

FIRST KEYSTONE CORP  
Form 10-Q  
August 07, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF  
<sup>X</sup> 1934

For the quarterly period ended June 30, 2017

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 or organization)

**23-2249083**

(I.R.S. Employer  
Identification No.)

**111 West Front Street, Berwick, PA 18603**  
(Address of principal executive offices) (Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark 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," and "small reporting 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

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

Common Stock, \$2 Par Value, 5,694,982 shares as of August 4, 2017



## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

(Unaudited)

(Dollars in thousands, except per share data)

	June 30, 2017	December 31, 2016
<b>ASSETS</b>		
Cash and due from banks	\$8,783	\$ 8,338
Interest-bearing deposits in other banks	1,328	790
Total cash and cash equivalents	10,111	9,128
Time deposits with other banks	1,482	1,482
Investment securities available-for-sale	393,703	379,637
Investment securities held-to-maturity (fair value 2017- \$0; 2016 - \$4)	—	4
Restricted investment in bank stocks	7,299	5,477
Loans	527,803	522,382
Allowance for loan losses	(7,353 )	(7,357 )
Net loans	520,450	515,025
Premises and equipment, net	18,693	19,237
Accrued interest receivable	4,314	3,917
Cash surrender value of bank owned life insurance	22,036	21,718
Investments in low-income housing partnerships	2,721	2,555
Goodwill	19,133	19,133
Foreclosed assets held for resale	1,283	1,273
Deferred income taxes	1,224	2,760
Other assets	2,975	2,937
<b>TOTAL ASSETS</b>	<b>\$ 1,005,424</b>	<b>\$ 984,283</b>
<b>LIABILITIES</b>		
Deposits:		
Non-interest bearing	\$ 122,630	\$ 110,314
Interest bearing	568,374	615,668
Total deposits	691,004	725,982
Short-term borrowings	128,730	69,290
Long-term borrowings	65,054	75,116
Accrued interest payable	499	427
Other liabilities	5,639	3,783
<b>TOTAL LIABILITIES</b>	<b>890,926</b>	<b>874,598</b>
<b>STOCKHOLDERS' EQUITY</b>		

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Preferred stock, par value \$2.00 per share; authorized 1,000,000 shares as of June 30, 2017 and December 31, 2016; issued 0 in 2017 and 2016		
Common stock, par value \$2.00 per share; authorized 20,000,000 shares as of June 30, 2017 and December 31, 2016; issued 5,928,094 as of June 30, 2017 and 5,904,563 as of December 31, 2016; outstanding 5,694,982 as of June 30, 2017 and 5,671,451 as of December 31, 2016	11,856	11,809
Surplus	35,617	35,047
Retained earnings	71,143	70,004
Accumulated other comprehensive income (loss)	1,638	(1,419 )
Treasury stock, at cost, 233,112 shares in 2017 and 2016	(5,756 )	(5,756 )
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>114,498</b>	<b>109,685</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$1,005,424</b>	<b>\$ 984,283</b>

See accompanying notes to consolidated financial statements.

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2017 AND 2016

(Unaudited)

<i>(Dollars in thousands, except per share data)</i>	Three Months Ended		Six Months Ended	
	June 30,	2016	June 30,	2016
	2017	2016	2017	2016
<b>INTEREST INCOME</b>				
Interest and fees on loans	\$ 5,544	\$ 5,468	\$ 11,056	\$ 10,924
Interest and dividend income on investment securities:				
Taxable	1,072	1,436	2,214	2,944
Tax-exempt	1,296	940	2,443	1,862
Dividends	11	16	22	31
Dividend income on restricted investment in bank stocks	78	64	155	124
Interest on interest-bearing deposits in other banks	9	8	17	16
Total interest income	8,010	7,932	15,907	15,901
<b>INTEREST EXPENSE</b>				
Interest on deposits	999	825	1,900	1,679
Interest on short-term borrowings	262	90	398	161
Interest on long-term borrowings	366	370	748	755
Total interest expense	1,627	1,285	3,046	2,595
Net interest income	6,383	6,647	12,861	13,306
Provision for loan losses	—	284	83	567
Net interest income after provision for loan losses	6,383	6,363	12,778	12,739
<b>NON-INTEREST INCOME</b>				
Trust department	219	230	457	430
Service charges and fees	461	446	897	861
Bank owned life insurance income	160	165	318	329
ATM fees and debit card income	356	331	683	643
Gains on sales of mortgage loans	88	55	124	157
Net investment securities gains	172	380	472	394
Other	39	59	82	152
Total non-interest income	1,495	1,666	3,033	2,966
<b>NON-INTEREST EXPENSE</b>				
Salaries and employee benefits	3,031	2,587	5,773	5,373
Occupancy, net	430	419	917	869
Furniture and equipment	137	128	276	264
Computer expense	267	240	513	470
Professional services	195	149	433	302
Pennsylvania shares tax	205	188	411	377
FDIC insurance	80	163	160	317

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ATM and debit card fees	188	167	325	306
Data processing fees	162	135	294	268
Foreclosed assets held for resale expense	80	61	106	112
Advertising	184	96	262	163
Other	707	681	1,459	1,333
Total non-interest expense	5,666	5,014	10,929	10,154
Income before income tax expense	2,212	3,015	4,882	5,551
Income tax expense	293	524	677	884
NET INCOME	\$ 1,919	\$ 2,491	\$4,205	\$4,667
PER SHARE DATA				
Net income per share:				
Basic	\$ 0.34	\$ 0.44	\$0.74	\$0.83
Diluted	0.34	0.44	0.74	0.83
Dividends per share	0.27	0.27	0.54	0.54

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended June 30,	
	2017	2016
<i>(Dollars in thousands)</i>		
Net Income	\$ 1,919	\$ 2,491
Other comprehensive income:		
Unrealized net holding gains on available-for-sale investment securities arising during the period, net of income taxes of \$1,205 and \$1,391, respectively	2,336	2,687
Less reclassification adjustment for net gains included in net income, net of income taxes of \$(58) and \$(129), respectively (a) (b)	(114 )	(251 )
Total other comprehensive income	2,222	2,436
Total Comprehensive Income	\$ 4,141	\$ 4,927

(a) Gross amounts are included in net investment securities 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.

	Six Months Ended June 30,	
	2017	2016
<i>(Dollars in thousands)</i>		
Net Income	\$4,205	\$4,667
Other comprehensive income:		
Unrealized net holding gains on available-for-sale investment securities arising during the period, net of income taxes of \$1,740 and \$3,536, respectively	3,368	6,858
Less reclassification adjustment for net gains included in net income, net of income taxes of \$(161) and \$(134), respectively (a) (b)	(311 )	(260 )
Total other comprehensive income	3,057	6,598



Total Comprehensive Income	\$7,262	\$11,265
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(a) Gross amounts are included in net investment securities 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.

See accompanying notes to consolidated financial statements.

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

SIX MONTHS ENDED JUNE 30, 2017 AND 2016

(Unaudited)

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

	Common Stock			Retained	Accumulated Other Comprehensive (Loss) Income	Treasury Stock	Total Stockholders' Equity
	Shares	Amount	Surplus	Earnings			
Balance at January 1, 2017	5,904,563	\$ 11,809	\$ 35,047	\$ 70,004	\$ (1,419 )	\$ (5,756 )	\$ 109,685
Net Income				4,205			4,205
Other comprehensive income, net of taxes					3,057		3,057
Issuance of common stock under dividend reinvestment plan	23,531	47	570				617
Dividends - \$0.54 per share				(3,066 )			(3,066 )
Balance at June 30, 2017	5,928,094	\$ 11,856	\$ 35,617	\$ 71,143	\$ 1,638	\$ (5,756 )	\$ 114,498
Balance at January 1, 2016	5,853,317	\$ 11,707	\$ 33,830	\$ 66,622	\$ 2,035	\$ (5,756 )	\$ 108,438
Net Income				4,667			4,667
Other comprehensive income, net of taxes					6,598		6,598
Issuance of common stock under dividend reinvestment plan	25,792	51	620				671
Dividends - \$0.54 per share				(3,038 )			(3,038 )
Balance at June 30, 2016	5,879,109	\$ 11,758	\$ 34,450	\$ 68,251	\$ 8,633	\$ (5,756 )	\$ 117,336

See accompanying notes to consolidated financial statements.

## FIRST KEYSTONE CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX MONTHS ENDED JUNE 30, 2017 AND 2016

(Unaudited)

(Dollars in thousands)	2017	2016
<b>OPERATING ACTIVITIES</b>		
Net income	\$4,205	\$4,667
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	83	567
Depreciation and amortization	564	589
Net premium amortization on investment securities	2,417	1,900
Deferred income tax benefit	(43 )	
Gains on sales of mortgage loans	(124 )	(157 )
Proceeds from sales of mortgage loans originated for resale	3,950	4,621
Originations of mortgage loans originated for resale	(4,280 )	(6,483 )
Gains on sales of investment securities	(472 )	(394 )
Net losses on sales of foreclosed real estate held for resale, including write-downs	15	37
(Increase) decrease in accrued interest receivable	(397 )	154
Earnings on investment in bank owned life insurance	(318 )	(329 )
Increase in other assets	(38 )	(118 )
Amortization of investment in real estate ventures	81	88
Increase in accrued interest payable	72	59
(Decrease) increase in other liabilities	(166 )	238
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>5,549</b>	<b>5,439</b>
<b>INVESTING ACTIVITIES</b>		
Proceeds from sales of investment securities available-for-sale	51,992	27,408
Proceeds from maturities and redemptions of investment securities available-for-sale	9,368	6,808
Purchases of investment securities available-for-sale	(70,722)	(25,571)
Proceeds from maturities and redemptions of investment securities held-to-maturity	4	6
Net change in restricted investment in bank stocks	(1,822 )	(880 )
Net (increase) decrease in loans	(5,189 )	1,512
Purchases of premises and equipment	(53 )	(208 )
Purchase of investment in real estate venture	(247 )	—
Proceeds from sales of foreclosed assets held for resale	152	230
<b>NET CASH (USED IN) PROVIDED BY INVESTING ACTIVITIES</b>	<b>(16,517)</b>	<b>9,305</b>
<b>FINANCING ACTIVITIES</b>		
Net decrease in deposits	(34,978)	(36,127)
Net increase in short-term borrowings	59,440	19,099
Proceeds from long-term borrowings	—	10,000
Repayment of long-term borrowings	(10,062)	(5,057 )
Common stock issued	617	629

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Dividends paid	(3,066 )	(3,038 )
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	11,951	(14,494)
INCREASE IN CASH AND CASH EQUIVALENTS	983	250
CASH AND CASH EQUIVALENTS, BEGINNING	9,128	9,008
CASH AND CASH EQUIVALENTS, ENDING	\$10,111	\$9,258
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Interest paid	\$2,974	\$2,536
Income taxes paid	932	1,730
SUPPLEMENTAL DISCLOSURE OF NON-CASH ACTIVITIES		
Purchased securities settling after quarter end	2,013	
Loans transferred to foreclosed assets held for resale	177	75
Loans transferred (from) to held for sale portfolio	—	(171 )
Common stock subscription receivable	—	42

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**NOTE 1 BASIS OF PRESENTATION AND ACCOUNTING POLICIES**

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial information. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for fair presentation have been included. Operating results for the three and six month periods ended June 30, 2017, are not necessarily indicative of the results for the year ending December 31, 2017. For further information, refer to the consolidated financial statements and notes thereto included in First Keystone Corporation’s Annual Report on Form 10-K for the year ended December 31, 2016.

For comparative purposes, the June 30, 2016 balances have been reclassified to conform to the June 30, 2017 presentation. Such reclassifications had no impact on net income.

The Corporation has evaluated events and transactions occurring subsequent to the consolidated balance sheet date of June 30, 2017 for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

**NOTE 2 RECENT ACCOUNTING STANDARDS UPDATES (“ASU”)**

Except as disclosed below, there were no new accounting pronouncements affecting the Corporation during the six months ended June 30, 2017 that were not already adopted by the Corporation.

In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which supersedes the revenue requirements in *Revenue Recognition (Topic 605)*. This ASU requires entities to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. The ASU is effective for annual reporting periods beginning after December 31, 2016, including interim periods within the reporting period. Early application is not permitted. In August 2015, the FASB issued an update ASU 2015-14 which approved a one-year delay of the effective date of this standard. The deferral would require public entities to apply the standard for annual reporting periods beginning after December 15, 2017. In March 2016, the FASB issued an update ASU 2016-08 which updates the new revenue standard by clarifying the principal versus agent implementation guidance, but does not change the core principle of the new standard. In April 2016, the FASB issued an update ASU 2016-10, that updates the standard by identifying performance obligations and licenses of intellectual property, which clarifies the guidance surrounding licensing arrangements and the identification of performance obligations. In May 2016, the FASB issued an update ASU 2016-12 which articulates narrow-scope improvements and practical expedients. Because the amended guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other U.S. GAAP, the Corporation’s preliminary analysis suggests that the adoption of this amended guidance is not expected to have a material impact on its consolidated financial statements, although the Corporation will also be subject to expanded disclosure requirements upon adoption and the Corporation’s revenue recognition processes for wealth and asset management revenue, and card and processing revenue may be affected. However, there are certain areas of the amended guidance, such as credit card interchange fees and related rewards programs, which are subject to interpretation and for which the Corporation has not made final conclusions regarding the applicability and the related impact, if any. In December, the FASB issued an update ASU 2016-20. The amendments affect narrow aspects of the guidance issued in ASU 2014-09 including Loan Guarantee Fees, Contract Costs, Provisions for Losses on Construction-Type and Production-Type Contracts, Disclosure of Remaining Performance Obligations, Disclosure of Prior Period Performance Obligations, Contract Modifications, Contract Asset vs. Receivable, Refund Liability, Advertising Costs, Fixed Odds Wagering Contracts in the Casino Industry, and Costs Capitalized for Advisors to Private Funds and Public Funds. In February 2017, the FASB issued an update ASU 2017-05 with amendments to clarify that a financial asset is within the scope of Subtopic 610.20 if it meets the definition of an in substance nonfinancial asset. Accordingly, the results of the Corporation’s materiality analysis, as well as its selected adoption method, may change as these conclusions are reached. The Corporation is currently assessing the impact that this guidance will have on its consolidated financial statements and related disclosures through the development and analysis of a bank-wide inventory of products and services and directly related income streams, consulting with outside business partners and evaluating the proper accounting system modifications as needed.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities*. The guidance addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. In particular, the guidance revises an entity's accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. The guidance also amends certain disclosure requirements associated with fair value of financial instruments. For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Entities should apply the amendments by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The adoption of this update is not expected to have a material impact on the Company's consolidated financial position or results of operations.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. Under the new guidance, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (i) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (ii) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Public business entities should apply the amendments in ASU 2016-02 for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted for all public business entities upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The adoption of this ASU will result in an increase to the Consolidated Balance Sheets for right-of-use assets and associated lease liabilities for operating leases in which the Corporation is the lessee. The Corporation is evaluating the significance and other effects of adoption on the consolidated financial statements and related disclosures.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The ASU requires that financial assets measured at amortized cost should 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 allowance for credit losses should reflect management's current estimate of credit losses that are expected to occur over the remaining life of a financial asset. This is in contrast to existing guidance whereby credit losses generally are not recognized until they are incurred. For public companies, this update will be effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early application will be permitted for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. While the Corporation is currently evaluating the provisions of the ASU 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 begun evaluating its current IT systems.

In August 2016, the Financial Accounting Standards Board ("FASB") issued ASU 2016-15, *Classification of Certain Cash Receipts and Cash Payments*. The amendments are intended to reduce diversity in practice. The guidance clarifies the classification of various business activities as financing, operating or investing activity. The ASU contains

additional guidance clarifying when an entity should separate cash receipts and cash payments and classify them into more than one class of cash flows (including when reasonable judgment is required to estimate and allocate cash flows) versus when an entity should classify the aggregate amount into one class of cash flows on the basis of predominance. The amendments are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The Corporation is currently assessing the impact that this guidance will have on its consolidated financial statements and related disclosures.



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 Company’s consolidated financial position or results of operations.

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. Early adoption is permitted as of the beginning of an annual period for which financial statements (interim or annual) have not been issued or made available for issuance. The adoption of this update is not expected to have a material impact on the Company’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. Early adoption is permitted, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. 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 is currently assessing the impact that this guidance will have on its consolidated financial statements and related disclosures.

### **NOTE 3 — INVESTMENT SECURITIES**

The Corporation classifies its investment securities as either “Held-to-Maturity” or “Available-for-Sale” at the time of purchase. Investment 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. Investment 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 and equity securities 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 income (loss) 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 from 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.

The amortized cost, related estimated fair value, and unrealized gains and losses for investment securities classified as “Available-For-Sale” or “Held-to-Maturity” were as follows at June 30, 2017 and December 31, 2016:

<i>(Dollars in thousands)</i>	Available-for-Sale Securities			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2017:				
U.S. Treasury securities	\$ 1,001	\$ —	\$ —	\$ 1,001
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	107,331	358	(916 )	106,773
Other	23,717	147	(268 )	23,596
Obligations of state and political subdivisions	223,321	4,591	(1,460 )	226,452
Corporate debt securities	34,955	79	(830 )	34,204
Marketable equity securities	809	868		1,677
Total	\$ 391,134	\$ 6,043	\$ (3,474 )	\$ 393,703

<i>(Dollars in thousands)</i>	Held-to-Maturity Securities			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2017:				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$ —	\$ —	\$ —	\$ —
Total	\$ —	\$ —	\$ —	\$ —

<i>(Dollars in thousands)</i>	Available-for-Sale Securities			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2016:				
U.S. Treasury securities	\$ 1,008	\$ 2	\$ —	\$ 1,010
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	112,155	83	(1,331 )	110,907
Other	21,399	82	(511 )	20,970
Obligations of state and political subdivisions	211,154	2,776	(2,796 )	211,134
Corporate debt securities	35,178	4	(1,206 )	33,976
Marketable equity securities	810	830	—	1,640
Total	\$ 381,704	\$ 3,777	\$ (5,844 )	\$ 379,637

<i>(Dollars in thousands)</i>	Held-to-Maturity Securities	
	Gross	Gross

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	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2016:				
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	\$ 4	\$ —	\$ —	\$ 4
Total	\$ 4	\$ —	\$ —	\$ 4

Securities Available-for-Sale with an aggregate fair value of \$272,439,000 at June 30, 2017 and \$320,319,000 at December 31, 2016, and securities Held-to-Maturity with an aggregate book value of \$0 at June 30, 2017 and \$4,000 at December 31, 2016, were pledged to secure public funds, trust funds, securities sold under agreements to repurchase, debtor in possession funds and the Federal Discount Window aggregating \$159,686,000 at June 30, 2017 and \$221,818,000 at December 31, 2016.

The amortized cost, estimated fair value and weighted average yield of debt and equity securities, by contractual maturity, are shown below at June 30, 2017. 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)*

	<b>June 30, 2017</b>					<b>Held-To-Maturity</b>	
	<b>Available-For-Sale</b>		<b>Obligations</b>		<b>Marketable</b>	<b>U.S. Government Corporations &amp; Agencies Obligations<sup>1</sup></b>	
	<b>U.S. Treasury Securities</b>	<b>U.S. Government Corporations &amp; Agencies Obligations<sup>1</sup></b>	<b>of State &amp; Political Subdivisions<sup>2</sup></b>	<b>Corporate Debt Securities</b>	<b>Equity Securities<sup>3</sup></b>		
<b>Within 1 Year:</b>							
Amortized cost	\$1,001	\$	\$ 1,250	\$ 535	\$	\$	
Fair value	1,001		1,250	520			
Weighted average yield	0.96 %		1.40 %	2.78 %			
<b>1 - 5 Years:</b>							
Amortized cost	—	16,510	27,821	11,559			—
Fair value	—	16,549	28,104	11,491			—
Weighted average yield	—	2.15 %	2.90 %	2.37 %			—
<b>5 - 10 Years:</b>							
Amortized cost		48,081	71,569	22,861			
Fair value		47,308	72,654	22,193			
Weighted average yield		2.14 %	3.29 %	2.67 %			
<b>After 10 Years:</b>							
Amortized cost		66,457	122,681		809		
Fair value		66,512	124,444		1,677		
Weighted average yield		1.98 %	3.59 %		5.44 %		
<b>Total:</b>							
Amortized cost	\$1,001	\$ 131,048	\$ 223,321	\$ 34,955	\$ 809	\$	—
Fair value	1,001	130,369	226,452	34,204	1,677		—
Weighted average yield	0.96 %	2.06 %	3.40 %	2.57 %	5.44 %		—

<sup>1</sup>Mortgage-backed securities are allocated for maturity reporting at their original maturity date.

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

<sup>3</sup>Marketable equity securities are not considered to have defined maturities and are included in the after ten year category.

There were no aggregate investments 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 June 30, 2017. 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 and equity securities for the three months ended June 30, 2017 and 2016 were \$27,501,000 and \$20,374,000, respectively. Gross gains realized on these sales were \$197,000 and \$380,000, respectively. Gross losses realized on these sales were \$25,000 and \$0, respectively. There were no impairment losses realized on Available-for-Sale equity securities for the three months ended June 30, 2017 and 2016.

Proceeds from sales of investments in Available-for-Sale debt and equity securities for the six months ended June 30, 2017 and 2016 were \$51,992,000 and \$27,408,000, respectively. Gross gains realized on these sales were \$535,000 and \$435,000, respectively. Gross losses realized on these sales were \$63,000 and \$41,000, respectively. There were no impairment losses realized on Available-for-Sale equity securities for the six months ended June 30, 2017 and 2016.

There were no proceeds from sales of investments in Held-to-Maturity debt securities during the three or six month periods ended June 30, 2017 or 2016. Therefore, there were no gains or losses realized during these periods.

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. Investment 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.

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 income (loss), 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 amount of the total other-than-temporary impairment is recognized in other comprehensive income (loss), net of applicable taxes. The previous cost basis less the other-than-temporary impairment recognized in earnings becomes the new cost basis of the investment.

The Corporation and its investment advisors monitor the entire portfolio monthly 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 June 30, 2017 or December 31, 2016.





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 investments, aggregated by investment category, that individual securities have been in a continuous unrealized loss position for less than 12 months or 12 months or more as of June 30, 2017 and December 31, 2016:

June 30, 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	41,537	(727 )	14,400	(189 )	55,937	(916 )
Other	11,380	(268 )	—	—	11,380	(268 )
Obligations of state and political subdivisions	54,016	(1,391 )	1,513	(69 )	55,529	(1,460 )
Corporate debt securities	6,249	(402 )	17,717	(428 )	23,966	(830 )
Marketable equity securities						
	\$ 113,182	\$ (2,788 )	\$ 33,630	\$ (686 )	\$ 146,812	\$ (3,474 )

December 31, 2016

(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	89,444	(1,216 )	8,783	(115 )	98,227	(1,331 )
Other	10,340	(500 )	1,741	(11 )	12,081	(511 )
Obligations of state and political subdivisions	95,481	(2,796 )	—	—	95,481	(2,796 )
Corporate debt securities	21,656	(749 )	10,298	(457 )	31,954	(1,206 )
Marketable equity securities						
	\$ 216,921	\$ (5,261 )	\$ 20,822	\$ (583 )	\$ 237,743	\$ (5,844 )

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 marketable equity securities consist of stocks in other bank holding companies. 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 79 securities with a one year or less unrealized loss position or any of their 16 securities with a greater than one year unrealized loss position as of June 30, 2017, 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.

#### **NOTE 4 — LOANS AND ALLOWANCE FOR LOAN LOSSES**

##### **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 resale 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 \$553,000 and \$100,000 at June 30, 2017 and December 31, 2016, respectively.

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.

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. 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 loans 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.

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 June 30, 2017 and December 31, 2016, the amount of the reserve for unfunded lending commitments was \$109,000 and \$202,000, 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.

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.

They 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.

The following table presents the classes of the loan portfolio summarized by risk rating as of June 30, 2017 and December 31, 2016:

(Dollars in thousands)	Commercial and Industrial		Commercial Real Estate	
	June 30, 2017	December 31, 2016	June 30, 2017	December 31, 2016
Grade:				
1-6 Pass	\$85,298	\$ 78,319	\$ 251,852	\$ 243,023
7 Special Mention	443	4,425	2,813	6,224
8 Substandard	1,367	684	13,459	13,817
9 Doubtful				
Add (deduct): Unearned discount and Net deferred loan fees and costs	156	145	525	455
Total loans	\$87,264	\$ 83,573	\$ 268,649	\$ 263,519

	Residential Real Estate Including Home Equity		Consumer	
	June 30, 2017	December 31, 2016	June 30, 2017	December 31, 2016
Grade:				
1-6 Pass	\$ 162,848	\$ 165,862	\$6,005	\$ 6,073
7 Special Mention	1,527	1,664	1	71
8 Substandard	1,440	1,523	9	9
9 Doubtful				
Add (deduct): Unearned discount and Net deferred loan fees and costs	(3 ) (6 )	(35 ) (8 )	98	102
Total loans	\$ 165,777	\$ 169,035	\$6,113	\$ 6,255

	Total Loans	
	June 30, 2017	December 31, 2016
Grade:		
1-6 Pass	\$506,003	\$ 493,277
7 Special Mention	4,784	12,384
8 Substandard	16,275	16,033
9 Doubtful		
Add (deduct): Unearned discount and Net deferred loan fees and costs	(3 ) (6 )	744 694
Total loans	\$527,803	\$ 522,382

Commercial and Industrial and Commercial Real Estate include loans categorized as tax-free in the amounts of \$41,089,000 and \$2,387,000 at June 30, 2017 and \$36,289,000 and \$2,780,000 at December 31, 2016. Loans held for sale amounted to \$553,000 at June 30, 2017 and \$100,000 at December 31, 2016.

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

<b>(Dollars in thousands)</b>	<b>Commercial and Industrial</b>	<b>Commercial Real Estate</b>	<b>Residential Real Estate</b>	<b>Consumer</b>	<b>Unallocated</b>	<b>Total</b>
As of and for the three month period ended June 30, 2017:						
Allowance for Loan Losses:						
Beginning balance	\$ 875	\$ 4,457	\$ 1,749	\$ 95	\$ 285	\$7,461
Charge-offs	—	(88 )	(42 )	(12 )	—	(142 )
Recoveries	6	27	—	1	—	34
Provision	(36 )	186	5	19	(174 )	—
Ending Balance	\$ 845	\$ 4,582	\$ 1,712	\$ 103	\$ 111	\$7,353

<b>(Dollars in thousands)</b>	<b>Commercial and Industrial</b>	<b>Commercial Real Estate</b>	<b>Residential Real Estate</b>	<b>Consumer</b>	<b>Unallocated</b>	<b>Total</b>
As of and for the six month period ended June 30, 2017:						
Allowance for Loan Losses:						
Beginning balance	\$ 836	\$ 4,421	\$ 1,777	\$ 95	\$ 228	\$7,357
Charge-offs	—	(97 )	(61 )	(34 )	—	(192 )
Recoveries	73	27	—	5	—	105
Provision	(64 )	231	(4 )	37	(117 )	83
Ending Balance	\$ 845	\$ 4,582	\$ 1,712	\$ 103	\$ 111	\$7,353
Ending balance: individually evaluated for impairment	\$	\$ 261	\$ 12	\$	\$	\$273
Ending balance: collectively evaluated for impairment	\$ 845	\$ 4,321	\$ 1,700	\$ 103	\$ 111	\$7,080
Loans Receivable:						
Ending Balance	\$ 87,264	\$ 268,649	\$ 165,777	\$ 6,113	<u>\$</u>	\$527,803
Ending balance: individually evaluated for impairment	\$ 1,232	\$ 12,823	\$ 931	\$	<u>\$</u>	\$14,986
Ending balance: collectively evaluated for impairment	\$ 86,032	\$ 255,826	\$ 164,846	\$ 6,113	<u>\$</u>	\$512,817

<b>(Dollars in thousands)</b>	<b>Commercial and Industrial</b>	<b>Commercial Real Estate</b>	<b>Residential Real Estate</b>	<b>Consumer</b>	<b>Unallocated</b>	<b>Total</b>
As of and for the three month period ended June 30, 2016:						
Allowance for Loan Losses:						

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Beginning balance	\$ 731	\$ 3,983	\$ 1,749	\$ 101	\$ 448	\$7,012
Charge-offs	(2 )	(57 )	(25 )			(84 )
Recoveries	4			3		7
Provision	(31 )	88	(27 )	2	252	284
Ending Balance	\$ 702	\$ 4,014	\$ 1,697	\$ 106	\$ 700	\$7,219



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(Dollars in thousands)	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
As of and for the six month period ended June 30, 2016:						
Allowance for Loan Losses:						
Beginning balance	\$ 725	\$ 3,983	\$ 1,777	\$ 96	\$ 158	\$6,739
Charge-offs	(2 )	(57 )	(25 )	(23 )		(107 )
Recoveries	4		12	4		20
Provision	(25 )	88	(67 )	29	542	567
Ending Balance	\$ 702	\$ 4,014	\$ 1,697	\$ 106	\$ 700	\$7,219
Ending balance: individually evaluated for impairment	\$	\$ 393	\$ 19	\$	\$	\$412
Ending balance: collectively evaluated for impairment	\$ 702	\$ 3,621	\$ 1,678	\$ 106	\$ 700	\$6,807
Loans Receivable:						
Ending Balance	\$ 79,399	\$ 263,524	\$ 167,755	\$ 6,320	\$	\$516,998
Ending balance: individually evaluated for impairment	\$ 478	\$ 11,993	\$ 858	\$	\$	\$13,329
Ending balance: collectively evaluated for impairment	\$ 78,921	\$ 251,531	\$ 166,897	\$ 6,320	\$	\$503,669

(Dollars in thousands)	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
As of and for the year ended December 31, 2016						
Allowance for Loan Losses:						
Beginning balance	\$ 725	\$ 3,983	\$ 1,777	\$ 96	\$ 158	\$6,739
Charge-offs	(195 )	(1,200 )	(61 )	(38 )	—	(1,494 )
Recoveries	9	—	12	8	—	29
Provision	297	1,638	49	29	70	2,083
Ending Balance	\$ 836	\$ 4,421	\$ 1,777	\$ 95	\$ 228	\$7,357
Ending balance: individually evaluated for impairment	\$ —	\$ 200	\$ 19	\$ —	\$ —	\$219
Ending balance: collectively evaluated for impairment	\$ 836	\$ 4,221	\$ 1,758	\$ 95	\$ 228	\$7,138
Loans Receivable:						
Ending Balance	\$ 83,573	\$ 263,519	\$ 169,035	\$ 6,255	\$ —	\$522,382
Ending balance: individually evaluated for impairment	\$ 416	\$ 12,873	\$ 1,008	\$ —	\$ —	\$14,297
Ending balance: collectively evaluated for impairment	\$ 83,157	\$ 250,646	\$ 168,027	\$ 6,255	\$ —	\$508,085

Of the \$1,283,000 in foreclosed assets held for resale at June 30, 2017, \$180,000 was secured by residential real estate, \$50,000 was secured by land, and \$1,053,000 was secured by commercial real estate. Of the \$1,273,000 in foreclosed assets held for resale at December 31, 2016, \$50,000 was secured by residential real estate, \$50,000 was secured by land, and \$1,173,000 was secured by commercial real estate. At June 30, 2017 and December 31, 2016, all foreclosed assets were held as the result of obtaining physical possession. 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 \$504,000 at June 30, 2017 and \$649,000 at December 31, 2016. These balances were not included in foreclosed assets held for resale at June 30, 2017 or December 31, 2016.

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 TDRs as of June 30, 2017 and December 31, 2016 was \$11,017,000 and \$11,629,000, respectively. The decrease in TDRs at June 30, 2017 as compared to December 31, 2016 is attributable to large principal payments and paydowns made on existing TDRs net against smaller loans modified as TDRs during the six months ended June 30, 2017. There was \$2,000 in unfunded commitments on TDRs at June 30, 2017 and December 31, 2016.

During the three months ended June 30, 2017, no loans were modified as TDRs as compared to the same period in 2016, when three loans with a combined post modification balance of \$114,000 were classified as TDRs. The loan modifications for the three months ended June 30, 2016 consisted of two term modifications and one payment modification.

During the six months ended June 30, 2017, two loans with a combined post modification balance of \$110,000 were classified as TDRs, as compared to the same period in 2016, when seven loans with a combined post modification balance of \$542,000 were classified as TDRs. The loan modifications for the six months ended June 30, 2017 consisted of two payment modifications. The loan modifications for the six months ended June 30, 2016 consisted of five term modifications and two payment modifications.

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

*(Dollars in thousands)*

	<b>June 30, 2017</b>	<b>December 31, 2016</b>
Non-accrual TDRs	\$ 290	\$ 267
Accruing TDRs	10,727	11,362
Total	\$ 11,017	\$ 11,629

At June 30, 2017, seven Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$454,000 and one Commercial and Industrial loan with a recorded investment of \$13,000 were not in compliance with the terms of their restructure, compared to June 30, 2016 when five Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$748,000 were not in compliance with the terms of their restructure.

During the three months ended June 30, 2017 and 2016, no loans that were modified as TDRs within the preceding twelve months had experienced payment defaults. During the six months ended June 30, 2017 and 2016, no loans that were modified as TDRs within the preceding twelve months had experienced payment defaults.

The following table presents information regarding the loan modifications categorized as TDRs during the six months ended June 30, 2017 and the three and six months ended June 30, 2016. No loans were modified as TDRs during the three months ended June 30, 2017.

(Dollars in thousands)	Three Months Ended June 30, 2016				
		<b>Pre-Modification</b>		<b>Post-Modification</b>	
	Number	Outstanding	Recorded	Outstanding	Recorded
	of	Investment		Investment	
	Contracts				
Commercial and Industrial	1	\$	18	\$	18
Commercial Real Estate	2		96		95
Total	3	\$	114	\$	113

(Dollars in thousands)	Six Months Ended June 30, 2017				
		<b>Pre-Modification</b>		<b>Post-Modification</b>	
	Number	Outstanding	Recorded	Outstanding	Recorded
	of	Investment		Investment	
	Contracts				
Commercial and Industrial	1	\$	38	\$	38
Commercial Real Estate	1		72		71
Total	2	\$	110	\$	109

(Dollars in thousands)	Six Months Ended June 30, 2016				
	Number of Contracts	Pre-Modification		Post-Modification	
		Outstanding	Recorded	Outstanding	Recorded
		Investment		Investment	
Commercial and Industrial	4	\$ 86	\$ 86		\$ 81
Commercial Real Estate	3	456	456		209
Total	7	\$ 542	\$ 542		\$ 290

The following table provides detail regarding the types of loan modifications made for loans categorized as TDRs during the six months ended June 30, 2017 and the three and six months ended June 30, 2016 with the total number of each type of modification performed. No loans were modified as TDRs during the three months ended June 30, 2017.

	Six Months Ended June 30, 2017			
	Rate Modification	Term Modification	Payment Modification	Number Modified
Commercial and Industrial		—	1	1
Commercial Real Estate		—	1	1
Total			2	2

	Three Months Ended June 30, 2016			Six Months Ended June 30, 2016				
	Rate Modification	Term Modification	Payment Modification	Number Modified	Rate Modification	Term Modification	Payment Modification	Number Modified
Commercial and Industrial		1		1		3	1	4
Commercial Real Estate		1	1	2		2	1	3
Total		2	1	3		5	2	7

While no new loans were modified as TDRs during the three months ended June 30, 2017, two existing TDRs experienced subsequent modifications. An existing Commercial and Industrial TDR to the owner of a greenhouse in the amount of \$309,000 was subsequently modified during the three months ended June 30, 2017 to extend the maturity date of the loan and change payments to interest-only with all other accrued interest and principal to be due in full at maturity. An existing Commercial Real Estate TDR to a travel agency in the amount of \$38,000 was subsequently modified during the three months ended June 30, 2017 to allow interest only payments through April 2018, after which time regular principal and interest payments will commence. Both TDRs retain their original classification as “payment” modifications as of June 30, 2017.

The recorded investment, unpaid principal balance, and the related allowance of the Corporation’s impaired loans are summarized below for the periods ended June 30, 2017 and December 31, 2016.

(Dollars in thousands)	June 30, 2017			December 31, 2016		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:						
Commercial and Industrial	\$1,232	\$1,232	\$	\$416	\$416	\$
Commercial Real Estate	11,606	13,856		11,905	14,352	
Residential Real Estate	830	991		584	745	
With an allowance recorded:						
Commercial and Industrial	—	—	—	—	—	—
Commercial Real Estate	1,217	2,632	261	968	2,383	200
Residential Real Estate	101	101	12	424	424	19
Total	\$14,986	\$18,812	\$273	\$14,297	\$18,320	\$219
Total consists of:						
Commercial and Industrial	\$1,232	\$1,232	\$	\$416	\$416	\$
Commercial Real Estate	\$12,823	\$16,488	\$261	\$12,873	\$16,735	\$200
Residential Real Estate	\$931	\$1,092	\$12	\$1,008	\$1,169	\$19

At June 30, 2017 and December 31, 2016, \$11,017,000 and \$11,629,000 of loans classified as TDRs were included in impaired loans with a total allocated allowance of \$0 and \$0, respectively. The recorded investment represents the loan balance reflected on the Consolidated Balance Sheets net of any charge-offs. The unpaid principal 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 three and six months ended June 30, 2017 and 2016.

(Dollars in thousands)	For the Three Months Ended June 30, 2017		For the Three Months Ended June 30, 2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial and Industrial	\$ 1,241	\$ 4	\$ 472	\$ 5
Commercial Real Estate	11,698	121	6,913	83
Residential Real Estate	865	—	423	
With an allowance recorded:				
Commercial and Industrial	—	—	—	—
Commercial Real Estate	1,221	—	5,179	37
Residential Real Estate	101	—	424	
Total	\$ 15,126	\$ 125	\$ 13,411	\$ 125
Total consists of:				
Commercial and Industrial	\$ 1,241	\$ 4	\$ 472	\$ 5
Commercial Real Estate	\$ 12,919	\$ 121	\$ 12,092	\$ 120
Residential Real Estate	\$ 966	\$ —	\$ 847	\$

Of the \$125,000 in interest income recognized on impaired loans for the three months ended June 30, 2017 and 2016, respectively, \$0 and \$0 in interest income was recognized with respect to non-accrual loans.

(Dollars in thousands)	For the Six Months Ended June 30, 2017		For the Six Months Ended June 30, 2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial and Industrial	\$ 966	\$ 17	\$ 447	\$ 10
Commercial Real Estate	11,736	245	6,904	171
Residential Real Estate	829	1	422	
With an allowance recorded:				
Commercial and Industrial	—	—	—	—
Commercial Real Estate	1,137	3	5,176	74

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Residential Real Estate	101	—	428	
Total	\$ 14,769	\$ 266	\$ 13,377	\$ 255

Total consists of:

Commercial and Industrial	\$ 966	\$ 17	\$ 447	\$ 10
Commercial Real Estate	\$ 12,873	\$ 248	\$ 12,080	\$ 245
Residential Real Estate	\$ 930	\$ 1	\$ 850	\$

Of the \$266,000 and \$255,000 in interest income recognized on impaired loans for the six months ended June 30, 2017 and 2016, respectively, \$17,000 and \$0 in interest income was recognized with respect to non-accrual loans.



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 June 30, 2017 and December 31, 2016 were as follows:

(Dollars in thousands)

	<b>June 30, 2017</b>	<b>December 31, 2016</b>
Commercial and Industrial	\$ 821	\$ —
Commercial Real Estate	2,508	1,927
Residential Real Estate	930	1,008
Total non-accrual loans	4,259	2,935
Foreclosed assets held for resale	1,283	1,273
Loans past-due 90 days or more and still accruing interest	204	34
Total non-performing assets	\$ 5,746	\$ 4,242

The following tables present the classes of the loan portfolio summarized by past-due status at June 30, 2017 and December 31, 2016:

(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
June 30, 2017:							
Commercial and Industrial	\$ 14	\$ 12	\$ 2	\$ 28	\$87,236	\$87,264	\$ 2
Commercial Real Estate	793	220	811	1,824	266,825	268,649	74
Residential Real Estate	788	203	588	1,579	164,198	165,777	126
Consumer	13	20	2	35	6,078	6,113	2
Total	\$ 1,608	\$ 455	\$ 1,403	\$ 3,466	\$524,337	\$527,803	\$ 204

(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, 2016:							
Commercial and Industrial	\$ 130	\$ —	\$ —	\$ 130	\$83,443	\$83,573	\$ —
Commercial Real Estate	1,019	273	1,927	3,219	260,300	263,519	—
Residential Real Estate	1,750	542	1,020	3,312	165,723	169,035	34

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Consumer	28	8	—	36	6,219	6,255	—
Total	\$ 2,927	\$ 823	\$ 2,947	\$ 6,697	\$515,685	\$522,382	\$ 34

At June 30, 2017 and December 31, 2016, 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.

**NOTE 5 — BORROWINGS**

**Short-Term Borrowings**

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

**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.

The following table presents the short-term borrowings subject to an enforceable master netting arrangement or repurchase agreements as of June 30, 2017 and December 31, 2016.

(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
June 30, 2017						
Repurchase agreements (a)	\$ 21,606	\$	\$ 21,606	\$ (21,606 )	\$	\$
December 31, 2016						
Repurchase agreements (a)	\$ 18,490	\$	\$ 18,490	\$ (18,490 )	\$	\$

(a) As of June 30, 2017 and December 31, 2016, the fair value of securities pledged in connection with repurchase agreements was \$26,721,000 and \$25,298,000, respectively.

The following table presents the remaining contractual maturity of the master netting arrangement or repurchase agreements as of June 30, 2017:

(Dollars in thousands)	Remaining Contractual Maturity of the Agreements				
	Overnight and Continuous	Up to 30 days	30 -90 Days	Greater than 90 Days	Total
<b>June 30, 2017:</b>					
Repurchase agreements and repurchase-to-maturity transactions:					
U.S. Treasury and/or agency securities	\$ 21,606	\$	\$	\$	\$ 21,606
Total	\$ 21,606	\$	\$	\$	\$ 21,606

### Long-Term Borrowings

Long-term borrowings are comprised of advances from FHLB and a capital lease assumed as a result of the acquisition of Pocono Community Bank. Under terms of a blanket agreement, collateral for the FHLB loans is certain qualifying assets of the Corporation's banking subsidiary. The principal assets are real estate mortgages and certain investment securities.

## **NOTE 6 — COMMITMENTS AND CONTINGENCIES**

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 or results of operations of the Corporation.

## **NOTE 7 — 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 nonperformance 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 June 30, 2017 and December 31, 2016, were as follows:

*(Dollars in thousands)*

	<b>June 30, 2017</b>	<b>December 31, 2016</b>
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$ 88,125	\$ 84,519
Financial standby letters of credit	\$ 434	\$ 453
Performance standby letters of credit	\$ 2,820	\$ 5,341

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 June 30, 2017, the Corporation had \$434,426,000 in loans secured by real estate, which represented 82.3% 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 June 30, 2017 and December 31, 2016, 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 8 — 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:

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 June 30, 2017 and December 31, 2016, investments measured at fair value on a recurring basis and the valuation methods used are as follows:

*(Dollars in thousands)*

June 30, 2017

	Level 1	Level 2	Level 3	Total
Available-for-Sale Securities:				
U.S. Treasury securities	\$	\$1,001	\$	\$1,001
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed		106,773		106,773
Other		23,596		23,596
Obligations of state and political subdivisions		226,452		226,452
Corporate debt securities		34,204		34,204
Marketable equity securities	1,677			1,677
Total	\$1,677	\$392,026	\$	\$393,703

*(Dollars in thousands)*

December 31, 2016

	Level 1	Level 2	Level 3	Total
Available-for-Sale Securities:				
U.S. Treasury securities	\$—	\$1,010	\$—	\$1,010
Obligations of U.S. Government Corporations and Agencies:				
Mortgaged-backed	—	110,907	—	110,907
Other	—	20,970	—	20,970
Obligations of state and political subdivisions	—	211,134	—	211,134
Corporate debt securities	—	33,976	—	33,976
Marketable equity securities	1,640	—	—	1,640
Total	\$1,640	\$377,997	\$—	\$379,637

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 investments. There were no transfers between Level 1 and Level 2 during 2017 or 2016.

### Financial Assets Measured at Fair Value on a Nonrecurring Basis

At June 30, 2017 and December 31, 2016, 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 June 30, 2017				
Impaired loans:				
Commercial Real Estate	\$	\$	\$4,830	\$4,830
Residential Real Estate			207	207
Total impaired loans	\$	\$	\$5,037	\$5,037

(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
Assets at December 31, 2016				
Impaired loans:				
Commercial Real Estate	\$	\$	\$ 4,763	\$ 4,763
Residential Real Estate			524	524
Total impaired loans	\$	\$	\$ 5,287	\$ 5,287

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 2017 and 2016.

#### Nonfinancial Assets Measured at Fair Value on a Nonrecurring Basis

At June 30, 2017 and December 31, 2016, 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 June 30, 2017				
Foreclosed assets held for resale:				
Commercial Real Estate	\$	\$	\$ 81	\$ 81
Total foreclosed assets held for resale	\$	\$	\$ 81	\$ 81

(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
Assets at December 31, 2016				
Other foreclosed assets held for resale:				
Commercial Real Estate	\$	—	\$ 248	\$ 248
Total foreclosed assets held for resale	\$	—	\$ 248	\$ 248

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 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 2017 and 2016.

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			Weighted Average
	Fair Value	Estimate Valuation Technique	Unobservable Input	
June 30, 2017				
Impaired loans	\$1,897	Appraisal of collateral <sup>1,3</sup>	Appraisal adjustments <sup>2</sup>	(10%) – (79%) (20 )%
Impaired loans	\$3,140	Discounted cash flow	Discount rate	(7%) – (7%) (7 )%
Foreclosed assets held for resale	\$81	Appraisal of collateral <sup>1,3</sup>	Appraisal adjustments <sup>2</sup>	(35%) – (35%) (35 )%
December 31, 2016				
Impaired loans	\$2,119	Appraisal of collateral <sup>1,3</sup>	Appraisal adjustments <sup>2</sup>	(10%) – (79%) (21 )%
Impaired loans	\$3,168	Discounted cash flow	Discount rate	(7%) – (7%) (7 )%
Foreclosed assets held for resale	\$248	Appraisal of collateral <sup>1,3</sup>	Appraisal adjustments <sup>2</sup>	(23%) – (37%) (32 )%

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

<sup>2</sup>Appraisals 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.

<sup>3</sup>Includes qualitative adjustments by management and estimated liquidation expenses.

### Fair Value of Financial Instruments

*(Dollars in thousands)*

FINANCIAL ASSETS:	Carrying	Fair Value Measurements at June 30, 2017			Total
	Amount	Level 1	Level 2	Level 3	

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Cash and due from banks	\$8,783	\$8,783	\$	\$	\$8,783
Interest-bearing deposits in other banks	1,328	—	1,328	—	1,328
Time deposits with other banks	1,482	—	1,482	—	1,482
Investment securities available-for-sale	393,703	1,677	392,026	—	393,703
Investment securities held-to-maturity	—	—	—	—	—
Restricted investment in bank stocks	7,299	—	7,299	—	7,299
Net loans	520,450	—	—	522,735	522,735
Mortgage servicing rights	395	—	—	395	395
Accrued interest receivable	4,314	—	4,314	—	4,314
<b>FINANCIAL LIABILITIES:</b>					
Core Deposits	494,793		494,793		494,793
Time Deposits	196,211	—	194,435	—	194,435
Short-term borrowings	128,730		128,730		128,730
Long-term borrowings	65,054		65,386		65,386
Accrued interest payable	499		499		499

OFF-BALANCE SHEET FINANCIAL INSTRUMENTS

(Dollars in thousands)	Carrying Amount	Fair Value Measurements at December 31, 2016			Total
		Level 1	Level 2	Level 3	
<b>FINANCIAL ASSETS:</b>					
Cash and due from banks	\$8,338	\$ 8,338	\$ —	\$ —	\$ 8,338
Interest-bearing deposits in other banks	790	—	790	—	790
Time deposits with other banks	1,482	—	1,482	—	1,482
Investment securities available-for-sale	379,637	1,640	377,997	—	379,637
Investment securities held-to-maturity	4	—	4	—	4
Restricted investment in bank stocks	5,477	—	5,477	—	5,477
Net loans	515,025	—	—	504,206	504,206
Mortgage servicing rights	431	—	—	431	431
Accrued interest receivable	3,917	—	3,917	—	3,917
<b>FINANCIAL LIABILITIES:</b>					
Core Deposits	532,661	—	532,661	—	532,661
Time Deposits	193,321	—	192,812	—	192,812
Short-term borrowings	69,290	—	69,290	—	69,290
Long-term borrowings	75,116	—	75,718	—	75,718
Accrued interest payable	427	—	427	—	427
<b>OFF-BALANCE SHEET FINANCIAL INSTRUMENTS</b>					

The following information should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Corporation's financial instruments at June 30, 2017 and December 31, 2016:

**Cash and Due From Banks, Interest-Bearing Deposits in Other Banks, Time Deposits with Other Banks, Restricted Investment in Bank Stocks, Accrued Interest Receivable and Accrued Interest Payable**

The fair values are equal to the current carrying values.

**Investment Securities**

The fair values of investment securities are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1) or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying on the securities' relationship to other benchmark quoted prices.

## **Loans**

Fair values are estimated for categories of loans with similar financial characteristics. Loans are segregated by type such as Commercial and Industrial, Commercial and Residential Real Estate mortgages and Consumer. For estimation purposes, each loan category is further segmented into fixed and adjustable rate interest terms.

The fair value of each category of performing loans is calculated by discounting future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Fair value for impaired loans is based on management's estimate of future cash flows discounted using a rate commensurate with the risk associated with the estimated future cash flows or based on the value of the collateral if repayment is expected solely from collateral. The assumptions used by management are judgmentally determined using information regarding each specific borrower.

## **Mortgage Servicing Rights**

Servicing rights are carried at cost. The carrying amount approximates fair value.



## Deposits

The fair value of deposits with no stated maturity, such as demand deposits, savings accounts and money market accounts, is equal to the amount payable on demand at June 30, 2017 and December 31, 2016.

Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar term borrowings, to a schedule of aggregated expected monthly maturities on time deposits.

## Short-Term and Long-Term Borrowings

The fair values of short-term borrowings are equal to the current carrying values, and long-term borrowings are estimated using discounted cash flow analyses based on the Corporation's incremental borrowing rate for similar instruments.

## Off-Balance Sheet Financial Instruments

The fair values for the Corporation's off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

## NOTE 9 — 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)

Three Months Ended

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	June 30,	
	2017	2016
Net income	\$ 1,919	\$ 2,491
Weighted-average common shares outstanding	5,683	5,633
Basic earnings per share	\$ 0.34	\$ 0.44
Weighted-average common shares outstanding	5,683	5,633
Common stock equivalents due to effect of stock options	2	2
Total weighted-average common shares and equivalents	5,685	5,635
Diluted earnings per share	\$ 0.34	\$ 0.44

(In thousands, except earnings per share)	Six Months Ended	
	June 30,	
	2017	2016
Net income	\$ 4,205	\$ 4,667
Weighted-average common shares outstanding	5,678	5,627
Basic earnings per share	\$ 0.74	\$ 0.83
Weighted-average common shares outstanding	5,678	5,627
Common stock equivalents due to effect of stock options	2	2
Total weighted-average common shares and equivalents	5,680	5,629
Diluted earnings per share	\$ 0.74	\$ 0.83

Item 2. First Keystone Corporation Management's Discussion and Analysis of Financial Condition and Results of Operation

This quarterly report contains certain forward-looking statements, which are included pursuant to the "safeharbor" provisions of the Private Securities Litigation Reform Act of 1995, and reflect management's beliefs and expectations based on information currently available. These forward-looking statements are inherently subject to significant risks and uncertainties, including changes in general economic and financial market conditions, the Corporation's ability to effectively carry out its business plans and changes in regulatory or legislative requirements. Other factors that could cause or contribute to such differences are changes in competitive conditions, and pending or threatened litigation. Although management believes the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially.

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 applies those accounting policies in a consistent manner. The Significant Accounting Policies are summarized in Note 1 to the consolidated financial statements included in the 2016 Annual Report on Form 10-K. There have been no changes to the Critical Accounting Estimates since the Corporation filed its Annual Report on Form 10-K for the year ended December 31, 2016.

RESULTS OF OPERATIONS

*Quarter ended June 30, 2017 compared to quarter ended June 30, 2016*

First Keystone Corporation realized earnings for the three months ended June 30, 2017 of \$1,919,000, a decrease of \$572,000, or 23.0% from the second quarter of 2016. The decrease in net income for the three months ended June 30, 2017 was primarily due to an increase in salaries and employee benefits as well as an increase in interest expense on deposits and short-term borrowings, as compared to the three months ended June 30, 2016.

On a per share basis, net income was \$0.34 for the three months ended June 30, 2017 versus \$0.44 for the three months ended June 30, 2016. Cash dividends amounted to \$0.27 per share for the three months ended June 30, 2017 and 2016.

## NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income, defined as interest income less interest expense. For the three months ended June 30, 2017, interest income amounted to \$8,010,000, an increase of \$78,000 or 1.0% from the three months ended June 30, 2016, while interest expense amounted to \$1,627,000 for the three months ended June 30, 2017, an increase of \$342,000 or 26.6% from the three months ended June 30, 2016. As a result, net interest income decreased \$264,000 or 4.0% to \$6,383,000 from \$6,647,000 for the same period in 2016.

The Corporation's net interest margin for the three months ended June 30, 2017 was 3.07% compared to 3.18% for the same period in 2016. The decrease in net interest margin was a result of the unprecedented continuing low interest rate environment.

## PROVISION FOR LOAN LOSSES

The provision for loan losses for the three months ended June 30, 2017 and June 30, 2016 was \$0 and \$284,000, respectively. The decrease in the provision for loan losses resulted from the Corporation's analysis of the current loan portfolio, including historic losses, past-due trends, current economic conditions, and other relevant factors. Net charge-offs for the three months ended June 30, 2017 and 2016 were \$108,000 and \$77,000, respectively. See Allowance for Loan Losses on page 40 for further discussion.

## NON-INTEREST INCOME

Total non-interest income was \$1,495,000 for the three months ended June 30, 2017, as compared to \$1,666,000 for the same period in 2016, a decrease of \$171,000, or 10.3%. ATM fees and debit card income increased \$25,000 or 7.6% to \$356,000 for the three months ended June 30, 2017. Gains on sales of mortgage loans increased \$33,000 or 60.0% due to an increase in loans originated with the intent to sell and volume of loans sold. Net gains on sales of investment securities decreased \$208,000 to \$172,000 for the three months ended June 30, 2017 as compared to the three months ended June 30, 2016. The Bank has taken gains and losses in the portfolio to reduce market risk and protect from further changes in value in the face of increases in long-term interest rates.

## NON-INTEREST EXPENSE

Total non-interest expense was \$5,666,000 for the three months ended June 30, 2017, as compared to \$5,014,000 for the three months ended June 30, 2016. Non-interest expense increased \$652,000 or 13.0%.

Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non-interest expense. Salaries and benefits amounted to \$3,031,000 or 53.5% of total non-interest expense for the three months ended June 30, 2017, as compared to \$2,587,000 or 51.6% for the same three months of 2016. The increase was due to the bank adding new sales positions in the commercial and residential mortgage lending areas, as well as increased costs associated with employee health care.

Net occupancy, furniture and equipment, and computer expense amounted to \$834,000 for the three months ended June 30, 2017, an increase of \$47,000 or 6.0%. The increase was due to higher branch maintenance costs plus additional costs associated with the implementation of new lending software and other software packages. Professional services increased \$46,000 or 30.9% to \$195,000 as of June 30, 2017. The increase was due to pricing increases associated with audit and tax services and additional fees incurred for financial services department analysis and consulting. Pennsylvania shares tax expense amounted to \$205,000 for the three months ended June 30, 2017, an increase of \$17,000 or 9.0% as compared to the three months ended June 30, 2016. The increase was the result of an increase in total assets and total equity and an increase in the Pennsylvania shares tax rate.

FDIC insurance expense decreased \$83,000 or 50.9% from the second quarter of 2016. The decrease was due to changes in assessment methodologies implemented by the FDIC in the second half of 2016. FDIC insurance expense varies with changes in net asset size, risk ratings, and FDIC derived assessment rates. ATM and debit card fees expense increased \$21,000 or 12.6% to \$188,000 for the three months ended June 30, 2017. The increase was due to higher debit card loss expense. Data processing expenses increased \$27,000 or 20.0% to \$162,000 for the three

months ended June 30, 2017. The increase was a result of pricing increases and new products from our main third party data processor. Foreclosed assets held for resale expense increased \$19,000 in the second quarter of 2017 as the result of normal costs related to foreclosed assets including a writedown on one property. Advertising expense increased \$88,000 or 91.6% during the three months ended June 30, 2017 as compared to the same three months of 2016. The increase was primarily due to increased media advertising for the rollout of new rewards checking and savings products.

Other non-interest expense amounted to \$707,000 for the three months ended June 30, 2017, an increase of \$21,000 or 3.8% as compared to the three months ended June 30, 2016. The increase was due to an increase in collections costs attributable to increased legal costs associated with non-accrual loan customers.

## INCOME TAXES

Income tax expense amounted to \$293,000 for the three months ended June 30, 2017, as compared to \$524,000 for the three months ended June 30, 2016, a decrease of \$231,000. The effective total income tax rate was 13.2% for the second quarter of 2017 as compared to 17.4% for the second quarter of 2016. The decrease in the effective tax rate was due to a net increase in tax-exempt interest earned from investments in state and local units of government.

*Six months ended June 30, 2017 compared to six months ended June 30, 2016*

First Keystone Corporation realized earnings for the six months ended June 30, 2017 of \$4,205,000, a decrease of \$462,000, or 9.9% from the same period in 2016. The decrease in net income for the six months ended June 30, 2017 was primarily due to an increase in salaries and employee benefits as well as an increase in interest expense on deposits and short-term borrowings, as compared to the six months ended June 30, 2016.

On a per share basis, for the six months ended June 30, 2017, net income was \$0.74 versus \$0.83 for the six months ended June 30, 2016. Cash dividends amounted to \$0.54 per share for the six months ended June 30, 2017 and 2016.

NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income, defined as interest income less interest expense. For the six months ended June 30, 2017, interest income amounted to \$15,907,000, an increase of \$6,000 or 0.03% from the first six months of 2016, while interest expense amounted to \$3,046,000 for the six months ended June 30, 2017, an increase of \$451,000, or 17.4% from the six months ended June 30, 2016. As a result, net interest income decreased \$445,000 or 3.43 to \$12,861,000 from \$13,306,000 for the same period in 2016.

The Corporation's net interest margin for the six months ended June 30, 2017 was 3.08% compared to 3.18% for the same period in 2016. The decrease in net interest margin was a result of the unprecedented continuing low interest rate environment.

PROVISION FOR LOAN LOSSES

The provision for loan losses for the six months ended June 30, 2017 and June 30, 2016 was \$83,000 and \$567,000, respectively. The decrease in the provision for loan losses resulted from the Corporation's analysis of the current loan portfolio, including historic losses, past-due trends, current economic conditions, and other relevant factors. Net charge-offs for the six months ended June 30, 2017 and 2016 were \$87,000. See Allowance for Loan Losses on page 40 for further discussion.

NON-INTEREST INCOME

Total non-interest income was \$3,033,000 for the six months ended June 30, 2017, as compared to \$2,966,000 for the same period in 2016, an increase of \$67,000, or 2.3%. ATM fees and debit card income increased by \$40,000 or 6.2% to \$683,000 for the six months ended June 30, 2017. Gains on sales of mortgage loans decreased \$33,000 or 21.0% due to a decrease in loans originated with the intent to sell and volume of loans sold. Net gains on sales of investment securities increased \$78,000 to \$472,000 for the six months ended June 30, 2017 as compared to the six months ended June 30, 2016. The Bank has taken gains and losses in the portfolio to reduce market risk and protect from further changes in value in the face of increases in long-term interest rates.

#### NON-INTEREST EXPENSE

Total non-interest expense was \$10,929,000 for the six months ended June 30, 2017, as compared to \$10,154,000 for the six months ended June 30, 2016. Non-interest expense increased \$775,000 or 7.6%.

Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non-interest expense. Salaries and benefits amounted to \$5,773,000 or 52.8% of total non-interest expense for the six months ended June 30, 2017, as compared to \$5,373,000 or 52.9% for the same six months of 2016. The increase was due to the bank adding new sales positions in the commercial and residential mortgage lending areas, as well as increased costs associated with employee health care.

Net occupancy, furniture and equipment, and computer expense amounted to \$1,706,000 for the six months ended June 30, 2017, an increase of \$103,000 or 6.4%. The increase was due to higher branch maintenance costs plus additional costs associated with the implementation of new lending software and other software packages. Professional services increased \$131,000 or 43.4% to \$433,000 as of June 30, 2017. The increase was due to pricing increases associated with audit and tax services, out of scope audit work associated with the 2016 annual report and additional fees incurred for financial services department analysis and consulting. Pennsylvania shares tax expense amounted to \$411,000 for the six months ended June 30, 2017, an increase of \$34,000 or 9.0% as compared to the six months ended June 30, 2016. The increase was the result of an increase in total assets and total equity and an increase in the Pennsylvania shares tax rate.



FDIC insurance expense decreased \$157,000 or 49.5% from the same six months of 2016. The decrease was due to changes in assessment methodologies implemented by the FDIC in the second half of 2016. FDIC insurance expense varies with changes in net asset size, risk ratings, and FDIC derived assessment rates. ATM and debit card fees expense increased \$19,000 or 6.2% to \$325,000 for the six months ended June 30, 2017. The increase was due to higher debit card loss expense. Data processing expenses increased \$26,000 or 9.7% to \$294,000 for the six months ended June 30, 2017. The increase was a result of pricing increases and new products from our main third party data processor. Foreclosed assets held for resale expense decreased \$6,000 in the first half of 2017. The decrease was due to lower maintenance costs and sales expenses in the early part of 2017. Advertising expense increased \$99,000 or 60.7% during the six months ended June 30, 2017 as compared to the same six months of 2016. The increase was primarily due to increased media advertising for the rollout of new rewards checking and savings products.

Other non-interest expense amounted to \$1,459,000 for the six months ended June 30, 2017, an increase of \$126,000 or 9.5% as compared to the six months ended June 30, 2016. The increase was due to an increase in Kasasa brand product fees incurred as a result of discontinued services, an increase in collections costs attributable to increased legal costs associated with non-accrual loan customers, and closing costs associated with the sale of a property.

## INCOME TAXES

Income tax expense amounted to \$677,000 for the six months ended June 30, 2017, as compared to \$884,000 for the six months ended June 30, 2016, a decrease of \$207,000. The effective total income tax rate was 13.9% for the six months ended June 30, 2017 as compared to 15.9% for the six months ended June 30, 2016. The decrease in the effective tax rate was due to a net increase in tax-exempt interest earned from investments in state and local units of government.

## FINANCIAL CONDITION

### SUMMARY

Total assets increased to \$1,005,424,000 as of June 30, 2017, an increase of \$21,141,000 from year-end 2016. Total assets as of December 31, 2016 amounted to \$984,283,000.

Total investments increased \$14,062,000 or 3.7% to \$393,703,000 as of June 30, 2017.

Total loans increased \$5,421,000 or 1.0%. Loan demand remained steady in the six months ended June 30, 2017 as the Bank has seen an increase in loan originations, primarily in the commercial real estate portfolio.

Total deposits decreased \$34,978,000 or 4.8% to \$691,004,000 as of June 30, 2017.

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. Total borrowings increased in the first six months of 2017 by \$49,378,000 to \$193,784,000 from \$144,406,000 as of December 31, 2016. Borrowings increased due to decreased deposit balances.

Total stockholders' equity increased to \$114,498,000 at June 30, 2017, an increase of \$4,813,000 or 4.4% from December 31, 2016.

## 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% at June 30, 2017, compared to 92.5% at June 30, 2016. 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.

Our primary earning asset, total loans, increased to \$527,803,000 as of June 30, 2017, up \$5,421,000, or 1.0% since year-end 2016. The loan portfolio continues to be well diversified. Non-performing assets increased since year-end 2016, and overall asset quality has remained consistent. Total non-performing assets were \$5,746,000 as of June 30, 2017, an increase of \$1,504,000, or 35.5% from \$4,242,000 reported in non-performing assets as of December 31, 2016. Total allowance for loan losses to total non-performing assets was 128.0% as of June 30, 2017 and 173.5% at December 31, 2016.

In addition to loans, another primary earning asset is our overall investment portfolio, which increased in size from December 31, 2016, to June 30, 2017. Available-for-sale securities amounted to \$393,703,000 as of June 30, 2017, an increase of \$14,066,000 from year-end 2016.

Interest-bearing deposits in other banks increased as of June 30, 2017, to \$1,328,000 from \$790,000 at year-end 2016. Time deposits with other banks were \$1,482,000 at June 30, 2017 and December 31, 2016.

## LOANS

Total loans increased to \$527,803,000 as of June 30, 2017 as compared to \$522,382,000 as of December 31, 2016. The table on page 19 provides data relating to the composition of the Corporation's loan portfolio on the dates

indicated. Total loans increased by \$5,421,000 or 1.0%.

Steady demand for borrowing by both individuals and businesses accounted for the 1.0% increase in the loan portfolio from December 31, 2016 to June 30, 2017. The Commercial and Industrial portfolio increased \$3,691,000 to \$87,264,000 as of June 30, 2017, as compared to \$83,573,000 at December 31, 2016. The increase in the Commercial and Industrial portfolio (which includes tax-free Commercial and Industrial loans) was attributed to new loan originations totaling \$14,940,000 offset by loan payoffs of \$8,525,000, as well as regular principal payments. The Commercial Real Estate portfolio (which includes tax-free Commercial Real Estate loans) increased \$5,130,000 to \$268,649,000 at June 30, 2017, as compared to \$263,519,000 at December 31, 2016. The increase was mainly the result of \$31,613,000 in new loan originations, offset by \$16,785,000 in loan payoffs in addition to regular principal payments and other typical amortizations in the Commercial Real Estate portfolio. Residential Real Estate loans decreased \$3,258,000 to \$165,777,000 at June 30, 2017, as compared to \$169,035,000 at December 31, 2016. The decrease was the result of \$7,598,000 in new loan originations offset by loan payoffs of \$8,052,000, net loans sold of \$840,000, and regular principal payments. Net loans sold in the Residential Real Estate portfolio for the six months ended June 30, 2017 consisted of total loans sold during the six months ended June 30, 2017 of \$3,826,000, offset with loans opened and sold in the same quarter during any quarter of 2017 which amounted to \$2,986,000. 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 \$355,913,000 at June 30, 2017. Of total loans, \$268,649,000 or 50.9% were secured by commercial real estate, primarily lessors of residential buildings and dwellings and lessors of non-residential buildings. The Corporation continues 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 \$14,916,000 at June 30, 2017. The individual owns a diverse mix of real estate entities which specialize in construction/development projects, leasing of commercial office space, and rental of multi-tenant residential units. This relationship is comprised of \$13,816,000 in term debt and two lines of credit totaling \$1,100,000. 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 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 June 30, 2017, the relationship had outstanding loan balances and unused commitments of \$10,177,000. The debt is comprised of \$10,122,000 in term debt and two lines of credit totaling \$55,000. The loans are secured by commercial real estate and business assets.

The third largest relationship consists of a large, suburban/rural public school district that provides educational services to over 5,000 students and employs approximately 750 individuals as administrative, professional, and support staff. At June 30, 2017, the relationship had outstanding balances totaling \$9,665,000 which consisted entirely of tax-free commercial term debt. The relationship is secured by business assets and the full faith, credit, and taxing power of the district.

The fourth 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 \$8,247,000 at June 30, 2017. The debt is comprised of \$7,797,000 in term debt and \$450,000 in lines of credit. The relationship is secured by commercial real estate and business assets, as well as the assignment of leases and a life insurance policy.

The fifth largest relationship consists of a city incorporated in 1870, encompassing approximately 2.7 square miles, with a population of over 9,000. In 2016, the city undertook to refinance existing general obligation notes and bonds, to obtain interim financing (pending receipt of grants) to complete construction of a new wastewater treatment plant, and to fund an easement acquisition and obstruction removal project pertaining to the city's municipal airport. At June 30, 2017, the relationship had outstanding loan balances and unused commitments of \$8,085,000, which was comprised of \$3,595,000 in term debt and \$4,490,000 in available credit on three tax-free commercial loans. The relationship is secured by the full faith, credit, and taxing power of the city.

Each of the five relationships is located within the Corporation's market area.

All of the above mentioned loans are performing as agreed and all are graded pass. The property securing each of the loans was appraised at the time the loan was originated. Appraisals are ordered independently of the loan approval process from appraisers on an approved list. All appraisals are reviewed internally for conformity with accepted standards of the Bank.

Overall, the portfolio risk profile as measured by loan grade is considered low risk, as \$506,003,000 or 96.0% of gross loans are graded Pass; \$4,784,000 or 0.9% are graded Special Mention; \$16,275,000 or 3.1% 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 decreased to \$21,059,000 at June 30, 2017, as compared to \$28,417,000 at December 31, 2016. Commercial and Industrial non-pass grades decreased to \$1,810,000 as of June 30, 2017 as compared to \$5,109,000 as of December 31, 2016. Commercial Real Estate non-pass grades decreased to \$16,272,000 as of June 30, 2017 as compared to \$20,041,000 as of December 31, 2016. The Residential Real Estate and Consumer loan non-pass grades decreased to \$2,977,000 as of June 30, 2017 as compared to \$3,267,000 as of December 31, 2016.

The \$3,299,000 decrease in Commercial and Industrial non-pass grades was mainly the result of the upgrade of four loans totaling \$3,946,000 net against the downgrade of four loans totaling \$822,000, combined with typical amortization and other fluctuations in the Commercial and Industrial non-pass grade portfolio. The four upgraded loans are to a manufacturer that produces parts for various industries. The loans were upgraded from Special Mention to pass-grade status during the three months ended June 30, 2017 due to improved profitability and debt service capacity based on 2016 and 2017 year-to-date financial results, positive movement in reducing sales concentrations, restored compliance with borrowing base formula, and good payment performance. The four downgraded loans are to a plastic processing company focused on non-post-consumer recycling. The loans were downgraded to Substandard and moved to non-accrual status during the first quarter of 2017 due to a downturn in revenues resulting from lower commodity prices for new plastic produced from petroleum and natural gas liquids.

The \$3,769,000 decrease in the Commercial Real Estate non-pass grade portfolio was the result of several fluctuations including a large upgrade to pass-grade status and significant payments, pay-downs, and pay-offs net against loans transferred to (or originated at) non-pass grade status, combined with other normal activity in the Commercial Real Estate non-pass grade portfolio during the six months ended June 30, 2017. One loan in the amount of \$1,086,000 to the owner of a golf course and related facilities was upgraded from Special Mention to pass-grade status during the three months ended June 30, 2017. The loan was upgraded due to the borrower's improved debt service capacity based on financial results for the fiscal year ended October 31, 2016, stable club membership, and good payment performance. Payments and principal pay-downs totaling \$330,000 were made on a purchased participation loan to the owner of a recreation facility during the six month period ended June 30, 2017. Two loans totaling \$674,000 to a plastic processing company focused on non-post-consumer recycling were downgraded to Substandard and moved to non-accrual status during the first quarter of 2017 due to a downturn in revenues resulting from lower commodity prices for new plastic produced from petroleum and natural gas liquids.

Activity associated with four loans to the developer of a residential sub-division resulted in a net decrease of \$2,617,000 in the Commercial Real Estate non-pass grade portfolio during the six months ended June 30, 2017. Two loans totaling \$2,220,000 were paid off and a \$500,000 pay-down was made on one of the guarantor's existing loans during the first quarter of 2017. A loan with an outstanding recorded investment of \$103,000 at June 30, 2017 was originated at substandard status during the three months ended June 30, 2017 to allow for the construction of an additional single family spec home in light of a perceived increase in interest on the part of prospective purchasers and to support sales momentum and provide available inventory of homes for sale in the aftermath of the successful sale of an existing spec home. The Bank granted the loan based on the borrower's excellent loan payment history with the Bank and taking into account the existence of other viable sources of repayment, but inadequate debt service capability based on historical income led to the loan's substandard risk rating.

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

### Total Loans

(Dollars in thousands)	June 30, 2017	December 31, 2016
Commercial and Industrial	\$87,264	\$ 83,573
Commercial Real Estate	268,649	263,519
Residential Real Estate	165,777	169,035
Consumer	6,113	6,255
Total loans	\$527,803	\$ 522,382

### ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of June 30, 2017, the allowance for loan losses was \$7,353,000 as compared to \$7,357,000 as of December 31, 2016. 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.

The Analysis of Allowance for Loan Losses table contains an analysis of the allowance for loan losses indicating charge-offs and recoveries for the six month periods ended June 30, 2017 and 2016. For the six month periods ended June 30, 2017 and 2016, net charge-offs as a percentage of average loans was 0.02%. Net charge-offs amounted to \$87,000 for the first six months of 2017 and the first six months of 2016.



For the first six months of 2017, the provision for loan losses was \$83,000 as compared to \$567,000 for the first six months of 2016. The provision, net of charge-offs and recoveries, increased the quarter end Allowance for Loan Losses to \$7,353,000 of which 11.5% was attributed to the Commercial and Industrial component; 62.3% attributed to the Commercial Real Estate component; 23.3% attributed to the Residential Real Estate component (primarily residential mortgages); 1.4% attributed to the Consumer component; and 1.5% being the unallocated component (refer to the activity in Note 4 – Loans and Allowance for Loan Losses on page 14). The Corporation determined that the provision for loan losses made during the current quarter was sufficient to maintain the allowance for loan losses at a level necessary for the probable losses inherent in the loan portfolio as of June 30, 2017.

### Analysis of Allowance for Loan Losses

(Dollars in thousands)	June 30, 2017	June 30, 2016		
Balance at beginning of the six month period	\$ 7,357	\$ 6,739		
Charge-offs:				
Commercial and Industrial	—	2		
Commercial Real Estate	97	57		
Residential Real Estate	61	25		
Consumer	34	23		
	192	107		
Recoveries:				
Commercial and Industrial	73	4		
Commercial Real Estate	27			
Residential Real Estate	—	12		
Consumer	5	4		
	105	20		
Net charge-offs	87	87		
Additions charged to operations	83	567		
Balance at end of the six month period	\$ 7,353	\$ 7,219		
Ratio of net charge-offs during the period to average loans outstanding during the period	0.02	%	0.02	%
Allowance for loan losses to average loans outstanding during the period	1.40	%	1.39	%

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 1.40% at June 30, 2017 and 1.39% at June 30, 2016.

## NON-PERFORMING ASSETS

The table on page 44 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 \$5,746,000 as of June 30, 2017 as compared to \$4,242,000 as of December 31, 2016. 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 \$4,259,000 as of June 30, 2017 as compared to \$2,935,000 as of December 31, 2016. The significant increase in non-accrual loans at June 30, 2017 as compared to December 31, 2016 is mainly attributable to seven loans to a plastic processing company focused on non-post-consumer recycling and a related guarantor totaling \$1,587,000 that were moved to non-accrual status during the first quarter of 2017. Foreclosed assets held for resale amounted to \$1,283,000 at June 30, 2017 as compared to \$1,273,000 at December 31, 2016. Loans past-due 90 days or more and still accruing interest amounted to \$204,000 as of June 30, 2017 as compared to \$34,000 as of December 31, 2016. At June 30, 2017, loans past-due 90 days and still accruing interest consisted of one Commercial and Industrial, two Commercial Real Estate, one Consumer, and three Residential Real Estate loans. The majority of the loans are well secured and in the process of collection. The Commercial and Industrial and Consumer loans, amounting to \$4,000 combined, are unsecured, but remain in the process of collection. Prior to June 30, 2017, arrangements were made by both borrowers for payments to be made subsequent to the end of the quarter. The borrower of one of the Residential Real Estate loans in the amount of \$25,000 has filed bankruptcy and loan payments are currently being made through a trustee.

Non-performing assets to total loans was 1.1% at June 30, 2017 as compared to 0.8% at December 31, 2016. Non-performing assets to total assets was 0.6% at June 30, 2017 as compared to 0.4% at December 31, 2016. The allowance for loan losses to total non-performing assets was 128.0% as of June 30, 2017 as compared to 173.5% as of December 31, 2016. Additional detail can be found on page 44 in the Non-Performing Assets and Impaired Loans table and page 25 in the Loans Receivable on Non-Accrual Status table. 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 \$5,082,000 at June 30, 2017, compared to \$5,556,000 at December 31, 2016.

Impaired loans were \$14,986,000 at June 30, 2017 and \$14,297,000 at December 31, 2016. The largest impaired loan relationship at June 30, 2017 consisted of one performing loan to a student housing holding company in the amount of \$3,140,000, 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 June 30, 2017 resulted in a specific allocation of \$0. The second largest impaired loan relationship at June 30, 2017 consisted of a substandard performing loan to a developer of a residential sub-division in the amount of \$2,690,000, which was secured by commercial real estate. The contract was extended and the loan was modified as a TDR during the fourth quarter of 2015 because the weak real estate market has hindered the process of the development plans and expected sales of building lots have not materialized. The discounted cash flow evaluation at June 30, 2017 resulted in a specific allocation of \$0. The third largest impaired loan relationship at June 30, 2017 consisted of seven loans to a plastic processing company focused on non-post-consumer recycling and a related guarantor totaling \$1,587,000. Two loans were secured by commercial real estate, one loan was secured by residential real estate, three loans were secured by business assets, and one loan was secured by a combination of business assets, commercial real estate, residential real estate, and assignment of mortgages. Six loans totaling \$1,549,000 were moved to non-accrual status and one loan totaling \$38,000 was moved to non-accrual status and modified as a TDR during the first quarter of 2017 due to a downturn in revenues as the result of lower commodity prices for new plastic produced from petroleum and natural gas liquids. The TDR modification was completed to extend the maturity date of the commitment and allow for interest only payments in order to provide the borrower with payment relief. The collateral evaluations of the seven loans at June 30, 2017 carried a total value of \$1,961,000, after considering appraisal adjustments and costs to sell of 21%, resulting in a specific allocation of \$11,000.

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 \$14,986,000 in impaired loans at June 30, 2017, none were located outside of the Corporation's primary market area.

The outstanding recorded investment of loans categorized as TDRs was \$11,017,000 as of June 30, 2017 as compared to \$11,629,000 as of December 31, 2016. The decrease in TDRs at June 30, 2017 as compared to December 31, 2016 is attributable to large principal payments and paydowns made on existing TDRs net against smaller loans modified as TDRs during the six months ended June 30, 2017. Of the thirty-one restructured loans at June 30, 2017, six loans are classified in the Commercial and Industrial portfolio and twenty-five loans are classified in the Commercial Real Estate portfolio. At June 30, 2017, seven Commercial Real Estate loans classified as TDRs with a combined recorded investment of \$454,000 and one Commercial and Industrial loan with a recorded investment of \$13,000 were not in compliance with the terms of their restructure, compared to June 30, 2016 when five Commercial Real Estate loans with a combined recorded investment of \$748,000 were not in compliance with the terms of their restructure. Troubled debt restructurings at June 30, 2017 consisted of sixteen term modifications beyond the original stated term, four interest rate modifications, and ten payment modifications. At June 30, 2017, there was also one troubled debt restructuring that experienced all three types of modifications – payment, rate, and term. TDRs are separately identified for impairment disclosures, and if necessary, a specific allocation is established. As of June 30, 2017 and December 31, 2016, there were no specific allocations attributable to the TDRs. There were \$2,000 in unused commitments attributable to TDRs at June 30, 2017 and December 31, 2016.

During the three months ended June 30, 2017 and 2016, no loans that were modified as TDRs within the preceding twelve months had experienced payment defaults. During the six months ended June 30, 2017 and 2016, no loans that were modified as TDRs within the preceding twelve months 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 2017. Excluding the assets disclosed in the Non-Performing Assets and

Impaired Loans tables below 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 June 30, 2017 and December 31, 2016, management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

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(Dollars in thousands)	June 30, 2017	December 31, 2016		
Non-accrual loans	\$4,259	\$ 2,935		
Foreclosed assets held for resale	1,283	1,273		
Loans past-due 90 days or more and still accruing interest	204	34		
Total non-performing assets	\$5,746	\$ 4,242		
Impaired loans				
Non-accrual loans	\$4,259	\$ 2,935		
Accruing TDRs	10,727	11,362		
Total impaired loans	14,986	14,297		
Allocated allowance for loan losses	(273 )	(219 )		
Net investment in impaired loans	\$14,713	\$ 14,078		
Impaired loans with a valuation allowance	\$1,318	\$ 1,392		
Impaired loans without a valuation allowance	13,668	12,905		
Total impaired loans	\$14,986	\$ 14,297		
Allocated valuation allowance as a percent of impaired loans	1.8 %	1.5 %		
Impaired loans to total loans	2.8 %	2.7 %		
Non-performing assets to total loans	1.1 %	0.8 %		
Non-performing assets to total assets	0.6 %	0.4 %		
Allowance for loan losses to impaired loans	49.1 %	51.5 %		
Allowance for loan losses to total non-performing assets	128.0 %	173.5 %		

Real estate mortgages comprise 82.3% of the loan portfolio as of June 30, 2017, as compared to 82.8% as of December 31, 2016. 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 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.

Total deposits decreased \$34,978,000 to \$691,004,000 as of June 30, 2017 as non-interest bearing deposits increased by \$12,316,000 and interest bearing deposits decreased by \$47,294,000 from year-end 2016. Total deposits decreased due to the withdrawal of funds by a municipal depositor through normal, seasonal use of funds. Demand deposits and savings accounts decreased, while certificates of deposit increased. Total short-term and long-term borrowings increased to \$193,784,000 as of June 30, 2017, from \$144,406,000 at year-end 2016, an increase of \$49,378,000, or 34.2%. Total borrowings increased due to decreased deposit balances and an increase in the balance of the investment portfolio.



## CAPITAL STRENGTH

Normal increases in capital are generated by net income, less dividends paid out. During the first six months of the year, net income less dividends paid increased capital by \$1,139,000. Accumulated other comprehensive income (loss) derived from net unrealized gains on investment securities available-for-sale also impacts capital. At December 31, 2016, accumulated other comprehensive loss was \$(1,419,000). Accumulated other comprehensive income stood at \$1,638,000 at June 30, 2017, an increase of \$3,057,000. Fluctuations in interest rates have regularly impacted the gain/loss position in the Bank's investment portfolio, as well as its decision to sell securities at a gain or loss. In order to protect the Bank from market risk in the event of further interest rate increases, the Bank chose to sell a portion of its securities during the first six months of 2017 at an overall net gain of \$472,000. These fluctuations from net unrealized gains on investment securities available-for-sale do not affect regulatory capital, as the Bank elected to opt-out of this item with the filing of the March 31, 2015 Call Report.

The Corporation held 233,112 shares of common stock as treasury stock at June 30, 2017 and December 31, 2016. This had an effect of reducing our total stockholders' equity by \$5,756,000 as of June 30, 2017 and December 31, 2016.

Total stockholders' equity was \$114,498,000 as of June 30, 2017, and \$109,685,000 as of December 31, 2016.

At June 30, 2017 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 June 30, 2017 and December 31, 2016:

	<b>June 30,</b>		<b>December 31,</b>		<b>To Be Well Capitalized Under Prompt Corrective Action Regulations</b>	
	<b>2017</b>		<b>2016</b>			
Tier 1 leverage ratio (to average assets)	8.65	%	8.67	%	5.00	%
Common Equity Tier 1 capital ratio (to risk-weighted assets)	13.21	%	13.06	%	6.50	%
Tier 1 risk-based capital ratio (to risk-weighted assets)	13.21	%	13.06	%	8.00	%
Total risk-based capital ratio	14.36	%	14.24	%	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 June 30, 2017, 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

The Corporation's objective is to maintain adequate liquidity to meet funding needs at a reasonable cost and to 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 June 30, 2017, the Corporation had \$278,497,000 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 \$4,104,000.

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 \$21,606,000 at June 30, 2017.

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 \$5,549,000 and \$5,439,000 during the six months ended June 30, 2017 and 2016, respectively. Net income amounted to \$4,205,000 for the six months ended June 30, 2017 and \$4,667,000 for the six months ended June 30, 2016. During the six months ended June 30, 2017 and 2016, net premium amortization on investment securities amounted to \$2,417,000 and \$1,900,000, respectively. Originations of mortgage loans originated for resale exceeded proceeds from sales of mortgage loans originated for resale by \$330,000 and \$1,862,000 for the six months ended June 30, 2017 and 2016, respectively. Other assets increased \$38,000 during the six months ended June 30, 2017 and \$118,000 during the six months ended June 30, 2016. Other liabilities decreased \$166,000 during the six months ended June 30, 2017 and increased \$238,000 during the six months ended June 30, 2016.

Investing activities used \$16,517,000 during the six months ended June 30, 2017 and provided \$9,305,000 during the six months ended June 30, 2016. Net activity in the available-for-sale securities portfolio (including proceeds from sales, maturities, and redemptions net against purchases) used cash of \$9,362,000 during the six months ended June 30, 2017 and provided cash of \$8,645,000 during the six months ended June 30, 2016. Net cash used to originate loans amounted to \$5,189,000 during the six months ended June 30, 2017, and net cash provided by the loan portfolio amounted to \$1,512,000 during the six months ended June 30, 2016.

Financing activities provided cash of \$11,951,000 during the six months ended June 30, 2017 and used cash of \$14,494,000 during the six months ended June 30, 2016. Net deposits used cash of \$34,978,000 and \$36,127,000 during the six months ended June 30, 2017 and 2016, respectively. Short-term borrowings increased by \$59,440,000 and \$19,099,000 during the six months ended June 30, 2017 and 2016, respectively. Repayment of long-term borrowings used cash of \$10,062,000 during the six months ended June 30, 2017 and proceeds from long-term borrowings exceeded repayment of long-term borrowings by \$4,943,000 during the six months ended June 30, 2016. Dividends paid amounted to \$3,066,000 and \$3,038,000 for the six months ended June 30, 2017 and 2016, 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 are 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.

## 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, *Investment Debt and Equity Securities*, changes in the unrealized gains and losses, net of taxes, on 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. 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. The Corporation's cumulative gap at one year indicates the Corporation is liability sensitive at June 30, 2017.

### *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 in 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.

The table on page 48 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 9.4%, 17.9% and 25.7% in the 100, 200 and 300 basis point increasing rate scenarios presented. In addition, the earnings simulation model projects net interest income would increase 4.4% and 3.2% in the 100 and 200 basis point decreasing rate scenarios presented. All of these forecasts are within the Corporation's one year policy guidelines.

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 100 – 150 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 six months ended June 30, 2017, the cost of interest-bearing liabilities averaged 0.8%, and the yield on average interest-earning assets, on a fully taxable equivalent basis, averaged 3.74%.

### *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 June 30, 2017, the 100 and 200 basis point immediate decreases in rates are estimated to affect net present value with decreases of 7.3% and 29.4%, respectively. Additionally, net present value is projected to decrease 0.9%, 6.3% and 14.9% in the 100, 200 and 300 basis point immediate increase scenarios, respectively. These 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.

### **Effect of Change in Interest Rates**

	Projected Change	
Effect on Net Interest Income		
1-Year Net Income Simulation Projection		
+300 bp Shock vs. Stable Rate	(25.7	)%
+200 bp Shock vs. Stable Rate	(17.9	)%
+100 bp Shock vs. Stable Rate	(9.4	)%
Flat rate		
-100 bp Shock vs. Stable Rate	4.4	%
-200 bp Shock vs. Stable Rate	3.2	%
Effect on Net Present Value of Balance Sheet		
Static Net Present Value Change		
+300 bp Shock vs. Stable Rate	(14.9	)%

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+200 bp Shock vs. Stable Rate	(0.3	)%
+100 bp Shock vs. Stable Rate	(0.9	)%
Flat rate		
-100 bp Shock vs. Stable Rate	(7.3	)%
-200 bp Shock vs. Stable Rate	(29.4	)%



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

Information with respect to quantitative and qualitative disclosures about market risk is included in the information under Management's Discussion and Analysis in Item 2.

### Item 4. 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 Securities Exchange Act of 1934 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 June 30, 2017.

Item 9A of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2016 indicated that management's review of the Corporation's internal control over financial reporting identified a material weakness at December 31, 2016, and described the Corporation's remediation plan to address such deficiency. Such remediation efforts include enhancements to the Corporation's review process to ensure a review is being performed at an appropriate level of precision to include expanded validation of inputs and assumptions to source documents and ensuring clerical accuracy. During the quarter ended June 30, 2017, the Corporation is continuing the remediation efforts described in Item 9A of its Annual Report on Form 10-K.

Changes in internal control over financial reporting. There were no other changes in the Corporation's internal control over financial reporting during the fiscal quarter ended June 30, 2017, that materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

## PART II - OTHER INFORMATION

## Item 1. Legal Proceedings

Although the Corporation is subject to various claims and legal actions that occur from time to time in the ordinary course of business, the Corporation is not party to any pending legal proceedings that management believes could have a material adverse effect on its business, results of operations, financial condition or cash flows.

## Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A “Risk Factors” in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2016.

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

<b>Period</b>	<b>(a) Total Number of Shares Purchased</b>	<b>(b) Average Price Paid per Share</b>	<b>(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</b>
April 1 — April 30, 2017				120,000
May 1 — May 31, 2017				120,000
June 1 — June 30, 2017				120,000
Total				120,000

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

50

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits required by Item 601 Regulation S-K

<b>Exhibit Number</b>	<b>Description of Exhibit</b>
3i	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3(i) to the Registrant's Report on Form 10-Q for the quarter ended June 30, 2012).
3ii	By-Laws, as amended and restated (Incorporated by reference to Exhibit 3(ii) to the Registrant's Report on Form 8-K dated February 14, 2013).
10.1(a)	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).*
10.1(b)	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).*
10.1(c)	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).*
10.1(d)	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).*
10.2	Management Incentive Compensation Plan (Incorporated by reference to Exhibit 10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2013).*
10.4	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).*
14	First Keystone Corporation Directors and Senior Management Code of Ethics (Incorporated by reference to Exhibit 14 to Registrant's Report on Form 8-K dated August 27, 2013).
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.**
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.**
32.1	Section 1350 Certification of Chief Executive Officer.**
32.2	Section 1350 Certification of Chief Financial Officer.**
101.INS	XBRL Instance Document.**
101.SCH	XBRL Taxonomy Extension Schema Document.**

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- 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.

FIRST KEYSTONE CORPORATION

SIGNATURES

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

FIRST KEYSTONE CORPORATION  
Registrant

August 7, 2017 /s/ Matthew P. Prosseda  
Matthew P. Prosseda  
President and Chief Executive Officer  
(Principal Executive Officer)

August 7, 2017 /s/ Diane C.A. Rosler  
Diane C.A. Rosler  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)

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