Rate Sensitivity Analysis

(Dollars in thousands)

| | December 31, 2018 | | | | |
|----------------------------------|-------------------|----------------|-------------------|-----------------------|--------------|
| | One Year | 1 - 5 Years | Beyond 5 Years | Not Rate Sensitive | Total |
| Assets | \$ 130,679 | \$ 347,862 | \$ 448,981 | \$ 84,478 | \$ 1,012,000 |
| Liabilities/Stockholders' Equity | 353,644 | 169,100 | 375,805 | 113,451 | 1,012,000 |
| Interest Rate Sensitivity Gap | \$ (222,965) | \$ 178,762 | \$ 73,176 | \$ (28,973) | |
| Cumulative Gap | \$ (222,965) | \$ (44,203) | \$ 28,973 | — | |

Earnings at Risk

The Bank's Asset/Liability Committee ("ALCO") is responsible for reviewing the interest rate sensitivity position and establishing policies to monitor and limit exposure to interest rate risk. The guidelines established by ALCO are reviewed by the Corporation's Board of Directors. The Corporation recognizes that more sophisticated tools exist for measuring the interest rate risk in the balance sheet beyond interest rate sensitivity gap. Although the Corporation continues to measure its interest rate sensitivity gap, the Corporation utilizes additional modeling for interest rate risk in the overall balance sheet. Earnings at risk and economic values at risk are analyzed.

Earnings simulation modeling addresses earnings at risk and net present value estimation addresses economic value at risk. While each of these interest rate risk measurements has limitations, taken together they represent a reasonably comprehensive view of the magnitude of interest rate risk to the Corporation.

Earnings Simulation Modeling

The Corporation's net income is affected by changes in the level of interest rates. Net income is also subject to changes in the shape of the yield curve. For example, a flattening of the yield curve would result in a decline in earnings due to the compression of earning asset yields and increased liability rates, while a steepening would result in increased earnings as earning asset yields widen.

Earnings simulation modeling is the primary mechanism used in assessing the impact of changes in interest rates on net interest income. The model reflects management's assumptions related to asset yields and rates paid on liabilities, deposit sensitivity, size and composition of the balance sheet. The assumptions are based on what management believes at that time to be the most likely interest rate environment. Earnings at risk is the change in net interest income from a base case scenario under various scenarios of rate shock increases and decreases in the interest rate earnings simulation model.

Table 17 presents an analysis of the changes in net interest income and net present value of the balance sheet resulting from various increases or decreases in the level of interest rates, such as two percentage points (200 basis points) in the level of interest rates. The calculated estimates of change in net interest income and net present value of the balance sheet are compared to current limits approved by ALCO and the Board of Directors. The earnings simulation model projects net interest income would decrease 11.5%, 22.2% and 31.1% in the 100, 200 and 300 basis point increasing rate scenarios presented. In addition, the earnings simulation model projects net interest income would increase 6.8% and 9.4% in the 100 and 200 basis point decreasing rate scenarios presented. All of these forecasts are within the Corporation's one year policy guidelines, aside from the 200 basis point immediate increase scenario at (22.2)% vs. a policy limit of (20.0)% and the 300 basis point immediate increase scenario at (31.1)% vs. a policy limit of (25.0)%.

The analysis and model used to quantify the sensitivity of net interest income becomes less reliable in a decreasing rate scenario given the current unprecedented low interest rate environment with federal funds trading in the 200 – 250 basis point range. Results of the decreasing basis point declining scenarios are affected by the fact that many of the Corporation's interest-bearing liabilities are at rates below 1% and therefore cannot decline 100 or more basis points. However, the Corporation's interest-sensitive assets are able to decline by these amounts. For the years ended December 31, 2018 and 2017, the cost of interest-bearing liabilities averaged 1.13% and 0.86%, respectively, and the yield on average interest-earning assets, on a fully taxable equivalent basis, averaged 4.11% and 3.79%, respectively.

Net Present Value Estimation

The net present value measures economic value at risk and is used for helping to determine levels of risk at a point in time present in the balance sheet that might not be taken into account in the earnings simulation model. The net present value of the balance sheet is defined as the discounted present value of asset cash flows minus the discounted present value of liability cash flows. At December 31, 2018, the 100 and 200 basis point immediate decreases in rates are estimated to affect net present value with a decrease of 7.0% and 25.7%, respectively. Additionally, net present value is projected to decrease 1.0%, 6.3%, and 13.6% in the 100, 200 and 300 basis point immediate increase scenarios, respectively. All scenarios presented are within the Corporation's policy limits.

The computation of the effects of hypothetical interest rate changes are based on many assumptions. They should not be relied upon solely as being indicative of actual results, since the computations do not account for actions management could undertake in response to changes in interest rates.

Table 17 — Effect of Change in Interest Rates

| | <u>Projected Change</u> |
|---|-------------------------|
| Effect on Net Interest Income | |
| 1-Year Net Income Simulation Projection | |
| +300 bp Shock vs. Stable Rate | (31.1)% |
| +200 bp Shock vs. Stable Rate | (22.2)% |
| +100 bp Shock vs. Stable Rate | (11.5)% |
| Flat rate | |
| –100 bp Shock vs. Stable Rate | 6.8% |
| –200 bp Shock vs. Stable Rate | 9.4% |
| Effect on Net Present Value of Balance Sheet | |
| Static Net Present Value Change | |
| +300 bp Shock vs. Stable Rate | (13.6)% |
| +200 bp Shock vs. Stable Rate | (6.3)% |
| +100 bp Shock vs. Stable Rate | (1.0)% |
| Flat rate | |
| –100 bp Shock vs. Stable Rate | (7.0)% |
| –200 bp Shock vs. Stable Rate | (25.7)% |

Table 18 shows the quarterly results of operations for the Corporation for the years ended December 31, 2018 and 2017:

Table 18 — Quarterly Results of Operations (Unaudited)

(Dollars in thousands, except per share data)

| 2018 | Three Months Ended | | | |
|--------------------------------------|--------------------|----------|--------------|-------------|
| | March 31 | June 30 | September 30 | December 31 |
| Interest income | \$ 8,271 | \$ 8,737 | \$ 9,169 | \$ 9,396 |
| Interest expense | 1,781 | 1,984 | 2,284 | 2,571 |
| Net interest income | 6,490 | 6,753 | 6,885 | 6,825 |
| Provision for loan losses | 50 | — | — | 150 |
| Non-interest income | 1,259 | 1,470 | 1,502 | 1,331 |
| Non-interest expense | 5,895 | 5,676 | 5,607 | 5,467 |
| Income before income tax expense | 1,804 | 2,547 | 2,780 | 2,539 |
| Income tax expense | 27 | 71 | 184 | 177 |
| Net income | \$ 1,777 | \$ 2,476 | \$ 2,596 | \$ 2,362 |
| Basic and diluted earnings per share | \$ 0.31 | \$ 0.43 | \$ 0.45 | \$ 0.41 |

(Dollars in thousands, except per share data)

| 2017 | Three Months Ended | | | |
|--------------------------------------|--------------------|----------|--------------|-------------|
| | March 31 | June 30 | September 30 | December 31 |
| Interest income | \$ 7,897 | \$ 8,010 | \$ 8,164 | \$ 8,197 |
| Interest expense | 1,419 | 1,627 | 1,787 | 1,715 |
| Net interest income | 6,478 | 6,383 | 6,377 | 6,482 |
| Provision for loan losses | 83 | — | 84 | 100 |
| Non-interest income | 1,538 | 1,495 | 1,713 | 1,425 |
| Non-interest expense | 5,263 | 5,666 | 5,681 | 4,911 |
| Income before income tax expense | 2,670 | 2,212 | 2,325 | 2,896 |
| Income tax expense | 384 | 293 | 269 | 509 |
| Net income | \$ 2,286 | \$ 1,919 | \$ 2,056 | \$ 2,387 |
| Basic and diluted earnings per share | \$ 0.40 | \$ 0.34 | \$ 0.36 | \$ 0.42 |

Critical Accounting Estimates

The Corporation has chosen accounting policies that it believes are appropriate to accurately and fairly report its operating results and financial position, and the Corporation has applied those policies in a consistent manner.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America require that the Corporation make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. These estimates and assumptions are based on historical or other factors believed to be reasonable under the circumstances. The Corporation evaluates these estimates and assumptions on an ongoing basis and may retain outside consultants, lawyers and actuaries to assist in its evaluation. These estimates, assumptions and judgments are based on information available as of the date of the consolidated financial statements; accordingly, as this information changes, the consolidated financial statements could reflect different estimates, assumptions and judgments.

The Corporation considers two accounting policies to be critical because they involve the most significant judgments and estimates used in preparation of its consolidated financial statements. The two policies are the determination of other-than-temporary impairment of securities and the determination of the allowance for loan losses.

Other-Than-Temporary Impairment of Securities. Valuations for the investment portfolio are determined using quoted market prices, where available. If quoted market prices are not available, investment valuation is based on pricing models, quotes for similar investment securities, and observable yield curves and spreads. In addition to valuation, management must assess whether there are any declines in value below the carrying value of the investments that should be considered other than temporary or otherwise require an adjustment in carrying value and recognition of the loss in the Corporation's Consolidated Statements of Income.

Allowance for Loan Losses. The allowance for loan losses represents management's estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the Corporation's Consolidated Balance Sheets.

Report of Independent Registered Public Accounting Firm

Stockholders and Board of Directors
First Keystone Corporation

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheet of First Keystone Corporation and Subsidiary (collectively the "Corporation") as of December 31, 2018, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows, for the year then ended, and the related notes (collectively referred to as the "consolidated financial statements"). We also have audited the Corporation's internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control – Integrated Framework: (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO").

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as of December 31, 2018, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control – Integrated Framework: (2013)* issued by COSO.

Basis for Opinions

The Corporation's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Corporation's consolidated financial statements and an opinion on the Corporation's internal control over financial reporting based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud and whether effective internal control over financial reporting was maintained in all material respects.

Our audit of the financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control Over Financial Reporting

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

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

/s/ Baker Tilly Virchow Krause, LLP

We have served as the Corporation's auditor since 2018.

Williamsport, Pennsylvania
March 18, 2019

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
First Keystone Corporation
Berwick, Pennsylvania

Opinion of the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheet of First Keystone Corporation and Subsidiary (the “Corporation”) as of December 31, 2017, the related consolidated statements of income, comprehensive income, changes in stockholders’ equity, and cash flows for the year then ended, and the related notes (collectively referred to as the “consolidated financial statements”). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Corporation at December 31, 2017, and the results of their operations and their cash flows for the year ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These consolidated financial statements are the responsibility of the Corporation’s management. Our responsibility is to express an opinion on the Corporation’s consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Corporation in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud.

Our audit included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audit provides a reasonable basis for our opinion.

/s/ BDO USA, LLP

We served as the Corporations auditor from 2014 to 2018.

Philadelphia, Pennsylvania
March 16, 2018

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands, except share and per share data)

| | December 31, | |
|--|---------------------|-------------------|
| | 2018 | 2017 |
| ASSETS | | |
| Cash and due from banks | \$ 9,822 | \$ 7,913 |
| Interest-bearing deposits in other banks | 1,128 | 826 |
| Total cash and cash equivalents | 10,950 | 8,739 |
| Time deposits with other banks | 1,482 | 1,482 |
| Available-for-sale debt securities, at fair value | 316,054 | 348,586 |
| Marketable equity securities, at fair value | 1,560 | 1,632 |
| Restricted investment in bank stocks | 8,681 | 4,058 |
| Loans | 606,027 | 558,563 |
| Loans held for sale | 365 | 834 |
| Allowance for loan losses | (6,745) | (7,487) |
| Net loans | 599,647 | 551,910 |
| Premises and equipment, net | 19,946 | 20,623 |
| Accrued interest receivable | 4,041 | 4,237 |
| Cash surrender value of bank owned life insurance | 22,963 | 22,354 |
| Investments in low-income housing partnerships | 2,096 | 2,626 |
| Goodwill | 19,133 | 19,133 |
| Foreclosed assets held for resale | 1,163 | 1,071 |
| Deferred income taxes | 1,469 | 936 |
| Other assets | 2,815 | 2,734 |
| TOTAL ASSETS | \$ 1,012,000 | \$ 990,121 |
| LIABILITIES | | |
| Deposits: | | |
| Non-interest bearing | \$ 126,361 | \$ 121,415 |
| Interest bearing | 545,192 | 656,731 |
| Total deposits | 671,553 | 778,146 |
| Short-term borrowings | 174,445 | 26,296 |
| Long-term borrowings | 45,000 | 65,000 |
| Accrued interest payable | 785 | 490 |
| Other liabilities | 3,461 | 3,470 |
| TOTAL LIABILITIES | 895,244 | 873,402 |
| STOCKHOLDERS' EQUITY | | |
| Preferred stock, par value \$2.00 per share; authorized 1,000,000 shares as of December 31, 2018 and 2017; issued 0 in 2018 and 2017 | — | — |
| Common stock, par value \$2.00 per share; authorized 20,000,000 shares as of December 31, 2018 and 2017; issued 5,996,322 as of December 31, 2018 and 5,950,951 as of December 31, 2017; outstanding 5,764,710 as of December 31, 2018 and 5,719,339 as of December 31, 2017 | 11,993 | 11,902 |
| Surplus | 37,255 | 36,193 |
| Retained earnings | 75,798 | 72,507 |
| Accumulated other comprehensive (loss) income | (2,581) | 1,826 |
| Treasury stock, at cost, 231,612 shares in 2018 and 2017 | (5,709) | (5,709) |
| TOTAL STOCKHOLDERS' EQUITY | 116,756 | 116,719 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 1,012,000 | \$ 990,121 |

The accompanying notes are an integral part of these consolidated financial statements.

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME**

| | Years Ended December 31, | |
|--|--------------------------|-----------------|
| | 2018 | 2017 |
| <i>(Dollars in thousands, except per share data)</i> | | |
| INTEREST INCOME | | |
| Interest and fees on loans | \$ 25,886 | \$ 22,615 |
| Interest and dividend income on investment securities: | | |
| Taxable | 4,585 | 4,304 |
| Tax-exempt | 4,576 | 4,979 |
| Dividends | 47 | 47 |
| Dividend income on restricted investment in bank stocks | 443 | 289 |
| Interest on interest-bearing deposits in other banks | 36 | 34 |
| Total interest income | 35,573 | 32,268 |
| INTEREST EXPENSE | | |
| Interest on deposits | 5,193 | 4,232 |
| Interest on short-term borrowings | 2,277 | 844 |
| Interest on long-term borrowings | 1,150 | 1,472 |
| Total interest expense | 8,620 | 6,548 |
| Net interest income | 26,953 | 25,720 |
| Provision for loan losses | 200 | 267 |
| Net interest income after provision for loan losses | 26,753 | 25,453 |
| NON-INTEREST INCOME | | |
| Trust department | 943 | 880 |
| Service charges and fees | 2,059 | 1,803 |
| Bank owned life insurance income | 609 | 636 |
| ATM fees and debit card income | 1,567 | 1,396 |
| Gains on sales of mortgage loans | 188 | 316 |
| Net securities (losses) gains | (65) | 938 |
| Other | 261 | 202 |
| Total non-interest income | 5,562 | 6,171 |
| NON-INTEREST EXPENSE | | |
| Salaries and employee benefits | 11,770 | 11,170 |
| Occupancy, net | 1,741 | 1,777 |
| Furniture and equipment | 598 | 569 |
| Computer expense | 1,017 | 1,025 |
| Professional services | 1,051 | 866 |
| Pennsylvania shares tax | 780 | 742 |
| FDIC insurance | 311 | 321 |
| ATM and debit card fees | 806 | 697 |
| Data processing fees | 1,032 | 992 |
| Foreclosed assets held for resale | 148 | 135 |
| Advertising | 507 | 530 |
| Other | 2,884 | 2,697 |
| Total non-interest expense | 22,645 | 21,521 |
| Income before income tax expense | 9,670 | 10,103 |
| Income tax expense | 459 | 1,455 |
| NET INCOME | \$ 9,211 | \$ 8,648 |
| PER SHARE DATA | | |
| Net income per share: | | |
| Basic | \$ 1.60 | \$ 1.52 |
| Diluted | 1.60 | 1.52 |
| Dividends per share | 1.08 | 1.08 |

The accompanying notes are an integral part of these consolidated financial statements.

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Dollars in thousands)

| | Years Ended December 31, | |
|--|--------------------------|------------------|
| | <u>2018</u> | <u>2017</u> |
| Net Income | \$ 9,211 | \$ 8,648 |
| Other comprehensive (loss) income: | | |
| Unrealized net holding (losses) gains on debt securities arising during the period, net of income taxes of \$(1,097) and \$2,002, respectively | (4,127) | 3,859 |
| Less reclassification adjustment for net gains included in net income, net of income taxes of \$(1) and \$(324), respectively (a) (b) | (6) | (614) |
| Total other comprehensive (loss) income | (4,133) | 3,245 |
| Total Comprehensive Income | <u>\$ 5,078</u> | <u>\$ 11,893</u> |

(a) Gross amounts are included in net securities (losses) gains on the Consolidated Statements of Income in non-interest income.

(b) Income tax amounts are included in income tax expense on the Consolidated Statements of Income.

The accompanying notes are an integral part of these consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years Ended December 31, 2018 and 2017

(Dollars in thousands, except share and per share data)

| | Common Stock | | Surplus | Retained Earnings | Accumulated Other Comprehensive (Loss) Income | Treasury Stock | Total Stockholders' Equity |
|--|------------------|------------------|------------------|-------------------|---|-------------------|----------------------------|
| | Shares | Amount | | | | | |
| Balance at January 1, 2017 | 5,904,563 | \$ 11,809 | \$ 35,047 | \$ 70,004 | \$ (1,419) | \$ (5,756) | \$ 109,685 |
| Net Income | | | | 8,648 | | | 8,648 |
| Other comprehensive income, net of taxes | | | | | 3,245 | | 3,245 |
| Issuance of common stock under dividend reinvestment plan and exercise of employee stock options | 46,388 | 93 | 1,146 | | | 47 | 1,286 |
| Dividends - \$1.08 per share | | | | (6,145) | | | (6,145) |
| Balance at December 31, 2017 | <u>5,950,951</u> | <u>11,902</u> | <u>36,193</u> | <u>72,507</u> | <u>1,826</u> | <u>(5,709)</u> | <u>116,719</u> |
| Net Income | | | | 9,211 | | | 9,211 |
| Other comprehensive loss, net of taxes | | | | | (4,133) | | (4,133) |
| Issuance of common stock under dividend reinvestment plan | 45,371 | 91 | 1,062 | | | | 1,153 |
| Impact of adoption of accounting standards ¹ | | | | 274 | (274) | | — |
| Dividends - \$1.08 per share | | | | (6,194) | | | (6,194) |
| Balance at December 31, 2018 | <u>5,996,322</u> | <u>\$ 11,993</u> | <u>\$ 37,255</u> | <u>\$ 75,798</u> | <u>\$ (2,581)</u> | <u>\$ (5,709)</u> | <u>\$ 116,756</u> |

¹Represents the impact of adopting Accounting Standard Updates (“ASU”) 2018-02 and ASU 2016-01 effective January 1, 2018. See Note 1 to the consolidated financial statements for more information.

The accompanying notes are an integral part of these consolidated financial statements.

**FIRST KEYSTONE CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in thousands)

| | Years Ended December 31, | |
|--|--------------------------|-----------------|
| | 2018 | 2017 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 9,211 | \$ 8,648 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 200 | 267 |
| Depreciation and amortization | 1,056 | 1,112 |
| Net premium amortization on debt securities | 3,343 | 4,546 |
| Deferred income tax expense | 566 | 146 |
| Gains on sales of mortgage loans | (188) | (316) |
| Proceeds from sales of mortgage loans originated for resale | 8,948 | 11,484 |
| Originations of mortgage loans originated for resale | (8,926) | (11,906) |
| Net securities losses (gains) | 65 | (938) |
| Net losses (gains) on sales of foreclosed real estate held for resale, including write-downs | 162 | (19) |
| Decrease (increase) in accrued interest receivable | 196 | (320) |
| Earnings on investment in bank owned life insurance | (609) | (636) |
| Net (gains) losses on disposals of premises and equipment | (10) | 2 |
| (Increase) decrease in other assets | (81) | 203 |
| Amortization of investment in low-income housing partnerships | 530 | 181 |
| Increase in accrued interest payable | 295 | 63 |
| Decrease in other liabilities | (17) | (313) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | <u>14,741</u> | <u>12,204</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from sales of debt securities available-for-sale | 44,122 | 81,807 |
| Proceeds from maturities and redemptions of debt securities available-for-sale | 22,058 | 21,662 |
| Purchases of debt securities available-for-sale | (42,216) | (72,735) |
| Proceeds from maturities and redemptions of investment securities held-to-maturity | — | 4 |
| Net change in restricted investment in bank stocks | (4,623) | 1,419 |
| Net increase in loans | (48,203) | (36,506) |
| Purchase of premises and equipment | (446) | (2,585) |
| Purchase of investment in low-income housing partnerships | — | (252) |
| Proceeds from sales of foreclosed assets held for resale | 263 | 398 |
| NET CASH USED IN INVESTING ACTIVITIES | <u>(29,045)</u> | <u>(6,788)</u> |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net (decrease) increase in deposits | (106,593) | 52,164 |
| Net increase (decrease) in short-term borrowings | 148,149 | (42,994) |
| Proceeds from long-term borrowings | 3,000 | — |
| Repayment of long-term borrowings | (23,000) | (10,116) |
| Common stock issued | 1,153 | 1,261 |
| Proceeds from exercise of stock options | — | 25 |
| Dividends paid | (6,194) | (6,145) |
| NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES | <u>16,515</u> | <u>(5,805)</u> |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | <u>2,211</u> | <u>(389)</u> |
| CASH AND CASH EQUIVALENTS, BEGINNING | 8,739 | 9,128 |
| CASH AND CASH EQUIVALENTS, ENDING | <u>\$ 10,950</u> | <u>\$ 8,739</u> |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION | | |
| Interest paid | \$ 8,325 | \$ 6,485 |
| Income taxes paid | 672 | 1,292 |
| SUPPLEMENTAL DISCLOSURE OF NON-CASH ACTIVITIES | | |
| Loans transferred to foreclosed assets held for resale | 517 | 177 |
| Loans transferred from held for sale portfolio | (611) | — |

The accompanying notes are an integral part of these consolidated financial statements.

NOTE 1 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of First Keystone Corporation and Subsidiary (the “Corporation”) are in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and conform to common practices within the banking industry. The more significant accounting policies follow:

Principles of Consolidation

The consolidated financial statements include the accounts of First Keystone Corporation and its wholly-owned subsidiary, First Keystone Community Bank (the “Bank”). All significant inter-company balances and transactions have been eliminated in consolidation.

Nature of Operations

The Corporation, headquartered in Berwick, Pennsylvania, provides a full range of banking, trust and related services through its wholly-owned Bank subsidiary and is subject to competition from other financial institutions in connection with these services. The Bank serves a customer base which includes individuals, businesses, governments, and public and institutional customers primarily located in the Northeast Region of Pennsylvania. The Bank has 18 full service offices, one loan production office, and 20 Automated Teller Machines (“ATM”) located in Columbia, Luzerne, Montour, Monroe, and Northampton counties. The Corporation and its subsidiary must also adhere to certain federal and state banking laws and regulations and are subject to periodic examinations made by various state and federal agencies.

Segment Reporting

The Corporation’s subsidiary acts as an independent community financial services provider, and offers traditional banking and related financial services to individual, business, government, and public and institutional customers. Through its branch and ATM network, the Bank offers a full array of commercial and retail financial services, including the taking of time, savings and demand deposits; the making of commercial, consumer and mortgage loans; and the providing of other financial services. The Bank also performs personal, corporate, pension and fiduciary services through its Trust Department.

Management does not separately allocate expenses, including the cost of funding loan demand, between the commercial, retail, trust and mortgage banking operations of the Corporation. As such, discrete financial information is not available and segment reporting would not be meaningful.

Significant Concentrations of Credit Risk

The majority of the Corporation’s activities involve customers located primarily in Columbia, Luzerne, Montour, Monroe, Northampton, and Lehigh counties in Pennsylvania. The types of securities in which the Corporation invests are presented in Note 3 – Securities. Credit risk as it relates to investment activities is moderated through the monitoring of ratings and geographic concentrations residing in the portfolio and the observance of minimum rating levels in the investment policy. Note 4 – Loans and Allowance for Loan Losses summarizes the types of lending in which the Corporation engages. The inherent risks associated with lending activities are mitigated by adhering to conservative underwriting practices and policies, as well as portfolio diversification and thorough monitoring of the loan portfolio. It is management’s opinion that the investment and loan portfolios were well balanced at December 31, 2018, to the extent necessary to avoid any significant concentrations of credit risk.

Use of Estimates

The preparation of these 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 disclosure of contingent assets and liabilities at the date of these consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from those estimates.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

Material estimates that are particularly susceptible to significant changes include the determination of other-than-temporary impairment on securities and the determination of the allowance for loan losses.

Subsequent Events

The Corporation has evaluated events and transactions occurring subsequent to the consolidated balance sheet date of December 31, 2018, for items that should potentially be recognized or disclosed in the consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

Cash and Cash Equivalents

For purposes of reporting consolidated cash flows, cash and cash equivalents include cash on hand and due from banks, interest-bearing deposits in other banks, and federal funds sold. The Corporation considers cash classified as interest-bearing deposits with other banks as a cash equivalent since they are represented by cash accounts essentially on a demand basis and mature within one year. Federal funds are also included as a cash equivalent because they are generally purchased and sold for one-day periods.

Time Deposits with Other Banks

Time deposits with other banks consist of fully insured certificates of deposit in other banks with maturity dates between one and five years.

Securities

The Corporation classifies its securities as either “Held-to-Maturity” or “Available-for-Sale” at the time of purchase. Securities are accounted for on a trade date basis. Debt securities are classified as Held-to-Maturity when the Corporation has the ability and positive intent to hold the securities to maturity. Securities classified as Held-to-Maturity are carried at cost adjusted for amortization of premium and accretion of discount to maturity.

Debt securities not classified as Held-to-Maturity are included in the Available-for-Sale category and are carried at fair value. The amount of any unrealized gain or loss, net of the effect of deferred income taxes, is reported as accumulated other comprehensive (loss) income (AOCI) in the Consolidated Balance Sheets and Consolidated Statements of Changes in Stockholders’ Equity. Management’s decision to sell Available-for-Sale securities is based on changes in economic conditions controlling the sources and applications of funds, terms, availability of and yield of alternative investments, interest rate risk and the need for liquidity.

The cost of debt securities classified as Held-to-Maturity or Available-for-Sale is adjusted for amortization of premiums and accretion of discounts to expected maturity. Such amortization and accretion, as well as interest and dividends, are included in interest and dividend income on investment securities. Realized gains and losses are included in net investment securities gains and losses. The cost of investment securities sold, redeemed or matured is based on the specific identification method.

Beginning January 1, 2018, upon adoption of ASU 2016-01, equity securities with readily determinable fair values are stated at fair value with realized and unrealized gains and losses reported in income. For periods prior to January 1, 2018, equity securities were classified as available-for-sale and stated at fair value with unrealized gains and losses reported as a separate component of AOCI, net of tax. Equity securities without readily determinable fair values are recorded at cost less impairment, if any.

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Securities classified as available-for-sale or held-to-maturity are generally evaluated for OTTI under FASB ASC 320, *Investments - Debt and Equity Securities*. In determining OTTI under the FASB ASC 320 model, management considers many factors, including (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

When other-than-temporary impairment occurs on debt securities, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the other-than-temporary impairment shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is determined based on the present value of cash flows expected to be collected, and the realized loss is recognized as impairment charges on securities on the Consolidated Statements of Income. The amount of the total other-than-temporary impairment related to the other factors shall be recognized in other comprehensive (loss) income, net of applicable taxes. The previous amortized cost basis less the other-than-temporary impairment recognized in earnings becomes the new amortized cost basis of the investment.

The fair market value of the equity securities tends to fluctuate with the overall equity markets as well as the trends specific to each institution. The equity securities portfolio is reviewed in a similar manner as that of the debt securities with greater emphasis placed on the length of time the market value has been less than the carrying value and the financial sector outlook. The Corporation also reviews dividend payment activities, levels of non-performing assets and loan loss reserves. The starting point for the equity analysis is the length and severity of market value decline. The realized loss is recognized as impairment charges on securities on the Consolidated Statements of Income. The previous cost basis less the other-than-temporary impairment recognized in earnings becomes the new cost basis of the investment.

Restricted Investment in Bank Stocks

The Bank owns restricted stock investments in the Federal Home Loan Bank of Pittsburgh ("FHLB-Pittsburgh") and Atlantic Community Bankers Bank ("ACBB"). These investments do not have a readily determinable fair value because their ownership is restricted and they can be sold back only to the FHLB-Pittsburgh, ACBB or to another member institution. Therefore, these investments are carried at cost. At December 31, 2018, the Corporation held \$8,646,000 in stock of FHLB-Pittsburgh and \$35,000 in stock of ACBB. At December 31, 2017, the Corporation held \$4,023,000 in stock of FHLB-Pittsburgh and \$35,000 in stock of ACBB.

Management evaluates the restricted investment in bank stocks for impairment on an annual basis. Management's determination of whether these investments are impaired is based on management's assessment of the ultimate recoverability of the cost of these investments rather than by recognizing temporary declines in value. The following factors were evaluated to determine the ultimate recoverability of the cost of the Corporation's restricted investment in bank stocks; (i) the significance of the decline in net assets of the correspondent bank as compared to the capital stock amount for the correspondent bank and the length of time this situation has persisted; (ii) commitments by the correspondent bank to make payments required by law or regulation and the level of such payments in relation to the operating performance of the correspondent bank; (iii) the impact of legislative and regulatory changes on the institutions and, accordingly, on the customer base of the correspondent bank; and (iv) the liquidity position of the correspondent bank. Based on the analysis of these factors, management determined that no impairment charge was necessary related to the restricted investment in bank stocks during 2018 or 2017.

Loans

Net loans are stated at their outstanding recorded investment, net of deferred fees and costs, unearned income and the allowance for loan losses. Interest on loans is recognized as income over the term of each loan, generally, by the accrual method. Loan origination fees and certain direct loan origination costs have been deferred with the net amount amortized using the straight line method or the interest method over the contractual life of the related loans as an interest yield adjustment.

Residential mortgage loans held for sale are carried at the lower of cost or market on an aggregate basis determined by independent pricing from appropriate federal or state agency investors. These loans are sold without recourse. Loans held for sale amounted to \$365,000 at December 31, 2018 and \$834,000 at December 31, 2017.

The loans receivable portfolio is segmented into commercial, residential and consumer loans. Commercial loans consist of the following classes: Commercial and Industrial and Commercial Real Estate.

Commercial and Industrial Lending

The Corporation originates commercial and industrial loans primarily to businesses located in its primary market area and surrounding areas. These loans are used for various business purposes, which include short-term loans and lines of credit to finance machinery and equipment, inventory and accounts receivable. Generally, the maximum term for loans extended on machinery and equipment is based on the projected useful life of such machinery and equipment. Most business lines of credit are written on demand and are reviewed annually.

Commercial and industrial loans are generally secured with short-term assets; however, in many cases, additional collateral such as real estate is provided as additional security for the loan. Loan-to-value maximum thresholds have been established by the Corporation and are specific to the type of collateral. Collateral values may be determined using invoices, inventory reports, accounts receivable aging reports, business financial statements, collateral appraisals, etc. Commercial and industrial loans are typically secured by personal guarantees of the borrower.

In underwriting commercial and industrial loans, an analysis is performed to evaluate the borrower's character and capacity to repay the loan, the adequacy of the borrower's capital and collateral, as well as the conditions affecting the borrower. Evaluation of the borrower's past, present and future cash flows is also an important aspect of the Corporation's analysis of the borrower's ability to repay.

Commercial and industrial loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions. Commercial and industrial loans are typically made on the basis of the borrower's ability to make repayment from cash flows from the borrower's primary business activities. As a result, the availability of funds for the repayment of commercial and industrial loans is dependent on the success of the business itself, which in turn, is likely to be dependent upon the general economic environment.

Commercial Real Estate Lending

The Corporation engages in commercial real estate lending in its primary market area and surrounding areas. The Corporation's commercial real estate portfolio is secured primarily by commercial retail space, commercial office buildings, residential housing and hotels. Generally, commercial real estate loans have terms that do not exceed twenty years, have loan-to-value ratios of up to eighty percent of the value of the collateral property, and are typically secured by personal guarantees of the borrowers.

In underwriting these loans, the Corporation performs a thorough analysis of the financial condition of the borrower, the borrower's credit history, and the reliability and predictability of the cash flow generated by the property securing the loan. The value of the property is determined by either independent appraisers or internal evaluations by Bank officers.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

Commercial real estate loans generally present a higher level of risk than residential real estate secured loans. Repayment of loans secured by commercial real estate is typically dependent upon the successful operation of the related real estate project and/or the effect of the general economic conditions on income producing properties.

Residential Real Estate Lending (Including Home Equity)

The Corporation's residential real estate portfolio is comprised of one-to-four family residential mortgage loan originations, home equity term loans and home equity lines of credit. These loans are generated by the Corporation's marketing efforts, its present customers, walk-in customers and referrals. These loans originate primarily within or with customers from the Corporation's market area.

The Corporation's one-to-four family residential mortgage originations are secured primarily by properties located in its primary market area and surrounding areas. The Corporation offers fixed-rate mortgage loans with terms up to a maximum of thirty years for both permanent structures and those under construction. Loans with terms of thirty years are normally held for sale and sold without recourse; most of the residential mortgages held in the Corporation's residential real estate portfolio have maximum terms of twenty years. Generally, the majority of the Corporation's residential mortgage loans originate with a loan-to-value of eighty percent or less, or those with primary mortgage insurance at ninety-five percent or less. Home equity term loans are secured by the borrower's primary residence and typically have a maximum loan-to-value of eighty percent and a maximum term of fifteen years. In general, home equity lines of credit are secured by the borrower's primary residence with a maximum loan-to-value of eighty percent and a maximum term of twenty years.

In underwriting one-to-four family residential mortgage loans, the Corporation evaluates the borrower's ability to make monthly payments, the borrower's repayment history and the value of the property securing the loan. The ability and willingness to repay is determined by the borrower's employment history, current financial conditions and credit background. A majority of the properties securing residential real estate loans made by the Corporation are appraised by independent appraisers. The Corporation generally requires mortgage loan borrowers to obtain an attorney's title opinion or title insurance and fire and property insurance, including flood insurance, if applicable.

Residential mortgage loans, home equity term loans and home equity lines of credit generally present a lower level of risk than consumer loans because they are secured by the borrower's primary residence. Risk is increased when the Corporation is in a subordinate position, especially to another lender, for the loan collateral.

Consumer Lending

The Corporation offers a variety of secured and unsecured consumer loans, including vehicle loans, stock loans and loans secured by financial institution deposits. These loans originate primarily within or with customers from the market area.

Consumer loan terms vary according to the type and value of collateral and creditworthiness of the borrower. In underwriting personal loans, a thorough analysis is performed regarding the borrower's willingness and financial ability to repay the loan as agreed. The ability to repay is determined by the borrower's employment history, current financial condition and credit background.

Consumer loans may entail greater credit risk than residential real estate loans, particularly in the case of personal loans which are unsecured or are secured by rapidly depreciable assets, such as automobiles or recreational equipment. In such cases, repossessed collateral for a defaulted personal loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. In addition, personal loan collections are dependent on the borrower's continuing financial stability and therefore, are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

Delinquent Loans

Generally, a loan is considered to be past-due when scheduled loan payments are in arrears 10 days or more. Delinquent notices are generated automatically when a loan is 10 or 15 days past-due, depending on loan type. Collection efforts continue on past-due loans that have not been brought current, when it is believed that some chance exists for improvement in the status of the loan. Past-due loans are continually evaluated with the determination for charge-off being made when no reasonable chance remains that the status of the loan can be improved.

Commercial and Industrial and Commercial Real Estate loans are charged off in whole or in part when they become sufficiently delinquent based upon the terms of the underlying loan contract and when a collateral deficiency exists. Because all or part of the contractual cash flows are not expected to be collected, the loan is considered to be impaired, and the Bank estimates the impairment based on its analysis of the cash flows or collateral estimated at fair value less cost to sell.

Residential Real Estate and Consumer loans are charged off when they become sufficiently delinquent based upon the terms of the underlying loan contract and when the value of the underlying collateral is not sufficient to support the loan balance and a loss is expected. At that time, the amount of estimated collateral deficiency, if any, is charged off for loans secured by collateral, and all other loans are charged off in full. Loans with collateral are charged down to the estimated fair value of the collateral less cost to sell.

Loans in which the borrower is in bankruptcy are considered on a case by case basis and are either charged off or reaffirmed by the borrower.

Generally, a loan is classified as non-accrual and the accrual of interest on such a loan is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan may currently be performing. A loan may remain on accrual status if it is well secured (or supported by a strong guarantee) and in the process of collection. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against interest income. Certain non-accrual loans may continue to perform; that is, payments are still being received. Generally, the payments are applied to principal. These loans remain under constant scrutiny, and if performance continues, interest income may be recorded on a cash basis based on management's judgment as to collectability of principal.

Allowance for Loan Losses

The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is maintained at a level estimated by management to be adequate to absorb potential loan losses. Management's periodic evaluation of the adequacy of the allowance for loan losses is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions, and other relevant factors. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are individually classified as impaired. Select loans are not aggregated for collective impairment evaluation, as such; all loans are subject to individual impairment evaluation should the facts and circumstances pertinent to a particular loan suggest that such evaluation is necessary. Factors considered by management in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. If a loan is impaired, a portion of the allowance may be allocated so that the loan is 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 is expected solely from collateral. Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan may be reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Corporation determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

The general component covers all other loans not identified as impaired and is based on historical losses and qualitative factors. The historical loss component of the allowance is determined by losses recognized by portfolio segment over a time period that management has determined represents the current credit cycle. Qualitative factors impacting each portfolio segment may include: delinquency trends, loan volume trends, Bank policy changes, management processes and oversight, economic trends (including change in consumer and business disposable incomes, unemployment and under-employment levels, and other conditions), concentrations by industry or product, internal and external loan review processes, collateral value and market conditions, and external factors including regulatory issues and competition.

The unallocated component of the allowance is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A reserve for unfunded lending commitments is provided for possible credit losses on off-balance sheet credit exposures. The reserve for unfunded lending commitments represents management's estimate of losses inherent in its unfunded loan commitments and, if necessary, is recorded in other liabilities on the Consolidated Balance Sheets. As of December 31, 2018 and 2017 the amount of the reserve for unfunded lending commitments was \$117,000 and \$116,000, respectively.

The Corporation is subject to periodic examination by its federal and state examiners, and may be required by such regulators to recognize additions to the allowance for loan losses based on their assessment of credit information available to them at the time of their examinations.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the original loan agreement. Under current accounting standards, the allowance for loan losses related to impaired loans is based on discounted cash flows using the loan's effective interest rate at inception or the fair value of the collateral for certain collateral dependent loans.

The restructuring of a loan is considered a "troubled debt restructuring" if both the following conditions are met: (i) the borrower is experiencing financial difficulties, and (ii) the Bank has granted a concession. The most common concessions granted include one or more modifications to the terms of the debt, such as (a) a reduction in the interest rate for the remaining life of the debt, (b) an extension of the maturity date at an interest rate lower than the current market rate for new debt with similar risk, (c) a temporary period of interest-only payments, and (d) a reduction in the contractual payment amount for either a short period or remaining term of the loan. A less common concession is the forgiveness of a portion of the principal.

The determination of whether a borrower is experiencing financial difficulties takes into account not only the current financial condition of the borrower, but also the potential financial condition of the borrower were a concession not granted. Similarly, the determination of whether a concession has been granted is very subjective in nature. For example, simply extending the term of a loan at its original interest rate or even at a higher interest rate could be interpreted as a concession unless the borrower could readily obtain similar credit terms from a different lender.

Loans modified in a troubled debt restructuring are considered impaired and may or may not be placed on non-accrual status until the Bank determines the future collection of principal and interest is reasonably assured, which generally requires that the borrower demonstrates a period of performance according to the restructured terms of six months.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

The Bank utilizes a risk grading matrix as a tool for managing credit risk in the loan portfolio and assigns an asset quality rating (risk grade) to all Commercial and Industrial, Commercial Real Estate, Residential Real Estate and Consumer borrowings. An asset quality rating is assigned using the guidance provided in the Bank's loan policy. Primary responsibility for assigning the asset quality rating rests with the lender. The asset quality rating is validated periodically by both an internal and external loan review process.

The commercial loan grading system focuses on a borrower's financial strength and performance, experience and depth of management, primary and secondary sources of repayment, the nature of the business and the outlook for the particular industry. Primary emphasis is placed on financial condition and trends. The grade also reflects current economic and industry conditions; as well as other variables such as liquidity, cash flow, revenue/earnings trends, management strengths or weaknesses, quality of financial information, and credit history.

The loan grading system for Residential Real Estate and Consumer loans focuses on the borrower's credit score and credit history, debt-to-income ratio and income sources, collateral position and loan-to-value ratio, as well as other variables such as current economic conditions, and individual strengths and weaknesses.

Risk grade characteristics are as follows:

Risk Grade 1 – MINIMAL RISK through Risk Grade 6 – MANAGEMENT ATTENTION (Pass Grade Categories)

Risk is evaluated via examination of several attributes including but not limited to financial trends, strengths and weaknesses, likelihood of repayment when considering both cash flow and collateral, sources of repayment, leverage position, management expertise, and repayment history.

At the low-risk end of the rating scale, a risk grade of 1 - Minimal Risk is the grade reserved for loans with exceptional credit fundamentals and virtually no risk of default or loss. Loan grades then progress through escalating ratings of 2 through 6 based upon risk. Risk Grade 2 - Modest Risk are loans with sufficient cash flows; Risk Grade 3 - Average Risk are loans with key balance sheet ratios slightly above the borrower's peers; Risk Grade 4 - Acceptable Risk are loans with key balance sheet ratios usually near the borrower's peers, but one or more ratios may be higher; and Risk Grade 5 – Marginally Acceptable are loans with strained cash flow, increasing leverage and/or weakening markets. Risk Grade 6 - Management Attention are loans with weaknesses resulting from declining performance trends and the borrower's cash flows may be temporarily strained. Loans in this category are performing according to terms, but present some type of potential concern.

Risk Grade 7 – SPECIAL MENTION (Non-Pass Category)

Generally, these loans or assets are currently protected, but are "potentially weak." They constitute an undue and unwarranted credit risk but not to the point of justifying a classification of substandard.

Assets in this category are currently protected but have potential weakness which may, if not checked or corrected, weaken the asset or inadequately protect the Bank's credit position at some future date. No loss of principal or interest is envisioned; however, they constitute an undue credit risk that may be minor but is unwarranted in light of the circumstances surrounding a specific asset. Risk is increasing beyond that at which the loan originally would have been granted. Historically, cash flows are inconsistent; financial trends show some deterioration. Liquidity and leverage are above industry averages. Financial information could be incomplete or inadequate. A Special Mention asset has potential weaknesses that deserve management's close attention.

Risk Grade 8 – SUBSTANDARD (Non-Pass Category)

Generally, these assets are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have "well-defined" weaknesses that jeopardize the full liquidation of the debt.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

These loans are characterized by the distinct possibility that the Bank will sustain some loss if the aggregate amount of substandard assets is not fully covered by the liquidation of the collateral used as security. Substandard loans have a high probability of payment default and require more intensive supervision by Bank management.

Risk Grade 9 – DOUBTFUL (Non-Pass Category)

Generally, loans graded doubtful have all the weaknesses inherent in a substandard loan with the added factor that the weaknesses are pronounced to a point whereby the basis of current information, conditions, and values, collection or liquidation in full is deemed to be highly improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to strengthen the asset, its classification is deferred until, for example, a proposed merger, acquisition, liquidation procedure, capital injection, perfection of liens on additional collateral and/or refinancing plan is completed. Loans are graded doubtful if they contain weaknesses so serious that collection or liquidation in full is questionable.

Premises and Equipment

Premises, improvements, and equipment are stated at cost less accumulated depreciation computed principally utilizing the straight-line method over the estimated useful lives of the assets. Long-lived assets are reviewed for impairment whenever events or changes in business circumstances indicate that the carrying value may not be recovered. Maintenance and minor repairs are charged to operations as incurred. The cost and accumulated depreciation of the premises and equipment retired or sold are eliminated from the property accounts at the time of retirement or sale, and the resulting gain or loss is reflected in current operations.

Mortgage Servicing Rights

The Corporation originates and sells real estate loans to investors in the secondary mortgage market. After the sale, the Corporation may retain the right to service these loans. The mortgage loans sold and serviced for others are not included in the Consolidated Balance Sheets. The unpaid principal balances of mortgage loans serviced for others were \$97,201,000 and \$100,179,000 at December 31, 2018 and 2017, respectively. When originated mortgage loans are sold and servicing is retained, a servicing asset is capitalized based on relative fair value at the date of the sale. Servicing assets are amortized as an offset to other fees in proportion to, and over the period of, estimated net servicing income. The servicing asset is included in other assets in the Consolidated Balance Sheets and amounted to \$316,000 at December 31, 2018 and \$379,000 at December 31, 2017. The amount of servicing income earned was \$247,000 and \$246,000 at December 31, 2018 and 2017, respectively. Amortization recognized in relation to mortgage servicing rights was \$129,000 and \$135,000 at December 31, 2018 and 2017, respectively. Both income and amortization are included in service charges and fees on the Consolidated Statements of Income. Gains or losses on sales of mortgage loans are recognized based on the differences between the selling price and the carrying value of the related mortgage loans sold.

Bank Owned Life Insurance

The cash surrender value of bank owned life insurance is carried as an asset, and changes in cash surrender value are recorded as non-interest income.

The Bank entered into agreements to provide post-retirement benefits to two retired employees in the form of life insurance payable to the employee's beneficiaries upon their death through endorsement split dollar life insurance arrangements. The Bank's accrued liabilities for this benefit agreement as of December 31, 2018 and 2017 was \$40,000 and \$41,000, respectively. The related expense for this benefit agreement amounted to \$(1,000) for the years ended December 31, 2018 and 2017.

Investments in Low-Income Housing Partnerships

The Bank is a limited partner in real estate ventures that own and operate affordable residential low-income housing apartment buildings for elderly and mentally challenged adult residents. The investments are accounted for under the cost method. Under the cost method, the Bank recognizes tax credits as they are allocated and amortizes the initial cost of the investment over the period that the tax credits are allocated to the Bank. The amount of tax credits allocated to the Bank were \$405,000 in 2018 and \$323,000 in 2017, and the amortization of the investments in the limited partnerships were \$530,000 and \$181,000 in 2018 and 2017, respectively. During 2015, the Bank became a limited partner in a real estate venture with an initial investment of \$590,000, and additional capital contributions of \$1,178,000 made in 2016 and \$252,000 made in 2017. The construction was completed and the property was occupied in 2017.

Goodwill and Core Deposit Intangibles

Goodwill resulted from the acquisition of the Pocono Community Bank in November 2007 and of certain fixed and operating assets acquired and deposit liabilities assumed of the branch of another financial institution in Danville, Pennsylvania, in January 2004. Such goodwill represents the excess cost of the acquired assets relative to the assets fair value at the dates of acquisition. During the first quarter of 2008, \$152,000 of liabilities related to the Pocono acquisition were recorded as a purchase accounting adjustment resulting in an increase in the excess purchase price. The amount was comprised of the finalization of severance agreements and contract terminations related to the acquisition. In accordance with current accounting standards, goodwill is not amortized. Management performs an annual evaluation for impairment. Any impairment of goodwill results in a charge to income. The Corporation periodically assesses whether events or changes in circumstances indicate that the carrying amounts of goodwill and other intangible assets may be impaired. Goodwill is evaluated for impairment at the reporting unit level and an impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. The Corporation has evaluated the goodwill included in its consolidated balance sheet at September 30, 2018, and has determined there was no impairment as of that date. In addition, the Corporation did not identify any impairment in 2017. No assurance can be given that future impairment tests will not result in a charge to earnings.

Intangible assets are comprised of core deposit intangibles and premium discount (negative premium) on certificates of deposit acquired. The core deposit intangible was being amortized over the average life of the deposits acquired as determined by an independent third party. Premium discount (negative premium) on acquired certificates of deposit resulted from the valuation of certificate of deposit accounts by an independent third party. The book value of certificates of deposit acquired was greater than their fair value at the date of acquisition which resulted in a negative premium due to higher cost of the certificates of deposit compared to the cost of similar term financing. The core deposit intangible was subject to impairment testing whenever events or changes in circumstances indicate its carrying amount may not reflect its benefit. As of June 30, 2015, the core deposit intangible was fully amortized.

Stock Based Compensation

The Corporation adopted a stock option incentive plan in 1998. Compensation cost is recognized for stock options to employees based on the fair value of these awards at the date of grant. A Black-Scholes Option Pricing Model is utilized to estimate the fair value of stock options. Compensation expense is recognized over the requisite service period. The Plan expired in 2008, and therefore, no stock options are available for issuance. After adjustments for the effects of stock dividends, options exercised and options forfeited, there are no exercisable options issued and outstanding as of December 31, 2018.

Foreclosed Assets Held for Resale

Real estate properties acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less costs to sell on the date of foreclosure establishing a new cost basis. After foreclosure, valuations are periodically performed and if fair value less costs to sell declines subsequent to foreclosure, a valuation allowance is recorded through expense. Revenues derived from and costs to maintain the assets and subsequent gains and losses on sales are included in non-interest expense on the Consolidated Statements of Income.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

Income Taxes

The Corporation accounts for income taxes in accordance with income tax accounting guidance FASB ASC Topic 740, *Income Taxes*.

Current income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Corporation determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are reduced by a valuation allowance if, based on the weight of the evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

The Corporation accounts for uncertain tax positions if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more-likely-than-not means a likelihood of more than 50%; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50% likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment.

The Corporation recognizes interest and penalties on income taxes, if any, as a component of income tax expense.

Earnings Per Share

Basic earnings per share ("EPS") is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Corporation. Potential common shares that may be issued by the Corporation relate solely to outstanding stock options and are determined using the treasury stock method. The following table sets forth the computation of basic and diluted earnings per share.

(In thousands, except earnings per share)

| | Year Ended December 31, | |
|---|-------------------------|----------------|
| | 2018 | 2017 |
| Net income | \$ 9,211 | \$ 8,648 |
| Weighted-average common shares outstanding | 5,737 | 5,689 |
| Basic earnings per share | \$ 1.60 | \$ 1.52 |
| Weighted-average common shares outstanding | 5,737 | 5,689 |
| Common stock equivalents due to effect of stock options | — | — |
| Total weighted-average common shares and equivalents | 5,737 | 5,689 |
| Diluted earnings per share | \$ 1.60 | \$ 1.52 |

Treasury Stock

The purchase of the Corporation's common stock is recorded at cost. At the date of subsequent reissue, the treasury stock account is reduced by the cost of such stock on a first-in-first-out basis.

Trust Assets and Revenues

Property held by the Corporation in a fiduciary or agency capacity for its customers is not included in the accompanying consolidated financial statements since such items are not assets of the Corporation. Assets held in Trust were \$105,917,000 and \$111,130,000 at December 31, 2018 and 2017, respectively. Trust Department income is generally recognized on a cash basis and is not materially different than if it were reported on an accrual basis.

Comprehensive Income (Loss)

The Corporation is required to present accumulated other comprehensive income (loss) in a full set of general-purpose financial statements for all periods presented. Accumulated other comprehensive income (loss) is comprised of net unrealized holding gains (losses) on the available-for-sale securities portfolio. The Corporation has elected to report these effects on the Consolidated Statements of Comprehensive Income.

Advertising Costs

It is the Corporation's policy to expense advertising costs in the period in which they are incurred.

Recent Accounting Standards Updates ("ASU") – Adopted:

Except as disclosed below, there were no new accounting pronouncements affecting the Corporation during the year ended December 31, 2018 that were not already adopted by the Corporation in previous periods.

On January 1, 2018, the Corporation adopted ASU 2014-09, *Revenue from Contracts with Customers*, and all subsequent amendments to the ASU (collectively "ASC 606"), which (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as OREO. The majority of the Corporation's revenue comes from interest income, including loans and securities, which are outside the scope of ASC 606. The Corporation's services that fall within the scope of ASC 606 are presented within other income on the consolidated statements of income and are recognized as revenue as the Corporation satisfies its obligation to the customer. Services within the scope of ASC 606 include deposit related fees and service charges, interchange fees and surcharges, and income from wealth management activities. ASC 606 did not result in a change to the accounting for any in-scope revenue streams; as such, no cumulative effect adjustment was recorded. New disclosures required by the ASU are included in Note 18, "Revenue Recognition".

On January 1, 2018, the Corporation adopted ASU 2016-01, *Financial Instruments-Overall (Topic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, which amended the guidance on the classification and measurement of financial instruments. Adoption of ASU 2016-01 resulted in: (1) separate classification of marketable equity securities previously included in investment securities available-for-sale on the consolidated balance sheets, (2) changes in the fair value of the equity securities being captured in the consolidated statements of income and (3) an increase in retained earnings and corresponding decrease in accumulated other comprehensive loss of \$634,000 at January 1, 2018 for the after-tax impact of the change in accounting for the unrealized gain on the equity securities. Adoption of the standard also resulted in the use of an exit price to determine the fair value of financial instruments not measured at fair value in the consolidated balance sheets. For more information about fair value disclosures, refer to Note 17, "Fair Value Measurements".

In August 2016, the Financial Accounting Standards Board ("FASB") issued ASU 2016-15 – *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force)*. ASU No. 2016-15 addresses eight cash flow issues with specific guidance on how certain cash receipts and cash payments should be presented on the statement of cash flows. ASU No. 2016-15 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2017. The adoption of ASU No. 2016-15 in 2018 had no material effect on the Corporation's cash flows.

In November 2016, the Financial Accounting Standards Board ("FASB") issued ASU No. 2016-18, *Statement of Cash Flows-Restricted Cash (Topic 230)*. The amendments in this Update clarify the inclusion of restricted cash in the cash and cash equivalents beginning-of-period and end-of-period reconciliation on the consolidated statement of cash flows. For public business entities that are SEC filers, such as the Corporation, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The implementation of this ASU in 2018 had no material effect on the Corporation's cash flows.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

In March 2017, the Financial Accounting Standards Board (“FASB”) issued ASU 2017-07, *Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. The amendments apply to all entities that offer employees defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under Topic 715, Compensation — Retirement Benefits. The amendments require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. The amendments also allow only the service cost component to be eligible for capitalization when applicable (e.g., as a cost of internally manufactured inventory or a self-constructed asset). The ASU is effective for public business entities for annual periods beginning after December 15, 2017, including interim periods within those annual periods. The adoption of this update in 2018 had no material impact on the Corporation’s consolidated financial position or results of operations.

In February 2018, the Financial Accounting Standards Board (“FASB”) issued ASU 2018-02, *Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income (“AOCI”)*. This ASU provides financial statement preparers with an option to reclassify stranded tax effects within AOCI to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (or portion thereof) are recorded. Effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. Organizations should apply the amendments either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. The Corporation elected to early adopt this standard update, effective January 1, 2018. Adoption resulted in a reclassification between retained earnings and accumulated other comprehensive loss of \$360,000 at January 1, 2018, which is included in the consolidated statements of changes in stockholders’ equity.

Pending ASUs:

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. ASU No. 2016-02 changes GAAP by requiring that lease assets and liabilities arising from operating leases be recognized on the balance sheet. In July 2018, the FASB issued ASU 2018-10 and ASU 2018-11, *Codification Improvements to Topic 842, Leases*, amending various aspects of Topic 842. Among other things, ASU 2018-11 provides for an optional transition method under which comparative periods presented in the financial statements will continue to be in accordance with Topic 840, *Leases*, and a practical expedient to not separate non-lease components from the associated lease component. Topic 842 would not significantly change the recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee from current U.S. GAAP. For leases with a term of 12 months or less, a lessee would be permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and liabilities. Topic 842 will become effective for the Corporation for annual and interim periods beginning in the first quarter 2019. The Corporation has elected to adopt this pronouncement using the optional transition method under ASU 2018-11 as of January 1, 2019. The Corporation estimates that the adoption will result in recognition of right-of-use assets and lease liabilities for operating leases of approximately \$1,465,000 and \$1,556,000, respectively, on its Consolidated Balance Sheets, with no expected adjustment to stockholders’ equity and no material impact to its consolidated statements of income.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. ASU No. 2016-13 requires financial assets measured at amortized cost to be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. ASU No. 2016-13 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2019. Early adoption is permitted for annual and interim periods beginning after December 15, 2018. While the Corporation is currently evaluating the provisions of ASU 2016-13 to determine the potential impact of the new standard will have on the Corporation’s Consolidated Financial Statements, it has taken steps to prepare for the implementation when it becomes effective, such as: forming an internal committee, gathering pertinent data, consulting with outside professionals, and subscribed to a new software system.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

In January 2017, the Financial Accounting Standards Board (“FASB”) issued ASU 2017-04, *Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The ASU simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Instead, under the amendments, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value with its carrying amount. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount when measuring the goodwill impairment loss, if applicable. The update also eliminated the requirements for zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. The amendments are effective for public business entities for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The adoption of this update is not expected to have a material impact on the Corporation’s consolidated financial position or results of operations.

In March 2017, the Financial Accounting Standards Board (“FASB”) issued ASU 2017-08, *Receivables- Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*. The ASU shortens the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The amendments are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Corporation does not expect this adoption to have a material impact on its consolidated financial statements and related disclosures.

In August 2018, The Financial Accounting Standards Board (“FASB”) issued ASU 2018-13, *Fair Value Measurement (Topic 820) – Disclosure Framework – Changes to Disclosure Requirements for Fair Value Measurement*. The amendments in this Update removed required disclosures regarding as follows: 1. The amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, 2. The policy for timing of transfers between levels, 3. The valuation processes for Level 3 fair value measurements, and 4. The Update modified the disclosure requirements on fair value measurements in Topic 820: 1. The changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period and 2. The range and weighted average significant unobservable inputs used to develop Level 3 fair value measurements. For certain unobservable inputs, an entity may disclose other quantitative information (such as the median or arithmetic average) in lieu of the weighted average if the entity determines that other quantitative information would be a more reasonable and rational method to reflect the distribution of unobservable inputs used to develop Level 3 fair value measurements. The amendments in this Update are effective for all entities for fiscal years, and interim periods within those fiscal years beginning after December 15, 2019. An entity is permitted to early adopt any removed or modified disclosures upon issuance of this Update and delay adoption of the additional disclosures until their effective date. The Corporation will be assessing the impact that this guidance will have on its consolidated financial statements and related disclosures.

Transfer of Financial Assets

Transfers of financial assets are accounted for as sales when control over assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Corporation, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit and letters of credit. Such financial instruments are recorded in the Consolidated Balance Sheets when they are funded.

Reclassifications

Certain amounts previously reported have been reclassified, when necessary, to conform with presentations used in the 2018 consolidated financial statements. Such reclassifications have no effect on the Corporation’s net income.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

NOTE 2 — RESTRICTED CASH BALANCES

The Bank is required to maintain certain average reserve balances as established by the Federal Reserve Bank. The amount of those reserve balances for the reserve computation period which included December 31, 2018 and 2017, was \$1,178,000 and \$1,402,000, respectively, which was satisfied through the restriction of vault cash. In addition, the Bank maintains a clearing balance at the Federal Reserve Bank to offset daily cash management activities and specific charges for services. At December 31, 2018 and 2017, the amount of this balance was \$1,118,000 and \$815,000, respectively.

NOTE 3 — SECURITIES

The amortized cost, related estimated fair value, and unrealized gains and losses for debt securities classified as “available-for-sale” were as follows at December 31, 2018 and 2017:

(Dollars in thousands)

| | Available-for-Sale Debt Securities | | | |
|---|------------------------------------|------------------------------|-------------------------------|-------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| December 31, 2018: | | | | |
| U.S. Treasury securities | \$ 5,307 | \$ — | \$ (12) | \$ 5,295 |
| Obligations of U.S. Government Corporations and Agencies: | | | | |
| Mortgage-backed | 66,300 | 105 | (1,529) | 64,876 |
| Other | 18,706 | 21 | (484) | 18,243 |
| Other mortgage backed securities | 4,767 | — | (18) | 4,749 |
| Obligations of state and political subdivisions | 182,621 | 1,678 | (2,021) | 182,278 |
| Asset backed securities | 14,323 | 47 | — | 14,370 |
| Corporate debt securities | 27,297 | 24 | (1,078) | 26,243 |
| Total | \$ 319,321 | \$ 1,875 | \$ (5,142) | \$ 316,054 |

(Dollars in thousands)

| | Available-for-Sale Debt Securities | | | |
|---|------------------------------------|------------------------------|-------------------------------|-------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| December 31, 2017: | | | | |
| U.S. Treasury securities | \$ — | \$ — | \$ — | \$ — |
| Obligations of U.S. Government Corporations and Agencies: | | | | |
| Mortgage-backed | 82,825 | 210 | (1,175) | 81,860 |
| Other | 22,409 | 132 | (308) | 22,233 |
| Other mortgage backed debt securities | — | — | — | — |
| Obligations of state and political subdivisions | 211,743 | 4,690 | (911) | 215,522 |
| Asset backed securities | — | — | — | — |
| Corporate debt securities | 29,645 | 90 | (764) | 28,971 |
| Total | \$ 346,622 | \$ 5,122 | \$ (3,158) | \$ 348,586 |

Available-for-sale debt securities with an aggregate fair value of \$149,993,000 at December 31, 2018 and \$290,104,000 at December 31, 2017, were pledged to secure public funds, trust funds, securities sold under agreements to repurchase, debtor in possession funds and the Federal Discount Window aggregating \$112,528,000 at December 31, 2018 and \$224,659,000 at December 31, 2017.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

The amortized cost and fair value of securities, by contractual maturity, are shown below at December 31, 2018. 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.

(Dollars in thousands)

| | Available for Sale | |
|-------------------------------|--------------------|-------------------|
| | Amortized | |
| | Cost | Fair Value |
| 1 year or less | \$ 4,268 | \$ 4,264 |
| Over 1 year through 5 years | 55,283 | 54,544 |
| Over 5 years through 10 years | 86,076 | 84,779 |
| Over 10 years | 102,627 | 102,842 |
| Mortgage-backed securities | 71,067 | 69,625 |
| Total | <u>\$ 319,321</u> | <u>\$ 316,054</u> |

There were no aggregate securities with a single issuer (excluding the U.S. Government and U.S. Government Agencies and Corporations) which exceeded ten percent of consolidated stockholders' equity at December 31, 2018. The quality rating of the obligations of state and political subdivisions are generally investment grade, as rated by Moody's, Standard and Poor's or Fitch. The typical exceptions are local issues which are not rated, but are secured by the full faith and credit obligations of the communities that issued these securities.

Proceeds from sales of investments in available-for-sale debt securities during 2018 and 2017 were \$44,122,000 and \$81,807,000, respectively. Gross gains realized on these sales were \$122,000 and \$1,024,000, respectively. Gross losses on these sales were \$115,000 and \$86,000, respectively. There were no impairment losses realized on available-for-sale debt securities during 2018 or 2017.

At December 31, 2018 and 2017, the Corporation had \$1,560,000 and \$1,632,000, respectively, in equity securities recorded at fair value. Prior to January 1, 2018, equity securities were stated at fair value with unrealized gains and losses reported as a separate component of accumulated other comprehensive income (AOCI), net of tax. At December 31, 2017, net unrealized gains, net of tax, of \$634,000 had been recognized in AOCI. On January 1, 2018, these unrealized gains and losses were reclassified out of AOCI and into retained earnings with subsequent changes in fair value being recognized in net income. The following is a summary of unrealized and realized gains and losses recognized in net income on equity securities during 2018:

(Dollars in thousands)

| | December 31, 2018 |
|---|-------------------|
| Net losses recognized during the period on equity securities | \$ (72) |
| Net gains and (losses) recognized during the period on equity securities sold during the period | — |
| Net losses recognized during the reporting period on equity securities still held at the reporting date | <u>\$ (72)</u> |

The Corporation and its investment advisors monitor the entire portfolio at least quarterly with particular attention given to securities in a continuous loss position of at least ten percent for over twelve months. Based on the factors described above, management did not consider any securities to be other-than-temporarily impaired at December 31, 2018 and 2017.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

In accordance with disclosures required by FASB ASC 320-10-50, *Investments - Debt and Equity Securities*, the summary below shows the gross unrealized losses and fair value of the Corporation's debt securities, aggregated by investment category, of which individual securities have been in a continuous unrealized loss position for less than 12 months or 12 months or more as of December 31, 2018 and 2017:

December 31, 2018

(Dollars in thousands)

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|-----------------|-------------------|-------------------|-------------------|-------------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Available-for-Sale: | | | | | | |
| U.S. Treasury securities | \$ 5,295 | \$ (12) | \$ — | \$ — | \$ 5,295 | \$ (12) |
| Obligations of U.S. Government Corporations and Agencies: | | | | | | |
| Mortgage-backed | 3,690 | (17) | 55,443 | (1,512) | 59,133 | (1,529) |
| Other | 7,553 | (66) | 7,067 | (418) | 14,620 | (484) |
| Other mortgage backed debt securities | 4,749 | (18) | — | — | 4,749 | (18) |
| Obligations of state and political subdivisions | 14,453 | (75) | 66,583 | (1,946) | 81,036 | (2,021) |
| Asset backed securities | — | — | — | — | — | — |
| Corporate debt securities | 1,823 | (29) | 19,477 | (1,049) | 21,300 | (1,078) |
| Total | \$ 37,563 | \$ (217) | \$ 148,570 | \$ (4,925) | \$ 186,133 | \$ (5,142) |

December 31, 2017

(Dollars in thousands)

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|-----------------|-------------------|-------------------|-------------------|-------------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Available-for-Sale: | | | | | | |
| U.S. Treasury securities | \$ — | \$ — | \$ — | \$ — | \$ — | \$ — |
| Obligations of U.S. Government Corporations and Agencies: | | | | | | |
| Mortgage-backed | 30,555 | (300) | 33,943 | (875) | 64,498 | (1,175) |
| Other | 2,905 | (4) | 7,179 | (304) | 10,084 | (308) |
| Other mortgage backed securities | — | — | — | — | — | — |
| Obligations of state and political subdivisions | 36,149 | (329) | 22,566 | (582) | 58,715 | (911) |
| Asset backed securities | — | — | — | — | — | — |
| Corporate debt securities | 6,746 | (24) | 15,174 | (740) | 21,920 | (764) |
| Total | \$ 76,355 | \$ (657) | \$ 78,862 | \$ (2,501) | \$ 155,217 | \$ (3,158) |

The Corporation invests in various forms of agency debt including mortgage backed securities and callable debt. The mortgage backed securities are issued by FHLMC ("Federal Home Loan Mortgage Corporation"), FNMA ("Federal National Mortgage Association") or GNMA ("Government National Mortgage Association"). The municipal securities consist of general obligations and revenue bonds. The fair market value of the above securities is influenced by market interest rates, prepayment speeds on mortgage securities, bid-offer spreads in the market place and credit premiums for various types of agency debt. These factors change continuously and therefore the market value of these securities may be higher or lower than the Corporation's carrying value at any measurement date. Management does not believe any of their 27 debt securities with a less than one year unrealized loss position, or any of their 103 debt securities with a one year or greater unrealized loss position, as of December 31, 2018, represent an other-than-temporary impairment, as these unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

NOTE 4 — LOANS AND ALLOWANCE FOR LOAN LOSSES

The following table presents the classes of the loan portfolio summarized by risk rating as of December 31, 2018 and 2017:

| <i>(Dollars in thousands)</i> | Commercial and Industrial | | Commercial Real Estate | |
|-------------------------------------|---------------------------|------------------|------------------------|-------------------|
| | 2018 | 2017 | 2018 | 2017 |
| Grade: | | | | |
| 1-6 Pass | \$ 90,835 | \$ 97,832 | \$ 329,126 | \$ 276,682 |
| 7 Special Mention | 6 | 10 | 5,249 | 1,514 |
| 8 Substandard | 1,219 | 1,334 | 13,403 | 12,210 |
| 9 Doubtful | — | — | — | — |
| Add (deduct): Unearned discount and | — | — | — | — |
| Net deferred loan fees and costs | 160 | 161 | 698 | 564 |
| Total loans | <u>\$ 92,220</u> | <u>\$ 99,337</u> | <u>\$ 348,476</u> | <u>\$ 290,970</u> |

| | Residential Real Estate Including Home Equity | | Consumer Loans | |
|-------------------------------------|---|-------------------|-----------------|-----------------|
| | 2018 | 2017 | 2018 | 2017 |
| Grade: | | | | |
| 1-6 Pass | \$ 158,755 | \$ 161,405 | \$ 5,854 | \$ 5,997 |
| 7 Special Mention | 121 | 124 | 1 | 52 |
| 8 Substandard | 941 | 1,444 | 9 | 24 |
| 9 Doubtful | — | — | — | — |
| Add (deduct): Unearned discount and | — | (1) | — | — |
| Net deferred loan fees and costs | (76) | (47) | 91 | 92 |
| Total loans | <u>\$ 159,741</u> | <u>\$ 162,925</u> | <u>\$ 5,955</u> | <u>\$ 6,165</u> |

| | Total Loans | |
|-------------------------------------|-------------------|-------------------|
| | 2018 | 2017 |
| Grade: | | |
| 1-6 Pass | \$ 584,570 | \$ 541,916 |
| 7 Special Mention | 5,377 | 1,700 |
| 8 Substandard | 15,572 | 15,012 |
| 9 Doubtful | — | — |
| Add (deduct): Unearned discount and | — | (1) |
| Net deferred loan fees and costs | 873 | 770 |
| Total loans | <u>\$ 606,392</u> | <u>\$ 559,397</u> |

Commercial and Industrial and Commercial Real Estate include loans categorized as tax-free in the amounts of \$24,161,000 and \$2,164,000 at December 31, 2018 and \$40,926,000 and \$2,315,000 at December 31, 2017. Loans held for sale amounted to \$365,000 at December 31, 2018 and \$834,000 at December 31, 2017.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

The activity in the allowance for loan losses, by loan class, is summarized below for the years indicated.

| <i>(Dollars in thousands)</i> | Commercial and Industrial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
|--|------------------------------|---------------------------|----------------------------|-----------------|---------------|-------------------|
| 2018 | | | | | | |
| Allowance for Loan Losses: | | | | | | |
| Beginning balance | \$ 949 | \$ 4,067 | \$ 1,656 | \$ 111 | \$ 704 | \$ 7,487 |
| Charge-offs | (18) | (783) | (181) | (57) | — | (1,039) |
| Recoveries | 31 | 60 | — | 6 | — | 97 |
| Provision | (238) | 356 | 175 | 57 | (150) | 200 |
| Ending Balance | <u>\$ 724</u> | <u>\$ 3,700</u> | <u>\$ 1,650</u> | <u>\$ 117</u> | <u>\$ 554</u> | <u>\$ 6,745</u> |
| Ending balance: individually evaluated for impairment | <u>\$ —</u> | <u>\$ 1</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 1</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 724</u> | <u>\$ 3,699</u> | <u>\$ 1,650</u> | <u>\$ 117</u> | <u>\$ 554</u> | <u>\$ 6,744</u> |
| Loans Receivable: | | | | | | |
| Ending Balance | <u>\$ 92,220</u> | <u>\$ 348,476</u> | <u>\$ 159,741</u> | <u>\$ 5,955</u> | <u>\$ —</u> | <u>\$ 606,392</u> |
| Ending balance: individually evaluated for impairment | <u>\$ 1,126</u> | <u>\$ 15,890</u> | <u>\$ 577</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 17,593</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 91,094</u> | <u>\$ 332,586</u> | <u>\$ 159,164</u> | <u>\$ 5,955</u> | <u>\$ —</u> | <u>\$ 588,799</u> |
| <i>(Dollars in thousands)</i> | | | | | | |
| 2017 | | | | | | |
| Allowance for Loan Losses: | | | | | | |
| Beginning balance | \$ 836 | \$ 4,421 | \$ 1,777 | \$ 95 | \$ 228 | \$ 7,357 |
| Charge-offs | — | (189) | (62) | (82) | — | (333) |
| Recoveries | 74 | 103 | 9 | 10 | — | 196 |
| Provision | 39 | (268) | (68) | 88 | 476 | 267 |
| Ending Balance | <u>\$ 949</u> | <u>\$ 4,067</u> | <u>\$ 1,656</u> | <u>\$ 111</u> | <u>\$ 704</u> | <u>\$ 7,487</u> |
| Ending balance: individually evaluated for impairment | <u>\$ —</u> | <u>\$ 305</u> | <u>\$ 22</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 327</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 949</u> | <u>\$ 3,762</u> | <u>\$ 1,634</u> | <u>\$ 111</u> | <u>\$ 704</u> | <u>\$ 7,160</u> |
| Loans Receivable: | | | | | | |
| Ending Balance | <u>\$ 99,337</u> | <u>\$ 290,970</u> | <u>\$ 162,925</u> | <u>\$ 6,165</u> | <u>\$ —</u> | <u>\$ 559,397</u> |
| Ending balance: individually evaluated for impairment | <u>\$ 1,203</u> | <u>\$ 11,673</u> | <u>\$ 1,050</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 13,926</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 98,134</u> | <u>\$ 279,297</u> | <u>\$ 161,875</u> | <u>\$ 6,165</u> | <u>\$ —</u> | <u>\$ 545,471</u> |

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

Of the \$1,163,000 in foreclosed assets held for resale at December 31, 2018, \$268,000 was secured by residential real estate, \$39,000 was secured by land, and \$856,000 was secured by commercial real estate. All foreclosed assets were held as the result of obtaining physical possession. Of the \$1,071,000 in foreclosed assets held for resale at December 31, 2017, \$15,000 was secured by residential real estate, \$50,000 was secured by land, and \$1,006,000 was secured by commercial real estate. Consumer mortgage loans secured by residential real estate for which the Bank has entered into formal foreclosure proceedings but for which physical possession of the property has yet to be obtained amounted to \$718,000 at December 31, 2018 and \$485,000 at December 31, 2017. These balances were not included in foreclosed assets held for resale at December 31, 2018 and 2017.

From time to time, the Bank may agree to modify the contractual terms of a borrower's loan. In cases where the modifications represent a concession to a borrower experiencing financial difficulty, the modification is considered a troubled debt restructuring ("TDR").

The outstanding recorded investment of loans categorized as TDRs as of December 31, 2018 and December 31, 2017 was \$13,777,000 and \$9,109,000, respectively. The increase in TDRs at December 31, 2018 is mainly attributable to a loan in the amount of \$4,296,000 to a real estate developer specializing in commercial office space that was modified as a TDR during the fourth quarter of 2018 to extend the maturity date of the loan. There were no unfunded commitments on TDRs at December 31, 2018 and 2017.

For the year ended December 31, 2018, twelve loans with a combined post modification balance of \$5,627,000 were classified as TDRs, as compared to the year ended December 31, 2017 when four loans with a combined post modification balance of \$1,170,000 were classified as TDRs. The loan modifications for the year ended December 31, 2018 consisted of one interest rate modification, three term modifications beyond the original stated term and eight payment modifications. The loan modifications for the year ended December 31, 2017 consisted of one term modification beyond the original stated term and three payment modifications.

The following table presents the outstanding recorded investment of TDRs at the dates indicated:

(Dollars in thousands)

| | December 31, 2018 | December 31, 2017 |
|------------------|------------------------------|----------------------|
| Non-accrual TDRs | \$ 80 | \$ 273 |
| Accruing TDRs | 13,697 | 8,836 |
| Total | <u>\$ 13,777</u> | <u>\$ 9,109</u> |

At December 31, 2018, nine Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$499,000 and one Commercial and Industrial loan classified as a TDR with a recorded investment of \$6,000 were not in compliance with the terms of their restructure, compared to December 31, 2017 when six Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$340,000 and one Residential Real Estate loan classified as a TDR with a recorded investment of \$60,000 were not in compliance with the terms of their restructure.

During the year ended December 31, 2018, five Commercial Real Estate loans totaling \$163,000 that were modified as TDRs within the twelve months preceding December 31, 2018 had experienced payment defaults, as compared to the year ended December 31, 2017 when no loans that were modified as TDRs within the twelve months preceding December 31, 2017 had experienced payment defaults.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

The following table presents information regarding the loan modifications categorized as TDRs during the years ended December 31, 2018 and 2017.

(Dollars in thousands)

| | Year Ended December 31, 2018 | | | |
|---------------------------|------------------------------|------------------------------------|------------------------------------|------------------------|
| | Number of Contracts | Pre-Modification | Post-Modification | Year-End |
| | | Outstanding Recorded Investment | Outstanding Recorded Investment | Recorded Investment |
| Commercial and Industrial | 3 | \$ 751 | \$ 751 | \$ 771 |
| Commercial Real Estate | 8 | 4,833 | 4,850 | 4,688 |
| Residential Real Estate | 1 | 26 | 26 | 25 |
| Total | <u>12</u> | <u>\$ 5,610</u> | <u>\$ 5,627</u> | <u>\$ 5,484</u> |

(Dollars in thousands)

| | Year Ended December 31, 2017 | | | |
|---------------------------|------------------------------|------------------------------------|------------------------------------|------------------------|
| | Number of Contracts | Pre-Modification | Post-Modification | Year-End |
| | | Outstanding Recorded Investment | Outstanding Recorded Investment | Recorded Investment |
| Commercial and Industrial | 1 | \$ 38 | \$ 38 | \$ 36 |
| Commercial Real Estate | 2 | 1,064 | 1,072 | 1,069 |
| Residential Real Estate | 1 | 32 | 60 | 60 |
| Total | <u>4</u> | <u>\$ 1,134</u> | <u>\$ 1,170</u> | <u>\$ 1,165</u> |

The following table provides detail regarding the types of loan modifications made for loans categorized as TDRs during the years ended December 31, 2018 and 2017 with the total number of each type of modification performed.

| | Year Ended December 31, 2018 | | | | Year Ended December 31, 2017 | | | |
|---------------------------|------------------------------|----------------------|-------------------------|--------------------|------------------------------|----------------------|-------------------------|--------------------|
| | Rate Modification | Term Modification | Payment Modification | Number Modified | Rate Modification | Term Modification | Payment Modification | Number Modified |
| Commercial and Industrial | — | — | 3 | 3 | — | — | 1 | 1 |
| Commercial Real Estate | 1 | 2 | 5 | 8 | — | 1 | 1 | 2 |
| Residential Real Estate | — | 1 | — | 1 | — | — | 1 | 1 |
| Total | <u>1</u> | <u>3</u> | <u>8</u> | <u>12</u> | <u>—</u> | <u>1</u> | <u>3</u> | <u>4</u> |

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

The recorded investment, unpaid principal balance, and the related allowance of the Corporation's impaired loans are summarized below for the periods ended December 31, 2018 and 2017.

(Dollars in thousands)

| | December 31, 2018 | | | December 31, 2017 | | |
|-------------------------------------|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| With no related allowance recorded: | | | | | | |
| Commercial and Industrial | \$ 1,126 | \$ 1,126 | \$ — | \$ 1,203 | \$ 1,203 | \$ — |
| Commercial Real Estate | 15,807 | 20,107 | — | 9,199 | 11,383 | — |
| Residential Real Estate | 577 | 619 | — | 878 | 1,024 | — |
| With an allowance recorded: | | | | | | |
| Commercial and Industrial | — | — | — | — | — | — |
| Commercial Real Estate | 83 | 83 | 1 | 2,474 | 3,889 | 305 |
| Residential Real Estate | — | — | — | 172 | 172 | 22 |
| Total | <u>\$ 17,593</u> | <u>\$ 21,935</u> | <u>\$ 1</u> | <u>\$ 13,926</u> | <u>\$ 17,671</u> | <u>\$ 327</u> |
| Total consists of: | | | | | | |
| Commercial and Industrial | <u>\$ 1,126</u> | <u>\$ 1,126</u> | <u>\$ —</u> | <u>\$ 1,203</u> | <u>\$ 1,203</u> | <u>\$ —</u> |
| Commercial Real Estate | <u>\$ 15,890</u> | <u>\$ 20,190</u> | <u>\$ 1</u> | <u>\$ 11,673</u> | <u>\$ 15,272</u> | <u>\$ 305</u> |
| Residential Real Estate | <u>\$ 577</u> | <u>\$ 619</u> | <u>\$ —</u> | <u>\$ 1,050</u> | <u>\$ 1,196</u> | <u>\$ 22</u> |

At December 31, 2018 and 2017, \$13,777,000 and \$9,109,000 of loans classified as TDRs were included in impaired loans with a total allocated allowance of \$1,000 and \$2,000, respectively. The recorded investment represents the loan balance reflected on the Consolidated Balance Sheets net of any charge-offs. The unpaid balance is equal to the gross amount due on the loan.

The average recorded investment and interest income recognized for the Corporation's impaired loans are summarized below for the years ended December 31, 2018 and 2017.

(Dollars in thousands)

| | For the Year Ended December 31, 2018 | | For the Year Ended December 31, 2017 | |
|-------------------------------------|---|----------------------------|---|----------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded: | | | | |
| Commercial and Industrial | \$ 1,157 | \$ 53 | \$ 1,032 | \$ 25 |
| Commercial Real Estate | 11,575 | 623 | 11,140 | 485 |
| Residential Real Estate | 794 | 11 | 789 | 7 |
| With an allowance recorded: | | | | |
| Commercial and Industrial | — | — | — | — |
| Commercial Real Estate | 662 | 3 | 1,630 | 4 |
| Residential Real Estate | 138 | — | 215 | — |
| Total | <u>\$ 14,326</u> | <u>\$ 690</u> | <u>\$ 14,806</u> | <u>\$ 521</u> |
| Total consists of: | | | | |
| Commercial and Industrial | <u>\$ 1,157</u> | <u>\$ 53</u> | <u>\$ 1,032</u> | <u>\$ 25</u> |
| Commercial Real Estate | <u>\$ 12,237</u> | <u>\$ 626</u> | <u>\$ 12,770</u> | <u>\$ 489</u> |
| Residential Real Estate | <u>\$ 932</u> | <u>\$ 11</u> | <u>\$ 1,004</u> | <u>\$ 7</u> |

Of the \$690,000 and \$521,000 in interest income recognized on impaired loans for the years ended December 31, 2018 and 2017, respectively, \$9,000 and \$20,000 was recognized with respect to non-accrual loans.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

Total non-performing assets (which includes loans receivable on non-accrual status, foreclosed assets held for resale and loans past-due 90 days or more and still accruing interest) as of December 31, 2018 and 2017 were as follows:

(Dollars in thousands)

| | December 31, 2018 | December 31, 2017 |
|--|------------------------------|----------------------|
| Commercial and Industrial | \$ — | \$ 798 |
| Commercial Real Estate | 3,402 | 3,302 |
| Residential Real Estate | 494 | 990 |
| Total non-accrual loans | 3,896 | 5,090 |
| Foreclosed assets held for resale | 1,163 | 1,071 |
| Loans past-due 90 days or more and still accruing interest | 228 | 70 |
| Total non-performing assets | \$ 5,287 | \$ 6,231 |

If interest on non-accrual loans had been accrued at original contract rates, interest income would have increased by \$784,000 in 2018 and \$328,000 in 2017.

The following tables present the classes of the loan portfolio summarized by the past-due status at December 31, 2018 and 2017:

(Dollars in thousands)

| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or Greater Past Due | Total Past Due | Current | Total Loans | 90 Days Or Greater Past Due and Still Accruing Interest |
|---------------------------|--------------------------------|--------------------------------|--|---------------------------|-------------------|------------------------|--|
| December 31, 2018: | | | | | | | |
| Commercial and Industrial | \$ 16 | \$ 30 | \$ — | \$ 46 | \$ 92,174 | \$ 92,220 | \$ — |
| Commercial Real Estate | 1,990 | 630 | 3,477 | 6,097 | 342,379 | 348,476 | 145 |
| Residential Real Estate | 1,519 | 228 | 456 | 2,203 | 157,538 | 159,741 | 83 |
| Consumer | 12 | — | — | 12 | 5,943 | 5,955 | — |
| Total | <u>\$ 3,537</u> | <u>\$ 888</u> | <u>\$ 3,933</u> | <u>\$ 8,358</u> | <u>\$ 598,034</u> | <u>\$ 606,392</u> | <u>\$ 228</u> |

(Dollars in thousands)

| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or Greater Past Due | Total Past Due | Current | Total Loans | 90 Days Or Greater Past Due and Still Accruing Interest |
|---------------------------|--------------------------------|--------------------------------|--|---------------------------|-------------------|------------------------|--|
| December 31, 2017: | | | | | | | |
| Commercial and Industrial | \$ 68 | \$ 42 | \$ — | \$ 110 | \$ 99,227 | \$ 99,337 | \$ — |
| Commercial Real Estate | 603 | 201 | 2,606 | 3,410 | 287,560 | 290,970 | 50 |
| Residential Real Estate | 1,952 | 484 | 584 | 3,020 | 159,905 | 162,925 | 20 |
| Consumer | 21 | 2 | — | 23 | 6,142 | 6,165 | — |
| Total | <u>\$ 2,644</u> | <u>\$ 729</u> | <u>\$ 3,190</u> | <u>\$ 6,563</u> | <u>\$ 552,834</u> | <u>\$ 559,397</u> | <u>\$ 70</u> |

At December 31, 2018, commitments to lend additional funds with respect to impaired loans consisted of one irrevocable letter of credit in the amount of \$1,249,000 that was associated with a loan to a developer of a residential sub-division. At December 31, 2017, commitments to lend additional funds with respect to impaired loans consisted of three irrevocable letters of credit totaling \$1,268,000. One irrevocable letter of credit in the amount of \$1,249,000 was associated with a loan to a developer of a residential sub-division. Two irrevocable letters of credit totaling \$19,000 were associated with a loan to a non-profit community recreation facility.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

NOTE 5 — PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2018 and 2017 is as follows:

(Dollars in thousands)

| | Estimated Useful Life (in years) | 2018 | 2017 |
|--------------------------------|--|------------------|------------------|
| Land | N/A | \$ 3,744 | \$ 3,744 |
| Buildings | 5-40 | 20,639 | 20,562 |
| Leasehold improvements | 3-20 | 174 | 147 |
| Equipment | 3-25 | 8,283 | 8,331 |
| | | <u>32,840</u> | <u>32,784</u> |
| Less: Accumulated depreciation | | 12,894 | 12,161 |
| Total | | <u>\$ 19,946</u> | <u>\$ 20,623</u> |

Depreciation amounted to \$1,141,000 for 2018 and \$1,197,000 for 2017.

The banking subsidiary previously leased land and a bank building in Stroudsburg, Pennsylvania, under a lease that expired in the fourth quarter of 2017. At the time of lease expiration, the land and bank building were purchased for a total cost of \$2,384,000.

NOTE 6 — DEPOSITS

Major classifications of deposits at December 31, 2018 and 2017 consisted of:

(Dollars in thousands)

| | 2018 | 2017 |
|--|-------------------|-------------------|
| Non-interest bearing demand | \$ 126,361 | \$ 121,415 |
| Interest bearing demand | 180,328 | 265,379 |
| Savings | 167,572 | 183,724 |
| Time certificates of deposits less than \$250,000 | 172,550 | 171,556 |
| Time certificates of deposits \$250,000 or greater | 23,597 | 34,933 |
| Other time | 1,145 | 1,139 |
| Total deposits | <u>\$ 671,553</u> | <u>\$ 778,146</u> |

The following is a schedule reflecting classification and remaining maturities of time deposits at December 31, 2018:

(Dollars in thousands)

| Year Ending | |
|-------------|-------------------|
| 2019 | \$ 96,639 |
| 2020 | 41,642 |
| 2021 | 33,030 |
| 2022 | 18,822 |
| 2023 | 6,684 |
| Thereafter | 475 |
| | <u>\$ 197,292</u> |

At December 31, 2018, the largest two depositors had aggregate deposits of approximately \$43,107,000 as follows:

(Dollars in thousands)

| | |
|-----------------|------------------|
| School district | \$ 22,457 |
| School district | 20,650 |
| Total | <u>\$ 43,107</u> |

NOTE 7 — SHORT-TERM BORROWINGS

Short-term borrowings include federal funds purchased, securities sold under agreements to repurchase, Federal Discount Window, and Federal Home Loan Bank (“FHLB”) advances, which generally represent overnight or less than 30-day borrowings.

Short-term borrowings and weighted-average interest rates at and for the years ended December 31, 2018 and 2017 are as follows:

(Dollars in thousands)

| | 2018 | | 2017 | |
|--|-------------------|--------------|------------------|--------------|
| | Amount | Average Rate | Amount | Average Rate |
| Federal funds purchased | \$ — | 2.19% | \$ — | 1.82% |
| Securities sold under agreements to repurchase | 12,957 | 0.56% | 22,844 | 0.41% |
| Federal Discount Window | — | 2.19% | — | 1.71% |
| Federal Home Loan Bank | 161,488 | 2.28% | 3,452 | 1.16% |
| | <u>\$ 174,445</u> | <u>2.04%</u> | <u>\$ 26,296</u> | <u>0.97%</u> |

At December 31, 2018, the maximum borrowing capacity of federal funds purchased and the Federal Discount Window was \$15,000,000 and \$4,741,000, respectively. Please refer to Note 8 — Long-Term Borrowings for the Corporation’s maximum borrowing capacity at FHLB.

Securities Sold Under Agreements to Repurchase (“Repurchase Agreements”)

The Corporation enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, the Corporation may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Corporation to repurchase the assets.

As a result, these repurchase agreements are accounted for as collateralized financing agreements (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability on the Corporation’s Consolidated Balance Sheets, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. In other words, there is not offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Corporation does not enter into reverse repurchase agreements, there is no such offsetting to be done with the repurchase agreements.

The right of setoff for a repurchase agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the repurchase agreement should the Corporation be in default (e.g., fails to make an interest payment to the counterparty). The collateral is held by a correspondent bank in the counterparty’s custodial account. The counterparty has the right to sell or repledge the investment securities.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

The following table presents the short-term borrowings subject to an enforceable master netting arrangement or repurchase agreements as of December 31, 2018 and 2017.

(Dollars in thousands)

| | Gross Amounts of Recognized Liabilities | Gross Amounts Offset in the Consolidated Balance Sheet | Net Amounts of Liabilities Presented in the Consolidated Balance Sheet | Financial Instruments | Cash Collateral Pledge | Net Amount |
|---------------------------|--|--|--|--------------------------|------------------------------|---------------|
| December 31, 2018 | | | | | | |
| Repurchase agreements (a) | \$ 12,957 | \$ — | \$ 12,957 | \$ (12,957) | \$ — | \$ — |
| December 31, 2017 | | | | | | |
| Repurchase agreements (a) | \$ 22,844 | \$ — | \$ 22,844 | \$ (22,844) | \$ — | \$ — |

(a) As of December 31, 2018 and 2017, the fair value of securities pledged in connection with repurchase agreements was \$16,970,000 and \$26,023,000, respectively.

The following table presents the remaining contractual maturity of the master netting arrangement or repurchase agreements as of December 31, 2018.

(Dollars in thousands)

| | Remaining Contractual Maturity of the Agreements | | | | Total |
|--|--|------------------|----------------|----------------------------|-----------|
| | Overnight and Continuous | Up to 30 days | 30 -90 Days | Greater than 90 Days | |
| Repurchase agreements and repurchase-to-maturity transactions: | | | | | |
| U.S. Treasury and/or agency securities | \$ 12,957 | \$ — | \$ — | \$ — | \$ 12,957 |
| Total | \$ 12,957 | \$ — | \$ — | \$ — | \$ 12,957 |

NOTE 8 — LONG-TERM BORROWINGS

Long-term borrowings are comprised of advances from FHLB. Under terms of a blanket agreement, collateral for the FHLB loans is certain qualifying assets of the Corporation's banking subsidiary. The qualifying assets are real estate mortgages and certain investment securities.

A schedule of long-term borrowings by maturity as of December 31, 2018 and 2017 follows:

(Dollars in thousands)

| | 2018 | 2017 |
|--------------------------|-----------|-----------|
| Due 2018, 1.27% to 4.86% | \$ — | \$ 23,000 |
| Due 2019, 1.79% to 2.11% | 20,000 | 20,000 |
| Due 2020, 1.62% to 1.95% | 10,000 | 10,000 |
| Due 2021, 1.42% to 1.58% | 10,000 | 10,000 |
| Due 2023, 2.96% | 3,000 | — |
| Due 2028, 5.14% | 2,000 | 2,000 |
| | \$ 45,000 | \$ 65,000 |

The Corporation's long-term borrowings consist of notes at fixed interest rates. Upon any default, under the terms of a master agreement, FHLB may declare all indebtedness of the Corporation immediately due. In addition, FHLB shall not be required to fund advances under any outstanding commitments. At December 31, 2018, the Corporation's maximum borrowing capacity at FHLB, which takes into account FHLB long-term notes and FHLB short-term borrowings, was \$313,923,000.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

NOTE 9 — INCOME TAXES

The current and deferred components of the income tax expense consisted of the following:

(Dollars in thousands)

| | <u>2018</u> | <u>2017</u> |
|--------------------|---------------|-----------------|
| Federal | | |
| Current | \$ (107) | \$ 1,309 |
| Deferred | 566 | 146 |
| Income tax expense | <u>\$ 459</u> | <u>\$ 1,455</u> |

The following is a reconciliation between the income tax expense and the amount of income taxes which would have been provided at the statutory rate of 21% in 2018 and 34% in 2017:

(Dollars in thousands)

| | <u>2018</u> | | <u>2017</u> | |
|--------------------------------------|---------------|-------------|-----------------|--------------|
| | <u>Amount</u> | <u>Rate</u> | <u>Amount</u> | <u>Rate</u> |
| Federal income tax at statutory rate | \$ 2,031 | 21.0% | \$ 3,435 | 34.0% |
| Tax-exempt income | (1,043) | (10.8) | (1,897) | (18.8) |
| Low-income housing credits | (405) | (4.2) | (323) | (3.2) |
| Bank owned life insurance income | (128) | (1.3) | (216) | (2.1) |
| Effect of tax rate change | — | — | 379 | 3.8 |
| Other | 4 | — | 77 | 0.7 |
| Income tax expense and rate | <u>\$ 459</u> | <u>4.7%</u> | <u>\$ 1,455</u> | <u>14.4%</u> |

The components of the net deferred tax asset at December 31, 2018 and 2017 are as follows:

(Dollars in thousands)

| | <u>2018</u> | <u>2017</u> |
|---|-----------------|---------------|
| Deferred Tax Assets: | | |
| Allowance for loan losses | \$ 1,417 | \$ 1,572 |
| Provision for unfunded commitments | 25 | 24 |
| Deferred compensation | 241 | 316 |
| Contributions | 1 | 8 |
| Leases | 53 | 66 |
| Limited partnership investments | 66 | 57 |
| Alternative minimum tax credits | 7 | 379 |
| Net unrealized investment securities losses | 449 | — |
| Impairment loss on investment securities | 4 | 4 |
| Writedowns on OREO properties | 34 | 5 |
| Capital and net operating loss carry forwards | — | 25 |
| Total | <u>2,297</u> | <u>2,456</u> |
| Deferred Tax Liabilities: | | |
| Net unrealized investment securities gains | — | 670 |
| Loan fees and costs | 183 | 162 |
| Accumulated depreciation | 311 | 332 |
| Accretion | 35 | 77 |
| Mortgage servicing rights | 42 | 38 |
| Intangibles | 257 | 241 |
| Total | <u>828</u> | <u>1,520</u> |
| Net Deferred Tax Asset | <u>\$ 1,469</u> | <u>\$ 936</u> |

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

A valuation allowance for deferred tax assets was recorded at December 31, 2018 and 2017 in the amount of \$70,000 and \$16,000, respectively. The valuation allowance relates to state net operating loss carryforwards for which realizability is uncertain. At December 31, 2018 and 2017, the Corporation had state net operating loss carryforwards, net of a valuation allowance, of \$0 and \$320,000, respectively, which are available to offset future state taxable income, and expire at various dates through 2038.

In 2017, the Corporation recognized a reduction in the carrying value of the net deferred tax asset of \$379,000 as a result of the December 2017 enactment of a reduction in the federal corporate income tax rate to 21% effective January 1, 2018, from the 34% marginal tax rate in effect throughout 2017. On December 22, 2017, the SEC staff issued Staff Accounting Bulletin No. 118 (“SAB 118”) which provides guidance on accounting for the tax effects of the Tax Cuts and Job Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Cuts and Jobs Act’s enactment date for companies to complete the accounting under ASC 740, Income Taxes. The Corporation’s financial results reflect the income tax effects of the Tax Cuts and Jobs Act for which the accounting under ASC Topic 740 is complete.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based on the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible and tax planning strategies, management believes it is more likely than not that the Corporation will realize the benefits of these deferred tax assets, net of any valuation allowance at December 31, 2018.

The Corporation did not have any uncertain tax positions at December 31, 2018 and 2017.

The Corporation and its subsidiary file a consolidated federal income tax return. The Corporation is no longer subject to examination by Federal or State taxing authorities for the years before 2015.

NOTE 10 — EMPLOYEE BENEFIT PLANS AND DEFERRED COMPENSATION AGREEMENTS

The Corporation maintains a 401k Plan which has a combined tax qualified savings feature and profit sharing feature for the benefit of its employees. Effective January 1, 2014, the plan became a Safe Harbor Plan. Under the savings feature, the Corporation makes safe harbor matching contributions of 100% of the first 3% of compensation an employee contributes to the Plan and 50% of the next 2% of compensation an employee contributes to the Plan. The safe harbor matching contributions amounted to \$296,000 and \$274,000 in 2018 and 2017, respectively. Under the profit sharing feature, contributions, at the discretion of the Board of Directors, are funded currently and amounted to \$304,000 and \$215,000 in 2018 and 2017, respectively.

The Bank also has non-qualified deferred compensation agreements with one of its officers and five retired officers. These agreements are essentially unsecured promises by the Bank to make monthly payments to the officers over a twenty year period. Payments begin based upon specific criteria — generally, when the officer retires. To account for the cost of payments yet to be made in the future, the Bank recognizes an accrued liability in years prior to when payments begin based on the present value of those future payments. The Bank’s accrued liability for these deferred compensation agreements, reported in other liabilities on the consolidated balance sheets, as of December 31, 2018 and 2017, was \$1,109,000 and \$1,464,000, respectively. The related expense for these agreements, reported in salaries and employee benefits on the consolidated statements of income, amounted to \$(229,000) and \$117,000 in 2018 and 2017, respectively. In 2018, there was a \$(305,000) plan expense reversal associated with the resignation of a previously covered officer.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

NOTE 11 — COMMITMENTS AND CONTINGENCIES

The Corporation's banking subsidiary currently leases three branch banking facilities, one loan processing office and one parcel of land under operating leases. Rent expense for the years ended December 31, 2018 and 2017 was \$170,000 and \$155,000, respectively. Minimum rental payments required under these operating leases are: 2019 - \$123,000, 2020 - \$72,000, 2021 - \$65,000, 2022 - \$68,000, 2023 - \$68,000 and thereafter \$2,394,000.

In the normal course of business, there are various pending legal actions and proceedings that are not reflected in the consolidated financial statements. Management does not believe the outcome of these actions and proceedings will have a material effect on the consolidated financial position of the Corporation.

NOTE 12 — RELATED PARTY TRANSACTIONS

Certain directors, executive officers and immediate family members of First Keystone Corporation and its subsidiary, and companies in which they are principal owners (i.e., at least 10% ownership), were indebted to the Corporation at December 31, 2018 and 2017. The loans do not involve more than the normal risk of collectability nor present other unfavorable features.

A summary of the activity on the related party loans consists of the following:

(Dollars in thousands)

| | 2018 | 2017 |
|------------------------|------------------|------------------|
| Balance at January 1 | \$ 10,997 | \$ 2,159 |
| Additions | 13,642 | 15,574 |
| Deductions | (4,691) | (6,736) |
| Balance at December 31 | <u>\$ 19,948</u> | <u>\$ 10,997</u> |

The summary of activity on the related party loans represent funds drawn and outstanding at the date of the consolidated financial statements. Commitments by the Bank to related parties on lines of credit and letters of credit for 2018 and 2017, presented an additional off-balance sheet risk to the extent of undisbursed funds in the amounts of \$4,958,000 and \$6,214,000 respectively, on the above loans.

Deposits from certain officers, directors and immediate family members and/or their related companies held by the Bank amounted to \$18,696,000 and \$15,180,000 at December 31, 2018 and 2017, respectively.

NOTE 13 — REGULATORY MATTERS

Under Pennsylvania banking law, the Bank is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval. At December 31, 2018, \$8,776,000 of retained earnings were available for dividends without prior regulatory approval, subject to the regulatory capital requirements discussed below. Regulations also limit the amount of loans and advances from the Bank to the Corporation to 10% of consolidated net assets.

The Corporation is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory — and possibly additional discretionary — actions by regulators that, if undertaken, could have a direct material effect on the Corporation's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation must meet specific capital guidelines that involve quantitative measures of the Corporation's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Corporation's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Management believes, as of December 31, 2018 and 2017, that the Corporation and the Bank met all capital adequacy requirements to which they are subject.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

On July 2, 2013, the Board of Governors of the Federal Reserve System finalized its rule implementing the Basel III regulatory capital framework, which the FDIC adopted on July 9, 2013. Under the rule, minimum requirements increased both the quantity and quality of capital held by banking organizations. Consistent with the Basel III framework, the rule included a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5 percent, and a common equity tier 1 conservation buffer of 2.5 percent of risk-weighted assets, that applies to all supervised financial institutions, which is to be phased in over a three year period beginning January 1, 2016, with the full 2.5 percent required as of January 1, 2019. The rule also raised the minimum ratio of tier 1 capital to risk-weighted assets from 4 percent to 6 percent, and includes a minimum leverage ratio of 4 percent for all banking organizations.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total capital, tier I capital and common equity tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of tier I capital (as defined) to average assets (as defined).

As of December 31, 2018 the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as Well Capitalized under the regulatory framework for prompt corrective action. To be categorized as Well Capitalized, the Bank must maintain minimum total risk-based, tier I risk-based, common equity tier 1 risk-based and tier I leverage ratios as set forth in the table. There are no conditions or events since the notification that management believes have changed the Bank's category.

(Dollars in thousands)

| | Actual | | For Capital Adequacy Purposes | | Minimum Capital Adequacy with Capital Buffer | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|--|-----------|--------|-------------------------------|-------|--|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2018: | | | | | | | | |
| Total Capital (to Risk-Weighted Assets) | \$ 96,065 | 13.87% | \$ 55,395 | 8.00% | \$ 68,378 | 9.88% | \$ 69,243 | 10.00% |
| Tier I Capital (to Risk-Weighted Assets) | \$ 89,203 | 12.88% | \$ 41,546 | 6.00% | \$ 54,529 | 7.88% | \$ 55,395 | 8.00% |
| Common Equity Tier 1 Capital (to Risk-Weighted Assets) | \$ 89,203 | 12.88% | \$ 31,160 | 4.50% | \$ 44,143 | 6.38% | \$ 45,008 | 6.50% |
| Tier I Capital (to Average Assets) | \$ 89,203 | 9.01% | \$ 39,616 | 4.00% | \$ 39,616 | 4.00% | \$ 49,521 | 5.00% |

(Dollars in thousands)

| | Actual | | For Capital Adequacy Purposes | | Minimum Capital Adequacy with Capital Buffer | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|--|-----------|--------|-------------------------------|-------|--|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2017: | | | | | | | | |
| Total Capital (to Risk-Weighted Assets) | \$ 93,566 | 14.21% | \$ 52,676 | 8.00% | \$ 60,907 | 9.25% | \$ 65,845 | 10.00% |
| Tier I Capital (to Risk-Weighted Assets) | \$ 85,963 | 13.06% | \$ 39,507 | 6.00% | \$ 47,738 | 7.25% | \$ 52,676 | 8.00% |
| Common Equity Tier 1 Capital (to Risk-Weighted Assets) | \$ 85,963 | 13.06% | \$ 29,630 | 4.50% | \$ 37,861 | 5.75% | \$ 42,800 | 6.50% |
| Tier I Capital (to Average Assets) | \$ 85,963 | 8.84% | \$ 38,901 | 4.00% | \$ 38,901 | 4.00% | \$ 48,626 | 5.00% |

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

The capital conservation buffer phase-in began January 1, 2016. The capital conservation buffer increased from 1.250% in 2017 to 1.875% in 2018.

The Corporation's capital ratios are not materially different from those of the Bank.

NOTE 14 — FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND CONCENTRATIONS OF CREDIT RISK

Financial Instruments with Off-Balance Sheet Risk

The Corporation 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 Consolidated Balance Sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Corporation has in particular classes of financial instruments. The Corporation does not engage in trading activities with respect to any of its financial instruments with off-balance sheet risk.

The Corporation's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments.

The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

The Corporation may require collateral or other security to support financial instruments with off-balance sheet credit risk.

The contract or notional amounts at December 31, 2018 and 2017 were as follows:

(Dollars in thousands)

| | <u>2018</u> | <u>2017</u> |
|---|-------------|-------------|
| Financial instruments whose contract amounts represent credit risk: | | |
| Commitments to extend credit | \$ 107,126 | \$ 90,373 |
| Financial standby letters of credit | \$ 331 | \$ 450 |
| Performance standby letters of credit | \$ 3,107 | \$ 2,901 |

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

Standby letters of credit are conditional commitments issued by the Corporation to guarantee payment to a third party when a customer either fails to repay an obligation or fails to perform some non-financial obligation. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Corporation may hold collateral (similar to the items held as collateral for commitments to extend credit) to support standby letters of credit for which collateral is deemed necessary.

Financial Instruments with Concentrations of Credit Risk

The Corporation originates primarily commercial and residential real estate loans to customers in northeastern Pennsylvania. The ability of the majority of the Corporation's customers to honor their contractual loan obligations is dependent on the economy and real estate market in this area. At December 31, 2018, the Corporation had \$508,217,000 in loans secured by real estate, which represented 83.8% of total loans. The real estate loan portfolio is largely secured by lessors of residential buildings and dwellings, lessors of non-residential buildings, and lessors of hotels/motels. As of December 31, 2018 and 2017, management is of the opinion that there were no concentrations exceeding 10% of total loans with regard to loans to borrowers who were engaged in similar activities that were similarly impacted by economic or other conditions.

As all financial instruments are subject to some level of credit risk, the Corporation requires collateral and/or guarantees for all loans. Collateral may include, but is not limited to property, plant, and equipment, commercial and/or residential real estate property, land, and pledge of securities. In the event of a borrower's default, the collateral supporting the loan may be seized in order to recoup losses associated with the loan. The Corporation also establishes an allowance for loan losses that constitutes the amount available to absorb losses within the loan portfolio that may exist due to deficiencies in collateral values.

NOTE 15 — STOCKHOLDERS' EQUITY

The Corporation also offers to its shareholders a Dividend Reinvestment and Stock Purchase Plan. Participation in this plan by shareholders began in 2001. The plan provides First Keystone shareholders a convenient and economical way to purchase additional shares of common stock by reinvesting dividends. A plan participant can elect full dividend reinvestment or partial dividend reinvestment provided at least 25 shares are enrolled in the plan. In addition, plan participants may make additional voluntary cash purchases of common stock under the plan of not less than \$100 per calendar quarter or more than \$2,500 in any calendar quarter.

Shares transferred under this Dividend Reinvestment and Stock Purchase Plan were 45,371 in 2018 and 46,388 in 2017. Remaining shares authorized in the plan were 577,048 as of December 31, 2018.

Shares of First Keystone common stock are purchased for the plan either in the open market by an independent broker on behalf of the plan, directly from First Keystone as original issue shares, or through negotiated transactions. A combination of the previous methods could also occur.

NOTE 16 — STOCK COMPENSATION PLAN

On February 10, 1998, the Board of Directors adopted the 1998 Employee Stock Option Plan and initially reserved 100,000 shares of common stock for issuance under the plan for certain employees of the Bank. After adjustments for the effects of stock dividends, options exercised and options forfeited, there are no exercisable options issued and outstanding. Under the Plan, options are granted at fair market value and the time period during which any option granted may be exercised may not commence before six months or continue beyond the expiration of ten years after the option is awarded. Upon exercise of the stock options, shares of the Corporation's stock are issued from Treasury Stock. The Plan expired in 2008, and therefore, no stock options are available for issuance.

The fair value of stock options issued to employees is measured on the date of the grant and is recognized as compensation expense over the requisite service period. Expected volatility and dividend yield are based on historical stock prices and dividend amounts over past time periods equal in length to the life of the options. The risk-free interest rate is determined using the U.S. Treasury yield curve in effect at the date of the grant. The expected life of the options is calculated using the average term of the vesting period and the maximum term.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

Information about stock options outstanding at December 31, 2018 and 2017, is summarized as follows:

| | 2018 | | 2017 | |
|----------------------------|---------------|---------------------------------|---------------|---------------------------------|
| | Stock Options | Weighted Average Exercise Price | Stock Options | Weighted Average Exercise Price |
| Balance at January 1 | — | — | 1,500 | \$ 16.75 |
| Exercised | — | — | (1,500) | 16.75 |
| Forfeited/Expired | — | — | — | — |
| Balance at December 31 | — | — | — | — |
| Exercisable at December 31 | — | — | — | — |

Under the terms of the Plan, the stock options including amendments as to price and terms were adjusted for the stock dividend in 2006.

The total intrinsic value of the options exercised during the years ended December 31, 2018 and 2017 was \$0 and \$18,000, respectively. Cash received from stock options exercised for the years ended December 31, 2018 and 2017 was \$0 and \$25,000, respectively.

NOTE 17 — FAIR VALUE MEASUREMENTS

Fair value measurement and disclosure guidance defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. This guidance provides additional information on determining when the volume and level of activity for the asset or liability has significantly decreased. The guidance also includes information on identifying circumstances when a transaction may not be considered orderly.

Fair value measurement and disclosure guidance provides a list of factors that a reporting entity should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with the fair value measurement and disclosure guidance.

This guidance clarifies that when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the entity must evaluate the weight of the evidence to determine whether the transaction is orderly. The guidance provides a list of circumstances that may indicate that a transaction is not orderly. A transaction price that is not associated with an orderly transaction is given little, if any, weight when estimating fair value.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own belief about the assumptions market participants would use in pricing the asset or liability based upon the best information available in the circumstances. Fair value measurement and disclosure guidance establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

Level 1 Inputs: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2 Inputs: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability;

Level 3 Inputs: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth as follows.

Financial Assets Measured at Fair Value on a Recurring Basis

At December 31, 2018 and 2017, securities measured at fair value on a recurring basis and the valuation methods used are as follows:

(Dollars in thousands)

| December 31, 2018 | Level 1 | Level 2 | Level 3 | Total |
|--|-----------------|-------------------|----------------|-------------------|
| Available-for-Sale Debt Securities: | | | | |
| U.S. Treasury securities | \$ — | \$ 5,295 | \$ — | \$ 5,295 |
| Obligations of U.S. Government Corporations and Agencies: | | | | |
| Mortgaged-backed | — | 64,876 | — | 64,876 |
| Other | — | 18,243 | — | 18,243 |
| Other mortgage backed debt securities | — | 4,749 | — | 4,749 |
| Obligations of state and political subdivisions | — | 182,278 | — | 182,278 |
| Asset backed securities | — | 14,370 | — | 14,370 |
| Corporate debt securities | — | 26,243 | — | 26,243 |
| Total debt securities available-for-sale | — | 316,054 | — | 316,054 |
| Marketable equity securities | 1,560 | — | — | 1,560 |
| Total | \$ 1,560 | \$ 316,054 | \$ — | \$ 317,614 |

(Dollars in thousands)

| December 31, 2017 | Level 1 | Level 2 | Level 3 | Total |
|--|-----------------|-------------------|----------------|-------------------|
| Available-for-Sale Debt Securities: | | | | |
| U.S. Treasury securities | \$ — | \$ — | \$ — | \$ — |
| Obligations of U.S. Government Corporations and Agencies: | | | | |
| Mortgaged-backed | — | 81,860 | — | 81,860 |
| Other | — | 22,233 | — | 22,233 |
| Other mortgage backed debt securities | — | — | — | — |
| Obligations of state and political subdivisions | — | 215,522 | — | 215,522 |
| Asset backed securities | — | — | — | — |
| Corporate debt securities | — | 28,971 | — | 28,971 |
| Total debt securities available-for-sale | — | 348,586 | — | 348,586 |
| Marketable equity securities | 1,632 | — | — | 1,632 |
| Total | \$ 1,632 | \$ 348,586 | \$ — | \$ 350,218 |

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

The estimated fair values of equity securities classified as Level 1 are derived from quoted market prices in active markets; these assets consist mainly of stocks held in other banks. The estimated fair values of all debt securities classified as Level 2 are obtained from nationally-recognized third-party pricing agencies. The estimated fair values are derived primarily from cash flow models, which include assumptions for interest rates, credit losses, and prepayment speeds. The significant inputs utilized in the cash flow models are based on market data obtained from sources independent of the Corporation (observable inputs), and are therefore classified as Level 2 within the fair value hierarchy. The Corporation does not have any Level 3 inputs for securities. There were no transfers between Level 1 and Level 2 during 2018 and 2017.

Financial Assets Measured at Fair Value on a Nonrecurring Basis

At December 31, 2018 and 2017, impaired loans measured at fair value on a nonrecurring basis and the valuation methods used are as follows:

(Dollars in thousands)

| | Level 1 | Level 2 | Level 3 | Total |
|------------------------------------|-------------|-------------|-----------------|-----------------|
| Assets at December 31, 2018 | | | | |
| Impaired loans: | | | | |
| Commercial Real Estate | \$ — | \$ — | \$ 6,400 | \$ 6,400 |
| Residential Real Estate | — | — | 81 | 81 |
| Total impaired loans | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 6,481</u> | <u>\$ 6,481</u> |

(Dollars in thousands)

| | Level 1 | Level 2 | Level 3 | Total |
|------------------------------------|-------------|-------------|-----------------|-----------------|
| Assets at December 31, 2017 | | | | |
| Impaired loans: | | | | |
| Commercial Real Estate | \$ — | \$ — | \$ 5,498 | \$ 5,498 |
| Residential Real Estate | — | — | 254 | 254 |
| Total impaired loans | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 5,752</u> | <u>\$ 5,752</u> |

The Bank's impaired loan valuation procedure for any loans greater than \$250,000 requires an appraisal to be obtained and reviewed annually at year end. A quarterly collateral evaluation is performed which may include a site visit, property pictures and discussions with realtors and other similar business professionals to ascertain current values. For impaired loans less than \$250,000 upon classification and annually at year end, the Bank completes a Certificate of Inspection, which includes an onsite inspection, insured values, tax assessed values, recent sales comparisons and a review of the previous evaluations. These assets are included as Level 3 fair values, based upon the lowest level that is significant to the fair value measurements. The fair value consists of the impaired loan balances less the valuation allowance and/or charge-offs. There were no transfers between valuation levels in 2018 and 2017.

Nonfinancial Assets Measured at Fair Value on a Nonrecurring Basis

At December 31, 2018 and 2017, foreclosed assets held for resale measured at fair value on a nonrecurring basis and the valuation methods used are as follows:

(Dollars in thousands)

| | Level 1 | Level 2 | Level 3 | Total |
|---|-------------|-------------|---------------|---------------|
| Assets at December 31, 2018 | | | | |
| Foreclosed assets held for resale: | | | | |
| Commercial Real Estate | \$ — | \$ — | \$ 856 | \$ 856 |
| Residential Real Estate | — | — | — | — |
| Total foreclosed assets held for resale | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 856</u> | <u>\$ 856</u> |

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

(Dollars in thousands)

| | Level 1 | Level 2 | Level 3 | Total |
|--|-------------|-------------|--------------|--------------|
| Assets at December 31, 2017 | | | | |
| Foreclosed assets held for resale: | | | | |
| Commercial Real Estate | \$ — | \$ — | \$ 81 | \$ 81 |
| Residential Real Estate | — | — | 13 | 13 |
| Total foreclosed assets held for resale | \$ — | \$ — | \$ 94 | \$ 94 |

The Bank's foreclosed asset valuation procedure requires an appraisal, which considers the sales prices of similar properties in the proximate vicinity, to be completed periodically with the exception of those cases in which the Bank has obtained a sales agreement. These assets are included as Level 3 fair values, based upon the lowest level that is significant to the fair value measurements. There were no transfers between valuation levels in 2018 and 2017.

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis and for which the Bank has utilized Level 3 inputs to determine the fair value:

(Dollars in thousands)

| | Quantitative Information about Level 3 Fair Value Measurements | | | | |
|-----------------------------------|--|--|------------------------------------|---------------|------------------|
| | Fair Value Estimate | Valuation Technique | Unobservable Input | Range | Weighted Average |
| December 31, 2018 | | | | | |
| Impaired loans | \$ 3,346 | Appraisal of collateral ^{1,3} | Appraisal adjustments ² | (15%) – (82%) | (18%) |
| Impaired loans | \$ 3,135 | Discounted cash flow | Discount rate | (6%) – (7%) | (7%) |
| Foreclosed assets held for resale | \$ 856 | Appraisal of collateral ^{1,3} | Appraisal adjustments ² | (16%) – (35%) | (18%) |
| December 31, 2017 | | | | | |
| Impaired loans | \$ 2,495 | Appraisal of collateral ^{1,3} | Appraisal adjustments ² | (7%) – (65%) | (15%) |
| Impaired loans | \$ 3,257 | Discounted cash flow | Discount rate | (7%) – (8%) | (7%) |
| Foreclosed assets held for resale | \$ 94 | Appraisal of collateral ^{1,3} | Appraisal adjustments ² | (35%) – (37%) | (36%) |

¹Fair value is generally determined through independent appraisals of the underlying collateral, as defined by Bank regulators.

²Appraisals may be adjusted downward by management for qualitative factors such as economic conditions and estimated liquidation expenses. The typical range of appraisal adjustments are presented as a percent of the appraisal value.

³Includes qualitative adjustments by management and estimated liquidation expenses.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

Fair Value of Financial Instruments

The estimated fair values, and related carrying amounts, of the Corporation's financial instruments that are not recorded at fair value are as follows:

(Dollars in thousands)

| | Carrying Amount | Fair Value Measurements at December 31, 2018 | | | |
|--|--------------------|--|---------|---------|----------|
| | | Level 1 | Level 2 | Level 3 | Total |
| FINANCIAL ASSETS: | | | | | |
| Cash and due from banks | \$ 9,822 | \$ 9,822 | \$ — | \$ — | \$ 9,822 |
| Interest-bearing deposits in other banks | 1,128 | — | 1,128 | — | 1,128 |
| Time deposits with other banks | 1,482 | — | 1,469 | — | 1,469 |
| Restricted investment in bank stocks | 8,681 | — | 8,681 | — | 8,681 |
| Net loans | 599,647 | — | — | 597,548 | 597,548 |
| Mortgage servicing rights | 316 | — | — | 316 | 316 |
| Accrued interest receivable | 4,041 | — | 4,041 | — | 4,041 |
| FINANCIAL LIABILITIES: | | | | | |
| Demand, savings and other deposits | 474,261 | — | 474,261 | — | 474,261 |
| Time deposits | 197,292 | — | 195,136 | — | 195,136 |
| Short-term borrowings | 174,445 | — | 174,491 | — | 174,491 |
| Long-term borrowings | 45,000 | — | 45,077 | — | 45,077 |
| Accrued interest payable | 785 | — | 785 | — | 785 |
| OFF-BALANCE SHEET FINANCIAL INSTRUMENTS | | | | | |
| | — | — | — | — | — |

(Dollars in thousands)

| | Carrying Amount | Fair Value Measurements at December 31, 2017 | | | |
|--|--------------------|--|---------|---------|----------|
| | | Level 1 | Level 2 | Level 3 | Total |
| FINANCIAL ASSETS: | | | | | |
| Cash and due from banks | \$ 7,913 | \$ 7,913 | \$ — | \$ — | \$ 7,913 |
| Interest-bearing deposits in other banks | 826 | — | 826 | — | 826 |
| Time deposits with other banks | 1,482 | — | 1,482 | — | 1,482 |
| Restricted investment in bank stocks | 4,058 | — | 4,058 | — | 4,058 |
| Net loans | 551,910 | — | — | 550,696 | 550,696 |
| Mortgage servicing rights | 379 | — | — | 379 | 379 |
| Accrued interest receivable | 4,237 | — | 4,237 | — | 4,237 |
| FINANCIAL LIABILITIES: | | | | | |
| Demand, savings and other deposits | 570,518 | — | 570,518 | — | 570,518 |
| Time deposits | 207,628 | — | 206,299 | — | 206,299 |
| Short-term borrowings | 26,296 | — | 26,296 | — | 26,296 |
| Long-term borrowings | 65,000 | — | 65,336 | — | 65,336 |
| Accrued interest payable | 490 | — | 490 | — | 490 |
| OFF-BALANCE SHEET FINANCIAL INSTRUMENTS | | | | | |
| | — | — | — | — | — |

NOTE 18 — REVENUE RECOGNITION

As disclosed in Note 1, as of January 1, 2018, the Corporation adopted ASU 2014-09 *Revenue from Contracts with Customers - Topic 606* and all subsequent ASUs that modified ASC 606. The Corporation has elected to apply the ASU and all related ASUs using the modified retrospective implementation method. The implementation of the guidance had no material impact on the measurement or recognition of revenue of prior periods, however, additional disclosures have been added in accordance with the ASU.

The main types of revenue contracts included in non-interest income within the Consolidated Statements of Income which are subject to ASC 606 are as follows:

Deposits related fees and service charges

Service charges and fees on deposits, which are included as liabilities in the consolidated balance sheets, consist of fees related to monthly fees for various retail and business checking accounts, automated teller machine (“ATM”) fees (charged for withdrawals by our deposit customers from other bank ATMs) and insufficient funds fees (“NSF”) (which are charged when customers overdraw their accounts beyond available funds). All deposit liabilities are considered to have one-day terms and therefore related fees are recognized in income at the time when the services are provided to the customers. The Corporation elected to adopt practical expedient related to incremental costs of obtaining deposit contracts. As such, any costs associated with acquiring the deposits, except for certificate of deposits (“CDs”) with maturities in excess of one year, are recognized as an expense within the non-interest expense in the consolidated statements of income when incurred as the amortization period of the deposit liabilities that otherwise would have been recognized is one year or less.

Wealth/Asset/Trust Management Fees

Wealth management services are delivered to individuals, corporations and retirement funds located primarily within our geographic markets. The Trust Department of the Corporation conducts the wealth management operations, which provides a broad range of personal and corporate fiduciary services, including the administration of estates.

Assets held in a fiduciary capacity by the Trust Department are not assets of the Corporation and, therefore, are not included in our Consolidated Financial Statements. Wealth management fees, which are contractually agreed with each customer, are earned each month and recognized on a cash basis based on average fair value of the trust assets under management. The services provided under such a contract are considered a single performance obligation under ASC 606 because they embody a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. Wealth management fees charged by the Trust Department follow a tiered structure based on the type and size of the assets under management. Wealth management fees are included within non-interest income in the consolidated statements of income. As of December 31, 2018 and December 31, 2017, the fair value of trust assets under management was \$105,917,000 and \$111,130,000, respectively. The costs of acquiring asset management customers are incremental and recognized within the non-interest expense of the consolidated statements of income.

Interchange Fees and Surcharges

Interchange fees are related to the acceptance and settlement of debit card transactions, both point-of-sale and ATM, to cover operating costs and risks associated with the approval and settlement of the transactions. Interchange fees vary by type of transaction and each merchant sector. Net income recognized from interchange fees is included in non-interest income on the consolidated statements of income. A surcharge is assessed for use of the Corporation’s ATMs by non-customers. All interchange fees and surcharges are recognized as received on a daily basis for the prior business day’s transactions. All expenses related to the settlement of debit card transactions (both point-of-sale and ATM) are recognized on a monthly basis and included in non-interest expense on the consolidated statements of income.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

NOTE 19 — PARENT COMPANY FINANCIAL INFORMATION

Condensed financial information for First Keystone Corporation (parent company only) was as follows:

BALANCE SHEETS

(Dollars in thousands)

| | December 31, | |
|---|-------------------|-------------------|
| | 2018 | 2017 |
| ASSETS | | |
| Cash | \$ 9,988 | \$ 8,984 |
| Investment in banking subsidiary | 105,755 | 106,647 |
| Marketable equity securities | 1,560 | 1,632 |
| Prepaid expenses and other assets | 232 | 30 |
| TOTAL ASSETS | \$ 117,535 | \$ 117,293 |
| LIABILITIES | | |
| Advances from banking subsidiary | \$ 536 | \$ 325 |
| Accrued expenses and other liabilities | 243 | 249 |
| TOTAL LIABILITIES | 779 | 574 |
| STOCKHOLDERS' EQUITY | | |
| Common stock | 11,993 | 11,902 |
| Surplus | 37,255 | 36,193 |
| Retained earnings | 75,798 | 72,507 |
| Accumulated other comprehensive (loss) income | (2,581) | 1,826 |
| Treasury stock, at cost | (5,709) | (5,709) |
| TOTAL STOCKHOLDERS' EQUITY | 116,756 | 116,719 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 117,535 | \$ 117,293 |

STATEMENTS OF INCOME

(Dollars in thousands)

| | Years Ended December 31, | |
|---|--------------------------|-----------------|
| | 2018 | 2017 |
| INCOME | | |
| Dividends from subsidiary bank | \$ 6,102 | \$ 6,102 |
| Net securities (losses) gains | (72) | 74 |
| Other income | 76 | 73 |
| TOTAL INCOME | 6,106 | 6,249 |
| OPERATING EXPENSES | | |
| | 176 | 117 |
| | 5,930 | 6,132 |
| INCOME TAX BENEFIT | | |
| | (41) | (110) |
| | 5,971 | 6,242 |
| EQUITY IN UNDISTRIBUTED EARNINGS OF BANKING SUBSIDIARY | | |
| | 3,240 | 2,406 |
| NET INCOME | \$ 9,211 | \$ 8,648 |

FIRST KEYSTONE CORPORATION AND SUBSIDIARY
Notes to Consolidated Financial Statements

STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in thousands)

| | Years Ended December 31, | |
|---|--------------------------|------------------|
| | 2018 | 2017 |
| Net Income | \$ 9,211 | \$ 8,648 |
| Other comprehensive (loss) income: | | |
| Unrealized net holding gains on available-for-sale investment securities arising during the period, net of income taxes of \$0 and \$55, respectively | — | 81 |
| Less reclassification adjustment for net gains included in net income, net of income taxes of \$0 and \$(30), respectively | — | (44) |
| Equity in other comprehensive (loss) income of banking subsidiary | (4,133) | 3,208 |
| Total other comprehensive (loss) income | (4,133) | 3,245 |
| Total Comprehensive Income | <u>\$ 5,078</u> | <u>\$ 11,893</u> |

STATEMENTS OF CASH FLOWS

(Dollars in thousands)

| | Years Ended December 31, | |
|---|--------------------------|-----------------|
| | 2018 | 2017 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 9,211 | \$ 8,648 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Losses (gains) on securities | 72 | (74) |
| Deferred income tax expense (benefit) | 5 | (110) |
| Equity in undistributed earnings of banking subsidiary | (3,240) | (2,406) |
| Increase in prepaid/accrued expenses and other assets/liabilities | (214) | (235) |
| Increase in advances from banking subsidiary | 211 | 216 |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | <u>6,045</u> | <u>6,039</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from sales of investment securities available-for-sale | — | 144 |
| NET CASH PROVIDED BY INVESTING ACTIVITIES | <u>—</u> | <u>144</u> |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from issuance of common stock | 1,153 | 1,261 |
| Proceeds from exercise of stock options | — | 25 |
| Dividends paid | (6,194) | (6,145) |
| NET CASH USED IN FINANCING ACTIVITIES | <u>(5,041)</u> | <u>(4,859)</u> |
| INCREASE IN CASH AND CASH EQUIVALENTS | 1,004 | 1,324 |
| CASH AND CASH EQUIVALENTS, BEGINNING | 8,984 | 7,660 |
| CASH AND CASH EQUIVALENTS, ENDING | <u>\$ 9,988</u> | <u>\$ 8,984</u> |

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

As previously reported by the Corporation on a Form 8-K filed March 19, 2018, the Corporation appointed Baker Tilly Virchow Krause, LLP (“Baker Tilly”) as the Corporation’s new independent registered public accounting firm for and with respect to the year ending December 31, 2018, and dismissed BDO USA, LLP (“BDO”) from that role.

During the Corporation’s most recent fiscal year and the subsequent interim period preceding BDO’s dismissal, there were: (i) no disagreements with BDO on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of BDO, would have caused it to make reference to the subject matter of the disagreements in its reports on the consolidated financial statements for the Corporation; and, (ii) no “reportable events”, as such term is defined in Item 304(a)(1)(v) of Regulation S-K.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

First Keystone Corporation maintains disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) designed to ensure that information required to be disclosed in the reports that the Corporation files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those disclosure controls and procedures performed as of the end of the period covered by this report, the Chief Executive Officer and Chief Financial Officer of the Corporation concluded that the Corporation’s disclosure controls and procedures were effective as of December 31, 2018.

Management’s Report on Internal Control Over Financial Reporting

The management of First Keystone Corporation is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities and Exchange Act of 1934). The Corporation’s internal control system was designed to provide reasonable assurance to the Corporation’s management and Board of Directors regarding the preparation and fair presentation of published financial statements.

The management of First Keystone Corporation, along with participation of the Chief Executive Officer and the Chief Financial Officer, assessed the effectiveness of the Corporation’s internal control over financial reporting as of December 31, 2018. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in the *Internal Control — Integrated Framework (2013)*. Based on our assessment we believe that, as of December 31, 2018, the Corporation’s internal control over financial reporting is effective based on those criteria.

First Keystone Corporation’s independent registered public accounting firm that audited the consolidated financial statements has issued an audit report on the effectiveness of the Corporation’s internal control over financial reporting as of December 31, 2018. This report can be found in Item 8 of this Form 10-K.

Changes in Internal Control over Financial Reporting

Other than the changes described above, there were no changes in the Corporation’s internal control over financial reporting during the fiscal quarter ended December 31, 2018, that materially affected, or are reasonably likely to materially affect, the Corporation’s internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

There was no information required on Form 8-K during this quarter that was not reported.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information under the captions “Information As To Directors and Nominees,” “Principal Officers of the Bank and the Corporation,” “Committees of the Board of Directors” and “Section 16(A) Beneficial Ownership Reporting Compliance” are incorporated here by reference from First Keystone Corporation’s definitive proxy statement.

CODE OF ETHICS

The Corporation has adopted a Directors and Senior Management Code of Ethics, which applies to all members of the Board of Directors and to senior officers of the Corporation. It can be found on the Investor Relations section of our website at www.firstkeystonecorporation.com.

ITEM 11. EXECUTIVE COMPENSATION

The information under the captions “Executive Compensation”, “Compensation Discussion and Analysis (CD&A)”, “Compensation Committee Interlocks and Insider Participation”, and “Compensation Committee Report” are incorporated here by reference from First Keystone Corporation’s definitive proxy statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information under the caption “Share Ownership” is incorporated here by reference from First Keystone Corporation’s definitive proxy statement.

Equity Compensation Plan Information

| Plan category | Number of securities to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted-average exercise price of outstanding options, warrants and rights (b) | Number of securities remaining available for future issuance under equity compensation plans excluding securities reflected in column (a) (c) |
|--|--|---|--|
| Equity compensation plans approved by shareholders | — | \$ — | — |
| Equity compensation plans not approved by shareholders | — | — | — |
| Total | — | \$ — | — |

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information under the captions “Related Person Transactions” and “Governance of the Company” are incorporated here by reference from First Keystone Corporation’s definitive proxy statement.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information under the captions “Report of the Audit Committee” and “Proposal No. 2: Ratification of Independent Registered Public Accounting Firm” are incorporated here by reference from First Keystone Corporation’s definitive proxy statement.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) 1. Financial Statements

The following consolidated financial statements are included in Part II, Item 8, of this Report:

First Keystone Corporation and Subsidiary.

| | |
|---|---------------------------|
| <u>Reports of Independent Registered Public Accounting Firm</u> | <u>47</u> |
| <u>Consolidated Balance Sheets</u> | <u>50</u> |
| <u>Consolidated Statements of Income</u> | <u>51</u> |
| <u>Consolidated Statements of Comprehensive Income</u> | <u>52</u> |
| <u>Consolidated Statements of Changes in Stockholders’ Equity</u> | <u>53</u> |
| <u>Consolidated Statements of Cash Flows</u> | <u>54</u> |
| <u>Notes to Consolidated Financial Statements</u> | <u>55</u> |

2. Financial Statement Schedules

Financial statements schedules are omitted because the required information is either not applicable, not required, or is shown in the financial statements or in their notes.

ITEM 16. FORM 10-K SUMMARY

None.

3. Exhibits

Exhibits required by Item 601 of Regulation S-K:

| <u>Exhibit Number Referred to Item 601 of Regulation S-K</u> | <u>Description of Exhibit</u> |
|--|--|
| <u>3i</u> | <u>Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3(i) to the Registrant's Report on Form 8-K dated August 28, 2018).</u> |
| <u>3ii</u> | <u>By-Laws, as amended and restated (Incorporated by reference to Exhibit 3(ii) to the Registrant's Report on Form 8-K dated August 28, 2018).</u> |
| <u>10.1(a)</u> | <u>Supplemental Employee Retirement Plan – J. Gerald Bazewicz (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*</u> |
| <u>10.1(b)</u> | <u>Supplemental Employee Retirement Plan – David R. Saracino (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*</u> |
| <u>10.1(c)</u> | <u>Supplemental Employee Retirement Plan – Matthew P. Prosseda (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*</u> |
| <u>10.1(d)</u> | <u>Supplemental Employee Retirement Plan – Elaine Woodland (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*</u> |
| <u>10.2</u> | <u>Management Incentive Compensation Plan</u> |
| <u>10.4</u> | <u>First Keystone Corporation 1998 Stock Incentive Plan (Incorporated by reference to Exhibit 10 to Registrant's Report on Form 10-Q for the quarter ended September 30, 2006).*</u> |
| <u>14</u> | <u>First Keystone Corporation Directors and Senior Management Code of Ethics (Incorporated by reference to Exhibit 99.1 to Registrant's Report on Form 8-K dated August 27, 2013).</u> |
| <u>21</u> | <u>List of Subsidiaries of the Issuer, filed with this annual report on Form 10-K.**</u> |
| <u>23.1</u> | <u>Consent of Baker Tilly Virchow Krause, LLP.**</u> |
| <u>23.2</u> | <u>Consent of BDO USA, LLP.**</u> |
| <u>31.1</u> | <u>Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.**</u> |
| <u>31.2</u> | <u>Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.**</u> |
| <u>32.1</u> | <u>Section 1350 Certification of Chief Executive Officer.**</u> |
| <u>32.2</u> | <u>Section 1350 Certification of Chief Financial Officer.**</u> |
| 101.INS | XBRL Instance Document.** |
| 101.SCH | XBRL Taxonomy Extension Schema Document.** |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document.** |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document.** |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document.** |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document.** |

* Denotes a compensatory plan.

** Filed herewith.

The Corporation will provide a copy of any exhibit upon receipt of a written request for the particular exhibit or exhibits desired. All requests should be addressed to the Corporation's principal executive offices.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST KEYSTONE CORPORATION

/s/ Elaine A. Woodland

Elaine A. Woodland
President and Chief Executive Officer
(Principal Executive Officer)

Date: March 18, 2019

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| | |
|---|-------------------------------|
| <u>/s/ John E. Arndt</u> John E. Arndt, Vice Chairman/Director | <u>March 18, 2019</u> Date |
| <u>/s/ Don E. Bower</u> Don E. Bower, Director | <u>March 18, 2019</u> Date |
| <u>/s/ Robert A. Bull</u> Robert A. Bull, Chairman/Director | <u>March 18, 2019</u> Date |
| <u>/s/ Robert E. Bull</u> Robert E. Bull, Director | <u>March 18, 2019</u> Date |
| <u>/s/ Joseph B. Conahan, Jr.</u> Joseph B. Conahan, Jr., Director | <u>March 18, 2019</u> Date |
| <u>/s/ Michael L. Jezewski</u> Michael L. Jezewski, Director | <u>March 18, 2019</u> Date |
| <u>/s/ Nancy J. Marr</u> Nancy J. Marr, Director | <u>March 18, 2019</u> Date |
| <u>/s/ William E. Rinehart</u> William E. Rinehart, Director | <u>March 18, 2019</u> Date |
| <u>/s/ Diane C.A. Rosler</u> Diane C.A. Rosler, Chief Financial Officer (Principal Financial Officer) | <u>March 18, 2019</u> Date |
| <u>/s/ David R. Saracino</u> David R. Saracino, Secretary/Director | <u>March 18, 2019</u> Date |
| <u>/s/ Elaine A. Woodland</u> Elaine A. Woodland, President/ Chief Executive Officer/Director | <u>March 18, 2019</u> Date |

[\(Back To Top\)](#)

Section 2: EX-10.2 (EXHIBIT 10.2)

FIRST KEYSTONE COMMUNITY BANK
MANAGEMENT INCENTIVE COMPENSATION PLAN

I. PURPOSE

The purpose of the Management Incentive Compensation Plan is to provide incentives and awards to top management employees who, through high levels of performance, contribute to the success and profitability of First Keystone Community Bank. The Plan is designed to support organizational objectives and financial goals, as defined by the Bank's Strategic and Financial Plans, by making available additional, variable, and contingent incentive compensation.

II. GENERAL DESCRIPTION

The Management Incentive Compensation Plan is based upon the achievement of a required budget net income figure before any incentive award "pool" is formed. The Plan specifies annual goals that are consistent with those contained in the Strategic Business Plan and the annual Profit Plan.

The calculation of share of profits to be distributed to the Plan participants, and the incentive formulas, are constructed to provide awards that are consistent with achieved profitability levels. The incentive formulas insure a level of incentive award that will enable First Keystone Community Bank to attract, retain, and motivate high-quality management personnel and support continued growth and profitability.

The Management Incentive Compensation Plan is established to augment regular salary and benefits programs already in existence. The Plan is not meant to be a substitute for salary increases, but as a supplement to salary, and, as stated earlier, as an incentive for performance that contributes to outstanding levels of achievement.

III. PLAN ADMINISTRATION

Throughout this Plan document, reference to the actions and authority of the Human Resource Committee of the Board of Directors also presumes that the Committee will recommend, and the Board of Directors will approve or disapprove, final disposition of all matters pertaining to the administration of the Plan. The Committee, with Board approval, has the responsibility to interpret, administer, amend, or recommend suspension or termination of the Plan as necessary. The recommendations of the Committee, as approved by the Board, affecting the construction, interpretation, and administration of the Plan shall be final and binding on all parties, including the Bank and its employees.

Matters before the Committee shall be decided upon a majority vote of the Committee and recommended to the Board for final action. Plan participants who are members of the Committee shall not be entitled to vote on matters relating to the eligibility for and/or determination of their own incentive compensation awards.

During the first quarter of each Plan Year, the Committee may review and revise the operating rules. Performance measures, and awards based upon those measures, may be changed in order to emphasize specific goals and objectives of the Plan. However, it is expected that the Plan will require modification only when significant changes in organization, goals, personnel, or performance occur. The Chief Executive Officer shall inform the Committee of any proposed changes to the operating rules.

Computation of incentive awards will be made by the Chief Executive Officer in consultation with the Chairman of the Board. Maintenance of participant payments and other related records shall be the responsibility of the Bank's Human Resource Manager. Such computations and records may be audited annually by the independent auditors of the Bank prior to submission to the Committee and the Board for review and approval.

Finally, the Committee, in the exercise of its discretion with respect to the determination of the amount of the incentive plan pool for any given Plan Year, may take into account the presence or absence of nonrecurring or extraordinary items of income, gain, expense, or loss, and any and all factors that, in its sole discretion, may deem relevant.

Extraordinary occurrences may be excluded when calculating performance results to insure that the best interests of the Bank are protected and are not brought into conflict with the best interest of plan participants.

IV. PLAN PARTICIPANTS

Participation in the Management Incentive Plan at First Keystone Community Bank is limited to the executive management team. This management team includes the following functional job titles:

- A. Chief Executive Officer
- B. Director of Lending
- C. Chief Financial Officer
- D. Deposit Operations Officer
- E. Chief Credit Officer
- F. Senior Trust Officer
- G. IT Manager/ISO

Plan participation by these seven (7) individuals recognizes the importance of this group to the Bank and the potential these officers have to influence the achievement of financial and strategic objectives.

V. OPERATING RULES

The Plan shall be effective as of April 1, 1988 and has been most recently amended and adopted on March 22, 2016 and January 22, 2019.

- A. The Board of Directors of First Keystone Community Bank may amend, suspend, or terminate the Plan at any time.
- B. The Plan shall be administered by the Human Resource Committee with assistance from Executive Management.
- C. The Human Resource Committee shall adopt such rules and regulations and shall make determinations and interpretations of the Plan thereunder as it shall deem appropriate. All such rules, regulations, and determinations, as approved by the Board of Directors, shall be conclusive and binding upon all parties.
- D. Eligibility for participation in the Plan is based upon the eligibility requirements as stated herein.
- E. Supplementary Plan Documents relating to participants, the targeted incentive plan pool, and other pertinent matters will be prepared by the Committee, and approved by the Board of Directors, during the first quarter of each Plan Year.
- F. The incentive plan pool may be funded, within the discretion of the Board of Directors, with the following to be used as a general guideline:

| Fund as a % of Budget | % of Budget Beyond Goal |
|---|----------------------------|
| Greater than 95% of budget up to 100% of budget | 10% |
| In excess of budget | 15% |

- G. Allocation of the plan pool will be made in accordance with the guidelines shown in Section VI of this Plan document. As noted in these guidelines, individual performance standards must be met before an eligible participant will receive all or part of his/her eligible portion of the pool.
 - H. Within thirty (30) days following the end of the Plan Year, or as soon as financial and operating results are known, eligible participants will receive their appropriate incentive plan payment. Unless otherwise determined and approved by the Board of Directors, this payment will be made in cash.
 - I. Basic Incentive Plan guidelines for any Plan Year shall be reviewed with the participants at the beginning of each Plan Year.
-

- J. Partial payments under the Plan shall be administered as follows:
1. Retirement: In the event of termination of employment through retirement, the employee may, at the discretion of the Committee, be considered to have earned one-twelfth (1/12) of the annual incentive compensation award of a particular year for each month of employment in the Plan Year of his/her retirement.
 2. Death: If a participant dies, the amount of the award may be prorated for each month of employment during the Plan Year at the discretion of the Committee, and paid to the estate or designated beneficiary.
 3. Termination for Reasons Other Than Death or Retirement: In the event of termination of employment for reasons other than death or retirement, the participant, at the discretion of the Committee, will forfeit all unpaid incentive awards.
- K. No right or interest of any participant in the plan shall be assignable or transferable, or subject to any lien, directly, by operation of law, or otherwise, including levy, garnishment, attachment, pledge, or bankruptcy, except to a beneficiary upon the death of a participant as herein provided.
- L. An award under the Plan shall not confer any right on the participant to continue in the employ of the bank, or limit in any way the right of the bank to terminate the participant's employment at any time. The receipt of an award for any one year shall not guarantee an employee the right to receive an award for any subsequent year.
- M. The Bank shall have the right to deduct from all payments under this Plan any federal or state taxes required by law to be withheld with respect to such payments.
- N. The Committee, with concurrence of the Board of Directors, may terminate, amend, or modify this Plan at any time.
- O. The amount of the pool shall be capped in the amount of \$100,000.00 in order to protect the interest of the Bank.

VI. CLAWBACK

In the event that the Corporation is required to prepare an accounting restatement because of the material noncompliance of the Corporation or Bank with any financial reporting requirement and if within the previous three years a participant received an award based upon the erroneous data, whether or not the participant engaged in any misconduct, the participant shall return and refund to the Bank within thirty (30) days' notice from the Bank, the amount equal to the excess of what would have been paid to the participant under the accounting restatement. In the event that the Corporation or the Bank is required to prepare an accounting restatement because of a participant's misconduct or fraudulent activity, then the participant shall return and refund to the Bank the entire award received based upon the erroneous data within thirty (30) days' notice from the Bank. In the event that the Bank has to file an action or incurs any legal fees in attempting to recoup any amounts due to the Bank, the participant shall also be liable to the Bank for the Bank's reasonable attorneys' fees and costs associated with such recoupment.

This Section does not abrogate the Bank's right to seek recoupment based upon any other law or policy of the Corporation or Bank.

VII. SUMMARY OF SUPPLEMENTARY PLAN DOCUMENTS

A. Allocation of Incentive Plan Pool

| Job Title | Maximum % of Pool |
|-------------------------------|-------------------|
| 1. Chief Executive Officer | 40% |
| 2. Director of Lending | 10% |
| 3. Chief Financial Officer | 20% |
| 4. Deposit Operations Officer | 5% |
| 5. Chief Credit Officer | 10% |
| 6. Senior Trust Officer | 5% |
| 7. IT Manager/ISO | 10% |

[\(Back To Top\)](#)

Section 3: EX-21 (EXHIBIT 21)

EXHIBIT 21

FIRST KEYSTONE CORPORATION

LIST OF SUBSIDIARIES OF THE ISSUER

Direct Subsidiary: First Keystone Community Bank, Pennsylvania state chartered commercial bank.

The consolidated financial statements include the accounts of the Corporation and its subsidiary.

[\(Back To Top\)](#)

Section 4: EX-23.1 (EXHIBIT 23.1)

EXHIBIT 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statements on Form S-3D (No. 333-227152) and Form S-3/A (No. 333-228140) of First Keystone Corporation of our report dated March 18, 2019, relating to the consolidated financial statements and the effectiveness of First Keystone Corporation's internal control over financial reporting, which appears in this annual report on Form 10-K for the year ended December 31, 2018.

/s/ Baker Tilly Virchow Krause, LLP

Williamsport, Pennsylvania
March 18, 2019

[\(Back To Top\)](#)

Section 5: EX-23.2 (EXHIBIT 23.2)

EXHIBIT 23.2

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

First Keystone Corporation
Berwick, Pennsylvania

We hereby consent to the incorporation by reference in the Registration Statements on Form S-3D (No. 333-227152) and Form S-3 (No. 333-228140) of First Keystone Corporation of our report dated March 16, 2018, relating to the consolidated financial statements of First Keystone Corporation, which appears in this Form 10-K.

/s/ BDO USA, LLP

Philadelphia, Pennsylvania

March 18, 2019

[\(Back To Top\)](#)

Section 6: EX-31.1 (EXHIBIT 31.1)

EXHIBIT 31.1

FIRST KEYSTONE CORPORATION CERTIFICATION

I, Elaine A. Woodland, certify that:

1. I have reviewed this annual report on Form 10-K for the period ended December 31, 2018, of First Keystone Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

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

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

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

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

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

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

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

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

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

/s/ Elaine A. Woodland

Elaine A. Woodland

President and Chief Executive Officer

(Principal Executive Officer)

Date: March 18, 2019

[\(Back To Top\)](#)

Section 7: EX-31.2 (EXHIBIT 31.2)

EXHIBIT 31.2

FIRST KEYSTONE CORPORATION CERTIFICATION

I, Diane C.A. Rosler, certify that:

1. I have reviewed this annual report on Form 10-K for the period ended December 31, 2018, of First Keystone Corporation;

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

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

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

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

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

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

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

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

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

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

/s/ Diane C.A. Rosler

Diane C.A. Rosler

Senior Vice President and Chief Financial Officer

(Principal Financial Officer)

Date: March 18, 2019

[\(Back To Top\)](#)

Section 8: EX-32.1 (EXHIBIT 32.1)

EXHIBIT 32.1

FIRST KEYSTONE CORPORATION

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

AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report on Form 10-K of First Keystone Corporation (the "Corporation") for the period ended December 31, 2018, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Elaine A. Woodland, President and Chief Executive Officer, certify, pursuant to and for the purposes of 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation as of and for the period covered by the Report.

/s/ Elaine A. Woodland

Elaine A. Woodland

President and Chief Executive Officer

(Principal Executive Officer)

March 18, 2019

A signed original of this written statement required by Section 906 has been provided to the Corporation and will be retained by the Corporation

and furnished to the Securities and Exchange Commission or its staff upon request.

[\(Back To Top\)](#)

Section 9: EX-32.2 (EXHIBIT 32.2)

EXHIBIT 32.2

FIRST KEYSTONE CORPORATION
CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report on Form 10-K of First Keystone Corporation (the "Corporation") for the period ended December 31, 2018, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Diane C.A. Rosler, Chief Financial Officer, certify, pursuant to and for the purposes of 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation as of and for the period covered by the Report.

/s/ Diane C.A. Rosler

Diane C.A. Rosler
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)

March 18, 2019

A signed original of this written statement required by Section 906 has been provided to the Corporation and will be retained by the Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

[\(Back To Top\)](#)