FIRST KEYSTONE CORP
Form 10-Q
November 08, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018

or

.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ________ to ________

Commission File Number: 2-88927

FIRST KEYSTONE CORPORATION
(Exact name of registrant as specified in its charter)

Pennsylvania	**23-2249083**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

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

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

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

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

Yes x No ¨

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

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	x
Emerging growth company	¨		

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 7(a)(2)(B) of the Exchange Act. ¨

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

Yes ¨ No x

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

Common Stock, $2 Par Value, 5,752,365 shares as of November 7, 2018.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

(Unaudited)

(Dollars in thousands, except share data)	September 30, 2018	December 31, 2017
ASSETS		
Cash and due from banks	$ 9,820	$ 7,913
Interest-bearing deposits in other banks	3,148	826
Total cash and cash equivalents	12,968	8,739
Time deposits with other banks	1,482	1,482
Debt securities available-for-sale	323,586	348,586
Marketable equity securities	1,684	1,632
Restricted investment in bank stocks	8,561	4,058
Loans	597,720	559,397
Allowance for loan losses	(6,871)	(7,487)
Net loans	590,849	551,910
Premises and equipment, net	20,178	20,623
Accrued interest receivable	3,919	4,237
Cash surrender value of bank owned life insurance	22,807	22,354
Investments in low-income housing partnerships	2,188	2,626
Goodwill	19,133	19,133
Foreclosed assets held for resale	983	1,071
Deferred income taxes	2,572	936
Other assets	2,870	2,734
TOTAL ASSETS	$ 1,013,780	$ 990,121
LIABILITIES		
Deposits:		
Non-interest bearing	$ 133,184	$ 121,415
Interest bearing	567,495	656,731
Total deposits	700,679	778,146
Short-term borrowings	151,281	26,296
Long-term borrowings	45,000	65,000
Accrued interest payable	740	490
Other liabilities	3,270	3,470
TOTAL LIABILITIES	900,970	873,402

STOCKHOLDERS' EQUITY		
Preferred stock, par value $2.00 per share; authorized 1,000,000 shares as of September 30, 2018 and December 31, 2017; issued 0 as of September 30, 2018 and December 31, 2017		
Common stock, par value $2.00 per share; authorized 20,000,000 shares as of September 30, 2018 and December 31, 2017; issued 5,983,977 as of September 30, 2018 and 5,950,951 as of December 31, 2017; outstanding 5,752,365 as of September 30, 2018 and 5,719,339 as of December 31, 2017	11,968	11,902
Surplus	37,003	36,193
Retained earnings	74,988	72,507
Accumulated other comprehensive (loss) income	(5,440)	1,826
Treasury stock, at cost, 231,612 shares as of September 30, 2018 and December 31, 2017	(5,709)	(5,709)
TOTAL STOCKHOLDERS' EQUITY	112,810	116,719
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 1,013,780	$ 990,121

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands, except per share data)	2018	2017	2018	2017
INTEREST INCOME				
Interest and fees on loans	$ 6,672	$ 5,662	$ 18,891	$ 16,718
Interest and dividend income on investment securities:				
Taxable	1,190	1,103	3,392	3,317
Tax-exempt	1,157	1,290	3,526	3,733
Dividends	11	11	32	33
Dividend income on restricted investment in bank stocks	129	89	309	244
Interest on interest-bearing deposits in other banks	10	9	27	26
Total interest income	9,169	8,164	26,177	24,071
INTEREST EXPENSE				
Interest on deposits	1,242	1,055	3,807	2,955
Interest on short-term borrowings	750	369	1,324	767
Interest on long-term borrowings	292	363	918	1,111
Total interest expense	2,284	1,787	6,049	4,833
Net interest income	6,885	6,377	20,128	19,238
Provision for loan losses	—	84	50	167
Net interest income after provision for loan losses	6,885	6,293	20,078	19,071
NON-INTEREST INCOME				
Trust department	268	203	726	660
Service charges and fees	525	460	1,514	1,357
Bank owned life insurance income	156	160	453	478
ATM fees and debit card income	395	351	1,151	1,034
Gains on sales of mortgage loans	72	81	139	205
Net investment securities gains	18	414	55	886
Other	68	44	193	126
Total non-interest income	1,502	1,713	4,231	4,746
NON-INTEREST EXPENSE				
Salaries and employee benefits	2,993	3,050	8,986	8,823
Occupancy, net	418	423	1,317	1,340
Furniture and equipment	159	146	451	422
Computer expense	250	252	743	765
Professional services	262	201	794	634
Pennsylvania shares tax	214	157	613	568
FDIC insurance	78	81	234	241

ATM and debit card fees	207	184	574	509
Data processing fees	258	248	791	734
Foreclosed assets held for resale expense	46	13	121	119
Advertising	181	146	391	408
Other	541	780	2,163	2,047
Total non-interest expense	5,607	5,681	17,178	16,610
Income before income tax expense	2,780	2,325	7,131	7,207
Income tax expense	184	269	282	946
NET INCOME	$ 2,596	$ 2,056	$ 6,849	$ 6,261
PER SHARE DATA				
Net income per share:				
Basic	$ 0.45	$ 0.36	$ 1.19	$ 1.10
Diluted	0.45	0.36	1.19	1.10
Dividends per share	0.27	0.27	0.81	0.81

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017

(Unaudited)

	Three Months Ended September 30,	
(Dollars in thousands)	2018	2017
Net Income	$ 2,596	$ 2,056
Other comprehensive (loss):		
Unrealized net holding (losses) gains on debt securities available-for-sale arising during the period, net of income taxes of $(485) and $134, respectively	(1,824)	251
Less reclassification adjustment for net losses (gains) included in net income, net of income taxes of $3 and $(140), respectively (a) (b)	10	(274)
Total other comprehensive (loss)	(1,814)	(23)
Total Comprehensive Income	$ 782	$ 2,033

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

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

	Nine Months Ended September 30,	
(Dollars in thousands)	2018	2017
Net Income	$ 6,849	$ 6,261
Other comprehensive (loss) income:		
Unrealized net holding (losses) gains on debt securities available-for-sale arising during the period, net of income taxes of $(1,858) and $1,874, respectively	(6,990)	3,619
Less reclassification adjustment for net gains included in net income, net of income taxes of $(1) and $(301), respectively (a) (b)	(2)	(585)

Total other comprehensive (loss) income	(6,992)	3,034
Total Comprehensive (Loss) Income	$ (143)	$ 9,295

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

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

See accompanying notes to consolidated financial statements.

4

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017

(Unaudited)

(Dollars in thousands, except per share data)	Common Stock Shares	Common Stock Amount	Surplus	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Treasury Stock	Total Stockholders' Equity
Balance at January 1, 2018	5,950,951	$11,902	$36,193	$72,507	$1,826	$(5,709)	$116,719
Net Income				6,849			6,849
Other comprehensive loss, net of taxes					(6,992)		(6,992)
Issuance of common stock under dividend reinvestment plan	33,026	66	810				876
Impact of adoption of accounting standards[1]				274	(274)		—
Dividends - $0.81 per share				(4,642)			(4,642)
Balance at September 30, 2018	5,983,977	$11,968	$37,003	$74,988	$(5,440)	$(5,709)	$112,810
Balance at January 1, 2017	5,904,563	$11,809	$35,047	$70,004	$(1,419)	$(5,756)	$109,685
Net Income				6,261			6,261
Other comprehensive income, net of taxes					3,034		3,034
Issuance of common stock under dividend reinvestment plan	34,790	70	862				932
Dividends - $0.81 per share				(4,603)			(4,603)
Balance at September 30, 2017	5,939,353	$11,879	$35,909	$71,662	$1,615	$(5,756)	$115,309

[1]Represents the impact of adopting Accounting Standard Updates ("ASU") 2018-02 and ASU 2016-01 effective January 1, 2018. See Note 2 to the consolidated financial statements for more information.

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017

(Unaudited)

(Dollars in thousands)	2018	2017
OPERATING ACTIVITIES		
Net income	$6,849	$6,261
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	50	167
Depreciation and amortization	796	841
Net premium amortization on investment securities	2,589	3,544
Deferred income tax expense	224	25
Gains on sales of mortgage loans	(139)	(205)
Proceeds from sales of mortgage loans originated for resale	6,718	6,749
Originations of mortgage loans originated for resale	(7,086)	(7,846)
Net securities gains	(55)	(886)
Net losses (gains) on sales of foreclosed real estate held for resale, including write-downs	162	(26)
Decrease (increase) in accrued interest receivable	318	(117)
Earnings on investment in bank owned life insurance	(453)	(478)
Net gains on disposals of premises and equipment	(12)	—
(Increase) decrease in other assets	(136)	110
Amortization of investment in real estate ventures	438	121
Increase in accrued interest payable	250	78
Decrease in other liabilities	(279)	(436)
NET CASH PROVIDED BY OPERATING ACTIVITIES	10,234	7,902
INVESTING ACTIVITIES		
Proceeds from sales of investment securities available-for-sale	33,274	77,710
Proceeds from maturities and redemptions of investment securities available-for-sale	17,467	15,518
Purchases of investment securities available-for-sale	(37,179)	(72,735)
Proceeds from maturities and redemptions of investment securities held-to-maturity	—	4
Net change in restricted investment in bank stocks	(4,503)	1,005
Net increase in loans	(38,756)	(19,291)
Purchases of premises and equipment	(323)	(173)
Purchase of investment in real estate venture	—	(239)
Proceeds from sales of foreclosed assets held for resale	263	398
NET CASH (USED IN) PROVIDED BY INVESTING ACTIVITIES	(29,757)	2,197
FINANCING ACTIVITIES		
Net (decrease) increase in deposits	(77,467)	33,734
Net increase (decrease) in short-term borrowings	124,985	(28,081)

Proceeds from long-term borrowings	3,000	—
Repayment of long-term borrowings	(23,000)	(10,094)
Common stock issued	876	932
Dividends paid	(4,642)	(4,603)
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	23,752	(8,112)
INCREASE IN CASH AND CASH EQUIVALENTS	4,229	1,987
CASH AND CASH EQUIVALENTS, BEGINNING	8,739	9,128
CASH AND CASH EQUIVALENTS, ENDING	$12,968	$11,115
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Interest paid	$5,799	$4,755
Income taxes paid	328	1,200
SUPPLEMENTAL DISCLOSURE OF NON-CASH ACTIVITIES		
Loans transferred to foreclosed assets held for resale	337	177
Loans transferred from held for sale portfolio	(611)	—

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 BASIS OF PRESENTATION AND ACCOUNTING POLICIES

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial information. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2018, are not necessarily indicative of the results for the year ending December 31, 2018. For further information, refer to the consolidated financial statements and notes thereto included in First Keystone Corporation’s Annual Report on Form 10-K for the year ended December 31, 2017.

For comparative purposes, certain 2017 balances have been reclassified to conform to the 2018 presentation. Such reclassifications had no impact on net income.

The Corporation has evaluated events and transactions occurring subsequent to the consolidated balance sheet date of September 30, 2018 for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

NOTE 2 RECENT ACCOUNTING STANDARDS UPDATES (“ASU”)

Recently adopted ASUs:

On January 1, 2018, the Corporation adopted ASU 2014-09, *Revenue from Contracts with Customers,* and all subsequent amendments to the ASU (collectively “ASC 606”), which (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as OREO. The majority of the Corporation’s revenue comes from interest income, including loans and securities, which are outside the scope of ASC 606. The Corporation’s services that fall within the scope of ASC 606 are presented within other income on the consolidated statements of income and are recognized as revenue as the Corporation satisfies its obligation to the customer. Services within the scope of ASC 606 include deposit related fees and service charges, interchange fees and surcharges, and income from wealth management activities. ASC 606 did not result in a change to the accounting for any in-scope revenue streams; as such, no cumulative effect adjustment was recorded. New disclosures required by the ASU are included in Note 9, “Revenue Recognition”.

On January 1, 2018, the Corporation adopted ASU 2016-01, *Financial Instruments-Overall (Topic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,* which amended the guidance on the classification and measurement of financial instruments. Adoption of ASU 2016-01 resulted in: (1) separate classification of marketable equity securities previously included in investment securities available-for-sale on the consolidated balance sheets, (2) changes in the fair value of the equity securities being captured in the consolidated statements of income and (3) an increase in retained earnings and corresponding decrease in accumulated other comprehensive loss of $634,000 at January 1, 2018 for the after-tax impact of the change in accounting for the unrealized gain on the equity securities. Adoption of the standard also resulted in the use of an exit price to determine the fair value of financial instruments not measured at fair value in the consolidated balance sheets. For more information about fair value disclosures, refer to Note 8, “Fair Value Measurements”.

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

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

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

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

Pending ASUs:

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. ASU No. 2016-02 requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. For public business entities, ASU No. 2016-02 is

effective for annual periods and interim periods within those annual periods beginning after December 15, 2018. Early adoption is permitted. The Corporation is currently assessing the effect that ASU No. 2016-02 will have on its results of operations, financial position and cash flows as it applies to the Corporation's three leased properties. In July 2018, The Financial Accounting Standards Board ("FASB") issued ASU 2018-11, *Leases (Topic 842): Targeted Improvements.* The amendments in this Update will provide entities with an additional (and optional) transition method to adopt the new lease requirements by allowing entities to initially apply the requirements by recognizing a cumulative effect adjustment to the opening balance of retained earnings in the period of adoption. The amendments in the Update provide lessors with a practical expedient, by class of underlying asset, to not separate nonlease components from the associated lease component and, instead, to account for those components as a single component if the nonlease components otherwise would be accounted for under the new revenue guidance (Topic 606) and certain criteria are met. The effective date of the Update will be the same date for those entities that have not yet adopted the Update 2016-02 as their adoption thereof. The Corporation is currently assessing the impact that this guidance will have on its consolidated financial statements and related disclosures.

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

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

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

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

9

NOTE 3 — SECURITIES

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

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

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

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

The amortized cost, related estimated fair value, and unrealized gains and losses for debt securities classified as “Available-For-Sale” were as follows at September 30, 2018 and December 31, 2017:

	Debt Securities Available-for-Sale			
(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2018:				
U.S. Treasury securities	$5,294	$ —	$ (23)	$5,271

Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	68,259	2	(2,097)	66,164
Other	19,809	22	(655)	19,176
Obligations of state and political subdivisions	193,602	1,043	(3,809)	190,836
Asset backed securities	14,632	1	(70)	14,563
Corporate debt securities	28,877	1	(1,302)	27,576
Total	$330,473	$ 1,069	$ (7,956)	$323,586

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

Securities Available-for-Sale with an aggregate fair value of $173,729,000 at September 30, 2018 and $290,104,000 at December 31, 2017, were pledged to secure public funds, trust funds, securities sold under agreements to repurchase, debtor in possession funds and the Federal Discount Window aggregating $136,669,000 at September 30, 2018 and $224,659,000 at December 31, 2017.

The amortized cost and estimated fair value of debt securities, by contractual maturity, are shown below at September 30, 2018. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	September 30, 2018 Debt Securities Available-For-Sale				
(Dollars in thousands)	U.S. Treasury Securities	U.S. Government Corporations & Agencies **Obligations**[1]	Obligations of State & Political **Subdivisions**	Asset Backed Securities	Corporate Debt Securities
Within 1 Year:					
Amortized cost	$—	$	$ 1,598	$ —	$ —
Fair value	—		1,601	—	—
1 - 5 Years:					
Amortized cost	5,294	17,259	26,654	—	16,339
Fair value	5,271	16,654	26,221	—	15,777
5 - 10 Years:					
Amortized cost		30,564	63,098	10,050	12,538
Fair value		28,926	61,759	10,000	11,799
After 10 Years:					
Amortized cost		40,245	102,252	4,582	—
Fair value		39,760	101,255	4,563	—
Total:					
Amortized cost	$ 5,294	$ 88,068	$ 193,602	$ 14,632	$ 28,877
Fair value	5,271	85,340	190,836	14,563	27,576

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

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 September 30, 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 three months ended September 30, 2018 and 2017 were $19,236,000 and $25,718,000, respectively. Gross gains realized on these sales were $49,000 and $414,000, respectively. Gross losses realized on these sales were $62,000 and $0, respectively. There were no impairment losses realized on Available-for-Sale debt securities during the three months ended September 30, 2018 or 2017.

Proceeds from sales of investments in Available-for-Sale debt securities for the nine months ended September 30, 2018 and 2017 were $33,274,000 and $77,710,000, respectively. Gross gains realized on these sales were $99,000 and $949,000, respectively. Gross losses realized on these sales were $96,000 and $63,000, respectively. There were no impairment losses realized on Available-for-Sale debt securities during the nine months ended September 30, 2018 or 2017.

At September 30, 2018 and December 31, 2017, the Corporation had $1,684,000 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 nine months ended September 30, 2018:

(Dollars in thousands)	Nine months ended September 30, 2018
Net gains and (losses) recognized during the period on equity securities	$ 52
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	$ 52

There were no proceeds from sales of investments in Held-to-Maturity debt securities during the first nine months 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 September 30, 2018 or December 31, 2017.

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 September 30, 2018 and December 31, 2017:

September 30, 2018

	Less Than 12 Months		12 Months or More		Total	
(Dollars in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Debt Securities Available-for-Sale:						
U.S. Treasury securities	$ 5,271	$ (23)	$	$	$ 5,271	$ (23)
Obligations of U.S. Government Corporations and Agencies:						
Mortgage-backed	4,230	(97)	56,232	(2,000)	60,462	(2,097)
Other	8,418	(71)	6,901	(584)	15,319	(655)
Obligations of state and political subdivisions	81,246	(1,266)	49,676	(2,543)	130,922	(3,809)
Asset backed securities	8,970	(341)	15,105	(961)	24,075	(1,302)
Corporate debt securities	9,543	(70)	—	—	9,543	(70)
	$ 117,678	$ (1,868)	$ 127,914	$ (6,088)	$ 245,592	$ (7,956)

December 31, 2017

	Less Than 12 Months		12 Months or More		Total	
(Dollars in thousands)	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)
Obligations of state and political subdivisions	36,149	(329)	22,566	(582)	58,715	(911)
Asset backed securities	—	—	—	—	—	—
Corporate debt securities	6,746	(24)	15,174	(740)	21,920	(764)
	$ 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 94 debt securities with a less than one year unrealized loss position, or any of their 84 debt securities with a one year or greater unrealized loss position as of September 30, 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.

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 $710,000 and $834,000 at September 30, 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 September 30, 2018 and December 31, 2017, the amount of the reserve for unfunded lending commitments was $138,000 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.

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 September 30, 2018 and December 31, 2017:

	Commercial and Industrial		Commercial Real Estate	
(Dollars in thousands)	September 30, 2018	December 31, 2017	September 30, 2018	December 31, 2017
Grade:				
1-6 Pass	$ 95,411	$ 97,832	$ 311,538	$ 276,682
7 Special Mention	397	10	9,673	1,514
8 Substandard	1,187	1,334	11,112	12,210
9 Doubtful				
Add (deduct):				
Unearned discount and				
Net deferred loan fees and costs	151	161	664	564
Total loans	$ 97,146	$ 99,337	$ 332,987	$ 290,970

	Residential Real Estate Including Home Equity		Consumer Loans	
	September 30, 2018	December 31, 2017	September 30, 2018	December 31, 2017
Grade:				
1-6 Pass	$ 159,916	$ 161,405	$ 5,936	$ 5,997
7 Special Mention	122	124	1	52
8 Substandard	1,576	1,444	10	24
9 Doubtful				
Add (deduct):				
Unearned discount and	—	(1)		
Net deferred loan fees and costs	(67)	(47)	93	92
Total loans	$ 161,547	$ 162,925	$ 6,040	$ 6,165

	Total Loans	
	September 30, 2018	December 31, 2017
Grade:		
1-6 Pass	$ 572,801	$ 541,916
7 Special Mention	10,193	1,700

8 Substandard	13,885	15,012
9 Doubtful		
Add (deduct):		
Unearned discount and	—	(1)
Net deferred loan fees and costs	841	770
Total loans	$597,720	$ 559,397

Commercial and Industrial and Commercial Real Estate include loans categorized as tax-free in the amounts of $33,534,000 and $2,203,000 at September 30, 2018 and $40,926,000 and $2,315,000 at December 31, 2017. Loans held for sale amounted to $710,000 at September 30, 2018 and $834,000 at December 31, 2017.

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 September 30, 2018:						
Allowance for Loan Losses:						
Beginning balance	$ 907	$ 3,980	$ 1,688	$ 105	$ 266	$ 6,946
Charge-offs	(10)	(117)	(25)	(14)	—	(166)
Recoveries	30	60	—	1	—	91
Provision	(169)	(385)	18	19	517	—
Ending Balance	$ 758	$ 3,538	$ 1,681	$ 111	$ 783	$ 6,871

(Dollars in thousands)	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
As of and for the nine month period ended September 30, 2018:						
Allowance for Loan Losses:						
Beginning balance	$ 949	$ 4,067	$ 1,656	$ 111	$ 704	$ 7,487
Charge-offs	(18)	(577)	(131)	(35)	—	(761)
Recoveries	31	60	—	4	—	95
Provision	(204)	(12)	156	31	79	50
Ending Balance	$ 758	$ 3,538	$ 1,681	$ 111	$ 783	$ 6,871
Ending balance: individually evaluated for impairment	$	$ 2	$ 16	$	$	$ 18
Ending balance: collectively evaluated for impairment	$ 758	$ 3,536	$ 1,665	$ 111	$ 783	$ 6,853
Loans Receivable:						
Ending Balance	$ 97,146	$ 332,987	$ 161,547	$ 6,040	$	$ 597,720
Ending balance: individually evaluated for impairment	$ 1,157	$ 10,938	$ 857	$	$	$ 12,952
Ending balance: collectively evaluated for impairment	$ 95,989	$ 322,049	$ 160,690	$ 6,040	$	$ 584,768

(Dollars in thousands)	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
As of and for the three month period ended September 30, 2017:						
Allowance for Loan Losses:						
Beginning balance	$ 845	$ 4,582	$ 1,712	$ 103	$ 111	$ 7,353
Charge-offs	—	—	—	(25)	—	(25)

Recoveries	1	25	9	1	—	36
Provision	55	(35)	30	35	(1)	84
Ending Balance	$ 901	$ 4,572	$ 1,751	$ 114	$ 110	$ 7,448

20

(Dollars in thousands)	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
As of and for the nine month period ended September 30, 2017:						
Allowance for Loan Losses:						
Beginning balance	$ 836	$ 4,421	$ 1,777	$ 95	$ 228	$ 7,357
Charge-offs	—	(97)	(61)	(59)	—	(217)
Recoveries	74	52	9	6	—	141
Provision	(9)	196	26	72	(118)	167
Ending Balance	$ 901	$ 4,572	$ 1,751	$ 114	$ 110	7,448
Ending balance: individually evaluated for impairment	$	$ 161	$ 16	$	$	$ 177
Ending balance: collectively evaluated for impairment	$ 901	$ 4,411	$ 1,735	$ 114	$ 110	$ 7,271
Loans Receivable:						
Ending Balance	$ 93,236	$ 276,849	$ 166,458	$ 6,242	$	$ 542,785
Ending balance: individually evaluated for impairment	$ 1,218	$ 13,992	$ 976	$	$	$ 16,186
Ending balance: collectively evaluated for impairment	$ 92,018	$ 262,857	$ 165,482	$ 6,242	$	$ 526,599

(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 $983,000 in foreclosed assets held for resale at September 30, 2018, $88,000 was represented by residential real estate, $39,000 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 September 30, 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 $858,000 at September 30, 2018 and $485,000 at December 31, 2017. These balances were not included in foreclosed assets held for resale at September 30, 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 September 30, 2018 and December 31, 2017 was $9,555,000 and $9,109,000, respectively. The increase in TDRs at September 30, 2018 as compared to December 31, 2017 is attributable to several modifications completed during the nine months ended September 30, 2018, combined with payments and pay-offs on existing TDRs and the Bank's proactive monitoring of the loan portfolio. Modifications were completed to resume principal and interest payments on non-accrual loans due to a slight improvement in the outlook surrounding the respective borrower's financial position although the borrower continues to experience financial difficulties. Additional modifications were completed to allow a temporary period of interest only payments or extend the maturity date of the loan due to deterioration in the respective borrowers' financial positions. There were no unfunded commitments on TDRs at September 30, 2018 and December 31, 2017.

During the three months ended September 30, 2018, one loan with a post modification balance of $26,000 was modified as a TDR as compared to the same period in 2017, when no loans were modified as TDRs. The loan modifications for the three months ended September 30, 2018 consisted of one term modification.

During the nine months ended September 30, 2018, ten loans with a combined post modification balance of $1,180,000 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 nine months ended September 30, 2018 consisted of one rate modification, two term modifications, and seven payment modifications. The loan modifications for the nine months ended September 30, 2017 consisted of two payment modifications.

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

(Dollars in thousands)	September 30 2018	December 31, 2017
Non-accrual TDRs	$ 844	$ 273
Accruing TDRs	8,711	8,836
Total	$ 9,555	$ 9,109

At September 30, 2018, ten Commercial Real Estate loans classified as TDRs with a combined recorded investment of $561,000 were not in compliance with the terms of their restructure, compared to September 30, 2017 when eight Commercial Real Estate loans classified as TDRs with a combined recorded investment of $469,000 and one Commercial and Industrial loan classified as a TDR with a recorded investment of $12,000 were not in compliance

with the terms of their restructure.

During the three months ended September 30, 2018, three Commercial Real Estate loans with a combined outstanding recorded investment of $144,000 that were modified as TDRs during the preceding twelve months had experienced payment defaults, compared to the three months ended September 30, 2017 when no loans that were modified as TDRs during the preceding twelve months had experienced payment defaults. During the nine months ended September 30, 2018, five Commercial Real Estate loans with a combined outstanding recorded investment of $190,000 that were modified as TDRs during the preceding twelve months had experienced payment defaults, compared to the nine months ended September 30, 2017 when no loans that were modified as TDRs during the preceding twelve months had experienced payment defaults.

The following table presents information regarding the loan modifications categorized as TDRs during the three and nine months ended September 30, 2018 and the nine months ended September 30, 2017. No loans were modified as TDRs during the three months ended September 30, 2017.

	Three Months Ended September 30, 2018			
(Dollars in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Recorded Investment
Commercial and Industrial	—	$ —	$ —	$ —
Commercial Real Estate	—	—	—	—
Residential Real Estate	1	26	26	26
Total	1	$ 26	$ 26	$ 26

22

	Nine Months Ended September 30, 2018			
(Dollars in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Recorded Investment
Commercial and Industrial	3	$ 751	$ 751	$ 735
Commercial Real Estate	6	386	403	290
Residential Real Estate	1	26	26	26
Total	10	$ 1,163	$ 1,180	$ 1,051

	Nine Months Ended September 30, 2017			
(Dollars in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Recorded Investment
Commercial and Industrial	1	$ 38	$ 38	$ 37
Commercial Real Estate	1	72	72	70
Residential Real Estate	—	—	—	—
Total	2	$ 110	$ 110	$ 107

The following table provides detail regarding the types of loan modifications made for loans categorized as TDRs during the three and nine months ended September 30, 2018 and the nine months ended September 30, 2017 with the total number of each type of modification performed. No loans were modified as TDRs during the three months ended September 30, 2017.

	Three Months Ended September 30, 2018				Nine Months Ended September 30, 2018			
	Rate Modification	Term Modification	Payment Modification	Number Modified	Rate Modification	Term Modification	Payment Modification	Number Modified
Commercial and Industrial	—	—	—	—		—	3	3
Commercial Real Estate	—	—	—	—	1	1	4	6
Residential Real Estate	—	1	—	1	—	1	—	1
Total	—	1	—	1	1	2	7	10

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

The recorded investment, unpaid principal balance, and the related allowance of the Corporation's impaired loans are summarized below for the periods ended September 30, 2018 and December 31, 2017.

	September 30, 2018			December 31, 2017		
(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	**Unpaid** Principal Balance	Related Allowance
With no related allowance recorded:						
Commercial and Industrial	$1,157	$1,157	$ —	$1,203	$1,203	$ —
Commercial Real Estate	10,854	13,837	—	9,199	11,383	—
Residential Real Estate	648	698	—	878	1,024	—
With an allowance recorded:						
Commercial and Industrial	—	—	—	—	—	—
Commercial Real Estate	84	84	2	2,474	3,889	305
Residential Real Estate	209	209	16	172	172	22
Total	$12,952	$15,985	$ 18	$13,926	$17,671	$ 327
Total consists of:						
Commercial and Industrial	$1,157	$1,157	$ —	$1,203	$1,203	$ —
Commercial Real Estate	$10,938	$13,921	$ 2	$11,673	$15,272	$ 305
Residential Real Estate	$857	$907	$ 16	$1,050	$1,196	$ 22

At September 30, 2018 and December 31, 2017, $9,555,000 and $9,109,000 of loans classified as TDRs were included in impaired loans with a total allocated allowance of $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 and nine months ended September 30, 2018 and 2017.

	For the Three Months Ended September 30, 2018		For the Three Months Ended September 30, 2017	
(Dollars in thousands)	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial and Industrial	$ 1,165	$ 4	$ 1,225	$ 5

Commercial Real Estate		11,024		102		11,353		127
Residential Real Estate		985		7		813		1
With an allowance recorded:								
Commercial and Industrial		—		—		—		—
Commercial Real Estate		85		1		2,271		2
Residential Real Estate		209		—		163		
Total	$	13,468	$	114	$	15,825	$	135
Total consists of:								
Commercial and Industrial	$	1,165	$	4	$	1,225	$	5
Commercial Real Estate	$	11,109	$	103	$	13,624	$	129
Residential Real Estate	$	1,194	$	7	$	976	$	1

Of the $114,000 and $135,000 in interest income recognized on impaired loans for the three months ended September 30, 2018 and 2017, respectively, $6,000 and $1,000 in interest income was recognized with respect to non-accrual loans.

(Dollars in thousands)	For the Nine Months Ended September 30, 2018 Average Recorded Investment	For the Nine Months Ended September 30, 2018 Interest Income Recognized	For the Nine Months Ended September 30, 2017 Average Recorded Investment	For the Nine Months Ended September 30, 2017 Interest Income Recognized
With no related allowance recorded:				
Commercial and Industrial	$ 1,180	$ 13	$ 1,240	$ 21
Commercial Real Estate	10,650	308	11,730	376
Residential Real Estate	946	9	910	2
With an allowance recorded:				
Commercial and Industrial	—	—	—	—
Commercial Real Estate	835	2	1,498	2
Residential Real Estate	174	—	229	—
Total	$ 13,785	$ 332	$ 15,607	$ 401
Total consists of:				
Commercial and Industrial	$ 1,180	$ 13	$ 1,240	$ 21
Commercial Real Estate	$ 11,485	$ 310	$ 13,228	$ 378
Residential Real Estate	$ 1,120	$ 9	$ 1,139	$ 2

Of the $332,000 and $401,000 in interest income recognized on impaired loans for the nine months ended September 30, 2018 and 2017, respectively, $6,000 and $18,000 in interest income was recognized with respect to non-accrual loans.

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 September 30, 2018 and December 31, 2017 were as follows:

(Dollars in thousands)	September 30, 2018	December 31, 2017
Commercial and Industrial	$ 764	$ 798
Commercial Real Estate	2,705	3,302
Residential Real Estate	772	990
Total non-accrual loans	4,241	5,090
Foreclosed assets held for resale	983	1,071
Loans past-due 90 days or more and still accruing interest	391	70
Total non-performing assets	$ 5,615	$ 6,231

The following tables present the classes of the loan portfolio summarized by past-due status at September 30, 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
September 30, 2018:							
Commercial and Industrial	$ 135	$ 25	$ 246	$ 406	$96,740	$97,146	$ 246
Commercial Real Estate	795	647	2,277	3,719	329,268	332,987	145
Residential Real Estate	1,261	457	679	2,397	159,150	161,547	—
Consumer	15	8	—	23	6,017	6,040	—
Total	$ 2,206	$ 1,137	$ 3,202	$ 6,545	$591,175	$597,720	$ 391

(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 September 30, 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.

NOTE 5 — DEPOSITS

Major classifications of deposits at September 30, 2018 and December 31, 2017 consisted of:

(Dollars in thousands)	September 30, 2018	December 31, 2017
Non-interest bearing demand	$ 133,184	$ 121,415
Interest bearing demand	199,746	265,379
Savings	171,168	183,724
Time certificates of deposits less than $250,000	171,467	171,556
Time certificates of deposits $250,000 or greater	23,333	34,933
Other time deposits	1,781	1,139
Total deposits	$ 700,679	$ 778,146

Total Deposits decreased $77,467,000 to $700,679,000 as of September 30, 2018 due to the declining balances of highly rate sensitive municipal depositors and the migration of approximately 80% of the Bank's largest depositor to a non-bank competitor.

NOTE 6 — 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. Short-term borrowings and weighted–average interest rates at September 30, 2018 and December 31, 2017 are as follows:

	September 30, 2018			December 31, 2017		
(Dollars in thousands)	Amount	Average Rate		Amount	Average Rate	
Federal funds purchased	$ —	2.19	%	$ —	1.82	%
Securities sold under agreements to repurchase	13,836	0.49	%	22,844	0.41	%
Federal Discount Window	—	2.19	%	—	1.71	%
Federal Home Loan Bank	137,445	2.11	%	3,452	1.16	%
	$ 151,281	1.84	%	$ 26,296	0.97	%

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.

26

The following table presents the short-term borrowings subject to an enforceable master netting arrangement or repurchase agreements as of September 30, 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
September 30, 2018						
Repurchase agreements (a)	$ 13,836	$	$ 13,836	$ (13,836)	$	$
December 31, 2017						
Repurchase agreements (a)	$ 22,844	$	$ 22,844	$ (22,844)	$	$

(a) As of September 30, 2018 and December 31, 2017, the fair value of securities pledged in connection with repurchase agreements was $15,875,000 and $26,023,000, respectively.

The following table presents the remaining contractual maturity of the master netting arrangement or repurchase agreements as of September 30, 2018:

	Remaining Contractual Maturity of the Agreements				
(Dollars in thousands)	Overnight and Continuous	Up to 30 days	30 -90 Days	Greater than 90 Days	Total
September 30, 2018:					
Repurchase agreements and repurchase-to-maturity transactions:					
U.S. Treasury and/or agency securities	$ 13,836	$	$	$	$ 13,836
Total	$ 13,836	$	$	$	$ 13,836

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 7 — 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 8 — 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 September 30, 2018 and December 31, 2017, were as follows:

(Dollars in thousands)	September 30, 2018	December 31, 2017
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	$ 120,933	$ 90,373
Financial standby letters of credit	$ 430	$ 450
Performance standby letters of credit	$ 3,104	$ 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 September 30, 2018, the Corporation had $494,534,000 in loans secured by real estate, which represented 82.7% 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 September 30, 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 9 — 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 September 30, 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
September 30, 2018				
Debt Securities Available-for-Sale:				
U.S. Treasury securities	$—	$5,271	$ —	$5,271
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	—	66,164	—	66,164
Other	—	19,176	—	19,176
Obligations of state and political subdivisions	—	190,836	—	190,836
Asset backed securities	—	14,563	—	14,563
Corporate debt securities	—	27,576	—	27,576
Total debt securities available-for-sale	—	323,586	—	323,586
Marketable equity securities	1,684	—	—	1,684
Total recurring fair value measurements	$1,684	$323,586	$ —	$325,270

29

(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 September 30, 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 September 30, 2018				
Impaired loans:				
Commercial Real Estate	$	$	$ 5,215	$ 5,215
Residential Real Estate			378	378
Total impaired loans	$	$	$ 5,593	$ 5,593

(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 September 30, 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 September 30, 2018				
Foreclosed assets held for resale:				
Commercial Real Estate	$	$	$ 856	$856
Residential Real Estate	—	—	—	—
Total foreclosed assets held for resale	$	$	$ 856	$856

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
Assets at December 31, 2017				
Foreclosed assets held for resale:				
Commercial Real Estate	$ —	$ —	$ 81	$ 81
Residential Real Estate	—	—	13	13
Total foreclosed assets held for resale	$ —	$ —	$ 94	$ 94

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

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

	Quantitative Information about Level 3 Fair Value Measurements				
(Dollars in thousands)	Fair Value Estimate	Valuation Technique	Unobservable Input	Range	Weighted Average
September 30, 2018					
Impaired loans	$2,443	Appraisal of collateral[1,3]	Appraisal adjustments[2]	(0%) – (82%)	(17%)
Impaired loans	$3,150	Discounted cash flow	Discount rate	(6%) – (7%)	(7%)
Foreclosed assets held for resale	$856	Appraisal of collateral[1,3]	Appraisal adjustments[2]	(16%) – (35%)	(18%)

December 31, 2017

Impaired loans	$2,495	Appraisal of collateral[1,3]	Appraisal adjustments[2]	(7%) – (65%)	(15%)
Impaired loans	$3,257	Discounted cash flow	Discount rate	(7%) – (8%)	(7%)
Foreclosed assets held for 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

	Carrying	Fair Value Measurements at September 30, 2018			
(Dollars in thousands)	Amount	Level 1	Level 2	Level 3	Total
FINANCIAL ASSETS:					
Cash and due from banks	$9,820	$ 9,820	$	$	$ 9,820
Interest-bearing deposits in other banks	3,148	—	3,148	—	3,148
Time deposits with other banks	1,482	—	1,469	—	1,469
Debt securities available-for-sale	323,586	—	323,586	—	323,586
Marketable equity securities	1,684	1,684	—	—	1,684
Restricted investment in bank stocks	8,561	—	8,561	—	8,561
Net loans	590,849	—	—	582,459	582,459
Mortgage servicing rights	329	—	—	329	329
Accrued interest receivable	3,919	—	3,919	—	3,919
FINANCIAL LIABILITIES:					
Core deposits	504,098	—	504,098	—	504,098
Time deposits	196,581	—	193,304	—	193,304
Short-term borrowings	151,281	—	151,402	—	151,402
Long-term borrowings	45,000	—	44,739	—	44,739
Accrued interest payable	740	—	740	—	740
OFF-BALANCE SHEET FINANCIAL INSTRUMENTS					

	Carrying	Fair Value Measurements at December 31, 2017			
(Dollars in thousands)	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	—	—	—	—	—

32

NOTE 10 — 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.

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 September 30, 2018 and December 31, 2017, the fair value of trust assets under management was $107,205,000 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 11 — 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.

	Three Months Ended September 30,	
(In thousands, except earnings per share)	2018	2017
Net income	$ 2,596	$ 2,056
Weighted-average common shares outstanding	5,742	5,695
Basic earnings per share	$ 0.45	$ 0.36
Weighted-average common shares outstanding	5,742	5,695
Common stock equivalents due to effect of stock options	—	2
Total weighted-average common shares and equivalents	5,742	5,697
Diluted earnings per share	$ 0.45	$ 0.36

	Nine Months Ended September 30,	
(In thousands, except earnings per share)	2018	2017
Net income	$ 6,849	$ 6,261
Weighted-average common shares outstanding	5,731	5,683
Basic earnings per share	$ 1.19	$ 1.10
Weighted-average common shares outstanding	5,731	5,683
Common stock equivalents due to effect of stock options	—	2
Total weighted-average common shares and equivalents	5,731	5,685
Diluted earnings per share	$ 1.19	$ 1.10

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 September 30, 2018 compared to quarter ended September 30, 2017

First Keystone Corporation realized earnings for the three months ended September 30, 2018 of $2,596,000, an increase of $540,000, or 26.3% from the third quarter of 2017. The increase in net income for the three months ended September 30, 2018 was primarily due to an increase in interest income and fees on loans as well as an increase in service charges and fees compared to the three months ended September 30, 2017.

On a per share basis, for the three months ended September 30, 2018, net income was $0.45 versus $0.36 for the same three month period of 2017. Cash dividends amounted to $0.27 per share for the three months ended September 30, 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. For the three months ended September 30, 2018, interest income amounted to $9,169,000, an increase of $1,005,000 or 12.3% from the three months ended September 30, 2017, while interest expense amounted to $2,284,000 in the three months ended September 30, 2018, an increase of $497,000, or 27.8% from the three months ended September 30, 2017. As a result, net interest income increased $508,000 or 8.0% to $6,885,000 from $6,377,000 for the same period in 2017.

The Corporation's net interest margin for the three months ended September 30, 2018 was 3.21% compared to 3.05% for same period in 2017. The increase in net interest margin was a result of an increase in yield on the loan portfolio.

PROVISION FOR LOAN LOSSES

The provision for loan losses for the three months ended September 30, 2018 and September 30, 2017 was $0 and $84,000, 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 $75,000 and net recoveries of $11,000 for the three months ended September 30, 2018 and 2017, respectively. See Allowance for Loan Losses on page 41 for further discussion.

NON-INTEREST INCOME

Total non-interest income was $1,502,000 for the three months ended September 30, 2018, as compared to $1,713,000 for the same period in 2017, a decrease of $211,000, or 12.3%. The decrease was mainly the result of a decrease in gains taken on the sales of securities in 2018. ATM fees and debit card income increased $44,000 or 12.5% to $395,000 for the three months ended September 30, 2018. Service charges and fee income increased $65,000 or 14.1% primarily due to increases in certain deposit account fees and transaction fees implemented in 2018. Gains on sales of mortgage loans decreased $9,000 or 11.1% due to a decrease in loans originated with intent to sell. Net securities gains decreased $396,000 to $18,000 for the three months ended September 30, 2018 as compared to the three months ended September 30, 2017.

NON-INTEREST EXPENSE

Total non-interest expense was $5,607,000 for the three months ended September 30, 2018, as compared to $5,681,000 for the three months ended September 30, 2017. Non-interest expense decreased $74,000 or 1.3%.

Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non-interest expense. Salaries and benefits amounted to $2,993,000 or 53.4% of total non-interest expense for the three months ended September 30, 2018, as compared to $3,050,000 or 53.7% for the same three months of 2017. The decrease was primarily due to lower overall health care costs during the three months ended September 30, 2018.

Net occupancy, furniture and equipment, and computer expense amounted to $827,000 for the three months ended September 30, 2018, an increase of $6,000 or 0.7%. Professional services increased $61,000 or 30.4% to $262,000 in the three months ended September 30, 2018. This increase was due to a combination of legal fees and accounting services regarding the form S-3 consent for the Bank’s dividend reinvestment plan. Pennsylvania shares tax expense amounted to $214,000 for the three months ended September 30, 2018, an increase of $57,000 or 36.3% as compared to the same three months in 2017.

FDIC insurance expense decreased $3,000 or 3.7% for the three months ended September 30, 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 $207,000 for the three months ended September 30, 2018, an increase of $23,000 or 12.5% as compared to the same three months of 2017. Data processing expenses increased $10,000 or 4.0% to $258,000 for the three months ended September 30, 2018 as compared to the same three months of 2017. Foreclosed assets held for resale expense increased $33,000 in the third quarter of 2018 as the result of expenses related to the sale of two OREO properties during the period. Advertising expense increased $35,000 or 24.0% during the three months ended

September 30, 2018. This increase was mainly due to an increase in media and print advertising during the period.

Other non-interest expense amounted to $541,000 for the three months ended September 30, 2018, a decrease of $239,000 or 30.6% as compared to the three months ended September 30, 2017. This was due to a decrease in collections related legal fees as compared to the same period in 2017, the right of set-off taken from a customer's deposit account to cover expenses paid by the Bank after repurchasing a participant's share of the loan participation and, a decrease in the provision for unfunded commitments during the period due to an increase in utilization of available credit on commercial and industrial loans and commercial real estate construction loans.

INCOME TAXES

Income tax expense amounted to $184,000 for the three months ended September 30, 2018, as compared to $269,000 for the three months ended September 30, 2017, a decrease of $85,000. The effective total income tax rate was 6.6% for the third quarter of 2018 as compared to 11.6% for the third 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 third quarter of 2018.

Nine months ended September 30, 2018 compared to nine months ended September 30, 2017

First Keystone Corporation realized earnings for the first nine months of 2018 of $6,849,000, an increase of $588,000, or 9.4% from the same period in 2017. The increase in net income for the nine months ended September 30, 2018 was primarily due to an increase in interest income and fees on loans, a decrease in interest expense on long-term borrowings, and a decrease in income tax expense compared to the nine months ended September 30, 2017.

On a per share basis, for the nine months ended September 30, 2018, net income was $1.19 versus $1.10 for the nine months ended September 30, 2017. Cash dividends amounted to $0.81 per share for the nine months ended September 30, 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. For the nine months ended September 30, 2018, interest income amounted to $26,177,000, an increase of $2,106,000 or 8.8% from the nine months ended September 30, 2017, while interest expense amounted to $6,049,000 for the nine months ended September 30, 2018, an increase of $1,216,000, or 25.2% from the nine months ended September 30, 2017. As a result, net interest income increased $890,000 or 4.6% to $20,128,000 from $19,238,000 for the same period in 2017.

The Corporation’s net interest margin for the nine months ended September 30, 2018 was 3.17% compared to 3.06% for same period in 2017. The increase in net interest margin was a result of an increase in yield on the loan portfolio.

PROVISION FOR LOAN LOSSES

The provision for loan losses for the nine months ended September 30, 2018 and September 30, 2017 was $50,000 and $167,000, 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 $666,000 and $76,000 for the nine months ended September 30, 2018 and 2017, respectively. See Allowance for Loan Losses on page 41 for further discussion.

NON-INTEREST INCOME

Total non-interest income was $4,231,000 for the nine months ended September 30, 2018, as compared to $4,746,000 for the same period in 2017, a decrease of $515,000, or 10.9%. The decrease was mainly the result of less gains taken on the sales of investments in 2018. ATM fees and debit card income increased $117,000 or 11.3% to $1,151,000 for the nine months ended September 30, 2018. Service charges and fee income increased $157,000 or 11.6% primarily due to increases in certain deposit account fees and transaction fees implemented in 2018. Gains on sales of mortgage loans decreased $66,000 or 32.2% due to a decrease in loans originated with intent to sell. Net securities gains decreased $831,000 to $55,000 for the nine months ended September 30, 2018 as compared to the nine months ended September 30, 2017.

NON-INTEREST EXPENSE

Total non-interest expense was $17,178,000 for the nine months ended September 30, 2018, as compared to $16,610,000 for the nine months ended September 30, 2017. Non-interest expense increased $567,000 or 3.4%.

Expenses associated with employees (salaries and employee benefits) continue to be the largest category of non-interest expense. Salaries and benefits amounted to $8,986,000 or 52.3% of total non-interest expense for the nine months ended September 30, 2018, as compared to $8,823,000 or 53.1% for the same nine months of 2017. The increase was primarily due to the addition of new sales positions in the commercial and residential mortgage lending areas plus additional staff and normal merit increases.

Net occupancy, furniture and equipment, and computer expense amounted to $2,511,000 for the nine months ended September 30, 2018, a decrease of $16,000 or 0.6%. Professional services increased $160,000 or 25.2% to $794,000 as of September 30, 2018. This increase was the result of additional accounting fees for 2017 out of scope audit work and additional engagements for the form S-3 consent for the Bank's dividend reinvestment plan, new accounting pronouncements, auditor transition fees, and 2017 state taxes. There were also engagement fees related to income generation consulting, higher legal fees relating to the resignation of an executive officer of the Bank and additional legal expenses associated with the dividend reinvestment plan recession offer and form S-3 filing. Pennsylvania shares tax expense amounted to $613,000 for the nine months ended September 30, 2018, an increase of $45,000 or 7.9% as compared to the same nine months of 2017.

FDIC insurance expense decreased $7,000 or 2.9% for the nine months ended September 30, 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 $574,000 for the nine months ended September 30, 2018, an increase of $65,000 or 12.8% as compared to the same nine months of 2017. The increase was due to higher electronic funds transfer fees. Data processing expenses increased $57,000 or 7.8% to $791,000 for the nine months ended June 30, 2018 as compared to the same nine 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 $2,000 or 1.7% to $121,000 in the first nine months of 2018 as compared to $119,000 in the first nine months of 2017. Advertising expense decreased $17,000 or 4.2% to $391,000 during the nine months ended September 30, 2018 as compared to the same nine months of 2017.

Other non-interest expense amounted to $2,163,000 for the nine months ended September 30, 2018, an increase of $116,000 or 5.7% as compared to the nine months ended September 30, 2017. The increase was due to an increase in amortization costs on one of the Corporation’s low income housing investment properties in 2018.

INCOME TAXES

Income tax expense amounted to $282,000 for the nine months ended September 30, 2018, as compared to $946,000 for the nine months ended September 30, 2017, a decrease of $664,000. The effective total income tax rate was 4.0% for the nine months ended September 30, 2018 as compared to 13.1% for the nine months ended September 30, 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 $303,000 of tax credits from low-income housing partnerships for the nine months ending September 30, 2018.

FINANCIAL CONDITION

SUMMARY

Total assets increased to $1,013,780,000 as of September 30, 2018, an increase of $23,659,000 from year-end 2017. Total assets as of December 31, 2017 amounted to $990,121,000.

Total debt securities decreased $25,000,000 or 7.2% to $323,586,000 as of September 30, 2018 from December 31, 2017.

Total loans increased $38,323,000 or 6.9% to $597,720,000 as of September 30, 2018 from December 31, 2017. Loan demand grew in the nine months ended September 30, 2018 as the Bank has seen an increase in loan originations, primarily in the commercial real estate portfolio.

Total deposits decreased $77,467,000 or 10.0% to $700,679,000 as of September 30, 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 nine months of 2018 by $104,985,000 to $196,281,000 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 $112,810,000 at September 30, 2018, a decrease of $3,909,000 or 3.3% 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 September 30, 2018 and September 30, 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 $597,720,000 as of September 30, 2018, up $38,323,000, or 6.9% 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 $5,615,000 as of September 30, 2018, a decrease of $616,000, or 9.9% 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 122.4% as of September 30, 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 September 30, 2018. Available-for-sale debt securities amounted to $323,586,000 as of September 30, 2018, a decrease of $25,000,000 from year-end 2017.

Interest-bearing deposits in other banks increased as of September 30, 2018, to $3,148,000 from $826,000 at year-end 2017. Time deposits with other banks were $1,482,000 at September 30, 2018 and December 31, 2017.

LOANS

Total loans increased to $597,720,000 as of September 30, 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 $38,323,000 or 6.9%.

Steady demand for borrowing by businesses accounted for the 6.9% increase in the loan portfolio from December 31, 2017 to September 30, 2018. The Commercial and Industrial portfolio decreased $2,191,000 to $97,146,000 as of September 30, 2018, as compared to $99,337,000 at December 31, 2017. The decrease in the Commercial and Industrial portfolio (which includes tax-free Commercial and Industrial loans) was attributed to new loan originations

totaling $11,327,000 and a $4,026,000 increase in utilization of existing Commercial and Industrial lines of credit offset by loan payoffs of $15,499,000, 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 $42,017,000 to $332,987,000 at September 30, 2018, as compared to $290,970,000 at December 31, 2017. The increase was mainly the result of $66,828,000 in new loan originations and a $5,410,000 increase in utilization of existing Commercial Real Estate lines of credit, offset by $16,355,000 in loan payoffs in addition to regular principal payments and other typical amortizations in the Commercial Real Estate portfolio. Residential Real Estate loans decreased $1,378,000 to $161,547,000 at September 30, 2018, as compared to $162,925,000 at December 31, 2017. The decrease was the result of $14,719,000 in new loan originations offset by loan payoffs of $8,414,000, net loans sold of $1,829,000 and regular principal payments. Net loans sold in the Residential Real Estate portfolio for the nine months ended September 30, 2018 consisted of total loans sold during the nine months ended September 30, 2018 of $6,579,000, offset with loans opened and sold in the same quarter during the first three quarters of 2018 which amounted to $4,750,000. 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 $430,133,000 at September 30, 2018. Of total loans, $332,987,000 or 55.7% 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 $12,398,000 at September 30, 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 $11,198,000 in term debt and two lines of credit totaling $1,200,000. The relationship is well secured by first lien mortgages on income producing commercial and residential real estate, plus assignment of governmental leases.

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 September 30, 2018, the relationship had outstanding loan balances and unused commitments of $9,742,000. The debt is comprised of $9,612,000 in term debt and three lines of credit totaling $130,000. The loans are secured by commercial real estate, the assignment of rents and leases, and business assets.

The 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 September 30, 2018, the relationship had outstanding balances totaling $9,640,000 which consisted entirely of tax-free commercial term debt. The relationship is secured by 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 September 30, 2018, the relationship had outstanding balances of $8,663,000 which consisted entirely of unsecured term debt. The debt will be utilized for general corporate needs, including upgrades to the company’s utility distribution system that will enhance its ability to continue providing safe and reliable natural gas service.

The fifth largest relationship consists of a real estate development/holding company that was established in 2006 to construct a multi-tenant medical complex, as well as the medical-related entities that operate out of the complex. The relationship had outstanding loan balances and unused commitments of $8,260,000 at September 30, 2018. The debt is comprised of $7,510,000 in term debt and $750,000 in lines of credit. The relationship is secured by commercial real estate, as well as business assets and the assignment of rents and leases.

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

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

Overall, the portfolio risk profile as measured by loan grade is considered low risk, as $572,801,000 or 96.0% of gross loans are graded Pass; $10,193,000 or 1.7% are graded Special Mention; $13,885,000 or 2.3% 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 $24,078,000 at September 30, 2018, as compared to $16,712,000 at December 31, 2017. Commercial and Industrial non-pass grades increased to $1,584,000 as of September 30, 2018 as compared to $1,344,000 as of December 31, 2017. Commercial Real Estate non-pass grades increased to $20,785,000 as of September 30, 2018 as compared to $13,724,000 as of December 31, 2017. The Residential Real Estate and Consumer loan non-pass grades increased to $1,709,000 as of September 30, 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 nine months ended September 30, 2018 was mainly attributable to four loans to a hotel management company in the amount of $8,224,000 that were downgraded to Special Mention during the first quarter of 2018 due to a warning letter that was issued by the hotel franchisor regarding unfavorable guest satisfaction survey and brand audit results, as well as one loan to a contractor specializing in concrete projects in the amount of $483,000 that was downgraded to Special Mention during the three months ended September 30, 2018 due to the borrower’s slow payment performance resulting from delayed accounts receivable turnover and inclement weather that hindered product delivery. The large downgrades to non-pass grade status were offset by several large fluctuations during the nine months ended September 30, 2018, including charge-offs, large payments/paydowns, and loans that were returned to pass-grade status due to the borrowers’ improving financial conditions, combined with other regular principal payments and typical fluctuations that reduced the balance of the Commercial Real Estate non-pass grade portfolio. A charge-off in the amount of $342,000 on a non-accrual loan to a student housing holding company was completed during the second quarter of 2018 and a charge-off in the amount of $111,000 was completed during the three months ended September 30, 2018 on a non-accrual troubled debt restructuring to the owner of a restaurant/bar that is no longer in operation. Both charge-offs were completed to charge the respective loan balances down to the net realizable value of the supporting collateral less costs to sell. The property securing a non-accrual purchased participation loan in the amount of $112,000 to a retailer of recreational vehicles was moved to foreclosed assets held for resale during the first quarter of 2018. Regular payments and paydowns totaling $330,000 were made during the nine months ended September 30, 2018 on a large performing Substandard loan to the owner of a recreation facility. 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 was upgraded from Special Mention to pass-grade status during the first quarter of 2018 in order 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. Two loans to a home improvement retailer and commercial property owner that carried a combined balance of $271,000 at December 31, 2017 were upgraded from Special Mention to pass-grade status during the second quarter of 2018 as the result of the borrower’s improved payment performance, as well as improvement in the adequacy of collateral coverage.

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)	**September 30, 2018**	**December 31, 2017**
Commercial and Industrial	$ 97,146	$ 99,337
Commercial Real Estate	332,987	290,970
Residential Real Estate	161,547	162,925
Consumer	6,040	6,165
Total loans	$ 597,720	$ 559,397

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses constitutes the amount available to absorb losses within the loan portfolio. As of September 30, 2018, the allowance for loan losses was $6,871,000 as compared to $7,487,000 as of December 31, 2017. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for possible loan losses when management believes that the collectability of the principal is unlikely. The risk characteristics of the loan portfolio are managed through various control processes, including credit evaluations of individual borrowers, periodic reviews, and diversification by industry. Risk is further mitigated through the application of lending procedures such as the holding of adequate collateral and the establishment of contractual guarantees.

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

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

The Analysis of Allowance for Loan Losses table contains an analysis of the allowance for loan losses indicating charge-offs and recoveries for the nine month periods ended September 30, 2018 and 2017. For the nine month periods ended September 30, 2018 and 2017, net charge-offs as a percentage of average loans was 0.12% and 0.01%, respectively. Net charge-offs amounted to $666,000 for the first nine months of 2018 as compared to $76,000 for the first nine months of 2017. The significant increase in net-charge offs during the nine months ended September 30, 2018 as compared to the nine months ended September 30, 2017 is mainly due to three large charge-offs that were completed during the nine months ended September 30, 2018. A charge-off in the amount of $106,000 was completed during the first quarter of 2018 on a loan to a retailer of recreational vehicles, a charge-off in the amount of $342,000 was completed during the second quarter of 2018 on a loan to a student housing holding company, and a charge-off in the amount of $111,000 was completed during the three months ended September 30, 2018 on a loan to the owner of a restaurant/bar that is no longer in operation. All three charge-offs were completed to charge the respective loan balances down to the net realizable value of the supporting collateral less costs to sell, as the underlying value of the collateral was deemed to be insufficient to cover the loan balances.

For the first nine months of 2018, the provision for loan losses was $50,000 as compared to $167,000 for the first nine months of 2017. The provision, net of charge-offs and recoveries, resulted in the quarter end Allowance for Loan Losses of $6,871,000 of which 11.0% was attributed to the Commercial and Industrial component; 51.5% attributed to the Commercial Real Estate component; 24.5% attributed to the Residential Real Estate component (primarily residential mortgages); 1.6% attributed to the Consumer component; and 11.4% 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 September 30, 2018.

Analysis of Allowance for Loan Losses

(Dollars in thousands)	**September 30, 2018**	**September 30, 2017**
Balance at beginning of the nine month period	$ 7,487	$ 7,357
Charge-offs:		
Commercial and Industrial	18	—
Commercial Real Estate	577	97
Residential Real Estate	131	61
Consumer	35	59
	761	217
Recoveries:		
Commercial and Industrial	31	74
Commercial Real Estate	60	52
Residential Real Estate	—	9
Consumer	4	6
	95	141
Net charge-offs (recoveries)	666	76
Additions charged to operations	50	167
Balance at end of the nine month period	$ 6,871	$ 7,448
Ratio of net charge-offs (recoveries) during the period to average loans outstanding during the period	0.12 %	0.01 %
Allowance for loan losses to average loans outstanding during the period	1.19 %	1.41 %

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 1.19% at September 30, 2018 and 1.41% at September 30, 2017.

NON-PERFORMING ASSETS

The table on page 45 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 $5,615,000 as of September 30, 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 $4,241,000 as of September 30, 2018 as compared to $5,090,000 as of December 31, 2017. Foreclosed assets held for resale amounted to $983,000 at September 30, 2018 as compared to $1,071,000 at December 31, 2017. Loans past-due 90 days or more and still accruing interest amounted to $391,000 as of September 30, 2018 as compared to $70,000 as of December 31, 2017. At September 30, 2018, loans past-due 90 days or more and still accruing interest consisted of one Commercial and Industrial loan and three Commercial Real Estate loans which were all well secured and in the process of collection as of September 30, 2018.

Non-performing assets to total loans was 0.9% at September 30, 2018 and 1.1% at December 31, 2017. Non-performing assets to total assets was 0.6% at September 30, 2018 and December 31, 2017. The allowance for loan losses to total non-performing assets was 122.4% as of September 30, 2018 as compared to 120.2% as of December 31, 2017. Additional detail can be found on page 45 in the Non-Performing Assets and Impaired Loans table and page 25 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 $4,853,000 at September 30, 2018, compared to $5,043,000 at December 31, 2017.

Impaired loans were $12,952,000 at September 30, 2018 and $13,926,000 at December 31, 2017. The largest impaired loan relationship at September 30, 2018 consisted of one performing loan to a student housing holding company in the amount of $3,068,000, 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 September 30, 2018 resulted in a specific allocation of $0. The second largest impaired loan relationship at September 30, 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 September 30, 2018 was $1,976,000. 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 September 30, 2018 carried a value of $3,177,000, after considering estimated

appraisal adjustments and cost to sell of 15%, resulted in the Bank's specific allocation of $0. The third largest impaired loan relationship at September 30, 2018 consisted of a substandard performing loan to a developer of a residential sub-division in the amount of $1,632,000, 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 September 30, 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 $12,952,000 in impaired loans at September 30, 2018, none were located outside of the Corporation's primary market area.

The outstanding recorded investment of loans categorized as TDRs was $9,555,000 as of September 30, 2018 as compared to $9,109,000 as of December 31, 2017. The increase in TDRs at September 30, 2018 as compared to December 31, 2017 is attributable to several modifications completed during the nine months ended September 30, 2018, combined with payments and pay-offs on existing TDRs and the Bank's proactive monitoring of the loan portfolio. Modifications were completed to resume principal and interest payments on non-accrual loans due to a slight improvement in the outlook surrounding the respective borrower's financial position although the borrower continues to experience financial difficulties. Additional modifications were completed to allow a temporary period of interest only payments or extend the maturity date of the loan due to the deterioration in the respective borrowers' financial positions. Of the forty restructured loans at September 30, 2018, nine loans are classified in the Commercial and Industrial portfolio, twenty-nine loans are classified in the Commercial Real Estate portfolio and two loans are classified in the Residential Real Estate portfolio. At September 30, 2018, ten Commercial Real Estate loans classified as TDRs with a combined recorded investment of $561,000, were not in compliance with the terms of their restructure, compared to September 30, 2017 when eight Commercial Real Estate loans classified as TDRs with a combined recorded investment of $469,000 and one Commercial and Industrial loan classified as a TDR with a recorded investment of $12,000 were not in compliance with the terms of their restructure. Troubled debt restructurings at September 30, 2018 consisted of sixteen term modifications beyond the original stated term, six interest rate modifications, and seventeen payment modifications. At September 30, 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. There were specific allocations of $2,000 attributable to the TDRs at September 30, 2018 and December 31, 2017. There were no unused commitments attributable to TDRs at September 30, 2018 and December 31, 2017.

During the three months ended September 30, 2018, three Commercial Real Estate loans with a combined outstanding recorded investment of $144,000 that were modified as TDRs during the preceding twelve months had experienced payment defaults, compared to the three months ended September 30, 2017 when no loans that were modified as TDRs during the preceding twelve months had experienced payment defaults. During the nine months ended September 30, 2018, five Commercial Real Estate loans with a combined outstanding recorded investment of $190,000 that were modified as TDRs during the preceding twelve months had experienced payment defaults, compared to the nine months ended September 30, 2017 when no loans that were modified as TDRs during 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 on page 45 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 September 30, 2018 and December 31, 2017, management is of the opinion that there were no loan concentrations exceeding 10% of total loans.

(Dollars in thousands)	**September 30, 2018**	**December 31, 2017**
Non-Performing Assets		
Non-accrual loans	$ 4,241	$ 5,090
Foreclosed assets held for resale	983	1,071
Loans past-due 90 days or more and still accruing interest	391	70
Total non-performing assets	$ 5,615	$ 6,231
Impaired Loans		
Non-accrual loans	$ 4,241	$ 5,090
Accruing TDRs	8,711	8,836
Total impaired loans	12,952	13,926
Allocated allowance for loan losses	(18)	(327)
Net investment in impaired loans	$ 12,934	$ 13,599
Impaired loans with a valuation allowance	$ 293	$ 2,646
Impaired loans without a valuation allowance	12,659	11,280
Total impaired loans	$ 12,952	$ 13,926
Allocated valuation allowance as a percent of impaired loans	0.1%	2.3%
Impaired loans to total loans	2.2%	2.5%
Non-performing assets to total loans	0.9%	1.1%
Non-performing assets to total assets	0.6%	0.6%
Allowance for loan losses to impaired loans	53.0%	53.8%
Allowance for loan losses to total non-performing assets	122.4%	120.2%

Real estate mortgages comprise 82.7% of the loan portfolio as of September 30, 2018, as compared to 81.1% as of December 31, 2017. Real estate mortgages consist of both residential and commercial real estate loans. The real estate loan portfolio is well diversified in terms of borrowers, collateral, interest rates, and maturities. Also, the residential real estate loan portfolio is largely comprised of fixed rate mortgages. The real estate loans are concentrated primarily in the Corporation's market area and are subject to risks associated with the local economy. The commercial real estate loans typically reprice approximately every three to five years and are also concentrated in the Corporation's market area. The Corporation's loss exposure on its impaired loans continues to be mitigated by collateral positions on these loans. The allocated allowance for loan losses associated with impaired loans is generally computed based upon the related collateral value of the loans. The collateral values are determined by recent appraisals, but are generally discounted by management based on historical dispositions, changes in market conditions since the last valuation and management's expertise and knowledge of the borrower and the borrower's business.

DEPOSITS AND OTHER BORROWED FUNDS

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

Total deposits decreased $77,467,000 to $700,679,000 as of September 30, 2018 as non-interest bearing deposits increased by $11,769,000 and interest bearing deposits decreased by $89,236,000 from year-end 2017. Total deposits decreased due to the declining balances of municipal depositors including the migration of approximately 80% of the Bank's largest depositor to a non-bank competitor. Not including the decrease of highly rate sensitive municipal depositors, total deposits increased $15,962,000. Demand deposits and savings accounts increased from year-end 2017. Total short-term and long-term borrowings increased to $196,281,000 as of September 30, 2018, from $91,296,000 at year-end 2017, an increase of $104,985,000 or 115.0%. 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 nine months of the year, net income less dividends paid increased capital by $2,207,000. 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 $(5,440,000) at September 30, 2018, a decrease of $7,266,000. 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 nine months of 2018 at an overall net gain of $3,000. 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 September 30, 2018 and December 31, 2017. This had an effect of reducing our total stockholders' equity by $5,709,000 as of September 30, 2018 and December 31, 2017.

Total stockholders' equity was $112,810,000 as of September 30, 2018, and $116,719,000 as of December 31, 2017.

At September 30, 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 September 30, 2018 and December 31, 2017:

	To Be Well Capitalized Under Prompt

	September 30, 2018		December 31, 2017		Corrective Action Regulations	
Tier 1 leverage ratio (to average assets)	8.84	%	8.84	%	5.00	%
Common Equity Tier 1 capital ratio (to risk-weighted assets)	12.74	%	13.06	%	6.50	%
Tier 1 risk-based capital ratio (to risk-weighted assets)	12.74	%	13.06	%	8.00	%
Total risk-based capital ratio	13.75	%	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 September 30, 2018, the Corporation would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if all such requirements were currently in effect.

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

LIQUIDITY

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 September 30, 2018, the Corporation had $305,374,000 in available borrowing capacity at FHLB (which takes into account FHLB long-term notes and FHLB short-term borrowings); the maximum borrowing capacity at ACBB was $15,000,000 and the maximum borrowing capacity of the Federal Discount Window was $4,751,000.

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 $13,836,000 at September 30, 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 $10,234,000 and $7,902,000 during the nine months ended September 30, 2018 and 2017, respectively. Net income amounted to $6,849,000 for the nine months ended September 30, 2018 and $6,261,000 for the nine months ended September 30, 2017. During the nine months ended September 30, 2018 and 2017, net premium amortization on investment securities amounted to $2,589,000 and $3,544,000, respectively. 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 $368,000 and $1,097,000 for the nine months ended September 30, 2018 and 2017, respectively. Net securities gains were $55,000 during the nine months ended September 30, 2018 and $886,000 during the nine months ended September 30, 2017. Other assets increased $136,000 during the nine months ended September 30, 2018 and decreased $110,000 during the nine months ended September 30, 2017. Other liabilities decreased $279,000 and $436,000 during the nine months ended September 30, 2018 and 2017, respectively.

Investing activities used cash of $29,757,000 during the nine months ended September 30, 2018 and provided cash of $2,197,000 during the nine months ended September 30, 2017. Net activity in the available-for-sale securities portfolio (including proceeds from sales, maturities, and redemptions net against purchases) provided cash of $13,562,000 and $20,493,000 during the nine months ended September 30, 2018 and 2017, respectively. Net cash used to originate loans amounted to $38,756,000 during the nine months ended September 30, 2018 and $19,291,000 during the nine months ended September 30, 2017.

Financing activities provided cash of $23,752,000 during the nine months ended September 30, 2018 and used cash of $8,112,000 during the nine months ended September 30, 2017. Net deposits used cash of $77,467,000 during the nine months ended September 30, 2018 and provided cash of $33,734,000 during the nine months ended September 30, 2017. Short-term borrowings increased by $124,985,000 during the nine months ended September 30, 2018 and decreased by $28,081,000 during the nine months ended September 30, 2017. Repayment of long-term borrowings exceeded proceeds from long-term borrowings by $20,000,000 for the nine months ended September 30, 2018 and repayment of long-term borrowings amounted to $10,094,000 for the nine months ended September 30, 2018. Dividends paid amounted to $4,642,000 and $4,603,000 for the nine months ended September 30, 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 debt securities classified as available-for-sale are reflected in the Corporation’s stockholders’ equity. The Corporation does not own any trading assets.

Asset/Liability Management

The principal objective of asset/liability management is to manage the sensitivity of the net interest margin to potential movements in interest rates and to enhance profitability through returns from managed levels of interest rate risk. The Corporation actively manages the interest rate sensitivity of its assets and liabilities. 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 September 30, 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 the following 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 10.7%, 20.5% and 28.6% in the 100, 200 and 300 basis point increasing rate scenarios presented. In addition, the earnings simulation model projects net interest income would increase 5.8% and 6.7% in the 100 and 200 basis point decreasing rate scenarios presented. All of these forecasts are within the Corporation's one year policy guidelines, aside from the 200 basis point immediate increase scenario at (20.5)% vs. a policy limit of (20.0)% and the 300 basis point immediate increase scenario at (28.6)% vs. a policy limit of (25.0)%.

The analysis and model used to quantify the sensitivity of net interest income becomes less reliable in a decreasing rate scenario given the current unprecedented low interest rate environment with federal funds trading in the 200 – 250 basis point range. Results of the decreasing basis point declining scenarios are affected by the fact that many of the Corporation's interest-bearing liabilities are at rates below 1% and therefore cannot decline 100 or more basis points. However, the Corporation's interest-sensitive assets are able to decline by these amounts. For the nine months ended September 30, 2018, the cost of interest-bearing liabilities averaged 1.06%, and the yield on interest-earning assets, on a fully taxable equivalent basis, averaged 4.04%.

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 September 30, 2018, the 100 and 200 basis point immediate decreases in rates are estimated to affect net present value with decreases of 3.5% and 17.8%, respectively. Additionally, net present value is projected to decrease 2.7%, 8.2% and 15.8% 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	(28.6)%
+200 bp Shock vs. Stable Rate	(20.5)%
+100 bp Shock vs. Stable Rate	(10.7)%
Flat rate	
-100 bp Shock vs. Stable Rate	5.8%
-200 bp Shock vs. Stable Rate	6.7%
Effect on Net Present Value of Balance Sheet	
Static Net Present Value Change	
+300 bp Shock vs. Stable Rate	(15.8)%
+200 bp Shock vs. Stable Rate	(8.2)%
+100 bp Shock vs. Stable Rate	(2.7)%
Flat rate	
-100 bp Shock vs. Stable Rate	(3.5)%
-200 bp Shock vs. Stable Rate	(17.8)%

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 September 30, 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 September 30, 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
July 1 — July 31, 2018				120,000
August1 — August 31, 2018				120,000
Sept. 1 — Sept. 30, 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.

51

Item 6. Exhibits and Reports on Form 8-K

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

Exhibit	**Description**
3i	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3(i) to the Registrant's Report on Form 8-K dated August 28, 2018).
3ii	By-Laws, as amended and restated (Incorporated by reference to Exhibit 3(ii) to the Registrant's Report on Form 8-K dated August 28, 2018).
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.

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
November 8, 2018	/s/ Elaine A. Woodland Elaine A. Woodland President and Chief Executive Officer (Principal Executive Officer)
November 8, 2018	/s/ Diane C.A. Rosler Diane C.A. Rosler Senior Vice President and Chief Financial Officer (Principal Financial Officer)

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 8-K dated August 28, 2018).
3ii	By-Laws, as amended and restated (Incorporated by reference to Exhibit 3(ii) to the Registrant's Report on Form 8-K dated August 28, 2018).
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.