PRUDENTIAL FINANCIAL INC
Form 4
June 20, 2016

FORM 4

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

OMB APPROVAL

OMB Number:	3235-0287
Expires:	January 31, 2005
Estimated average burden hours per response...	0.5

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
Pianalto Sandra

(Last) (First) (Middle)

751 BROAD STREET, 4TH FLOOR, ATTN: CORPORATE COMPLIANCE

(Street)

NEWARK, NJ 07102

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
PRUDENTIAL FINANCIAL INC [PRU]

3. Date of Earliest Transaction (Month/Day/Year)
06/16/2016

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

__X__ Director _____ 10% Owner
_____ Officer (give title below) _____ Other (specify below)

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.

SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price o Derivativ Security (Instr. 5)
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares	
2015 Restricted Stock Units	$ 0 (1)	06/16/2016		A		16		(2)	(2)	Common Stock	16	$ 71.7
2016 Restricted Stock Units	$ 0 (1)	06/16/2016		A		18		(3)	(3)	Common Stock	18	$ 71.7

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
Pianalto Sandra 751 BROAD STREET, 4TH FLOOR ATTN: CORPORATE COMPLIANCE NEWARK, NJ 07102	X			

Signatures

/s/John M. Cafiero, attorney-in-fact	06/20/2016
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Each restricted stock unit represents a contingent right to receive one share of PRU common stock.

(2) The restricted stock units vest in one year on July 1, 2016 and were deferred until retirement from the Board under the Prudential Financial, Inc. 2011 Deferred Compensation Plan for Non-Employee Directors.

(3) The restricted stock units vest the earlier of the annual meeting or in one year on May 10, 2017 and were deferred until retirement from the Board under the Prudential Financial, Inc. 2011 Deferred Compensation Plan for Non-Employee Directors.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. pt; font-weight: bold"> Within 1 Year: Amortized

cost $— $ $2,343 $— $529 Fair value — 2,356 — 529 Weighted average yield — 3.29% — 2.66% Years: Amortized cost 2,823 16,907 25,009 — 12,429 Fair value 2,819 16,389 24,865 — 12,211 Weighted average yield 2.21% 2.03% 2.72% — 2.77% 5 - 10 Years: Amortized cost 31,064 67,301 5,025 16,606 Fair value 29,800 66,716 5,025 15,662 Weighted average yield 2.09% 3.23% 4.32% 2.75% After 10 Years: Amortized cost 56,910 108,908 — — Fair value 56,730 108,991 — — Weighted average yield 2.56% 3.75% — — Total: Amortized cost $2,823 $104,881 $203,561 $5,025 $29,564 Fair value 2,819 102,919 202,928 5,025 28,402 Weighted average yield 2.21% 2.34% 3.45% 4.32% 2.76%

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

[2]Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 21% tax rate.

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

Proceeds from sales of investments in Available-for-Sale debt securities for the first quarter of 2018 and 2017 were $14,038,000 and $24,491,000, respectively. Gross gains realized on these sales were $50,000 and $341,000, respectively. Gross losses realized on these sales were $34,000 and $38,000, respectively. There were no impairment losses realized on Available-for-Sale debt securities during the first quarter of 2018 or 2017.

At March 31, 2018 and December 31, 2017, the Corporation had $1,599,000 and $1,632,000, respectively, in equity securities recorded at fair value. Prior to January 1, 2018, equity securities were stated at fair value with unrealized gains and losses reported as a separate component of AOCI, net of tax. At December 31, 2017, net unrealized gains net of tax of $634,000 had been recognized in AOCI. On January 1, 2018, these unrealized gains and losses were reclassified out of AOCI and into retained earnings with subsequent changes in fair value being recognized in net income. The following is a summary of unrealized and realized gains and losses recognized in net income on equity securities during the three months ended March 31, 2018:

(Dollars in thousands)

	Three months ended March 31, 2018		
Net gains and (losses) recognized during the period on equity securities	$	(33	)
Less: Net gains and (losses) recognized during the period on equity securities sold during the period		—	
Unrealized gains and (losses) recognized during the reporting period on equity securities still held at the reporting date	$	(33	)

There were no proceeds from sales of investments in Held-to-Maturity debt securities during the first quarter of 2018 or 2017. 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. 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 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 March 31, 2018 or December 31, 2017.

12

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

March 31, 2018

(Dollars in thousands)

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized **Loss**	Fair Value	Unrealized **Loss**	Fair Value	Unrealized **Loss**
Debt Securities Available-for-Sale:						
U.S. Treasury securities	$ 2,819	$ (4)	$	$	$ 2,819	$ (4)
Obligations of U.S. Government Corporations and Agencies:						
Mortgage-backed	31,668	(489)	34,194	(1,226)	65,862	(1,715)
Other	2,823	(10)	7,006	(478)	9,829	(488)
Obligations of state and political subdivisions	84,238	(1,142)	26,264	(1,294)	110,502	(2,436)
Corporate debt securities	6,832	(87)	19,570	(1,075)	26,402	(1,162)
	$ 128,380	$ (1,732)	$ 87,034	$ (4,073)	$ 215,414	$ (5,805)

December 31, 2017

(Dollars in thousands)

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Debt Securities Available-for-Sale:						
U.S. Treasury securities	$ —	$ —	$ —	$ —	$ —	$ —
Obligations of U.S. Government Corporations and Agencies:						
Mortgage-backed	30,555	(300)	33,943	(875)	64,498	(1,175)
Other	2,905	(4)	7,179	(304)	10,084	(308)
	36,149	(329)	22,566	(582)	58,715	(911)

Obligations of state and political subdivisions						
Corporate debt securities	6,746	(24)	15,174	(740)	21,920	(764)
	$ 76,355	$ (657)	$ 78,862	$ (2,501)	$ 155,217	$ (3,158)

The Corporation invests in various forms of agency debt including mortgage-backed securities and callable debt. The mortgage-backed securities are issued by FHLMC (“Federal Home Loan Mortgage Corporation”), FNMA (“Federal National Mortgage Association”) or GNMA (“Government National Mortgage Association”). The municipal securities consist of general obligations and revenue bonds. The fair market value of the above securities is influenced by market interest rates, prepayment speeds on mortgage securities, bid-offer spreads in the market place and credit premiums for various types of agency debt. These factors change continuously and therefore the market value of these securities may be higher or lower than the Corporation’s carrying value at any measurement date. Management does not believe any of their 100 debt securities with a less than one year unrealized loss position, or any of their 58 debt securities with a one year or greater unrealized loss position as of March 31, 2018, represent an other-than-temporary impairment, as the unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

13

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 sale are carried at the lower of cost or market on an aggregate basis determined by independent pricing from appropriate federal or state agency investors. These loans are sold without recourse. Loans held for sale amounted to $708,000 and $834,000 at March 31, 2018 and December 31, 2017, 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. Loans with terms of thirty years are normally held for sale and sold without recourse; most of the residential mortgages held in the Corporation's residential real estate portfolio have maximum terms of twenty years. Generally, the majority of the Corporation's residential mortgage loans originate with a loan-to-value of eighty percent or less, or those with primary mortgage insurance at ninety-five percent or less. Home equity term loans are secured by the borrower's primary residence and typically have a maximum loan-to-value of eighty percent and a maximum term of fifteen years. In general, home equity lines of credit are secured by the borrower's primary residence with a maximum loan-to-value of eighty percent and a maximum term of twenty years.

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

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

Consumer Lending

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

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

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

Delinquent Loans

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

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

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

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

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

Allowance for Loan Losses

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

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

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are individually classified as impaired. Select loans are not aggregated for collective impairment evaluation, as such;

all loans are subject to individual impairment evaluation should the facts and circumstances pertinent to a particular loan suggest that such evaluation is necessary. Factors considered by management in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. If a loan is impaired, a portion of the allowance may be allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from collateral. Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the 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 March 31, 2018 and December 31, 2017, the amount of the reserve for unfunded lending commitments was $170,000 and $116,000, respectively.

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

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

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

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

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

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.

17

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 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 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.

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

Risk Grade 9 – DOUBTFUL (Non-Pass Category)

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

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

(Dollars in thousands)

	Commercial and Industrial		Commercial Real Estate	
	March 31, 2018	December 31, 2017	March 31, 2018	December 31, 2017
Grade:				
1-6 Pass	$105,794	$ 97,832	$276,671	$ 276,682
7 Special Mention	10	10	9,892	1,514
8 Substandard	1,221	1,334	11,759	12,210
9 Doubtful	—	—	—	
Add (deduct): Unearned discount and	—	—	—	
Net deferred loan fees and costs	150	161	613	564
Total loans	$107,175	$ 99,337	$298,935	$ 290,970

	Residential Real Estate Including Home Equity		Consumer Loans	
	March 31, 2018	December 31, 2017	March 31, 2018	December 31, 2017
Grade:				
1-6 Pass	$160,215	$ 161,405	$5,302	$ 5,997
7 Special Mention	123	124	50	52
8 Substandard	1,385	1,444	23	24
9 Doubtful	—	—	—	
Add (deduct): Unearned discount and	(1)	(1)	—	—
Net deferred loan fees and costs	(49)	(47)	86	92
Total loans	$161,673	$ 162,925	$5,461	$ 6,165

	Total Loans	
	March 31, 2018	December 31, 2017
Grade:		
1-6 Pass	$547,982	$ 541,916
7 Special Mention	10,075	1,700
8 Substandard	14,388	15,012

9 Doubtful	—	—
Add (deduct): Unearned discount and	(1)	(1)
Net deferred loan fees and costs	800	770
Total loans	$573,244	$ 559,397

Commercial and Industrial and Commercial Real Estate include loans categorized as tax-free in the amounts of $42,128,000 and $2,278,000 at March 31, 2018 and $40,926,000 and $2,315,000 at December 31, 2017. Loans held for sale amounted to $708,000 at March 31, 2018 and $834,000 at December 31, 2017.

19

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

(Dollars in thousands)

	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
As of and for the three month period ended March 31, 2018:						
Allowance for Loan Losses:						
Beginning balance	$ 949	$ 4,067	$ 1,656	$ 111	$ 704	$ 7,487
Charge-offs	—	(117)	(29)	(13)	—	(159)
Recoveries	1	—	—	—	—	1
Provision	67	578	45	(3)	(637)	50
Ending Balance	$ 1,017	$ 4,528	$ 1,672	$ 95	$ 67	$ 7,379
Ending balance: individually evaluated for impairment	$	$ 625	$ 20	$	$	$ 645
Ending balance: collectively evaluated for impairment	$ 1,017	$ 3,903	$ 1,652	$ 95	$ 67	$ 6,734
Loans Receivable:						
Ending Balance	$ 107,175	$ 298,935	$ 161,673	$ 5,461	$	$ 573,244
Ending balance: individually evaluated for impairment	$ 1,188	$ 11,611	$ 994	$	$	$ 13,793
Ending balance: collectively evaluated for impairment	$ 105,987	$ 287,324	$ 160,679	$ 5,461	$	$ 559,451

(Dollars in thousands)

	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
As of and for the three month period ended March 31, 2017:						
Allowance for Loan Losses:						
Beginning balance	$ 836	$ 4,421	$ 1,777	$ 95	$ 228	$ 7,357
Charge-offs	—	(9)	(19)	(22)	—	(50)
Recoveries	67	—	—	4	—	71
Provision	(28)	45	(9)	18	57	83
Ending Balance	$ 875	$ 4,457	$ 1,749	$ 95	$ 285	$ 7,461

Ending balance: individually evaluated for impairment	$	$ 241	$ 19	$	$	$ 260
Ending balance: collectively evaluated for impairment	$ 875	$ 4,216	$ 1,730	$ 95	$ 285	$ 7,201
Loans Receivable:						
Ending Balance	$ 89,336	$ 262,651	$ 166,982	$ 6,020	$	$ 524,989
Ending balance: individually evaluated for impairment	$ 1,250	$ 13,062	$ 1,169	$	$	$ 15,481
Ending balance: collectively evaluated for impairment	$ 88,086	$ 249,589	$ 165,813	$ 6,020	$	$ 509,508

20

(Dollars in thousands)

	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
As of and for the year ended December 31, 2017						
Allowance for Loan Losses:						
Beginning balance	$ 836	$ 4,421	$ 1,777	$ 95	$ 228	$ 7,357
Charge-offs	—	(189)	(62)	(82)	—	(333)
Recoveries	74	103	9	10	—	196
Provision	39	(268)	(68)	88	476	267
Ending Balance	$ 949	$ 4,067	$ 1,656	$ 111	$ 704	$ 7,487
Ending balance: individually evaluated for impairment	$ —	$ 305	$ 22	$ —	$ —	$ 327
Ending balance: collectively evaluated for impairment	$ 949	$ 3,762	$ 1,634	$ 111	$ 704	$ 7,160
Loans Receivable:						
Ending Balance	$ 99,337	$ 290,970	$ 162,925	$ 6,165	$ —	$ 559,397
Ending balance: individually evaluated for impairment	$ 1,203	$ 11,673	$ 1,050	$ —	$ —	$ 13,926
Ending balance: collectively evaluated for impairment	$ 98,134	$ 279,297	$ 161,875	$ 6,165	$ —	$ 545,471

Of the $1,115,000 in foreclosed assets held for resale at March 31, 2018, $209,000 was represented by residential real estate, $50,000 was represented by land, and $856,000 was represented by commercial real estate. Of the $1,071,000 in foreclosed assets held for resale at December 31, 2017, $15,000 was represented by residential real estate, $50,000 was represented by land, and $1,006,000 was represented by commercial real estate. At March 31, 2018 and December 31, 2017, 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 $516,000 at March 31, 2018 and $485,000 at December 31, 2017. These balances were not included in foreclosed assets held for resale at March 31, 2018 or December 31, 2017.

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

The outstanding recorded investment of TDRs as of March 31, 2018 and December 31, 2017 was $9,063,000 and $9,109,000, respectively. The decrease in TDRs at March 31, 2018 as compared to December 31, 2017 is attributable to principal payments, paydowns, and charge-offs made on existing TDRs net against smaller loans modified as TDRs during the three months ended March 31, 2018. There were no unfunded commitments on TDRs at March 31, 2018 and December 31, 2017.

During the three months ended March 31, 2018, three loans with a combined post modification balance of $164,000 were modified as TDRs as compared to the same period in 2017, when two loans with a combined post modification balance of $110,000 were classified as TDRs. The loan modifications for the three months ended March 31, 2018 consisted of one term modification and two payment modifications. The loan modifications for the three months ended March 31 2017 consisted of two payment modifications.

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

(Dollars in thousands)

	March 31, 2018	December 31, 2017
Non-accrual TDRs	$ 160	$ 273
Accruing TDRs	8,903	8,836
Total	$ 9,063	$ 9,109

21

At March 31, 2018, eight Commercial Real Estate loans classified as TDRs with a combined recorded investment of $573,000, one Commercial and Industrial loan classified as a TDR with a recorded investment of $10,000 and one Residential Real Estate loan classified as a TDR with a recorded investment of $60,000 were not in compliance with the terms of their restructure, compared to March 31, 2017 when seven Commercial Real Estate loans classified as TDRs with a combined recorded investment of $642,000 and one Commercial and Industrial loan classified as a TDR with a recorded investment of $13,000 were not in compliance with the terms of their restructure.

During the three months ended March 31, 2018 and March 31, 2017, 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 three months ended March 31, 2018 and March 31, 2017.

(Dollars in thousands)

	Three Months Ended March 31, 2018			
		Pre-Modification	**Post-Modification**	
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment	Recorded Investment
Commercial and Industrial	—	$ —	$ —	$ —
Commercial Real Estate	3	152	164	160
Total	3	$ 152	$ 164	$ 160

(Dollars in thousands)

	Three Months Ended March 31, 2017			
		Pre-Modification	**Post-Modification**	
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment	Recorded Investment
Commercial and Industrial	1	$ 38	$ 38	$ 38
Commercial Real Estate	1	72	72	72
Total	2	$ 110	$ 110	$ 110

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

	Three Months Ended March 31, 2018				Three Months Ended March 31, 2017			
	Rate Modification	Term Modification	Payment Modification	Number Modified	Rate Modification	Term Modification	Payment Modification	Number Modified
Commercial and Industrial	—	—	—	—		—	1	1
Commercial Real Estate	—	1	2	3		—	1	1
Total	—	1	2	3		—	2	2

22

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

(Dollars in thousands)

	March 31, 2018			December 31, 2017		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:						
Commercial and Industrial	$1,188	$1,188	$ —	$1,203	$1,203	$ —
Commercial Real Estate	9,284	11,574	—	9,199	11,383	—
Residential Real Estate	866	1,012	—	878	1,024	—
With an allowance recorded:						
Commercial and Industrial	—	—	—	—	—	—
Commercial Real Estate	2,327	3,742	625	2,474	3,889	305
Residential Real Estate	128	128	20	172	172	22
Total	$13,793	$17,644	$ 645	$13,926	$17,671	$ 327
Total consists of:						
Commercial and Industrial	$1,188	$1,188	$ —	$1,203	$1,203	$ —
Commercial Real Estate	$11,611	$15,316	$ 625	$11,673	$15,272	$ 305
Residential Real Estate	$994	$1,140	$ 20	$1,050	$1,196	$ 22

At March 31, 2018 and December 31, 2017, $9,063,000 and $9,109,000 of loans classified as TDRs were included in impaired loans with a total allocated allowance of $0 and $2,000, respectively. The recorded investment represents the loan balance reflected on the Consolidated Balance Sheets net of any charge-offs. The unpaid balance is equal to the gross amount due on the loan.

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

(Dollars in thousands)

	For the Three Months Ended March 31, 2018		For the Three Months Ended March 31, 2017	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial and Industrial	$ 1,196	$ 4	$ 833	$ 12
Commercial Real Estate	9,307	101	11,960	127
Residential Real Estate	873	1	632	1
With an allowance recorded:				
Commercial and Industrial	—	—	—	—
Commercial Real Estate	2,327	—	985	
Residential Real Estate	128	—	424	
Total	$ 13,831	$ 106	$ 14,834	$ 140
Total consists of:				
Commercial and Industrial	$ 1,196	$ 4	$ 833	$ 12
Commercial Real Estate	$ 11,634	$ 101	$ 12,945	$ 127
Residential Real Estate	$ 1,001	$ 1	$ 1,056	$ 1

Of the $106,000 and $140,000 in interest income recognized on impaired loans for the three months ended March 31, 2018 and 2017, respectively, $0 and $17,000 in interest income was recognized with respect to non-accrual loans.

23

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

(Dollars in thousands)

	March 31, 2018	December 31, 2017
Commercial and Industrial	$ 787	$ 798
Commercial Real Estate	3,168	3,302
Residential Real Estate	935	990
Total non-accrual loans	4,890	5,090
Foreclosed assets held for resale	1,115	1,071
Loans past-due 90 days or more and still accruing interest	18	70
Total non-performing assets	$ 6,023	$ 6,231

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

(Dollars in thousands)

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Total Loans	90 Days Or Greater Past Due and Still Accruing Interest
March 31, 2018:							
Commercial and Industrial	$ 10	$ 34	$ —	$ 44	$107,131	$107,175	$ —
Commercial Real Estate	592	921	2,555	4,068	294,867	298,935	—
Residential Real Estate	1,646	635	534	2,815	158,858	161,673	18
Consumer	1	3	—	4	5,457	5,461	—
Total	$ 2,249	$ 1,593	$ 3,089	$ 6,931	$566,313	$573,244	$ 18

(Dollars in thousands)

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

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

24

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 March 31, 2018 and December 31, 2017.

(Dollars in thousands)

	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Consolidated Balance Sheet	Net Amounts of Liabilities Presented in the Consolidated Balance Sheet	Financial Instruments	Cash Collateral Pledge	Net Amount
March 31, 2018						
Repurchase agreements (a)	$ 14,714	$	$ 14,714	$ (14,714)	$	$
December 31, 2017						
Repurchase agreements (a)	$ 22,844	$	$ 22,844	$ (22,844)	$	$

(a) As of March 31, 2018 and December 31, 2017, the fair value of securities pledged in connection with repurchase agreements was $24,020,000 and $26,023,000, respectively.

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

(Dollars in thousands)

	Remaining Contractual Maturity of the Agreements				
	Overnight and Continuous	Up to 30 days	30 -90 Days	Greater than 90 Days	Total
March 31, 2018:					
Repurchase agreements and repurchase-to-maturity transactions:					
U.S. Treasury and/or agency securities	$ 14,714	$	$	$	$ 14,714
Total	$ 14,714	$	$	$	$ 14,714

25

Long-Term Borrowings

Long-term borrowings are comprised of advances from FHLB. Under terms of a blanket agreement, collateral for the FHLB loans is certain qualifying assets of the Corporation’s banking subsidiary. The 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 non-performance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments.

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

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

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

(Dollars in thousands)

	March 31, 2018	December 31, 2017
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	$ 119,274	$ 90,373
Financial standby letters of credit	$ 430	$ 450
Performance standby letters of credit	$ 2,952	$ 2,901

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

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

Financial Instruments with Concentrations of Credit Risk

The Corporation originates primarily commercial and residential real estate loans to customers in northeastern Pennsylvania. The ability of the majority of the Corporation's customers to honor their contractual loan obligations is dependent on the economy and real estate market in this area. At March 31, 2018, the Corporation had $460,608,000 in loans secured by real estate, which represented 80.4% 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 March 31, 2018 and December 31, 2017, management is of the opinion that there were no concentrations exceeding 10% of total loans with regard to loans to borrowers who were engaged in similar activities that were similarly impacted by economic or other conditions.

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

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

(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
March 31, 2018				
Debt Securities Available-for-Sale:				
U.S. Treasury securities	$	$2,819	$	$2,819
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed		81,986	—	81,986
Other		20,933	—	20,933
Obligations of state and political subdivisions		202,928	—	202,928
Asset backed securities	—	5,025	—	5,025
Corporate debt securities		28,402		28,402
Total debt securities available-for-sale	—	342,093	—	342,093
Marketable equity securities	1,599	—		1,599
Total recurring fair value measurements	$1,599	$342,093	$	$343,692

(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
December 31, 2017				
Debt Securities Available-for-Sale:				
U.S. Treasury securities	$—	$—	$ —	$—
Obligations of U.S. Government Corporations and Agencies:				
Mortgaged-backed	—	81,860	—	81,860
Other	—	22,233	—	22,233
Obligations of state and political subdivisions	—	215,522	—	215,522
Asset backed securities	—	—	—	—
Corporate debt securities	—	28,971	—	28,971

Total debt securities available-for-sale	—	348,586	—	348,586
Marketable equity securities	1,632	—	—	1,632
Total recurring fair value measurements	$ 1,632	$ 348,586	$ —	$ 350,218

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

Financial Assets Measured at Fair Value on a Nonrecurring Basis

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

(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
Assets at March 31, 2018				
Impaired loans:				
Commercial Real Estate	$	$	$ 4,903	$ 4,903
Residential Real Estate			212	212
Total impaired loans	$	$	$ 5,115	$ 5,115

28

(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
Assets at December 31, 2017				
Impaired loans:				
Commercial Real Estate	$ —	$ —	$ 5,498	$ 5,498
Residential Real Estate	—	—	254	254
Total impaired loans	$ —	$ —	$ 5,752	$ 5,752

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

Nonfinancial Assets Measured at Fair Value on a Nonrecurring Basis

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

(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
Assets at March 31, 2018				
Foreclosed assets held for resale:				
Commercial Real Estate	$	$	$ 856	$ 856
Residential Real Estate	—	—	209	209
Total foreclosed assets held for resale	$	$	$ 1,065	$ 1,065

(Dollars in thousands)

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

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

29

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

(Dollars in thousands)

	Quantitative Information about Level 3 Fair Value Measurements				
	Fair Value Estimate	Valuation Technique	Unobservable Input	Range	Weighted Average
March 31, 2018					
Impaired loans	$2,018	Appraisal of collateral[1,3]	Appraisal adjustments[2]	(17%) – (67%)	(21%)
Impaired loans	$3,097	Discounted cash flow	Discount rate	(7%) – (7%)	(7%)
Foreclosed assets held for resale	$1,065	Appraisal of collateral[1,3]	Appraisal adjustments[2]	(2%) – (35%)	(7%)
December 31, 2017					
Impaired loans	$2,495	Appraisal of collateral[1,3]	Appraisal adjustments[2]	(7%) – (65%)	(15%)
Impaired loans	$3,257	Discounted cash flow	Discount rate	(7%) – (8%)	(7%)
Foreclosed assets held for sale	$94	Appraisal of collateral[1,3]	Appraisal adjustments[2]	(35%) – (37%)	(36%)

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

[2]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.

[3]Includes qualitative adjustments by management and estimated liquidation expenses.

Fair Value of Financial Instruments

(Dollars in thousands)

	Carrying Amount	Fair Value Measurements at March 31, 2018 Level 1	Level 2	Level 3	Total

FINANCIAL ASSETS:					
Cash and due from banks	$8,973	$8,973	$	$	$8,973
Interest-bearing deposits in other banks	1,328	—	1,328	—	1,328
Time deposits with other banks	1,482	—	1,482	—	1,482
Debt securities available-for-sale	342,093	—	342,093	—	342,093
Marketable equity securities	1,599	1,599	—	—	1,599
Restricted investment in bank stocks	5,445	—	5,445	—	5,445
Net loans	565,865	—	—	560,037	560,037
Mortgage servicing rights	363	—	—	363	363
Accrued interest receivable	3,852	—	3,852	—	3,852
FINANCIAL LIABILITIES:					
Core deposits	535,379	—	535,379	—	535,379
Time deposits	213,467	—	210,647	—	210,647
Short-term borrowings	80,791	—	80,791	—	80,791
Long-term borrowings	55,000	—	54,852	—	54,852
Accrued interest payable	549	—	549	—	549

OFF-BALANCE SHEET FINANCIAL INSTRUMENTS

30

(Dollars in thousands)

	Carrying	Fair Value Measurements at December 31, 2017			
	Amount	Level 1	Level 2	Level 3	Total
FINANCIAL ASSETS:					
Cash and due from banks	$7,913	$ 7,913	$ —	$ —	$ 7,913
Interest-bearing deposits in other banks	826	—	826	—	826
Time deposits with other banks	1,482	—	1,482	—	1,482
Debt securities available-for-sale	348,586	—	348,586	—	348,586
Marketable equity securities	1,632	1,632	—	—	1,632
Restricted investment in bank stocks	4,058	—	4,058	—	4,058
Net loans	551,910	—	—	550,696	550,696
Mortgage servicing rights	379	—	—	379	379
Accrued interest receivable	4,237	—	4,237	—	4,237
FINANCIAL LIABILITIES:					
Core deposits	570,518	—	570,518	—	570,518
Time deposits	207,628	—	206,299	—	206,299
Short-term borrowings	26,296	—	26,296	—	26,296
Long-term borrowings	65,000	—	65,336	—	65,336
Accrued interest payable	490	—	490	—	490
OFF-BALANCE SHEET FINANCIAL INSTRUMENTS	—	—	—	—	—

NOTE 9 — REVENUE RECOGNITION

As disclosed in Note 2, as of January 1, 2018, the Corporation adopted ASU 2014-09 *Revenue from Contracts with Customers - Topic 606* and all subsequent ASUs that modified ASC 606. The Corporation has elected to apply the ASU and all related ASUs using the modified retrospective implementation method. The implementation of the guidance had no material impact on the measurement or recognition of revenue of prior periods, however, additional disclosures have been added in accordance with the ASU.

The main types of revenue contracts included in non-interest income within the consolidated statements of income are as follows:

Deposits related fees and service charges

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

31

Wealth/Asset/Trust Management Fees

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

Assets held in a fiduciary capacity by the Trust Department are not assets of the Corporation and, therefore, are not included in our Consolidated Financial Statements. Wealth management fees, which are contractually agreed with each customer, are earned each month and recognized on a cash basis based on average fair value of the trust assets under management. The services provided under such a contract are considered a single performance obligation under ASC 606 because they embody a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. Wealth management fees charged by the Trust Department follow a tiered structure based on the type and size of the assets under management. Wealth management fees are included within non-interest income in the consolidated statements of income. As of March 31, 2018 and December 31, 2017, the fair value of trust assets under management was $114,498,000 and $111,130,000 respectively. The costs of acquiring asset management customers are incremental and recognized within the non-interest expense of the consolidated statements of income.

Interchange Fees and Surcharges

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

NOTE 10 — 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 March 31,	
	2018	2017
Net income	$ 1,777	$ 2,286
Weighted-average common shares outstanding	5,719	5,672
Basic earnings per share	$ 0.31	$ 0.40
Weighted-average common shares outstanding	5,719	5,672
Common stock equivalents due to effect of stock options	—	2
Total weighted-average common shares and equivalents	5,719	5,674
Diluted earnings per share	$ 0.31	$ 0.40

32

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 2017 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, 2017.

RESULTS OF OPERATIONS

Quarter ended March 31, 2018 compared to quarter ended March 31, 2017

First Keystone Corporation realized earnings for the first quarter of 2018 of $1,777,000, a decrease of $509,000, or 22.3% from the first quarter of 2017. The decrease in net income for the three months ended March 31, 2018 was primarily due to increases in salaries and employee benefits and interest expense on deposits and short-term borrowings, as well as a decrease in net investment securities gains.

On a per share basis, for the three months ended March 31, 2018, net income was $0.31 versus $0.40 for the same three month period of 2017. Cash dividends amounted to $0.27 per share for the three months ended March 31, 2018 and 2017.

NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income, defined as interest income less interest expense. In the first quarter of 2018, interest income amounted to $8,271,000, an increase of $374,000 or 4.7% from the first quarter of 2017, while interest expense amounted to $1,781,000 in the first quarter of 2018, an increase of $362,000, or 25.5% from the first quarter of 2017. As a result, net interest income increased $12,000 or 0.2% to $6,490,000 from $6,478,000 for the same period in 2017.

The Corporation's net interest margin for the three months ended March 31, 2018 was 3.12% compared to 3.10% for the three months ended March 31, 2017. The increase in net interest margin was a result of an increase in yield on the investment portfolio.

PROVISION FOR LOAN LOSSES

The provision for loan losses for the three months ended March 31, 2018 and March 31, 2017 was $50,000 and $83,000, 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. Charge-off and recovery activity in the allowance for loan losses resulted in net charge-offs of $158,000 and net recoveries of $21,000 for the three months ended March 31, 2018 and 2017, respectively. See Allowance for Loan Losses on page 37 for further discussion.

NON-INTEREST INCOME

Total non-interest income was $1,259,000 for the three months ended March 31, 2018, as compared to $1,538,000 for the same period in 2017, a decrease of $279,000, or 18.1%. The decrease was mainly the result of a decrease in net securities gains during the quarter. ATM fees and debit card income increased $30,000 or 9.2% to $357,000 for the three months ended March 31, 2018. Gains on sales of mortgage loans decreased $7,000 or 19.4% due to a decrease in loans originated with the intent to sell. Net gains on sales of securities decreased $320,000 to $(17,000) for the three months ended March 31, 2018 as compared to the three months ended March 31, 2017.

NON-INTEREST EXPENSE

Total non-interest expense was $5,895,000 for the quarter ended March 31, 2018, as compared to $5,263,000 for the quarter ended March 31, 2017. Non-interest expense increased $632,000 or 12.0%.

Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non-interest expense. Salaries and benefits amounted to $3,036,000 or 51.5% of total non-interest expense for the three months ended March 31, 2018, as compared to $2,742,000 or 52.1% for the same three months of 2017. The increase was primarily due to increased costs associated with employee health care, as well as the addition of new sales positions in the commercial and residential mortgage lending areas.

Net occupancy, furniture and equipment, and computer expense amounted to $865,000 for the three months ended March 31, 2018, a decrease of $7,000 or 0.8%. Professional services decreased $15,000 or 6.3% to $223,000 as of March 31, 2018. Pennsylvania shares tax expense amounted to $199,000 for the three months ended March 31, 2018, a decrease of $7,000 or 3.4% as compared to the same three months in 2017.

FDIC insurance expense increased $1,000 or 1.3% for the three months ended March 31, 2018. FDIC insurance expense varies with changes in net asset size, risk ratings, and FDIC derived assessment rates. ATM and debit card fees expense amounted to $175,000 for the three months ended March 31, 2018, an increase of $38,000 or 27.7% as compared to the same three months of 2017. The increase was due to higher electronic funds transfer fees. Data processing expenses increased $40,000 or 17.6% to $267,000 for the three months ended March 31, 2018 as compared to the same three months of 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 $42,000 in the first quarter of 2018 as the result of one OREO property purchased and the write down of two OREO property values during the three months ended March 31, 2018. Advertising expense increased $3,000 or 3.8% during the three months ended March 31, 2018.

Other non-interest expense amounted to $900,000 for the three months ended March 31, 2018, an increase of $243,000 or 37.0% as compared to the three months ended March 31, 2017. The increase was due to an increase in amortization costs on one of the Corporation’s low income housing investment properties.

INCOME TAXES

Income tax expense amounted to $27,000 for the three months ended March 31, 2018, as compared to $384,000 for the three months ended March 31, 2017, a decrease of $357,000. The effective total income tax rate was 1.5% for the first quarter of 2018 as compared to 14.4% for the first quarter of 2017. The decrease in the effective tax rate was due to major tax reform legislation signed into law in December 2017 which reduced the Corporation’s tax rate from 34% to 21%, effective January 1, 2018. The Corporation recognized $101,000 of tax credits from low-income housing partnerships in the first quarter of 2018.

34

FINANCIAL CONDITION

SUMMARY

Total assets increased to $1,001,430,000 as of March 31, 2018, an increase of $11,309,000 from year-end 2017. Total assets as of December 31, 2017 amounted to $990,121,000.

Total debt securities decreased $6,493,000 or 1.9% to $342,093,000 as of March 31, 2018 from December 31, 2017.

Total loans increased $13,847,000 or 2.5% to $573,244,000 as of March 31, 2018 from December 31, 2017. Loan demand grew in the three months ended March 31, 2018 as the Bank has seen an increase in loan originations, primarily in the commercial real estate and commercial and industrial portfolios.

Total deposits decreased $29,300,000 or 3.8% to $748,846,000 as of March 31, 2018 from December 31, 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 three months of 2018 by $44,495,000 to $135,791,000 from $91,296,000 as of December 31, 2017. Borrowings increased mainly due to decreased deposit balances and the need to fund growth in the loan portfolio.

Total stockholders’ equity decreased to $112,428,000 at March 31, 2018, a decrease of $4,291,000 or 3.7% from December 31, 2017 due to a decrease in accumulated other comprehensive income.

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 March 31, 2018 and March 31, 2017. 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 $573,244,000 as of March 31, 2018, up $13,847,000, or 2.5% since year-end 2017. The loan portfolio continues to be well diversified. Non-performing assets decreased since year-end 2017, and overall asset quality has remained consistent. Total non-performing assets were $6,023,000 as of March 31, 2018, a decrease of $208,000, or 3.3% from $6,231,000 reported in non-performing assets as of December 31, 2017. Total allowance for loan losses to total non-performing assets was 122.5% as of March 31, 2018 and 120.2% at December 31, 2017.

In addition to loans, another primary earning asset is our overall investment portfolio, which decreased in size from December 31, 2017 to March 31, 2018. Available-for-sale debt securities amounted to $342,093,000 as of March 31, 2018, a decrease of $6,526,000 from year-end 2017.

Interest-bearing deposits in other banks increased as of March 31, 2018, to $1,328,000 from $826,000 at year-end 2017. Time deposits with other banks were $1,482,000 at March 31, 2018 and December 31, 2017.

LOANS

Total loans increased to $573,244,000 as of March 31, 2018 as compared to $559,397,000 as of December 31, 2017. 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 $13,847,000 or 2.5%.

Steady demand for borrowing by businesses accounted for the 2.5% increase in the loan portfolio from December 31, 2017 to March 31, 2018. The Commercial and Industrial portfolio increased $7,838,000 to $107,175,000 as of March 31, 2018, as compared to $99,337,000 at December 31, 2017. The increase in the Commercial and Industrial portfolio (which includes tax-free Commercial and Industrial loans) was attributed to new loan originations totaling $9,646,000 and a $6,055,000 increase in utilization of existing Commercial and Industrial lines of credit offset by loan payoffs of $3,274,000, as well as regular principal payments and other typical fluctuations and activity in the Commercial and Industrial portfolio. The Commercial Real Estate portfolio (which includes tax-free Commercial Real Estate loans) increased $7,965,000 to $298,935,000 at March 31, 2018, as compared to $290,970,000 at December 31, 2017. The increase was mainly the result of $15,066,000 in new loan originations, offset by $4,725,000 in loan payoffs in addition to regular principal payments and other typical amortizations in the Commercial Real Estate portfolio. Residential Real Estate loans decreased $1,252,000 to $161,673,000 at March 31, 2018, as compared to $162,925,000 at December 31, 2017. The decrease was the result of $3,753,000 in new loan originations offset by loan payoffs of $3,079,000, net loans sold of $478,000, and regular principal payments. Net loans sold in the Residential Real Estate portfolio for the quarter ended March 31, 2018 consisted of total loans sold during the quarter ended March 31, 2018 of $1,764,000, offset with loans opened and sold during the quarter ended March 31, 2018 which amounted to $1,286,000. 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 $406,110,000 at March 31, 2018. Of total loans, $298,935,000 or 52.1% 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 $12,682,000 at March 31, 2018. The individual owns a diverse mix of real estate entities which specialize in construction/development projects (which include VA clinics), leasing of commercial office space, and rental of multi-tenant residential units. This relationship is comprised of $11,682,000 in term debt and a line of credit totaling $1,000,000. 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 March 31, 2018, the relationship had outstanding loan balances and unused commitments of $9,899,000. The debt is comprised of $9,844,000 in term debt and two lines of credit totaling $55,000. The loans are secured by commercial real estate, the assignment of rents and leases, 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 March 31, 2018, the relationship had outstanding balances totaling $9,640,000 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 distributor and marketer of energy products and services including natural gas, propane, butane, and electricity. During 2017, the company undertook to partner with local banks to finance its capital needs while promoting regional economic development. At March 31, 2018, the relationship had outstanding balances of $8,888,000 which consisted entirely of unsecured term debt. The debt will be utilized for general corporate needs, including upgrades to the company's utility distribution system that will enhance its ability to continue providing safe and reliable natural gas service.

The fifth largest relationship consists of a hotel management company that has been in operation since 1987 and successfully owns and operates seven hotels. At March 31, 2018, the relationship had outstanding balances totaling $8,431,000, which consisted entirely of term debt. The relationship is secured by commercial real estate and business assets, as well as the assignment of leases and a life insurance policy. The four loans included in this relationship were downgraded to special mention status during the three month period ended March 31, 2018 as the result of a warning letter that was received from the hotel franchisor regarding unfavorable guest satisfaction survey and brand audit results.

Each of the five relationships is headquartered in Corporation's market area.

All of the above mentioned loans are performing as agreed. All loans are graded pass with the exception of the loans to the hotel management company. 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 $547,982,000 or 95.7% of gross loans are graded Pass; $10,075,000 or 1.8% are graded Special Mention; $14,388,000 or 2.5% are graded Substandard; and $0 are graded Doubtful. The rating is intended to represent the best assessment of risk available at a given point in time, based upon a review of the borrower's financial statements, credit analysis, payment history with the Bank, credit history and lender knowledge of the borrower. See Note 4 — Loans and Allowance for Loan Losses for risk grading tables.

Overall, non-pass grades increased to $24,463,000 at March 31, 2018, as compared to $16,712,000 at December 31, 2017. Commercial and Industrial non-pass grades decreased to $1,231,000 as of March 31, 2018 as compared to 1,344,000 as of December 31, 2017. Commercial Real Estate non-pass grades increased to $21,651,000 as of March 31, 2018 as compared to $13,724,000 as of December 31, 2017. The Residential Real Estate and Consumer loan non-pass grades decreased to $1,581,000 as of March 31, 2018 as compared to $1,644,000 as of December 31, 2017.

The increase in the Commercial Real Estate non-pass grade portfolio during the three months ended March 31, 2018 was mainly attributable to four loans to a hotel management company in the amount of $8,431,000 that were downgraded to Special Mention due to a warning letter that was issued by the hotel franchisor regarding unfavorable guest satisfaction survey and brand audit results. This large downgrade to non-pass grade status was offset by a $112,000 charge-off of a non-accrual purchased participation loan to a retailer of recreational vehicles that was moved to foreclosed assets held for resale during the three months ended March 31, 2018, $330,000 in regular payments and paydowns made during the three months ended March 31, 2018 on a large Substandard loan to the owner of a recreation facility, and a real estate-secured working capital line of credit to a commercial real estate developer that carried a balance of $148,000 at December 31, 2017 that was upgraded from Special Mention to pass-grade status during the three months ended March 31, 2018 to bring the risk rating of the credit facility into alignment with the risk ratings assigned to loans to a related entity and also as the result of good payment history and an acceptable loan-to-value ratio associated with the specific credit facility.

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)	March 31, 2018	December 31, 2017
Commercial and Industrial	$ 107,175	$ 99,337
Commercial Real Estate	298,935	290,970
Residential Real Estate	161,673	162,925
Consumer	5,461	6,165
Total loans	$ 573,244	$ 559,397

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of March 31, 2018, the allowance for loan losses was $7,379,000 as compared to $7,487,000 as of December 31, 2017. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for possible loan losses when management believes that the collectability of the principal is unlikely. The risk characteristics of the loan portfolio are managed through various control processes, including credit evaluations of individual borrowers, periodic reviews, and diversification by industry. Risk is further mitigated through the application of lending procedures such as the holding of adequate collateral and the establishment of contractual guarantees.

37

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 three month periods ended March 31, 2018 and 2017. For the three month period ended March 31, 2018, net charge-offs as a percentage of average loans was 0.028% as compared to net recoveries of 0.004% of average loans for the three month period ended March 31, 2017. Net charge-offs amounted to $158,000 for the first three months of 2018 as compared to net recoveries of $21,000 for the first three months of 2017.

For the first three months of 2018, the provision for loan losses was $50,000 as compared to $83,000 for the first three months of 2017. The provision, net of charge-offs and recoveries, resulted in the quarter end Allowance for Loan Losses of $7,379,000 of which 13.8% was attributed to the Commercial and Industrial component; 61.4% attributed to the Commercial Real Estate component; 22.6% attributed to the Residential Real Estate component (primarily residential mortgages); 1.3% attributed to the Consumer component; and 0.9% 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 March 31, 2018.

Analysis of Allowance for Loan Losses

(Dollars in thousands)	March 31, 2018	March 31, 2017
Balance at beginning of the three month period	$ 7,487	$ 7,357
Charge-offs:		
Commercial and Industrial	—	—
Commercial Real Estate	117	9
Residential Real Estate	29	19
Consumer	13	22
	159	50
Recoveries:		

Commercial and Industrial	1	67
Commercial Real Estate	—	
Residential Real Estate	—	—
Consumer	—	4
	1	71
Net charge-offs (recoveries)	158	(21)
Additions charged to operations	50	83
Balance at end of the three month period	$ 7,379	$ 7,461
Ratio of net charge-offs (recoveries) during the period to average loans outstanding during the period	0.028 %	(0.004)%
Allowance for loan losses to average loans outstanding during the period	1.300 %	1.413 %

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 1.30% at March 31, 2018 and 1.41% at March 31, 2017.

NON-PERFORMING ASSETS

The table on page 41 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 deferments 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 $6,023,000 as of March 31, 2018 as compared to $6,231,000 as of December 31, 2017. The economy, in particular, high unemployment/labor underutilization rate, weak job markets, unsettled fuel prices and energy costs, and the continued slowness in the housing industry in our market areas had a direct effect on the Corporation's non-performing assets. The Corporation is closely monitoring its Commercial Real Estate portfolio because of the current economic environment. In particular, vacancy rates are rising, while property values in some markets have fallen. Non-accrual loans totaled $4,890,000 as of March 31, 2018 as compared to $5,090,000 as of December 31, 2017. Foreclosed assets held for resale amounted to $1,115,000 at March 31, 2018 as compared to $1,071,000 at December 31, 2017. Loans past-due 90 days or more and still accruing interest amounted to $18,000 as of March 31, 2018 as compared to $70,000 as of December 31, 2017. At March 31, 2018, loans past-due 90 days or more and still accruing interest consisted of one Residential Real Estate loan for which the borrower has filed bankruptcy and loan payments are currently being made through a trustee.

Non-performing assets to total loans was 1.1% at March 31, 2018 and December 31, 2017. Non-performing assets to total assets was 0.6% at March 31, 2018 and December 31, 2017. The allowance for loan losses to total non-performing assets was 122.5% as of March 31, 2018 as compared to 120.2% as of December 31, 2017. Additional detail can be found on page 41 in the Non-Performing Assets and Impaired Loans table and page 24 in the Non-Performing Assets 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 $4,580,000 at March 31, 2018, compared to $5,043,000 at December 31, 2017.

Impaired loans were $13,793,000 at March 31, 2018 and $13,926,000 at December 31, 2017. The largest impaired loan relationship at March 31, 2018 consisted of one performing loan to a student housing holding company in the amount of $3,097,000, 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 March 31, 2018 resulted in a specific allocation of $0. The second largest impaired loan relationship at March 31, 2018 consisted of a non-performing participation loan to a student housing holding company which was secured by commercial real estate. The Corporation’s share of the loan at March 31, 2018 was $2,318,000. The loan was downgraded to substandard and placed on non-accrual status during the third quarter of 2015 due to the borrower’s inability to reach a break-even rental income, related to the borrower’s failure to meet projected occupancy rates. One participant’s share in the amount of $1,350,000 was repurchased during the third quarter of 2017. The collateral evaluation of the total participation at March 31, 2018 carried a value of $3,044,000, after considering estimated appraisal adjustments and cost to sell of 18%, resulted in the Bank’s specific allocation of $624,000. The third largest impaired loan relationship at March 31, 2018 consisted of a substandard performing loan to a developer of a residential sub-division in the amount of $1,664,000, 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 loan experienced a subsequent modification during the fourth quarter of 2017 to extend the maturity date to October 2020, reset the interest rate from a floating rate to a fixed rate, commence regular principal and interest payments, and take additional real estate collateral. The discounted cash flow evaluation at March 31, 2018 resulted in a specific allocation of $0.

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 $13,793,000 in impaired loans at March 31, 2018, none were located outside of the Corporation's primary market area.

The outstanding recorded investment of loans categorized as TDRs was $9,063,000 as of March 31, 2018 as compared to $9,109,000 as of December 31, 2017. The decrease in TDRs at March 31, 2018 as compared to December 31, 2017 is attributable to large principal payments, paydowns, and charge-offs made on existing TDRs net against smaller loans modified as TDRs during the three months ended March 31, 2018. Of the thirty-three restructured loans at March 31, 2018, six loans are classified in the Commercial and Industrial portfolio, twenty-six loans are classified in the Commercial Real Estate portfolio and one loan is classified in the Residential Real Estate portfolio. At March 31, 2018, eight Commercial Real Estate loans classified as TDRs with a combined recorded investment of $573,000, one Commercial and Industrial loan classified as a TDR with a recorded investment of $10,000, and one Residential Real Estate loan classified as a TDR with a recorded investment of $60,000 were not in compliance with the terms of their restructure, compared to March 31, 2017 when seven Commercial Real Estate loans classified as TDRs with a combined recorded investment of $642,000 and one Commercial and Industrial loan classified as a TDR with a recorded investment of $13,000 were not in compliance with the terms of their restructure. Troubled debt restructurings at March 31, 2018 consisted of sixteen term modifications beyond the original stated term, four interest rate modifications, and twelve payment modifications. At March 31, 2018, 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 March 31, 2018 and December 31, 2017, there were $0 and $2,000, respectively in specific allocations attributable to the TDRs. There were no unused commitments attributable to TDRs at March 31, 2018 and December 31, 2017.

During the three months ended March 31, 2018 and 2017, 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 2018. 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 March 31, 2018 and December 31, 2017, management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

(Dollars in thousands)	March 31, 2018	December 31, 2017
Non-Performing Assets		
Non-accrual loans	$ 4,890	$ 5,090
Foreclosed assets held for resale	1,115	1,071
Loans past-due 90 days or more and still accruing interest	18	70
Total non-performing assets	$ 6,023	$ 6,231
Impaired loans		
Non-accrual loans	$ 4,890	$ 5,090
Accruing TDRs	8,903	8,836
Total impaired loans	13,793	13,926
Allocated allowance for loan losses	(645)	(327)
Net investment in impaired loans	$ 13,148	$ 13,599
Impaired loans with a valuation allowance	$ 2,455	$ 2,646
Impaired loans without a valuation allowance	11,338	11,280
Total impaired loans	$ 13,793	$ 13,926
Allocated valuation allowance as a percent of impaired loans	4.7 %	2.3 %
Impaired loans to total loans	2.4 %	2.5 %
Non-performing assets to total loans	1.1 %	1.1 %
Non-performing assets to total assets	0.6 %	0.6 %
Allowance for loan losses to impaired loans	53.5 %	53.8 %
Allowance for loan losses to total non-performing assets	122.5 %	120.2 %

Real estate mortgages comprise 80.4% of the loan portfolio as of March 31, 2018, as compared to 81.1% as of December 31, 2017. Real estate mortgages consist of both residential and commercial real estate loans. The real estate loan portfolio is well diversified in terms of borrowers, collateral, interest rates, and maturities. Also, the residential real estate loan portfolio is largely comprised of fixed rate mortgages. The real estate loans are concentrated primarily in the Corporation’s market area and are subject to risks associated with the local economy. The commercial real estate loans typically reprice approximately every three to five years and are also concentrated in the Corporation’s market area. The Corporation’s loss exposure on its impaired loans continues to be mitigated by collateral positions on these loans. The allocated allowance for loan losses associated with impaired loans is generally computed based upon the related collateral value of the loans. The collateral values are determined by recent appraisals, but are generally discounted by management based on historical dispositions, changes in market conditions since the last valuation and management's expertise and knowledge of the borrower and the borrower's business.

DEPOSITS AND OTHER BORROWED FUNDS

Consumer and commercial retail deposits are attracted primarily by the Bank's eighteen full service office locations 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 $29,300,000 to $748,846,000 as of March 31, 2018 as non-interest bearing deposits increased by $9,867,000 and interest bearing deposits decreased by $39,167,000 from year-end 2017. Total deposits decreased due to the withdrawal of funds by municipal depositors through normal, seasonal fluctuations. Demand deposits, savings accounts and certificates of deposit increased from year-end 2017. Total short-term and long-term borrowings increased to $135,791,000 as of March 31, 2018, from $91,296,000 at year-end 2017, an increase of $44,495,000, or 48.7%. Total borrowings increased due to decreased deposit balances and an increase in the balance of the loan portfolio.

CAPITAL STRENGTH

Normal increases in capital are generated by net income, less dividends paid out. During the first three months of the year, net income less dividends paid increased capital by $232,000. Accumulated other comprehensive income (loss) derived from net unrealized gains on debt securities available-for-sale also impacts capital. At December 31, 2017 accumulated other comprehensive income was $1,826,000. Accumulated other comprehensive loss stood at $(2,971,000) at March 31, 2018, a decrease of $4,797,000. 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 three months of 2018 at an overall net gain of $16,000. These fluctuations from net unrealized gains on debt 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 231,612 shares of common stock as treasury stock at March 31, 2018 and December 31, 2017. This had an effect of reducing our total stockholders’ equity by $5,709,000 as of March 31, 2018 and December 31, 2017.

Total stockholders’ equity was $112,428,000 as of March 31, 2018, and $116,719,000 as of December 31, 2017.

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

	March 31,	December 31,	To Be Well Capitalized Under Prompt Corrective Action

	2018		2017		Regulations	
Tier 1 leverage ratio (to average assets)	8.85	%	8.84	%	5.00	%
Common Equity Tier 1 capital ratio (to risk-weighted assets)	12.84	%	13.06	%	6.50	%
Tier 1 risk-based capital ratio (to risk-weighted assets)	12.84	%	13.06	%	8.00	%
Total risk-based capital ratio	13.96	%	14.21	%	10.00	%

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

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

42

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 March 31, 2018, the Corporation had $299,115,000 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 $5,142,000.

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 $14,714,000 at March 31, 2018.

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

Net cash flows provided by operating activities were $3,342,000 and $2,047,000 during the three months ended March 31, 2018 and 2017, respectively. Net income amounted to $1,777,000 for the three months ended March 31, 2018 and $2,286,000 for the three months ended March 31, 2017. During the three months ended March 31, 2018 and 2017, net premium amortization on investment securities amounted to $901,000 and $1,186,000, respectively. Cash proceeds (including gains) from sales of mortgage loans originated for resale exceeded net cash utilized for originations of mortgage loans originated for resale by $152,000 for the three months ended March 31, 2018 and net cash utilized for originations of mortgage loans originated for resale exceeded cash proceeds (including gains) from sales of mortgage loans originated for resale by $421,000 for the three months ended March 31, 2017. Other assets decreased $416,000 and $469,000 during the three months ended March 31, 2018 and 2017, respectively. Other liabilities increased $36,000 during the three months ended March 31, 2018 and decreased $502,000 during the three months ended March 31, 2017.

Investing activities used $15,721,000 and $12,198,000 during the three months ended March 31, 2018 and 2017, respectively. Net activity in the available-for-sale securities portfolio (including proceeds from sales, maturities, and redemptions net against purchases) used cash of $117,000 and $9,570,000 during the three months ended March 31, 2018 and 2017, respectively. Net cash used to originate loans amounted to $14,197,000 during the three months ended March 31, 2018 and $2,123,000 during the three months ended March 31, 2017.

Financing activities provided cash of $13,941,000 and $10,977,000 during the three months ended March 31, 2018 and 2017, respectively. Net deposits used cash of $29,300,000 during the three months ended March 31, 2018 and provided cash of $6,604,000 during the three months ended March 31, 2017. Short-term borrowings increased by $54,495,000 and $5,635,000 during the three months ended March 31, 2018 and 2017, respectively. Repayment of long-term borrowings used cash of $10,000,000 and $31,000 during the three months ended March 31, 2018 and 2017, respectively. Dividends paid amounted to $1,254,000 and $1,532,000 for the three months ended March 31, 2018 and 2017, respectively.

Managing liquidity remains an important segment of asset/liability management. The overall liquidity position of the Corporation is maintained by an active asset/liability management committee. The Corporation believes that its core deposit base is stable even in periods of changing interest rates. Liquidity and funds management are governed by policies and 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 March 31, 2018.

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 this page 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 9.1%, 17.7% and 24.8% in the 100, 200 and 300 basis point increasing rate scenarios presented. In addition, the earnings simulation model projects net interest income would increase 4.3% and 1.9% 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 150 – 200 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 three months ended March 31, 2018, the cost of interest-bearing liabilities averaged 0.9%, and the yield on interest-earning assets, on a fully taxable equivalent basis, averaged 3.9%.

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 March 31, 2018, the 100 and 200 basis point immediate decreases in rates are estimated to affect net present value with decreases of 5.7% and 22.2%, respectively. Additionally, net present value is projected to decrease 1.6%, 6.8% and 14.0% 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	(24.8	)%
+200 bp Shock vs. Stable Rate	(17.7	)%
+100 bp Shock vs. Stable Rate	(9.1	)%
Flat rate		
-100 bp Shock vs. Stable Rate	4.3	%
-200 bp Shock vs. Stable Rate	1.9	%
Effect on Net Present Value of Balance Sheet		
Static Net Present Value Change		
+300 bp Shock vs. Stable Rate	(14.0	)%
+200 bp Shock vs. Stable Rate	(6.8	)%
+100 bp Shock vs. Stable Rate	(1.6	)%
Flat rate		
-100 bp Shock vs. Stable Rate	(5.7	)%
-200 bp Shock vs. Stable Rate	(22.2	)%

45

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

a) 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 March 31, 2018.

b) 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 March 31, 2018, 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, 2017.

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

Period	**(a) Total Number of Shares Purchased**	**(b) Average Price Paid per Share**	**(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs**	**(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs**
Jan. 1 — Jan. 31, 2018				120,000
Feb.1 — Feb. 28, 2018				120,000
March 1 — March 31, 2018				120,000
Total				120,000

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

47

Item 6. Exhibits and Reports on Form 8-K

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

Exhibit Number	Description of Exhibit
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 September 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 99.1 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.**

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.

48

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
May 9, 2018	/s/ Elaine A. Woodland Elaine A. Woodland Interim President and Chief Executive Officer (Principal Executive Officer)
May 9, 2018	/s/ Diane C.A. Rosler Diane C.A. Rosler Senior Vice President and Chief Financial Officer (Principal Financial Officer)

49

INDEX TO EXHIBITS

Exhibit	Description
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 September 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 99.1 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.**
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.